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KPMG report: Initial impressions about final and proposed regulations, high-tax exception under GILTI and subpart F

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The U.S. Treasury Department and IRS yesterday, July 20, 2020, released for publication in the Federal Register final regulations (T.D. 9902) related to the "global intangible low-taxed income" (GILTI) high-tax exception[1] (the "final GILTI high-tax exception") and proposed regulations (REG-127732-19) which would establish uniformity between the historic subpart F high-tax exception in section 954(b)(4) and the final GILTI high-tax exception by providing for a single high-tax exception.

Read the **final regulations** [PDF 434 KB] (30 pages as published in the Federal Register)

Read the **proposed regulations** [PDF 418 KB] (26 pages as published in the Federal Register)

Below is a description of the key provisions of the final regulations and the proposed regulations. In a future release, KPMG will provide a more detailed analysis of these regulations, including key insights and observations.

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[1] The final regulations use the term "exclusion" rather than "exception." However, the proposed regulations use the word "exception" for the single high-tax exception provided therein. For ease of understanding, the word "exception" is exclusively used herein.

Initial impressions

The final regulations finalize the proposed regulations under section 951A that were published on June 21, 2019 ("2019 proposed regulations") in respect of high-taxed tested income. The final regulations largely adopt the framework of the 2019 proposed regulations, with certain key departures described below. The most significant departures are that an election to apply the GILTI high-tax exception may be made annually instead of once every five years, and that the calculation is made with respect to each "tested unit" (as defined below) of a controlled foreign corporation (CFC), rather than on a qualified business unit (QBU)-by-QBU basis.

As initially proposed in the 2019 proposed regulations and finalized in these final regulations, significant differences exist between the final GILTI high-tax exception and the subpart F high-tax exception. This could significantly increase the complexity of already complex rules and, as noted by Treasury, could potentially incentivize taxpayers to engage in uneconomic tax-planning to convert income that would otherwise be tested income into subpart F income in order to take advantage of the disparities in the two rules. In order to achieve a measure of simplification and to reduce incentives for uneconomic planning, the proposed regulations would provide a single unified high-tax election for both subpart F income and tested income pursuant to which the existing subpart F high-tax exception would be largely conformed to the final GILTI high-tax exception. The proposed regulations also include a number of additional revisions to the final GILTI high-tax exception. Because the proposed regulations would provide for a single election under section 954(b)(4) for both subpart F income and tested income, the proposed regulations would remove the final GILTI high-tax exception from Reg. § 1.951A-2(c)(7) as promulgated by these final regulations and replace it with a single high-tax exception in Reg. § 1.954-1(d). However, much of the substance of the unified election mechanism contained in the proposed regulation is unchanged from the GILTI-specific election provided in the final regulation.

Applicability dates and reliance

The final regulations generally apply to tax years of foreign corporations that begin on or after July 23, 2020, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. In addition, taxpayers can rely on the final regulations for tax years of foreign corporations that begin after December 31, 2017 and before July 23, 2020 and to tax years of U.S. shareholders in which or with which such tax years of the foreign corporations end, provided they consistently apply the final regulations to each year in which they elect to apply the GILTI high-tax exception. The ability to retroactively apply the GILTI high-tax exception was not included in the 2019 proposed regulations. Any taxpayer seeking to apply the GILTI high-tax exception retroactively should pay special attention to the rules and deadlines prescribed by the final regulations for making a high tax election on an amended return.

The proposed regulations relating to the single high-tax exception generally apply to tax years of CFCs beginning on or after the date the regulations finalizing the proposed rules are filed with the Federal Register. A rule relating to the carryover of subpart F recapture accounts (described below) is proposed to apply to tax years of a foreign corporation ending on or after July 20, 2020. Taxpayers are not provided any election or other opportunity to apply the proposed regulations prior to their general applicability dates.

The final GILTI high-tax exception and the proposed single high-tax exception

The final regulations make a number of modifications to the substantive rules and election procedures described in the 2019 proposed regulations in respect of the GILTI high-tax exception but also declined to make some changes requested by commenters. Separately, the proposed regulations would revise certain of these final rules in promulgating the single high-tax exception. This report describes general changes made to the 2019 proposed regulations by the final regulations, and, where relevant, also notes further changes that would be made to these final rules in the proposed regulations below. Where a rule included in the final regulations with respect to the final GILTI high-tax exception is generally unchanged in the proposed regulations, it should be understood to apply in the final regulations in respect of the single high-tax exception.

