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Subpart F vs. GILTI: Strategies for U.S. Companies, Foreign Tax Credit Rules, New GILTI High-Tax Exclusion

TUESDAY, AUGUST 18, 2020, 1:00-2:50 pm Eastern

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Subpart F vs. GILTI

August 18, 2020

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Subpart F v. GILTI:

Strategies for U.S. Companies, Foreign Tax Credit Rules, and Opportunities presented by the

New GILTI High-Tax Exclusion Regs

AGENDA

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II. Overview of Subpart F and Its Expanded Purview

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- B. Impact of Repeal of § 958(b)(4), and Recent Guidance regarding reporting & due diligence
- C. Role of "new" § 245A 100% Dividends-Received Deduction (a partial territorial exemption)
- D. The § 962 Election: benefits and drawbacks
- E. High Foreign Tax "Kick-Out" Exception to Foreign Base Company Income – § 954(d)(4).

III. GILTI

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- B. GILTI Mechanics & Computation
- C. Application to Domestic Partnerships (Regs.)
- D. Modeling considerations to analyze which regime to be in (GILTI or Subpart F)
- E. GILTI High Tax Exception – New Final Regulations (2020)

IV. Foreign Tax Credit considerations relating to GILTI and Subpart F

- A. Proposed and Final Regulations (December 2019)

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Ms. Fuller advises a wide range of clients--including private and public companies, joint ventures, private equity funds, individuals, C-Suite executives, "start- ups," and government entities--on transactional, investment, and supply-chain strategies to achieve optimal tax and business results. As a seasoned practitioner and tax technician, Ms. Fuller is accustomed to handling nuanced matters involving highly technical questions of law, policy, and procedure at the federal, state, local, and international levels. She provides sophisticated tax planning services across most industry sectors, including software & emerging digital technologies, financial services, real estate development, healthcare, pharmaceutical, construction & engineering, infrastructure, oil & energy, and retail.

Ms. Fuller is also an effective taxpayer advocate, with nearly two decades of experience resolving U.S. federal, state, and foreign tax controversies, as well as asserted tax penalties. Some of the controversies Ms. Fuller has handled have involved novel questions of law. She also has significant experience with complex *transfer pricing issues--skills Ms. Fuller first acquired when she clerked for the* United States Tax Court, serving three consecutive 2-year terms as *Attorney Advisor to that court's Chief Judge immediately following graduation with her Juris Doctorate (U.S.) degree.*

Ms. Fuller chairs the Tax Policy Committee of the American Bar Association's Tax Section. She is also Co-Chair of the International Tax Committee of the ABA's International Law Section. She is a Fellow of the American College of Tax Counsel, and was named to 100 Influential Women in International Tax last year by a consortium of European law firms. Ms. Fuller holds an LL.M. in Tax Law from New York University School of Law, where she served as Graduate Editor of that school's international law review and completed post-LL.M. studies in international business and comparative law; a J.D. from Seattle University; and a B.A. from the University of Washington. She is admitted to practice law in several U.S. state jurisdictions and multiple federal courts, including the U.S. Tax Court.

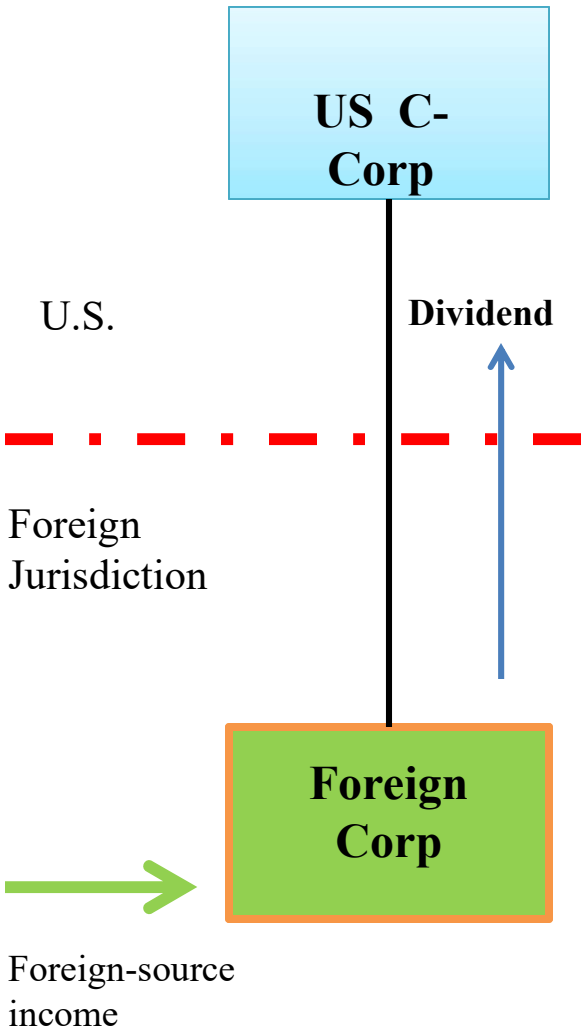
Prior to becoming an attorney, Ms. Fuller was a business news reporter and an all-news radio anchor for a highly regarded NBC News affiliate in Seattle, Washington, covering regional, national, and transnational business and geo-political developments.

I. Impact of U.S. International Tax Reform

An Overview

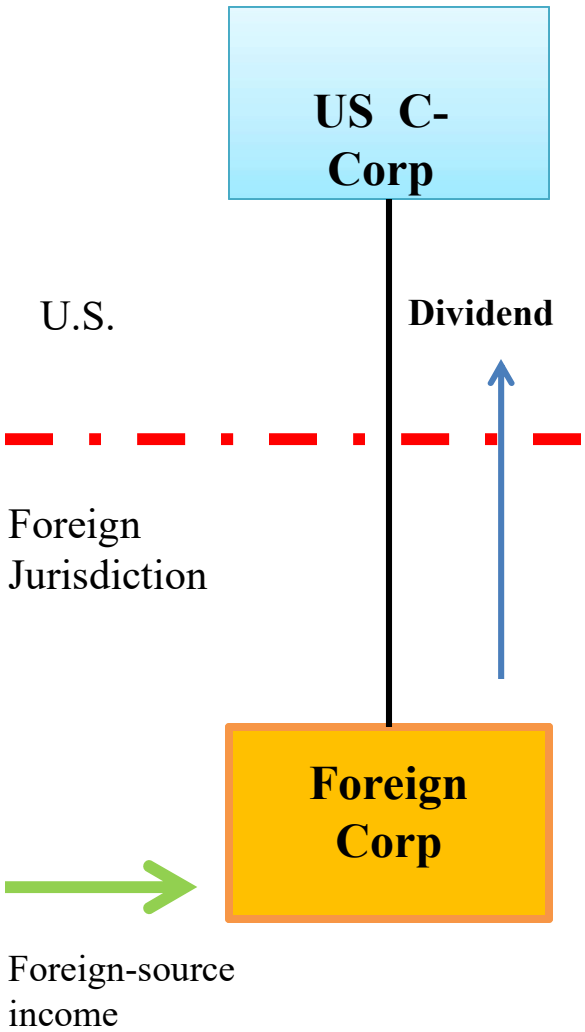
The 2017 TCJA Drastically Changed How Foreign Subsidiary Income of US Corporations is Taxed

BEFORE 2017 US Tax Act



- **General Rule:** United States generally taxes US corporations on a "worldwide" basis—*i.e.,* US corporations taxed currently on both US-source income and foreign source income they receive. (Contrast with a pure "territorial jurisdiction," which taxes its resident corporations only on income earned within its borders—not on foreign-source dividends and other foreign income).
- **Policy for Worldwide ("Residence-Based") System:** Belief that capital is allocated more efficiently when investors' choices about *where to invest* are not distorted by tax considerations. Economists believe it is more efficient if investments are made on the basis of pure economic fundamentals.
- **Deferral "Privilege" Exception: If a FOREIGN corporate Sub (of US corporate parent- as per diagram) earns foreign-source income, US corporate tax is not imposed on the foreign Sub's income unless and *until it is repatriated* to the US—in an actual or deemed dividend. (Indefinite tax deferral is tantamount to a complete tax exemption due to time-value of money.)**
- **Policy Rationale:** US-owned foreign Subs need a "level playing field" to compete and should not have to pay both foreign and US taxes when their competitors do not. Thus, U.S. tax deferral is allowed so long as the foreign Sub can be viewed as truly competing in an active trade/business in its relevant market abroad. However, to the extent the foreign Sub receives income that is either "passive" or looks like "conduit income" (i.e., earned through an low-tax branch/tax haven), the deferral "privilege" ends w/respect to that income, which is then taxed currently to its US shareholder(s) under one of several statutory anti-abuse regimes. Rationale: Foreign Sub is just there for tax advantages—not to compete in a foreign trade/business (i.e., "capital import neutrality" policy objective no longer being served).
- **Foreign Tax Credits**: The corporate income taxes imposed by U.S. upon actual or deemed repatriation of a foreign Sub's E&P may generally be offset with the foreign taxes already paid on that E&P via a tax credit (to extent it eliminates double juridical taxation).

The 2017 TCJA Drastically Changed How Foreign Sub Income is Taxed:
No More Deferral—CFCs' post-86 E&P are either taxed currently or exempted



AFTER 2017 US Tax Act

- **General Rule:** United States still generally taxes its US corporations on a "worldwide" basis—*but* at a much lower rate—i.e., 21% (down from 35%). However, the corporate tax base is broader with more foreign Subs' E&P subject to US tax. Also, there is some foreign-source income that is completely exempt from U.S. corporate taxation . Thus, new system is still a "hybrid system" exhibiting attributes of both a residence-based AND territorial system.

- **"Deferral Privilege" Exception is formally eliminated:** Now, all income of a foreign subsidiary owned by a U.S. corporation will be either:

  - **Taxed currently by US** (either under one of the pre-existing anti-abuse regimes (PFIC or expanded Subpart F) **OR** under the new very broad category of §951A "GILTI" income (*Global Intangible Low-Taxed Income*), which functions as a minimum tax , which can reach a foreign Sub's income even if it's not passive or conduit income; **OR**

  - **EXEMPT from U.S. corporate taxation (forever).**

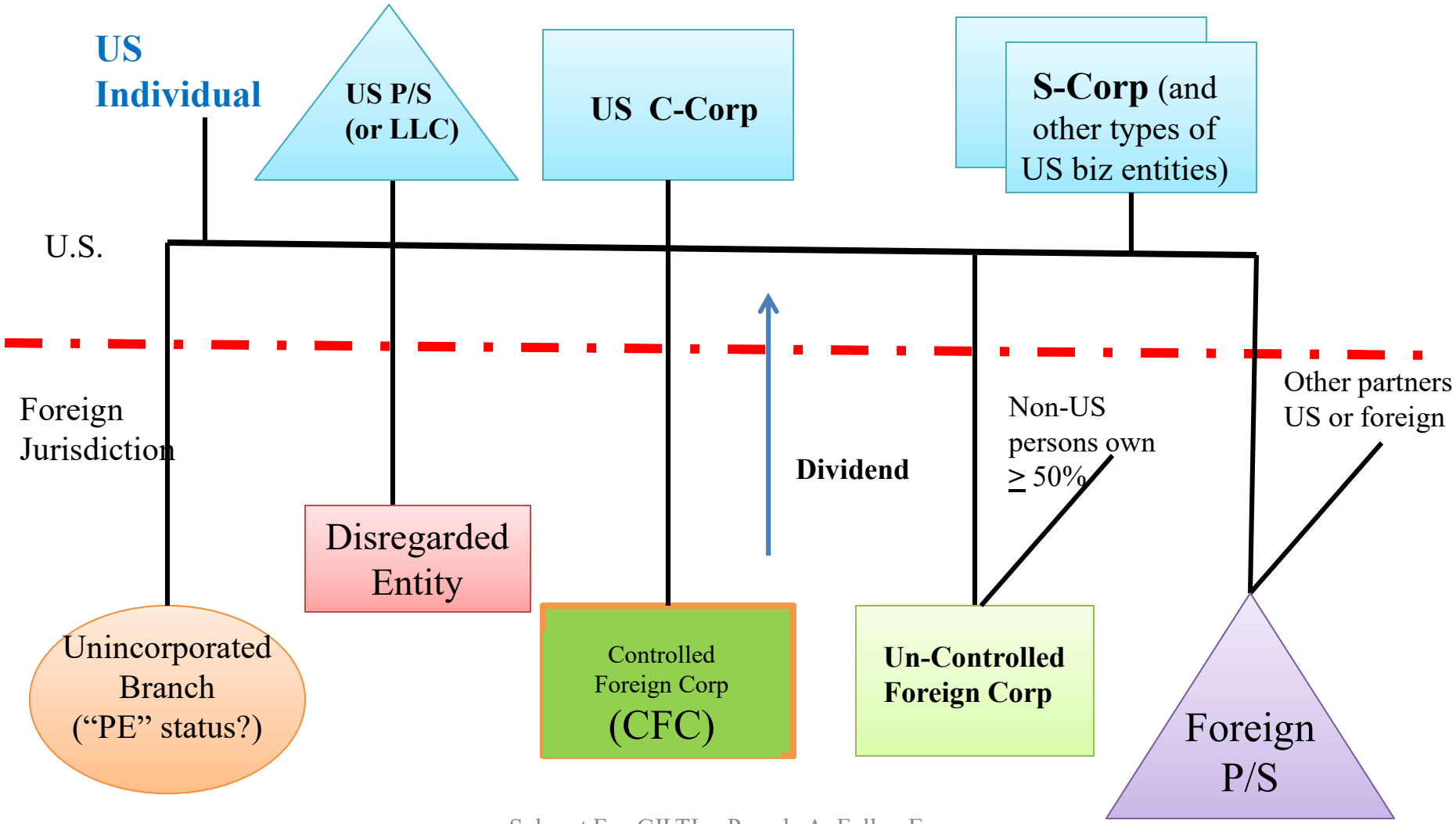
Three categories of foreign-source income of foreign Subs are now EXEMPT . *But these may not amount to much due to the breadth of the new GILTI minimum tax.* They include:

1. CFC's earnings attributable to the 10% notional return in the GILTI regime (QBAI), which qualifies for the § 245A DRD when repatriated:
2. Income of 10% corporate "US Shareholders" of foreign Subs that do not qualify as CFCs (but do qualify as "specified foreign corporations" and so get the § 245A DRD); and
3. Pre-1987 E&P accumulated by foreign Subs, but only to extent of the pro rata share owned by 10% U.S. CORPORATE shareholders, since the §965 Transition Tax does not apply to those earnings and the §245A DRD applies when repatriated.

