KPMG report: Analysis of final and proposed regulations, high-tax exception under GILTI and subpart F

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The Internal Revenue Service ("IRS") and the Department of the Treasury (collectively, "Treasury") on July 20, 2020, released for publication in the Federal Register final regulations (T.D. 9902) relating to the "global intangible low-taxed income" (GILTI) high-tax exclusion[1] (the "final GILTI high-tax exception" or "final regulations" or "final rules") and proposed regulations (REG-127732-19) relating to both the GILTI high-tax exception and the subpart F high-tax exception (the "proposed regulations" or "proposed rules").

Read text of the **final regulations** [PDF 434 KB] (30 pages) and **proposed regulations** [PDF 418 KB] (26 pages).

This report provides a detailed discussion of and observations about the final GILTI high-tax exception as well as the proposed high-tax exception.

[1] The final regulations use the term "GILTI high-tax exclusion" whereas the election in respect of high-taxed subpart F income has historically been described in Reg. § 1.954-1(d) as the "subpart F high-tax exception." Because the proposed regulations describe the joint election in respect of high-taxed subpart F income and tested income as the "high-tax exception," "exception" is uniformly used herein in lieu of alternatively using "exclusion" when describing the final regulations. Additionally, in discussing the GILTI high-tax election of the final regulations, substantive changes that would be made under the proposed regulations are noted. Because the proposed high-tax election covers both GILTI and subpart F, this discussion uses the phrase "high-tax exception" and it should be understood to refer to the GILTI high-tax exclusion in the context of the final regulations and the unified high-tax exception in the context of the proposed regulations.

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Overview of the final regulations and proposed regulations

The final regulations finalize proposed regulations under section 951A that were published on June 21, 2019 (the "2019 proposed regulations") with respect to high-taxed tested income. The final regulations largely adopt the framework of the 2019 proposed regulations. However, the final regulations include a number of noteworthy changes from the 2019 proposed regulations, including that an election to apply the GILTI high-tax exception may be made annually instead of once every five years, that the election may be made retroactively for tax years of foreign corporations that begin after December 31, 2017, 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.

The final regulations retain both the significant computational and procedural differences between the GILTI high-tax exception and the long-standing subpart F high-tax exception as initially proposed in the 2019 proposed regulations. These differences broadly result in the characterization of income as subpart F income potentially being more taxpayer-favorable than the characterization of income as tested income, and therefore 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 reduce the incentives for such uneconomic planning, the proposed regulations would provide a single unified high-tax exception for both subpart F income and tested income (the "proposed high-tax election") pursuant to which the existing subpart F high-tax exception would be largely conformed to the final GILTI high-tax exception with a number of revisions, thus preventing the optionality in application of the high-tax exception that taxpayers might seek to exploit. 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).

KPMG observation

However, in certain cases it may still prove beneficial for a taxpayer to convert what would otherwise by tested income into subpart F income. For example, if a large foreign tax was paid on subpart F income, the taxpayer could choose not to elect the high-tax exception that year and therefore have significant general category foreign tax credits it could carryforward to future U.S. tax years where the taxpayer expects to have excess limitation in its general basket in such years. By not electing the high-tax exception in a given year, the taxpayer would have to include all of its tested income in its GILTI determination in that year under the proposed regulations. Therefore, careful modeling is required to determine if a net benefit would result.

The discussion below begins with general background of the two regimes (i.e., the GILTI regime and the subpart F regime) and a brief history of the long-standing subpart F high-tax exception and the development of the GILTI high-tax exception.

Next, some general observations are made as to key implications of making the GILTI high-tax exception and the different potential costs and benefits that should be evaluated in deciding whether to make the election on a year-by-year basis. Because the impact of the election is inherently fact specific, these observations are not exhaustive.

Thereafter, a summary of the key provisions of the final regulations follows, noting where the proposed regulations would alter the final rules. This discussion is presented based on the order in which a taxpayer would make a determination as to whether income qualifies for the high-tax exception. Once a taxpayer has determined that it is beneficial to make an election, a number of procedural requirements must be satisfied in order to have a valid election and an overview of these is provided herein.

Finally, the discussion concludes with a review of the revisions to the mechanics of the subpart F regime contained in the proposed regulations.

Background

GILTI, generally

The 2017 U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017)—the law that is often referred to as the "Tax Cuts and Jobs Act" ("TCJA")—generally retained the existing subpart F regime that applies to passive income and related-party sales and services, and created a new type of inclusion for GILTI, which is based on a broad class of CFC income (other than that generally covered by the subpart F regime). As a result, following the TCJA the income of a CFC generally falls into one of three categories: (1) "tested income" taxed under the GILTI regime, (2) income taxed under the subpart F regime, and (3) the CFC's remaining income, which is exempt from both regimes. Given the broad definitional scope of "tested income" under section 951A(c), this last category is quite limited in amount for most CFCs. The GILTI high-tax exception, together with the subpart F high-tax exception, have the potential to broadly expand a CFC's exempt income where it operates in sufficiently high-taxed environments.

Similar to a subpart F inclusion, "U.S. Shareholders" of CFCs include GILTI in income on an annual basis. Unlike a subpart F inclusion, a U.S. Shareholder calculates a single GILTI inclusion, based on all of its CFCs. In contrast, subpart F inclusions are calculated on a CFC-by-CFC basis. In general, GILTI is the excess of a U.S. Shareholder's "net tested income" (that is, the excess of the aggregate of its CFCs' tested income over its CFCs' tested losses), over its "net deemed tangible income return" ("net DTIR"), which is a deemed return on the CFCs' tangible assets (10% of qualified business asset investment or "QBAI") reduced by the CFCs' "specified interest expense"). Further, U.S. corporations may be entitled under section 250 to a deduction of up to 50% of their GILTI inclusion and related section 78 gross-up.

Tested income generally does not include income within the ambit of the subpart F regime. One important exception in the subpart F rules is the exception for high-taxed income found in section 954(b)(4) (i.e., the statutory high-tax exception). Under this exception, as further implemented by Reg. § 1.954-1(d), the controlling U.S. Shareholders of a CFC may elect to exclude certain net items of income from its subpart F income if such income is subject to a high effective foreign rate of tax. In particular, the subpart F high-tax exception election may be made when an item of income of a CFC is subject to foreign tax at an effective rate of greater than 90% of the maximum U.S. corporate tax rate (currently 18.9%). Tested income also does not include any gross income "excluded from the foreign base company income[2] … by reason of section 954(b)(4)."[3] In the final GILTI regulations issued at the same time as the 2019 proposed regulations, Treasury explicitly in fact provided that, for this exception to apply to gross income, gross income had to otherwise constitute foreign base company income ("FBCI").[4]

[2] Foreign base company income is the category of subpart F income that includes certain types of sales and services income, as well as its passive income.
[3] Section 951A(c)(2)(i)(III).
[4] As further discussed below, in adopting that rule, the earlier final regulations were consistent with the proposed regulations on which they were based.

Accordingly, before the finalization of the GILTI high-tax exception, qualification for the subpart F high-tax exception was an important method for a corporate U.S. Shareholder to avoid the residual U.S. federal income tax on its locally (relatively) high-taxed foreign operations that could result from the allocation of expenses with respect to such operations.

The historical subpart F high-tax exception

In order to fully appreciate the changes in the final and proposed regulations, it is helpful to understand the history of the subpart F high-tax exception. At the time of its enactment, the policy behind the high-tax exception was clearly expressed in the accompanying legislative history. The basic premise behind the subpart F regime is to deny the deferral of U.S. federal income tax for what Congress deems easily moveable income earned through a CFC (so-called "tax haven" operations).[5] Nevertheless, if a U.S. Shareholder earns an item of income through a CFC and is otherwise paying tax in the foreign jurisdiction at a rate comparable to that of the United States, then the U.S. Shareholder has not obtained a tax advantage by investing in the CFC. If the U.S. Shareholder does not receive a tax advantage by investing through the CFC, then the basic premise of the subpart F rules has not been met and the relevant item of income need not be subject to immediate inclusion by the U.S. Shareholder as subpart F income.[6]

The historical rules for applying the subpart F high-tax exception are contained in Reg. § 1.954-1. These rules are both detailed and mechanical and are thus not generally discussed in this report at length. However, as referenced above, the proposed regulations prescribe changes to certain mechanics of this election, namely the interaction of the subpart F high-tax exception with both the earnings and profits ("E&P") limitation under section 952(c)(1) and the de minimis and full inclusion rules of section 954(b)(3)(A) and (B). These aspects of the current subpart F high-tax exception are therefore appropriately discussed in context.

