Highlights of the final and proposed 'GILTI' regulations under Section 951A

June 17, 2019

In brief

Treasury and the IRS on June 14, 2019 released 318-page final regulations (the Final Regulations) and 74-page proposed regulations (the Proposed Regulations) under Section 951A as enacted by the 2017 tax reform legislation (the Act) and provisions related to implementing Section 951A. The Final Regulations and Proposed Regulations provide guidance relating to a US shareholder's pro rata share of its global intangible low-tax income (GILTI).

The Final Regulations incorporate with modifications the rules described in prior proposed regulations (the 2018 Proposed Regulations) under Section 951A and set forth additional guidance on a range of issues relating to the implementation of that provision. Among the changes, the Final Regulations clarify the interaction of subpart F and GILTI for purposes of determining tested income, modify anti-abuse rules for property transactions taking place prior to the effective date of Section 951A, and modify the treatment of domestic partnerships for purposes of determining a domestic partner's GILTI inclusion.

The Final Regulations also include final rules under Sections 78, 861, and 965 which were originally proposed in a separate proposed regulation package relating to foreign tax credits. These rules finalize the rules under Prop. Reg. sec. 1.78-1 including the provision to treat Section 78 dividend relating to taxable years of foreign corporations beginning before January 1, 2018 as ineligible for the dividends-received deduction under Section 245A, modify certain rules under Prop. Reg. sec. 1.861-12(c) relating to basis adjustments to controlled foreign corporation (CFC) stock taking into account Section 965 basis adjustment elections, and finalize rules related to the Section 965(n) election to forgo use of a net operating loss (NOL) in the toll charge year.

The Proposed Regulations provide guidance on carving out an exception from GILTI gross tested income for certain income subject to 'high tax' in a foreign jurisdiction, as well as amending the treatment of domestic partnerships for purposes of determining a foreign corporation's status as a CFC and computing a US shareholder's subpart F and GILTI inclusion.

Taxpayers subject to these rules should immediately review the Final Regulations and Proposed Regulations to determine the impact, if any, on their GILTI and Section 965 tax liability.

Some of the key highlights we have identified thus far are set forth below. In addition, we will discuss the Final Regulations and Proposed Regulations on an upcoming webcast.

In detail

Background

Prior Section 951A guidance

As discussed in a prior PwC Insight, Section 951A requires a US shareholder to include in income the GILTI of its CFCs. While the full amount of GILTI is includible in the US shareholder's income, the net GILTI inclusion is reduced through a 50% deduction in tax years beginning after December 31, 2017, and before January 1, 2026 (and a 37.5% deduction in tax years beginning after December 31, 2025).

Subsequently, on September 13, 2018, Treasury and the IRS released the 2018 Proposed Regulations relating to Section 951A, which generally provided guidance relating to the mechanics of determining a US shareholder's GILTI inclusion, including CFCs held through partnerships and determining a GILTI inclusion on a consolidated basis.

Highlights of the Final Regulations

The Final Regulations, released June 14, 2019, retain the overall structure and basic approach of the Proposed Regulations, with certain revisions. The Final Regulations adopted certain taxpayer comments received in response to the Proposed Regulations. The following is a high-level summary of the key modifications and revisions in the Final Regulations.

Determining pro rata share

The Final Regulations provide a helpful clarification of the scope of the pro rata share anti-abuse rule under Prop. Reg. sec. 1.951-1(e)(6) (the proposed pro rata share anti-abuse rule).

The proposed pro rata share anti-abuse rule provides that any transaction or arrangement that is part of a plan a principal purpose of which is the avoidance of Federal income taxation, including, but not limited to, a transaction or arrangement to reduce a US shareholder's pro rata share of subpart F income or a tested item of a CFC is disregarded in determining such US shareholder's pro rata share of subpart F income or a tested item of the corporation. To address the concern that the rule is overbroad and could be interpreted to apply to nearly all transactions, arrangements, or tax elections that reduce the pro rata share amounts of a US shareholder, including, for example, requiring a US shareholder that disposes of CFC stock to indefinitely include its pro rata share of the CFC's subpart F income or tested items with respect to such stock, the Final Regulations clarify that the rule applies only to reallocate the allocable E&P (as defined under Treas. Reg. sec. 1.951-1(e)(1)(ii)) that would be distributed in a hypothetical distribution with respect to any share of stock outstanding as of the hypothetical distribution date. Under the rule, reallocations will be made solely between shareholders that own, directly or indirectly, stock of the CFC as of the relevant hypothetical distribution date. This means that the rule would not affect a US shareholder that disposes of CFC stock prior to such hypothetical distribution date.

