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IRS Finalizes High-Tax Exception to GILTI

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The U.S. Treasury Department and the IRS have released final regulations (2020 Final Regulations) allowing certain domestic shareholders of a “controlled foreign corporation” (CFC) to elect under a high-tax exception to opt out of the tax imposed on the CFC’s “global intangible low-taxed income” (GILTI). The GILTI regime was created in 2017 as part of the *Tax Cuts and Jobs Act of 2017* (TCJA); generally, GILTI is the portion of a CFC’s earnings that exceeds a specified return on the CFC’s foreign assets.

The 2020 Final Regulations, which were released on July 20, 2020, are based on proposed regulations issued by the IRS in 2019 (2019 Proposed Regulations) that included an exception from the GILTI rules for income subject to a relatively high rate of tax in a foreign country. In addition to the 2020 Final Regulations, the IRS issued a new set of proposed regulations (the 2020 Proposed Regulations) modifying the high-tax exception to the subpart F income (i.e., income of a foreign corporation) rules to conform such exception to the newly finalized GILTI exception under the 2020 Final Regulations.

GILTI

The TCJA 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 if U.S. 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 (U.S. 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 U.S. 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%). For purposes of determining whether the high-tax exception applies (including for purposes of the 2020 Final Regulations), the threshold rate is determined based on the effective foreign tax rate actually imposed on an item of income and not merely the stated tax rate under the foreign jurisdiction.

The TCJA added a new tax on a U.S. 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, U.S. shareholders that are corporations (and certain U.S. 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 U.S. 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.

The 2019 Proposed Regulations

The 2019 Proposed Regulations provided a high-tax exception with respect to GILTI, comparable to the high-tax exception from subpart F. Under the exception contained in the 2019 Proposed Regulations, a controlling domestic shareholder of a CFC could elect to exclude GILTI from gross income, provided that the GILTI was subject to foreign income tax in excess of 90% of the U.S. corporate income tax rate (i.e., the same 18.9% rate). The election, as proposed, must be made consistently with respect to all CFCs under common control of the controlling domestic shareholders.

Of note, the 2019 Proposed Regulations provided that the calculation of foreign tax rates would be determined separately with respect to each qualified business unit (QBU) of a CFC, precluding blending of high-taxed income and low-taxed income that if determined on an aggregate basis would permit broader application of the high-tax exception. In addition, the 2019 Proposed Regulations generally required that (i) the high-tax exception be elected by a CFC's controlling domestic shareholders, (ii) the election be binding on all U.S. shareholders of the CFC and (iii) once the election was made or revoked, the action cannot be changed (with a revocation or new election) for 60 months.

The generally taxpayer-friendly provisions of the 2019 Proposed Regulations were drafted to be applicable to taxable years of a CFC beginning on or after the date that the rules were adopted as final regulations. Therefore, prior to the issuance of the 2020 Final Regulations, taxpayers generally were unable to take advantage of the high-tax exception with respect to GILTI (except for certain limited situations in which the income was excluded from subpart F income as a result of the high-tax exception under subpart F).

The 2020 Final Regulations

The 2020 Final Regulations generally adopted the GILTI high-tax exception of the 2019 Proposed Regulations with some modifications. The basic rules providing an opt-out from the GILTI regime for income that is subject to foreign income tax in excess of 90% of the U.S. corporate income tax rate were retained. Although various comments from taxpayers were considered, and some were incorporated into the 2020 Final Regulations, many were rejected on the basis of complexity.

Key takeaways from the 2020 Final Regulations include the following:

- **Tested Unit Determination.** With respect to calculating the foreign tax rate, the 2020 Final Regulations apply neither the QBU-by-QBU approach of the 2019 Proposed Regulations nor the CFC-by-CFC approach requested by taxpayers and commentators. Instead, the 2020 Final Regulations determine the GILTI effective rate on the basis of a tested unit by tested unit. A tested unit generally includes a CFC, an interest in a pass-through entity held by a CFC and certain branches of a CFC. Moreover, under a new combination rule, tested units of a CFC must be treated as a single tested unit if they are located in or residents of the same foreign country.
- **Disregarded Payments.** The 2020 Final Regulations add some additional complexity with respect to payments that are disregarded for U.S. tax purposes and made from one tested unit to another tested unit by providing that gross income be reallocated among the tested units to ensure that the income is properly associated with the tested unit in which such income is subject to tax.
- **Annual Election.** The 2020 Final Regulations eliminate the 60-month waiting period for taxpayers to revoke or remake the high-tax exception, and instead provide that taxpayers can determine whether to make the high-tax exception election on an annual basis.
- **Consistency Requirement.** Notwithstanding commentators requesting that the high-tax exception election be made available on a CFC-by-CFC basis, the 2020 Final Regulations retained the consistency requirement that the election or revocation apply to all related CFCs.

The 2020 Proposed Regulations

Following the issuance of the 2019 Proposed Regulations, although taxpayers welcomed guidance permitting a high-tax exception for GILTI, many practitioners commented that the high-tax exception for GILTI under the 2019 Proposed Regulations should be modified to conform to the subpart F income high-tax exception. Although the Treasury Department and the IRS agree that the GILTI high-tax exception and the subpart F income high-tax exception should be conformed, ultimately, it was determined that the high-tax exception of the 2020 Final Regulations better reflects the policies underlying the high-tax exception than the current subpart F income high-tax exception.

Based on the above determination, and in order to prevent inappropriate tax planning and to reduce complexity resulting from different high-tax exceptions, the 2020 Proposed Regulations (i) modify the existing subpart F income high-tax exception to conform to the GILTI

high-tax exception of the 2020 Final Regulations and (ii) provide for a single high-tax exception election to be applied for purposes of both the GILTI regime and the subpart F income regime.

Effective Date

The 2020 Final Regulations are effective for tax years of foreign corporations beginning on or after July 23, 2020, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. In a bit of good news, taxpayers may choose to apply the 2020 Final Regulations for tax years beginning after December 31, 2017, and before July 23, 2020, as long as certain consistency requirements are satisfied.

The 2020 Proposed Regulations are generally effective for tax years beginning on or after the date that the 2020 Proposed Regulations are finalized.

Conclusion

The package of regulations issued by the IRS provides taxpayer-friendly guidance by expanding the high-tax exception from subpart F into the GILTI regime, which generally should reduce the amount of tax payable by taxpayers with interests in foreign corporations. While multinational corporate enterprises and international investors are sure to welcome this measure of relief from the application of the GILTI regime, they may be less enamored by the decision to modify the high-tax exception for subpart F income to conform to the new GILTI rules in the 2020 Final Regulations, introducing some additional complexities that are not reflected in the current subpart F income high-tax exception.

In light of the retroactive relief granted to taxpayers for the GILTI high-tax exception, which, under certain circumstances can be elected for tax years beginning after December 31, 2017, taxpayers and their tax advisers should consider whether they can benefit from applying the 2020 Final Regulations to prior tax years.

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