A DEEP DIVE INTO G.I.L.T.I. GUIDANCE

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INTRODUCTION

The 2017 Tax Cuts and Jobs Act ("T.C.J.A.") introduced a new anti-abuse tax regime applicable to controlled foreign corporations ("C.F.C.'s"). The Treasury Department and the I.R.S. introduced Proposed Treasury Regulations on September 13, 2018, ("Proposed Regulations") that provide guidance on calculating global intangible low-taxed income ("G.I.L.T.I."). For an introduction to the G.I.L.T.I. regime, see "A New Tax Regime for C.F.C.'s: Who Is G.I.L.T.I.?" in *Insights*.

At one level, the G.I.L.T.I. regime is designed to decrease the incentive for a U.S.-based multinational group to shift corporate profits to controlled subsidiaries based in low-tax jurisdictions. This treatment is particularly important because the T.C.J.A. has modified U.S. tax law to provide a dividends received deduction ("D.R.D.") for dividends received from foreign subsidiaries. Without G.I.L.T.I., a U.S.-based group could erode its U.S. tax base by shifting profit-making activities to its C.F.C.'s that could generate low-tax profits abroad and distribute them to the U.S. parent on a tax-free basis under the D.R.D.

At another level, the G.I.L.T.I. regime reflects a shift in U.S. tax policy regarding international operations. Prior to the T.C.J.A., U.S. tax policy was nominally one of global taxation, but as news articles relating to the largest of U.S. multinational companies indicated, it was effectively a territorial tax system. With a large enough budget, U.S. rules such as those embodied in Subpart F and Code §367(a) and (d) could be gamed so that U.S. tax jurisdiction was limited to income from U.S. operations. With the enactment of the T.C.J.A., the U.S. tax system nominally became a modified territorial tax system. However, the effect of provisions such as the Transition Tax, G.I.L.T.I., and F.D.I.I. is that the U.S. effectively adopted a global tax system with several effective rates. The rates are (i) 8% or 15.5% for transition tax, (ii) 21% for income from domestic operations and international operations caught by Subpart F, and (iii) 13.125% under F.D.I.I. for U.S. operations that service a foreign market and under G.I.L.T.I. for international operations that do not generate immediate tax under Subpart F (once the 80% foreign tax credit on G.I.L.T.I. is factored into the computation).

COMPUTATIONAL CAVEAT

While similarities exist as to the purpose of the G.I.L.T.I. regime and Subpart F Income – each provides for current taxation of certain income of a C.F.C. – certain fundamental differences exist in the way income is included in the tax return of a U.S. Shareholder.

Subpart F Income is determined at the level of each C.F.C. Once it is determined, a U.S. Shareholder of that C.F.C. includes in gross income its *pro rata* share. In this way, the amount of the U.S. Shareholder's inclusion with respect to one C.F.C. is not taken into account in determining that U.S. Shareholder's inclusion with respect to another C.F.C. Stated somewhat differently, a silo exists between each U.S. Shareholder and each separate C.F.C. that is owned. If multiple C.F.C.'s are owned, multiple silos exist.

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In comparison, when a U.S. Shareholder computes its income inclusion under the G.I.L.T.I. regime, it aggregates and then nets or multiplies its *pro rata* share of all items into a single shareholder level amount. Consequently, no matter how many C.F.C.'s exist, only one single aggregate Tested Income amount is computed. That amount is reduced by aggregate Tested Loss of all C.F.C.'s reporting losses. The result is only one net Tested Income for the C.F.C.'s and only one aggregate qualified business asset investment ("Q.B.A.I.") that is multiplied by 10% to arrive at only one single deemed tangible income return ("D.T.I.R."). A U.S. Shareholder's G.I.L.T.I. inclusion amount for a taxable year is calculated by subtracting only one aggregate shareholder level amount from another. The U.S. Shareholder's net D.T.I.R. is the excess of the D.T.I.R. over certain interest expense. Finally, the G.I.L.T.I. inclusion amount is the excess of the net C.F.C. Tested Income over its net D.T.I.R. Because there is only one set of computations no matter how many C.F.C.'s are owned by a U.S. Shareholder, an inclusion of G.I.L.T.I. will occur.

GENERAL RULES AND DEFINITIONS

The Proposed Regulations under Prop. Treas. Reg. §1.951A-1 provide general operating rules and definitions:

- Prop. Treas. Reg. §1.951A-1(c)(3) defines D.T.I.R., which is computed at the U.S. Shareholder level based on Q.B.A.I. held by the C.F.C.'s of the shareholder and reduces the shareholder's net C.F.C. Tested Income for purposes of determining the G.I.L.T.I inclusion amount. The Proposed Regulations clarify that a Tested Loss C.F.C. is treated as not having specified tangible property. As a result, tangible property of a Tested Loss C.F.C. is not taken into account in calculating a U.S. Shareholder's aggregate *pro rata* share of Q.B.A.I., its D.T.I.R., or its net D.T.I.R.
- As prescribed by the Code, the Proposed Regulations incorporate the *pro rata* share rules of Subpart F, with modifications to account for the differences between Subpart F Income and the components of G.I.L.T.I. (specifically, Tested Income, Tested Loss, and Q.B.A.I.):
    - The *pro rata* share of Tested Loss and Q.B.A.I. of a preferred shareholder must be computed (discussed below).
    - Tested Income must be allocated among U.S. Shareholders of a C.F.C., so that a C.F.C. having more than one U.S. Shareholder must allocate Tested Income to each U.S. Shareholder's in the same manner as it allocates Subpart F Income to each U.S. Shareholder under Code §951(a)(2) and Prop. Treas. Reg. §1.951-1(b) and (e). In other words, it is based on the relative amount that would be received by

each U.S. Shareholder in a year-end hypothetical distribution of all the C.F.C.'s current year earnings.[1]