- **In Sum**: U.S. still has a "hybrid system" –i.e., part Residence-based (perhaps more so now) and part Territorial. Despite its new territorial attributes, the purview of US corporate tax is probably greatly expanded… but at a much LOWER rate—21% (vs. the former 35%).

Overview of Tax Stakes in Business Entity Selection

General Rule: *When a foreign venture rises to the level of "permanent establishment" status, then foreign entity selection becomes more relevant, and a choice needs to be made. Traditionally, choice was between "foreign E&P deferral" or "no deferral."*



KEY TCJA Provisions to Consider when Structuring

- New lower 21% US corporate tax rate: For post-2017 tax years, the top federal corporate income tax rate was lowered 14 points.

- New "GILTI" tax under § 951A: Although not technically a new category of Subpart F income, it taxes "US shs" of CFC on a sweeping new basis, functioning as sort of a residual "minimum tax." Specifically, new § 951A imposes US tax on 10% (or greater) US shldrs (as defined in amended § 951(b)) on "tested income" of their CFCs.

- New § 245A - a limited "participation exemption": "US shareholders" (as defined in 951(b)) that are C Corps, can deduct 100% of "dividends" received (DRD) from their CFCs or "specified foreign corporations" if a one-year holding period is satisfied. This 100% Dividends-Received Deduction (DRD) is helpful in only a few situations where the foreign-source earnings being distributed were not previously subject to US tax (and this is rare after 2017 US Tax Act, due to introduction of new GILTI category of income). The 245A DRD is helpful when dividends are received from non-controlled foreign corporations by US persons that own at least 10% but not greater than 50% of the foreign corporation's vote or value. (NOTE: Regs clarify that S Corps and individuals can also take advantage of Section 245A if they make a "Section 962 Election" to be treated like a C Corp in this limited situation (i.e., receiving dividends).

- The "Secction 962 Election ": Allows US shareholders that are not "C corporations" to get: (1) the lower 21% corporate rate on dividends; (2) to take the 50% GILTI deduction under §250; (so as to obtain a headline 10.5% rate on GILTI (before foreign tax credit computation)); and (3) an "indirect foreign tax credit" on non-US income taxes paid by the foreign entity (An S-Corp can no longer get an indirect FTC unless it makes a § 962 Election because old § 902 was repealed in 2017).

- § 902 Indirect Credit Repealed: Prior to its repeal, § 902 allowed US Shs of CFCs that received an "dividend" to credit the foreign taxes paid on the CFC's earnings out of which the dividend was paid (or deemed paid). Deemed "dividends" under §1248 were also allowed a § 902 indirect credit. The § 902 credit was replaced by the § 245A DRD. The indirect § 960 FTC (for Subpart F deemed divs) was retained, but amended.

- § 245A can be material factor for CFCs with large amounts of exempt QBAI. (Indeed, § 245A can work as an incentive for Purchasers to get higher-bases depreciable tangible assets that generate QBAI, because that sliver of notional income can be repatriated tax free. Because the § 245A DRD only is available to Corporate shareholders (owning at least 10%) of so-called 10/50 corporations, and such non-CFCs cannot generate GILTI, a greater percentage of such 10/50 corporations' earnings may be eligible for the § 245A DRD.

- 962 Election to treat a non-corporate taxpayer as a C Corporation for purposes of Subpart F (including the Transition Tax and 951A is not more important.

II. Overview of Subpart F and Its Expanded Purview

A. Broader application of Subpart F after TCJA
B. Impact of Repeal of 958(b)(4), and Recent Guidance regarding reporting & due diligence
C. Role of "new" 245A 100% Dividends-Received Deduction (a partial territorial exemption)
D. The § 962 Election: Benefits and Drawbacks
E. Interaction of § 956 inclusions and § 245A DRD; Foreign tax credit implications of 956.
F. High Foreign Tax Exception to Foreign Base Company Income – 954(d)(4).

Broader application of Subpart F after TCJA:

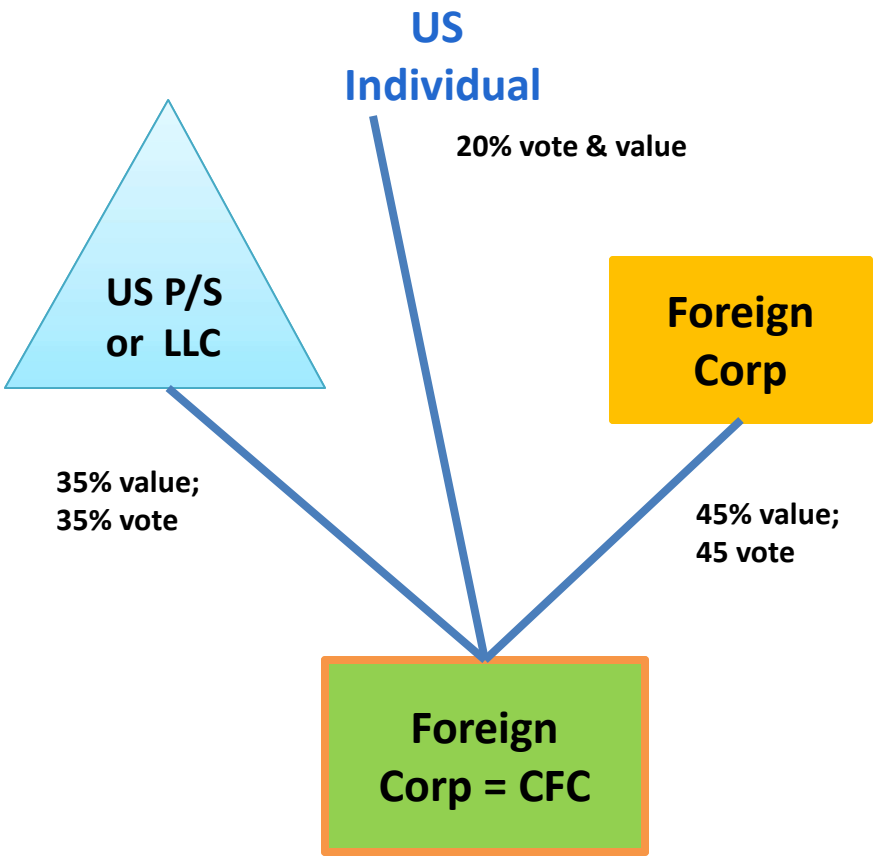
6 ways the Act expanded purview of Subpart F

1. § 951(b) definition of "US shareholder" was broadened to include a value test -(after TCJA, the test for "US shldr" is a US person owning at least 10% of EITHER vote OR *10% of value* of a foreign corporation (directly, indirectly through foreign entities, or constructively through modified § 318 attribution rules).
2. Amended § 951(b) to provide that the new definition of "U.S. shareholder" applies "for purposes of this title," – (i.e., Title 26—the whole U.S. Internal Revenue Code)—instead of just for purposes of Subpart F as under pre-TCJA law.
3. Repealed IRC § 958(b)(4), which had (prior to repeal) turned-off the downward stock attribution rules of § 318(a)(3)(A) through (C) for purposes of imputing stock owned by a foreign person to a US person (in identifying US shldrs and CFCs).
4. Eliminated from § 951's income inclusion rule the requirement that a foreign corporation must be a CFC for at least "an uninterrupted period of 30 days" during any taxable year in order for a US shldr to be taxed. (Now a foreign corporation need only be a CFC for 1 day.)
5. Added a broad new category of income to Subpart F—*i.e.*, § 951A "Global Intangible Low Taxed Income" (GILTI). Although § 951A GILTI is not technically within § 952's definition of "Subpart F Income," GILTI is part of Subpart F, and GILTI's application thresholds are basically the same (*i.e.*, only "US shlders" in a "CFC" are taxed on GILTI inclusions, as that new residual category is defined).
6. Added , to very end of Subpart F, new § 965 --"Treatment of deferred foreign income upon transition to participation exemption system of taxation" (*i.e.*, the "Transition Tax")

Broader application of Subpart F after TCJA:

Basically, when does Subpart F regime apply?

- Subpart F regime can potentially apply whenever there is a "controlled foreign corporation" (CFC).
- CFC is defined in § 958(a) as "any foreign corporation if > 50% of the total voting power OR > 50% of total value is owned by 10% "US shareholders" on any 1 day.
- For purposes of identifying "US shldrs" and testing for "CFC" status, stock ownership can be direct, indirect through foreign entities, or constructive. (Attribution rules of § 318 are incorporated by reference in Subpart F, but with modifications.)
- Beware of control premiums and value discounts ("drag along" & "tag along" rights)
- With respect to voting power, courts have looked *to power to control board of directors*. See Framatome v. *Cir.* 118 TC (2002) (because the veto powers and supermajority requirements prevented US shldr from exercising powers over Japanese corp ordinarily exercised by a domestic board of directors, US shareholder did not have > 50% voting power. Court relied on *Alumax v. Cir., 109 TC 133 (1997), aff'd 11th Cir.*



Foreign Corp is a "CFC" because the "US shareholders" (i.e., the US LLC and the US individual together own > 50% of the vote (and here, also 55% of the value). IF US individual owned only 5%, then there would be no CFC.

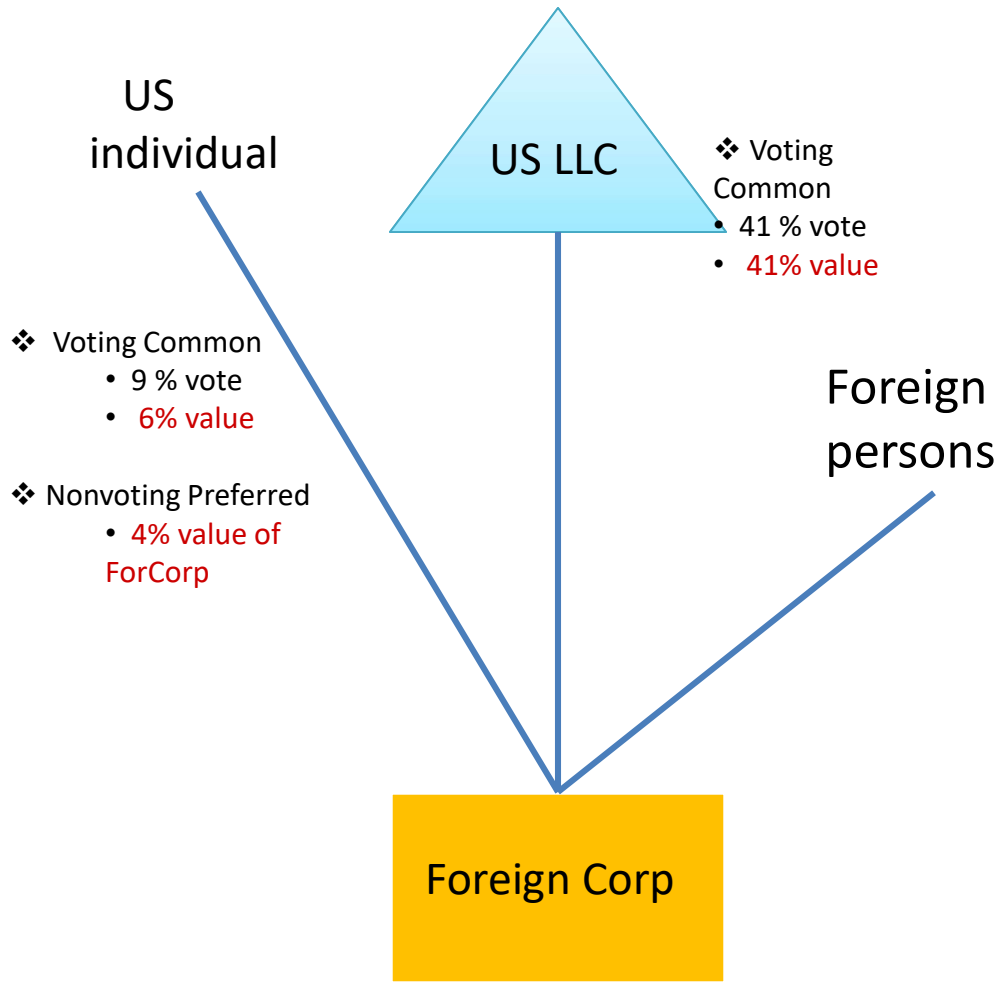
Broader application of Subpart F after TCJA:

951(b) "US shareholder" now looks at both 10% vote ***OR VALUE***

- "US shareholder" was historically defined in § 951(b) as a "US person" that owns at least 10% of the foreign corporation's VOTING stock . VALUE WAS IGNORED.
- The 2017 Tax Act amended § 951(b) to add a value test….so that a U.S. shareholder is now defined as any "US person" that owns (directly, indirectly, or constructively) at least 10 % of foreign corp's voting stock OR 10 % of foreign corp's VALUE.
- Value test is likely to import all the judicial and administrative IRS authority regarding control premiums, minority discounts, and in some instances, "drag-along" and "tag along" rights, valuation of beneficial ownership—making process of identifying "US shldrs" in complex family trust and/or corporate arrangement more complex.
- **Effective date of new "US shldr" definition is prospective:** Applies to CFC tax years beginning after 12/31/2017,and for taxable years of US shldrs in which or with which the CFC's year ends. Sec. 14214(b), TCJA.
- **"US person**" includes US citizens, US residents, US C- corp, S Corps, partnerships formed in the US, Estates taxable in the U.S., and non-foreign trust
- For § 951(b) purposes (defining "US Shareholder"), stock ownership has always been computed, and continues to be computed, using the "direct" and "indirect through foreign entities" of § 958(a) AND the constructive attribution rules of § 958(b) (which incorporate § 318, but modifies them in significant ways)
- Although constructive ownership rules are used to identify "US shareholders" and "CFCs," income is included in proportion to each US shldr's direct and/or indirect ownership only! *US shldrs are never subject to tax based on shares they own only constructively.* *See* flush language of § 958,and confirmed in House Report and 2018 Notices.
  - § 965: While constructive ownership can cause § 965 to apply, only the E&P of foreign corporations attributable to shares actually owned (directly and indirect) are deemed repatriated.
  - § 951A: While constructive ownership can cause § 951A to apply, inclusion is based on shares of the CFC owned directly and indirectly (not constructively).

