

Treasury Finalizes GILTI High-Tax Exclusion Rules

July 28, 2020

On July 20, 2020 Treasury released final regulations (the “2020 Final Regulations”) allowing U.S. Shareholders of controlled foreign corporations (“CFCs”) to elect to exclude Global Intangible Low-Taxed Income (“GILTI”) that is subject to an effective foreign income tax at rate exceeding ninety percent of the maximum U.S. corporate rate (currently 21%), or 18.9%. The Final Regulations provide greater flexibility with respect to this high-tax exclusion than the proposed regulations issued on June 14, 2019 (the “2019 Proposed Regulations”).

I. Background

The Tax Cuts and Jobs Act of 2017 enacted the GILTI regime, which requires a “U.S. Shareholder” of a CFC (generally, a U.S. person that is a 10% direct or indirect shareholder) to include global intangible low-taxed income, or GILTI, in gross income. A GILTI inclusion aggregates the tested income and losses of its CFCs, and then subtracts a net deemed tangible income return (10% of qualified business asset investment in excess of certain allocated interest expense). A CFC’s tested income begins with its gross income, but excludes certain categories of income, including subpart F gross income and gross income “excluded from” subpart F “by reason of section 954(b)(4),” because it is subject to an effective foreign tax rate greater than ninety percent of the maximum U.S. corporate rate.

The 2019 Proposed Regulations permitted elective exclusion from gross tested income of a CFC’s high-tax (>18.9%) non-subpart F income. The election generally applied on a CFC-by-CFC basis, and to all of each CFC’s items of high-tax income or none. However, if certain common ownership and control thresholds were met, the election applied with respect to a group of commonly controlled CFCs instead (the “CFC Group”). The controlling domestic shareholder(s) of the CFC or the CFC Group made the election by filing a statement with their original or amended tax return for the U.S. Shareholder inclusion year in which or with which the CFC inclusion year ended. Importantly, the election applied for each subsequent inclusion year unless and until revoked and could be revoked only after a 60-month period following the close of the CFC inclusion year for which the previous election was made or revoked.

The 2019 Proposed Regulations required aggregation of all gross income items attributable to each qualified business unit (a “QBU”) of the CFC to determine whether the income was “high tax” and therefore excludible. For this purpose, deductions were allocated and apportioned to each QBU’s gross tested income, and the effective rate of foreign tax on each QBU was then calculated. If the QBU’s effective tax rate exceeded 90% of the maximum corporate rate, the income of such QBU was excluded if a high-tax election was made for the CFC.

II. 2020 Final Regulations

A. Annual Election; Elimination of 60-month Restriction

The 2020 Final Regulations eliminate the 60-month restriction and permit a controlling domestic shareholder of a CFC Group to make the election to exclude GILTI high-tax income on an annual basis. However, if there are multiple CFCs in the same CFC Group, the election to exclude high-tax income extends to all CFCs in the group. A

controlling domestic shareholder is required to provide notice of any such election (or revocation of such election) to the other U.S. Shareholders that are not controlling domestic shareholders.

B. Election on Amended Return; Election May Be Made Retroactively to First GILTI Year

Additionally, the 2020 Final Regulations allow taxpayers to amend previous years' tax returns and retroactively elect to exclude GILTI high-tax income or to revoke an election already made. This retroactive (without extensions) election or revocation may be made on an amended return filed within 24 months of the due date for the controlling domestic shareholder's original return for the taxable year with or within which the CFC inclusion year, for which the election is made or revoked, ends. All U.S. Shareholders of a CFC for a CFC inclusion year subject to such election or revocation must file amended tax returns to reflect the effect of such election or revocation, and pay the associated taxes, within a single six-month period that entirely falls within the 24-month period previously described.

C. Definition of CFC Group

The 2020 Final Regulations define a CFC Group as two or more CFCs that meet the requirements under section 1504 for affiliated groups, with certain modifications, including reducing the threshold for including a CFC in the group to greater than 50% common ownership, rather than the 80% required under section 1504. Stock ownership is determined under the constructive ownership rules of section 318(a), with certain modifications. A CFC may not be a member of more than one CFC Group. If a CFC would belong to more than one CFC Group, then its ownership is determined under section 1504 based solely on the voting power of the controlling domestic shareholders, rather than the value of their shares, or based on the ownership existing as of the end of the first CFC inclusion year of a CFC that would cause a CFC Group to exist.

D. Application Based on Tested Units rather than QBUs

Under the 2020 Final Regulations, a new "tested unit" approach has replaced the QBU approach taken by the 2019 Proposed Regulations, such that CFC income items qualify for the GILTI high-tax exclusion only if the income items belong to a tested unit that is subject to an effective foreign tax rate greater than ninety percent of the maximum U.S. corporate rate. There are three categories of tested units. First, a CFC is itself a tested unit. Second, a tested unit also includes an interest in a pass-through entity (such as a partnership or disregarded entity) held by a CFC, if the pass-through entity is a tax resident of a foreign country or is treated as a corporation (or otherwise not fiscally transparent) under the tax laws of the foreign country in which its CFC owner is tax resident. Third, a tested unit includes a branch or even a portion of a branch of a CFC, the activities of which are carried on directly or indirectly by a CFC, provided that the branch is subject to certain foreign income taxation requirements. If the same item of income is attributable to more than one tested unit in a tier of tested units (such as where the books and records of each are prepared under different accounting methods), then the item is ultimately attributable to the lowest-tier tested unit.

The 2020 Final Regulations also clarify that multiple tested units in the same foreign country must be treated as a single combined tested unit, with the exception of a branch that is treated as not giving rise to a taxable presence in the foreign country where it is located under the tax laws of that foreign country. This combination rule applies

regardless of whether the tested units are subject to the same foreign tax rate and whether they use the same functional currency.

E. Effective Date

Although the 2020 Final Regulations generally apply to taxable years of foreign corporations beginning on or after July 23, 2020, a taxpayer may choose to apply the 2020 Final Regulations to a taxable year of a foreign corporation that begins after December 31, 2017 and before the July 23, 2020, but the taxpayer must consistently apply the 2020 Final Regulations to each such year.

III. 2020 Proposed Regulations

New proposed regulations (the “2020 Proposed Regulations”) were also released on the same date as the 2020 Final Regulations and propose to conform the subpart F high-tax exclusion to the GILTI high-tax exclusion set forth in the 2020 Final Regulations. The 2020 Proposed Regulations would require a taxpayer to make a single election on an annual basis, for both the GILTI high-tax exclusion and the subpart F high-tax exclusion, applicable to all CFCs in the CFC Group of which the electing U.S. Shareholder was the controlling domestic shareholder.

The conformed rules and single election would apply to taxable years of foreign corporations beginning on or after the date the 2020 Proposed Regulations are finalized.

IV. Final Thoughts

The 2020 Final Regulations create greater flexibility to elect the GILTI high-tax exclusion and the option to elect the exclusion for prior taxable years. As an election to exclude high-tax income from GILTI extends to all CFCs in a CFC Group, taxpayers must consider the applicability of the exclusion to all of their CFCs.

Attorneys in [Caplin & Drysdale’s International Tax](#) practice group are here to help with any questions, including advice on the benefits and drawbacks of making the GILTI high-tax exclusion election.

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