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Global Tax Alert

US: "Tested unit" standard in final GILTI regulations limits aggregating items of income, while proposed regulations would adopt the same standard for subpart F income high-tax exception

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Final regulations under Internal Revenue Code[1] Section 951A (TD 9902), which were published in the Federal Register on 23 July 2020, implement an elective exclusion for high-tax global intangible low-taxed income (GILTI). Proposed regulations under Section 954 (REG-127732-19), which were published simultaneously with the final regulations, propose changes to the existing subpart F income high-tax exception under Section 954(b)(4).

The final GILTI high-tax exclusion:

- Excludes from a controlled foreign corporation's (CFC) gross tested income under Section 951A income items subject to an effective foreign tax rate over 18.9% (i.e., 90% of the highest corporate rate based on the current 21% corporate tax rate)
- Appears to apply regardless of whether the CFC has tested income or a tested loss
- Applies at the level of each "tested unit" of a CFC, substantially eliminating blending of income subject to different rates of foreign tax
- Applies to every CFC in which a taxpayer holds, or is treated as holding, a majority equity interest (a CFC group)
- May be elected on an annual basis
- Applies generally for tax years beginning on or after 23 July 2020
- Permits taxpayers to apply the election retroactively to any CFC tax year beginning after 31 December 2017, if they apply the final regulations consistently to each year for which the election is made

Building a better working world

The proposed regulations would conform the existing subpart F income high-tax exception to the GILTI high-tax exclusion and would apply a single unified election to both provisions (or neither) for a tax year. That is, the proposed regulations generally would:

- Incorporate the tested unit principles of the GILTI high-tax exclusion into the subpart F income high-tax exclusion
- Combine the GILTI high-tax election and the subpart F income high-tax election into a single election, requiring the election to apply simultaneously to both the GILTI and the subpart F income high-tax "exceptions," or to neither
- Conform generally to the rules governing the elections (including the requirement to apply the unified election to every CFC in a CFC group)

This Alert summarizes these and other notable aspects of the final GILTI high-tax exclusion and the proposed revisions to the existing subpart F income high-tax exception.

Background: GILTI high-tax exclusion

Section 951A requires a US shareholder[2] of a CFC to include annually in gross income the US shareholder's GILTI for the year. A US shareholder's GILTI inclusion is an aggregate amount derived from its pro rata shares of certain CFC-level items, including tested income and tested losses. Gross tested income is a CFC's gross income determined without regard to: (i) US-source income effectively connected with a US trade or business; (ii) income taken into account in determining the CFC's subpart F income; (iii) dividends received from related persons, (iv) foreign oil and gas extraction income (as defined in Section 907(c)(1)); and (v) income excluded from subpart F income by reason of the subpart F income high-tax exception.[3]

Although Section 951A does not expressly exclude other high-tax items (i.e., high-taxed income that would not be subpart F income) from gross tested income, Treasury issued proposed regulations in 2019 extending the statutory high-tax exclusion to other high-taxed gross tested income items. Those rules, as finalized, are summarized below.

Final regulations: The GILTI high-tax exclusion

The GILTI high-tax exclusion allows taxpayers to elect to exclude from their GILTI inclusion a CFC's gross tested income subject to a high effective rate of foreign tax. The final regulations adopt the threshold rate of foreign tax of 18.9% (i.e., 90% of the highest domestic corporate tax rate under Section 11 (currently, 21%)) to determine whether an item is subject to a high effective foreign tax rate.

Generally, the determination of whether an item of a CFC's gross tested income is subject to the requisite effective rate of foreign tax is determined according to the following analytical steps:

1. Identify the CFCs that are members of the same CFC group for the relevant tax year of the US shareholder.
2. For each such CFC, identify the CFC's tested units.
3. Identify the tentative gross tested income items of each tested unit of a CFC.
4. Allocate and apportion the CFC's deductions (including current-year taxes) to each tentative gross tested income item to determine the (net) tentative tested income item.
5. For each tentative tested income item, calculate the item's effective foreign tax rate with reference to the current-year taxes allocated and apportioned to the item.

A detailed discussion of each of these steps follows.

Step 1: Identify the CFCs that are members of the same CFC group for the relevant tax year of the US shareholder

A CFC group is an affiliated group, as defined in Section 1504(a), with the following modifications:

- A foreign corporation can constitute an "includible corporation."
- The ownership threshold of "more than 50[%]" replaces the threshold of "at least 80[%]," and ownership of that amount of either voting power or value suffices (i.e., both are not required).
- Stock ownership is determined by applying the constructive ownership rules of Section 318(a), modified for this purpose.