"US shareholder" broadened to include 10% of vote ***OR VALUE - Example***

- **PRE- TCJA law:** "US shareholder" defined as a US person owning stock representing 10% or more of the total voting power of all stock of the foreign corporation. § 951(b). (Ownership could be direct, indirect, or constructive.)
- Thus, a US person holding nonvoting preferred shares representing 10% of the VALUE was not treated as a "US shlder." That US person could not be counted for purposes of determining whether a foreign corporation was a CFC. And, if it was a CFC, such shldr would not be subject to US taxation under Subpart F.
- **POST-TCJA Law**: TCJA expanded definition of "US shareholder" to include a US person owning shares representing 10% or more of the VALUE of all shares of the foreign corporation (regardless of the shareholder's voting power).
- **RIGHT:** US individual qualifies as a "US shareholder" of the Foreign Corp because she owns stock representing at least 10% of the foreign corporation's value.
- But IF the value of US individual's shares is only 9% of the Foreign Corp's total value, then US individual is not a "US shareholder" and her shares can not be counted to determine if Foreign Corp is a CFC. (Note that she also only owns 9% of vote.)
- Here, value of US individual's shares is critical. If the value of her shares is only 9%, then Foreign Corp is not a CFC because US LLC does not own > 50% of vote or value. IF US individual's shares can be counted (because she has at least 10% of total value, then her ownership counts, and together US LLC and US individual own shares totaling > 50% of the total value of Foreign Corp.



Expansion of Subpart F:
Repeal of "uninterrupted 30-day ownership" test

- **PRE- TCJA:** Income earned by a foreign corporation that would otherwise qualify as Subpart F income of a CFC was not subject to U.S. tax if the foreign corporation was not a "CFC" for an uninterrupted period of at least 30 days. § 951(a).
  - Example: Assume a foreign corporation with one class of stock and a December 31st year end met qualified as a "CFC" during its last month because a US person acquired more than 50% of its stock on Dec. 3rd. Because the foreign corporation would not have qualified as a CFC for an uninterrupted period of 30 days during its taxable year, the US shareholder will not have any inclusion under 951(a) for the year of the acquisition.
- *TCJA repealed this 30-day rule*. Sec. 14215(a), TCJA.
- **POST-TCJA:** Now, a US shldr will be taxed on its pro rata share of Subpart F income even if the foreign corporation qualifies as a "CFC" for only ONE DAY, provided the US owns the CFC on the last day of the CFC's tax year.
- New rule is effective prospectively: Repeal of the 30-day rule is effective for tax years of foreign corporations beginning after December 31, 2017, and taxable years of U.S. Shareholders in which or with which those taxable years of a foreign corporation end.

Expansion of Subpart F:

EXAMPLE - Repeal "uninterrupted 30-day ownership" test

ASSUMED FACTS: A is a US green card holder and wants to become a US citizen. A's father (F) is not a US citizen, resides outside US, and owns all the stock in a large foreign holding company (HC) with highly appreciated assets.

A's sister is visiting A, and she is a non-resident alien (NRA) under US rules.

A's father dies, leaving to A the majority of the total outstanding stock in a foreign HC (classified as a "corporation" for US purposes). On date of death, father is classified as both an NRA for US income tax purposes and a "non-domiciled alien" for US estate tax purposes.

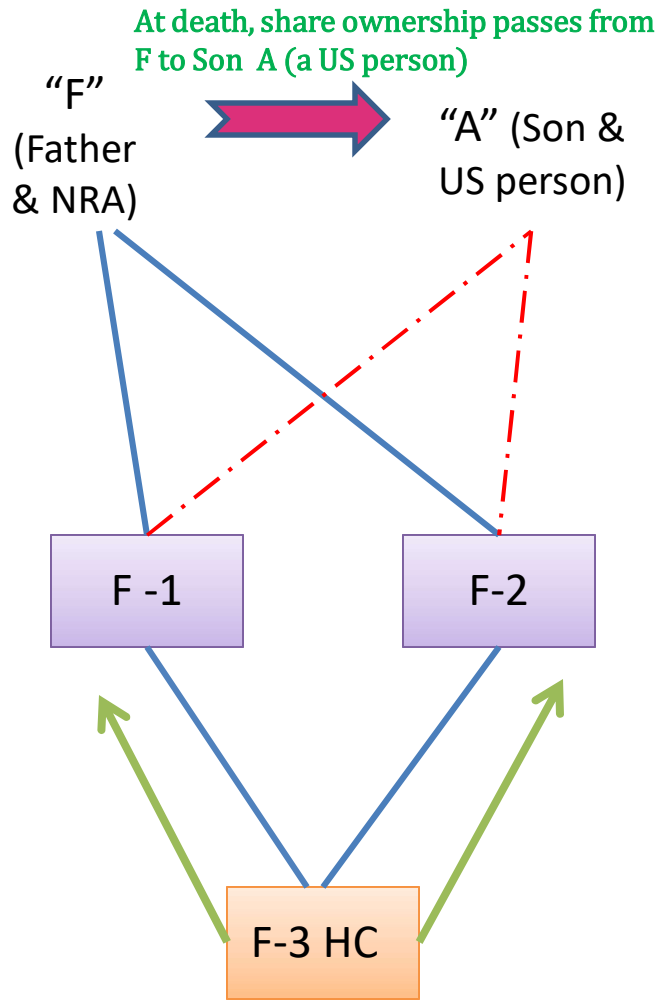
PRE TCJA: Before repeal of the 30-day rule in 951(a), A had 29 days to liquidate the foreign HC in order to avoid having the built-in gain taxed to him as Subpart F income. (Or alternatively, transfer enough shares to NRA sister to avoid having >50% vote or value….no attribution between siblings under § 318.

POST-TCJA: HC qualifies as a "CFC" on date A inherits the shares because as a US person, he owns >50% for at least ONE DAY during the corporation's tax year.

Pre-Death Planning Alternatives: (1) A transfers sufficient shares to a NRA sibling or other NRA relative to get below CFC thresholds. (But transfer of ownership must be genuine--not a loan); (2) F could sell & repurchase any marketable securities to gradually step-up assets bases to eliminate built-in gain; (3) arrange for US persons to inherit < 50% and compensate A with other assets.

More complex planning: Arrange for foreign HC to be equally owned by two upper tier foreign HCs, and for F's estate to make a retroactive check-the-box election to liquidate the bottom HC as of a date shortly *prior* to alien F's death, thereby effecting a deemed §331 liquidation that would step up the basis of the underlying distributed US assets. Then when F1 and F2 are liquidated, there is not built-in gain.

Beware of effects of repeal of § 958(b)(4). Attribution under 318(a)(3) need not be from a foreign corporation (could be a from trust, partnership, or estate).



Consider a § 331 liquidation before F's death to step-up asset bases

Broader Application of Subpart F (post TCJA)
Compare the Ownership Attributions Rules of § 958(a) and (b)

§ 958 contains the rules for determining stock ownership. Subsections (a) and (b) serve different purposes, and contain distinct rules.

§ 958(a)(1) - General Rule: For purposes of Subpart F (other than § 960(a)(1)), stock owned means—

- § 958(a)(1) and (2):
  - stock owned ***directly*** (§ 958(a)(1) and
  - Stock owned ***indirectly through foreign entities***, including a foreign corporation, foreign partnership, foreign trust, or foreign estate. § 958(a)(2). (Do not attribute up through domestic entities.)
- US shlds are taxed only on their direct and indirect ownership as determined under §958(a)(1) & (2)—not on their constructive ownership.

==========

§ 958(b) defines "constructive ownership" of stock, for purposes of identifying a

- "US shareholder" defined in § 951(b);
- "CFC" defined in § 957;
- "related person" as defined in § 954(d)(3); and
- US shldr(s) that has "invested in US property" under through domestic corporations, pursuant to §956(c)(2).

- § 958(b) expressly incorporates the familiar attribution rules of § 318(a), but modifies them in important ways with respect to attribution thresholds.

Family Constructive Attribution Rules of § 318:
Incorporated in §958(b) and not changed by TCJA

Family Attribution

An individual is considered to own stock that is owned, directly or indirectly, by or for

- a spouse (unless legally separated by decree of divorce or separate maintenance),
- children,
- grandchildren, and
- parents.

However, the family attribution rules under §318(a)(1) do not treat an individual as owning stock actually owned by the individual's siblings, grandparents, great-grandparents, great-grandchildren, uncles, aunts, nephews, nieces, or cousins.

- Stock constructively owned by applying the family attribution rules cannot be attributed a second time to another family member. § 318(a)(5)(B). Thus, while shares of stock owned by a child are attributed to a parent, that stock cannot be reattributed from the parent to another child.
- **NO NRA to US person attribution:** Family attribution rules do not apply for purposes of attributing stock owned by a nonresident alien individual (NRA), other than a foreign trust/estate, TO to a US person (e.g., for purposes of identifying a US shldr). §958(b)(1).
- These rules remained unchanged under the TCJA.

How did § 958(b) modify the §318(a) attribution rules, which §958(b) expressly incorporates ?

PRE-TCJA:

Section 958(b): Constructive attribution rules, for purposes of Subpart F, incorporate the attribution rules of § 318, but modify them as follows:

1) **NO NRA to US individual stock attribution:** In applying § 318(a)(1)(A), no stock of a non-resident alien is to be attributed to a US citizen or a US resident alien for purposes of making the US individual a "US shareholder" or § 954(d)(3) "related person" or identifying a CFC;

2) **Upward Attribution (*i.e.*, up TO owners of entities from the entities):** In applying §318(a)(2)(A) – (C), if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 % of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning ALL the stock entitled to vote. (Policy: effective control is assumed.)

3) **In applying § 318(a)(2)(C),** the phrase "10 percent" shall be substituted for the phrase "50 percent" used in subparagraph (C).

4) **Downward Attribution rules of 318(a)(3)(A) –(C) are turned OFF**: Such rules can never be applied so as attribute stock owned by a foreign person to a US person (*e.g.*, to make the US person a US shareholder).

Broader application of Subpart F after TCJA:

TCJA repealed §958(b)(4)'s limit on downward attribution

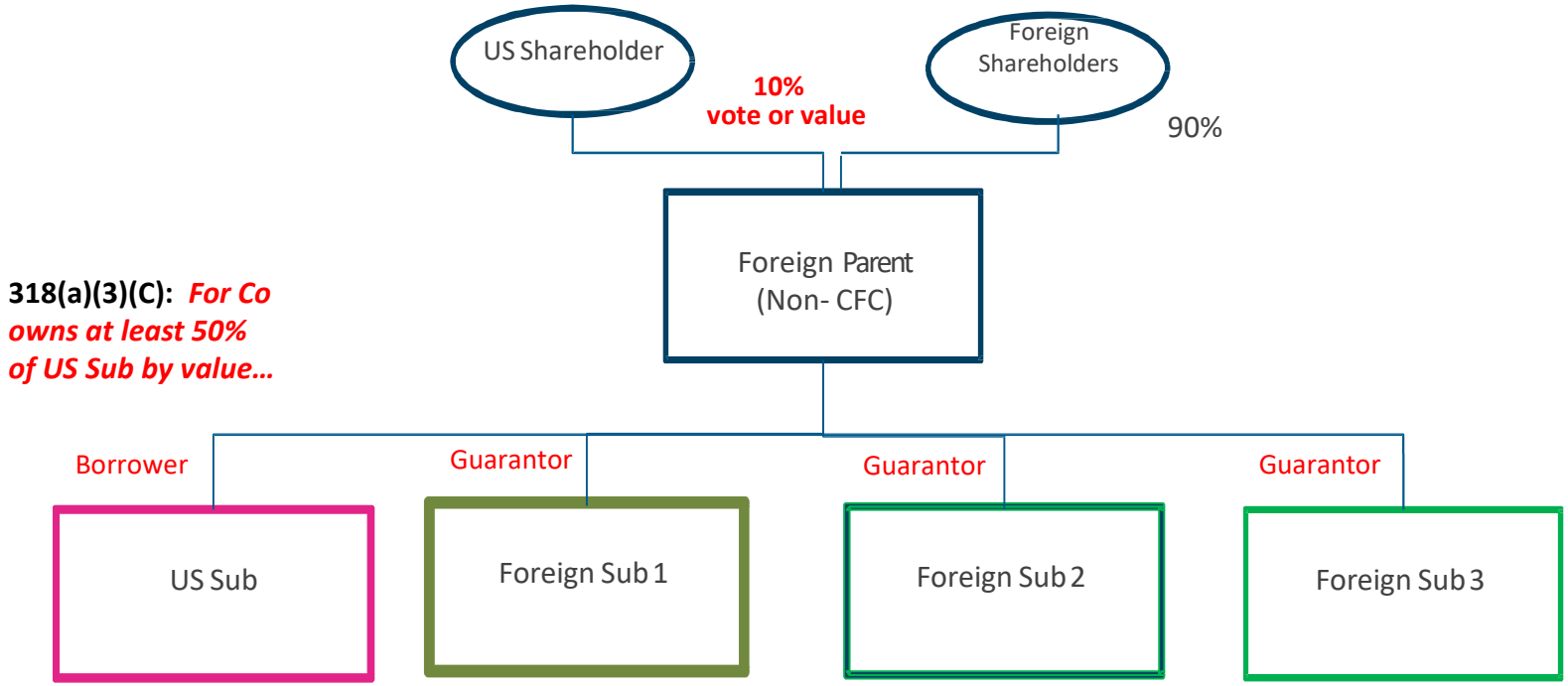
- The 2017 Act repealed IRC § 958(b)(4)…..***RETROACTIVELY.***
- This change is applicable to the last year of the foreign corporation that begins before Jan. 1, 2018 (and the taxable years of its US shareholders that end with or within the CFC's taxable year). This means that for calendar year taxpayers, the repeal of § 958(b)(4) applies retroactively—*i.e.,* to taxable years ending in 2017.
- Before its deletion from the US Tax Code, § 958(b)(4) provided:
  " Subparagraphs (A), (B), and (C) of Section 318(a)(3) shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person."
  - § 318(a)(3)(A) provides for downward attribution of stock ownership **TO partnerships and estates .** (The partnership/estate is treated as owning whatever the partner or estate owns.)
  - § 318(a)(3)(B) provides for downward attribution of stock ownership **TO trusts** (exception for "remote contingent interests" in which case there is no downward attribution to the trust).
  - § 318(a)(3)(C) provides for downward attribution of stock ownership **TO corporations**:

    "If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person." *

* Note that the relevant threshold under § 318(a)(3)(C) is "AT LEAST 50%" of the value…

Repeal of § 958(b)(4) – Myriad Collateral Effects:

"Pop-Up CFCs" & real, substantive Subpart F tax exposure



- Prior to the TCJA, Foreign Subs 1, 2 and 3 were not CFCs
- Because Foreign Parent Co owns US Sub stock w/at least 50% total value, § 318(a)(3)(C) is triggered. Thus, ALL the stock owned by Foreign Parent is treated as owned by US Sub--making US Sub both a § 951(b) "US shlr" and Foreign Subs 1, 2, and 3 "CFCs."
- US Sub not taxed on constructive ownership (which is all it owns in this diagram).
- BUT the 10% US shlder (at the top) owns 10% of the CFC indirectly (through Foreign Corps) and thus IS taxed on its pro rata share of all Subpart F earnings of Foreign Subs 1, 2, 3. Also, the indirect US Shldr could also have tax under §§ 956 (Earnings invested in US Property); §951A (GILTI; § 965 Transition Tax (even though none of the foreign corps are "controlled" directly or indirectly by US shs.
- **Here, advisors should review income and earnings of each CFC. Also, need to review loan documentation requiring guarantees** (because under of § 956 Investment in US Property, any CFC guarantee of a U.S. obligation could trigger a deemed dividend).

