# New Unified High-Tax Election Brings Planning Challenges

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On July 20, the U.S. Department of the Treasury issued final regulations allowing a high-tax election for global intangible low-taxed income, or GILTI, purposes and proposed a further set of regulations that would unify that election and the Internal Revenue Code Subpart F high-tax election.

This article discusses some of the key issues and challenges associated with these new final and proposed regulations.

**Background**

The Tax Cuts and Jobs Act purportedly moved the U.S. toward a territorial system of taxation of foreign earnings by permitting certain income of a foreign corporation to be repatriated back to the U.S. without U.S. tax. In doing so, however, Congress recognized that this system would incentivize companies to shift inherently mobile income to low-tax jurisdictions and understood that the existing Subpart F rules were not sufficient to curb this incentive.

To further protect the U.S. tax base from the shifting of profits to non-U.S. jurisdictions, Congress added the GILTI regime to the Internal Revenue Code.[1] Broadly speaking, Section 951A was enacted to require U.S. shareholders of a controlled foreign corporation, or CFC, to pay a minimum level of tax on their GILTI.[2]

In determining the applicable rate of tax for GILTI, Congress attempted to balance the need to tax mobile income with the need to protect the competitive position of U.S. multinationals relative to their foreign peers. As a result, Congress set the GILTI tax rate at one-half of the U.S. federal corporate income tax rate — currently 10.5%. This is achieved by allowing U.S. corporate shareholders and certain U.S. individual shareholders a deduction under Section 250 equal to 50% of their GILTI inclusion.[3] Moreover, a U.S. shareholder is entitled to an 80% foreign tax credit on foreign taxes attributable to the CFC's tested income that gives rise to GILTI.[4]

In theory, the combination of the Section 250 deduction and the 80% foreign tax credit should effectively mean that a U.S. shareholder should not pay residual U.S. tax on a GILTI inclusion from CFC income that is subject to an effective rate of foreign tax of at least 13.125%.

In practice, however, this often does not hold true as a result of the expense allocation rules and the inability to carryback or carryforward foreign tax credits in the GILTI basket.

Moreover, the results are particularly harsh on taxpayers with high-taxed income and net operating losses, or NOLs. Because a U.S. shareholder must first offset its GILTI against its NOLs before it applies the Section 250 deduction or its GILTI foreign tax credits, the value of those NOLs is effectively lost when the GILTI would not otherwise have been subject to

U.S. tax due to the associated foreign tax credits.

Since the enactment of the GILTI regime, taxpayers and commentators have argued that high-taxed income NOLs should be excluded from GILTI to avoid these unfavorable results.

The Subpart F income rules in Section 954 have long included a high-tax exception under which a U.S. shareholder of a CFC can elect to exclude from the application of the Subpart F rules income which is subject to a high rate of foreign taxation. Under Section 954(b)(4), the relevant rate of foreign tax for purposes of the Subpart F high-tax exception is 90% of the maximum corporate rate.

On June 21, 2019, the Treasury and the Internal Revenue Service responded to taxpayers' requests by proposing regulations that would also allow a high-tax election for GILTI purposes.[5] More recently, on July 20, the Treasury issued final regulations adopting the 2019 proposed regulations with important changes — including the possibility of retroactive application — and proposed a further set of regulations that would unify the Subpart F and GILTI high-tax elections.

While taxpayers and commentators had recommended aligning the GILTI and Subpart F high-tax elections, most were hoping that the GILTI election would be conformed to the more flexible Subpart F election. Instead, the 2020 proposed regulations take the opposite approach, unifying both elections as a single election, and subjecting the Subpart F high-tax exclusion to the stricter rules of the GILTI election. This will require U.S. multinationals to revisit their GILTI planning as well as their use of the Subpart F high-tax election.

**Threshold Rate**

The legislative history of the TCJA indicated that if a CFC is subject to an effective rate of tax of at least 13.125%, a U.S. shareholder should expect no residual U.S. tax on its GILTI inclusion. On this basis, many commentators suggested that the threshold rate at which GILTI would be excluded should be 13.125%.

The Treasury rejected this approach in both the 2019 proposed regulations and the 2020 final regulations, and set the threshold rate at 90% of the corporate tax rate — i.e., 18.9%. Of course, this threshold rate would increase with any increase to the U.S. federal corporate tax rate.

**Tested-Unit Standard**

The 2019 proposed regulations provided for the calculation of the effective foreign tax rate on a qualified business unit basis. Some commentators requested that the test apply on a CFC-by-CFC basis, but the Treasury rejected this idea, arguing that it would inappropriately allow the blending of high-taxed and low-taxed income in a manner inconsistent with the purpose of the GILTI regime.

