Looking High and Low, Don't Know Where to Go: GILTI Regulations Promise Relief for High-Tax Operations, but at a Price

July 30, 2020

Treasury and the IRS have released Final Regulations providing an exception from the tax on global intangible low-taxed income ("GILTI") for operations taxed outside the United States at moderate or high rates, along with Proposed Regulations modifying the pre-existing equivalent concept under the "Subpart F" regime applicable to controlled foreign corporations. These Final and Proposed Regulations may allow U.S. multinationals to exclude from current U.S. taxation the income of subsidiaries operating in foreign jurisdictions with effective tax rates greater than 18.9%. Although the finalization of the high-tax exclusion to GILTI may be helpful to U.S.-based multinationals, the Proposed Regulations could reduce the flexibility of the existing Subpart F high-tax exclusion.

The GILTI rules were enacted as part of the Tax Cuts and Jobs Act ("TCJA") in December 2017. Under the GILTI rules, a 10% or greater U.S. shareholder of a controlled foreign corporation ("CFC") is subject to a current tax on its share of the CFC's GILTI; if the shareholder is a U.S. corporation, the rate is 10.5%. The GILTI rules apply in addition to the long-existing Subpart F rules under which a 10% shareholder of a CFC is taxed currently on its share of certain categories of portable income of the CFC, such as interest, dividends and insurance income. The purpose of the Subpart F rules is to remove the incentive to earn portable income in low-tax foreign jurisdictions. The TCJA extended that philosophy to many forms of active income.

Despite its name, the tax on GILTI is not limited to intangible or low-taxed income. Rather, GILTI includes all earnings that exceed a "routine" return (10%) on foreign tangible assets. Although the GILTI rules permit U.S. corporate taxpayers to credit 80% of the foreign taxes imposed on GILTI, strict limits apply; notably, unused credits cannot be carried forward. This rule can be particularly unfavorable if a taxpayer has net operating losses that eliminate its U.S. tax in a year when a GILTI tax credit arises. The Final Regulations therefore provide important relief in allowing taxpayers to elect to exclude income from high-taxed CFCs. However, a corporate taxpayer may prefer to pay current tax under the GILTI rules if the taxpayer can shelter the tax with foreign tax credits and avoid future tax on repatriation of funds, particularly given the lower U.S. tax rate on GILTI.

Our summary highlights important aspects of the Final and Proposed Regulations. As further described below, the Final Regulations on the GILTI high-tax exclusion apply to all taxable years of foreign corporations beginning on or after July 23, 2020 and may be applied to taxable years beginning after December 31, 2017 by election. The Proposed Regulations on the Subpart F high-tax exclusion will not be effective until issued in final form.

CALCULATING THE EFFECTIVE FOREIGN TAX RATE

- For purposes of determining whether income may be eligible for the GILTI high-tax exclusion, the effective foreign tax rate on such income is determined not based on the CFC's overall tax rate, but on a "tested unit-by-tested unit" basis. The tested unit is a new concept that departs from the "qualified business unit" standard in prior proposed regulations, which was criticized by taxpayers as unwieldy. Tested units include: (i) a CFC, (ii) interests in a foreign pass-through entity (including a disregarded entity) held by a CFC and (iii) certain branches operated by a CFC. Generally, tested units of a CFC are aggregated if they are tax residents of or are located in the same foreign country.

Comment: The tested unit concept is meant to limit taxpayers' ability to "shelter" low-taxed income with high-taxed income that would in the aggregate qualify for the exception. It could be helpful to a taxpayer that pays low tax overall but has a highly taxed branch, but harmful to a taxpayer with the opposite tax profile.

- The income of a tested unit may be eligible for the GILTI high-tax exclusion if it is subject to an effective foreign tax rate of greater than 90% of the maximum U.S. statutory corporate tax rate. Currently, this requires that the relevant income be subject to an effective foreign tax rate of greater than 18.9%. Income generally is determined under U.S. principles, with some adjustments for payments between tested units that would be disregarded for U.S. tax purposes (*e.g.*, payments between disregarded entities).

