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Global Tax Alert

US final, temporary and proposed regulations on GILTI and ownership attribution affect domestic pass-through owners and individuals

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On 21 June 2019, the United States (US) Treasury Department and the Internal Revenue Service (IRS) published two different regulation packages: TD 9866 providing guidance under Internal Revenue Code (IRC) Sections 78, 861, 951, 951A, 965,1502, and 6038 (the Final GILTI Regulations) and (Reg 101828-19) under IRC Sections 951, 951A, and 958 (the Proposed 958 Regulations).[1] The Final GILTI Regulations were published following Treasury's consideration of public comments to proposed guidance published on 10 October 2018 (the Proposed GILTI Regulations) and address issues regarding the application of Section 951A and the applicability dates of certain foreign tax credit proposed regulations. Issued simultaneously, the Proposed 958 Regulations provide new guidance on the treatment of GILTI and subpart F inclusions incurred through pass-through entities, as well as a GILTI high-tax exclusion.

Detailed discussion

Purpose of this Alert

This Alert provides an overview of how the Final GILTI Regulations and the Proposed 958 Regulations operate together to affect taxpayers investing in foreign companies through domestic pass-through entities. Specifically, this Alert will cover the new approach the Final GILTI Regulations and Proposed 958 Regulations take with respect to the aggregate/entity treatment of pass-throughs for the purposes of GILTI and Subpart F and the related inclusion

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and reporting requirements under Treas. Reg. Sections 1.951A-1(e), (h), 1.951A-3(g)(3), (6) and (7), 1.951A-5(d), and Prop. Reg. Section 1.958-1(d). This Alert also addresses the proposed exclusion of certain high-tax income from GILTI under Prop. Reg. Section 1.951A-2(c)(6)(v). A discussion of certain provisions of the Final GILTI Regulations and the Proposed 958 Regulations that are not covered in this Alert can be found in EY Global Tax Alert, *US final and proposed GILTI and subpart F regulations include favorable and unfavorable provisions for taxpayers*, dated 21 June 2019.

Historic approach to pass-through entities

The *Revenue Act of 1962* codified the Subpart F regime to limit deferral of US taxation on certain types of investment income arising from a controlled foreign corporations (CFC). The *Tax Cuts and Jobs Act* (TCJA) enacted Section 951A, which generally aims to limit deferral of US tax on the active business income of CFCs to the extent that income is taxed by non-US jurisdictions at low tax rates. Thus, the GILTI rules target income other than a CFC's investment income, subtracting certain types of enumerated income. The GILTI rules, similar to Subpart F, require a US Shareholder (as defined in Section 951(b)[2]) in a CFC to include in gross income its pro-rata share GILTI income.

Neither Section 958(a) nor any other provision of the Code specifies whether a domestic pass-through should be treated as an entity or an aggregate for purposes of determining stock ownership under Sections 951 and 951A. Section 1373(a) treats an S corporation as a partnership and its shareholders as partners for purposes of Subpart F, including Section 951A; thus, reference in this Alert to a partnership includes reference to an S corporation.

Historically, the Treasury Department and the IRS have taken the view that a domestic partnership should be treated as an entity for Subpart F purposes. That is, the partnership is treated as separate and distinct from its partners, and the partnership (not the partners) is treated as the owner of partnership assets. Under this view, if a domestic partnership owns more than 50% of the stock of a foreign corporation, then the foreign corporation will be a CFC. This is true even if 100% of the partners of the domestic partnership are non-US persons or would otherwise not be considered US Shareholders. In the context of partnerships, this is generally referred to as the "entity approach." Under the entity approach, each US owner of a partnership with Subpart F inclusions is considered to recognize its distributive share of Subpart F income, irrespective of its own status as a US Shareholder of CFCs held by the domestic partnership.

Conversely, foreign partnerships have historically been analyzed under the "aggregate approach for purposes of ascertaining CFC status. Under that approach, the foreign partnership is treated as an aggregate of its owners, meaning the partners of the partnership are treated as owning the partnership's assets. As a foreign partnership cannot be a US shareholder or cause a foreign corporation to be treated as a CFC, Section 958(a) requires taxpayers to look through a foreign partnership to determine whether some combination of its partners are US shareholders and whether the foreign corporation is a CFC. Under the aggregate approach, only partners that are themselves US Shareholders recognize a distributive share of Subpart F income.