Congress' Repeal of § 958(b)(4): **Myriad Collateral Damage – (intended or not?)**

- **RETROACTIVE Effective Date:** The repeal of the limit on the downward attribution rules applies beginning in the last taxable year of a foreign corp that begins before Jan. 1, 2018 (and the taxable years of its US shlders that end with or within the corporation's taxable year). This means that for calendar year taxpayers, the repeal of § 958(b)(4) applies somewhat retroactively—*i.e.,* to taxable years ending in 2017.
- *This is not just an outbound issue for U.S. shareholders.*
- Without the old restriction of § 958(b)(4), a U.S. sub of a foreign parent company may be considered a U.S. shareholder of a *non-U.S.* sister subsidiary of the foreign parent.
- Myriad Implications of this repeal, which were likely NOT intended by Congress:
  - If foreign parent has a 10% direct or indirect U.S. direct or indirect shareholder (not constructive) such shareholder could have Subpart F, §951A GILTI, IRC § 956, or other "phantom" income (not within the scope of the post-inversion decontrol-of-CFC transactions;
  - Foreign investors in U.S. corporations may cause their non-U.S. subsidiaries to become CFCs;
  - Qualification for U.S. *portfolio interest exemption* for withholding may be implicated (i.e., lost! -- the foreign corporate recipient of the US-source "portfolio interest" cannot qualify for the exemption if it is a CFC receiving interest from a related person).
  - Will often wreak havoc with PFIC/CFC overlap rules.
  - May cause the PFIC rules to not apply with respect to new § 951(b) "US shareholders"
  - May cause § 1248 to apply, triggering "dividends" that qualify for the new § 245A DRD.

Effect of repeal of § 954(b)(4): Obligation to file IRS Form 5471

- Repeal of § 958(b)(4) dramatically increases the number of US shareholders who are now required to file Form 5471.
- **IRC § 6038:** If any foreign corporation is treated as a CFC for any purpose under subpart F, the Secretary of Treasury may require any US person treated as a US shareholder (or officer or director) of such corporation to file an information return on Form 5471, providing information about the entity.
- **IRS Form 5471,** entitled "*Information Return of US Persons with respect to Certain Foreign Corporations*" is normally required to be filed with the US shareholder's tax return. The US persons required to file, and the extent of the information they are required to provide on Form 5471, varied based on the person's filing "category" (e.g., Category 2, 3, 4, or 5.)
- **Under Category 5**, a Form 5471 is required to be filed for each CFC with respect to which the US person is a "US shareholder." (Form 5471 Instructions).
- **Stiff Penalties for Failure to Timely File Form 5471**: $10,000 for each annual accounting period (for each missing Form 5471). If any failure continues for more than 90 days after the day on which the Secretary mails notice of such failure to the United States person, such person shall pay [increased penalties] not exceeding $50,000 (for each foreign corp for which a Form 5471 was due). IRC § 6038(c).
- **Failure to file a Form 5471 can also result in decreased foreign tax credits.** IRC § 6038(c).
- **Repeal of 958(b)(4), as well as expanded definition of "US shareholder" dramatically increases the number of CFCs and US shldrs, and therefore the obligation to file Forms 5471 (many being obligated with respect to their 2017 taxable years).** But see "group filing exception" below.
- **Fairness Concerns:** US shldrs and US subs could get hit with substantial penalties for not reporting on the operations of foreign corporations over which they have no control and from which they will never be entitled to receive income (because their ownership is only constructive). The "Category 5" filing obligation can apply even when a US shldr is not otherwise subject to tax under subpart F.

Increased Obligation to file IRS Form 5471:
Notice 2018-13 provides limited relief

- **General Rule: Notice 2018-13 provides limited relief for "constructive US shldrs" from obligation to file a Form 5471 but only with respect to "constructive" CFCs**
- Specifically, in section 5.02 of the Notice (and echoed in Preamble or the Proposed 965 Regs) IRS announced its intent to "amend the Instructions for Form 5471 to provide an exception from Category 5 filing for a US person that is a US shareholder with respect to a CFC if:

  (1) *"no US shareholder (including such US person) owns, within the meaning of §958(a), stock (directly or indirectly) in such CFC, and*

  (2) *the foreign corporation is a CFC solely because such US person is considered to own the stock of the CFC owned by a foreign person under § 318(a)(3)."*
- Thus, a very limited exception! Basically, it is a "but for" test. If the foreign corp would not be a CFC *but for* the constructive ownership of the US shareholder (who owns no stock directly or indirectly), then a Form 5471 may not need to be filed. Also, it appears from language in the Notice, that no other US shareholder may hold ANY stock directly or indirectly. So…use caution when trying to fit within this narrow exception.
- **Group filing exception to filing Form 5471:** To alleviate redundant filings, a joint ownership exception generally allows one U.S. person to file a joint 5471 on behalf of other persons required to file the same information for the same CFC. Example: Only one Form 5471 for a CFC may need to be filed by a consolidated group even when there multiple Category 5 US shldrs due to expanded § 958(b) constructive ownership rules.
- When a U.S. person files a Form 5471 on behalf of a person that is not in its consolidated return group, the person relying on the exception must attach to its return a statement that identifies the filer and provides certain other information.
- *Look for updated Instructions to Form 5471. Anticipate more guidance on Form 5471 filing obligations from IRS.*

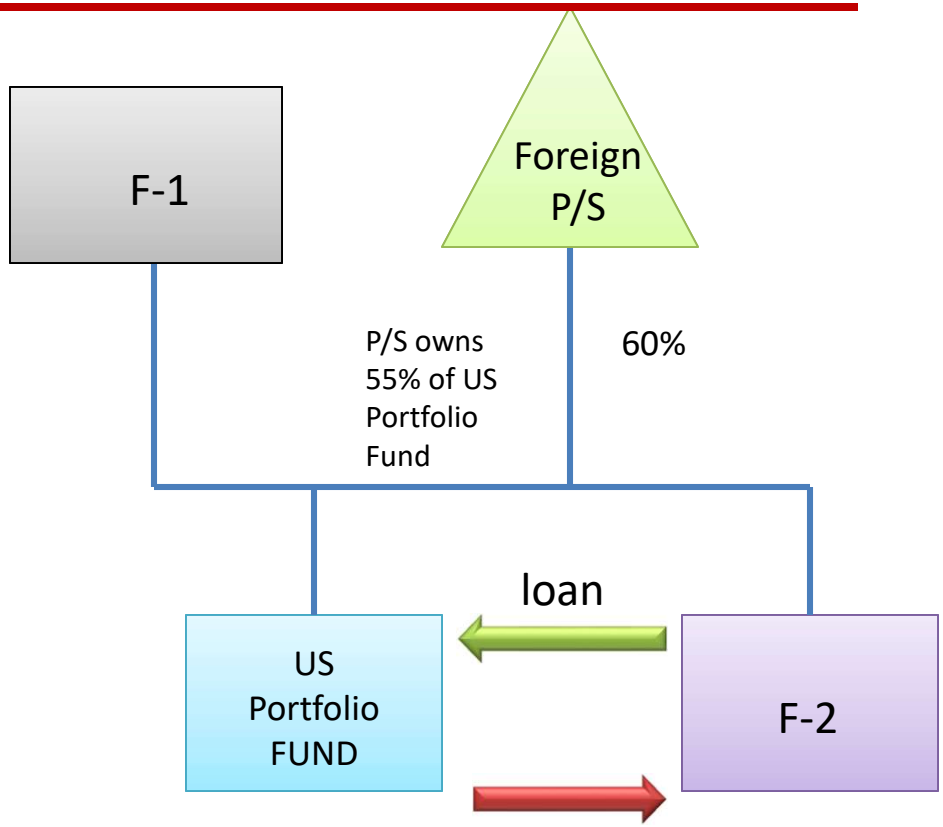
Repeal of § 958(b)(4): **Increases exposure to § 951(a), as well as § 956, § 951A GILTI, and § 965 Transition Tax**

- Not only can classification of the foreign sub as a CFC under § 318(a)(3)(C) increase exposure to taxation under § 951(a) (Foreign Personal Holding Company Income, Foreign Base Company Sale & Services Income and other categories of § 951(a) "Subpart F Income," it can also trigger the application of many other tax provisions in the Code. For example:
- **§ 956 Earning Invested in U.S. Property:** Where a foreign corp suddenly becomes a "CFC," many types of transactions can be characterized as "deemed repatriations" under § 956 (e.g., loans, pledges of stock).
- **GILTI Exposure under § 951A**: applies to §951(b) "US shareholder" of a "CFC," using the same exact same definitions and ownership thresholds. But as under § 951(a), § 951A GILTI tax is computed on with respect to shares actually owned (i.e., directly and indirectly).
- **§ 965 Transition Tax:** The mandatory repatriation rules of 965 apply to "US shareholders" of "specified foreign corporations" (SPF) that have post-1986 E&P that was not previously taxed (or repatriated). A SPF is defined as a CFC or any foreign corporation that has at least one domestic C-Corp that is a § 951(b).
- **Many other provisions can be triggered,** even though the underlying policy reasons for the application of those provisions is often not present.

Repeal of § 958(b)(4) – Collateral Effects:

Could Destroy Eligibility for US Portfolio Interest Exemption

- **A CFC cannot qualify for the all important US Portfolio Interest Exemption if it received interest from a "related person." § 881(c)(3)(C).**
- Excluded from the definition of "portfolio interest" is interest "received by a CFC from a related person" (within meaning of §864(d)(4)/ **§** 267(b), (f).
- Because TCJA repealed §958(b)(4), the downward attribution rules of §318(a)(3) are no longer "turned off," and are operative beginning with foreign corporation's tax years beginning before 12/31/2018.
- Because Foreign Partnership owns at least 50% of the value in US Portfolio Corporate Fund, such Fund is deemed to own all the stock that Foreign P/S owns. (Same rule would apply if F-1 owned at 50% of the value). Therefore, under §318(a)(2), US Portfolio Fund constructively owns 60% of F-2, making it a "US shldr" and making F-2 a CFC.
- Suddenly, F-2 (a CFC) cannot qualify for the US Portfolio interest exemption because F-2 is a CFC receiving the interest from a "related person" within the meaning of §267(b), (f)
- A lot of restructuring has been (or must be) done to get around this sudden loss of the US Portfolio Interest Exemption…(lost retroactively for taxable year beginning before 2018).



Interest payments *(often exempted from US 30% withholding tax if they qualify as "portfolio interest")*

2017 Tax Act - Expansion of Subpart F:
More unintended consequences of § 958(b)(4)'s repeal (a non-exclusive list)

- **Qualifying for the 245A Participation Exemption**: US shareholder that sells stock in a "faux CFC" may have a §1248 "dividend" that can qualify for the §245A DRD. ("A good thing.")
- **Basis bump-ups and more PTI:** Inclusions of any extra Subpart F and/or GILTI income can give rise to positive basis adjustments under §961 and create PTI for purposes of §959 and §965. ("A good thing.")
- **Portfolio Interest Exemption**: Section 881(c)(3)(C) and §881(c)(5) limit the availability of the US Portfolio Interest Exemption as applied to interest paid to CFCs by "related persons." Clearly, the policy underlying these restrictions is not implicated in the case of a faux CFC.
- **Expatriations:** §877 provides punitive tax rules for US citizens or long-term green card holders who expatriate. §877(d)(1)(C) and §877(d)(4) punish expatriates who own or form CFCs (apparently including these "faux CFCs" that pop-up due to the repeal of § 958(b)(4).
- **Subpart F Insurance Income.** Repeal of § 958(b)(4) makes it easier to create income under § 953, which was already sweepingly broad. A US tax-exempt org may be subject to the UBIT (Unrelated Business Income Tax) if it is a shareholder of a faux CFC that has insurance income. §512(b)(17).
- **Downward E&P adjustments under § 312(m).** § 312(m) prohibits a downward adjustment to E&P of a foreign corporation that pays interest on an obligation that fails to meet the registration requirements of §163(f). This punitive rule does not apply to a foreign corporation that is not a CFC and does not have a tax-avoidance purpose. However, if a foreign corporation is a CFC, it will be subject to the punitive rule, regardless of its purpose.
- **International Shipping & Aircraft Income.** § 883 generally exempts income earned by foreign corps from intern'l ships and aircraft so long as the foreign corp is not "treaty shopping" and resides in a country granting US carriers an similar exemption. § 883(c)(2) turns off the treaty shopping restriction for CFCs.

