FINAL G.I.L.T.I. HIGH-TAX REGULATIONS AND THE TESTED UNIT: WOULD A ROSE BY ANY OTHER NAME SMELL AS SWEET?

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INTRODUCTION

> "What's in a name? That which we call a rose
> By any other word would smell as sweet."
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> – Juliet to Romeo, in *Romeo and Juliet*, Act 2, Scene 2

In the Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97 ("T.C.J.A."), the U.S. Congress enacted the most dramatic change to the U.S. Tax Code since 1986, adding among other provisions G.I.L.T.I.'s quasi-territorial tax under Code §951A. The conceptual underpinnings were inspired by the muse of Dave Camp, Chairman of the House Ways and Means Committee's 2014 blueprint for tax reform, in which he recommended a territorial system including a D.R.D., repeal of indirect foreign tax credits, and enactment of a new category of Subpart F income referred to as "foreign base company intangible income", startlingly similar to G.I.L.T.I.[1] G.I.L.T.I. requires U.S. shareholders owning at least 10% of a controlled foreign corporation, by vote or value ("U.S. Shareholders"), in which U.S. Shareholders collectively own more than 50% by vote or value ("C.F.C.") to compute for each year the "tested income" for each C.F.C., which includes all gross income over the deductions allocable to such income, excepting certain enumerated categories completely excluded from G.I.L.T.I., including high-taxed foreign income excluded from Subpart F income by reason of Code §954(b)(4) (the "High-Tax Exception").

While Chairman Camp's proposal sought to remove all electivity and make the High-Tax Exception automatic (upon being taxed at a rate of between 50-100% of the U.S. corporate tax rate) for both Subpart F and G.I.L.T.I., the T.C.J.A.'s High- Tax Exception is not automatic. While taxpayers previously had no clear guidance to apply the Exception (which is not self-executing), on July 23, 2020 – nearly a full six years after Chairman Camp dropped his tax reform blueprint and three years since Congress enacted a significant number of his proposals into law – the I.R.S. provided one of the last missing pieces of the puzzle in T.D. 9902 ("Final Regulations"), providing rules for when the High-Tax Exception applies to foreign income and containing detailed guidance on how to make the election. These regulations finalize one of the largest remaining pieces in regulations previously proposed on June 21, 2019 (REG-101828-19) ("2019 Proposed Regulations"); though rules relating to treatment of domestic partnerships, including special rules for S corporations,[2] are still pending.

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1 Tax Reform Act of 2014 Discussion Draft, §4211, full text available here.

2 See Notice 2020-69, providing an irrevocable election for S corporations with C period accumulated earnings and profits to be treated as the U.S. Shareholder recognizing G.I.L.T.I. income for purposes of adjusting the S corporation's accumulated adjustments account ("A.A.A."), extending the hybrid approach for domestic passthroughs feature of the 2018 proposed G.I.L.T.I. regulations under Code §951A (REG-104390-18), abandoned for an aggregate approach in T.D. 9866, solely for A.A.A. determination purposes.

The Final Regulations, characterized by some as a "gymnastic" exercise to coax workable rules for the G.I.L.T.I. area in an exception that originated in the alien Subpart F context,[3] provide that the Election is an affirmative annual election and may only be made when a taxable rate condition is met: foreign-taxed income is taxed at an effective rate higher than 90% of the U.S. corporate tax rate, which currently being 21%, means the foreign income must be taxed at an effective rate higher than 18.9%, after factoring in allocable deductions. For this purpose, all deductions at the C.F.C. level allocable to G.I.L.T.I. are relevant to its effective tax rate, including depreciation, amortization, and interest expense.[4] The Final Regulations both enable the U.S. Shareholder to determine whether tentative tested net income is high-taxed and provide a mechanism for electing the benefit of the High-Tax Exception ("Election") – based on a novel concept, the "Tested Unit."

Given a strong anti-blending legislative purpose it derived from the legislative history of the Tax Reform Act of 1986, Pub. L. No. 99-514, which also indicated the I.R.S.'s authority to provide for "reasonable groupings of . . . income", the I.R.S. designed the Tested Unit to ensure low-taxed foreign income is not camouflaged amid high-taxed income, escaping U.S. tax. The Final Regulations rely on Tested Units as (i) the level at which to test whether foreign tax exceeds 18.9%, and (ii) the basis on which to exclude high-taxed income from G.I.L.T.I. computations, once the Election is made.

Until simultaneously-issued proposed regulations in REG-127732-19 ("2020 Proposed Regulations") are finalized, extending the Tested Unit concept to Subpart F, Subpart F's high-tax exception continues to apply on an item-of-income basis under preexisting law (instead of Tested Units); the proposal appears a bold move for such a young concept but elegant insofar as it contemplates a unitary election applicable for both high-taxed G.I.L.T.I. and Subpart F income across all C.F.C.'s owned in a C.F.C. group. This reduces planning.

This article introduces the Tested Unit, summarizes the mechanics for making the annual Election, which is made with respect to either a C.F.C. or a C.F.C. Group, and highlights certain issues and concerns, as well as challenges and opportunities for taxpayers contemplating making an Election.