The determination of whether a CFC is part of a CFC group is made as of the close of the CFC's tax year ending with or within the tax years of the "controlling domestic shareholders." Controlling domestic shareholders are any US shareholders that (i) own (directly or indirectly), in the aggregate, more than 50% of the total combined voting power of all classes of the CFC's voting stock; and (ii) undertake to act on the CFC's behalf. If US shareholders do not own stock exceeding that threshold, controlling domestic shareholders are the US shareholders that own (directly or indirectly) any CFC stock. Because a CFC is not intended to be a member of more than one CFC group, "tie-breaking" rules exist for this purpose. It appears, however, that the tie-breaking rules are not comprehensive enough to "break all ties."

Step 2: For each such CFC, identify the CFC's tested units

A CFC generally has more than one tested unit if the CFC has income that is subject to the tax laws of more than one foreign country. This income may be derived directly or through a pass-through entity, including a disregarded entity. Focusing on tested units substantially eliminates "blending" of a CFC's high-tax and low-tax items of income.

A CFC may have three types of tested units:

- The CFC itself
- An *interest in a pass-through entity* (e.g., a partnership or a disregarded entity) that the CFC holds directly or indirectly through one or more pass-through entities, if the entity (a) is a tax resident of a foreign country or (b) is not treated as fiscally transparent for purposes of the tax laws of the foreign country of its tested unit owner
- A *branch* of the CFC, if the branch gives rise to a taxable presence under the laws of the foreign country in which either (a) the branch is located or (b) the branch's direct owner is tax resident, if that country's laws exclude the branch's income from taxable income or tax the branch's income preferentially (the latter type of branch, a nontaxed branch)

Under a mandatory combination rule, tested units of a CFC that are tax residents of, or located in, a single foreign country generally are treated as a single tested unit. The combination rule does not apply, however, to (i) nontaxed branches or (ii) tested units owned by different CFCs, even if the tested units are tax residents of the same foreign country.

Step 3: Identify the tentative gross tested income items of each tested unit of a CFC

A tentative gross tested income item is the aggregate of all the CFC's items of gross income in its relevant tax year that:

- Are attributed to a single tested unit of the CFC based on special rules
- Would be tested income but for the GILTI high-tax exclusion
- Would be in a single "tested income group" under the foreign tax credit regulations (in general, constitute solely passive category income or general category income)[4]

For example, all of a CFC's items of general category gross tested income (before consideration of the GILTI high-tax exclusion) that are attributed to a single tested unit of the CFC are a single tentative gross tested income item; similarly, all of the CFC's items of passive category gross tested income that are attributed to the same tested unit are a separate single tentative gross tested income item.

A CFC's item of gross income — as determined under US tax principles but adjusted for certain disregarded payments — is attributed to the CFC's tested unit to the extent that the item is properly "reflected on" the separate set of books and records of the tested unit. If a separate set of books and records is not maintained for a tested unit, the amounts that would have been properly "reflected on" a separate set of books and records must be determined. If an item of gross income is not properly taken into account for financial accounting purposes in the relevant CFC tax year, the item is treated as properly "reflected on" the separate set of books and records as if the item were taken into account for financial accounting purposes in that year. Each item of a CFC's gross income is attributed to one, and only one, tested unit.

Adjusting items of gross income for certain disregarded payments

The final regulations provide rules that reallocate gross income between tested units to account for disregarded payments between tested units. Generally, these rules more closely align the amount of gross income attributable to a tested unit with the tested unit's taxable income under foreign law, because disregarded payments typically give rise to income and deductions for foreign law purposes.

More specifically, if a tested unit makes a disregarded payment to another tested unit, gross income that was preliminarily attributable to the tested units is adjusted. The items are adjusted by applying modified principles of the disregarded payment rules applicable to foreign branches[5] (e.g., for these purposes, a disregarded payment of interest, if deductible under foreign tax law by the payor tested unit, can result in reallocation of gross income — in contrast to the foreign-branch rules).

In this context, when a tested unit makes a disregarded payment to another tested unit, gross income is reallocated from the payor tested unit to the payee tested unit to the extent that the payment would be deductible (or capitalized) by the payor tested unit if the payment were regarded for US federal income tax purposes. (Similarly, gain from the sale of property in a disregarded transaction may cause gross income of the purchasing tested unit to be reallocated to the selling tested unit.)