Potential Solutions to Mitigate Unintended Tax Liability due to §958(b)(4)'s Repeal (i.e., before release of Rev. Proc. 2019-40)

1. Convert the Foreign "Pop-Up" CFCs to "Disregarded Entities" with CTB Election
   - Treated by US taxable "liquidations" triggering a § 1248 dividend, but the "all 1248 amount" may be zero, if E&P already picked up by the Transition Tax.
   - *This strategy would likely not avoid the 2017 imposition of the one-time Transition Tax* unless a retroactive CTB election could be made—NOT likely to be allowed under Final 965 regulations

2. Make Maximum Use of the *High Foreign Tax Exception* to reduce both Subpart F & GILTI income

3. Elect § 962 to Treat the Foreign Dividends "as if" they were received by a U.S. C Corporation. *But see Smith v. CIR*, __T.C. (2018)(no qualified dividend treatment allowed – C corp is not real….so need to have the CFC is a US tax treaty jurisdiction to get "qualified dividend" rate).

4. Create a U.S. Irrevocable Non-Grantor Foreign Trust (to reduce the indirect U.S. shareholder's interest to below 10% vote or value). How does this work? (If remaindermen are NRA children, might work under the § 318 attribution rules)

5. Interpose a US C corporation between the § 951(b) individual /S-Corp US shareholder and the CFCs (to get the 100% DRD under § 245A , and the 50% GILTI deduction under § 250). But some foreign countries forbid a foreign corporate (US) shareholder (*e.g.*, China, Lebanon if real estate)

6. Actually liquidate the CFCs (But usually not pragmatic…and then the "liability shield" is lost. Also expensive!)

7. Take "Wait & See" attitude: Wait and see if Congress adopts any Technical Corrections Bill (2 have already died in the US House of Reps). Or hope IRS/Treasury does something…

Finally, on Oct. 1, 2019, *Some Relief* given for effects of §958(b)(4) Repeal:

IRS issues Rev. Proc. 2019-40 and Package of Proposed Regs.

- **Revenue Procedure 2019-40:**
  - **What it does NOT do:** Does NOT "undo" the substantive effects of the repeal of §958(b)(4). Thus, if a foreign corporation is a "CFC" under the downward attribution rules, it remains a CFC, and direct and indirect US shareholders will still have to report phantom income from that CFC (to the extent of shares they actually own), and will have filing requirements –i.e., Form 5471, even if the foreign corp would not have qualified as a "CFC" prior to the repeal of § 958(b)(4).

  - **What it DOES do**:
  - *Gives some limited relief from the due diligence requirements* in certain situations, but only if certain ownership paradigms are met with respect to a "foreign controlled CFC."
  - *Limits application of penalties* under § 6038 (for failure to file Form 5471) and under § 6662 for tax underpayments but ONLY if the taxpayer is within certain "safe harbors."
  - Eases compliance burden by providing a hierarchical list of acceptable "alternative info" in certain situations where getting the normally required info to determine E&P and QBAI proves difficult or impossible.

Revenue Procedure 2019-40:
Three Safe Harbors that reduce compliance burdens

- **Safe Harbors Mitigate Potential Penalties for Non-Compliance**: IF Tp is within the safe harbors, then penalties for NOT filing Form 5471 (when filing it was required) or underreporting Subpart F income or GILTI (when obligation is due to §958(b)(4) repeal) are not likely to apply.

- **Examples & Definitions** in the Rev. Proc. are very important:
  - **"Foreign Controlled CFC":** is a foreign corp that is a CFC but would not be one if the downward attribution rules of § 318(a)(3)(A)—(C) did *no*t apply.
  - **"§ 958(a) US Shareholder":** is, with respect to a foreign corp, a US person that owns at least some stock in the foreign corp either directly, or indirectly through foreign entities (need not be 10%).
  - **"Related person":** relies on § 954(d)(3) definition of controlled by, or commonly controlled by, another person, with "control" meaning ownership of > 50% vote or value (with all attribution rules applying to determine control).
  - **"Related constructive US shareholder":** US shareholder that owns shares only constructively (i.e., thru downward attribution) but is in a > 50% relationship with the foreign corp (*i.e.,* controlling, or controlled by, or they are commonly controlled by another entity).

Revenue Procedure 2019-40:
No. #1: Safe Harbor for Determining CFC Status

- Just answers question of "Did you try hard enough to find out if there was a CFC?" But does NOT turn off the substantive effects of the downward attribution rules!!

- It merely lessens the due diligence burden, and if Tp is within this Safe Harbor #1, and turns out to be wrong, penalties are not applied.

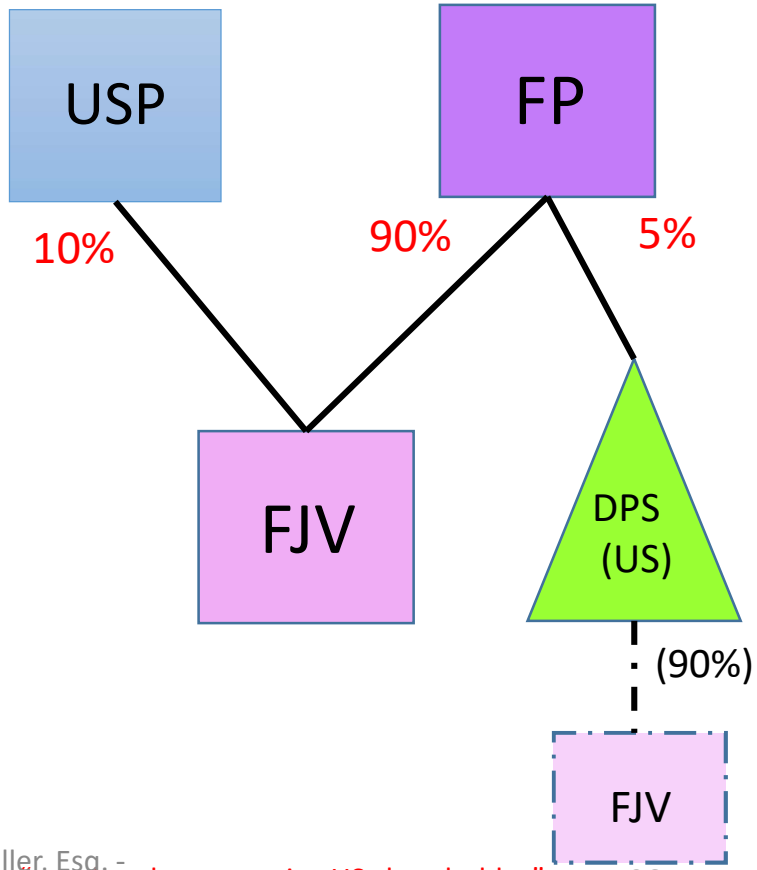
Revenue Procedure 2019-40:
No. #1: Safe Harbor for Determining CFC Status

- Two main requirements
- The IRS will accept a US person's determination that a foreign corp does not meet the § 957 ownership requirements to be a CFC if:
  - (i) the US person *does not have actual knowledge*, and is not deemed to have knowledge by having received statements and/or reliable publicly available information sufficient to make that determination, AND
  - (ii) IF the US person directly owns equity in a foreign entity (top-tier entity), the US person inquires of the top-tier entity whether it meets the ownership requirements, including whether, how, and to what extent, the top-tier entity directly or indirectly owns equity in other foreign corps or domestic entities.
- *A US shareholder can rely on this Safe Harbor No. #1 without having to affirmatively ask any unrelated foreign shareholders in the foreign corp whether they own any interests in US entities to which their stock may be attributed for purposes of determining whether the foreign corp is a CFC—and not having to do this due diligence can greatly reduce compliance costs! ($$$$)*

Revenue Procedure 2019-40: Example of Safe Harbor #1 for Determining CFC Status

- **Facts:** In 2020, USP, a domestic corp, and FP, a foreign corp, invest in FJV, a newly formed foreign corp. USP receives 10% of the single class of stock of FJV, and FP receives the remaining 90%. Assume that FP is not a related person with respect to USP and that FP has no US shareholders. FP owns 5% of a domestic partnership, DPS, with the remainder held by unrelated persons.
- **Analysis**: DPS is an unrelated constructive "US shareholder" with respect to FJV. Because FP is a partner in DPS, DPS is considered to own, under §958(b) and **§ 318(a)(3)(A),** 90% of FJV. Thus, DPS is a constructive US shareholder of FJV, and FJV is a "foreign-controlled CFC" as defined in Rev. Proc. 2019-40.
- **Further assume**: USP inquired of FJV whether FJV is a "CFC."—whether the § 957 ownership test is met. FJV does not report that it meets the §957 ownership requirements; there is no reliable publicly available info that indicates FJV is a CFC; and USP has not received a statement indicating that FJV is a CFC. Furthermore, after making the inquiry of FJV, USP does not have actual knowledge that FJV is a CFC.
- **Analysis:** Because FJV is not a US-controlled CFC and FP is not a "related person" with respect to USP, for purposes of determining if FJV meets the § 957 ownership requirements for CFC status, USP may rely on the SAFE HARBOR described in § 4.02 of Rev. Proc. 2019-40 without inquiring of FP whether FP owns directly or indirectly (under § 958(a)(2)) or constructively owns (under § 958(b)) stock of, or an interest in, a domestic entity.
- **RESULT:** Because there is no reliable publicly available info indicating FJV is a CFC, and USP has not received a statement so indicating, and, after making a good-faith inquiry of FJV, USP does not have actual knowledge that FJV is a CFC, **USP may treat FJV as not meeting the § 957 ownership requirements for CFC status.**
- **If USP turns out to be WRONG and later finds out FJV is, in fact, a CFC-- no penalties will be imposed if Tp was within Safe Harbor #1.**

- Ex. 4 in Rev. Proc. 2019-40



DPS = "unrelated constructive US shareholder"
FJV = a "Foreign Controlled CFC" →→

Revenue Procedure 2019-40 - Safe Harbor No. #2
Safe Harbor for Using "Alternative Information

- General Rule: If the information necessary to accurately calculate Subpart F income and GILTI inclusions (but not Transition Tax amounts) with respect to a CFC is not readily available and there's no § 958(a) direct/indirect US shareholder that is "related" the CFC, an "unrelated § 958(a) US shareholder" generally may determine its inclusion amounts using "alternative information."
- For this purpose, "alternative information" generally means readily available separate-entity financial statements, with certain adjustments.
- Rev. Proc. Provides ordering rules that generally prefer financial statements prepared under U.S. GAAP over all else. But if US GAAP is not available, then the "next best" must be used, which is the following in descending order of preference:
  1. US GAAP
  2. IFRS (International Financial Reporting Standards):
  3. Local-country GAAP;
  4. Audited financial statements over unaudited financial statements; and
  5. Other records used for other tax reporting, regulatory or internal management purposes, but only if the above is not available.
- Alternative information may also be used to comply with Form 5471 reporting requirements of US shareholders with respect to any unrelated foreign-controlled CFCs that do not have related §958(a) US Shareholders.
- NOTE: Alternative information may NOT be used for claiming indirect foreign tax credits.

Rev.Proc. 2019-40 - Safe Harbor No. #3

Safe Harbor for §965 Transition Tax Amounts

- General Rule: IF the info necessary to accurately calculate § 965 Transition Tax amounts with respect to a "specified foreign corporation" (SFC) is not readily available and the SFC is neither:
  - a "foreign-controlled CFC" with respect to which there is a "related § 958(a) U.S. Shareholder" NOR
  - a U.S.-controlled CFC (i.e., a real CFC),
  - THEN an unrelated § 958(a) US Shareholder generally may determine its Transition Tax amounts (but not any Indirect FTCs) using "alternative information."
- However, there are timing limitations: This Safe Harbor No. 3 only applies to amounts reported on a return both due and filed before October 1, 2019 OR a return both due and filed after October 1, 2019.
  - Thus, taxpayers with returns due after Oct, 1, 2019 who filed early (i.e., on or before Oct. 1, 2019) are not able to take advantage of this safe harbor. Nor are those with returns due before October 1, 2019 who file late (i.e., after Oct, 1, 2019).
- Alternative information may also be used to comply with Form 5471 reporting requirements of US Shareholders with respect to any SFC that is neither a "foreign-controlled CFC" with respect to which there is a "related §958(a) US Shareholder" nor a "US-controlled CFC."

Revenue Procedure 2019-40

Other Relief regarding Duty to File Form 5471

- Rev. Proc. 2019-40 also states that IRS intends to narrow the Form 5471 filing obligations for "Category 5 filers" (i.e., US Shareholders who directly, indirectly, or constructively owned stock of the CFC on last day in year on which it was a CFC) in certain circumstances.
- Specifically, fewer of Form 5471's Schedules will be required by a Category 5 filer if either:
  - (i) the filer IS a §958(a) US Shldr and NOT "related" to the foreign-controlled CFC

  OR
  - (ii) the filer is NOT a §958(a) US Shareholder but IS "related" to the foreign-controlled CFC.
- A Category 5 filer that is not a § 958(a) direct or indirect US shareholder (i.e., constructive only) and also not "related" to the foreign-controlled CFC will not be required to file Form 5471 at all!!
- Applicability Dates: Taxpayers generally may apply Rev. Proc. 2019-40 **retroactively** –i.e., to the last taxable year of a foreign corporation beginning before Jan. 1, 2018, each subsequent taxable year of such foreign corporation, and the taxable years of US Shareholders in which or with which such taxable years of such foreign corporation end.

Other §958(b)(4)-Repeal Relief issued on Oct. 1, 2019: Proposed Regs Altering Effects of Downward Attribution Rules

- § 267: Prop. Regs provide that certain payments to foreign related persons eligible for treaty benefits may be deductible when accrued notwithstanding that the foreign related person is a CFC, provided that it has no §958(a) US Shareholders.
- § 332: Prop. Regs deny exchange treatment to a foreign corporation that receives distributions in complete LQ of certain domestic holding companies if the foreign corp is a CFC solely because of § 958(b)(4) repeal, resulting in such distributions being governed by §301 and thus potentially taxable as dividends in whole or in part.
- §367: Prop. Regs expand events that trigger the recognition of gain under GRA rules by providing that §958(b) is to be applied without regard to the repeal of §958(b)(4).
- § 1297: Provide that the asset test for passive foreign investment company (PFIC) status does not need to be determined by reference to the adjusted basis (rather than value) of assets for a non-publicly traded foreign corporation that is a foreign-controlled CFC.