Threshold rate of tax

Treasury received several comments requesting that the effective rate of foreign tax that must be met to satisfy the GILTI high-tax exception be reduced to 13.125% on the basis of the discussion of the legislative history to the GILTI regime. Treasury rejected these comments on the basis of the statutory directive in section 954(b)(4) that the effective rate of foreign tax be greater than 90% of the highest rate in section 11 (21%), which currently is 18.9%. Consistent with the 2019 proposed regulations, the effective rate of foreign tax is determined as the U.S. dollar amount of current year foreign income taxes paid or accrued with respect to a "tentative tested income item" (defined below), over the sum of the U.S. dollar amount of the tentative tested income item and the amount of foreign income taxes paid or accrued with respect to the tentative net tested income item.

Negative or undefined tax rates under the proposed regulations

In certain instances, the effective tax rate may result in a negative number or a "divide by zero result." Such could be the case where the tested item of a tested unit has foreign taxes apportioned to it (according to the process described below), but the item of income itself is negative or zero because deductions apportioned to the gross item of income exceed the gross income itself. In such a case, the high-tax exception is deemed satisfied with respect to such tentative net item under the proposed regulations. The final regulations contain no rule addressing this situation. Comments are requested as to any case in which this may not be appropriate.

Comments received in respect of determining effective rate of foreign tax

Consistent with the 2019 proposed regulations, the final regulations provide that the amount of foreign taxes relevant to the final GILTI high-tax exception derives from current year foreign taxes (as paid or accrued under U.S. federal income tax principles rather than foreign tax principles). Timing differences in the recognition of the income and the accrual of the foreign taxes can therefore result in foreign taxes accruing in a separate year than the related income under U.S. tax principles for purposes of applying the GILTI high-tax exception. Treasury received comments requesting alternative methodologies that would alleviate this potential mismatch. This comment was rejected on the basis of the plain language of the statute and concerns over the administrability of such a standard.

Overview of the mechanics of the final GILTI high-tax exception

Much like the historic subpart F high-tax election, the final GILTI high-tax exception involves a multiple step process in which gross tested income of a CFC is first assigned to gross tested income items of the tested units of a CFC to arrive at "tentative gross tested income items." From there, deductions of the CFC are allocated and apportioned to each tentative gross tested income item to arrive at "tentative tested income items." Current year foreign taxes are allocated and apportioned to the tentative tested income items and the foreign effective tax rate is determined by dividing the U.S. dollar value of the current year foreign taxes apportioned to the tentative tested income items by the sum of the U.S. dollar value of the tentative tested income item and the foreign taxes thereto apportioned.

Determination made based on "tested unit" rather Than QBU

The 2019 proposed regulations determined whether income was eligible for the GILTI high-tax exception on a QBU by QBU basis. More specifically, the determination was made separately with respect to all of the income that otherwise would be gross tested income (but for the election) that falls within a single section 904 category and that is attributable to a single QBU. The final regulations revise the rules to apply based on "tested units" of a CFC rather than QBUs. In general, the "tested unit" concept aims to identify an entity, or subset of activities thereof, that is/are actually subject to tax of a foreign country as either a tax resident or a permanent establishment (or similar taxable presence) therein. The definition of a tested unit aims to isolate income that is expected to be taxed in a given foreign jurisdiction. As such "tested unit" is not just a CFC itself, but also includes, for example, certain interests in pass through entities that are tax residents in a foreign country as well as branches that have a taxable presence where located. The definition of "tested unit" is complex and is not limited to the foregoing examples.

Same country aggregation

The 2019 proposed regulations did not allow for the aggregation of QBUs, including QBUs that were in the same foreign country. In response to comments, the final regulations generally allow a CFC's tested units that are tax residents, or (in the cases of certain branches) located in the same foreign country to be combined for purposes of determining whether the combined income is eligible for the GILTI high-tax exception. Under an exception, a foreign branch without a taxable presence in its foreign jurisdiction is not included in the aggregation rule as it is not likely to be subject to tax therein. The aggregation rule applies only to tested units of a particular CFC; there is no aggregation for tested units of commonly controlled CFCs.

De minimis aggregation under the proposed regulations

Where a CFC has tested units the gross income of which is less than the lesser of 1% of the CFC's gross income or $250,000, the proposed regulations provide a rule that would combine such tested units. Such a rule would provide a limited form of blending of effective tax rates where it applies. This rule would apply only after the same country aggregation rule.

"Tentative gross tested income"

Once the tested units of a CFC have been determined, the tentative gross tested income of each tested unit must then be determined. Much like the historic subpart F high-tax exception, the first step in arriving at the net tested income item to which the test is to be applied is to calculate the gross amount of income that comprises the "tentative tested income item". Consistent with the 2019 proposed regulations, items of gross income of a CFC are attributed to the CFC's tested units to the extent they are properly reflected on the separate "books and records" (as defined in Reg. § 1.989(a)-1(d)) of the tested unit. Tentative gross tested income of a tested unit is adjusted to take into account disregarded payments made between tested units of the CFC under the principles of Reg. § 1.904-4(f)(2)(vi) (the disregarded reallocation transaction rules that apply in determining an entity's foreign branch basket gross income for section 904 purposes, or, the "DRT rules"), subject to a number of important modifications (such as in connection with interest payments). Finally, the rules state that an item of gross tested income can be attributed to only one tested unit, and provide that where an item of tested income is attributed to multiple tested units in a tier of tested units, the item is treated as attributable only to the lowest-tier tested unit. For example, if an item is reflected on the books and records of a lower-tier tested unit, as well as the books and records of an upper-tier tested unit that owns it, the item is considered to be attributable only to the lowest-tier tested unit.

