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Global Tax Alert

US final and proposed GILTI and subpart F regulations include favorable and unfavorable provisions for taxpayers

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Executive summary

The United States (US) Treasury Department (Treasury) and the Internal Revenue Service (IRS) have released final and proposed regulations on global low-taxed income (GILTI) under Internal Revenue Code[1] Section 951A and proposed regulations on subpart F income under Section 951. Both sets of regulations are expected to be published in the Federal Register on or before 21 June 2019.

The final GILTI regulations are largely consistent with the proposed GILTI regulations released last year, with some modifications. The new proposed GILTI regulations would provide for a GILTI "high-taxed exclusion," which would exclude from a US shareholder's GILTI amount certain items of income of its CFCs that are subject to a foreign effective rate of tax of at least 18.9% (so 90% of the highest rate under Section 11). The proposed Section 951 regulations would treat a domestic partnership as an aggregate of its partners for identifying the US shareholder(s) required to include any subpart F income owned by CFCs of the domestic corporation. The proposed GILTI regulations would apply prospectively to tax years of a foreign corporation beginning on or after the date final regulations are published in the Federal Register. The proposed subpart F income regulations would similarly apply prospectively, though taxpayers may apply the aggregate treatment to earlier tax years in certain cases.

Building a better working world

This EY Global Tax Alert contains:

- An overview of the GILTI regime
- A detailed discussion of the proposed Section 951 regulations, the proposed GILTI regulations, and the final regulations, including their notable implications
- A short summary of the critical implications of the new proposed and final regulations

Detailed discussion

Overview of the GILTI regime

Section 951A requires a US person that is a US shareholder of a CFC for any tax year to include in its gross income for that tax year (US shareholder inclusion year) its GILTI for that year (GILTI Inclusion). In contrast to a subpart F income inclusion, a US shareholder's GILTI Inclusion is based on the aggregate of the shareholder's pro-rata share of certain items (e.g., tested income, tested loss and qualified business asset investment (QBAI)) from all the CFCs in which the shareholder is a US shareholder for that year. Under current law, subject to a taxable income limitation, a corporate US shareholder is allowed a deduction equal to 50% of its GILTI inclusion under Section 250. Section 960(d) also treats the corporate US shareholder as paying 80% of the foreign taxes paid or accrued by its CFCs with taxable income (tested income) that is considered in determining its GILTI inclusion. Those taxes can be claimed as a credit subject to the limitations under Section 904(a).

New proposed regulations and final regulations

The following discussion describes the new proposed regulations and the final regulations. The discussion of the final regulations focuses on the provisions that deviate from the original proposed regulations.

Treatment of domestic partnerships

When a US person is a partner of a domestic partnership that owns, under Section 958(a), stock in a CFC, the final GILTI regulations treat the domestic partnership as foreign, thus requiring the US partner to account directly for the GILTI items of that CFC in determining its GILTI inclusion. However, the domestic partnership can still constitute a US shareholder of the CFC and the foreign corporation can still constitute a CFC because of the domestic partnership. As a result, the domestic partnership will not have a GILTI inclusion with respect to that CFC; instead, the GILTI inclusion would be directly to the US partners for which the inclusion is required. This approach departs from the "hybrid" approach included in the original proposed GILTI regulations, which would have treated the domestic partnership as foreign with respect to any US partner that was also a US shareholder of any CFCs owned by the partnership but as domestic for all other partners.

As noted, the treatment of domestic partnerships as foreign does not apply for purposes of determining whether a US person is a US shareholder (thus, a domestic partnership can still be a US shareholder) or whether a foreign corporation is a CFC, nor does it apply for purposes of determining ownership under Section 958(a) for any other provision of the Code (e.g., Section 1248).

The proposed subpart F income regulations would extend this treatment to determining the US shareholders that must include subpart F income with respect to a CFC. That treatment would apply prospectively to tax years beginning after the final regulations are published in the Federal Register, but taxpayers may apply the rules for tax years of foreign corporations beginning after 31 December 2017, provided the partnership, its US shareholder partners and other related domestic partnerships apply the rule consistently to all their foreign corporations.

