The Proposed GILTI High-Tax Exception

By Lowell D. Yoder

Proposed regulations would add a high-tax exception for purposes of calculating the amount of a U.S. shareholder's global intangible low-taxed income ("GILTI").[1] The exception would be available for taxable years beginning on or after the publication of the final regulations in the Federal Register.[2]

As background, Subpart F income derived by a controlled foreign corporation ("CFC") is included currently in the gross income of its U.S. shareholders, and subject to the corporate tax rate of 21%.[3] Subpart F income includes passive income and certain sales and services income.[4] If an item of Subpart F income is subject to an effective foreign income tax rate that is greater than 90% of the corporate tax rate (*i.e.*, 18.9%), an election can be made to exclude the item from the gross income of the U.S. shareholders.[5]

The remaining amount of a CFC's gross income generally is "tested income" that is taken into account in calculating the amount included in the income of the U.S. shareholder as GILTI.[6] The amount of a U.S. shareholder's tested income is reduced by 10% of the aggregate adjusted bases of the depreciable tangible property of the CFCs of the U.S. shareholder giving rise to its tested income (*i.e.*, "qualified business asset investment").[7] The resulting amount generally is subject to an effective tax rate of 10.5% for corporate U.S. shareholders.[8] The Code and final regulations do not provide an exception for high-taxed tested income.

Proposed regulations would provide an election to exclude from gross tested income items of high-taxed tested income. This election would be available for an item of net tested income that is subject to an effective foreign income tax rate which is greater than 90% of the corporate tax rate (*i.e.*, 18.9%).[9]

The high-tax election for tested income may be made for a CFC.[10] The proposed regulations require an election to apply to *all* CFCs within a "controlling domestic shareholder group" (*e.g.*, all of a domestic corporation's foreign subsidiaries).[11] An election made for a CFC remains in effect until revoked. If an election for a CFC is revoked, the election generally cannot be made again for the CFC (including other CFCs within the controlling domestic shareholder group) for 60 months following the year of the revocation.[12]

The high-tax calculation is made for each "tentative gross tested income item" of a CFC. Generally, this consists of all gross tested income attributable to a



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single qualified business unit ("QBU") of the CFC.[13] For example, if a CFC has no separate QBUs, then the CFC generally has a single item of tentative gross tested income. If the CFC owns a disregarded entity in a separate country and the CFC also derives income at its home office, then there generally would be two items of income for purposes of applying the GILTI high-tax exception.[14] Gross income of a QBU is determined under U.S. tax principles and is income properly reflected on the books and records of the QBU, adjusted to reflect disregarded payments.[15]

In summary, the proposed GILTI high-tax exception is a welcomed addition.

Determining the effective tax rate requires a calculation of a CFC's tentative net tested income items. This is calculated by reducing a tentative gross tested income item for deductions properly allocated and apportioned to such item under the principles of Proposed Reg. §1.960-1(d)(3).[16] Such expenses would include foreign income taxes paid on the item of income.

The foreign income taxes taken into account for purposes of calculating the GILTI high-tax exception are determined under the rules provided by the foreign tax credit regulations.[17] These rules generally attribute taxes to an item of income on a current year basis.[18] While only 80% of the taxes paid on GILTI may be claimed as a deemed-paid tax credit,[19] 100% of the taxes attributable to an item of tested income are taken into account for purposes of applying the high-tax exception.[20]

The effective tax rate is calculated as the foreign income taxes paid or accrued with respect to the tentative net tested income item divided by the net tentative tested income item increased by the taxes paid or accrued with respect to such item. All amounts are calculated in U.S. dollars.[21]

If an election is made for a CFC, then all items of tentative gross tested income of the CFC (and of all other CFCs within the controlling domestic shareholder group) that meet the high-tax exception must be excluded from the CFC's tested income (and excluded from the tested income of all other CFCs within the group). The taxpayer cannot exclude only some high-taxed items.[22] On the other hand, a CFC may have some items of tentative gross tested income that qualify for the exception and others that do not qualify for the exception.