For example, assume that CFCX, a CFC organized in Country X, owns a foreign disregarded entity (FDEY) that is a tax resident of Country Y. CFCX (a CFC) and FDEY (a pass-through entity tax resident in a foreign country) are both tested units. According to their respective separate sets of books and records, and consistent with US federal income tax principles, CFCX generated $100x of gross income and FDEY generated $10x of gross income. All gross income of CFCX and FDEY would be gross tested income in the general category before applying the GILTI high-tax exclusion. Additionally, CFCX makes a $40x royalty payment to FDEY that is deductible for Country X purposes. If that disregarded payment were regarded for US federal income tax purposes, the resulting deduction would be allocable to CFCX's $100X of gross income. To account for the disregarded royalty payment from CFCX to FDEY, the gross income attributable to the CFCX tested unit and FDEY tested unit, respectively, is adjusted by $40x. Accordingly, the tentative gross tested income item attributable to the CFCX tested unit is $60x ($100x - $40x) and the tentative gross tested income item attributable to the FDEY tested unit is $50x ($10x + $40x).[6]

Step 4: Allocate and apportion the CFC's deductions (including current year taxes) to each tentative gross tested income item to determine the (net) tentative tested income item

After identifying a CFC's tentative gross tested income items, the CFC's deductions for the relevant tax year are allocated and apportioned (including current-year taxes) among the CFC's tentative gross tested income items.

This is accomplished largely under the allocation and apportionment rules of the Section 861 regulations (e.g., determining US-source and foreign-source taxable income) by treating each of the CFC's tentative gross tested income items as assigned to a separate tested income group and all other income as assigned to a residual income group. The resulting (net) amounts are described as tentative tested income items.

A special rule applies to interest expense. Generally, interest expense must be allocated and apportioned based on the CFC's assets or modified gross income (MGI); an upper-tier CFC may be treated as holding the assets, or earning the income, of a lower-tier CFC.[7]

Under the final regulations, the portion of an upper-tier CFC's interest expense that is allocated and apportioned based on a lower-tier CFC's assets or income is not allocated and apportioned to any of the upper-tier CFC's tested units. For example, under the MGI method, if a lower-tier CFC's MGI is $300x, and an upper-tier CFC's MGI (exclusive of lower-tier MGI) is $100x, then 75% (i.e., $300x ÷ $400x) of the upper-tier CFC's interest expense would generally be allocated based on the income of the lower-tier CFC. Consequently — solely for purposes of applying the GILTI high-tax exception — 75% of the upper-tier CFC's interest expense is allocated and apportioned to the upper-tier CFC's residual income grouping and thus not taken into account for purposes of applying the GILTI high-tax exclusion to items of the upper-tier CFC's gross income.[8]

Current year taxes

A CFC's current year taxes are generally allocated and apportioned among the CFC's various tentative gross tested income items by allocating current year taxes to Section 904 categories and income groups within a category to determine the amount and category of foreign income taxes deemed paid by a US shareholder under Section 960. Taxes are generally associated with the US item of gross income that corresponds to the foreign item of gross income on which the taxes are imposed. Special rules apply to taxes (including withholding taxes) imposed by reason of disregarded payments. Subject to certain exceptions, taxes imposed on a disregarded payment that reallocates gross income from one tested unit to another are generally attributed to the payee tested unit.

The two sets of disregarded payment rules — those that reallocate items of gross income among tested units, and those that allocate and apportion taxes imposed by reason of disregarded payments — can substantially affect eligibility for the GILTI high-tax exclusion. For example, if one tested unit makes a disregarded payment to another tested unit of the same CFC, the disregarded payment rules would, in many cases, require a reallocation of gross income from the payor tested unit to the payee tested unit. The reallocation would increase a tentative gross tested income item of the payee tested unit, potentially decreasing its foreign effective tax rate. However, withholding taxes levied on the disregarded payment generally would be allocated and apportioned to any tentative gross tested income item of the payee tested unit that was adjusted, potentially increasing its foreign effective tax rate.

Step 5: For each tentative tested income item, calculate the item's effective foreign tax rate with reference to the current year taxes allocated and apportioned to the item

The effective foreign tax rate of each tentative tested income item is determined separately by dividing (i) the US dollar amount of foreign taxes allocated and apportioned to the tentative tested income item in Step 3 (the Step 3 taxes) by (ii) the US dollar amount of the tentative tested income item plus the US dollar amount of the Step 3 taxes.