Certain features of the current subpart F high-tax exception that make it generally more taxpayer-favorable than the GILTI high-tax exception should be noted so as to properly understand the proposed regulation's aim for uniformity between the two exceptions. As a threshold matter, the determination of whether the subpart F high-tax exception is met is made separately for the relevant categories of subpart F income delineated in Reg. § 1.954-1. Further, a CFC's subpart F income that results from sales and services are aggregated for this purpose even when earned through separate QBUs, while passive income is generally tested on a QBU-by-QBU basis. Passive income is also grouped on the basis of local applicable withholding tax whereas sales and service subpart F income is not segregated on the basis of source taxation. As a result, a U.S. Shareholder historically had some level of flexibility to make an election for one type of income and not for another. Finally, the high-tax exception election is made on an CFC-by-CFC basis (and also item-by-item other than in respect of passive foreign holding company income) and the existing final regulations do not impose a consistency requirement (e.g., a U.S. Shareholder may make the election for certain CFCs, but not others). Therefore, under the final regulations, where sales and/or services income of a CFC is subject to substantial foreign tax, qualifying such income as subpart F income (as opposed to tested income) provides the taxpayer with increased U.S. federal income tax planning opportunities.

The evolution of the GILTI high-tax exception and move to a unified election

The GILTI regime, as enacted by the TCJA, did not include a stand-alone high-tax exception. The statute expressly excludes from a CFC's tested income the CFC's high-tax income that is excluded from subpart F "by reason of section 954(b)(4)"—namely income that is excluded from foreign base company income ("FBCI") and insurance income because it is subject to an effective tax rate greater than 90% of the U.S.

[5] *See* S. Rpt. No. 87-1881, at 79 (1962).
[6] *See* H. Rep. No. 99-426, at 401 (1986).

corporate tax rate. Given legislative history promising that "at foreign tax rates greater than or equal to 13.125%, there is no residual U.S. tax owed on GILTI," taxpayers and practitioners were surprised that the statute contained no such special exception from GILTI for high-taxed income.

Proposed regulations under section 951A issued in 2018 (the "2018 GILTI proposed regulations") similarly offered no generalized high-tax exception for tested income. To the contrary, the 2018 GILTI proposed regulations provided that the only income of a CFC excluded from tested income by virtue of being high-taxed is income excluded from FBCI and insurance income solely by reason of an election made to exclude the income under the high-tax exception of section 954(b)(4) and Reg. § 1.954-1(d)(5). Treasury took the view that only income that would not otherwise be excluded from subpart F income by reason of another exception is eligible for such election. Thus, because tested income would not otherwise be included in subpart F income, section 954(b)(4) was inapplicable to such income. For a more detailed discussion of the 2018 GILTI proposed regulations, read ***TaxNewsFlash***.

Numerous comments on the 2018 GILTI proposed regulations advocated for a broad high-tax exception from GILTI. Rather than including such an exception in the 2019 final regulations in respect of the 2018 GILTI proposed regulations (which maintained the position of the 2018 GILTI proposed regulations), Treasury included the exception in the 2019 proposed regulations. Upon further consideration, Treasury concluded that section 951A allowed for application of the high-tax exception to tested income because section 954(b)(4) could be appropriately interpreted to cause tested income to be excluded from subpart F income, even if the income would be so excluded for other reasons. The preamble to the final regulations includes a discussion of such interpretation of the phrase "by reason of" largely based on case law.

The proposed regulations would go a step further and provide a unified high-tax exception under section 954(b)(4) for both subpart F and GILTI. Treasury explains in the preamble to the final regulations that conforming various aspects of the subpart F high-tax exception to the final rules implementing the GILTI high-tax exception, rather than the other way around, "better reflect[s] the policies underlying section 954(b)(4) in light of the changes made by the [TCJA]." At any rate, aligning the inconsistencies between the subpart F high-tax exception and the GILTI high-tax exception would largely curtail taxpayer benefits from converting tested income into subpart F income with its more flexible high-tax exception. As noted above, unlike the GILTI high-tax exception, the subpart F exception currently does not have a consistency requirement that would require the U.S. Shareholder to make the election for all of its CFCs, and therefore can be applied selectively to separate CFCs or to separate classes of general category income earned by a single CFC for optimal U.S. federal income tax planning, in contrast with the GILTI election, which applies to all high-tax income of all CFCs in a CFC group (discussed further below). Accordingly, the unified high-tax exception is specifically intended to prevent this type of planning, in addition to providing the benefit of simplicity.

Threshold rate of tax

The GILTI high-tax exception applies only where the foreign effective tax rate exceeds 90% of the highest tax rate in section 11, in accordance with section 954(b)(4).

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 in the legislative history to the GILTI regime. Treasury rejected these comments because the statutory authority for the GILTI high-tax exception rests on section 954(b)(4), which does not permit application of a threshold rate other than 90% of the highest rate in section 11 (i.e., 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" under the final regulations or "tentative net item" under the proposed regulations (each defined below), over the sum of the U.S. dollar amount of the such item plus the U.S. dollar amount of foreign income taxes paid or accrued with respect to the such item.

KPMG observation

A tentative tested income item or tentative net income, as applicable, is calculated in accordance with U.S. federal income tax principles with the result that timing differences can cause the foreign effective tax rate to differ (even substantially) from the foreign jurisdiction's statutory tax rate.

KPMG observation

Treasury clearly states in the preamble to the final regulations that their statutory authority for the GILTI high-tax exception derives from section 951A(c)(2)(A)(i)(III) (excluding from tested income "any gross income excluded from the foreign base company income (as defined in section 954) and the insurance income (as defined in section 953) of such corporation by reason of section 954(b)(4)"). Since the effective tax rate set forth in section 954(b)(4) (i.e., 90% of the highest rate in section 11 (21%)) is not contingent on the type of income earned, Treasury did not find there was any authority to deviate from such effective tax rate for GILTI. While the oft-cited legislative history that there should not be residual GILTI when the foreign effective rate is 13.125% may well justify a lower threshold rate for a GILTI high-tax exception, Treasury does not believe that Section 951A gives it the authority to do so.

Further, Treasury explains that the lack of residual tax on GILTI described in the legislative history is predicated on the taxpayer crediting foreign taxes attributable to GILTI under section 960(d), and does not imply that the U.S. Shareholder does not have a GILTI inclusion when the foreign effective rate exceeds 13.125%. Since U.S. Shareholder-level expense allocation impacts the U.S. Shareholder's foreign tax credit capacity with respect to its GILTI, and Treasury otherwise had no authority to turn off expense allocation, the 13.125% was only based on a limited (possibly non-existent) fact pattern.

Considerations and consequences in respect of the GILTI high-tax exception

While the decision to make a high-tax election in any given year, and the attendant consequences thereof, is a fact intensive inquiry, some general observations can be made.

If the GILTI high-tax election is made, the foreign tax credits utilized by a corporate taxpayer will generally be less than if such election was not made because fewer taxes will be deemed paid by the U.S. Shareholder under section 960(d). This is of potentially significant value to taxpayers who would otherwise be subject to the BEAT because reducing the number of foreign tax credits utilized will result in a reduction of the taxpayer's "base erosion minimum tax amount" (as defined in section 59A and generally referenced to be a taxpayer's BEAT liability) on which the BEAT is calculated.

When the GILTI high-tax election is made, the corresponding decrease to the U.S. Shareholder's taxable income could create or increase a net operating loss ("NOL") in a given year. This is particularly important in light of the ability of a taxpayer to carryback certain NOLs under the CARES Act (Pub. L. 116-136, enacted March 27, 2020). Further, if the NOL results, in whole or in part, from deductions subject to section 904(b)(4) (interest expense apportioned to a qualifying CFC), utilizing such deductions to create an NOL and using such NOL in a carryover year would decrease taxable income in such year without potentially creating a separate limitation loss ("SLL") or overall foreign loss ("OFL") account under section 904(f). In light of this, taxpayers may benefit from changes in accounting methods that could accelerate U.S. source deductions because when the high-tax exception is elected, such deductions will not result in a reduction of the taxpayer's GILTI basket foreign tax credit capacity.

If the GILTI high-tax election is made, the qualifying tested income of a CFC will become untaxed E&P of the CFC. Therefore, whether the taxpayer expects to qualify for section 245A on a subsequent distribution of such E&P is an important consideration. Further, since section 245A(d) results in a disallowance of foreign tax credits attributable to a dividend qualifying for section 245A, the future loss of foreign tax credits for any withholding taxes should be considered. Moreover, the applicability of the section 245A(e) rules must be considered in connection with distributions of untaxed E&P through structures involving hybrid instruments. Additionally, if a CFC making a distribution has previously taxed E&P ("PTEP") from a prior year, the distribution could now be attributable to such other PTEP (since no (or a lesser) current year annual PTEP account will arise from a current year GILTI inclusion) and the U.S. Shareholder could be subject to taxation under section 961(b)(2) if it does not have sufficient tax basis in the CFC. The risk of gain under section 961(b)(2) may be exacerbated by distributions of section 965(b) PTEP made on the assumption of GILTI inclusions giving rise to basis, if a retroactive election to apply the GILTI high-tax election would eliminate such basis.

Because the high-tax election generally eliminates "blending" of the high-taxed and low-taxed earnings of a taxpayer's CFCs, the GILTI inclusion that results if the taxpayer elects the GILTI high-tax exception could be subject to significant U.S. federal income tax if it is sufficiently low-taxed. Without the GILTI high-tax exception, U.S. tax on this income could have been reduced by foreign tax credits deemed paid in respect of its high-taxed tested income. A taxpayer would also lose some amount of QBAI that offsets this low-taxed inclusion because assets of a tested unit that produce income that qualify for the high-tax exception would no longer be "specified tangible property" (as defined in section 951A(d)).