Example

Facts. USP owns 40% of the capital and profits of a domestic partnership, PRS. An unrelated foreign individual, FX, owns the remaining 60% of the capital and profits of PRS. PRS wholly owns a foreign corporation, FC.

Analysis. Under the final regulations, PRS is still a US shareholder of FC, which is a CFC as a result. Further, for GILTI purposes, because USP owns 40% of FC indirectly through the partnership (now treated as foreign), USP is a US shareholder of FC. Therefore, USP, and not PRS, determines its pro-rata share of any GILTI items of FC based on its Section 958(a) (40%) ownership of FC stock.

Because of the final GILTI and proposed subpart F income regulations, domestic partnerships may no longer have either subpart F income or GILTI inclusions. This removes some, but not all, of the typical disadvantages of using a domestic partnership structure to own foreign corporations. Domestic partnerships that dispose of CFC stock at a gain are still subject to the re-characterization rules of Section 1248, which generally treat the gain as a dividend to the extent of untaxed earnings and profits. Furthermore,

the reporting requirements on Form 5471 (Information Return of US Persons with Respect to Certain Foreign Corporations) remain unchanged. Therefore, the application of Section 1248 and Form 5471 reporting remains a consideration in selecting a partnership's domicile.

Taxpayers should be aware of the increased significance of the passive foreign investment company (PFIC) rules. Domestic partnerships should consider the PFIC consequences to their partners before electing aggregate treatment under the proposed subpart F income regulations. The CFC/PFIC overlap rule in Section 1297(d) generally shields partners of a domestic partnership that is a US inclusion shareholder of a CFC (which is also a PFIC) from being treated as indirect PFIC shareholders subject to the PFIC regime. It appears, however, that the CFC/PFIC overlap rule no longer protects a partner who is not an Section 951(b) US shareholder of the CFC from being treated as an indirect PFIC shareholder under the PFIC regime if the partner is no longer required to include subpart F income on a distributive share basis under the proposed subpart F income regulation.

For purposes of other provisions that apply Section 951A and the Section 951A regulations by reference (e.g., Sections 959, 960, and 961), the final GILTI regulations treat stock that a domestic partnership owns in a foreign corporation as being owned by the partners within the meaning of Section 958(a).

The pro-rata share rules

A US shareholder's pro-rata share of subpart F income as to a particular CFC tax year is generally based on a "hypothetical distribution" of the CFC's earnings and profits (E&P) generated during that year on the last day of the year on which the corporation is a CFC (the hypothetical distribution date). The amount of E&P distributed to a US shareholder in the hypothetical distribution is a critical component in the formula that generates a US shareholder's pro-rata share of subpart F income.

Pro-rata share anti-abuse rule. The original proposed regulations included a broad anti-abuse rule that would disregard transactions intended to avoid US tax, "including, but not limited to" transactions to reduce a US shareholder's pro-rata share of a CFC's subpart F income (or a tested item). The scope of the proposed rule was uncertain, and it appeared to apply in perpetuity, including following a complete disposition by a US shareholder of its interest in a CFC.

The final regulations adopt a narrower anti-abuse rule that applies based on the shares of CFC stock outstanding as of a given hypothetical distribution date. Specifically, the final anti-abuse rule applies only to transactions undertaken with a principal purpose of avoiding US tax by "changing" the amount of allocable E&P that an outstanding share of CFC stock would have been deemed to receive in a hypothetical distribution. If the rule applies, the transaction would be disregarded in determining pro-rata shares of relevant items considered in determining a US shareholder's subpart F income or GILTI amount.

GILTI anti-abuse rules

The final regulations include three distinct anti-abuse rules. Two of these rules disregard certain basis amounts in specified tangible property for purposes of computing a tested income CFC's QBAI. The third rule relates to the treatment of certain expenses for purposes of calculating tested income and subpart F income. In each case, the final GILTI regulations modify an anti-abuse rule that was included in the original proposed regulations.