Once a taxpayer computes its effective foreign tax rate for each tentative tested income item, and the tentative tested income items eligible for the election have been identified, taxpayers must compute the US tax consequences of making the election. If elected, the GILTI high-tax exclusion excludes from a CFC's gross tested income the tentative gross tested income item corresponding to each of the CFC's tentative tested income items with an effective tax rate over 18.9% (under current law). Because the gross item is excluded from gross tested income, deductions that would have been allocable and apportionable to (and therefore would have reduced) gross tested income are no longer so allocable and apportionable.

In this manner, the GILTI high-tax exclusion reduces a CFC's gross tested income by the amount of any excluded (gross) item — but it is likely also to affect the overall amount of the CFC's (net) tested income or tested loss (discussed immediately below). Additionally, foreign income taxes allocated and apportioned to excluded items may not be claimed as a credit, which may make the election less beneficial for certain taxpayers. The election may also increase the amount of a taxpayer's interest expense that is allocated to the GILTI category under Section 904, which may limit the extent to which the taxpayer may claim a foreign tax credit with respect to its GILTI inclusion. For these reasons, taxpayers evaluating whether to make the GILTI high-tax exclusion election will benefit from robust modeling tools.

Effect on tested losses

Taxpayers may be surprised that the GILTI high-tax exclusion appears to apply to a CFC that incurs a tested loss.[9] A CFC's gross tested income is its gross income, less each tentative gross tested income item that qualifies for the GILTI high-tax exclusion (if elected). The CFC is not required to have been a tested income CFC absent the high-tax exclusion. When a tentative gross tested income item is excluded from a CFC's gross tested income by reason of the GILTI high-tax exclusion, expenses allocated and apportioned to that tentative gross tested income item are similarly excluded for purposes of determining the CFC's tested income or tested loss. As a result, to the extent that the expenses allocable to a tentative gross tested income item exceed that gross income item, the application of the GILTI high-tax exclusion to the gross income items would appear to decrease or eliminate a CFC's tested loss or increase its overall tested income. Similarly, if the amount of a tentative gross tested income item of a tested loss CFC exceeds the amount of expenses allocated and apportioned to the gross income item, then the exclusion of the gross income item under the GILTI high-tax exclusion may increase the amount of the CFC's tested loss.

For example, assume a CFC has two tested units — High-Tax Tested Unit A and Low-Tax Tested Unit B. High-Tax Tested Unit A has a tentative gross tested income item of $100x, $90x of non-tax expenses, and foreign tax expense of $40x (with its foreign tax liability resulting from timing differences between foreign tax law and US tax law). Both expenses are allocated to the High-Tax Tested Unit A tentative gross tested income item. Low-Tax Tested Unit B has a tentative gross tested income item of $50x, $45x of non-tax expenses and no current year taxes.

Absent the application of the GILTI high-tax exclusion, the CFC would have a $25x tested loss ($150x gross income - $175x expenses (including the current taxes)). The effective foreign tax rate of High-Tax Tested Unit A's tentative tested income item would appear to be 400% ($40x ÷ $10x). If the GILTI high-tax exclusion applied to eliminate that item, then the CFC would determine its tested income or loss solely by reference to the items of Low-Tax Tested Unit B. As a result, the CFC would appear to have $5x tested income for the year ($50x gross income - $45x expenses).[10]

Annual election

A taxpayer may elect to apply the GILTI high-tax exclusion (or not) annually by filing a statement with a timely filed original federal income tax return or, as described later, an amended return. Consequently, taxpayers may assess their GILTI and foreign tax credit profile annually and determine whether the election may be favorable without the fear of locking in unfavorable results in future years.

Consistency requirement

In the case of a CFC that is a member of a CFC group, an election to apply the GILTI high-tax exclusion, which is binding on all US shareholders, is made (or revoked) with respect to all CFCs that are members of the CFC group.

Requirement for amended tax returns

The final regulations permit taxpayers to elect to apply the GILTI high-tax exclusion or revoke a prior election to apply the GILTI high-tax exclusion, on an amended federal income tax return. The CFC's US shareholders, however, must file amended federal income tax returns within 24 months of the unextended due date of the original return of the controlling domestic shareholder's inclusion year that includes the relevant CFC inclusion year.[11] Moreover, due to administrability concerns, the final regulations require amended returns for all US shareholders of each CFC subject to the election to be filed within a single six-month period.