TESTED UNIT – WHAT IS IT?

Prior to the enactment of G.I.L.T.I, Subpart F's High Tax Exception was always applied on an item of income basis. The Tested Unit may appear doggedly alien to anyone used to Subpart F, for under those rules the process is slightly different: a U.S. Shareholder identifies each C.F.C.'s Subpart F income, as defined in Code §952(a) (including foreign personal holding company income, and certain other categories of income), excluding any U.S. effectively-connected income; under the *de minimis* rule, if less than 5% of gross income is Subpart F, then none of the C.F.C.'s

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[3] Mindy Herzfeld, "GILTI High-Tax Exception: Who Benefits?", Tax Notes, Aug. 24, 2020 (observing that "expanding the Subpart F high-tax exception to exclude [income] from the GILTI regime . . . requires a gymnastic reading of the statutory language," suggesting aggressive corporate lobbying was involved).

[4] The last item, interest expense is subject to Code §163(j) based on a recently-issued Notice of Proposed Rulemaking; see T.D. 9905, Preamble discussion of Treas. Reg. §1.163(j)-7 and REG-107911-18, Notice of Proposed Rulemaking.

income is treated as Subpart F, whereas if more than 70% qualifies as Subpart F, then 100% is treated as Subpart F under the full inclusion rule. Unless some other exception applies, each item of Subpart F income is then separately evaluated under the High-Tax Exception.

Based on the 1985 legislative history to Code §954(b)(4), which directed Treasury and the I.R.S. to permit reasonable groupings of income, the I.R.S. found that a purpose of the High-Tax Exception in the G.I.L.T.I. context includes preventing blending of income subject to substantially different rates of tax. This meant that a grouping principle unlike what was used in the Subpart F context was required. The 2019 Proposed Regulations required the taxpayer's effective tax rate be determined for G.I.L.T.I. purposes at the level of a qualified business unit as defined in Code §989(a) ("Q.B.U."), which refers to a "separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records". The trade or business concept lives in case law.[5] Applying the concept requires inherent factual determinations, making the I.R.S.'s call to scuttle that idea in the Final Regulations a very good one.

2020 Final Regulations – the Tested Unit

After considering alternatives, the I.R.S. settled upon something new and seemingly better. Consistent with Congress's purpose to prevent blending of income taxed by different jurisdictions at different rates, the Final Regulations introduce the Tested Unit. At first it may be somewhat confusing that the term "Tested Unit" sometimes refers to a C.F.C., whereas on other occasions, a C.F.C. may include multiple Tested Units. Generally speaking, the former situation arises if the C.F.C. maintains operations in a single country and owns no passthrough interests or branches in another country. In short, in contrast with the Subpart F historic regime, the drafters' selection of the Tested Unit for G.I.L.T.I. high-tax purposes reflects a move to transcend the entity concept.

According to the definition of Treas. Reg. §1.951A-2(c)(7)(iv)(A) a Tested Unit includes

- a C.F.C.;
- an interest in a pass-through entity held, directly or indirectly, by a C.F.C., that is
  - tax resident of a third country, or
  - treated as a corporation or other non-fiscally transparent entity under the tax law of the C.F.C.'s country of incorporation; or
- a branch, or portion of a branch, the activities of which are carried on directly or indirectly by the C.F.C. provided that the branch

[5] Treas. Reg. §1.989(a)-1(c) defines a trade or business obliquely, by reference to whether a group of activities constitutes an independent economic enterprise carried on for a profit the expenses of which are deductible for tax purposes, and ordinarily includes every operation that's a part of or step in such activities. The trade or business concept appears in some shape or form in each of the following sections, among others: Code §§162(a), 166(d)(2)(A), 167(a)(1), 172(d)(4), 355(b), 864(b), and 954(c)(2)(A).

- gives rise to a taxable presence in the third country where it is located; or
- if it does not give rise to a taxable presence under the third country's tax law, it gives rise to a taxable presence under the owner's tax law and the owner's tax law provides an exclusion, exemption, a preferential rate or other similar relief for income attributable to the branch.

Additional Mechanics

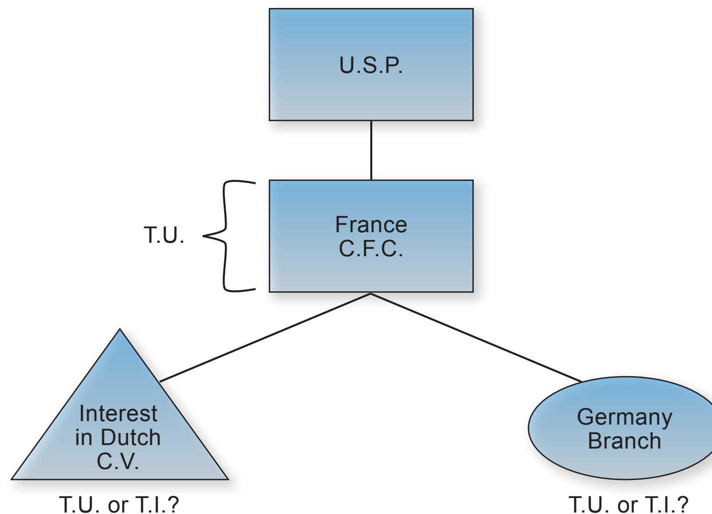
If a passthrough entity/branch fails to qualify as a separate unit under the above definition, it is referred to as a transparent interest and all its items of income and deduction, including foreign taxes, are rolled up into the Tested Unit that directly owns it, both for purposes of the calculation and Election. Tested Units owned by the same C.F.C. and located in the same foreign country are aggregated together.