Other §958(b)(4)-Repeal Relief issued on Oct. 1, 2019: Prop. Regs Limiting Downward Attribution (Cont.)

- **§ 672:** Limit the application of certain grantor trust rules to trusts owned by foreign corporations that are CFCs without regard to downward attribution from foreign persons (US-controlled CFCs).

- **§ 706:** In determining a partnership's tax year, disregard partners that are CFCs with no § 958(a) US Shareholders.

- **§ 863:** Limit application of the special CFC sourcing rules for space & ocean income and international communications income to US-controlled CFCs.

- **§ 904:** Limit application of the affiliated group rules in the § 904 active rents and royalties exception and financial services income rules, and certain CFC look-through rules, to US-controlled CFCs.

- **§ 6049:** Reduce the scope of foreign corporations subject to IRS Form 1099 reporting requirements and backup withholding rules by narrowing the definition of "US payor" to include only US-controlled CFCs.

- ***Effective Date.*** Final Regs are proposed to apply on or after Oct. 1, 2019. **However, a Tp can opt to apply the final regs retroactively** to to the last tax year of a foreign corp beginning before 1/1/2018, and each subsequent taxable year and to taxable years of "US shareholders" in which or with which such taxable years of the foreign corporation end.
- ***A taxpayer may rely on these proposed regulations NOW with respect to any period before the date that they are published as final regulations.***

II. C. Role of IRC § 245A 100% DRD

The Partial "Participation Exemption"

IRC § 245A: a limited but important role

- **New § 245A - a limited "participation exemption":** "US shareholders" (as defined in 951(b)) that are C Corps, can deduct 100% of "dividends" received from their CFCs or "specified foreign corporations" is a one-year holding period is satisfied. (HP is 1year within the 2-yr period surrounding ex-dividend date). A "specified foreign corp" is defined as any foreign corporation that has *at least one 10% corporate shlder* that would qualify as a § 951(b) shldr if the foreign corporation were a CFC.
- Not always a benefit, because most E&P of foreign corporations will already have been subject to tax (i.e., "previously taxed E&P" or PTEP).
- **§ 245A can be material factor** for CFCs with large amounts of exempt QBAI. (Indeed, § 245A can work as an incentive for Purchasers to get higher-bases depreciable tangible assets that generate QBAI, because that sliver of notional income can be repatriated tax free.
- Because the § 245A DRD is available to Corporate shareholders (owning at least 10%) of so-called 10/50 corporations, and such non-CFCs cannot generate GILTI, a greater percentage of such 10/50 corporations' earnings may be eligible for the § 245A DRD.
- The 245A DRD is available to 10% corporate shareholders of foreign corporations with respect to:
  - Actual dividends (assuming holding period and other requirements are satisfied);
  - The "All E&P Amount" in § 367(b) transactions
  - The "§ 1248" amount in sales of CFCs (or former CFCs), including lower tier CFCs (or former CFCs), or in cross-border reorgs where the §1248 "deemed dividend" is available.
  - The deemed dividend under § 956, for Earnings Invested in US Property.

II. D. The IRC § 962 Election

The Partial "Participation Exemption"

IRC §962 Election: Benefits & Drawbacks

- Puts non-corporate US shareholders on more equal footing with US corporations, by allowing them to be treated as a US C-Corporation for purposes of Subpart F (including the Transition Tax). Thus, if a US individual or S Corporation elects § 962 (an annual election), that shareholder is entitled to:
  1. The lower US corporate tax rate (presently 21%);
  2. The GILTI deduction under IRC 250 (presently a 50% deduction); AND
  3. An indirect foreign tax credit.

- But making a 962 election does NOT entitle the electing shareholder to:
  1. The 100% Dividends Received Deduction under 245A; OR to
  2. Treat the dividends taken out of the S-corporation or partnership (or foreign corporation if it is not in a qualifying treaty jurisdiction) as "qualified dividends" entitled to the lower capital gains rate.
- **Lesson:** One must MODEL OUT the tax consequences to determine whether making the 962 election would be tax efficient.

IRC §962 Election: Example

- **Assume:** Individual A owns, directly or through a pass-through entity, 00 percent of a foreign services corporation, which pays a 30% rate of foreign income tax. If the foreign company generates $1,000 US of income, that income is first subject to $300 of foreign taxes, then potentially the entire $700 remainder could be currently taxed as GILTI and subject to an additional 37 percent U.S. individual tax rate in the year incurred.
  - Result: The outcome: a current effective tax rate of over 55 percent, regardless of whether the individual owner draws a dividend or reinvests the business' earnings.

- If Individual A elects 962: Individual A will pay tax on his or her pro rata share of GILTI as if he or she were a U.S. corporation—thus at 10.5% (or 50% of the 21% rate due to the 50% GILTI deduction under section 250). Individual may also claim an indirect FTC for any foreign taxes that the foreign corporation has paid. If the foreign tax rate significantly exceeds the 21 percent U.S. corporate rate, the election potentially eliminates the GILTI tax entirely. The foreign entity is now free to reinvest its earnings locally without needing to make a distribution so that the individual can pay additional U.S. taxes.
- However, when the foreign corporation makes a distribution to a US individual (or S-Corp) shareholder that has made a § 962 election, the non-corporate shareholder must pay tax at its normal ordinary rate, but only on the distribution that exceeds the amount of tax previously paid as a result of the § 962 election. (While a distribution from a "qualified foreign corporation" would likely be eligible for the lower rates applicable to qualified dividends, electing 962 does not make it a "qualified corp" or a "qualified dividend.")
- **Result:** If individual A elects §962 for the year, the foreign earnings are now subject to GILTI tax at the deemed-corporate level instead of the individual level. Applying GILTI's rules for corporate indirect foreign tax credits and § 250 deductions, the $1,000 of pre-tax income is eligible for a 50 % deduction ($500and the net income of $500 is subject to a 21% corporate rate.
- A FTC is available of up to 80% of the foreign taxes, or $240 (U.S.). The FTC offsets the full $105 (U.S.) of corporate-level tax and, assuming the foreign earnings are not distributed to the shareholder, there is zero residual U.S. tax in the current year.
- If in a future year those $700 (U.S.) of earnings are distributed, they will be treated as a "qualified dividend "to the shareholder taxable at 20%, for an extra $140 of U.S. tax at the shareholder level. This brings the total worldwide tax liability to $440 U.S. dollars, a much better answer than the $559 U.S. dollars of worldwide tax in the absence of the election. Because of nuances such as differing foreign tax rates and qualified dividend rates only being available with respect to investments in certain countries, the exact differential in tax with and without the election will vary depending upon each fact pattern considered. (Example credit to RSM).

II. E. High Foreign Tax "Kick-Out" Exception to Subpart F Income

IRC § 954(d)(4)

(Really an exception to one category of Subpart F Income)

Other §958(b)(4)-Repeal Relief issued on Oct. 1, 2019: Prop. Regs Limiting Downward Attribution (Cont.)

- **§ 672:** Limit the application of certain grantor trust rules to trusts owned by foreign corporations that are CFCs without regard to downward attribution from foreign persons (US-controlled CFCs).

- **§ 706:** In determining a partnership's tax year, disregard partners that are CFCs with no § 958(a) US Shareholders.

- **§ 863:** Limit application of the special CFC sourcing rules for space & ocean income and international communications income to US-controlled CFCs.

- **§ 904:** Limit application of the affiliated group rules in the § 904 active rents and royalties exception and financial services income rules, and certain CFC look-through rules, to US-controlled CFCs.

- **§ 6049:** Reduce the scope of foreign corporations subject to IRS Form 1099 reporting requirements and backup withholding rules by narrowing the definition of "US payor" to include only US-controlled CFCs.

- ***Effective Date.*** Final Regs are proposed to apply on or after Oct. 1, 2019. **However, a Tp can opt to apply the final regs retroactively** to to the last tax year of a foreign corp beginning before 1/1/2018, and each subsequent taxable year and to taxable years of "US shareholders" in which or with which such taxable years of the foreign corporation end.
- ***A taxpayer may rely on these proposed regulations NOW with respect to any period before the date that they are published as final regulations.***

II. F. High Foreign Tax "Kick-Out" Exception to Subpart F Income

IRC § 954(d)(4)

(Really an exception to one category of Subpart F Income)

Tax Strategies to Reduce Subpart F Income (and GILTI inclusions)
§954(b)(4) – High Tax Kick-Out (HTKO) Exception

- § 954(b)(4) has long provided an exception to both Foreign Base Company Income (§954) and Insurance Income (§ 953). It was not amended by the TCJA—but its function & importance were changed due to its availability for GILTI.
- § 954(b)(4) provides that FBC income shall not include "**any"item of income"** of a CFC that the taxpayer establishes has been subject to an effective rate of income tax of at least 90% of the US corporate rate (which means >18.9%, for years beginning after Jan. 1, 2018—i.e., 90% X 21% rate = 18/9%).
  - Although Code refers to "any item of income," the current HTKO test is actually applied to 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.
    - Newly proposed Regs (TD 9902, published in Fed. Reg. July 23, 2020) would change this and require test be applied to "tested units (which substantially eliminates blending)
- **Post TCJA, the HTKO is one path to true territoriality for certain categories of income because if the exception's prerequisites are satisfied, the income is not includible as either the Subpart F income OR GILTI—*and yet can still be eligible for the § 245A DRD.***
- High taxed income meeting the threshold in § 954(b)(4) is excluded from "tested income" for GILTI purposes. § 951A(c)(2)(A)(i)(III).
- However, the Preamble to the GILTI Regs states that the § 954(b)(4) exception from GILTI only applies to income that is excluded from Subpart F income ***solely*** by reason of the high-taxed exception.
  - Thus, high-taxed income that is eligible for another exception to FBC income, such a the active financing exception or the look-thru rule of § 954(c)(6), would still be GILTI "tested income."
  - Also, income that is high-taxed but would not fall within the general definition of FBC income is also not excluded from GILTI tested income.

§954(b)(4) – High Tax Kick-Out (HTKO) Exception (cont'd)

- **Post TCJA, the HTKO is one path to true territoriality for certain categories of income because if the exception's prerequisites are satisfied, the income is not includible as either the Subpart F income OR GILTI—*and yet can still be eligible for the § 245A DRD.***
- High taxed income meeting the threshold in § 954(b)(4) is excluded from "tested income" for GILTI purposes. § 951A(c)(2)(A)(i)(III).
- **Former debate (prior to release of July 2020 Regs):** the Preamble to the GILTI Regs states that the § 954(b)(4) exception from GILTI only applies to income that is excluded from Subpart F income ***solely*** by reason of the high-taxed exception.
  - Thus, high-taxed income that is eligible for another exception to FBC income, such a the active financing exception or the look-thru rule of § 954(c)(6), would still be GILTI "tested income." Also, income that is high-taxed but would not fall within the general definition of FBC income is also not excluded from GILTI tested income.
  - **UPDATE:** However, the Final GILTI High-Tax Exception Regs (released July 2020) resolve this issue by providing for a separate High Tax GILTI Exclusion, that is independent from the longstanding High Foreign Tax Exception under 954(b)(4), which was available for certain items of Subpart F income.

Tax Strategies
§ 954(b)(4) – High Tax Kick-Out (HTKO) Exception

- **One key to applying 954(b)(4) is Identifying Income that is "High Taxed":** The §954 regulations looked to § 902 (now repealed), which used an E&P "pooling" convention to associate foreign taxes with the income inclusion. This allowed low-taxed income items and higher-taxed income items to be averaged or blended, resulting in more income qualifying for the HTKO Exception.

- **Post TCJA:** with § 902 repealed, and § 960 amended, the pooling convention has been replaced with an annualized tracing convention which requires that the foreign income taxes be "attributable to" the item of income. See § 960(a).

- Recently Proposed Regulations under Code Sec. 960 adopt an annual tax approach that groups Subpart F income according to each of the categories in Reg. §1.954-1(c)(1)(iii); the taxes associated with items of income in the current year are then taken into account as an indirect credit.

- The Proposed FTC Regulations (now FINAL) require each type of FBC income , including sub-categories of § 954(c) FPHCI to be treated as its own group for purposes of the indirect credit under § 960.

- This greater degree of tracing required under § 960 and its Regs is likely to prevent some taxpayers from fully utilizing the HTKO Exception of § 954(b)(4).

Tax Strategies – Example of Pre-and Post TCJA application
§ 954(b)(4) – High Tax Kick-Out (HTKO) under Subpart F

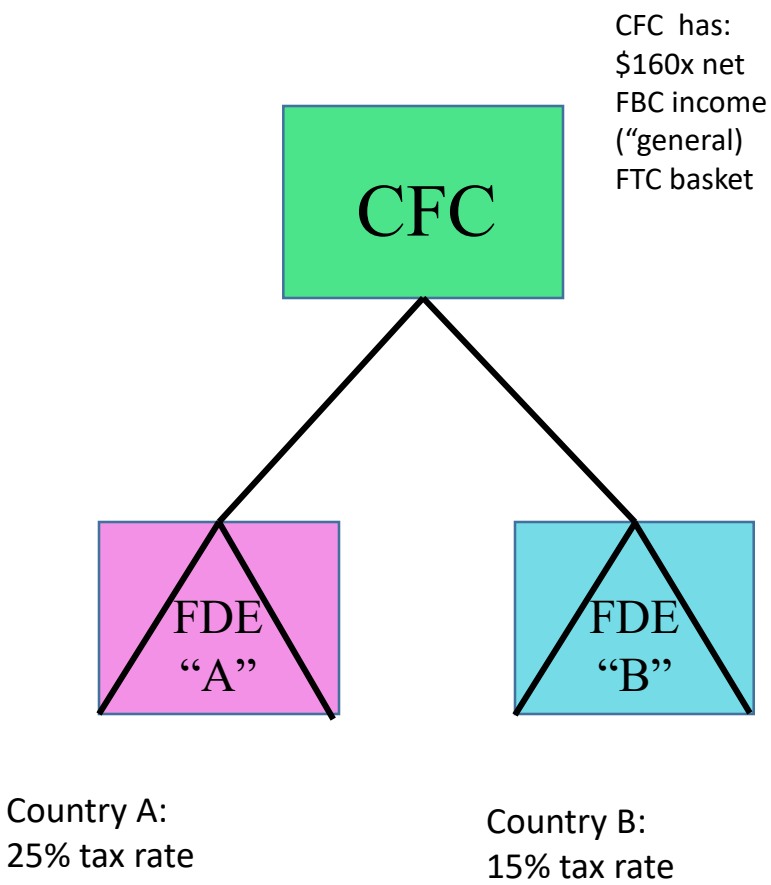
- **Assume:** CFC owns two Foreign Disregarded Entities (FDEs), each of which generates $100X of FBC income. FDE-A is taxed by its home country at 25% . FDE-"B" is taxed at 15%. Assume the CFC as a whole has a combined $160 of net foreign base company income in the general basket and pays $40 of foreign tax.