Effective date and retroactive applicability

The GILTI high-tax exclusion applies to tax years of foreign corporations beginning on or after 23 July 2020. A taxpayer may, however, apply the GILTI high-tax exclusion to any tax year of a CFC beginning after 31 December 2017, provided that the taxpayer applies the final regulations consistently to each year that the taxpayer elects to apply the GILTI high-tax exclusion. For some taxpayers, the requirement to apply the final regulations in their entirety may come with a cost: the final regulations include rules allocating deductions attributable to "disqualified basis" to earnings and profits that might otherwise give rise to dividends eligible for the Section 245A deduction. A CFC may hold property with disqualified basis if the CFC purchased the property from a related CFC in a taxable transaction during the "disqualified period" (i.e., the gap period between a CFC's final earnings and profits measurement date under Section 965 (31 December 2017) and the date on which Section 951A first applied to its income).[12] Thus, to obtain the benefit of applying the GILTI high-tax exclusion retroactively, a taxpayer that allocated deductions associated with disqualified basis (for example, amortization deductions) to subpart F income during those years may be required to retroactively increase its subpart F income.

Subpart F income high-tax exclusion

Section 951(a)(1) requires a US shareholder of a CFC to include annually in gross income the US shareholder's pro rata share of the CFC's subpart F income. Section 954(b)(4) provides a "high-tax exception" to subpart F income that permits a taxpayer to elect to exclude from a CFC's subpart F income certain items of income that are subject to an effective foreign income tax rate greater than 18.9% (i.e., 90% of the highest corporate rate of tax under Section 11 (currently, 21%)).

For purposes of the current subpart F income high-tax exception, a single "item of income," the effective tax rate of which is tested, is an aggregate of certain items of income, as determined at the CFC level (without distinguishing among divisions, branches, or other units of a CFC). For example, the aggregate amount of a CFC's foreign base company sales income generally constitutes a single item of income for purposes of the subpart F income high-tax exception — notwithstanding that that amount might include income that the CFC derives from multiple operations, in separate countries, subject to different foreign tax rates.

The proposed regulations would conform the rules governing the existing subpart F income high-tax exception with those governing the final GILTI high-tax exclusion. Accordingly, the proposed regulations would modify the existing subpart F income high-tax exception to incorporate the tested unit principles of the GILTI high-tax exclusion. Analytical steps similar to those previously described for the GILTI high-tax exclusion would also apply for purposes of determining the application of the subpart F income high-tax exception under the proposed regulations. Furthermore, the proposed regulations would combine the GILTI high-tax election and the subpart F income high-tax election into a single election (the unified high-tax exception). The procedural requirements applicable to the GILTI high-tax exclusion would apply to the unified high-tax election, including the requirement to apply the unified election to every CFC in a CFC group. As a result, a US shareholder would be required to elect to exclude from its CFCs' gross income all high-taxed GILTI income items of its CFCs and all high-taxed subpart F income items, or to exclude none.

This section addresses certain conforming amendments and notes significant new rules introduced in the proposed regulations. This is done with reference to some of the analytical steps described previously in the context of the GILTI high-tax exclusion — which would apply to both that exclusion and the subpart F income high-tax exception under the proposed regulations.

Proposed changes to Step 3: Identify the tentative gross tested income items of each tested unit of a CFC

The proposed regulations would apply the unified high-tax exception to income items defined by reference to tested units. This marks a significant departure from the current subpart F income high-tax exception, under which determinations are made at the CFC level. The current CFC-level determinations permit blending of subpart F income from a CFC's various business units (e.g., pass-through entities or branches) (to the extent the income corresponds to a single "item" category), even though those business units may be subject to different effective foreign tax rates.

For purposes of calculating the effective foreign tax rate, the proposed regulations would group — with one exception — general category items of income attributable to a tested unit that would otherwise be tested income, foreign base company income, or insurance income (the aggregate item, a "general gross item"). Thus, a taxpayer would not have to determine whether general category income of a tested unit was tested income or foreign base company income (or allocate foreign taxes between the two) to perform the unified high-tax exception calculation.

The exception: The proposed regulations would treat a general category "equity gross item" attributable to a CFC's tested unit as a distinct item of gross income. An equity gross item of a tested unit would be comprised of certain income derived from equity (including equity of a partnership or disregarded entity) — such as dividends or stock gain — if subject to a preferential rate or an exemption under the tax law applicable to the tested unit.

Finally, unlike general category income, passive foreign personal holding company income would generally continue to be grouped as it is under existing regulations (i.e., it would not be aggregated with tested income or across items of income), though the test would be performed at the tested-unit level. The proposed regulations refer to the separate passive category items of a tested unit as a "passive gross item."

