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# U.S. Issues Taxpayer-Favourable Regulations Under GILTI and Subpart F Regimes

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The U.S. Treasury Department and the IRS have issued guidance relating to the new tax on the “global intangible low-taxed income” (GILTI) of a “controlled foreign corporation” (CFC). Generally, GILTI is the portion of a CFC’s earnings that exceeds a specified return on the CFC’s foreign assets. The new guidance includes an exception from the GILTI rules for income subject to a relatively high rate of tax in the foreign country and changes the way that income of a foreign corporation is taxed when held by a partnership. This guidance may have implications beyond the U.S. border since the OECD specifically referred to the GILTI regime in a recent public consultation document that proposes a “global minimum tax” as part of the OECD’s base erosion and profit shifting initiative.

The GILTI regime was created in 2017 as part of the *Tax Cuts and Jobs Act of 2017* (TCJA). The IRS proposed regulations on GILTI in October 2018 (2018 Proposed Regulations). The recently issued guidance takes the form of final regulations based on the 2018 Proposed Regulations (2019 Final Regulations) and a new set of proposed regulations (2019 Proposed Regulations).

## GILTI

The TCJA, despite being the most comprehensive overhaul of the U.S. tax system in decades, retained (with modifications) the “subpart F” regime that taxes a U.S. person on the earnings of an affiliated foreign corporation. Specifically, under subpart F, a “United States shareholder” is taxed currently on certain, generally passive, income of a foreign corporation (known as subpart F income) if United States shareholders own more than 50% of the vote or value of the foreign corporation’s stock. For the purposes of subpart F, a United States shareholder is a U.S. person that owns at least 10% of the vote or value of the foreign corporation’s stock. A foreign corporation whose ownership meets these tests is known as a CFC.

Under subpart F, a United States shareholder may elect to exclude an item of subpart F income from its gross income if the item qualifies for a high-tax exception from subpart F. This high-tax exception is available with respect to an item of income that is taxed in a foreign country at a rate exceeding 90% of the highest U.S. corporate income tax rate (which currently equals 18.9%, since the TCJA reduced the corporate income tax rate to 21%). The aggregate national and subnational corporate income tax rates of most developed countries should currently meet this threshold.

The TCJA added a new tax on a United States shareholder’s share of GILTI earned by a CFC. Although the GILTI regime is intended to target low-taxed income, the GILTI rules as initially drafted did not include an exception for high-taxed income like the one available for subpart F income. Instead, United States shareholders that are corporations (and certain United States shareholders that have elected to be taxed as corporations with respect to their subpart F income) are permitted a deduction equal to 50% of their GILTI and a foreign tax credit for 80% of the foreign taxes paid with respect to their GILTI. The result of these deductions is that a United States shareholder generally does not pay tax on GILTI that is subject to foreign tax at a rate in excess of 13.125%. In addition, earnings of a CFC that are treated as subpart F income and earnings that are excluded from subpart F income based on the high-tax exception from subpart F are excluded from GILTI.

Many tax professionals were disappointed, however, that the 2018 Proposed Regulations did not provide a high-tax exception from GILTI that was broadly similar to the high-tax exception from subpart F.

The 2018 Proposed Regulations were also criticized for their treatment of GILTI recognized through a domestic partnership. Historically, under subpart F, if a domestic partnership met the ownership thresholds to be a United States shareholder of a CFC, each partner was allocated a share of the domestic partnership's subpart F income even if the partner's indirect interest in the CFC was below those thresholds. This approach was referred to as the "entity approach." (If subpart F used an "aggregate approach," a partner would only have to recognize subpart F income if the partner's indirect interest in the CFC was at least 10% – that is, the partner itself was a United States shareholder.)

Surprisingly, the 2018 Proposed Regulations did not follow the entity approach for allocations of GILTI through a domestic partnership, even though the subpart F and GILTI regimes are generally intended to act in tandem. Instead, the 2018 Proposed Regulations adopted a "hybrid approach" with respect to GILTI allocated through a domestic partnership that (i) applied the entity approach with respect to U.S. partners that were themselves United States shareholders of the CFC and (ii) applied the aggregate approach with respect to U.S. partners that were not United States shareholders of the CFC.