  - Q.B.A.I. deemed distributed to the U.S. Shareholder in the hypothetical distribution generally must be proportionate to the amount of the C.F.C.'s Tested Income distributed in the hypothetical distribution to the U.S. Shareholder.[2]

  - Tested Income between holders of preferred shares and common shares must also be allocated when, for G.I.L.T.I. purposes, a C.F.C. has a positive return on Q.B.A.I. but a loss from operations. Where a C.F.C.'s Q.B.A.I. exceeds its Tested Income by a factor of ten or more, so that the amount of Q.B.A.I. allocated to preferred stock exceeds ten times the Tested Income allocated to the preferred stock under the general proportionate allocation rule, the excess amount of Q.B.A.I. must be allocated solely to the C.F.C.'s common stock.[3] This rule is meant to ensure that the notional return associated with the C.F.C.'s Q.B.A.I. generally flows to the shareholders in a manner consistent with their economic rights in the earnings of the C.F.C.

  - Tested Loss allocated among a C.F.C.'s U.S. Shareholders is generally distributed solely with respect to the holder of a C.F.C.'s common stock, based on their proportional holdings.[4]

- A special rule addresses the allocation of Tested Loss when the shares of a C.F.C. are not held for an entire year by a U.S. Shareholder. Under the rule,[5] the Tested Loss is treated as a dividend received by another person even if an actual dividend is not made by the Tested Loss C.F.C. The effect of this rule is to reduce a U.S. Shareholder's *pro rata* share of Tested Loss in proportion to the number of days the shareholder did not own the stock of the Tested Loss C.F.C. in order to allocate to each U.S. Shareholder an amount commensurate with the economic loss borne by such person with respect to the Tested Loss.

TESTED INCOME AND TESTED LOSS

Both gross Tested Income and Subpart F Income are determined at the C.F.C. level – although, as previously mentioned, gross Tested Income is computed on an aggregate basis with regard to all C.F.C.'s. Consequently, aggregate net Tested Income of all C.F.C. subsidiaries and net Subpart F Income of each particular C.F.C. are taxed to a U.S. Shareholder on a current basis.

Use of U.S. Domestic Rules

At the C.F.C. level, the determination of gross income and allowable deductions for G.I.L.T.I. is made under procedures that are similar to the determination of Subpart

1 Prop. Treas. Reg. §1.951A-1(d)(2)(i).

2 Prop. Treas. Reg. §1.951A-1(d)(3)(i).

3 Prop. Treas. Reg. §1.951A-1(d)(3)(ii).

4 Prop. Treas. Reg. §1.951A-1(d)(4).

5 Prop. Treas. Reg. §1.951A-1(d)(4)(i)(D).

F Income. Accordingly, the Tested Income or Tested Loss of a C.F.C. is determined by treating the C.F.C. as a domestic corporation taxable under Code §11 and by applying the principles of Code §61.[6] Only items of deduction that are allowable in determining the taxable income of a domestic corporation may be taken into account for purposes of determining a C.F.C.'s net Tested Income or Tested Loss. Nondeductible expenses, such as additions to a reserve for estimated items or notional expenses, cannot be taken into account when determining the Tested Income or Tested Loss of the C.F.C. This treatment is not altered even if the item reduces the C.F.C.'s earnings and profits ("E&P"). The I.R.S. has requested comments on the application of the rules for purposes of determining Subpart F Income, Tested Income, and Tested Loss and the interactions of Code §§163(j) and 267A with Code §951A.

High-Tax Exception – Limited Application

The Proposed Regulations clarify how the high-tax exception is to be applied in the case of Tested Income. Under the high-tax exception, a U.S. Shareholder of a C.F.C. does not include in income any Subpart F Income that is subject to a high tax rate abroad. Broadly speaking, the effective rate of foreign tax on an item of income must exceed 90% of the highest rate of U.S. corporate tax on that income. In computing the effective tax rate in a foreign country, the C.F.C.'s gross income is computed by applying U.S. concepts of income and expense, not foreign concepts. Once income is computed, the actual foreign tax paid is compared with the notional U.S. tax computed under U.S. concepts. At the current corporate tax rate of 21%, the actual foreign tax must exceed 18.9% in order for the high-tax exception to be applicable. Income of a C.F.C. that would be Subpart F Income but for the high-tax exemption is excluded from Tested Income. The Proposed Regulations clarify that if the item of income of a C.F.C. is not Subpart F Income for the C.F.C., the high-tax exception is not applied in determining Tested Income. In such instance, the only tax relief available is the foreign tax credit applicable to G.I.L.T.I.