In addition, the 2020 final regulations abandoned the qualified business unit standard for a novel tested-unit approach.

There are three categories of so-called tested unit:

- A CFC;

- An interest in a pass-through entity — partnership or disregarded entity — held, directly or indirectly, by a CFC to the extent such pass-through entity is:
  - A tax resident of a foreign country; or
  - Treated as fiscally opaque for purposes of the CFC's tax laws; and
- A branch whose activities are carried on by a CFC, provided that either the branch gives rise to:
  - A taxable presence in the country where it is located; or
  - A taxable presence under the owner's tax law, and such tax law provides an exclusion or exemption for the branch income — the latter is referred to as a nontaxed branch-tested unit.

Once a tested unit is identified, items of gross income, deductions and foreign taxes attributable to the tested unit are evaluated separately. If an item of income is attributable to more than one tested unit in a tier of tested units, the item shall be attributed solely to the lowest-tier tested unit.

The 2020 final regulations include a combination rule pursuant to which tested units of a CFC, other than nontaxed branch-tested units, must generally be treated as a singlet-tested unit if the tested units are tax residents of, or located in, the same foreign country — regardless of whether the tested units are subject to the same foreign tax rate or have the same functional currency.

This combination rule seeks to reduce compliance burdens, and minimize the effects of timing and other differences between the U.S. and foreign tax bases.

In addition, the 2020 proposed regulations provide that taxpayers are generally required to combine tested units that are attributed gross income less than the lesser of 1% of the gross income of the CFC or $250,000. This proposed de minimis combination rule would apply to combine tested units that are not residents of, or located in, the same foreign country.

**Calculation of Effective Foreign Income Tax Rate**

Following the 2019 proposed regulations, the 2020 final regulations rely on a separate set of books and records as the starting point for determining gross income attributable to a tested unit. Therefore, items of gross income of a CFC that would be taken into account for federal income tax purposes are attributable to a tested unit of the CFC to the extent they are properly reflected on the separate set of books and records of the tested unit, or of the entity an interest in which is a tested unit (or would be so reflected if such books and records were kept).

The 2020 proposed regulations would replace the reference to "books and records" with an "applicable financial statements" standard, providing for an order of priority when there are various forms of financial statements available. Payments that are otherwise disregarded for U.S. federal income tax purposes are generally regarded for purposes of determining gross income attributable to a tested unit.

Under these rules, the 2020 final regulations provide for the aggregation of all items of income attributable to a tested unit. Further, according to the 2020 proposed regulations, that aggregation should also include items of income that would otherwise be Subpart F income.

After the gross income of each tested unit is determined, the CFC's deductions are allocated and apportioned to each tested unit in order to determine the so-called tentative tested-income item. Under the 2020 final regulations, this allocation and apportionment of deductions is made following the rules used for foreign tax credit purposes.

Subject to a request for further comments, the 2020 proposed regulations propose an alternative methodology where the allocation would follow the manner in which the deductions are reflected in the tested unit's applicable financial statements.

The effective foreign income tax rate on each tentative tested income item is calculated by dividing (a) the U.S. dollar amount of foreign income taxes paid or accrued that have been allocated and apportioned to the tentative tested income item by (b) the U.S. dollar amount of the tentative tested income item, grossed-up by the amount of such foreign income taxes.

**Rules Regarding the Election**

The high-tax election must be made by the controlling domestic shareholders of a CFC. These are generally the 10% U.S. shareholders that, in the aggregate, own more than 50% of the total combined voting power of all classes of stock and undertake to act on the CFC's behalf.

If U.S. shareholders do not, in the aggregate, own more than 50% of the total voting power of the CFC, the controlling domestic shareholders are all 10% U.S. shareholders who own stock of the CFC. The election made by the controlling U.S. shareholder is binding on all U.S. shareholders of the CFC. Controlling domestic shareholders must notify other 10% U.S. shareholders of the election and any revocation.

In light of these rules, it is expected that shareholder agreements may provide mechanics for decisions relating to the making or revocation of high-tax elections, as well as information rights for minority U.S. investors.

Because, as noted below, different foreign corporations controlled by a common partnership parent would be deemed to form part of a so-called CFC group, private equity funds should consider how the high-tax election would affect their U.S. investors. In this respect, the Treasury requested comments in the preamble to the 2020 final regulations on whether a U.S. partnership should be treated as a controlling shareholder for purposes of making the high-tax election.