When items are reported in more than one Tested Unit's books, the rules assign the income item, together with allocable deductions, to the lowest Tested Unit in the vertical tree – preventing double-counting. Adjustments may be required to the higher Tested Units' books.

Similar to a Q.B.U. each Tested Unit is required to maintain separate books and records, but they're not the same thing: a rose by any other name may smell equally sweet, but this is a wholly different flower. The Tested Unit concept corresponds closely to grouping of items reported on a single local-country income tax return, adjusted to eliminate items so they are not double counted.

The foregoing principles are illustrated by examples below.

Fig. 1 – Identifying the Tested Units



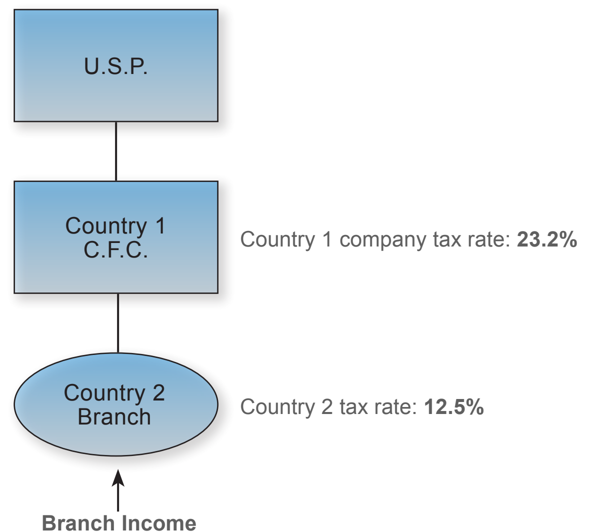
Above United States Parent ("U.S.P.") owns France C.F.C., which in turn owns an interest in a Dutch *Commanditaire venootschap*, referred to typically as a "C.V.", and separately, a German branch. Unless 100% of the relevant income below U.S.P. is Subpart F income excluded from G.I.L.T.I., U.S.P.'s first task in determining if the Election is applicable will be to identify the relevant Tested Units:

- France C.F.C. is a Tested Unit.
- Germany Branch, assuming it gives rise to a taxable presence in Germany, appears to be a Tested Unit too.
- As for the interest in the Dutch C.V., under Dutch tax rules if all general and limited partners are all required to consent to the addition of a new partner, a C.V. is not treated as a separate taxable entity (in such case, the partners are treated as owning their share of the assets and undertaking their share of activities). However, for U.S. tax purposes the real question may be whether France C.F.C. has a Dutch taxable presence on account of the C.V.'s activities and assets? U.S.P.'s tax team may be pleased to discover that the matter has already been carefully thought through in advance by the France C.F.C. finance team, who have prepared all Dutch tax filings.

In Figure 2, assuming that each Tested Unit's effective tax rate is approximately equal to the statutory rates shown at right, then Country 2 Branch would not qualify for the High-Tax Exception, whereas Country 1 C.F.C. would.

However, in reality the statutory headline rate's is of limited significance.

Fig. 2 – Computing the Effective Rate



Provided Country 2 Branch results in a taxable presence in Country 2 and separate books are maintained for each unit, they are separate Tested Units and the effective rate should be determined separately for each. For example, if Country 1 C.F.C. engaged in borrowing but expense was all allocated to the branch reducing its net tested income, the branch might qualify for the High-Tax Exception even while C.F.C. failed to qualify.

The move in the Tested Unit rules toward use of local financial statements – rather than earnings and profits computations that were the hallmark of Subpart F and centered on U.S. tax principles – has been compared to similar features currently under discussion as part of the O.E.C.D.'s pillar 2 initiative; with one observer critiquing what was referred to as the Final Regulations' nauseating whipsawing approach, requiring on the one hand use of foreign financial statements of the Tested Unit as the starting point for the high-tax computation, but mandating on the other that

allocation of expenses and deductions is done based on U.S. tax principles. Such complexity may not serve clear policy objectives, while leaving open the door to new tax planning opportunities.[6]

WHO MAKES THE ELECTION (AND FOR WHOM)?

The Election, which is an annual election,[7] must be made on a unitary basis for all C.F.C.'s in a C.F.C. group, by the group's Controlling Domestic Shareholder(s). If G.I.L.T.I. transcended legal entities by focusing on Tested Units, why do we keep returning to C.F.C.'s? The simple answer may be that the Election must be made for C.F.C.'s because U.S. Shareholders know their percentage interests in C.F.C.'s, but not in T.U.'s; at the end of the day, every Tested Unit is owned, directly or indirectly, by a C.F.C.