Applicable financial statements

While the final regulations use "books and records" as the starting point for determining the gross income attributable to a tested unit's gross income, the proposed regulations would replace the "books and records" standard with an "applicable financial statement" standard. The proposed regulations list (in order of their priority) the various types of financial statements that are to be used. A lower-priority financial statement could only be used if a higher-priority financial statement was "not readily available."

Proposed changes to Step 4: Allocate and apportion the CFC's deductions (including current year taxes) to each tentative gross tested income item to determine the (net) tentative tested income item

Under the GILTI high-tax exclusion, gross income items are attributed to a tested unit by reference to the separate set of books and records of the tested unit, but deductions are allocated and apportioned to gross income under US tax principles (without regard to whether the items are "reflected on" the separate set of books and records of the tested unit). This can result in discrepancies between the amount of a tentative tested income item for purposes of the GILTI high-tax exclusion and the corresponding amount of foreign taxable income actually subject to tax. For example, interest expense that is "reflected on" the separate set of books and records of a tested unit and deducted for foreign tax purposes may be allocated and apportioned to the CFC's other tested units (or to the residual category), lowering the effective foreign tax rate for purposes of applying the GILTI high-tax exclusion.

The Preamble to the proposed regulations includes the following illustration of this problem:

Assume that a CFC owns interests in two disregarded entities the interests in which are tested units ("TU1" and "TU2"), an equal amount of gross income is attributable to each of TU1 and TU2, and the CFC has no other activities. TU1's income is subject to a 30[%]rate of foreign tax, and TU2's income is subject to a 15[%]rate of foreign tax. TU1 accrues deductible interest expense payable to a third party that is allocated and apportioned to the CFC's gross income using the modified gross income method of [Treas. Reg. Section] 1.861-9T(j)(1), such that interest expense incurred by TU1 is allocated and apportioned equally between TU1 and TU2 for purposes of the GILTI high-tax exclusion. The foreign countries in which TU1 and TU2 are tax residents allow for deductions of interest expense only to the extent that resident entities in the country actually accrue such interest expenses. Therefore, the foreign country in which TU1 is tax resident allows a full deduction for the interest accrued by TU1, and TU2's country of tax residence does not allow an interest deduction for any interest accrued by TU1. Under the final regulations, the allocation of interest expense for federal income tax purposes may cause TU1's gross income to fail to qualify for the high-tax exception and may cause TU2's gross income to qualify for the high-tax exception, notwithstanding the higher tax rate in TU1's country of residence and the lower tax rate in TU2's country of residence.

See 85 Fed. Reg. 44650, 44652 (23 July 2020).

In contrast to the final regulations, the proposed regulations would determine tentative net items[13] by allocating and apportioning deductions to items of gross income by reference to the tested unit's applicable financial statements. Specifically, the proposed regulations would allocate and apportion deductions to items of gross income to the extent the deductions are properly "reflected on" the tested unit's applicable financial statement, consistent with the manner in which gross income is attributed to a tested unit. This rule would not affect the amount or timing of items of income, gain, deduction, and loss for other US tax purposes, which would continue to be determined under US tax principles. However, Treasury noted that it is considering whether it would be appropriate to use a similar approach to allocate and apportion deductions incurred by a CFC for other US tax purposes and requested comments on this issue.

Proposed changes to Step 5: For each tentative tested income item, calculate the item's effective foreign tax rate with reference to the current year taxes allocated and apportioned to the item

The proposed regulations contain an anti-abuse rule to address failures to include items on an applicable financial statement or disregarded payments made, or not made, to manipulate the application of the unified high-tax exception with a "significant purpose" of avoiding the purposes of Sections 951, 951A and the proposed high-tax exclusion rules (a lower bar than the more common "principal purpose" standard).

Separately, the proposed regulations include an anti-abuse rule to address transactions or structures involving certain instruments or reverse hybrid entities that are undertaken with a significant purpose of manipulating whether an item of income qualifies for the unified high-tax exception. This rule targets transactions that manipulate a tested unit's effective foreign tax rate (and potential qualification for the high-tax exclusion) by lowering tentative net income items without a corresponding reduction in foreign taxes paid.

If the effective foreign tax rate for a tentative net item is negative or an undefined value, the proposed regulations would deem the item to be high-taxed. This may occur, for example, if the amount of expenses and taxes allocated and apportioned to a tentative net income item exceed the tentative net income item.[14] Consequently, to the extent that foreign taxes are allocated and apportioned to a tested unit's net item that is a loss (or equal to zero), the item will be treated as high-taxed. As noted previously, taxpayers should be wary of such circumstances, as the application of the unified high-tax exception in these cases may both increase their subpart F or GILTI inclusion (by eliminating losses) and decrease creditable foreign income taxes (because taxes associated with high-taxed income are not creditable).