The 2020 final regulations retain the consistency rule from the 2019 proposed regulations by providing that a shareholder must make the election for all or none of the CFCs in a CFC group. Given the new unified GILTI/Subpart F election under the 2020 proposed regulations, the consistency rule takes on added significance as it will also apply with respect to Subpart F inclusions.

The 2020 final regulations generally define a CFC group as CFCs that are directly, indirectly or constructively connected through stock ownership of more than 50% (by vote or value) with a common parent. Given the application of constructive ownership rules for purposes of this determination, two or more CFCs owned by the same U.S. individual or partnership would be considered part of a CFC group.

A CFC may only be a member of one CFC group and the 2020 final regulations include a special tie-breaker rule to this effect.

Under the 2019 proposed regulations, a GILTI high-tax exclusion election remained effective for the CFC inclusion year for which the election was made and all subsequent CFC inclusion years unless the election was revoked. Once revoked, the 2019 proposed regulations did not permit a new election for 60 months.

Importantly, the 2020 final regulations eliminate this 60-month restriction and permit taxpayers to elect the high-tax exclusion on an annual basis, subject to the consistency rule described above. This added flexibility is a welcome change for taxpayers.

The 2020 final regulations also permit taxpayers to retroactively make a GILTI high-tax exclusion election or revocation on an amended return for a prior taxable year.

This is permitted so long as the amended return is filed within 24 months of the unextended due date of the original return of the controlling domestic shareholder's inclusion year, and so long as all other U.S. shareholders of the CFC file amended returns within a single six-month period. The six-month period must be within the 24-month period referenced above.

If an election or revocation is made, the 2020 final regulations require controlling domestic shareholders to provide notice of such election or revocation to each U.S. shareholder that is not a controlling domestic shareholder.

**Proposed Regulations on Subpart F High-Tax Exception**

As mentioned above, the 2020 proposed regulations contemplate a single unified election for purposes of both Subpart F income and GILTI modeled on the rules of the 2020 final regulations for the GILTI high-tax election. Therefore, taxpayers would no longer be able to elect for the Subpart F high-tax exclusion on an item-by-item basis, as allowed under current law.

The 2020 proposed regulations also include coordination rules relating to the calculation of Subpart F income. First, they provide that the high-tax exception applies without regard to the earnings and profits limitation in Section 952(c)(1). Second, they indicate that the high-tax exception should be applied before the full inclusion rule.

**Applicability Dates**

As a general matter, the 2020 final regulations apply to tax years beginning on or after July 23. Notably, however, the 2020 final regulations allow taxpayers to retroactively apply the high-tax election to tax years that began after Dec. 31, 2017, provided they consistently apply the 2020 final regulations to such tax years.

This is an important change from the 2019 proposed regulations, which did not contemplate this retroactive application.

The 2020 proposed regulations are would apply to tax years beginning after the date the rules are finalized. Taxpayers may not rely on the 2020 proposed regulations currently.

**Planning With the New High-Tax Election**

When proposed in 2019, the GILTI high-tax election was a welcome response to requests by U.S. multinationals and their advisers. However, in the vein of "be careful what you wish for," the Treasury went several steps further by conforming the Subpart F and GILTI high-tax elections, and imposing the CFC-group consistency rules to Subpart F inclusions as well.

This will significantly impact international tax planning for U.S. multinationals, essentially grouping CFCs into two buckets — those with foreign effective tax rates below 18.9% and those with foreign effective tax rates above 18.9%.

The GILTI high-tax election will permit U.S. multinationals to avoid the residual U.S. taxes on their high-taxed GILTI inclusions that often result from the application of the expense apportionment rules. However, the consistency rules do not allow for CFC-by-CFC planning and thus reduce the opportunity to blend high-taxed and low-taxed income.

This may limit the utility of the election and taxpayers should carefully model all consequences of making or not making the election. For example, electing to exclude GILTI or Subpart F high-taxed income will eliminate the ability to cross-credit foreign taxes paid on such high-taxed income against other low-taxed income in the same basket.

Moreover, the election would also remove the benefit from any qualified business asset investment in the high-taxed CFC for purposes of calculating the U.S. taxpayer's GILTI inclusion. Given that the unified high-tax election may now be made on an annual basis, taxpayers will need to carefully model the impact of the election on a regular basis.

Fresh consideration should be given to making check-the-box elections for low-taxed CFCs to move GILTI inclusions and related foreign taxes into the foreign-branch, foreign-tax-credit basket, especially where a taxpayer has excess credits in that basket.