For example, assume CFC-A has an operating Branch-B in another country. CFC-A earns $20 of income not subject to any tax, and Branch-B earns $80 of net income subject to a 25% foreign income tax rate (resulting in $20 of taxes). The CFC would have two items of tentative gross tested income for purposes of applying the GILTI high-tax exception, *i.e.*, $20 for the home office QBU and $60 for the Branch-B QBU. The $20 derived by the home office would not qualify for the high-tax exception, and would be included in tested income. On the other hand, assuming the high-tax election is properly made, the $60 of tentative net tested income derived by Branch-B would be excluded from tested income in calculating GILTI.[23]

To the extent the high-tax exception applies to exclude an item of gross tested income, the foreign income taxes associated with such item are not creditable by the U.S. shareholder.[24] In addition, the amount of any qualified business asset investment associated with the high-taxed item of tested income is not taken into account for purposes of calculating the amount of the U.S. shareholder's GILTI inclusion.[25]

Whether electing the GILTI high-tax exception for a CFC group is beneficial will require calculating the tax consequences with and without the election. Making the election may be beneficial for a U.S. shareholder's high-taxed tested income where the GILTI foreign tax credit limitation category has excess credits and the GILTI inclusion would result in additional expenses of the U.S. group being allocated to the GILTI category for purposes of calculating the foreign tax credit limitation. On the other hand, making the election may not be beneficial if excess foreign tax credits associated with a GILTI inclusion would offset U.S. tax on low-taxed GILTI.

For example, CFC-M earns $2,000 of net tested income from its operations in Mexico and pays $600 of Mexican taxes. This results in a GILTI inclusion of $2,000 ($1,400 + $600),[26] and the corporate U.S. shareholder deducts $1,000 under Code Sec. 250(a), with the remaining taxable amount resulting in $210 of U.S. tax ($1,000 × 21%).[27] The U.S. shareholder would have income taxes available for credit of $480 ($600 × 80%).[28] In calculating the foreign tax credit limitation, assume $300 of U.S. expenses are allocated to the inclusion, limiting the credit to $147.[29] Thus, incremental U.S. tax would be paid in the amount of $63 ($210 – $147). If this is the only CFC of the taxpayer, it would be beneficial to elect the GILTI high-tax exception.

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On the other hand, assume that in addition to CFC-M, the corporate U.S. shareholder also owns CFC-S, which conducts operations in Singapore that has $3,000 of net tested income subject to a 5% tax rate. This results in a GILTI inclusion of $3,000 ($2,850 + $150), and the corporation deducts $1,500 under Code Sec. 250(a), with the remaining taxable amount resulting in $315 of U.S. tax ($1,500 × 21%). The U.S. shareholder has Singapore taxes available for credit of $120 ($150 × 80%). In calculating the foreign tax credit limitation, assume $450 of U.S. expenses are allocated to the inclusion, limiting the credit to $221.[30] Thus, additional U.S. tax on the Singapore GILTI inclusion would be $101 ($221 – $120). Alternatively, if the GILTI high-tax exception were not made for the Mexican CFC's tested income, the $101 of U.S. tax would be eliminated with the excess foreign tax credits associated with the Mexican GILTI inclusion, and thus it would not be beneficial to elect the high-tax exception.

The analysis quickly becomes very complex as additional CFCs are added to the picture, and QBAI impacts are taken into account (particularly since it is common for QBAI to be relatively high in higher-tax jurisdictions).

In summary, the proposed GILTI high-tax exception is a welcomed addition. It provides relief particularly for taxpayers with overall high-taxed GILTI income. Taxpayers will need to perform calculations to determine whether it is beneficial to make the election for its CFCs, and will have to project the benefits for future years due to the limited flexibility in changing the election.[31] Of course, it would have been more appropriate (and consistent with the legislative history of GILTI) to provide a high-tax exception for net tested income that is subject to the intended maximum tax rate on GILTI of 13.125%.[32]

ENDNOTES

1 REG-101828-19, 84 FR 29,114 (June 21, 2019).

2 Proposed Reg. §1.951A-7(b). It has been reported, however, that officials are considering allowing the election to be available earlier.

3 Code Sec. 951(a)(1)(A).

4 Code Secs. 952(a) and 954(a).

5 Code Sec. 954(b)(4); Reg. §1.954-1(d). Such item also is excluded from GILTI. Code Sec. 951A(c)(2)(A)(i)(III); Reg. §1.951A-2(c)(1)(iii).