If a corporate taxpayer is eligible for a section 245A deduction with respect to a CFC that qualifies for the high-tax exception, then an increased portion of its stock will be characterized as in a section 245A subgroup for purposes of interest (and potentially stewardship) allocation and apportionment and therefore subject to section 904(b)(4). Section 904(b)(4) would require that these deductions not be taken into account for purposes of determining the taxpayer's worldwide taxable income for purposes of section 904 (and such deductions would also not be taken into account in determining the taxpayer's general category income for purposes section 904). As a result, a taxpayer's foreign tax credit capacity in each basket would be expected to vary depending on whether or not the taxpayer makes the high-tax election. For a taxpayer that is generally excess credit in a given basket, impact of the election on its FTC capacity in such basket should be evaluated.

Finally, if the proposed regulations are finalized as proposed, a taxpayer will no longer be able to selectively not elect the high-tax exception with respect to certain high-taxed items of subpart F income if it has excess foreign tax credit limitation in its general basket without entirely foregoing the exception in respect of all of its tested income and subpart F income. Converting tested income into subpart F income will no longer provide opportunities with respect to taxpayers seeking to rely on the high-tax election with respect to the tested income of their CFCs.

Final GILTI high-tax exception and proposed single high-tax exception: Mechanics

Much like the historic subpart F high-tax exception, the final GILTI high-tax exception involves a multiple step computational process, which is maintained in the proposed regulations.

As described more fully below, the exception is applied on a tested unit basis and with respect to each prescribed income item thereof. Therefore, a CFC's tested units must be first be determined. Once this is done, the gross income of each must be determined in accordance with U.S. federal income tax principles and divided into specified income items. Deductions (including current year foreign taxes) must then be allocated and apportioned to arrive at net items, and finally, the effective tax rate in respect of such item is determined. These steps are discussed sequentially below and changes that would be implemented by the proposed regulations are highlighted.

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 decline 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.[7] In particular, careful attention should be paid to the various anti-abuse rules contained in the proposed regulations. These rules are highlighted in the discussion below at the stage at which they apply to the computation.

Determination made based on "tested units" of a CFC

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 2019 proposed regulations required the determination on a QBU-by-QBU basis to minimize the impact of "blending" of tax rates where a CFC has multiple types of income subject to disparate foreign tax rates.

KPMG observation

The existence of a QBU requires the determination that a set of activities constitutes a trade or business, which is an inherently factual determination. Because the determination lacks clear, bright-line rules, taxpayers would likely reach differing conclusions as to whether a certain set of activities constitute a QBU, and the high-tax election could therefore be applied inconsistently. Nevertheless, the QBU standard is utilized in other areas of U.S. federal income tax (e.g., foreign currency gain or loss, foreign branch basket determination), so incorporation of the QBU standard lent some familiarity to taxpayers.

[7] 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 no change by the proposed regulations is indicated in respect of a rule included in the final regulations with respect to the final GILTI high-tax exception, it should be understood to apply in the proposed regulations in respect of the single high-tax exception.

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 exclusion of other activities or entities over which that foreign country does not exercise taxing jurisdiction is intended to prevent blending of taxed and untaxed operations.

The definition of a tested unit aims to isolate income of a CFC that is expected to be taxed in the CFC's country of tax residence and separate it from income expected to be taxed in other foreign jurisdictions or not taxed at all in order to avoid potential distortions in calculating the effective foreign tax rate on such income if income not taxed in the same jurisdiction were also included in that determination. Specifically, included in the definition is:

- A CFC

- An interest held directly or indirectly by the CFC in a pass-through entity (such as a partnership or disregarded entity) if (i) that pass-through entity is a tax resident in a foreign country, or (ii) if the pass-through entity is not a tax resident in a foreign country, such pass-through entity is not treated as fiscally transparent (as defined in Reg. §1.267A-5(a)(8)) under the law of the country in which the CFC is a tax resident (or, if the interest is held indirectly through a tested unit, the laws of the foreign country in which the tested unit is a tax resident).

KPMG observation

The intent of the tested unit concept is well illustrated in this prong. If the entity is a tax resident in a foreign country, then its activities should generally be expected to be taxed therein and, therefore, it should constitute a separate taxable unit subject to a fairly uniform foreign tax rate. If the entity is not a tax resident in any foreign country and so does not constitute a tested unit on that basis, then inappropriate "blending" of foreign tax rates could occur if the entity was not transparent in the CFC's home country. In particular, this could result because the directly earned income of the CFC would be taxed by its home country whereas the income of the entity would not generally be subject to this same rate of tax due to the lack of the entity's transparency under the tax laws of the CFC's home country.

KPMG observation

The final regulations provide that an "interest" in a pass-through entity may be a tested unit, as opposed to the entity itself. This is because an entity may have multiple owners and characterization depends on each owner's tax treatment of the interest. For example, suppose CFC1 and CFC2 each own 50% of a foreign partnership ("FP") that is not a tax resident in any foreign country. Further suppose FP is treated as transparent by CFC1's country of residence, but is not treated as transparent in CFC2's country of residence. CFC1's interest in FP would not be a tested unit of CFC1, but CFC2's interest in FP would be treated as a tested unit of CFC2. As a result, CFC1's interest in FP would be included in the CFC-level tested unit, which is appropriate as CFC1's country of residence views FP as transparent and therefore the income of FP would be subject to tax therein.

- A branch (as defined in Reg. § 1.267A-5(a)(2)), or portion thereof, whose activities are carried on directly or indirectly by the CFC and that has a taxable presence in the foreign country in which it is located. If the branch does not have a taxable presence, then it is a tested unit only if an exclusion, exemption, or other similar relief applies with respect to income attributable to the branch under the laws of the country in which the CFC (or, as relevant, a tested unit that carries out the branch activity) is a tax resident.

KPMG observation

Notably, the use of a branch tested unit rule in the final regulations should not result in significantly increased compliance burdens on taxpayers because the rule is focused on how certain activities are treated for foreign law purposes—an exercise taxpayers likely will have undertaken for local country purposes independent of the final regulations. As an example, taxpayers may have already engaged in this analysis in order to determine whether a local country tax return must be filed as a result of the CFC having a permanent establishment in a particular jurisdiction.

KPMG observation

The latter half of this prong segregates a branch that is effectively not taxed anywhere (or taxed to a much lesser extent than its owner) (a "non-taxed branch"). That is, if the branch does not have a taxable presence where located and it is also subject to a preferential regime in its operator's jurisdiction, it is likely that no jurisdiction is taxing the income to any significant extent. The non-taxed branch is therefore ring-fenced as its own tested unit and would generally not qualify for the GILTI high-tax exception.

An interest in a pass-through entity that does not meet either requirement to be a tested unit is a "transparent interest" and its income items are generally reflected at the level of the tested unit owning the transparent interests.

KPMG observation

Determining tested units of a CFC will prove time-consuming for some taxpayers because it requires an understanding of where the direct and indirect activities of a given CFC are taxed. This complexity may lead taxpayers to rethink their foreign structure to reduce the number the number of transparent entities and branches owned or operated by a CFC and instead opt to conduct operations in different jurisdictions in separate CFCs. Operating in this manner would substantially eliminate the time required for the tested unit determination. However, even though GILTI is calculated on an aggregate basis, such a restructuring may impact the taxpayer's GILTI inclusion and resulting deemed paid foreign tax credits. For instance, if operations of a CFC are separated into two CFCs, one generating tested income and one generating a tested loss, the QBAI and foreign taxes of the tested loss CFC would be lost.

Tested unit combination rules

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 treat a CFC's tested units that are tax residents of, or located in, the same foreign country as a single tested unit ("same country aggregation"). However, non-taxed branches are never subject to combination pursuant to this rule; again, such a branch is not likely to be subject to any meaningful amount of tax in the country in which located and therefore, aggregating it may give rise to inappropriate blending of tax rates. The combination rule applies only to tested units of a particular CFC; there is no aggregation for tested units of commonly controlled CFCs.

KPMG observation

Same country aggregation is mandatory and not elective. The rule applies regardless of whether the tested units are subject to the same tax rate or whether they use the same functional currency. The preamble explains that because the foreign effective tax rate is determined in U.S. dollars, the differing currency of operations is unlikely to result in a meaningful distortion.

KPMG observation

Some foreign jurisdictions permit loss sharing among members of a foreign group. Generally, under these regimes, members of a group in the same jurisdiction may "share" losses with another member, which results in a lower foreign tax due for the entity receiving the loss. Because the taxable income of the individual entities for U.S. federal income tax purposes remains the same, the sharing of losses for foreign purposes can cause one member of a foreign group to be viewed as paying a high rate of foreign tax, while another member may be viewed as paying a low rate of foreign tax. The combination rule prevents distortive results that may occur in the case of loss sharing among tested units of the same CFC, but does not cover a situation in which there is loss sharing *among* different CFCs.