E&P Limitation

Code §952(a) identifies items of Subpart F Income. For most U.S. taxpayers, the principal item of concern is Foreign Base Company Income. Included in that category of income are Foreign Personal Holding Company Income, Foreign Base Company Sales Income, and Foreign Base Company Services Income. Subpart F Income is limited to current E&P.[7] Where that ceiling prevents the full inclusion of Subpart F Income, the benefit is recaptured from excess earnings of Subpart F Income in subsequent years. The proposed regulations address the interplay of the definitional rule and the ceiling for G.I.L.T.I. purposes. Simply stated, all income that is identified as Subpart F Income under Code §952(a) is included in gross Tested Income. Consequently, the recapture of Subpart F Income under Code §952(c)(2) is irrelevant – income that is recaptured as Subpart F Income in a subsequent year is not excluded from gross Tested Income in the recapture year.[8]

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6 Prop. Treas. Reg. §1.952-2(a)(1); Prop. Treas. Reg. §1.951A-2(c)(2), subject to the special rules in Prop. Treas. Reg. §1.952-2(c).

7 Code §952(c)(1).

8 Prop. Treas. Reg. §1.951A-2(c)(4).

Example

A domestic corporation, USCo, owns 100% of the single class of stock of a C.F.C., C.F.C. 1. USCo and C.F.C. 1 use the calendar year as the taxable year. In Year 1, C.F.C. 1 has Foreign Base Company Income of $100, a loss in foreign oil and gas extraction income of $100, and E&P of $0. C.F.C. 1 has no other income. In Year 2, C.F.C. 1 has a gross income of $100 and E&P of $100. Without regard to Code §952(c)(2), the C.F.C. has no other income in Year 2. The C.F.C. has no allowable deductions properly allocable to gross Tested Income for Year 2.

As a result of the E&P limitation of Code §952(c)(1), C.F.C. 1 has no Subpart F Income in Year 1, and USCo has no inclusion with respect to C.F.C. 1 under Code §951(a)(1)(A). The gross Tested Income of the C.F.C. is determined without regard to Code §952(c)(1). Therefore, in determining the gross Tested Income of C.F.C. 1 in Year 1, the $100 Foreign Base Company Income of the C.F.C. in Year 1 is excluded, and C.F.C. 1 has no gross Tested Income in Year 1.

In Year 2, under Code §952(c)(2), C.F.C. 1's E&P ($100) in excess of its Subpart F Income ($0) is treated as Subpart F Income. Therefore, C.F.C. 1 has Subpart F Income of $100 in Year 2, and USCo has an inclusion of $100 with respect to C.F.C. 1 under Code §951(a)(1)(A). The gross Tested Income of C.F.C. 1 is determined without regard to Code §952(c)(2). Accordingly, C.F.C. 1's income in Year 2 is not Subpart F Income, and C.F.C. 1 has $100 of gross Tested Income.

Q.B.A.I.

The Proposed Treasury Regulations provide that the Q.B.A.I. of a tested income C.F.C. for any taxable year is the average of the C.F.C.'s aggregate adjusted bases as of the close of each quarter in specified tangible property that is used in a trade or business of the corporation and of a type with respect to which a deduction is allowable under Code §167.[9] In general, specified tangible property is tangible property used in the production of Tested Income.[10] Tangible property is defined as property for which the depreciation deduction provided by Code §167(a) is eligible to be determined under Code §168 (even if the C.F.C. has elected not to apply Code §168).[11] The Proposed Regulations define tangible property by reference to property that can be depreciated under Code §168. A substantial amount of guidance exists regarding property that may be depreciated under Code §168.

Dual-Use Property

Dual-use property is treated as specified tangible property on a proportional basis[12] based on the relative amount of gross Tested Income to other gross Tested Income that the property generates for the taxable year.[13] A special rule is provided

9 Prop. Treas. Reg. §1.951A-3(b).

10 Prop. Treas. Reg. §1.951A-3(c)(1).

11 Prop. Treas. Reg. §1.951A-3(c)(2).

12 Prop. Treas. Reg. §1.951A-3(d)(1).

13 Prop. Treas. Reg. §1.951A-3(d)(2)(i).

for determining the proportion of the property treated as specified tangible property if the property generates no directly identifiable income.[14]

Example

A tested income C.F.C., C.F.C. 1, owns a machine that only packages Product A, which is acquired from a related party based in the U.S. In Year 1, C.F.C. 1 sells Product A to related and unrelated resellers for use and consumption in a third country and earns $1,000 of gross income. For Year 1, sales of Product A produce gross Tested Income of $750 and Foreign Base Company Sales Income of $250. Packaging does not meet the definition of manufacturing for purposes of Subpart F. The average adjusted basis of the machine for Year 1 in the hands of C.F.C. 1 is $4,000. C.F.C. 1 also owns an office building for its administrative functions, with an average adjusted basis for Year 1 of $10,000. The office building does not produce directly identifiable income. C.F.C. 1 has no other specified tangible property. For Year 1, C.F.C. 1 also earns $1,250 of gross Tested Income and $2,750 of Foreign Base Company Sales Income from sales of Product B. Neither the machine nor the office building is used in the production of income related to Product B. For Year 1, C.F.C. 1's gross Tested Income is $2,000 and its total gross income is $5,000.

The machine and office building are both properties for which depreciation deductions under Code §167(a) may be claimed and qualify as tangible property under Code §168. The basis in the machine allocated to specified tangible property is equal to C.F.C. 1's average basis in the machine for the year ($4,000), multiplied by the percentage that gross Tested Income produced by the property ($750) bears to the total gross income produced by the property ($1,000), or 75%. Accordingly, $3,000 ($4,000 x .75) of C.F.C. 1's adjusted basis in the machine is taken into account in determining the average of C.F.C. 1's aggregate adjusted bases. The portion of the basis in the office building treated as basis in specified tangible property is equal to C.F.C. 1's average basis in the office building for the year ($10,000), multiplied by the percentage that gross Tested Income produced by the property ($2,000) bears to the total gross income produced by the property ($5,000), or 40%. Accordingly, $4,000 ($10,000 x .40) of C.F.C. 1's adjusted basis in the office building is taken into account in determining the average of C.F.C. 1's aggregate adjusted bases in specified tangible property.