The Proposed GILTI Regulations provided for a hybrid approach to GILTI inclusions received through domestic partnerships. Under the hybrid approach, a domestic partnership was treated as both an entity and an aggregate: a domestic partnership was treated as an aggregate of its partners for partners who were US Shareholders and as an entity for partners who were not US Shareholders. Partners who were themselves US Shareholders when looking through the domestic partnership computed their GILTI inclusion akin to ownership through a foreign partnership (i.e., after being allocated a distributive share of the domestic partnership's GILTI tested items). Conversely, a non-US Shareholder partner of a domestic partnership would have been allocated a net GILTI inclusion by the domestic partnership.

Comments to the Proposed GILTI Regulations identified difficulties with the hybrid approach, including complexities with capital accounting, basis adjustments and disparate treatment of US owners of CFCs via domestic and foreign pass-through entities. In response, the Final GILTI Regulations and Proposed 958 Regulations instead opt for an aggregate approach for the purposes of determining a US Shareholder with respect to domestic partnerships (discussed in more detail later).

Treatment of domestic partnerships under Final GILTI Regulations

Section 951A requires US Shareholders of a CFC to include in gross income their pro rata share of the GILTI recognized by the CFC. Under the Final GILTI Regulations, a domestic partnership is considered an aggregate of its partners for

purposes of determining the US person for which a GILTI inclusion amount is calculated and taken into gross income. Specifically, the Final GILTI Regulations do not treat, for purposes of Section 951A, a domestic partnership as owning foreign corporation stock within the meaning of Section 958(a). Instead, the partners of a domestic partnership are treated as owning proportionately the stock of CFCs owned by the partnership in the same manner as if the partnership were a foreign partnership under Section 958(a)(2).

As a result, each US shareholder that owns Section 958(a) stock of a CFC must determine its pro rata share of each tested item of a CFC. A US shareholder's pro rata share is determined under the rules of Treas. Reg. Section 1.951-1(e) in the same manner as those provisions apply to Subpart F income (determined based on a hypothetical distribution of all of the CFC's earnings and profits (E&P)). If a partner of a domestic partnership is not a US shareholder of the underlying CFC, the partner will not have a GILTI inclusion.

Applicability dates: The Final GILTI Regulations adopt the applicability dates of the Proposed GILTI Regulations without substantial changes. Therefore, consistent with the applicability date of Section 951A, Treas. Reg. Sections 1.951A-1 through 1.951A-6 apply to tax years of foreign corporations beginning after 31 December 2017, and to tax years of US Shareholders in which or with which the foreign corporations' tax years end.

Implications

- *The elimination of the hybrid approach under the Final GILTI Regulations is a favorable provision that will prevent partners who are not US Shareholders of the underlying CFCs from being subject to GILTI taxation. The move to a pure aggregate approach means that the GILTI taxation of partners who are US Shareholders of the underlying CFCs is unchanged from the Proposed GILTI Regulations.*
- *Considering the elimination of the hybrid approach applies for tax years of foreign corporations beginning after 31 December 2017, domestic partnerships and S corporations should consider the effect of this rule when preparing 2018 Schedules K and K-1s. In addition, if a partner of a domestic partnership or shareholder of an S corporation has already received a 2018 K-1 allocating GILTI to the owner, but that owner is not a US Shareholder of the underlying CFC, the owner does not need to include that amount in its income. The owner may want to contact the domestic partnership or S corporation to determine whether the entity will issue an amended K-1. Minority partners or shareholders who fail to receive an amended K-1 should file Form 8082 with their return. The return should indicate that, while excluding GILTI income is inconsistent with the K-1, the Final GILTI Regulations provide that there is no inclusion to a minority partner or shareholder.*

Treatment of domestic partnerships under Proposed 958 Regulations

While Treas. Reg. Section 1.951A-1(e) only applies for purposes of Section 951A and the sections that apply by reference, Proposed. Reg. Section 1.951-1(d)(1) would extend this treatment to Subpart F income. That is, the Proposed 958 Regulations would require a partner of a domestic partnership to include Subpart F income only if the partner were a US Shareholder of the underlying CFC. In stark contrast to the long-standing rules, under the Proposed 958 Regulations, a partner of a domestic partnership that is not a US Shareholder of the underlying CFC would not have a Subpart F income inclusion. Like the limitation provided by Treas. Reg. Section 1.951A-1(e), Proposed. Reg. Section 1.951-1(d)(1) does not apply for purposes of determining whether any US person is a US Shareholder, whether a US Shareholder is a controlling domestic shareholder, or whether a foreign corporation is a CFC.