6 Code Sec. 951A(a), (c)(2)(A). A CFC's tested income does not include dividends received from a related CFC and income that is effectively connected with a U.S. trade or business. Reg. §1.951A-2(c). Also, tested losses of one CFC offset tested income of another CFC. Code Sec. 951A(c)(1)(B); Reg. §1.951A-1(c)(2)(ii).

7 Code Sec. 951A(b)(2)(A); Reg. §1.951A-1(c)(3)(i)(A), (ii).

8 Code Sec. 250(a).

9 Proposed Reg. §1.951A-2(c)(6)(i).

10 Proposed Reg. §1.951A-2(c)(6)(v). This election is separate from the Subpart F income high-tax exception.

11 Proposed Reg. §1.951A-2(c)(6)(v)(E). A controlling domestic shareholder group generally means two or more CFCs with a domestic shareholder owning (within the meaning of Code Sec. 958(a)) more than 50% of the voting power of the stock.

12 Proposed Reg. §1.951A-2(c)(6)(v)(D)(*2*). If a high-tax election for tested income is made for a CFC 60 months after revocation of a prior election, the election cannot be revoked for 60 months.

13 Proposed Reg. §1.951A-2(c)(6)(ii)(A)(*1*). *See* Code Sec. 989(a) for the definition of a QBU.

14 Items of a single QBU may be further subdivided into separate tested income groups as defined in Proposed Reg. §1.960-1(d)(2)(ii)(C), but generally the items will fall within the general foreign tax credit limitation category. *See* Proposed Reg. §1.960-1(d)(2)(ii)(E), *Ex.* 2 (sales and services income are both general category income and thus fall within one tested income group of a QBU).

15 Proposed Reg. §1.951A-2(c)(6)(ii)(A)(*2*).

16 Proposed Reg. §1.951A-2(c)(6)(ii)(B).

17 Proposed Reg. §1.951A-2(c)(6)(iv).

18 *See* Proposed Reg. §1.960-1(b)(4) and -1(d)(3)(ii).

19 Code Sec. 960(d).

20 The amount of the deemed paid taxes taken into account is determined without regard to the Code Sec. 904 limitation rules that apply at the U.S. shareholder level.

21 Proposed Reg. §1.951A-2(c)(6)(iii).

22 Proposed Reg. §1.951A-2(c)(6)(v)(B).

23 [$20/($60 + $20) = 25%]. *See* Proposed Reg. §1.951A-2(c)(6)(vi), *Ex.*

24 Proposed Reg. §1.960-1(e).

25 Reg. §1.951A-3(b) and (c)(1).

26 Net tested income is grossed up for deemed paid foreign income taxes. Code Sec. 78.

27 The examples assume no reduction for qualified business asset investment.

28 A foreign tax credit is allowed for 80% of foreign income taxes paid on a GILTI inclusion, but the income of the U.S. shareholder is still grossed up for 100% of the amount of the deemed paid taxes. Code Secs. 78 and 960(d). Excess GILTI credits cannot be used to reduce U.S. tax on other foreign source income, and cannot be carried over to another year (they disappear). Code Sec. 904(c).

29 [($1,000 $300) × 0.21 = $147]. Code Sec. 904(a).

30 [($1,500 $450) × 21% = $221].

31 A taxpayer subject to the BEAT under Code Sec. 59A may also benefit from the GILTI high-tax exception, because the BEAT calculation does not permit a credit for foreign income taxes.

32 Even with a GILTI high-tax exception, there remain circumstances where, if feasible, it would be beneficial to convert tested income into Subpart F income because of the greater flexibility in applying the Subpart F income high-tax exception (annual CFC-by-CFC election and item-by-item application) and the more favorable foreign tax credit results (*e.g.*, use excess credits against other business income and carry over excess credits for 10 years). *See* Yoder, *The Subpart F High-Tax Exception*, 48 Tax Mgmt. Int'l J. 139 (Mar. 1, 2019); Yoder, *A Few GILTI Planning Tips*, Int'l Tax J., Nov.–Dec. 2018, at 3.

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