Computing Adjusted Basis

The Proposed Regulations provide that the adjusted basis in any property is determined by using the alternative depreciation system under Code §168(g) ("A.D.S.") and allocating the depreciation deduction with respect to the property ratably to each day during the period in the taxable year to which the depreciation relates. A.D.S. applies for purposes of determining Q.B.A.I. even if another depreciation method is used for other purposes of the Code. In circumstances where specified tangible property was acquired before December 22, 2017, the adjusted basis in the property is determined using A.D.S. as if this system applied from the date that the property was placed in service.[15]

14 Prop. Treas. Reg. §1.951A-3(d)(2)(ii).

15 Prop. Treas. Reg. §1.951A-3(e)(3).

Short Taxable Year

The Proposed Regulations provide a methodology to reduce the Q.B.A.I. of a C.F.C. with a short taxable year to an amount that would produce an amount equal to the Q.B.A.I. if annualized for a full 12-month taxable year.[16]

In determining the Q.B.A.I. of a tested income C.F.C. for a short taxable year, the quarters are the full three-month quarters beginning and ending within the short taxable year plus one or more short quarters that exist. The Q.B.A.I. is the sum of the following two amounts:

- The C.F.C.'s aggregate adjusted bases in specified tangible property as of the close of each full quarter divided by four
- The aggregate adjusted bases in specified tangible property as of the close of each short quarter, multiplied by the sum of the number of days in each short quarter, and divided by 365

Operation Through Partnerships

If a C.F.C. holds an interest in a partnership at the close of the C.F.C.'s taxable year, the C.F.C. takes into account its distributive share of the aggregate of the partnership's adjusted bases.[17] Because the term "distributive share" is used in Subchapter K of the Code only with respect to income, gain, loss, and credits of a partnership, the Proposed Regulations use the term "share" when referring to the inside basis of a partnership asset that a partner may include in its Q.B.A.I.

A C.F.C.'s share of the partnership's adjusted basis in specified tangible property is computed by reference to the partnership's average adjusted basis in the property as of the close of each quarter of the partnership's taxable year that ends with or within the C.F.C.'s taxable year.[18] Consistent with the general rule for Q.B.A.I., only a C.F.C. with Tested Income can increase its Q.B.A.I. by reason of specified tangible property owned by a partnership.[19]

A C.F.C. determines its share of a partnership's average adjusted basis in specified tangible property by reference to its distributive share of the gross income produced by the property that is included in Tested Income of the C.F.C. as a percentage relative to the total amount of gross income produced by the property.[20] If the partnership has dual-use property, similar rules to those discussed above are applied for addressing specified tangible property that does not produce any directly identifiable income. The calculation is performed separately for each item of specified tangible property held by the partnership, taking into account the C.F.C. partner's distributive share of income with respect to such property.

Anti-Abuse Provisions

Specified tangible property of a C.F.C. is disregarded for purposes of determining the average aggregate basis in specified tangible property if the property is

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16 Prop. Treas. Reg. §1.951A-3(f).

17 Code §951A(d)(1).

18 Prop. Treas. Reg. §1.951A-3(g)(3).

19 Prop. Treas. Reg. §1.951A-3(g)(1).

20 Prop. Treas. Reg. §1.951A-3(g)(2).

acquired on a temporary basis at quarter-end with a principal purpose of reducing the G.I.L.T.I. inclusion amount of a U.S. Shareholder.[21] For this purpose, property held for less than a 12-month period that includes at least one quarter-end during the taxable year of a tested income C.F.C. is treated as temporarily held and acquired with a principal purpose of reducing the G.I.L.T.I. inclusion amount of a U.S. Shareholder.[22] This eliminates any opportunity for one C.F.C. to acquire tangible property from another C.F.C. to provide the transferee C.F.C. with a stepped-up basis in the transferred property, thereby increasing Prop. Treas. Reg. Q.B.A.I.[23]

"A U.S. Shareholder's Specified Interest Expense is the excess of its aggregate pro rata share of the Tested Interest Expense of each C.F.C. over its aggregate pro rata share of the Tested Interest Income of each C.F.C."

TESTED INTEREST EXPENSE

To calculate a U.S. Shareholder's net D.T.I.R., 10% of the aggregate of the U.S. Shareholder's *pro rata* share of the Q.B.A.I. of each C.F.C.[24] is reduced by the amount of net interest expense taken into account in determining net C.F.C. Tested Income for the taxable year. This interest expense is referred to as Specified Interest Expense.[25] Specified Interest Expense is a U.S. Shareholder level determination that is net of "attributable" interest income taken into account by the U.S. Shareholder.

To be more precise, Specified Interest Expense of a U.S. Shareholder is its *pro rata* share of interest expense properly allocable to gross Tested Income reduced by its *pro rata* share of interest income that is included in gross Tested Income and attributable to that interest expense. In this way, the interest expense attributed to interest income does not reduce D.T.I.R. The effect of the computation is to reduce net D.T.I.R. by a U.S. Shareholder's *pro rata* share of interest expense allocable to gross Tested Income. If the lender is another C.F.C. that is related to the C.F.C. and the related interest income is reflected in the U.S. Shareholder's *pro rata* share of the Tested Income of that other C.F.C., the expense of the payor C.F.C. is not allocated to reduce gross Tested Income.