"The Election, which is an annual election, must be made on a unitary basis for all C.F.C.'s in a C.F.C. group, by the group's Controlling Domestic Shareholder(s)."

The determination of whether a C.F.C. is included in a C.F.C. group is made as of the close of the relevant C.F.C. inclusion year of the C.F.C. that ends with or within the Controlling Domestic Shareholder(s)' taxable year. The term Controlling Domestic Shareholder(s) refers to U.S. Shareholders who own, in the aggregate, more than 50% of the total combined vote (not value) of the C.F.C.'s stock and who undertake to act on its behalf and make the Election. The 50% voting test is determined under the direct and indirect ownership rules under Code section 958(a). Treas. Reg. §1.964-1(c)(5) provides mechanisms whereby such shareholders may make accounting method elections or determine a C.F.C.'s taxable year.

Where there is no Controlling U.S. Shareholder owning greater than 50% of voting interests in the C.F.C.'s stock within the meaning of Code §958(a), then Controlling Domestic Shareholders refers to all U.S. Shareholders who own stock in the C.F.C. group within the meaning of Code §958(a). A C.F.C. can belong to no more than one C.F.C. group.

A C.F.C. group is specially defined for this purpose to include an affiliated group of corporations owned through one or more chains with a common parent corporation, in which the parent owns directly stock in at least one other corporation, and group members own, in the aggregate, more than 50% of the vote or the value of the outstanding stock of each member affiliate.[8] The definition is modified from the U.S. domestic context to include all corporations in which the ownership criterion is satisfied including foreign corporations. For this purpose, modified Code §318(a) ownership attribution applies;[9] in particular, "50%" ownership in paragraph (a)(2)(C) of Code §318 relating to upward attribution from corporations is replaced with "5%", meaning that where an individual, partnership, corporation or trust owns 5% or more of the value of a corporation's outstanding stock it is attributed stock owned directly or indirectly by such corporation;[10] downward attribution to partnerships, estates,

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6 Mindy Herzfeld, "GILTI High-Tax Exception: Who Benefits?", *supra*.

7 This is different from the approach of the 2019 Proposed Regulations, which included a 60-month cooling-off period.

8 Treas. Reg. Section 1.951A-2(c)(7)(viii)(E)(2)(i).

9 This includes option attribution but does not include downward attribution to partnerships, estates, and trusts.

10 This appears to override the modified attribution rule of Code §958(b)(3) generally applicable to C.F.C.'s based on "10%" in the Election context.

and trusts under paragraphs (a)(3)(A) and (B) is turned off. Option attribution rules apply.

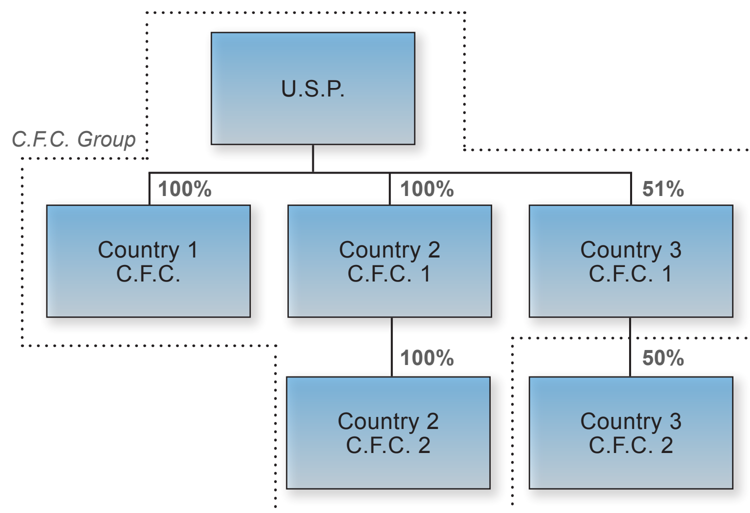
Two noteworthy differences emerge from the above definitions of terms "Controlled Domestic Shareholder(s)" and "C.F.C. Group":

1. While the status of a Controlled Domestic Shareholder is determined solely on the basis of the voting rights owned by a U.S. Shareholder in the C.F.C., a foreign corporation is treated as a member of a C.F.C. Group if the parent corporation owns more than 50% of its total voting rights ***or*** value.

2. The 50% voting test for determining the Controlled Domestic Shareholder status of a U.S. Shareholder is determined under the direct and indirect ownership rules provided under Code section 958(a). In other words, the constructive ownership rules of Code section 958(b) read with Code section 318 is ignored for the purpose of this test. However, whether a foreign corporation is a member of a C.F.C. Group is determined under the constructive ownership rules provided under Code section 318 subject to certain modifications.

Examples of the C.F.C. group, together with certain questions not fully answered by the Regulations, are explored in relation to Figures 3 through 7 below.