KPMG observation

Because a non-taxed branch is not subject to same country aggregation, taxpayers cannot merely aggregate all entities in the same country. Instead, where a branch exists, taxpayers must determine whether the branch has a taxable presence in the country in which it is located. For example, assume a CFC organized in Country A ("CFC1") owns a Country A disregarded entity ("FDEA"), a Country B disregarded entity ("FDEB"), and a branch that is also located in Country B ("FBB"), but does not give rise to a taxable presence in Country B and qualifies for an exclusion, exemption, or other similar relief under Country A tax law. While CFC1 and its interest in FDEA would be aggregated under the combination rule, FDEB and FBB would not be aggregated.

De minimis aggregation (proposed regulations). Where a CFC has a tested unit 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 and, therefore, would only apply to tested units subject to the same country combination rule if the combined unit, in the aggregate, was below the required gross income threshold. The preamble to the proposed regulations indicates that Treasury will continue to study whether this rule could result in inappropriate blending. Further, the rule contains its own anti-abuse rule that applies to transfers undertaken with a "significant purpose" to qualify for this rule. A significant purpose need not be a principal purpose. A non-taxed branch also cannot be combined with another tested unit under this proposed rule.

"Tentative gross tested income item" ("gross item" under the proposed regulations)

Overview and items of gross income

Once the tested units of a CFC have been determined, the tentative gross tested income of each tested unit must be determined. A tentative gross tested income item is determined in accordance with U.S. federal income tax principles and therefore may differ significantly from foreign gross income as a result of timing or base differences.

As discussed below, the starting point for determining a tentative gross tested income item of a tested unit is the tested unit's "books and records" (as defined in Reg. § 1.989(a)-1(d)). Such books and records must be adjusted in accordance with U.S. federal income tax principles and are also to take into account disregarded payments made between tested units of the same CFC.

KPMG observation

The applicability of the existing subpart F high-tax exception is generally determined at the CFC level except in the case of items of income that are passive foreign personal holding company income ("FPHCI"), which are grouped by QBU and may be further subdivided based on withholding tax and income taxes paid with respect to the item of income.

All items of income are attributable to a tested unit, but an item of gross tested income can be attributed to only one tested unit. 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.

KPMG observation

Absent this rule that gives priority to the lowest-tier tested unit, the item of income would be allocable to two tested units. A priority rule was necessary in order to properly determine how to allocate gross income among the tier of tested units. Taxes imposed under the jurisdiction of tax residence of a higher-tier tested unit can be associated with the income allocated to the lower-tier tested unit where such income is included in the foreign tax base of the higher-tier tested unit.

The proposed regulations provide significant modifications to the definition of items of income in applying the unified high-tax exception. Items of income continue to be calculated on a tested unit basis. Because the high-tax exception applies to both tested income and subpart F income of a tested unit to the same extent under the proposed high-tax exception, general category tested income and subpart F income of a single tested unit would be aggregated into a single item of income. Such item, referred to as a "general gross item," is the aggregate amount of all gross income attributable to a tested unit that is in a single section 904 category, not an equity gross item (as described below) or passive FPHCI, and of a type that would otherwise be gross tested income, gross FBCI, or gross insurance income.

KPMG observation

The aggregation of gross income that would be tested income or subpart F income as a general gross item could allow for some blending of tax rates, notwithstanding Treasury's stated concerns in that regard. Consider, for example, the case of a tested unit in a country with a foreign income tax regime with preferential export tax rates, under which the tested unit's in-country sales would be taxed at a high rate relative to its export sales. Depending on the relative amounts of such income and their rates of taxation, aggregation could allow all of the sales income to qualify for the unified high-tax exception, even if the export sales would not have qualified if tested separately, or conversely could cause none of the income to qualify for the exception, even if the in-country sales would have qualified if tested separately.

Under the unified high-tax exception, the historic grouping rules for passive FPHCI, which divide such income into separate items based on the types of income described in section 954(c)(1) and groupings of passive income described in Reg. § 1.904-4(c), would be retained. Each such item is a "passive gross item."

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. Equity gross items consist of dividends, income or gain recognized from dispositions of stock, and similar items, as well income or gain recognized on the disposition of, or a distribution with respect to, an interest in a pass-through entity. In order to be included as an equity gross item, income must be subject to an exclusion, exemption, or other similar relief (such as a preferential tax rate) under the country of tax residence or location, as applicable, of the tested unit. Foreign income tax credits and deductions do not constitute similar relief for this purpose. Furthermore, gain with respect to the disposition of stock that would be dealer property is excluded from equity gross items.

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. If a separate set of books and records is not maintained, items that would be reflected on the books and records must be determined and are deemed to be properly reflected on the separate set of books and records. Notably, this rule prevents taxpayers from avoiding the rules by merely choosing not to maintain books and records. The final regulations also provide certain rules to address situations in which certain items of gross income may not be reflected on the books and records of a tested unit. First, in certain situations, a CFC's items of gross income may not be reported on a tested unit's books and records because they are not taken into account during the year for financial accounting purposes or for foreign tax purposes. When this occurs, the final regulations provide that such amount is to be treated as properly reflected on the books and records to the extent such item would have been reported if taken into account for financial accounting purposes during the year. Further, items reflected on the separate books and records of pass-through entities or branches that are not tested units (defined as "transparent interests") are treated as reflected on the books and records of the tested unit that holds the transparent entity.

KPMG observation

Along with the requirements that books and records be essentially reconstructed if not otherwise prepared and that adjustments be made for U.S. federal income tax principles and disregarded payments, these rules seem to significantly undermine the significance of the books and records starting point.

KPMG observation

The special rule for transparent entities is necessary in order to take into account the income of such entity. In particular, the general rule for attributing income to a tested unit starts with the CFC's items of gross income and then attributes the income to the various tested units based on the books and records of each separate unit. Without the special rule for transparent entities, none of the transparent entity's income would be reflected on the books and records of a tested unit, and therefore, a portion of the CFC's gross income would not be attributed to any tested unit even though the income of the transparent entity should generally be subject to tax in the jurisdiction of the tested unit that owns it.

The proposed regulations would replace the use of "books and records" with "applicable financial statements." 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, included as an appendix to this report; 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 with U.S. GAAP.

Several rules are included in the proposed regulations that would prevent potential abuse related to the applicable financial statement requirement. First, if an applicable financial statement is not prepared, the regulations would require taxpayers to determine the amount that would be properly reflected on such a financial statement. In addition, the proposed regulations contain certain anti-abuse rules that can adjust the items of gross income and deductions on an applicable financial statement when there exists a "significant purpose" of avoiding the purposes of the subpart F or GILTI regimes or the high-tax exception. A "significant purpose" is presumed to exist with respect to an item of gross income where an item is factually unrelated to activities of the tested unit and subject to a materially different effective rate of foreign tax. A similar presumption exists with respect to a deduction that is not incurred in connection with funding the activities of the tested unit or incurred in the ordinary course of such activities and is not deductible in the relevant foreign jurisdiction.

KPMG observation

The preamble to the proposed regulations does not discuss the reasoning for the selection of a "significant purpose" standard as opposed to the more commonly used "principal purpose" standard, but it would appear to lower the bar for application of the anti-abuse rule relative to a "principal purpose" standard.

Adjustments for disregarded payments

The final regulations provide for adjustments to gross income of a tested unit (as initially determined for U.S. federal income tax purposes) to properly reflect disregarded payments made or received by such tested unit. These rules are based on the principles of the disregarded reallocation transaction rules of Reg. § 1.904-4(f)(2)(vi) (the "FTC DRT rules"), with notable modifications.

KPMG observation

Disregarded transfers of property can result in adjustments to income under the FTC DRT rules for years after such transfers. For example, a disregarded transfer of IP can result in an adjustment of income by reason of a deemed paid royalty under the principles of sections 367(d) and 482), and a disregarded transfer of depreciable property can result in a reallocation of income to the extent of any related "disregarded cost recovery deduction." The final regulations do not provide a "transactional" effective date for purposes of applying the principles of the FTC DRT rules. It is not clear whether the "principles" of the FTC DRT rules take into account only adjustments related to disregarded transfers that occurred on or after the effective date of the proposed regulations for purposes of applying the GILTI high-tax exception.

The proposed regulations further build on the rules provided in the final regulations for adjustments to reflect disregarded payments, providing their own definition of disregarded payments, as well as providing additional rules for the allocation of disregarded interest payments and modified ordering rules in the case of multiple disregarded payments.

KPMG observation

Accounting for disregarded payments between tested units more closely reflects the amount of income that is subject to tax in a given jurisdiction. Without such rules, "rate blending" could be achieved if one tested unit made a disregarded payment to another tested unit that resulted in a foreign income tax deduction for the payor unit and thereby shifted the incidence of foreign taxation to the payee of the disregarded payment.

Both regulations provide that the adjustments are made to the gross income of a tested unit to reflect disregarded payments "to the extent thereof."