The Final Regulations also clarify the regulations under Section 951(a)(2)(B) to prevent a dividend distributed by a CFC to a person other than the US shareholder during the taxable year from reducing both a US shareholder's pro rata share of subpart F income and its pro rata share of tested income on a dollar-for-dollar basis.

Additionally, the Final Regulations clarify that the rule treating a controlled domestic partnership as a foreign partnership for purposes of determining stock ownership in a CFC by a US person under Section 958(a) applies with respect to all partners of the partnership, as opposed to only a specific US shareholder.

Pro rata share of QBAI

The Final Regulations modify the excess qualified business asset investment (QBAI) rule proposed under Prop. Reg. sec. 1.951A-1(d)(3)(ii) to apply a hypothetical distribution model to excess QBAI. Specifically, the final rule provides that in the case of a tested income CFC with tested income that is less than 10% of its QBAI (hypothetical tangible return), a shareholder's pro rata share of QBAI is determined based on the shareholder's pro rata share of this hypothetical tangible return, which is in turn determined using the same hypothetical distribution rules for determining pro rata share of tested income. Unlike the excess QBAI rule in the Proposed Regulations, the modified rule is not limited to preferred stock.

Stock owned through domestic partnerships

The Final Regulations modify the treatment of domestic partnership for purposes of applying Sections 951A and for determining the status of a person as a US shareholder or CFC.

Specifically, a domestic partnership that owns a foreign corporation is treated as an entity for purposes of determining whether the partnership and its partners are US shareholders, whether the partnership is a controlling domestic shareholder, and whether the foreign corporation is a CFC. However, such domestic partnership is treated as an aggregate of its partners for purposes of

determining its partners' GILTI inclusions and for purposes of any other provision that applies by reference and 951A (e.g., Sections 959, 960, and 961).

The Final Regulations modify the approach taken in the 2018 Proposed Regulations which proposed a hybrid approach for domestic partnerships by treating a domestic partnership as an entity for non-US shareholder domestic partners and as an aggregate for US shareholder domestic partners.

Determining gross income and allocable deduction

The Final Regulations adopt the application of Treas. Reg. sec. 1.952-2 provided in the 2018 Proposed Regulations for purposes of determining a CFC's gross income and allowable deductions. However, the preamble indicates that future guidance is expected to clarify that any provision that is expressly limited in its application to domestic corporations, such as Section 250, generally does not apply to a CFC by reason of Treas. Reg. sec. 1.952-2 for purposes of computing a CFC's tested income.

Subpart F exclusion

Section 951A(c)(2)(A)(i)(II) provides that gross tested income is determined without regard to any gross income taken into account in determining the subpart F income of the CFC (the subpart F exclusion). The Final Regulations provide guidance for determining gross income taken into account in subpart F income for purposes of the subpart F exclusion. The Final Regulations provide coordination rules with the de minimis rule under Section 954(b)(3)(A) and the full inclusion rule under Section 954(b)(3)(B), requiring that these rules be taken into account for purposes of determining 'gross income taken into account' in determining subpart F income within the meaning of the subpart F exclusion. The effect is that full inclusion subpart F income is taxed solely under Section 951, whereas de minimis subpart F income is taxed solely under Section 951A.

Under the Final Regulations, however, full inclusion income excluded from subpart F income by reason of Treas. Reg. sec. 1.954-1(d)(6) (exception to the full inclusion rule for high-taxed income) is not excluded from gross tested income by reason of the subpart F exclusion.

The Final Regulations further provide that gross income that qualifies for an exception to foreign base company income under Section 954(a) or 954(h) (active financing income) does not constitute 'gross income taken into account' in determining subpart F income. Such income, therefore, is includible in gross tested income.