The proposed regulations provide significant modifications to the definition of items of income in applying the unified high-tax election. Items of income continue to be calculated on a tested unit basis. Because the high-tax election applies to both tested income and subpart F income of a tested unit to the same extent under the proposed high-tax election, general category tested income and subpart F income of a single tested unit would no longer be grouped separately, but instead would be aggregated into a single item of income. The historic grouping rules for passive foreign personal holding company income would be retained. Further, certain items of gross income related to equity interests held by a tested unit are segregated into a separate item of income (equity gross items) rather than grouped with other general category income.

Separate books and records and "applicable financial statement"

As mentioned above, for purposes of determining the effective tax rate, gross income generally is attributable to a tested unit to the extent the gross income is properly reflected on the books and records (as defined in Reg. § 1.989(a)-1(d)) of the tested unit. The proposed regulations would replace the use of "books and records" with the "applicable financial statement". The applicable financial statement that applies for a given tested unit is based on a hierarchy of financial statements that may be available for a tested unit; a given financial statement is used only if none of the higher priority financial statements are available. Under this definition, the most preferred applicable financial statement is an audited separate-entity financial statement that is prepared in accordance U.S. GAAP. The proposed regulations contain certain anti-abuse rules that can adjust the items of gross income on an applicable financial statement where they apply.

Adjustments for the use of net operating losses (NOLs) for foreign tax purposes

One commenter requested that the proposed rules be revised to take into account for purposes of calculating foreign effective tax rate NOLs carryovers that are deducted for foreign tax purposes. Treasury declined to adopt this comment on the basis of complexity and administrability.

"Tentative tested income item"

A tentative tested income item of a tested unit is calculated under the final regulations by allocating and apportioning current year deductions of the CFC to the tentative gross tested income item under the principles of Reg. § 1.960-1(d)(3) (the rules which provide for the calculation of net income in an income group for purposes of calculating taxes deemed paid with respect to an inclusion, if any, resulting from such income group) in which each tentative gross tested income item is treated as a statutory grouping and all other income is treated as in the residual income category.

The proposed regulations introduce significant changes into the allocation and apportionment of deductions solely for the purpose of arriving at tentative net items. Under the proposed regulations, tentative net items are arrived at by allocating and apportioning deductions to the gross income items of a tested unit to the extent those deductions are reflected on the applicable financial statement of the tested unit (a "booking" approach). This approach generally better aligns the calculation of a tentative net item with the amount of income that is included in the foreign tax base with respect to the tested unit. This rule applies solely for purposes of applying the high-tax election, although the preamble notes that Treasury and the IRS are considering whether it may also be appropriate in the calculating of deemed paid credits and GILTI inclusions generally, or to a more limited extent to achieve more consistent results between the high-tax election and these other calculations. For example, it is noted that it is inappropriate for a deduction apportioned to a net income item that qualifies for the high-tax election to also be apportioned to another item of income that does not so qualify in determining a U.S. shareholder's GILTI inclusion.

Allocating and apportioning foreign taxes to a "tentative tested income item"

Consistent with the 2019 proposed regulations, the final regulations provide that foreign taxes relevant to determining whether an item of subpart F income or tested income qualify for the respective high-tax exceptions are determined at the CFC-level pursuant to "properly attributable" standard set forth in Reg. § 1.960-1(d). Under the final regulations, foreign taxes are generally allocated and apportioned to tentative tested income items under the principles of Reg. § 1.960-1(d)(3), by treating each tentative gross tested income item as assigned to a separate tested income group. As a result, the principles of Reg. § 1.904-6(a)(1) generally apply to allocate and apportion foreign income taxes to a tentative gross tested income item. However, the principles of Reg. § 1.904-6(a)(2) are applied, in lieu of the principles of Reg. § 1.904-6(a)(1), to associate foreign taxes with income in the case of disregarded payments between tested units.