Fig. 3 – C.F.C. Group (Ex. 1)



In Ex. 1 (Figure 3), to identify the C.F.C.s that are the members of a C.F.C. Group for purposes of making the Election, we need to ascertain which C.F.C.'s can be said to be owned more than 50% (by vote or value) by U.S.P. under the attribution rules of Code section 318. The C.F.C. group (apparently) includes each of U.S.P, Country 1 C.F.C., Country 2 C.F.C. 1, Country 2 C.F.C. 2, and Country 3 C.F.C. 1, because U.S.P. meets the greater-than-50% ownership by vote or value with respect to each of the entities. In addition, while Code §1504 is modified to include foreign corporations, domestic corporations are not excluded.

Under Code §318(a) attribution, without considering application of Code §958(b)(2), because U.S.P. owns 51% (or more than 5%) of Country 3 C.F.C. 1 as measured by value, U.S.P. is attributed a *pro-rata* share of ownership in whatever legal entities

Country 3 C.F.C. 1 owns, including its 50% ownership interest in Country 3 C.F.C. 2. Therefore, U.S.P. is treated as actually owning interests in Country 3 C.F.C. 2 based on its indirect *pro rata* ownership. However, U.S.P.'s ownership in Country 3 C.F.C. 2 is insufficient to include it in the U.S.P. C.F.C. group, because 51% * 50% = 25.5%, which falls below the greater-than 50% of vote or value threshold.

Now, the question is who is the Controlling Domestic Shareholder? Of course, here, USP is the only U.S. Shareholder that directly or indirectly owns more than 50% of the total voting rights in Country 1 C.F.C., Country 1 C.F.C. 2, Country 1 C.F.C. 3, and Country 2 C.F.C. 2.[11] Therefore, USP is the Controlling Domestic Shareholder that can make the Election for all the members of the C.F.C. Group, as explained above. It may be noted that U.S.P.'s ownership in Country 3 C.F.C. 2 is insufficient to treat U.S.P. as its Controlled Domestic Shareholder because it indirectly owns only 51% * 50% = 25.5%, which falls below the greater-than 50% of vote threshold.[12]

No matter how tangled attribution rules work themselves out, the ultimate problem for U.S.P. with respect to Country 3 C.F.C. 2 is still unresolved, as U.S.P. does not own more than 50%. Under the alternative rule of Treas. Reg. §1.964-5(c)(1)(i) (third sentence), should U.S.P. desire to make an Election for Country 3 C.F.C. 2, it will be necessary first to locate at least one other Code §958(a) U.S. Shareholder.

In addition, Code §964 requires the Controlling Domestic Shareholder(s) to provide notice of the Election to the non-controlling Code §958(a) U.S. Shareholders, on or before the due date of their U.S. tax return (or information return) for the taxable year in which or with which the C.F.C.'s taxable year ends and for which the Election is made. In addition to finding another U.S. Shareholder with whom to make the election, U.S.P. may have to separately identify other Code §958(a) U.S. Shareholders, if they exist, and provide the requisite notices (though as discussed below, the Regulations are ambiguous and conflicting as to whether a failure to do so is fatal).

A more practical challenge is that, even if another U.S. Shareholder is located, U.S.P. and one or more other U.S. Shareholders may be unable to agree as to the desirability of an Election for any given inclusion year. Because a decision to make the Election should be based on careful computations that take into account each U.S. Shareholder's tax attributes for any given year, different U.S. Shareholders can be expected to disagree as a matter of course. As a result, U.S. persons acquiring a 10% or greater stake in a foreign joint venture are strongly recommended to agree up front with their fellow U.S. investors in the J.V.A. as to who has final decision-making power regarding U.S. tax elections.

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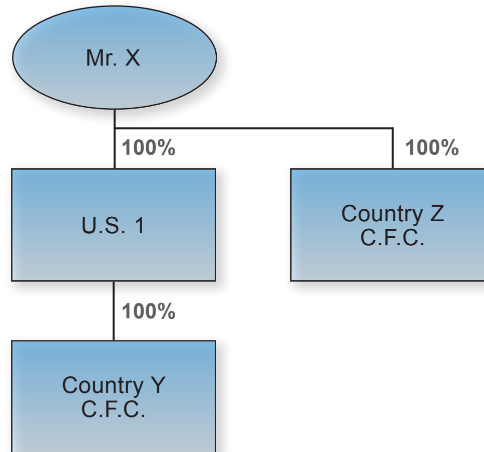
11 For C.F.C. determination purposes, under mega-attribution of Code §958(b)(2), U.S.P. is considered as owning 100% of Country 3 C.F.C.1, and in turn 50% of Country 3 C.F.C. 2, which by is still not enough to make Country 3 C.F.C. 2 a C.F.C.; the hypothetical's facts assume additional U.S. Shareholders at either at the first- or second-tier C.F.C level.