Section 952(c) coordination rule

The Final Regulations, dismissing comments for revision and clarification, adopt the Section 952(c) (E&P limitation and recapture rule for subpart F purposes) coordination rule in the Proposed Regulations which provides that gross tested income is determined without regard to the application of Section 952(c). That is, income that would be subpart F income but for the application of the E&P limitation in Section 952(c)(1)(A) is excluded from gross tested income by reason of the subpart F exclusion while income that give rise to E&P that results in subpart F recapture under section 952(c)(2) is not excluded from gross tested income by reason of the subpart F exclusion. The Final Regulations revise the Section 952(c) coordination rule to apply also to disregard the effect of a qualified deficit or a chain deficit in determining gross tested income.

Determining QBAI

The Final Regulations largely adopt the approach taken in the 2018 Proposed Regulations for determining QBAI. However, the Final Regulations provide a transition rule for CFCs that are not otherwise required to use Section 168(g) alternative depreciation system (ADS) for purposes of computing income and E&P. Such CFCs may elect, for purposes of computing QBAI, to use a non-ADS depreciation method with respect to property placed in service before the first tax year beginning after December 22, 2017. However, this transition rules does not apply for purposes of determining the foreign-derived intangible income of a domestic corporation.

The Preamble notes that the determination of the adjusted basis in property under Section 951A(d) is not a method of accounting subject to the consent requirement of Section 446(e). However, a change to ADS from another depreciation method for purposes of computing tested income or tested loss is a change in method of accounting subject to Section 446(e). However, Treasury and the IRS expect that most such changes are already eligible for automatic consent under Rev. Proc. 2015-13 and they intend to publish another revenue procedure further expanding the availability of automatic consent for depreciation change.

Anti-abuse rules

The 2018 Proposed Regulations included a rule that generally disregards, for purposes of calculating tested income or tested loss, any deduction or loss attributable to disqualified basis in specified property resulting from the transfer of the

property to a related party during the disqualified period.

The Final Regulations expand the application of this rule to treat the basis in any property (other than Section 1221(a)(1) inventory) as disqualified basis if such basis was determined, in whole or in part, by reference to basis in property with disqualified basis. For example, if property with disqualified basis is contributed in a Section 351 exchange, both the stock received by the transferor and the disqualified basis property of the transferee will have disqualified basis.

The Final Regulations also broaden the effect of deductions attributable to disqualified basis by giving regard to such deductions but requiring that they be allocated and apportioned to gross income other than gross tested income, subpart F income, or effectively connected income (ECI).

The Final Regulations permit taxpayers to elect to reduce the basis in property by the amount of disqualified basis and therefore eliminate the disqualified basis for all purposes of the Code (including for Section 901(m)).

In addition, the 'temporarily held' rule provided in the 2018 Proposed Regulations for tangible property held for less than 12 months was modified. The 2018 Proposed Regulations treated property held for less than 12 months as 'per se' temporarily held and, thus, basis in such property was excluded from QBAI. The Final Regulations now make such rule a rebuttable presumption rather than a per se rule. Further, the Final Regulations treat property held for more than 36 months as presumed not held temporarily.

Specified interest expense

The Final Regulations modify the definition of interest income and expense by cross-referencing Section 163(j). The Preamble states that the comments as to the validity of the definition of interest income and expense provided in the proposed Section 163(j) regulations will be addressed in the final Section 163(j) regulations when promulgated.

The Final Regulations also reduce the amount of tested interest expense of a tested loss CFC by 10% of such tested loss CFC's QBAI for purposes of computing a US shareholder's specified interest expense. However, the Final Regulations do not modify the rule provided in the 2018 Proposed Regulations which disregards QBAI of tested loss CFCs for purposes of computing net deemed tangible income return.

The Final Regulations provide several modifications to the rules for computing qualified interest expense for purposes of determining specified interest expense, including allowing taxpayers to avail themselves of the benefits of qualified interest expense on an optional basis.

Basis adjustments for used tested loss amounts

The Final Regulations reserve on the basis adjustment rules for tested loss CFCs first proposed in Prop. Reg. sec. 1.951A-6. The Preamble notes that such rules will be addressed in a separate package and that any rules issued under Treas. Reg. sec. 1.951A-6(c) will only apply prospectively for tax years ending after the date of publication.