KPMG observation

The preambles to the regulations do not provide whether this cap on reallocation applies under the FTC DRT rules or is a deviation therefrom. As such, it remains unclear whether adjustments can be made under the FTC DRT rules that result in the gross income of a payor foreign branch (or branch owner, as applicable) becoming negative.

Unlike the FTC DRT rules, adjustments are made to reflect disregarded payments between tested units even if no tested unit makes a disregarded payment to, or receives a disregarded payment from, the CFC owner.

KPMG observation

For foreign tax credit purposes, the foreign branch basket reflects an aggregate of the taxpayer's foreign branch category income (and taxes). As such, tracking disregarded payments between foreign branches was unnecessary if no payments were also made to or received from the foreign branch owner because disregarded payments solely among branches would not impact the aggregate amount of income and taxes in the foreign branch basket. However, the high-tax exception applies to each tested unit separately. Therefore, disregarded payments between tested units have relevance regardless of whether a payment is also made with respect to the CFC owner of the tested units.

Adjustments to gross income of a tested unit are made to reflect payments of disregarded interest, notwithstanding its exclusion under the FTC DRT rules, but only to the extent it is deductible in the country of tax residence or location (as applicable) of the tested unit payor. Such disregarded interest payments are generally allocated and apportioned ratably to all the gross income of the tested unit payor. Where the two tested units make interest payments to each other, the payments are netted and only the remaining amount results in a reallocation. The proposed regulations also contain a further "netting concept" that applies whenever a tested unit is both a payor and payee of disregarded interest; in such instance, the payor first allocates the interest paid to gross income allocated to it as a result of the receipt of disregarded interest to the extent thereof before applying the general ratable allocation rule. Further, the proposed regulations also incorporate the principles of direct apportionment rules of Reg. § 1.861-10T(b) or (c) to disregarded interest payments.

In the case of multiple disregarded payments, the regulations provide a set or ordering rules in lieu of applying those contained in the FTC DRT rules. Under the final regulations, with respect to a tested unit, adjustments are first made to account for payments received by the tested unit before payments made by the tested unit.

When a tested unit both makes and receives disregarded payments, the final regulations provide for adjustments to be made in the following order:

- First, with respect to disregarded payments that would be definitely related to a single class of gross income under the principles of Reg. § 1.861-8.
- Next, with respect to disregarded payments that would be definitely related to multiple, but not all, classes of gross income.
- Then, with respect to non-interest disregarded payments that related to all classes of gross income.
- Finally, with respect to disregarded interest payments and payments not definitely related to any class of gross income.

KPMG observation

The ordering rules of the final regulations appear to leave unresolved the proper method to account for multiple disregarded payments in various circumstances. As one example, the final regulations provide a "netting concept" where two tested units make interest payments to each other. Because interest is allocated and apportioned ratably to all gross income of the tested unit (including reallocated income resulting from disregarded payments), absent the netting rule, where a tested unit (TU1) and another tested unit (TU2) each make interest payments to the other, the reallocation of income would be circular. However, the final regulations do not provide a similar netting rule for other crossing payments made by tested units that might also be apportioned on a gross income basis (which would include reallocated income from another branch). For example, suppose two tested units make disregarded payments to each other for support services, which are properly allocable to all gross income of the tested unit (including the gross income reallocated from the very tested unit it is paying). Proper reallocation of gross income is not clear in such instance.

The proposed regulations modify the foregoing ordering rules in ways that may resolve some of the aforementioned ambiguities created by the final regulations. For example, pursuant to the proposed regulations, if a given tested unit is both a payor and payee of disregarded interest, the interest payment made by it is first allocated to any gross income allocated to the unit as a result of a disregarded interest payment received by it. In addition, the proposed regulations provide that adjustments are first made with respect to disregarded payments received by a payee tested unit that are not attributable to disregarded payments received by the payor tested unit (modifying the final regulation's approach of first adjusting for all received payments).

KPMG observation

To the extent the ambiguities are still not resolved by the ordering rules in the proposed regulations, consideration should be given to whether the ordering rules in the section 904 related entity look-through rules may suggest resolutions by analogy.

Adjustments for the use of NOLs for foreign tax purposes

One commenter requested that the 2019 proposed regulations be revised to take into account NOL carryovers that are deducted for foreign tax purposes for purposes of calculating the foreign effective tax rate. Treasury declined to adopt this comment on the basis of complexity and administrability.

KPMG observation

This decision is consistent with the overarching policy in the final regulations that the foreign effective tax rate be calculated by applying U.S. federal income tax principles to determining the amount of income that is taxed. The historical subpart F high-tax exception determination was made on the basis of income as determined for U.S. federal gross income purposes. Further, the amount of deemed paid credits under section 960 with respect to a subpart F or GILTI inclusion is also so determined. Therefore, any departure from U.S. federal income tax purposes in the high-tax exception would have been a marked deviation from related rules.

"Tentative tested income item" ("tentative net item" under the proposed regulations)

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 applying these principles, each tentative gross tested income item of a tested unit is treated as a statutory grouping and all other income is treated as in the residual income category. The final regulations provide that the allocation and apportionment of deductions for purposes of the GILTI high-tax exception must be consistent with the results in apportioning deductions to determine a U.S. Shareholder's GILTI and subpart F inclusions.

KPMG observation

The allocation and apportionment of expenses among a CFC's tested units under the rules in Reg. § 1.960-1(d)(3) for purposes of determining tentative tested income items may lead to unexpected results. In particular, when a CFC allocates its interest expense among its items of income using either the asset method or the modified gross income method, the CFC may be required to allocate a portion of its interest expense based on the assets or gross income of a lower-tier CFC. In this case, the portion of the interest expense allocated against the assets or income of the lower-tier CFC is not taken into account for purposes of applying the GILTI high-tax exception to the tentative tested income items of the tested units of the CFC. However, this interest expense may be allocated against any item of tested income of the CFC that does not qualify for the GILTI high-tax exception if the lower-tier CFC's income also does not qualify for the GILTI high-tax exception. Further, interest expense incurred by one tested unit of a CFC is generally allocated against all the gross tentative tested income items of the CFC, including the gross tentative tested income items of its other tested units, and may result in a distortion of the effective tax rate, that, as discussed below, Treasury determined in connection with the proposed regulations is inappropriate.

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 (other than deductions for current year taxes) to the gross income items of a tested unit to the extent those deductions are properly 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. However, the determination of gross income and deductions is still done in accordance with U.S. federal income tax purposes and therefore the tentative item may continue to differ substantially from the amount calculated under foreign income tax law.

KPMG observation

Unlike the final regulations that, as discussed above, can result in distortion through their allocation and apportionment of interest expense, the proposed regulations specifically provide that interest expense of a tested unit is allocated and apportioned only against the tentative gross tested income items of the tested unit.

KPMG observation

This rule applies solely for purposes of applying the high-tax exception and not for the calculation of a CFC's subpart F income or tested income generally or for purposes of section 960. However, the preamble notes that Treasury is considering whether it may also be appropriate for purposes of sections 954(b)(5), 951A(c)(2)(A)(ii), and 960 for calculating deemed paid credits and subpart F or GILTI inclusions generally. Alternately, a "booking" rule could apply to a more limited extent to achieve more consistent results between the high-tax exception and these other calculations, such as by allocating and apportioning deductions to a tested unit only to the extent of its gross income and allocating and apportioning any excess deductions to all gross income of the CFC. The preamble also notes that it is inappropriate for a deduction apportioned to a net income item that qualifies for the high-tax exception to also be apportioned to another item of income that does not so qualify in determining a U.S. Shareholder's GILTI inclusion and suggests that a future rule may be promulgated that would prevent such a result.

The proposed regulations further provide that, after deductions are attributed to tested units under the "booking" rule, in applying the principles of Reg. § 1.960-1(d)(3) to allocate and apportion deductions (other than current year taxes) to items of gross income, deductions are allocated and apportioned on the basis of the income and activities to which the expense relates. Interest deductions are allocated and apportioned only on the basis of assets (or gross income, in the case of the modified gross income method) of the tested unit. Deductions may only reduce items of gross income in the tested unit.

KPMG observation

The wording of the "booking" rule is not entirely clear. If a deduction attributable to a tested unit is unrelated to its own direct income and activities, it is unclear what the consequences of the "booking" rule are.

Anti-abuse rules

In addition to general anti-abuse rules targeting planning with a "significant purpose" of avoiding the purposes of section 951, 951A, 954(b)(4), or the regulatory unified high-tax exception rules, the proposed regulations contain an additional anti-abuse rule that applies in the case of a formation or use of a reverse hybrid or the issuance or acquisition of an "applicable instrument." An applicable instrument is an instrument or arrangement (including a repo) that gives rise to a deduction to the issuer for U.S. tax purposes but not foreign tax purposes, or that gives rise to income to the holder for foreign tax purposes but not U.S. tax purposes. The divergent treatment of a deduction could reduce the net tentative item on which a foreign tax is imposed, while the divergent treatment of income could increase the foreign tax imposed on a net tentative item. Accordingly, the proposed regulations provide that the appropriate adjustments made pursuant to the anti-abuse rule could include adjustments to foreign income taxes paid with respect to a tentative net item or adjustments to the tentative net item. An example in the proposed regulations illustrates the latter, on facts in which the interest deduction with respect to an applicable instrument would reduce a net tentative item to the extent that it would qualify for the unified high-tax exception. Thus, as the example illustrates, the net tentative item determined under the general rules is increased by the amount of the deduction pursuant to the anti-abuse rule.