Under the first rule (the Temporarily Held Property Rule), the basis in specified tangible property is disregarded for QBAI purposes if (i) the CFC acquires the property with a principal purpose of decreasing a US shareholder's GILTI inclusion, (ii) the property is held temporarily (but over at least one quarter-close), and (iii) the transfer results in a decrease to the US shareholder's GILTI inclusion. The final regulations also include a safe harbor for transfers of property between tested-income CFCs that meet certain conditions. While the original proposed regulations included a per se rule for property held for less than 12 months, the final GILTI regulations provide a rebuttable presumption that property held for less than 12 months was acquired with a principle purpose of decreasing GILTI. Conversely, the final GILTI regulations also include a presumption (which may be rebutted by the Service) that property held for more than 36 months was not acquired with a principle purpose of decreasing GILTI. Overall, these refinements significantly narrow the scope of the Temporarily Held Property Rule and should be welcome changes for taxpayers.

The second rule (the Gap Period Step-Up Rule) applies to compute QBAI and generally disregards basis resulting from transfers from 1 January 2018, through the effective date of the GILTI provisions for fiscal-year taxpayers (or calendar-year taxpayers with fiscal-year CFCs). Unlike the Temporarily Held Property Rule, the final regulations significantly expand

the Gap Period Step-Up Rule. Consistent with the original proposed regulations, the final GILTI regulations permit the amount of disqualified basis to be reduced or eliminated through (among other things) depreciation or taxable sales or exchanges. For sales to related parties, however, the final regulations now provide that the amount of disqualified basis retains its character as such in the hands of the related purchaser. Further, the disqualified basis can also be replicated or carried over to other property in non-recognition transfers, such as like-kind exchanges under Section 1031 or Section 351 contributions.

The final GILTI regulations offer some relief to the Gap Period Step-Up Rule in the form of an election to eliminate the disqualified basis for all purposes. The election must be made for all related CFCs and partnerships that hold property with disqualified basis. In addition, any return that has already been filed that is inconsistent with the elimination of the disqualified basis must be amended. The election to eliminate the disqualified basis would also provide relief for taxpayers losing foreign tax credits because of Section 901(m).

The last anti-abuse rule treats deductions and losses that relate to disqualified basis resulting from transfers from 1 January 2018 through the effective date of the GILTI provisions as not properly allocable to gross tested income, gross subpart F income or gross income that is ECI. The proposed regulations would have disregarded any deductions or losses resulting from disqualified basis for purposes of calculating tested income. Treasury modified the rule in response to comments suggesting that the statute did not authorize this treatment. This change may be problematic for taxpayers that entered into gap period basis step-up transactions with the understanding that the depreciation or amortization would be allocable to subpart F income. Now, such deductions can only reduce a subpart F income inclusion through operation of the Section 952(c) E&P limitation. When the Section 952(c) E&P limitation applies, however, a recapture account would be created that would result in additional subpart F income in future years, including by reason of tested income.

Computational rules

Coordination with Section 952. The final GILTI regulations confirm that subpart F income resulting from Section 952(c)(2) recapture is not gross income considered in determining subpart F income, which means that gross tested income can give rise to both subpart F income and tested income in the same tax year. The final GILTI regulations also provide however, that reductions to subpart F income because of qualified deficits or chain deficits do not increase gross tested income. While taxpayers were hoping Treasury would eliminate the perceived "double inclusion" that can result in a year of subpart F recapture, the inclusion of qualified deficits and chain deficits in this rule at least provides some balance.

QBAI. The final GILTI regulations modify the definition of specified tangible property to exclude items typically considered intangible property — namely computer software, qualified film or television productions, and qualified live theatrical productions. In addition, the regulations provide a transition rule for taxpayers that were not calculating, and were not required to calculate, their QBAI adjusted basis using ADS. Under the transition rule, taxpayers may elect to continue to depreciate property that was placed in service before a CFC's first tax year beginning after 22 December 2017, using the same method the CFC used for purposes of determining income under Treas. Reg. Section 1.952-2.