Effective dates

Consistent with the 2018 Proposed Regulations, the Final Regulations generally apply retroactively as of the effective date of Section 951A, i.e., to tax years of foreign corporations beginning after December 31, 2017, and to tax years of US shareholders in which or with which such tax years of foreign corporations end. Treas. Reg. sec. 1.951-1(e) (except for paragraph (e)(1)(ii)(B)), dealing with the pro rata share of subpart F income, applies to tax years of US shareholders ending on or after October 3, 2018. Note, however, that the effective date for the aggregate treatment of domestic partnerships in Treas. Reg. sec. 1.951A-1(e) and (h) would be modified when Prop. Reg. sec. 1.958-1(d) is finalized, discussed below.

Highlights of the Proposed Regulations

High-tax exception

The Proposed Regulations provide a high-tax exception similar to the exception provided for subpart F under section 954(b)(4) pursuant to an election under Treas. Reg. sec. 1.954-1(d).

Similar to the subpart F exception, tested income must be subject to an effective tax rate greater than 90% of the 21% corporate tax rate (i.e., 18.9%) to qualify for the exception. Further, the determination as to whether income is high-taxed is made at the qualified business unit (QBU) level.

The Proposed Regulations provide that the election be made by the controlling domestic shareholder (as defined in Treas. Reg. sec. 1.964-1(c)(5)) and can be made at any time. While the election can be revoked by the controlling domestic shareholder, once revoked it cannot be re-elected for 60 months following the close of the CFC inclusion year for which the previous election was revoked.

The election is an 'all or nothing' election, meaning the election, if

made, must be made for all CFCs within the same controlling domestic shareholder group. The controlling domestic shareholder group is generally defined as two or more CFCs if more than 50% of the stock of each CFC is owned by the same controlling domestic shareholder.

Stock owned through domestic partnerships

The Proposed Regulations expand the modifications in the Final Regulations for aggregate and entity treatment of domestic partnerships. While the Final Regulations apply only for purposes Section 951A and any other provisions that apply by reference to 951A, the Proposed Regulations expand such treatment to Section 951 and any other provisions that apply by reference to Section 951. The Proposed Regulations provides such rules in Prop. Reg. sec. 1.958-1(d), whereas the Final Regulations provide such rules in Treas. Reg. sec. 1.951A-1(e) and (h).

Accordingly, the Proposed Regulations propose to revise the effective date of Treas. Reg. sec. 1.951A-1(e) and (h) to no longer apply once Prop. Reg. sec. 1.958-1(d) is finalized. Because of the similarity in scope between the two rules (the Proposed Regulations merely expand the rule to apply to Section 951 as well), the Preamble notes that Treas. Reg. sec. 1.951A-1(e) and (h) would be subsumed by the finalized Prop. Reg. sec. 1.958-1(d).

Effective dates

The Proposed Regulations provide that the high tax exception and the attribution rules for domestic partnerships apply to the taxable years of foreign corporations beginning on or after the date of publication of the Treasury decision adopting such rules as final regulations in the Federal Register, and to taxable years of US shareholders in which or with which such taxable years of foreign corporations end.

However, taxpayers may apply Prop. Reg. sec. 1.958-1(d) to taxable years of foreign corporations beginning on or after December 31, 2017, and to taxable years of domestic partnerships in which or with which such taxable years of the foreign corporation ended, provided that the partnership, its US shareholder partners, and other domestic partnerships that bear relationships described in 267(b) or 707(b) to the partnership and its partners consistently apply such rule.

The takeaway

Although the Final Regulations generally follow the structure and approach set forth in the 2018 Proposed Regulations, there are significant modifications that are likely to impact a taxpayer's GILTI tax calculation. Taxpayers should also consider the modifications proposed in the Proposed Regulations as they could have a significant impact in the future.

Taxpayers should immediately review the Final Regulations and Proposed Regulations to determine whether their GILTI and Section 965 tax liability may be affected.

The above-mentioned highlights are not an exhaustive list of the provisions in the Final Regulations or Proposed Regulations.

See also:

PwC Tax Insight: IRS issues proposed rules on 'GILTI' under Section 951A

PwC Tax Insight: House and Senate tax reform proposals could significantly impact US international tax rule

Let's talk

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