## The 2019 Final and Proposed Regulations

The key provisions of the 2019 Final Regulations and 2019 Proposed Regulations are as follows:

### High-Tax Exception Provided with Respect to GILTI

The 2019 Proposed Regulations provide a high-tax exception with respect to GILTI, comparable to the high-tax exception from subpart F. Under the new high-tax exception, a controlling domestic shareholder of a CFC may elect to exclude GILTI from gross income, provided that the GILTI is subject to foreign income tax in excess of 90% of the U.S. corporate income tax rate (i.e., 90% of the corporate income tax rate of 21%, which equals 18.9%). This election must be made consistently with respect to all CFCs under common control of the domestic shareholder.

Confusingly, the 2019 Final Regulations provide that the high-tax exception with respect to GILTI applies only to income that is not subpart F income as a result of the high-tax exception from subpart F. The 2019 Proposed Regulations allow an election to apply the high-tax exception to GILTI whether or not the excluded income would otherwise be subpart F income.

The generally taxpayer-friendly provisions of the 2019 Proposed Regulations are applicable to taxable years of a CFC beginning on or after the date that the rules are adopted as final regulations. Therefore, until the 2019 Proposed Regulations become final, the availability of the high-tax exception with respect to GILTI is limited to situations in which income is excluded from subpart F income as a result of the high-tax exception under subpart F.

### Clarification of Approach with Respect to GILTI Recognized Through Partnerships

The 2019 Final Regulations clarified the hybrid approach to GILTI recognized through domestic partnerships as provided in the 2018 Proposed Regulations, described above.

Under the 2019 Final Regulations, for GILTI purposes, the entity approach is used to determine whether a foreign corporation owned by a domestic partnership is a CFC, but the aggregate approach is used to determine whether a partner of the domestic partnership is a United States shareholder of the CFC and, if so, to calculate the partner's allocable share of the domestic partnership's GILTI.

For example, assume that a domestic limited partnership (USLP) owns 100% of a foreign corporation (FC) and has two U.S. partners, Partner A and Partner B. Partner A owns 5% and Partner B owns 15% of the limited partnership interests of USLP. Under the 2019 Final Regulations, for GILTI purposes, (i) FC would be a CFC under the entity approach, and (ii) USLP and Partner B would be United States shareholders, and Partner A would not be a United States shareholder, under the aggregate approach. Therefore, USLP would allocate 15% of FC's GILTI to Partner B and would not allocate any of FC's GILTI to Partner A.

### Extension of Aggregate Approach to Subpart F Income

The 2019 Proposed Regulations, in what may be one of the most significant changes resulting from the new guidance, would apply the aggregate approach to determine whether a partner of a domestic partnership is a United States shareholder for the purposes of subpart F in general. This change would make the treatment of domestic partnerships under subpart F consistent with the GILTI regime.

As a result, to continue the example above, no subpart F income earned by FC would be allocated to Partner A, because Partner A is not a United States shareholder with respect to FC under the aggregate approach. This is a significant departure from the historic treatment of domestic partnerships under subpart F.

The 2019 Proposed Regulations are generally effective for tax years beginning on or after the date that the 2019 Proposed Regulations are finalized. Meanwhile, the 2019 Proposed Regulations may be relied on by a domestic partnership as long as the rules are applied consistently with respect to all CFCs held by the domestic partnership.

## Conclusion

The 2019 Final Regulations and the 2019 Proposed Regulations show that the IRS listened to the criticism of the 2018 Proposed Regulations that was submitted by tax practitioners and other commentators. The expansion of the high-tax exception from subpart F into the GILTI regime and the application of the aggregate approach to both GILTI and subpart F income are likely to ease taxpayers' compliance burden as well as generally reduce the amount of tax payable by taxpayers with interests in foreign corporations. Multinational corporate enterprises and international investors are sure to welcome this measure of relief from the complexities of the GILTI regime.

As noted above, the broader version of the high-tax exception from GILTI will be effective only once the 2019 Proposed Regulations are finalized. Accordingly, clients and their tax advisers should support the speedy finalization of the 2019 Proposed Regulations.

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