Current regulations do not require US shareholders to maintain any specific documentation to substantiate amounts excluded under the subpart F income high-tax exception or the GILTI high-tax exclusion. Under the proposed regulations, however, each US shareholder of a CFC for which the unified high-tax exception election would be in effect would be required to maintain specific contemporaneous documentation to establish that the taxpayer reasonably concluded whether each CFC income item satisfied (or did not satisfy) the unified high-tax exception requirements. The requirements are generally consistent with the documentation a taxpayer would produce in the normal course of performing a complete unified high-tax exception calculation for a CFC under the proposed regulations, including the identification of tested units, gross income, deductions, foreign taxes attributable to each tested unit and disregarded payments made or received by a tested unit. The proposed regulations would apply the same documentation standards to all US shareholders of a CFC, even if the US shareholder is a minority shareholder lacking such information.

The substantiating documents would be required to exist as of the filing date of the income tax return on which the election was made and would need to be provided to the Internal Revenue Service (IRS) within 30 days of an IRS request.

The proposed regulations would likely expand the filing requirements for taxpayers electing the unified high-tax exception. Currently, taxpayers need only file a statement with their return identifying the items to be excluded under the existing subpart F income high-tax exception. While the proposed regulations do not specify the type of information that will be required, the Preamble to the proposed regulations suggests that Form 5471 may require inclusion of the same information taxpayers will use to substantiate their entitlement to the unified high-tax exception (e.g., tested unit-by-tested unit breakdown of gross income, deductions, disregarded payments, etc.).

(i) Other proposed changes

Section 952(c) recapture accounts

Under Section 952(c)(1), a CFC's subpart F income cannot exceed its earnings and profits in the current year. The current Section 952(c) and Section 954(b)(4) coordination rules generally determine the net income item tested for high-tax eligibility after applying the Section 952(c)(1) earnings and profits limitation. When applicable, this ordering rule may increase a US shareholder's effective foreign tax by reducing the potential subpart F income subject to testing without affecting the associated taxes.

The proposed regulations would eliminate this ordering rule by applying the unified high-tax exception without regard to the limitation in Section 952(c)(1). The proposed regulations may, therefore, reduce the amount of income qualifying for the unified high-tax exception when a CFC is subject to a Section 952(c)(1) limitation.

Full inclusion rule

Current regulations treat all of a CFC's gross income as subpart F income if over 70% of its gross income is subpart F gross income. If over 90% of the CFC's subpart F income (determined without regard to the full inclusion rule) is excluded from subpart F under the high-tax exception, however, then none of the CFC's income will be considered subpart F income (the 90% high-tax test). The proposed regulations would modify the subpart F full inclusion rule to apply the high-tax exception before the full inclusion rule. The proposed regulations would eliminate this 90% high-tax test, and instead apply the unified high-tax exception (if elected) before determining whether over 70% of a CFC's gross income is subpart F gross income. As a result, taxpayers that previously were not subject to the full inclusion rule due to the 90% high-tax test may be subject to the full inclusion rule.

Carryover of Section 952(c) accounts

The proposed regulations would require any Section 952(c) recapture accounts of a CFC that distributes or transfers property in a Section 381(a) transfer (for example, a tax-free liquidation or asset reorganization) to carry over to the transferee corporation (including a foreign corporation that is not a CFC). The Preamble to the proposed regulations describes this as a "clarification," and indicates that Treasury and the IRS believe this rule is consistent with general successor principles under current law.

(ii) Applicability dates

The proposed regulations contain two proposed applicability dates:

- Proposed rules adopting a unified high-tax exception would apply to CFC tax years beginning after the date final regulations are filed with the Federal Register.
- Proposed rules requiring Section 952(c) recapture accounts to carry over in Section 381(a) transactions would apply to foreign corporate tax years ending on or after 20 July 2020, even if the Section 381(a) transaction occurred in an earlier year.

The proposed regulations would not allow taxpayers to currently apply the unified high-tax exception; therefore, taxpayers may only continue applying the current subpart F income high-tax exception rules until these regulations are finalized as proposed.

Implications

Many taxpayers will find the high effective foreign tax rate threshold adopted by the final regulations difficult to meet, especially as it applies to each tested unit of a CFC. Whether and the extent to which the exclusion reduces a taxpayer's GILTI inclusion, however, will require careful modeling — for current year (tax year 2019), future years, and also for previously filed tax years beginning after 2017.