12 Code §958(a)(2).

A different set of challenges – arising from application of attribution principles – is illustrated by the following Ex. 2 (Figure 4):

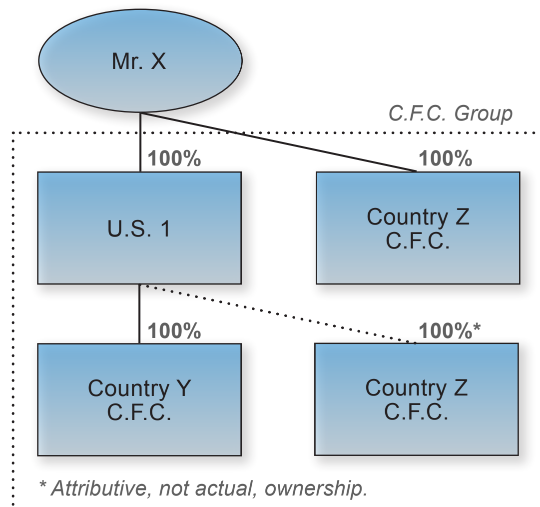
Fig. 4 – C.F.C. Group (Ex. 2)



In the above structure, two C.F.C.'s are owned in parallel chains by the same U.S. individual, Mr. X.; the first corporation, Country Z C.F.C., is owned directly by Mr. X, whereas the second, Country Y C.F.C., is owned indirectly via U.S. 1, a U.S. corporation.

Under attribution, because Mr. X owns 100% of U.S. 1, his ownership in Country Z C.F.C. is attributed (downward) to U.S. 1 under attribution; in consequence, as Code §318 appears relevant for C.F.C. group determinations, the preliminary conclusion is that U.S. 1 together with Country Y C.F.C. and Country Z C.F.C. jointly comprise a C.F.C. group, as shown in Fig. 5:

Fig. 5 – C.F.C. Group (Ex. 2 – Presumed C.F.C. Group via Attribution)



Through an oddity of how the C.F.C. group is defined, corporate U.S. Shareholders (such as U.S. 1, above) are technically included as members of a C.F.C. group, even though domestic corporations never earn tested gross income. In addition, the

Controlling Domestic Shareholder of this constructive C.F.C. group initially appears to be U.S. 1, since under attribution it owns more than 50% in two other C.F.C.'s, and therefore is the party the regulation appears to contemplate as making an election (similar to U.S.P. in Ex. 1, above). The only difficulty is that U.S. 1 does not actually own more than 50% of Country Z C.F.C.'s stock within the meaning of Code §958(a), as required by Treas. Reg. §1.964-1(c)(5). Although Code §318 provides that stock constructively owned is treated as actually owned to create the group, the Controlling Domestic Shareholder rules do not appear to have contemplated U.S. Shareholders of a C.F.C. group, but only particular C.F.C.'s viewed in isolation; separately, Treas. Reg. §1.964-1(c)(5) omits reference to Code §958(b), which is the short-hand reference in the international tax provisions signifying constructive ownership, referencing only Code §958(a) in defining Controlling Domestic Shareholders.

If U.S. 1 is not the appropriate Controlling Domestic Shareholder to file the Election for the constructive C.F.C. group, then perhaps might Mr. X be the appropriate Controlling Domestic Shareholder? The Controlling Domestic Shareholder rules are clear that only Code §958(a) ownership is considered. What makes Mr. X a better candidate to be the Controlling Domestic Shareholder for all of these related C.F.C.'s is that he directly or indirectly owns 100% of all the affected C.F.C.'s stock.

"In short, Mr. X cannot be the Controlling Domestic Shareholder vis-à-vis all the entities in this constructive group.

There are at least two ways out of this impasse. . ."

Is there a C.F.C. group? If so, who is the Controlling Domestic Shareholder? While the proffered solution of a constructive C.F.C. group including 3 entities, with Mr. X as the Controlling Domestic Shareholder seems to make initial sense, Code §958(a) indirect ownership stops with the first U.S. person in the chain,[13] so unless Code §318 can be imported into either Code §958(a), or Treas. Reg. §1.964-1(c)(5) through the back door of Treas. Reg. §1.951A-2(c)(7)(viii)(E)(2)(i), this approach doesn't work. The Final Regulations are quite clear that Code §318 only applies to determine members of the C.F.C. group, not to alter application of the Controlling Domestic Shareholder rule. It appears this is simply a remaining area of latent ambiguity and unreconciled regulatory constructs. In short, Mr. X cannot be the Controlling Domestic Shareholder *vis-à-vis* all the entities in this constructive group.

There are at least two ways out of this impasse:

1. The definition of a C.F.C. group in Treas. Reg. §1.951A-2(c)(7)(viii)(E)(2)(i) may be intended to be applied on the basis that individuals are included in the C.F.C. group as though they were corporations; if so, the difficulty with this approach is that Code §1504 only refers to includible corporations. This doesn't really work satisfactorily and requires us to apply Code §318 selectively, in a way that both considers Mr. X to be a member of the group, and not to be a member of the group to avoid including an ineligible person.

2. A more natural approach which eliminates most of the problems is to read Code §318 out of the C.F.C. group definition entirely whenever the effect would be to pull individuals like Mr. X or their separate stockholdings into a C.F.C. group; under such approach, the individual owner, like Mr. X., is the sole person entitled to make an Election under Treas. Reg. §1.951A-2(c)(7)(viii)(A) for any stock he or she owns directly, including Country Z C.F.C. The

[13] Treas. Reg. §1.958-1 (attribution under this paragraph stops with the first U.S. person in the chain of ownership running from the foreign entity).

same would hold true in any fact patterns where Mr. X owned 51% or more in a C.F.C. directly; and if he owned 50% or less, he would be required to locate additional Code §958(a) Shareholders, similar to U.S.P. in Ex. 1.