Because GILTI inclusions are isolated in a separate foreign-tax-credit basket and credits in that basket cannot be carried back or forward, moving income and foreign taxes into the foreign-branch basket may improve the taxpayer's overall foreign tax credit position.

The expansion of the consistency rules to the Subpart F high-tax election will also require U.S. multinationals to review their Subpart F planning.

Previously, a taxpayer could pick and choose among its CFCs to determine the optimal high-tax election position. This allowed U.S. multinationals to calibrate Subpart F inclusions and optimize the utilization of foreign tax credits.

By forcing consistency for Subpart F purposes as well, making a high-tax election may result in an overall increased Subpart F effective tax cost.

The punitive foreign tax credit rules for GILTI inclusions have also encouraged some taxpayers to consider restructuring the operation of CFCs to convert income from GILTI-tested income to Subpart F income. This planning may still prove favorable in some circumstances, but must now also take into consideration the impact of the unified high-tax election.

Taxpayers' planning is further complicated by the mechanics for determining the effective tax rate of a CFC. As discussed above, the effective tax rate determination is a complex calculation made by reference to the foreign taxes imposed on each tested unit after application of U.S. tax principles and limitations. Of particular note is the potential application of the Section 163(j) interest deduction limitations to CFCs.[6] Tested unit grouping rules must also be taken into account.

Finally, the retroactivity of the GILTI high-tax election may also allow taxpayers to maximize the benefit of NOL carrybacks under the Coronavirus Aid, Relief, and Economic Security Act.[7]

By making the GILTI high-tax election for 2018, 2019 and/or 2020, a taxpayer may increase the amount of NOLs that can be carried back to prior years and, importantly, may maximize the value of such carrybacks by preventing the NOLs from offsetting GILTI that would otherwise benefit from the Section 250 50% deduction or would be completely absorbed by the associated foreign tax credits.

**Relationship to Pillar Two**

Readers will be familiar with the Organization for Economic Cooperation and Development's two-pillar project, which furthers the work of its base erosion and profit shifting initiatives.[8] Pillar One represents a proposed approach for the taxation of the digital economy. Pillar Two is the OECD's global base erosion project.

Pillar Two involves four components designed to ensure a minimum level of tax is paid in each country. One of these components is an income inclusion rule which would operate similar to a CFC regime and allocate a minimum level of income to each country.

The income inclusion mechanism is very similar to the GILTI regime. For this reason, many commentators, including the authors' firm, recommended that the GILTI regime be considered an acceptable mechanism and that no additional legislation be required in the U.S. to comply with Pillar Two.[9]

Based on recent commentary by the OECD, there is strong expectation that GILTI will be considered an acceptable regime. While this commentary predated the release of the 2020 final regulations, the adoption of a high-tax election should not undermine the acceptability of GILTI as a conforming regime for purposes of Pillar Two.

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[1] Tax Cuts and Jobs Act, 115 P.L. 97. All section references are to the Internal Revenue Code of 1986, as amended.

[2] Despite its name, GILTI is not limited to intangible or low-taxed income. Very generally, GILTI is defined as a U.S. shareholder's aggregate net CFC-tested income over a routine 10% return on the qualified business asset investment of its CFCs.

[3] Individual shareholders that make a Section 962 election.

[4] To prevent the cross-crediting of foreign taxes, GILTI inclusions are treated as a separate basket for purposes of the foreign tax credit limitation.

[5] See REG-101828-19; 84 FR 29114, as corrected at 84 FR 37807.

[6] The Treasury recently issued final regulations (T.D. 9905) and proposed regulations (REG-107911-18) under Section 163(j). The proposed regulations provide for application of the Section 163(j) interest deduction limitations to CFCs.

[7] For a summary of the NOL carryback provisions under the CARES Act, see "CARES Act Adds Five-Year Carryback Period and Suspends 80% Limitation for 2018, 2019 and 2020 Net Operating Losses" available at https://www.mayerbrown.com/en/perspectives-events/publications/2020/03/cares-act-adds-five-year-carryback-period-and-suspends-80-limitation-for-2018-2019-and-2020-net-operating-losses.

[8] For an update on the OECD's two pillar project, see "OECD Takes Important Steps in Advancing Pillar One, Progress Noted on Pillar Two" available at https://www.mayerbrown.com/en/perspectives-events/publications/2020/02/taxing-the-digital-economy.

[9] Mayer Brown's comments to the OECD are available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/12/mayer-brown-pillar-two-submission-2-december-2019.pdf.