The amount of interest income "attributable" to interest expense is not defined in the Code. For administrative simplicity, a netting approach is adopted in the Proposed Regulations. Under this approach, a U.S. Shareholder's Specified Interest Expense is the excess of its aggregate *pro rata* share of the Tested Interest Expense of each C.F.C. over its aggregate *pro rata* share of the Tested Interest Income of each C.F.C.[26] Tested Interest Expense and Tested Interest Income are generally defined by reference to all interest expense and interest income that is taken into account in determining a C.F.C.'s Tested Income or Tested Loss.[27]

A U.S. Shareholder's Specified Interest Expense and its net D.T.I.R. and G.I.L.T.I. inclusion excludes interest income and interest expense of one or more C.F.C.'s engaged in the active conduct of a financing or insurance business, as long as the

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21 Prop. Treas. Reg. §1.951A-3(h)(1).

22 *Id.*

23 Prop. Treas. Reg. §1.951A-3(h)(2).

24 Defined as Deemed Tangible Income Return in Prop. Tres. Reg. §1.951A-1(c)(3)(ii).

25 Prop. Treas. Reg. §1.951A-1(c)(3)(iii).

26 Prop. Treas. Reg. §1.951A-1(c)(3)(iii)

27 Prop. Treas. Reg. §1.951A-4(b)(1) and (2).

interest expense of the C.F.C. is incurred exclusively to fund such business with unrelated persons and not incurred to fund the acquisition of specified tangible property. Specifically, the Proposed Regulations exclude Qualified Interest Expense[28] from the definition of Tested Interest Expense. This means any interest expense of a Qualified C.F.C. – *i.e.*, an eligible C.F.C. that is in the active conduct of a banking or finance business (within the meaning of Code §954(h)(2)) or a qualifying insurance company (within the meaning of Code §953(e)(3)) – except to the extent of assets unrelated to its financing or insurance business and any interest income the Qualified C.F.C. received from loans to certain related persons. In short, the definition of Tested Interest Income is any interest income of a Qualified C.F.C. that would be included in gross Tested Income except that it is expressly excluded from Subpart F Income due to the active financing exception of Code §954(h) or the active insurance exception of Code §954(i) ("Qualified Interest Income").[29]

When computing Specified Interest Expense, the Proposed Regulations provide that interest income and interest expense should be defined broadly to encompass any amount treated as interest under the Code or regulations and any other amount incurred or recognized in a transaction or series of integrated or related transactions in which the use or forbearance of funds is secured for a period of time if the expense or loss is predominately incurred in consideration of the time value of money.[30]

Whether interest expense increases Tested Loss or reduces Tested Income, the expense is taken into account in determining a U.S. Shareholder's net C.F.C. Tested Income. To prevent a taxpayer from avoiding Specified Interest Expense by incurring offshore debt through a Tested Loss C.F.C., the Proposed Regulations confirm that any interest expense taken into account for purposes of determining the Tested Income or Tested Loss of a C.F.C. is also taken into account in determining a U.S. Shareholder's Specified Interest Expense.

DOMESTIC PARTNERSHIPS AND PARTNERS

The Proposed Regulations provide guidance to domestic partnerships and their partners on how to compute the G.I.L.T.I. inclusion amount.[31] A domestic partnership generally is defined as a partnership created or organized in the U.S. or under the law of the U.S. or a state in the U.S.[32] A domestic partnership is a U.S. person.[33] Therefore, it may be a U.S. Shareholder. This guidance also applies to S-corporations and their shareholders, as the S-corporation is treated as a partnership and its shareholders are treated as partners for purposes of Subpart F.[34]

In comparison to G.I.L.T.I., Subpart F Income is computed at the C.F.C. level. As a result, for purposes of computing the Subpart F Income of a domestic partnership that is a U.S. Shareholder, the domestic partnership includes in gross income its Subpart F inclusion amount with respect to a C.F.C., and its partners include in

28 Prop. Treas. Reg. §1.951A-4(b)(1)(iii).

29 Prop. Treas. Reg. §1.951A-4(b)(2)(iii).

30 Prop. Treas. Reg. §1.951A-4(b)(1)(ii) and (2)(ii).

31 Prop. Treas. Reg. §1.951A-5

32 Code §7701(a)(4).

33 Code §7701(a)(30)(B).

34 Code §1373(a).

gross income their distributive share of such inclusion. Since the G.I.L.T.I. inclusion amount must be computed at the shareholder level, the above approach raises issues when the partnership and its partners are each U.S. Shareholders. The preamble to the Proposed Regulations states that the I.R.S. considered whether to apply the aggregate approach or the entity approach to the computation of the G.I.L.T.I. inclusion amount in such a case.

A pure aggregate approach would treat the partnership as an aggregate of its partners so that each partner would compute its own G.I.L.T.I. inclusion amount taking into account its *pro rata* share of C.F.C. items through the partnership. The preamble to the Proposed Regulations states that such an approach might be interpreted to exempt a U.S. person from the G.I.L.T.I. regime in circumstances where the person is not a U.S. Shareholder in its own right with respect to the C.F.C. even though the partnership of which it is a partner is a U.S. Shareholder of a C.F.C. The I.R.S. concluded that this exclusion is not clearly contemplated in Code §951A or its legislative history.