- Under this approach, if Country Z C.F.C. owned 100% of another controlled foreign corporation (*e.g.*, "Country Z C.F.C. 2"), then the two Country Z C.F.C.'s would form a second C.F.C. group parallel to the first, with respect to which Mr. X would be the Controlling Domestic Shareholder entitled to make the Election; as for U.S. 1's C.F.C. group, U.S. 1 would be the Controlling Domestic Shareholder entitled to make the Election. The groups never overlap and Code §318 would be ignored.

- If this is the proper reading of the C.F.C. group rules, then attribution principles should only be applied in a manner that does not combine otherwise unaffiliated entities or groups – including for determining who is a U.S. Shareholder or a Controlling Domestic Shareholder, or obviously and as illustrated in Ex. 3, below, whether a foreign corporation is a C.F.C. – though this selective application chafes against the explicit language of the Regulation to the effect that Code §318 is applicable for determining membership in a C.F.C. group.[14]

While the Final Regulations leave some ambiguity, particularly in pockets of discontinuity between the High-Tax Exception rules and pre-G.I.L.T.I. Treas. Reg. §1.964-1(c) (which, as previously noted, does not appear to have contemplated C.F.C. groups), the second reading proffered above feels more natural and harmonizes the dueling provisions better than the alternatives. In addition, these conflicts do not appear to be resolved by special tie-breaker rules applicable to situations where a C.F.C. may fall under more than one C.F.C. group.

The Preamble also suggests that the above may be what the drafters had in mind, stating that the "if a CFC is not a member of a CFC group, a high-tax election is made . . . only with respect to the CFC[.]" (citing Treas. Reg. §1.951A-2(c)(7)(viii)(A)). Unfortunately the statement flies in face of the explicit language of Treas. Reg. §1.951A-2(c)(7)(viii)(E)(2), which provides that "for purposes of this paragraph [defining the C.F.C. group], stock ownership is determined by applying the constructive ownership rules of section 318(a)," without excluding individuals. The Final Regulations would benefit from a subsequent clarification in this regard.

Based on this reading, Ex. 2 should be modified to reflect the presence of just one C.F.C. group, which includes U.S. 1 and Country Y C.F.C. Attribution via Mr. X, an individual, is ignored, and Country Z C.F.C. would be treated as a standalone entity for purposes of the Election, as depicted in Figure 6.

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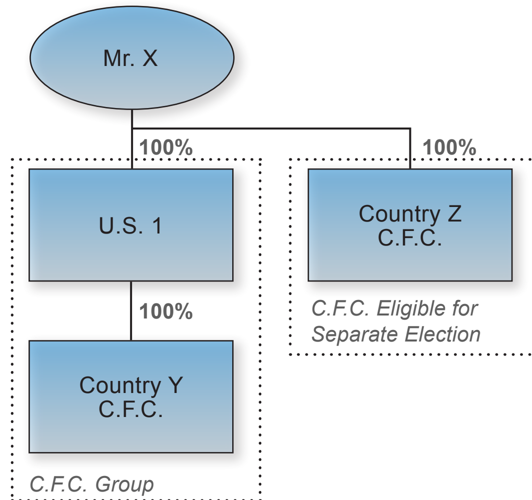
[14] The difficulty with this proposed approach to resolving some of the inconsistencies is that Code §318(a) principles must be selectively read in or out of the provision's language depending on circumstances not contemplated by rule's explicit language. In short, failure to state that Code §318 should not aggregate pre-existing corporate groups into larger affiliated groups appears to be an oversight.

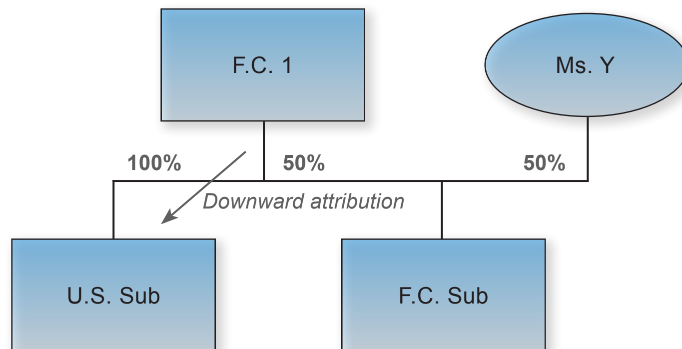
Fig. 6 – C.F.C. Group (Ex. 2 – as Modified)



A positive takeaway from the above interpretation is that U.S. Shareholders who own C.F.C. stock directly, rather than indirectly through vertical chains of foreign corporations, enjoy complete latitude to decide on a standalone basis whether or not to make an Election with respect to each entity they own, each year.

While the I.R.S. has mentioned it intends to revisit "faux C.F.C.'s" created by downward attribution,[15] after the T.C.J.A. Code §§318 and 958(b) apply in determining whether a foreign corporation is a C.F.C. as exemplified in the following hypothetical.