Allocating and apportioning foreign taxes to a "tentative tested income item" ("tentative net item" under the proposed regulations)

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 the "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 of a tested unit 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. The principles of Reg. § 1.904-6(a)(2) are applied (with appropriate modifications), in lieu of the principles of Reg. § 1.904-6(a)(1), to associate foreign taxes imposed by reason of a disregarded payment between tested units.

KPMG observation

Even though foreign taxes are determined at the CFC level, reliance on Reg. § 1.960-1 incorporates U.S. federal income tax principles that disallow a foreign tax credit for certain taxes. For example, any foreign tax credit not taken into account for purposes of section 960 by section 901(m) or section 909 would not be allocated and apportioned to an income item despite that these are foreign taxes paid by the CFC. This result should be considered in determining whether to make a section 338 election upon acquisition of a CFC.

KPMG observation

The allocation and apportionment of foreign taxes is inherently complicated. The foreign tax base must be determined, including any foreign tax law principles for allocating and apportioning deductions for foreign tax purposes. Once the foreign tax base and associated taxes are understood, the foreign taxes are then allocated and apportioned according to the characterization of the items included in the foreign tax base under U.S. federal income tax principles.

The proposed regulations would not introduce significant changes with respect to the allocation and apportionment of current year taxes. Notably, the "booking rule" does not apply to current year taxes, leaving the result observed above unchanged.

KPMG observation

As previously noted, where an upper-tier tested unit is also subject to tax on income of a lower-tier tested unit, the income is reflected only in the tentative tested income item of the lower-tier tested unit. However, the taxes imposed on the upper-tier unit in respect of such income should be apportioned to the item of the lower-tier tested unit to reflect the true amount of foreign tax paid on such income.

Effective rate at which foreign taxes are imposed

Under the final regulations, 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. Under the proposed regulations, "tentative net item" is substituted for "tentative tested income item."

KPMG observation

Neither the final regulations nor the proposed regulations provide explicit rules for translating foreign taxes, tentative tested income items, or tentative net items into U.S. dollars, although the proposed regulations reference section 989(b)(3) for purposes of translating gross income for purposes of the de minimis combination rule.

Presumably the reference in Reg. § 1.960-1(c)(3) to section 986 applies to determine the U.S. dollar amount of foreign taxes. However, it is not entirely clear that section 989(b)(3), which applies to translate inclusions, or Reg. § 1.951A-1(d)(1), which similarly applies to translate a U.S. Shareholder's pro rata share of any tested item, would apply to translate CFC-level income items in the absence of a rule. Because these rules provide for the average exchange rate for the year, as section 986 generally does for taxes, their application would generally prevent distortion of the effective tax rate by foreign currency translation.

It is possible that translation rules in Reg. § 1.952-2, which concerns the determination of gross income and taxable income of a CFC, could be considered to apply for purposes of translating tentative net items. The section 952 regulations provide that amounts determined when applying U.S. accounting principles are generally to be translated into U.S. dollars in accordance with the principles of Reg. § 1.964-1(d). The section 952 and section 964 rules would require separate translation of subpart F income and non-subpart F income in the case of fluctuating currencies, creating complexity. In addition, they provide generally for translation of items in a year based on an average of exchange rates on month closings during the year, which would not necessarily be consistent with the average rate applied under section 986(c) or 989(b)(3), which is based on daily exchange rates.

Current year taxes generally do not take into account a potential reduction in taxes that may occur by reason of a distribution of the tested income to the CFC's shareholders. However, taxes reasonably certain to be returned to a shareholder of the entity are not treated as paid or accrued.

KPMG observation

Pursuant to the TJCA, section 905(c) now requires a redetermination of U.S. tax liability in connection with a foreign tax redetermination. Therefore, if an audit or adjustment to foreign taxes is made in a subsequent year, the effective tax rate is recomputed on such basis with the result that qualification for the high-tax election could change upon the resolution of foreign tax audits. Moreover, even if a redetermination relates to income that would not qualify for the high-tax exception regardless, its consequences for cross-crediting could affect the determination of whether the high-tax exception election would be beneficial. In any event, as discussed below, the limited time period for making or revoking a high-tax exception election may prevent a taxpayer from adequately taking into account the consequences of the redetermination.

Negative or undefined tax rates under the proposed regulations

The preamble to the proposed regulations notes that in certain instances, the calculation of the effective tax rate may result in a negative number or a "divide by zero" result. Such could be the case where a tentative net item of a tested unit has foreign taxes apportioned to it (according to the process described above), but the tentative net item itself (as determined for U.S. federal income tax purposes) is negative because deductions apportioned to the gross item of income exceed the gross income itself (by at least the amount of the foreign taxes apportioned to the item). In such a case, the proposed regulations would provide the high-tax exception is deemed satisfied with respect to such tentative net item. Comments are requested as to any case in which this may not be appropriate. Significantly, under the proposed regulations, where the high-tax exception is elected, where a tested unit's net income item is a loss, such item would qualify for the high-tax exception and therefore the loss would not be taken into account in determining the U.S. Shareholder's GILTI inclusion.

KPMG observation

The final regulations are silent as to whether a tentative tested income item exists if the result of subtracting allocated and apportioned deductions from the related gross income results in zero or a negative number and how to evaluate the ETR in such cases.

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, such as the use of the statutory rate or even a rolling average of effective rates. These comments were rejected on the basis of the plain language of the statute and concerns over the administrability of such a standard.

KPMG observation

Consistent with the treatment in the final foreign tax credit regulations, Treasury has recognized the annual accounting period for determining foreign taxes, regardless of whether there may be timing differences that produce what taxpayers believe to be “unreasonable” results. In particular, in the final foreign tax credit regulations, Treasury similarly opted to use an annual accounting period for determining foreign taxes paid, only taking into account taxes that accrued during the annual accounting period. The government decided to apply this standard fully recognizing that CFCs may have different year-ends for U.S. and local tax purposes (e.g., CFCs that have elected one-month deferral under section 898, or CFCs formed in jurisdictions such as India that mandate a particular year-end), regardless of the fact that this can create a timing mismatch between when the CFC’s income is taken into account for U.S. federal income tax purposes and when the associated foreign taxes can be claimed as a credit.

Consistency and procedural requirements of the high-tax exceptions

The final regulations prescribe who is eligible to elect the high-tax exception and the means by which to do so, provide consistency requirements, and include a requirement to notify other U.S. Shareholders. These rules deserve special attention because a failure to fully comply results in an invalidated election. In addition, the proposed regulations add a detailed contemporaneous substantiation requirement and provide additional reporting that must be made in respect of a CFC subject to the election on its Form 5471.

While an election may be made or revoked on an original or amended tax return, the time period in which an election or revocation can be made by amendment is limited and requires coordination among all U.S. Shareholders of the affected CFC, as discussed more fully below.

Election made by controlling domestic shareholders

As in the 2019 proposed regulations, the high-tax exception is made by the controlling domestic shareholders of the CFC, which can include U.S. domestic partnerships and is binding on all U.S. Shareholders of the CFC. "Controlling domestic shareholders" are generally 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 the corporation's behalf. If U.S. Shareholders of the CFC do not, in the aggregate, directly or indirectly own more than 50% of the foreign corporation, 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.

With respect to a partnership U.S. Shareholder that is a "controlling domestic shareholder," elections (on original or amended returns) are made with respect to the Form 1065 (or, in the case of an election or revocation thereof by amendment, the Form 1065 or administrative adjustment request).

A U.S. Shareholder that is a partner in a partnership that is also a U.S. Shareholder must also file an amended return; however, alternative means of satisfying notification requirements where the partnership files an administrative adjustment request are permitted.

KPMG observation

Note that even though the final GILTI regulations (and regulations proposed under subpart F) do not treat a domestic partnership as a section 958(a) U.S. Shareholder, this principle does not extend to the definition of "controlling domestic shareholder."

Duty to notify

Due to the effect an election has on non-controlling U.S. Shareholders, the final regulations provide that the controlling domestic shareholders must notify each domestic shareholder who is not a controlling domestic shareholder of any election or revocation. The final regulations cross reference the notice requirements in Reg. § 1.964-1(c)(3)(iii), which generally require written notice to all domestic shareholders (within the meaning of section 958(a)) that includes certain identifying information for both the foreign corporation and the controlling domestic shareholders, describes the action taken on behalf of the foreign corporation and the tax year for which the action is taken, and identifies a designated shareholder who retains a jointly executed consent confirming that the action has been approved by all of the controlling domestic shareholders and containing the signature of a principal officer of each such shareholder.

KPMG observation

Contrary to the general existing rules in Reg. § 1.964-1(c)(3)(iii), the final regulations provide that an election is not valid if the controlling domestic shareholders fail to provide this notice.