The proposed regulations would replace the existing subpart F income high-tax exception and the newly-finalized GILTI high-tax exclusion with a unified high-tax exception. Many aspects of the proposed regulations were foreseeable (for example, the CFC group consistency rules and the tested unit standard). Yet the combination of the subpart F income high-tax exception and GILTI high-tax exclusion into a unified high-tax exception may surprise many taxpayers -particularly those that have applied the current high-tax exception in recent years. Taxpayers should soon evaluate whether the unified high-tax exception is likely to be available, and advantageous, under the proposed regulations.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986.
2. Section 951(b) defines a US shareholder for this purpose to mean a US person that directly or indirectly owns (within the meaning of Section 958(a)) or is considered as owning under the constructive ownership rules of Section 958(b), 10% or more of either the total voting power or the total value of the CFC's stock.
3. *See* Section 951A(c)(2)(A)(i).
4. *See* Treas. Reg. Section 1.960-1(d)(2)(ii)(C). Passive category income, subject to certain exceptions, includes income that would be treated as foreign personal holding company income (as defined in Section 954(c)) if the taxpayer were a CFC, and certain income attributable to passive foreign investment companies. See Treas. Reg. Section. 1.904-4(b)(2)(i). General category income includes all income that is not passive category income, foreign branch category income, Section 951 income, or income in certain specified separate categories. See Treas. Reg. Section 1.904-4(d).
5. *See* Treas. Reg. Section 1.904-4(f)(2)(vi).
6. *See*, *e.g.*, Treas. Reg Section 1.951A-2(c)(8)(iii)(A).
7. *See generally* Treas. Reg. Sections 1.861-9 and 1.861-9T.
8. *See* Treas. Reg. Section 1.951A-2(c)(8)(iii)(C) Example 3.
9. Generally, a CFC is treated as having a tested loss to the extent that its deductions (including taxes) that are allocated and apportioned to tested income in a tax year exceed the CFC's gross tested income. *See* Treas. Reg. Section 1.951A-2(b)(2). When a taxpayer makes the GILTI high-tax exclusion election, the final regulations require the expenses to be allocated to gross tested income in a manner that is consistent with the manner in which they are allocated and apportioned for purposes of the GILTI high-tax exclusion. *See* Treas. Reg. Section 1.951A-2(c)(3)(ii).
10. Under the final regulations, this result appears to be limited to cases in which foreign taxes incurred exceed the net loss that would otherwise be attributable to a tested unit (because the denominator of the effective foreign tax rate fraction would equal zero or less than zero when losses exceed foreign taxes — *see* Step 5). As discussed later, the proposed regulations would eliminate this limitation.
11. The term "CFC inclusion year" refers to any tax year of a foreign corporation beginning after 31 December 2017 (the effective date of Section 951A for a foreign corporation that is a CFC) at any time during which the corporation is a CFC. *See* Treas. Reg. Section 1.951A-1(f)(1).
12. *See* Treas. Reg. Sections 1.951A-2(c)(5) and 1.951A-3(h)(2)(ii).
13. The proposed regulations would replace the term "tentative tested income item" with the term "tentative net item," in part to reflect that the item is a combination of tested income items and subpart F income items.
14. This may arise, for example, when timing differences, differences in expense allocation rules, or other differences in US and foreign law result in a net loss for US federal income tax purposes and net income for foreign tax purposes.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP (United States), International Tax and Transaction Services

- Craig Hillier, *Boston* craig.hillier@ey.com
- Jose Murillo, *Washington, DC* jose.murillo@ey.com
- Allen Stenger, *Washington, DC* allen.stenger@ey.com
- Raymond Stahl, *Washington, DC* raymond.stahl@ey.com
- Carlos Vaca Valverde, *Washington, DC* carlos.j.vaca.valverde@ey.com

International Tax and Transaction Services

Global ITTS Leader, **Jeffrey Michalak,** *Detroit*

ITTS Director, Americas, **Craig Hillier,** *Boston*

ITTS Markets Leader, Americas, **Laynie Pavio,** *San Jose, CA*

ITTS NTD Leader, **Jose Murillo,** *Washington, DC*

ITTS Regional Contacts, Ernst & Young LLP (US)

West
Sadler Nelson, *San Jose*

East
Colleen O'Neill, *New York*

Central
Aaron Topol, *Atlanta*

Financial Services
Chris J Housman, *New York*

Canada – Ernst & Young LLP (Canada)
Warren Pashkowich, *Calgary*

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