- **Pre-TCJA:** the two FDEs' income would be averaged for purposes of the high-taxed exception under the § 902 E&P "pooling" convention, and the test would be applied based on the general basket at their blended or averaged tax rate, which would be 20%. (**Thus, both would qualify for the 954(b)(4) HTKO exception if the threshold were 18.9%.)**

- **Proposed Regs:** the treatment depends on whether the FDEs earned the same type of Subpart F income; if both FDEs earned FBC sales income under § 954(d), averaging would be permitted. But if one earned FBC Sales income, and the other FBC Services income under 954(e), or FPHCI income under 954(c**), only the higher 25% rate item would be eligible to be excluded under § 954(b)(4). (No blending!)**

- **In Sum:** Post-TCJA, a lower US corporate tax rate, and thus a lower 18.9% threshold for being "high taxed" (reduced from 31.5%) will make this HTKO Exception more available. But rules against blending (both in the new Final GILTI regulations (and in the Proposed Subpart F High-Tax rules under 954(b)(4)) will limit the High Tax Exception's utility.

- **Update:** **FINAL Regs, published July 23, 2020,** set forth specific rules to qualify for a GILTI High Tax Exception. See Treas. Decision T.D. 9902, Reg. 127732-19.



Proposed Regs (issued June 2019—recently FINAL as of July 2020--proposed to EXPAND availability of the §954(b)(4) HTKO "GILTI Exclusion"

- **Reg. 101828-19, released on Friday, June 14, 2019, among other things, EXPANDED the "GILTI high-taxed exclusion" on an *elective* basis.**

- "In response to comments, the Treasury Department and the IRS have determined that the GILTI high tax exclusion should be expanded (on an elective basis) to include certain high-taxed income even if that income would not otherwise be FBCI or insurance income. ***"

- *Proposed Reg would eliminate the requirement that the income not be eligible for another Foreign Base Company Income exception, but does not mention repealing the pooling convention.*

- Preamble notes that "[t]he legislative history evidences an intent to exclude high-taxed income from gross tested income. See Senate Explanation at 371 ("The Committee believes that certain items of income earned by CFCs should be excluded from the GILTI, either because they should be exempt from U.S. tax—as they are generally not the type of income that is the source of base erosion concerns—or are already taxed currently by the United States…." The proposed regulations, which permit taxpayers to electively exclude a CFC's high-taxed income from gross tested income, are consistent, therefore, with this legislative history.

- Furthermore, an election to exclude a CFC's high-taxed income from gross tested income allows a US shareholder to ensure that its high-taxed non-subpart F income is eligible for the same treatment as its high-taxed FBCI and insurance income, and thus eliminates an incentive for taxpayers to restructure their CFC operations in order to convert gross tested income into FBCI for the sole purpose of availing themselves of section 954(b)(4) and, thus, the GILTI high tax exclusion.

- **Manner of making the Election:** CFC's controlling domestic shareholders make the election by attaching a statement to an amended or filed return in accordance with forms, instructions, or administrative pronouncements. See proposed §1.951A-2(c)(6)(v)(A). If an election is made with respect to a CFC, the election applies to exclude from gross tested income all the CFC's items of income for the taxable year that meet the effective rate test in proposed §1.951A-2(c)(6)(iii) *and is binding on all the U.S. shareholders of the CFC*. See proposed §1.951A-2(c)(6)(v)(B).

- **Effective Date:** Election is effective for a CFC for the CFC inclusion year for which it is made and all subsequent CFC inclusion years of the CFC unless revoked by the controlling domestic shareholders of the CFC. See proposed §1.951A-2(c)(6)(v)(C).

NEW!! Final Regs (published July 23, 2020) adopt the proposed Regs as FINAL "GILTI High Tax Exclusion" Rule

Summary: The final GILTI high-tax exclusion Regs (> 80 pages long) provide that:

- The GILTI High-Tax Exclusion is elected on an ANNUAL Basis.
- When elected by the taxpayer, it operates to xclude from a CFC's gross tested income under IRC §951A income items subject to an effective foreign tax rate that is greater than 90% of the highest corporate rate in effect (i.e., presently that is a rate > 18.95 based on the current 21% corporate tax rate)
- Appears to apply regardless of whether the CFC has "tested income" or a "tested loss." (Thus, a tested loss could be reduced.)
- **"Tested Unit" is the key measurement gui**de: Applies at the level of each "tested unit" of a CFC, substantially eliminating blending of income subject to different rates of foreign tax. Final Regs abandoned the proposed use of "qualified business units" to determine how tax rates should be measured in relation to income.
- Applies to every CFC in which a taxpayer holds, or is treated as holding, a majority equity interest (a CFC group). These rules adopt a § 1504 definition, replacing 80% with 50%.
- Applies generally for tax years beginning on or after July 23, 2020.
- Limited retroactive application: Taxpayers are permitted to apply the election retroactively to any CFC tax year beginning after December 31, 2017, if they apply the final regulations consistently to each year for which the election is made.
- Final Regs refer to the "GILTI High Tax EXCLUSION" and the Subpart F High Tax EXCEPTION.
- To read these Regs: Go to the Federal Register website, and look for T.D. 9902, published July 23, 2020.

NEW!! Companion PROPOSED Regs (published July 23, 2020) address the High Tax Kick-Out Exception of § 954(b)(4)

Summary:

- The companion Proposed Regulations address the Subpart F High Tax Exception. If adopted, they would:
  - Conform the existing Subpart F income HTKO exception to the "GILTI high-tax exclusion" and would apply a single "Unified Election" to both provisions for a tax year. Thus, the proposed regulations addressing the Subpart F 954(b)(4) High Tax Exception would generally:
    - Incorporate the "tested unit" principles of the GILTI high-tax exclusion into the Subpart F income high-tax exclusion (thus limiting "blending" of rates);
    - 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; and*
    - Conform generally to the rules governing the elections (including the requirement to apply the unified election to every CFC in a CFC group)

Final GILTI High Tax Exclusion Regulations (7/2020): Brief Background

- IRC § 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.
  - In the Code, gross "tested income" is a CFC's gross income determined without regard to:
    a. US-source income effectively connected with a US trade or business;
    b. income taken into account in determining the CFC's subpart F income;
    c. dividends received from related persons;
    d. foreign oil and gas extraction income (as defined in IRC Section 907(c)(1)); and
    e. income excluded from subpart F income by reason of the subpart F income high-tax exception.
- Although IRC § 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 for GILTI purposes, Treasury issued proposed regulations in 2019 extending the statutory high-tax exclusion in 951A (and the principles of § 954(b)(4)) to other high-taxed gross tested income items in determining the GILTI inclusion.
- The Proposed GILTI High-Tax Exclusion Regulations were adopted as final, with some modifications. One big change is that the concept of "qualified business unit" was abandoned (after practitioners/commenters claimed it was too complex). Instead, the Final Regs employ the concept called "tested unit" (as defined in the Regs).

Final GILTI High Tax Exclusion Regulations (7/2020): Overview

- 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 IRC 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.

Tax Strategy:
Using the "Current E&P Limit" to Qualify for the HTKO Election

- **Key priority rule:** Rule coordinates the HTKO with the "Current E&P Limitation" and can work to expand the availability of the HTKO Exception. The rule provides that the E&P limitation is applied BEFORE the HTKO Exception. Reg. §1.954-1(d)(4)(ii).

- **EXAMPLE:** Assume a CFC earns $100 of FBC income, and pays $15 of related taxes, and has a loss of ($50) in the non-subpart F category. Under current regulations, the Current E&P limit would be applied first, resulting in net $50 of FBC income and $15 of related taxes. Result: $50 of net subpart F income after the E&P limitation is high-taxed income, and thus eligible for exclusion from Subpart F (and presumably GILTI). See Ex. in former Temp. Reg. §1.954- 1T(d)(4)(ii), TD 8618 (Sept. 6, 1995).

- **In Sum:** By providing that the current E&P limitation reduces both the numerator and denominator of the newly amended §960 credit fraction, the new proposed regulations appear to retain this result from the current regulations.

- Thus, the Current E&P limit, when it applies, appears to augment the foreign tax rate on a CFC's Subpart F income for purposes identifying income that is subject to a sufficiently high rate of foreign tax so a to qualify for the HTKO Exception of § 954(b)(4).

- The Proposed Regulations, published July 23, 2020, would eliminate this ordering rule (and thus the benefits of this tax strategy).

Final GILTI High Tax Exclusion Regulations (7/2020): **Key Take-Aways**

- The GILTI high effective foreign tax rate threshold adopted by the Final Regs will be difficult to meet for most taxpayers. (Many countries' effective tax rates do not exceed 18.9%.) This is especially true as it applies to each tested unit of a CFC.

- A LOT of careful modeling will be required to determine the extent to which the new GILTI High Tax Exclusion will, if elected, actually result in a reduction of a taxpayer's GILTI inclusion (for current year, 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 come as a surprise to many practitioners and 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 proposals, if they become Final Regulations.

IV. Foreign Tax Credit Considerations Related to Subpart F and GILTI

An Overview of Tax Stakes

and

Recent Developments

Subpart F v. GILTI?
Foreign Tax Credit Considerations: Background

- The policy underlying the US foreign tax credit (FTC) is to prevent US taxpayers from being subject to double juridical taxation on their foreign-source income. However, if the foreign taxes exceed the US taxes, there is no "refund."

- The general "foreign tax credit" limitation under Section 904 is calculated separately for various categories of foreign-source income. The § 904 FTC Limitation is computed separately for each income category (or "baskets").
  - "General income" basket allows for some "blending" of income in that catch-all category.
  - "Passive income basket": Passive income and losses must be grouped, and foreign taxes on passive income go into a separate "passive income" basket.
  - TCJA added 2 new separate income categories: Foreign Branch income and GILTI
  - Subpart F income may be in several baskets—including the "General Basket" (allowing for some blending). The § 904 imitation is generally determined separately with respect to each category:

$$\text{FTC Limitation} = \frac{\text{Foreign-source income in the category}}{\text{World wide Income}} \times \text{US Tax before the FTC}$$

- The numerator of the § 904 limitation in formula above incudes foreign-source income subject to U.S. income tax reduced by deductions allocated or apportioned to the income under §§ 861- 865.

- So expense allocation is VERY important to determining the overall effects of the FTC rules, and have been hotly debated for decades—particularly the interest expense allocation rules.

- If the allocation and apportionment of the deductions results in an overall loss in one or more categories, the separately computed losses will be allocated against net income in other categories, if any. When a net loss offsets net income of a different category, various loss recapture rules may be apply.

Subpart F v. GILTI?
Foreign Tax Credit Considerations

- The Subpart F rules have proven to be largely "manageable" in that Subpart F inclusions can often be avoided. (Many international tax professionals have spent their careers becoming super adept at structuring transactions so as to avoid Subpart F income inclusions.
- But post-TCJA, it is often tax efficient to "plan into" Subpart F (to avoid imposition of GILTI)—often due to the following foreign tax credit differences.

	Subpart F	GILTI
Inclusion Tax Rate	21% - 40.8%	10.5% - 40.8%
FTC Basket	"General Basket" ?? (some X-crediting may be available)	"GILTI Basket" (no cross crediting with other baskets)
% of Foreign Tax allowed to be credited	100%	80% max
Excess FTC Carryovers	Back 1 year; Forward 10 years	NO carryovers "Use it or Lose it"

Key Considerations (other than foreign entity selection): Comparing U.S. international tax regimes' statutory tax rates and limits on foreign tax credit utilization

	Offshore				Onshore		
	§245A DRD	§951(a) Subpart F	§951A GILTI	Foreign branch	§956 Invest US property	§250 FDII	Non-FDII
Effective rates (%)	0	21	10.5	21	21	13.125	21
Foreign tax credits (%)	None	100%	80%	100%	100%	100%	100%
FTC Carryforward	None	10-yrs	None	10-yrs	10-yrs	10-yrs	10-yrs
Other	Creates exempt income/ partially exempt asset For corps, PTI generally means little 245A	GL or passive	Separate Basket	Separate Basket	Converts Exempt Income Multiple year FTCs?	Most income U.S. source – no FTCs	Most income U.S. source – no FTCs Avoid/ get in FDII

Subpart F v. GILTI?