Applicability dates: The Proposed 958 Regulations are proposed to apply to tax years of foreign corporations beginning on or after the date of publication of the Treasury Decision adopting these rules as final regulations; however, domestic partnerships may choose to "early adopt" the Proposed 958 Regulations in tax years of their CFCs beginning after 31 December 2017, provided that they apply the rules consistently to all CFCs whose stock the domestic partnerships own.

Implications

- *Regarding Subpart F income, the Proposed 958 Regulations' extension of aggregate treatment to domestic partnerships may be favorable for partners who are not US Shareholders of the underlying CFCs because those partners would not have Subpart F income inclusions. However, taxpayers should be aware of the increased significance of the passive foreign investment company (PFIC) rules. The CFC/PFIC overlap rule in Section 1297(d) generally shields partners of a domestic partnership from being treated as indirect PFIC shareholders subject to the PFIC regime if the domestic partnership is a US Shareholder of a CFC (which is also a PFIC). That is, if a domestic*

partnership is a US Shareholder of a CFC, the CFC cannot be treated as a PFIC with respect to any of the partners of the partnership (even if the partners are not themselves US Shareholders of the CFC). Under the Proposed 958 Regulations, it appears, however, that the CFC/PFIC overlap rule will no longer protect a partner who is not an 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. This may add additional complexity to the compliance for both the partnership and partners. Treasury and the IRS have asked for comments on this issue.

- *The reporting requirements on Form 5471 (Information Return of US Persons with Respect to Certain Foreign Corporations) and Form 8992 (US Shareholder Calculation of Global Intangible Low-Taxed Income) remain unchanged. Treas. Reg. Sections 1.6038-2(a) and Section 1.6038-5 apply to foreign corporations' tax years beginning on or after 3 October 2018.*

Determination of Partnership QBAI and impact of Section 743(b) adjustments on QBAI

For purposes of calculating qualified business asset investment as defined in Section 951A(d) (QBAI), Section 951A(d)(3) provides that, if a CFC holds an interest in a partnership at the close of the CFC's tax year, the CFC takes into account its distributive share of the partnership's adjusted basis in depreciable tangible property used in its trade or business. For this purpose, a CFC's distributive share of the adjusted basis in any partnership property equals the CFC's distributive share of tested income with respect to that property.

The Proposed GILTI Regulations implemented a rule that a CFC with tested income (Tested Income CFC) that holds an interest in one or more partnerships as of the close of a CFC inclusion year would increase the sum of the Tested Income CFC's partnership QBAI with respect to each partnership for the inclusion year. In the Proposed GILTI Regulations, partnership QBAI was determined by two ratios — a ratio that describes the portion of the partnership specified tangible property that is used in the production of gross tested income, and a ratio that described a Tested Income CFC's proportionate interest in all the income produced by the property.

The Final GILTI Regulations simplify this computation, providing that a Tested Income CFC's "partner adjusted basis" with respect to partnership specified tangible property is generally the Tested Income CFC's proportionate share of the partnership's adjusted basis in the property for the partnership tax year. A Tested Income CFC's partner adjusted basis with respect to specified tangible property used in the production of gross tested income and gross income that is not gross tested income (Dual-Use Partnership Property) is generally the Tested Income CFC's proportionate share of the partnership's adjusted basis in the property for the partnership tax year, multiplied by the Tested Income CFC's dual-use ratio with respect to the property (determined by reference to the Tested Income CFC's distributive share of amounts described in Treas. Reg. Section 1.951A-3(d)(3)).

For Dual-Use Partnership Property QBAI, the Final GILTI Regulations determine the proportionate share ratio for partnership specified tangible property by reference to the depreciation allowed for that property.

The Final GILTI Regulations do not require a CFC to use the Alternative Depreciation System (ADS) for purposes of computing income and E&P. For purposes of calculating QBAI, the CFC may elect to use its non-ADS depreciation method to determine the adjusted basis in specified tangible property placed in service before the first tax year beginning after 22 December 2017, subject to a special rule related to salvage value. Such election also applies to the determination of a CFC's partner adjusted basis under Treas. Reg. Section 1.951A-3(g)(3) in partnership-specified tangible property placed in service before the CFC's first tax year beginning after 22 December 2017.

The Final GILTI Regulations also permit a partner that has a distributive share of income from a partnership to take into account partnership QBAI with respect to that partnership. The Final GILTI Regulations provide that a partner need only hold an interest in a partnership during the CFC inclusion year to have partnership QBAI. The Final GILTI Regulations also provide that Section 706(d) applies to determine a Tested Income CFC's partner adjusted basis in partnership-specified tangible property owned by a partnership if there is a change in the Tested Income CFC's interested in the partnership during the CFC inclusion year.