Consistency among 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. Treasury explains in the preamble that this consistency requirement is necessary to prevent "a distortive application of the foreign tax credit limitation under section 904." If a taxpayer were "to include high-taxed income in GILTI to claim foreign tax credits up to the amount of their section 904 limitation, while electing to exclude the remainder of such income under the GILTI high-tax exclusion," the resulting section 904 limitation would not include all the deductions attributable to the high-taxed income. The consistency requirement seeks to prevent this result by requiring a taxpayer to take into account all of its high-taxed tentative tested income (along with all the deductions properly allocated and apportioned to that income) if the taxpayer wishes to cross credit high-taxed tested income against low-taxed tested income.

The final regulations provide "CFC group" rules for purposes of determining the commonly-controlled 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 other modifications, including a revision to determine a CFC group based on "more than 50 percent" of the voting power or value (rather than at least 80%, as in section 1504(a)(2)), and by requiring more than 50% of vote or value, rather than both.

Modified constructive ownership rules under section 318(a) apply: section 318(a)(3)(A) (attribution from partnerships) and (B) (attribution from trusts) do not apply; section 318(a)(4) only applies to options that are reasonably certain to be exercised; and section 318(a)(2)(C) (attribution to corporations) is applied by substituting "5 percent" for "50 percent."

KPMG observation

As a result of the application of the attribution principles of section 318, a CFC group can exist even when there is no corporate common parent. For example, the preamble to the final regulations point out that if Individual 1 owns 100% of CFC1 and CFC2, CFC1 and CFC2 would form a CFC group. The operative rule would appear to apply similarly to multiple CFCs owned by a single domestic partnership.

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. A CFC group may exist when the requisite relationship exists at the end of any of the CFC's CFC inclusion year, even if the relationship does not exist at the end of another member of the CFC group's CFC inclusion year. A CFC may only be a member of one CFC group. Special rules apply to determine whether a CFC is a member of a given CFC group where it would otherwise qualify as a member of more than one CFC group.

Year-by-year election

Under the 2019 proposed regulations, once made, an election would apply for all subsequent tax years unless revoked. The final regulations instead provide that the election is made on an annual basis. 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.

KPMG observation

This is an important taxpayer-favorable change from the 2019 proposed regulations. Since the election is now made year-by-year, the controlling domestic shareholders can skip the election in a year in which there are significant foreign tax credits that they want to bring up to the United States if modeling reveals this would be beneficial. Accordingly, even if the proposed regulations are finalized such that a tested unit has one general tested item that includes both its subpart F and tested income, in certain circumstances, it may still be advantageous to selectively implement affirmative subpart F structures and not make the GILTI high-tax exception in one year, thereby bringing up large amounts of general basket foreign tax credits for which there would be a carryforward, and revert back to making the election in subsequent years.

Contemporaneous documentation (proposed regulations)

The proposed regulations include a contemporaneous documentation requirement to substantiate the high-tax exception as well as a requirement for U.S. Shareholders to provide additional information as may be required on the Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, if a high-tax exception is in effect for a CFC. The proposed substantiation rules require each U.S. Shareholder of the CFC to maintain documentation that establishes its conclusion as to whether each "item" of the CFC's gross income satisfies, or does not satisfy, the effective rate of foreign tax that triggers the high-tax exception. The proposed regulations include a number of items that must be included in the documentation in order for the documentation to sufficiently establish the application of the high-tax exception, including an effective tax rate calculation for each item of gross income. The documentation must be in existence by the filing date of the U.S. Shareholder's federal income tax return (or amended return) for the relevant CFC inclusion year, and must be provided to the IRS within thirty days of a request for the documentation.

KPMG observation

The documentation rules in the proposed regulations are imposed on each U.S. Shareholder rather than, for example, only the controlling domestic shareholders. Thus, each U.S. Shareholder will need to maintain sufficient documentation, including the effective rate of foreign tax on each "item" of a CFC's gross income, in connection with applying the high-tax exception. The proposed regulations provide general authority for the IRS to require U.S. Shareholders to report information related to the high-tax exception on Form 5471, but do not specify the particular type of information that will reported on the form.

KPMG observation

Among the items required by the contemporaneous documentation rules are a list of all disregarded payments properly taken into account in determining a tested unit's gross income items. It would be advisable for taxpayers to anticipate questions around disregarded payments to be raised on audit.

KPMG observation

The requirement that supporting documentation must be in "existence" by the filing date and must be provided to the IRS within 30 days of request are also requirements for the specific substantiation rules in the final FDII regulations. Like the lists of information the final FDII regulations require, the list of information the high-tax exception substantiation rules require appears to be modeled after the substantiation rules under sections 170 and 274(d). As discussed in the *TaxNewsFlash* for the final FDII regulations, based on public statements by government officials, the specific substantiation rules are intended to deny taxpayers the benefit of the so-called "*Cohan* rule," under which a court may be permitted to estimate the amount of a tax benefit even in the absence of sufficient substantiation maintained by the taxpayer.

Amended return

The final regulations continue to allow the election to be made (or revoked) on an amended return, but on a more restrictive basis. The final regulations narrow the timeframe in which the amended return must be filed to allow the IRS adequate time to audit and collect any additional tax due as a result of changes resulting from the amended return and application of the GILTI high-tax exception. Importantly, all U.S. Shareholders that are controlling domestic 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-month period. Amended returns for any other tax year in which the U.S. tax liability of the U.S. Shareholder is impacted by the change in election must also be filed within such period.

KPMG observation

Note that since the final regulations allow retroactive reliance provided the rules are consistently applied (discussed further below), a taxpayer may choose to amend a return to apply the GILTI high-tax exception for tax years beginning as early as January 1, 2018. A controlling domestic shareholder wishing to elect the GILTI high-tax exception on an amended return for the 2018 calendar year would have until April 2021 (24 months from April 2019 and less than nine months from the issuance of the regulations) for all U.S. Shareholders of the CFC to file their amended returns and pay any resulting taxes. Additionally, all the U.S. Shareholders will have to both file their amended returns and pay any outstanding liability within a six-month period. As noted above, if other years of the U.S. Shareholder are impacted by the election, amended returns for such years must be filed within this time period as well. Moreover, before such an amended return is considered, the controlling domestic shareholders would need to determine the affected CFC group (since the election will apply to all CFCs in the CFC group) and the tested units of the relevant CFCs and apply the computation rules to each such tested unit in order to model whether making such a retroactive election is beneficial. Accordingly, time is of the essence and taxpayers will need to act quickly if they wish to make the GILTI high-tax election for 2018.

KPMG observation

As a result of the TCJA, the eligibility of a tested unit for the high-tax exception must be redetermined each time there is a foreign tax redetermination pursuant to section 905(c). Such redeterminations may commonly occur after the 24-month period for making or revoking an election via an amended return has expired. Taxpayers should consider that foreign tax redeterminations may result in the high-tax exception becoming, or ceasing to be, advantageous at a time when it is too late to make or revoke the election. It is therefore advisable for taxpayers to bear this consideration in mind when settling foreign audits and potentially model various foreign tax redetermination scenarios in reaching a determination as to whether to elect the high-tax exception for a given year. Treasury requests comments regarding the 24-month limitation in the preamble to the proposed regulations.

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 of which FBCI is a component.

Under the current regulations, gross FBCI of a CFC is first calculated; then the full inclusion and de minimis rules are applied to determine "adjusted gross FBCI"; then, deductions of the CFC are allocated and apportioned to determine "net FBCI"; finally, the E&P limitation of section 952(c) (described below) followed by the high-tax exception are applied to determine "adjusted net FBCI" of the CFC (colloquially known as FBCI).

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

Section 952(c) limits a subpart F inclusion where such exceeds current year E&P. When a current year subpart F inclusion is so limited, a recapture account is established by which an item of income of the CFC which would otherwise not be subpart F income in a future year is treated as subpart F income.

The existing subpart F high-tax exception is applied to each item of income of a CFC after the application of the section 952(c) E&P limitation. This potentially produces odd results: (1) a net item of subpart F income may qualify for the high-tax exception solely by virtue of the E&P limitation (that is, without the E&P haircut, the item would not be considered high-taxed), and (2) subpart F income resulting from recapture in a later year may not qualify for the high-tax exception even if it would have so qualified in the earlier year had the E&P limitation not applied.

The proposed regulations would apply the high-tax exception before the E&P limitation, thereby eliminating these oddities. This change is effectuated through revisions to the definitions that prescribe the steps for determining FBCI. Under the proposed regulations, the unified high-tax exception would apply at the beginning of the computation process, in determining the amounts of the categories of gross income that constitute gross FBCI. The E&P limitation would not apply until net FBCI is reduced to determine adjusted net FBCI (the last step).

The proposed regulations would provide that items recharacterized as subpart F income under section 952(c)(2) by virtue of a recapture account would not be subject to de minimis, full inclusion, or high-tax exception rules by effectuating recapture of subpart F income at the end of the calculation process, in determining adjusted net FBCI.