A pure entity approach would require the G.I.L.T.I. inclusion amount to be computed at the partnership level so that all U.S. persons owning a partnership interest would take into income a distributive share of the inclusion, no matter how small the interest. In the case of a partner that is a U.S. Shareholder with respect to C.F.C.'s owned through the partnership and outside of the partnership, its G.I.L.T.I. inclusion amount would be fragmented. That is, instead of computing the G.I.L.T.I. inclusion amount at the shareholder level for all of the C.F.C.'s held by the U.S. Shareholder partner, the G.I.L.T.I. inclusion amount would be computed at the shareholder level for C.F.C.'s held directly and at the partnership level for C.F.C.'s held through U.S. Shareholder partnerships.

"A domestic partnership is treated as an entity with respect to partners that are not U.S. Shareholders of any C.F.C.'s owned by the partnership . . . [and] as an aggregate for the purposes of partners that are U.S. Shareholders."

Again, the I.R.S. concluded that this result is not supported by the statutory framework of Code §951A. The provision requires a shareholder level computation of the G.I.L.T.I. inclusion amount. Moreover, the problems with a pure entity approach are accentuated when the partner is a U.S. Shareholder. Certain provisions in the G.I.L.T.I. regime apply to a corporate U.S. Shareholder that would not work if a partnership were treated as the sole U.S. person in the ownership chain. Examples are Code §250, which provides corporations with a tax rate equivalent deduction for a G.I.L.T.I. inclusion, and Code §960(d), which provides an indirect foreign tax credit for corporations that are U.S. Shareholders of a C.F.C. in connection with an income inclusion under Subpart F.

The Proposed Regulations adopt a blended approach in the case of a partnership or S-corporation that is a U.S. Shareholder of a C.F.C. having Tested Income that can result in a G.I.L.T.I. inclusion. Under the blended approach, a domestic partnership is treated as an entity with respect to partners that are not U.S. Shareholders of any C.F.C.'s owned by the partnership. At the same time, it is treated as an aggregate for the purposes of partners that are U.S. Shareholders of one or more C.F.C.'s owned by the partnership.

According to the preamble that accompanied the Proposed Regulations, this approach ensures that each non-U.S. Shareholder partner takes into income its distributive share of the domestic partnership's G.I.L.T.I. inclusion amount (similar to the way it would include Subpart F Income), while permitting a partner that is itself a U.S. Shareholder to determine a single G.I.L.T.I. inclusion amount with reference to all C.F.C.'s it owns, whether directly or through a domestic partnership. The

I.R.S. has requested comments on whether any other approach would be more appropriate in harmonizing the provisions of the G.I.L.T.I. regime. It also requested comments on adjustments that might be required at the level of the partner of a domestic partnership by reason of computing a G.I.L.T.I. inclusion amount. Possible adjustment items include

- a partner's basis in a partnership interest,
- a partner's Code §704(b) capital account (relating to book-ups of capital accounts),
- a partnership's basis in C.F.C. stock under Code §961 (relating to adjustments in the basis of C.F.C. stock, such as increases in basis as a result of recognizing Subpart F Income or decreases in basis as a result of receiving a distribution of previously taxed income), and
- a C.F.C.'s previously taxed E&P with respect to the partner or partnership under Code §959 (relating to the exclusion of gross income of the C.F.C.'s previously taxed E&P).

TREATMENT OF G.I.L.T.I. INCLUSION AMOUNTS AND ADJUSTMENTS TO E&P AND BASIS

Treatment of G.I.L.T.I. as Subpart F Income for Certain Purposes

G.I.L.T.I. has a form of split personality disorder for U.S. tax purposes. On one hand, a U.S. Shareholder's G.I.L.T.I. inclusion amount is not an inclusion under Code §951(a)(1)(A), which states that a U.S. Shareholder of a C.F.C. must include Subpart F Income in its gross income for the current year. On the other hand, for the purposes of applying numerous Code sections outside of the G.I.L.T.I. regime, G.I.L.T.I. inclusion amounts are treated in a way that is similar to Subpart F inclusion amounts.[35] The I.R.S. has been granted authority to issue guidance on how various Code sections will apply to G.I.L.T.I. inclusion amounts.[36] Under that authority, the Proposed Regulations state that the G.I.L.T.I. inclusion amounts are "net investment income" for the purpose of applying Code §1411 since Subpart F Income is subject to that Code section. Code §1411 imposes a 3.8% tax on the net investment income of U.S. persons that are individuals, trusts, and estates. The tax is imposed in addition to the U.S. income tax capital gain.

Interaction with Code §§267(a)(3)(B) and 163(e)(3)(B)(i)

Code §267(a)(3)(B) generally provides that a deduction for an item payable to a related C.F.C. is not allowed to a U.S. person until such time as payment is made or includible in the gross income of a U.S. Shareholder (determined without regard to properly allocable deductions and qualified deficits). Code §163(e)(3)(B)(i) provides a similar rule for original issue discount on a debt instrument held by a related C.F.C. Original issue discount exists to the extent periodic payments of interest are deferred. The Proposed Regulations state that these deduction deferral rules should not apply to the extent an item is taken into account in determining a U.S.

[35] Code §951A(f)(1)(A).