Foreign Tax Credit FINAL Regulations (T.D. 9882 – Dec. 2, 2019)

- The 2017 TCJA made numerous changes to the foreign tax credit rules:
  - It implemented the 100% DRD under Section 245A,
  - It added new FTC categories (foreign branches and GILTI) and repealed FTC "pooling" under § 902.
  - The enactment of GILTI now requires taxpayers to compute a foreign tax credit much more frequently. GILTI also increases the complexity of such calculations.
- Final FTC Regs largely retain the basic approach of the 2018 proposed FTC Regs (with some changes). They do not simplify the existing rules (Final Regs are hundreds of pages long). Here are some highlights:
- **No "Free Pass" for GILTI Income:** Final FTC Regs continue to require deductions be allocated and apportioned to all foreign tax credit categories, ***including GILTI.*** Preamble notes that Treasury considered comments requesting exemptions from expense allocation to GILTI, but ultimately concluded that such an exemption is not consistent with the legislative intent of Section 951A. (But the concurrently issued Proposed FTC Regs do offer some relief, precluding the allocation of certain R&E expenses to GILTI.)
- **Treatment of Exempt Income & Exempt Assets**: The Final FTC Regs provide that under § 864(e)(3), GILTI income offset by the §250 deduction will be "exempt income" and a percentage of the CFC stock that generates GILTI income will be an "exempt asset." Accordingly, exempt treatment will generally reduce the allocation and apportionment of deductions to GILTI income (particularly interest expense allocations), which tends to increase the GILTI FTC (by not reducing the numerator of the § 904 fraction).
- **Statutory Groupings of CFCs:** The Final FTC Regs adopt the complex rules in the original 2018 proposals that characterize the stock of certain CFCs, but clarify that for purposes of the various statutory groupings, the U.S. shareholder must use the same method (either the "asset method" or "modified gross income method") that the CFC uses to apportion its interest expense.

Subpart F v. GILTI?
Final FTC Regs "Highlights" (continued)

- **One-time exception to the 5-year binding election period retained:** The rule allows taxpayers to switch between the gross income or sales method for R&E expense allocations.
- **Section 250 deduction – allocation and apportionment:** Final FTC Regs provide separate rules for the portion of the § 250 deduction that pertains to FDII and that pertains to GILTI.
- **Assignment of dividends and related expenses to a new § 245A subgroup**. The dividends and deductions assigned to the § 245A subgroup are disregarded for purposes of the § 904 limitation. Disregarding expenses assigned to the § 245A subgroup may, in effect, increase the GILTI FTC available in certain circumstances.
- **Retention of transition rule allowing FTC carryforwards in general basket to offset post-2017 foreign branch basket in some circumstances.** IRS also provides a simplifying safe harbor.
- **New Foreign Branch income category under § 904(d)(1)(B) retained (from the proposals):** These rules provide guidelines for adjusting gross income including rules that provide disregarded transactions between a foreign branch and its owner, or between foreign branches, are considered regarded for purposes of re-determining whether gross income should be attributable to a foreign branch or its owner. The Final FTC Regs modify & clarify some aspects of these rules, including treatment of intangibles, disregarded payments, and the scope of what constitutes a trade or business.
- **List of the PTEP groups is updated** in Reg. § 1.960-3 to include 10 PTEP groups. (The IRS intends to issue more comprehensive regulations addressing the maintenance of annual PTEP accounts and the PTEP groups in a separate notice of proposed rulemaking under § 959.)

Subpart F v. GILTI?

Final FTC Regs "Highlights" (continued)

Foreign Tax Redeterminations: The final regulations provide that, if a foreign tax redetermination occurs with respect to foreign tax claimed as a direct credit, then a redetermination of U.S. tax liability is required for the taxable year in which the credit was claimed and any year to which unused foreign taxes from such year were carried under §904(c).

The final regulations include several clarifying changes to what constitutes a foreign tax redetermination, revising the definition to include:

- Accrued taxes that are not paid on or before the date 24 months after the close of the taxable year to which such taxes relate (clarifying the prior rule that referred to two taxable years)
- Adjustments such as a correction to an accrual that determined the tax due with reasonable accuracy, but is revised after additional consideration to reflect the correct final tax liability
- Any tax that is claimed as a credit or added to previously taxed E&P (PTEP) group taxes is subsequently refunded, regardless of whether the tax was properly treated as paid when claimed as a credit or added to PTEP group taxes.

- **One obvious takeaway:** The Final FTC Regulations (Dec. 2019) make the FTC computations much more complex...in part owing to GILTI.

Subpart F vs. GILTI: Strategies for U.S. Companies After Tax Reform and New Foreign Tax Credit Rules

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Introduction

- Historically, U.S.-based shareholders of foreign corporations have largely deferred tax on income earned directly by the foreign corporation if not repatriated to them
  - The primary exception to this deferral ability has been Subpart F, imposing immediate tax on of specified income items earned by the foreign corporation
- With implementation of GILTI, the ability to defer income earned by foreign corporations has been reduced significantly
  - This has shifted the calculus for how foreign operations should be conducted – both as to whether corporate status for a foreign entity is appropriate and whether the Subpart F regime – long avoided by U.S. shareholders – is preferable to GILTI exposure

United States Taxpayers – Taxation of Foreign Transactions

- United States generally subjects domestic entities to tax on a worldwide basis
  - Looks to residence of entities (place where created/organized) for jurisdiction to tax on all income from any source
  - Credits applicable to taxes paid to foreign countries on foreign-sourced income
- Numerous options exist for structuring transactions of a United States-domiciled business overseas
  - Where activities are undertaken through a branch or flow-through entity, income goes directly to the parent entity for United States tax purposes

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United States Taxpayers – Taxation of Foreign Transactions

- Activities of foreign corporations (including foreign subsidiaries) have historically been exempt from U.S. tax, subject to exceptions
  - System incentivized income-shifting efforts in order to delay U.S. tax imposition
    - Could hope for a repatriation holiday which allowed funds to come back for a reduced tax rate
    - Historically, the primary exception has been Subpart F, though others – like the passive foreign investment company rules – also existed
  - Under the Tax Cuts and Jobs Act, there is a shift in the tax of foreign subsidiary distributions, but an increase in anti-deferral mechanisms

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Foreign Entities – Entity Classification

- Foreign-domiciled entities generally are able to elect their classification for United States tax purposes
  - EXCEPTION: Per-se corporations (as listed in the Regulations)
    - Per-se corporations automatically classified as corporate for U.S. tax purposes
    - Entity list: Regs. Sec. 301.7701-2(b)(8)
  - Default rules for classification exist, and hinge on the limited liability of owners/members
    - If limited liability for all stakeholders – association taxable as a corporation
    - If no limited liability for at least one stakeholder – partnership if multiple members, disregarded entity if one

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Foreign Entities – Subpart F Income

- Subpart F imposes a direct tax on a U.S. shareholder of a controlled foreign corporation ("CFC") as to the CFC's Subpart F income
  - Tax imposed directly on U.S. shareholder, regardless of whether distributions of income are made to the shareholder
    - Provides a method for the United States to disincentivize transactions improperly sourcing income to foreign jurisdictions
  - For future distributions which previously were taxed under Subpart F, Sec. 959 prevents double taxation of the same income
    - For non-Subpart F income, income is taxed by the United States once distributions (usually dividends) are made to the U.S. shareholder

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Foreign Entities – Subpart F Income

- Threshold requirements must be met for Subpart F regime to apply
  - Requirements: look to (1) whether a U.S. shareholder exists, (2) whether there is a CFC, and (3) whether the CFC has Subpart F income
    - U.S. shareholder – United States person owning at least 10% of the foreign corporation's voting stock *or* value
      - TCJA modification – under prior rules, only voting interests were considered
        - Functional impact: United States persons with significant equity but no voting interest are now classified as U.S. shareholders
    - Controlled foreign corporation exists if on any day during a given year U.S. shareholders own more than 50% of the stock of the foreign corporation

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Foreign Entities – Subpart F Income

Subpart F income is primarily comprised of “movable income” – income that can be shifted to foreign jurisdictions more easily

- Foreign base company income is typically the largest component of a foreign corporation’s Subpart F income
  - Includes foreign personal holding company income, foreign base company sales income, foreign base company services income, etc.
    - Foreign personal holding company income: dividends, interest, rents, royalties, annuities
      - Also includes certain net gains from sale of property which generates passive income
      - Exceptions exist (i.e. rents not included if resulting from an active trade or business)

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Foreign Entities – Subpart F Income

- Foreign personal holding company income (FPHCI): dividends, interest, rents, royalties, annuities
  - FPHCI also includes net gains both from the sale of property which generates passive income *and from the sale of property generating no income prior to sale*
    - Additional FPHCI inclusions: foreign currency net gains, commodities transactions, income from notational principal contracts
  - Exceptions exist (i.e. rents not included if resulting from an active trade or business)
  - Distributive share of income earned by a CFC from a flowthrough entity also subject to Subpart F inclusion (as if earned directly by the CFC)

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Foreign Entities – Subpart F Income

Foreign base company sales income - CFC buys or sells tangible personal property from/to a related person where property is manufactured/produced outside the CFC's country of incorporation and purchased/sold for use outside the country of incorporation

- Person is a related person if they control/are controlled by the CFC or are a entity which is controlled by the same persons who control the CFC
  - Control generally classified as a >50% interest

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Foreign Entities – Subpart F Income

Foreign base company services income - income from personal services performed for/on behalf of any related person and performed outside the CFC's country of organization

- Compensation, commissions, fees, etc. derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial services
- For both foreign base company sales income and foreign base company services income, look to activities outside the corporation's country of domicile and the transactions with related persons

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Foreign Entities – Subpart F Income

Tax Cuts and Jobs Act made significant modifications in Subpart F context

- U.S. shareholder definition changed – pre-TCJA, only looked to voting power (rather than value)
- Sec. 958(b)(4) repealed – previously prevented "downward attribution" for U.S. shareholder/CFC purposes
  - Post-TCJA, can now have attribution of a foreign subsidiary owned by a foreign parent to a U.S. subsidiary!
    - Importantly, Subpart F inclusion occurs only to the extent of direct ownership and stock indirectly held via foreign entities under Sec. 958(a)

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Foreign Corporations - GILTI

- Under Sec. 951A, U.S shareholders of a controlled foreign corporation must include their share of global intangible low-taxed income in US tax
  - U.S. shareholder and controlled foreign corporation concepts mirror Subpart F
    - GILTI inclusion treated similarly to Subpart F in many ways, but not technically a component of Subpart F
  - **50% deduction available for GILTI, but ONLY for C-Corporations!**
    - Makes the effective tax rate for corporate shareholders 10.5%
    - For non-corporate U.S. shareholders, rate can be 37%

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Foreign Corporations - GILTI

- GILTI Application
  - Functionally, GILTI essentially is tax imposed on U.S. shareholders of a CFC on the excess of an assumed 10% rate of return on tangible business assets of the CFC
    - GILTI imposes a minimum tax on foreign earnings that exceed a standard rate of return amount
  - GILTI: Excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return
    - Need to determine (1) net CFC tested income and (2) net deemed tangible income return

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Foreign Corporations - GILTI

- GILTI Application
  - Net CFC Tested Income: aggregate of U.S. SH's pro rata share of the tested income of each of their CFCs over the aggregate of the U.S. SH's pro rata share of the tested loss of each CFC
    - Tested income – excess of gross income from the CFC (subject to exclusions) over deductions properly allocable to that income
      - Income excluded includes effectively connected income and Subpart F income
      - Tested loss: excess of deductions properly allocable to a CFC's income over gross income
  - No direct reference to intangibles is made in Sec. 951A
    - Aim may have been intangible income, but application will be significantly more far-reaching, and not limited to one type of income (i.e. movable income)

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Foreign Corporations - GILTI

- GILTI Application
  - Net Deemed Tangible Income Return: excess of 10% of the aggregate of U.S. SH's pro rata share of qualified business asset investment (QBAI) of each CFC
    - QBAI - average of the CFC's aggregate adjusted bases in specified tangible property used in a trade or business of the corporation and of a type with respect to which a deduction under Sec. 167 is allowable
      - Computed quarterly; adjusted basis determined using the alternative depreciation system

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Foreign Corporations - GILTI

- GILTI Application
  - Application of GILTI leads to significant change in immediate inclusion scope for U.S. shareholders of foreign corporations
    - For foreign corporations with limited tangible business assets, GILTI is largely unavoidable, and creates current U.S. tax inclusion for CFC income for U.S. SHs
      - GILTI can be mitigated through C-corporation deduction; individuals/non-corporate entities not eligible, however
        - Sec. 962 election can be beneficial, but not a complete elixir

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GILTI – Regulatory Guidance

- GILTI regulations were proposed in 2019, and made final on July 20, 2020
  - Biggest takeaway is inclusion of a “high-tax exclusion” for CFC income earned by foreign corporations
    - For income subject to tax at an effective foreign rate greater than 18.9%, no GILTI inclusion occurs if taxpayer makes required election
      - Generally applied to the gross income of a CFC attributable to a “tested unit”
  - *Applicable to tax years beginning on or after December 31, 2017*
    - Can be applied retroactively!

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GILTI – Regulatory Guidance

- GILTI high-tax exception excludes CFC income from GILTI calculation on which a foreign tax is imposed at a rate greater than 90% of the U.S. corporate rate
  - Determinations of foreign tax rates looks to tested units, as determined by the CFC – tested units include (1) CFCs, (2) interests in a passthrough entity held (directly or indirectly) by the CFC (if meeting requirements), and (3) specified branches (or portions thereof) the activities of which are carried on by the CFC
    - Interests in passthroughs are included if (a) the passthrough is a tax resident of a foreign country or (b) if the passthrough is not subject to tax as a resident, but is treated as a corporation for purposes of the CFC's tax law
    - Branches included if either (a) the branch gives rise to a taxable presence in the country in which the branch is located or (b) the branch gives rise to a taxable presence under the owner's tax law, and the owner's tax law provides an exclusion, exemption, or other similar relief (such as a preferential rate) for income attributable to the branch
  - Combination rule applies to tested units resident of the same jurisdiction

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GILTI – Regulatory Guidance

- Once tested units are determined, income items of the CFC are attributed to the tested units ("tentative gross tested income item")
  - CFC's deductions and foreign taxes paid are allocated and apportioned tested units ("tentative tested income item")
    - Effective foreign tax rate is then computed by dividing the amount of foreign tax by the amount of the income item itself (grossed up for taxes paid)
      - If rate exceeds 90% of U.S. corporate rate, the income is excluded from the GILTI computation

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GILTI – Regulatory Guidance

- High-tax exception election made by the controlling domestic shareholder(s) of the CFC
  - Either the CFC's U.S. shareholders owning more than 50% of the CFC or, if none, all of the CFC's U.S. shareholders
    - If a controlling domestic shareholders owns a >50% interest in multiple CFCs, she must make the high-tax exclusion election for all such CFCs or for none
  - Elections made on a timely filed return or within 24 months of the original due date for the return (without extensions)

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