Consistency and procedural requirements of the high-tax exceptions

Commonly controlled CFCs

As in the 2019 proposed regulations, the election, if made, applies to all commonly controlled CFCs that meet the effective tax rate test. The final regulations provide new "CFC group" rules for purposes determining the CFCs subject to this requirement. For this purpose, a CFC group is defined by cross-reference to the affiliated group definition in section 1504(a) without the exclusion of foreign corporations (and certain other entities) from the definition of includible corporations and with certain modifications including a revision to determine a CFC group based on "more than 50 percent" of the voting power and value (rather than at least 80%, as in section 1504(a)) and section 1504(a)(2)(A) is applied by substituting "or" for "and." Modified constructive ownership rules under section 318(a) are applied in making this determination. The determination of whether a CFC is included in a CFC group is made as of the close of the CFC inclusion year of the CFC that ends with or within the tax years of the controlling domestic shareholders. Special rules are provided to determine whether a CFC is a member of a given CFC group where it may otherwise appear to qualify as a member of more than one CFC group and where the potential members of a CFC group or controlling domestic shareholders have different U.S. tax year-ends.

"Controlling domestic shareholders" of a CFC generally means the U.S. shareholders who, in the aggregate, directly or indirectly (but not constructively) own more than 50% of the total combined voting power of all classes of the stock of such foreign corporation entitled to vote and who undertake to act on its behalf. If U.S. shareholders of the CFC do not, in the aggregate, directly or indirectly own more than 50% of the total combined voting power of all classes of the stock of such foreign corporation entitled to vote, the controlling U.S. shareholders of the CFC are all those U.S. shareholders who own (within the meaning of section 958(a)) stock of such corporation.

Year-by-year election

Under the 2019 proposed regulation, once made, an election applied for all subsequent tax years unless it was revoked. The final regulations provide that the election is made on an annual basis. As in the 2019 Proposed Regulations, the election is made by the controlling domestic shareholders, which can include U.S. domestic partnerships. The election by the controlling domestic shareholders has attendant notice requirements for other U.S. shareholders of the CFC. Further, under the 2019 proposed regulation, once revoked, the election could not be made for 60 months following the closing of the CFC inclusion year in which the revocation was made (subject to certain exception in the case of a change of control). The final regulations remove this restriction.

Contemporaneous documentation

The proposed regulations include a contemporaneous documentation requirement that substantiation of the high-tax exception computations must be included on Form 5471.

Amended return

The final regulations continue to allow the election to be made on an amended return, but add additional requirements that must be satisfied in order for the election to be made on an amended return. Also, the final regulations narrow the time-frame in which the amended return must be filed so as to ensure the ability of the IRS to have adequate time to audit and collect additional tax due as a result to changes made in respect of the GILTI high-tax election as a result of amended returns. Importantly, all U.S. shareholders of the CFC must file amended federal income tax returns or original federal income tax returns consistent with the amendment within 24 months of the unextended due date of the original federal income tax return of the controlling domestic shareholder's inclusion year with or within which the CFC inclusion year, for which the election is made (or revoked), ends. Additionally, amended federal income tax returns for all U.S. shareholders of the CFC for the CFC inclusion year must be filed within a single six-month period (within the 24-month period) and any tax due as a result of such adjustments must be paid within such six months period. Special rules are applied in respect of partnerships which are controlling domestic shareholders of a CFC or through which a U.S. shareholder partner owns an interest in the applicable CFC.

Other subpart F rules contained in the proposed regulations

The proposed regulations also provide a number of rules that modify the application of the historic subpart F calculation.

Interaction of the high-tax election and E&P limitation under section 952(c)

Under the existing subpart F high-tax exception, the amount of income that is a net item of income is determined after the application of the section 952(c) E&P limitation (which may reduce the amount of a net item of subpart F income where the subpart F income of a CFC exceeds its current year E&P). The amount of the reduction of current year subpart F income by virtue of the E&P limitation is recaptured in a later year. This potentially produced odd results: (1) a net item of subpart F income may qualify for the high-tax election solely by virtue of the E&P limitation (i.e., it would not have but for the E&P limitation) and (2) subpart F income resulting from recapture in a later year may not qualify for the high-tax election even if it would have so qualified in the earlier year had the E&P limitation not applied. As such, the proposed regulations provide that the high-tax exception applies before the E&P limitation. Therefore, items recharacterized as subpart F by virtue of a recapture account are not subject to de minimis, full inclusion or high-tax election rules.

Interaction of the high-tax election and full inclusion rule

Under the existing subpart F high-tax election, the full inclusion and de minimis rules are applied in determining adjusted gross foreign base company income (FBCI) before application of the high-tax exception. This raised a number of complexities in applying the high-tax exception to income that would not be subpart F income but for the full inclusion rule. Under the proposed regulations, the high tax exception would apply before the determination of full inclusion FBCI, eliminating the need for existing co-ordination rule in Reg. § 1.954-1(d)(6) and the complexities that it can create.

Carryover of recapture accounts. The proposed regulations provide that in a section 381(a) transaction, any recapture account of an acquired foreign corporation carries over to the acquiring foreign corporation even if it is not a CFC; this rule is described as a clarification.

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