The proposed regulations contain consistent revisions to the definitions outlining the process for the computation of insurance income.

KPMG observation

Although the current ordering of the section 952(c)(1) E&P limitation before the subpart F high-tax exception can increase the likelihood that an item of income will be treated as high-taxed, it can also result in an item of income that would be high-tax without regard to the E&P limitation giving rise to a recapture account to the extent excluded pursuant to the E&P limitation. Accordingly, it may result in subpart F income in a subsequent year, when there is no foreign income tax available to be taken into account for purposes of the high-tax exception, even though the income would have been fully excluded from subpart F income in the initial year if not for the E&P limitation. In this way, the changes appear equitable.

KPMG observation

The changes described above, which introduce the exclusion of income that qualifies for the unified high-tax exception at the beginning of the subpart F income computation process and apply the section 952(c)(1) E&P limitation significantly later, reflect a complete reordering of such process. The final regulations also delete all of the examples in the current regulations illustrating the full subpart F income computation process, and the preamble thereto indicates examples will be included with the finalization of the proposed regulations.

Interaction of the high-tax exception and full inclusion rule

As indicated above, the subpart F high-tax exception is currently applied after the full inclusion rule. As such, a coordination rule ensures that if a significant amount (90%) of the CFC's gross income that caused the full inclusion rule to apply in the first instance is excluded from subpart F income under the subpart F high-tax exception, the full inclusion rule is turned off, lending a degree of circularity to the computation.

Under the proposed regulations, because the high-tax exception would apply in determining gross FBCI, while the full inclusion rule would apply in determining adjusted gross FBCI, the high-tax exception would apply before the determination of full inclusion FBCI. As a result, there is no need to reassess income initially determined to be full inclusion FBCI after the high-tax exception is applied, eliminating the need for the existing coordination rule and the complexities that it can create. The proposed regulations would also modify the coordination rules in the final GILTI regulations accordingly and delete the example illustrating them.

KPMG observation

As noted above with respect to the section 952(c)(1) E&P limitation, the introduction of the unified high-tax exception at the beginning of the subpart F income computation process, such that it applies before the full inclusion test reflects a complete reordering of such process. The deletion of the existing coordination rule in Reg. § 1.954-1(d)(6) is a happy byproduct of that rationalization.

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 consistent with existing successor principles. Accordingly, the applicability date differs from the majority of the proposed regulations in applying for recapture accounts of an acquiring corporation for tax years of the foreign corporation ending on or after July 20, 2020, even if the distribution or transfer described in section 381(a) occurred in a tax year ending before July 20, 2020.

KPMG observation

As a result of the formulation of the applicability date, the recapture account carryover rule can have significant retroactive effect. For example, a calendar year CFC that was a successor in section 381(a) transaction that occurred 20 years ago would be required to ensure that it takes into account this year (and going forward) any recapture account that it would have succeeded in that long ago transaction.

KPMG observation

The recapture rule and the more illuminating discussion thereof in the preamble conspicuously fail to address the consequences of a section 381(a) transaction in which the acquiring corporation is a domestic corporation. Although such a domestic corporation clearly could not have a recapture account, it is not clear whether a liquidating first-tier CFC's recapture account would simply disappear with no more consequence. Query whether some mechanism similar to section 904(f) could apply to require an inclusion in the acquiring domestic corporation's income to reflect the recapture account at the time of the liquidation, and if it could do so in the absence of guidance to such effect. Arguably, such a rule is not justifiable where all of the income earned by the domestic acquiring entity will be subject to direct U.S. federal income taxation.

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 rules 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 rules to each year in which they elect to apply the GILTI high-tax exception. The final regulations have been determined to be a "major rule" under the Congressional Review Act ("CRA") and therefore pursuant to section 801(3) of the CRA, the effective date of the regulations is delayed in accordance with the timing prescribed by the CRA as described in the preamble to the final regulations.

KPMG observation

The ability to retroactively apply the GILTI high-tax exception election 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 the election on an amended return.

The proposed regulations generally apply to tax years of CFCs beginning on or after the date the proposed rules are finalized. However, as explained above, the rule relating to the carryover of subpart F recapture accounts (Prop. Reg. § 1.952-1(f)(4)) is proposed to apply to tax years of a foreign corporation ending on or after July 20, 2020.

KPMG observation

The proposed regulations do not expressly permit or prohibit reliance. However, as there are current final regulations contrary to the proposed rules (i.e., the existing subpart F regulations), it appears that taxpayers **cannot** rely on the proposed regulations before they are finalized.

Comment period and hearing

Comments or requests for a public hearing on the proposed high-tax exception must be received by September 21, 2020.

Requests for comments

Treasury made a number of specific and general requests for comments in the proposed regulations:

- **Income grouping rules.** As noted above, the proposed regulations group passive FPHCI as in existing Reg. § 1.954-1(c)(1)(iii)(B). Treasury is considering conforming changes to the income grouping rules in Reg. § 1.904-4(c), and requests comments on any issues concerning such revisions.

- **Expanded use of applicable financial statements.** As noted above, the proposed regulations only use applicable financial statements to allocate and apportion deductions for section 954(b)(4). Treasury requests comments on whether to expand the use of applicable financial statements ("in limited cases (for example to reduce administrative and compliance burdens)") to sections 954(b)(5), 951A(c)(2)(A)(ii), and 960, or to continue using section 861.

  In particular, Treasury requested comments on one approach that would "provide that deductions allocated and apportioned to an item of gross income based on an applicable financial statement for purposes of calculating a tentative net item under the high-tax exception cannot be allocated and apportioned to a different item of gross income that does not qualify for the high-tax exception for purposes of calculating the inclusion under section 951(a) or section 951A." Comments are requested on this approach, which is described in the preamble as a limited change to avoid double counting between the high-tax exception and subpart F and GILTI inclusions for different items of gross income.

- **Certain items deemed to be high-taxed.** The proposed regulations deem any tentative net item resulting in an undefined value or negative effective foreign tax rate as having a high effective foreign tax rate. As described above, the result is that the item of gross income and deductions are assigned to the residual grouping from which no foreign tax credit is allowed. Treasury requests comments regarding whether this result is appropriate in all cases.

- **De minimis combination rule.** As discussed above, the proposed regulations provide a rule that would, subject to an anti-abuse rule, automatically combine tested units that are attributed less than the lesser of 1% of the gross income of the CFC or $250,000. Treasury requests comments on this rule, "including whether the rule could be better tailored to reduce administrative burden without permitting an excessive amount of blending of income subject to different foreign tax rates."

- **24-month rule for amended returns.** As discussed in detail above, the proposed regulations provide that that the high-tax exception may be made (or revoked) on an amended return only if all U.S. Shareholders of the CFC file amended returns for the year in a single six month period within 24 months of the due date (without extension) of the original return of the controlling domestic shareholder. Treasury notes in the preamble that it is "aware that changes in circumstances occurring after the 24-month period may cause a taxpayer to benefit from making (or revoking) the election, for example, if there is a foreign tax redetermination with respect to one or more CFCs," and requests comments on rules allowing a taxpayer to make the election after the 24-month period "in cases where the taxpayer can establish that the election (or revocation) will not result in time-barred tax deficiencies."

- **Transition rules.** Treasury requests comments on transition rules in the final regulations for the application of existing Reg. § 1.954-1(d) to situations in which a U.S. Shareholder's CFCs have different tax years, given the lack of a consistency requirement in Reg. § 1.954-1(d).

- **Attribution of items to tested unit when CFC holds more than one interest in the entity.** Treasury requests comments on how to attribute items to a tested unit, based on an applicable financial statement, where a CFC holds (directly or indirectly) more than one interest in an entity. An example is posited in the preamble that "assume[s] a CFC directly owns DEX, a disregarded entity that is a tax resident in Country X, and DEY, a disregarded entity that is a tax resident in Country Y. DEX and DEY together own all the interests in DEZ, a disregarded entity organized in Country Z that is viewed as fiscally transparent under the laws of all countries." Treasury specifically requests comments on "how items that are properly reflected on the applicable financial statement of DEZ, and taken into account by CFC, should be attributed to CFC's interests in DEX and DEY, each of which is a tested unit."

- **Information collection/paperwork burdens.** As is customary, Treasury requests comments on all aspects of information collection and any paperwork burdens created by the proposed regulations.

Appendix: Applicable financial statement

1. Audited separate-entity financial statement that is prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP").

2. Audited separate-entity financial statement that is prepared on the basis of international financial reporting standards ("IFRS").

3. Audited separate-entity financial statements of the foreign corporation that are prepared on the basis of the generally accepted accounting principles of the jurisdiction in which the entity is organized or the activities are located ("local-country GAAP").

4. Unaudited separate-entity financial statement that is prepared in accordance with U.S. GAAP.

5. Unaudited separate-entity financial statement that is prepared on the basis of IFRS.

6. Unaudited separate-entity financial statement that is prepared on the basis of local-country GAAP.

7. Separate-entity records used for tax reporting.

8. Separate-entity records used for internal management controls or regulatory or other similar purposes.

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