The Proposed GILTI Regulations provide that partnership QBAI is the sum of the Tested Income CFC's share of the partnership's adjusted basis in specified tangible property. The Final GILTI Regulations clarify that an adjustment under Section 743(b) to the adjusted basis of partnership specified tangible property with respect to a Tested Income CFC is taken into account in determining the Tested Income

CFC's partner adjusted basis in the partnership specified tangible property. To ensure that the adjusted basis in intangible property is not inappropriately shifted to tangible property for purposes of determining QBAI, the Final GILTI Regulations provide that basis adjustments to partnership specified tangible property under Section 734(b) are taken into account only if they are basis adjustments under Section 734(b)(1)(B) or 734(b)(2)(B) attributable to distributions of tangible property or basis adjustments under Section 734(b)(1)(A) or 734(b)(2)(A) by reason of gain or loss recognized by a distributee partner under Section 731(a).

Implications

- *The Final GILTI Regulations simplify the determination of a CFC's partnership QBAI and dual-use partnership QBAI.*
- *The Final GILTI Regulations permit a CFC to elect to use its non-ADS depreciation system to determine the adjusted basis in specified tangible property placed in service before the first tax year beginning after 22 December 2017.*
- *Section 743(b) adjustments are taken into account in determining a CFC's share of a partnership's adjusted basis in specified tangible property.*

Treatment of GILTI inclusion amounts for purposes of personal holding company rules

Personal holding companies (PHC) are subject to 20% tax on their undistributed personal holding company income, defined generally as different types of passive income; Section 543(a)(1)(C), however, provides that personal holding company income does not include dividends received by a US shareholder from a CFC, among other statutory exclusions. Treas. Reg. 1.951A-5(d) clarifies that, in determining whether a US Shareholder that is a domestic corporation is a personal holding company, a GILTI inclusion amount is not treated as personal holding company income.

Implications

- *While GILTI inclusions are not subject to taxation under the PHC tax regime, there is still risk of accumulated earnings tax exposure when a domestic corporation accrues GILTI earnings and profits as a CFC holding company.*

The Proposed GILTI High-Tax Exclusion

Section 951A(c)(2)(A)(i) defines a CFC's gross tested income as all of its gross income except certain types of income, such as income that is excluded from foreign base company income (FBCI) (as defined in Section 954) and insurance income (as defined in Section 953) by reason of the high-tax exception under Section 954(b)(4). A provision included with the Proposed 958 Regulations would expand the high-tax exclusion, provided an election is made, to include certain income that is subject to high foreign taxes and would otherwise be included in the GILTI tax base. For this purpose, income is considered high-tax if the effective tax rate is greater than 90% of the maximum corporate tax rate, which is currently 21% (i.e., income is high-tax if it is subject to a foreign tax rate greater than 18.9%), determined on an annual basis based on the income at the CFC level after allocation and apportionment of foreign taxes. Whether an item of income is high-tax is determined at the level of a qualified business unit (QBU).

Prop. Reg. Section 1.951A-2(c)(6)(v) provides rules for the election. The controlling US Shareholders of a CFC would make the election to exclude this high-tax income, and the election would be binding on all US Shareholders until revoked by the controlling shareholders. If the initial election is revoked, the controlling US Shareholders must wait 60 months before making a new election to exclude unless there is a change in control of the CFC. Once an item of income is excluded, the property used to produce the income is not treated as specified tangible property used in the production of gross tested income and, therefore, is not used to calculate QBAI.

The proposed high-tax exclusion is proposed to apply to tax years of foreign corporations beginning on or after the date that Final GILTI Regulations are published.

Implications:

- *The GILTI high-tax exclusion will be available to individuals and trusts, even though the 18.9% rate is determined based on the corporate rate, and the maximum individual rate exceeds that rate.*
- *For planning purposes, taxpayers should keep in mind that the final regulations could modify the application of the high-tax exclusion.*
- *Modelling will be necessary to determine whether to make a high-tax exclusion election.*

Endnotes

1 All "Section" references are to the Internal Revenue Code of 1986, and its regulations (the IRC). Capitalized terms, unless otherwise defined herein, have the meaning ascribed to them in the IRC.

2 Section 951(b) defines US Shareholder as a US person that directly, indirectly or constructively owns (within the meaning of Section 958(a) and (b) with reference to the attribution rules in Section 318), 10% or more of the total combined voting power of all classes of stock entitled to vote or 10% or more of the total value of shares of all classes of stock of a CFC.

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