Relevant date for pro-rata share determination. The final GILTI regulations confirm that GILTI inclusions with respect a CFC occur based on the CFC's tax year that ends with or within the US shareholder's year. This is a change from the original proposed regulations, which would have required inclusion on the last day of the foreign corporation's year on which it was a CFC, irrespective of the entity's year end.

Tested loss "recapture" regime

The final GILTI regulations do not adopt the complex "used tested loss recapture" rules included in the original proposed regulations. Treasury is, however, considering a separate regulatory project on this issue and has requested comments.

GILTI for consolidated groups

The final GILTI regulations apply single-entity principles to consolidated groups by (i) aggregating GILTI-relevant items other than tested income (i.e., tested loss, QBAI and specified interest expense) at the consolidated group level, and (ii) allocating the group's items back to the members in proportion to relative tested income. This approach effectively makes the location of CFCs with such items generally irrelevant (e.g., the net tested income of a member that owns a tested income CFC is reduced by the tested loss of a different CFC regardless of whether the tested loss CFC is owned by the same member or a different member). Notwithstanding this single-entity approach, the relevant Section 958(a) shareholder is the member (not the group), and the Section 951A inclusion is at the member-level.

The final regulations do not adopt the proposed stock basis adjustments included in the proposed regulations. Those adjustments would have:

- Reduced basis in member stock, to the extent a tested loss of a CFC that is owned by the member is used to offset tested income of another CFC (whether the other CFC is owned by the same member or a different member)
- Reversed the basis reductions, to the extent the same CFC with the shared loss later (or earlier) has offset tested income
- Increased basis in member stock immediately before the stock sale, to the extent of offset tested income of CFCs that are owned by the member

The Preamble, however, indicates Treasury will continue to study this issue. Taxpayers that are contemplating the disposition of stock of a member that owns a CFC with offset tested income should consider "self-help" transactions to increase the basis in member stock notwithstanding the elimination of the basis adjustments that had been provided by the original proposed regulations. For example, a pre-disposition dividend from the offset tested income CFC to the disposed of member might qualify for Section 245A and cause a basis increase in the member's stock under Treas. Reg. Section 1.1502-32.

Final foreign tax credit (FTC) rules

The final FTC regulations finalize with minor modifications three discrete proposed foreign tax credit regulations under Sections 78, 861, and 965. The most notable of these rules denies an Section 245A DRD for an Section 78 "dividend" deemed received after 31 December 2017, but for a tax year of a foreign corporation beginning before 1 January 2018. Absent this rule, US shareholders owning fiscal-year foreign corporations might claim an Section 245A deduction for Section 78 dividends attributable to Section 965 inclusions in 2018.

The final rule under Section 861 modifies certain basis adjustment rules considered in determining the tax book value of stock of a foreign corporation that was an Section 965 specified foreign corporation under Treas. Reg. Section 1.861-12 for interest expense allocation and apportionment purposes. The final rule under Section 965 adopts with certain modifications the proposed rule coordinating the effect of an Section 965(n) election on the computation of the separate Section 904 limitation categories for the Section 965 inclusion year.

The proposed GILTI high-tax exception

The proposed GILTI regulations would generally allow taxpayers to elect a "high-tax exception" that would exclude from a US shareholder's GILTI inclusion items of income of its CFCs that would otherwise be part of the GILTI inclusion. The exception would apply if the items are subject to foreign income tax at an effective rate that is greater than 90% of the maximum income tax rate under Section 11 (currently 21%, so a foreign effective tax rate greater than 18.9%). This GILTI high-tax exception would apply to each item of income at the level of each qualified business unit (QBU) of a CFC (for this purpose, items of income within each Section 904(d) limitation at the QBU level would be treated as a single item of income). Foreign income taxes would be assigned to each item of income for this purpose under the principles of the Section 960 regulations, which implement the post-TCJA "properly attributable to" standard by allocating foreign income taxes based on the foreign tax base. For example, assume a CFC wholly owns three foreign disregarded entities: DRE1 is subject to a 10% local tax rate, DRE2 is subject to a 25% local tax rate, and DRE3 is subject to a 5% local tax rate. In this case, the CFC would have four QBUs, with the CFC being deemed a QBU under Section 989, and the GILTI high-tax exception would apply separately to each QBU (with only DRE2's items of income likely excluded from the relevant US shareholder's GILTI inclusion). Further, any foreign income taxes paid or accrued with respect to a CFC's items of income that are excluded from a US shareholder's GILTI inclusion under the GILTI high-tax exception would not be deemed paid under Section 960(d). Instead, they would be assigned to the CFC's residual income category (which means no credit would be allowed for those foreign taxes).