Comment: If the U.S. corporate tax rate were to increase, the threshold for the high-tax exclusion would increase proportionally. Further, the use of U.S. principles to determine the effective foreign tax rate disregards foreign NOL carryforwards and similar items, which could reduce a company's effective foreign tax rate in any given year, causing it to fail to qualify for the GILTI high-tax exclusion (even if the local tax rate is significantly greater than 18.9%).

HIGH-TAX EXCLUSION ELECTION CONSISTENCY REQUIREMENTS

- The Final and Proposed Regulations establish a single election for both the GILTI and Subpart F high-tax exemptions, which can be changed each year. Under this approach, the taxpayer must elect the exception (and forgo foreign tax credits) with respect to all of its high-taxed tested units for both GILTI and Subpart F purposes. Low-taxed units would continue to be subject to the GILTI and Subpart F rules.

- By conforming the old Subpart F election to the GILTI election, the Subpart F exemption will become subject to "tested unit" aggregation and no longer apply separately to different categories of income.

- The controlling U.S. shareholder of a CFC may choose to elect or revoke the application of the high-tax exclusion to the CFC by filing a high-tax exclusion election with its U.S. tax return and providing notice of such election to all other 10% U.S. shareholders.

Comment: Public comments on prior proposed regulations requested changes to the GILTI exemption to coordinate it with the existing Subpart F rules. However, Treasury surprised many by instead conforming the Subpart F exception to the new GILTI rules. As a result, taxpayers will no longer be able to apply the high-taxed exclusion to certain related CFCs and not to other CFCs, where some group members may have had better tax outcomes from including income currently and utilizing foreign tax credits.

Comment: The year-by-year election period is a taxpayer-friendly change compared to prior proposed regulations, which included a five-year restriction on changes to the GILTI election.

- The election must be made consistently with respect to all related CFCs. For these purposes, the test for relatedness is based on the existing test for affiliated groups, modified to require only chains of 50% ownership by vote or value and incorporating certain constructive ownership rules.

Comment: The group consistency requirement may have unfortunate results for portfolio companies owned by a single private equity fund partnership, removing the flexibility to take different approaches to both Subpart F and GILTI and requiring cross-portfolio company coordination (and raising potential conflicts), despite lack of operational relationships among their businesses.

ACTIVE INSURANCE AND FINANCING INCOME

- The Final Regulations broaden the scope of the GILTI high-tax exclusion in comparison to the prior regulations. Under the prior regulations, the high-tax exemption was only available to income that qualified for the Subpart F high-tax exemption, and not any other exclusion from the Subpart F rules. Under the Final Regulations, taxpayers can elect the GILTI high-tax exclusion to apply to any item of income that is subject to a sufficiently high effective foreign tax rate.

Comment: The expanded exemption is welcome, as the prior regulations had the counterintuitive result of rendering the high-tax exemption unavailable to certain types of highly taxed income, such as insurance income from local operations of a CFC in a high-tax jurisdiction. However, Treasury warns that electing to apply the GILTI high-tax exclusion in this case may increase U.S. tax on other foreign income due to complex interactions with other provisions in the corporate tax system, such as expense allocation and foreign tax credit rules.

RETROACTIVE ELECTIONS

- The GILTI high-tax exclusion election can be made or revoked retroactively. However, a retroactive election or revocation can only be made within two years of the initial tax return due date (without accounting for extensions) and with the approval of all 10% U.S. shareholders. Taxpayers can choose to have the GILTI high-tax exclusion apply to taxable years beginning after December 31, 2017 and before July 23, 2020, provided that the rules are applied consistently.

Comment: Elective retroactivity is taxpayer-friendly; however shareholders may need to coordinate quickly to take advantage.

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Please do not hesitate to contact us with any questions.

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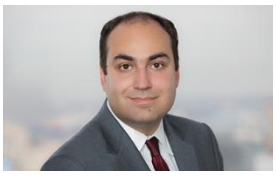

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