[36] Code §951A(f)(1)(B).

Shareholder's G.I.L.T.I. inclusion amount. Thus, a deduction is allowed under Code §§267(a)(3)(B) and 163(e)(3)(B)(i) for an item taken into account in determining the net C.F.C. Tested Income of a U.S. Shareholder.[37]

This rule also applies to a U.S. Shareholder treated as directly or indirectly owning stock of a C.F.C. owned by a domestic partnership. However, in the case of a U.S. Shareholder that is a domestic partnership, this rule applies in two circumstances. The first is where one or more U.S. persons (other than domestic partnerships) that are direct or indirect partners of the domestic partnership include in gross income their distributive share of the partnership's G.I.L.T.I. inclusion amount. The second is where the item is taken into account by a U.S. Shareholder partner of the domestic partnership by reason of the Proposed Regulations applying the aggregate method to determine the G.I.L.T.I. inclusion amount of a U.S. Shareholder partner discussed above.[38]

Basis Adjustments for the Use of Tested Losses

In determining a U.S. Shareholder's net C.F.C. Tested Income, the U.S. Shareholder's *pro rata* share of a Tested Loss of one C.F.C. may offset the shareholder's *pro rata* share of Tested Income of another C.F.C. However, under the statute, such a use of a Tested Loss does not reduce the U.S. Shareholder's basis in the stock of the Tested Loss C.F.C., increase the stock basis of the tested income C.F.C., or affect the E&P of either the Tested Loss C.F.C. or the tested income C.F.C.

The preamble to the Proposed Regulations provides an example in which the lack of basis adjustment can lead to inappropriate results. In the example, the U.S. Shareholder's basis in the stock of the Tested Loss C.F.C. is not reduced to reflect the use of the Tested Loss to offset Tested Income taken into account by the U.S. Shareholder. Upon a subsequent disposition of the Tested Loss C.F.C., the U.S. Shareholder would recognize a duplicative benefit either through the recognition of a loss or the reduction of gain.[39] The basis reduction is only made at the time of the disposition and therefore does not affect the stock basis prior to a disposition. Requiring the basis reduction only at the time of the disposition prevents the use of Tested Losses alone from causing the recognition of gain if the reduction exceeds the amount of stock basis.

The basis adjustments apply only to the extent a "net" Tested Loss of the C.F.C. has been used. This limitation is intended to ensure that the reduction applies only to the extent necessary to eliminate the duplicative loss in the stock. The following example illustrates this feature of the rule.

Example

A U.S. Shareholder holds interests in two C.F.C.'s, C.F.C. 1 and C.F.C. 2. In Year 1, C.F.C. 1 has a Tested Loss of $100x. This Tested Loss offsets $100x of Tested Income of C.F.C. 2 when determining the U.S. Shareholder's net C.F.C. Tested Income. In Year 2, C.F.C. 1 has $20x of Tested Income that is used to offset a $20x Tested Loss of C.F.C. 2. In this circumstance, adjustments are made to limit the effect of the Tested Income and Tested Loss

37 Prop. Treas. Reg. §1.951A-6(c)(1).

38 Prop. Treas. Reg. §1.951A-6(c)(2).

39 Prop. Treas. Reg. §1.951A-6(e).

of the two C.F.C.'s to recognize the effect of the flip of Tested Income and Tested Loss reported by the two C.F.C.'s. On a retroactive basis, the $100x used Tested Loss attributable to the C.F.C. 1 stock from Year 1 is reduced by the $20x of its Tested Income from Year 2 that was offset by the Tested Loss of C.F.C. 2, resulting in a "net" used Tested Loss of $80x.[40]

In the case of a direct disposition of C.F.C. stock that results in the indirect disposition of the stock of one or more lower-tier C.F.C.'s, basis adjustments may be made to both the stock of the upper-tier C.F.C. and the stock of the lower-tier C.F.C.'s.[41] The Proposed Regulations provide ordering rules for making these adjustments that generally are intended to prevent gain resulting from a basis adjustment attributable to the use of a single Tested Loss from being taken into account more than once.[42]

In the case of certain nonrecognition transactions involving C.F.C.'s, the Proposed Regulations provide rules intended to prevent the elimination or avoidance of the basis adjustment rules discussed above through the use of nonrecognition transactions.

The preamble to the Proposed Regulations request comments on whether similar rules should apply to non-corporate U.S. Shareholders, taking into account the fact that non-corporate U.S. Shareholders are not entitled to the Code §245A D.R.D. Comments are also requested on whether the definition of "disposition" should be modified, such as broadening the term to include transactions that do not involve an actual transfer of stock but might result in taxable gain but for the presence of tax basis in C.F.C. stock. Examples of such transactions include distributions subject to Code §301(c)(2) (relating to distributions to shareholders not attributable to accumulated or current E&P and that result in the reduction of stock basis).

PROPOSED MODIFICATIONS TO REGULATIONS UNDER CODE §951

Pro Rata Share Rules

Final regulations under Code §951 contain rules to address certain avoidance structures, such as structures that result in non-economic allocations of Subpart F Income to shareholders of C.F.C.'s that are not U.S. Shareholders. Prop. Treas. Reg. §1.951-1(e) would address additional avoidance structures that implicate Code §951A (as well as Code §951). The following changes to the *pro rata* share rules are included in the regulations:

- For purposes of determining a U.S. Shareholder's *pro rata* share of Subpart F Income, E&P for the tax year is first hypothetically distributed among the classes of stock and then hypothetically distributed to each share in the class on the hypothetical distribution date, which is the last day of its tax year on which it is a C.F.C. The amount of E&P that would be distributed with respect to classes of stock would be based on all relevant facts and circumstances.[43]

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[40] Prop. Treas. Reg. §1.951A-6(e)(2).