On balance, the GILTI high-tax exception should provide some benefit to those taxpayers operating in higher-taxed jurisdictions. Considering the TCJA Conference Report suggested that income subject to a 13.125% or greater foreign effective tax rate would be "high-taxed income," however, the exception will likely fall short of taxpayer expectations. See Conf. Rep. No. 115-466 (PL 115-97) at 626 ("Since only a portion (80%) of foreign tax credits can offset [US] tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no [US] residual tax is owed by a domestic corporation is 13.125[%].").

The election to apply the GILTI high-tax exception to a CFC would be made by US shareholders that collectively own, directly or indirectly, more than 50% of the CFC's stock. Once made, the election applies for the CFC's subsequent tax year

unless revoked. If revoked, the election would not be available to that CFC for 60 months. Further, a subsequent election to apply the high-tax exception could not be revoked for another 60 months. If the same US shareholders own a majority of the stock of two or more CFCs, an election to apply the GILTI high-tax exception to one CFC (or to revoke such an election) would apply to all the CFCs.

Effective dates

Generally, the final GILTI regulations, with some exceptions, are effective for tax years of foreign corporations beginning after 31 December 2017, and to tax years of US shareholders in which or with which those foreign corporations' tax years end.

The proposed GILTI and subpart F income regulations will be effective for tax years of foreign corporations beginning after the date the final regulations are published, and to tax years of US shareholders in which or with which those foreign corporations' tax years end. The treatment of a domestic corporation as foreign for subpart F income purposes can, however, be applied for a foreign corporation's tax years beginning after 31 December 2017, and for tax years of a domestic partnership in which or with which the foreign corporation's tax years end, provided that certain related parties also apply the regulations.

Implications

The final and proposed regulations are a mixed bag for taxpayers. The most significant favorable provisions in the final and proposed regulations are those:

- Treating a US partnership generally as an aggregate for GILTI purposes in the final regulations (and similarly providing rules under the proposed regulations that would treat a US partnership generally as an aggregate for subpart F inclusion purposes)
- Exempting domestic partnerships from GILTI inclusions (in the final regulations) and subpart F inclusions (in the proposed regulations)
- Narrowing the scope of the pro-rata share anti-abuse rule (Treas. Reg. Section 1.951-1(e)(6))
- Abandoning the burdensome proposed tested loss "recapture" regime for net used tested losses (original Prop. Reg. Section 1.951A-6)
- Providing an election to eliminate disqualified basis for all US tax purposes (and thus avoid losing foreign tax credits under Section 901(m))

The unfavorable provisions, however, are significant and include:

- Proposing a narrow GILTI high-tax exception that applies only after regulations are finalized
- Expanding the GILTI anti-abuse rule to prevent deductions from disqualified basis from being considered when determining tested income, subpart F income and ECI
- Denying Section 245A DRDs for Section 78 dividends from fiscal-year corporations (absent this rule, US shareholders owning fiscal-year foreign corporations might claim an Section 245A deduction for Section 78 dividends attributable to Section 965 inclusions in 2018)

Overall the final regulations, the proposed GILTI regulations, and the proposed Section 951 regulations provide both opportunities and challenges for taxpayers. The changes in the final regulations will need to be addressed in short order for companies that have not yet filed their 2018 tax returns. Companies affected by the final regulations should also consider filing an amended 2018 tax return to reflect the final regulations and potentially early adopt the aggregate partnership treatment for subpart F purposes. When considering current restructuring and preparing for the eventual finalization of the GILTI high-tax exception, modeling will be more important than ever given these complex and highly computational provisions.

Endnote

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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