[41] Prop. Treas. Reg. §1.951A-6(e)(6)(ii)(B).

[42] Prop. Treas. Reg. §1.951A-6(e)(1)(iv).

[43] Prop. Treas. Reg. §1.951-1(e)(3).

Under the current regulations, the E&P allocations between classes of stock with discretionary distribution rights are based on the fair market value of the stock. The I.R.S. views this rule as susceptible to manipulation because taxpayers can allocate E&P to classes of stock that have a fair market value that has been inflated because they include preferred distribution or liquidation rights.

- Existing Subpart F rules[44] will be modified in order to take into account Code §951A in certain ways. The Proposed Regulations provide that a U.S. Shareholder's *pro rata* share of a C.F.C.'s Subpart F Income is determined by reference to its proportionate share of the total current E&P that would be distributed in a hypothetical distribution at the end of the year. That hypothetical distribution also applies to the shareholder's *pro rata* share of a C.F.C.'s Tested Income.[45] However, certain adjustments must be made to reflect the specific rules under Code §951A. Thus, because (i) Tested Income is not limited to the E&P of a C.F.C. and (ii) a C.F.C.'s Tested Loss increases its E&P for purposes of determining the Subpart F Income limitation in Code §952(c)(1), the E&P allocated in the hypothetical distribution may exceed the E&P of the C.F.C. computed under Code §964. Accordingly, the hypothetical distribution in the Proposed Regulations is based on the greater of (i) the Code §964 E&P or (ii) the sum of the Subpart F Income (increased by any Tested Loss add-back)[46] and Tested Income of the C.F.C.

- More broadly, any transaction or arrangement that is part of a plan that has as a principal purpose the reduction of a U.S. Shareholder's *pro rata* share of the Subpart F Income of a C.F.C. is disregarded.[47]

These rules would apply to tax years of a U.S. Shareholder ending on or after October 3, 2018.

"The Proposed Regulations would treat certain controlled domestic partnerships as foreign partnerships for purposes of identifying a U.S. Shareholder for purposes of applying the Subpart F and G.I.L.T.I. rules."

Partnership Blocker Structures

In 2010, the I.R.S. issued a notice, applicable in specific circumstances, stating that regulations would be issued calling for a domestic partnership to be treated as a foreign partnership when identifying the specific U.S. Shareholder required to include in gross income a *pro rata* share of a C.F.C's Subpart F Income.[48] Of concern to the I.R.S. was a situation in which (i) a U.S. taxpayer-owned two C.F.C.'s, C.F.C.1 and C.F.C. 2, and (ii) each of C.F.C. 1 and C.F.C. 2 owned 50% of a third C.F.C., C.F.C. 3, through a domestic partnership. The Subpart F Income of C.F.C. 3 flowed to the domestic partnership as the first U.S. Shareholder in the ownership chain. As a result, the domestic partnership acted as a blocker of Subpart F Income.

Following the notice, the Proposed Regulations would treat certain controlled domestic partnerships as foreign partnerships for purposes of identifying a U.S. Shareholder for purposes of applying the Subpart F and G.I.L.T.I. rules.[49]

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44 Prop. Treas. Reg. §1.951-1(e).

45 Prop. Treas. Reg. §1.951A-1(d)(2).

46 Code §951A(c)(2)(B)(ii) and Prop. Treas. Reg. §1.951A-6(d).

47 Prop. Treas. Reg. §1.951-1(e)(6).

48 Notice 2010-41, 2010-22 I.R.B. 715.

49 Prop. Treas. Reg. §1.965-1(e).

These rules would apply to tax years of domestic partnerships beginning on or after May 14, 2010, and before January 1, 2018 (consistent with the 2010 Notice, discussed above).[50] For Code §951A purposes, the Proposed Regulations would apply to tax years of domestic partnerships beginning after December 31, 2017.

<u>New Reporting Requirements</u>

To report information and tax computations with respect to G.I.LT.I., U.S. Shareholders must file certain forms:

- New Schedule I-1, *Information for Global Intangible Low-Taxed Income*, as a schedule to Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*[51]
- New Form 8992, *U.S Shareholder Calculation of Global Intangible Low-Taxed Income (G.I.L.T.I.)*[52]

Notably, the rules that set forth the above filing requirements are proposed to apply to tax years of foreign corporations beginning on or after October 3, 2018.

<u>Applicability Dates</u>

Except as otherwise discussed above, the Proposed Regulations under Code §§951 and 951A apply to the tax year of the foreign corporation beginning after December 31, 2017, and the tax year of the U.S. Shareholder in which such tax year of the foreign corporation ends.

CONCLUSION

The T.C.J.A. moved U.S. tax policy for profitable international operations in the direction of current taxation but at a lower rate. In so doing, it introduced new terms to U.S. tax law but did so in a summary way. The Proposed Regulations fill in the gap between policy and practice.

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50 This means that the transition tax under Code §965 will apply to the partnership arrangement that holds an interest in a C.F.C.

51 See Prop. Treas. Reg. §1.6038-2(a).

52 See Prop. Treas. Reg. §1.6038-5.