Fig. 7 – Constructive Attribution Scenario (Ex. 3)



F.C. Sub is treated as a C.F.C. solely as a result of downward attribution. This is because Ms. Y, a U.S. person, owns 50% of F.C. Sub's outstanding equity and in addition, F.C. 1's 50% ownership in F.C. Sub is attributed to U.S. Sub under Code §958(b), meaning that U.S. Shareholders collectively own, directly or constructively, 100% of F.C. Sub. However, unlike Ms. Y, U.S. Sub is not a Code §958(a) Shareholder to be considered as part of a Controlling Domestic Shareholder group,

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15 Andrew Velarde, "IRS May Refine Tested Unit Rule in GILTI High-Tax Exclusion Regs", Tax Notes, Aug. 5, 2020 (attributing quote regarding faux C.F.C. issues to John Merrick, senior-level counsel to I.R.S. Associate Chief Counsel (International)).

within the meaning of Treas. Reg. §1.964-1(c)(5),and for purposes of making an Election for high-tax purposes. Under the regulation's alternative approach, Ms. Y is treated as the Controlling Domestic Shareholder if she undertakes to act as such, because there are no other Code §958(a) U.S. Shareholders; this presupposes Ms. Y knows about the existence of U.S. Sub, and while she may have a duty to inquire about the matter with F.C. Sub, as the I.R.S. indicated in Rev. Proc. 2019-40,[16] in practice she may fail to do so, or she may only hear back from F.C. 1 group after it's already too late.

If F.C. Sub owns 100% of a second corporation ("F.C. Sub 2"), downward attribution also results in creation of a C.F.C. group, though, similar to the sound of a proverbial tree falling in the forest, no one may perceive its existence.

WHAT IS REQUIRED TO BE INCLUDED IN THE ELECTION?

The Controlling Domestic Shareholder makes the Election via the following steps:

1. File a statement under Treas. Reg. §1.964-1(c)(3)(ii), which includes identifying information for both the C.F.C. and each Controlling Domestic Shareholder approving the Election, identifying other U.S. domestic shareholders notified of action taken, and other required details; unless there is one sole 100% U.S. owner, the Controlling Domestic Shareholders all are required to attach a statement describing the action taken to their U.S. tax or information returns.

2. Provide notice to other U.S. domestic shareholders in the C.F.C., though failure to do so (apparently) will not invalidate the Election.

3. Provide any additional information required by applicable administrative pronouncements.

4. Additional requirements apply if the Election is made with retroactive effect on an amended return, filed within 24 months of the unextended due date.

Under item (2) above, Controlling Domestic Shareholders are required provide "any notices required under [Treas. Reg.] §1.964-1(c)(3)(iii)" to minority U.S. Shareholders upon making the Election. This is because there is a consistency requirement, making the Election binding on all U.S. Shareholders, even if they did not participate in the Election, or potentially are opposed to it.

In another example of discontinuities between the Final Regulations and Treas. Reg. §1.964-1(c)(5), despite the requirement to give the remaining U.S. Shareholders notice,[17] Treas. Reg. §1.964-1(c)(5) states that failure to do so shall not invalidate an election.[18] A less jarring inconsistency between the rules, old and new, may

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[16] 2019-43 I.R.B. 982.

[17] *Cf.* Treas. Reg. §§1.951A-2(c)(7)(viii)(A)(1)(ii) & -2(c)(7)(viii)(D).

[18] Treas. Reg. §1.964-1(c)(3)(iii) (Notice) (see last sentence, appearing to make a dead letter of the requirement to provide "required" notices).

be seen in the fact that Treas. Reg. §1.964-1(c) generally contemplates elections that remain valid until revoked, whereas the Election is an annual election valid only for the inclusion year. While this regulation was designed to address elections relating to accounting methods and tax years rather than annual elections, it would be helpful to have certain clarifications relating to the G.I.L.T.I. context.

HOW DOES ONE DECIDE WHETHER TO MAKE THE ELECTION?

An Election may not always yield positive tax consequences. If the Controlling Domestic Shareholder is eligible to make it vis-à-vis one or more Tested Units exceeding the requisite effective rate of tax, it may be tempting to make the election without giving any further thought, however, several factors should be kept in mind before making the Election, which are discussed below and illustrated with numerical examples.

1. **The Election may Interfere with the Taxpayer's Eligibility to Cross-Credit Foreign Taxes between High-tax and Low-tax Jurisdictions.**

A U.S. Shareholder of more than one C.F.C. that are organized in both high-taxed and low-taxed jurisdictions may lose its eligibility to claim a credit of the foreign taxes paid in the high tax jurisdiction for which a high tax exception election is made against its G.I.L.T.I. tax liability arising from the operations of the C.F.C. located in the low-tax jurisdiction.

Example A

X Co., a U.S. corporation is the sole shareholder of C.F.C. 1 (Tested Unit 1) organized in Jurisdiction 1 and C.F.C. 2 (Tested Unit 2) organized in Jurisdiction 2. The effective tax rate of C.F.C. 1 and C.F.C. 2 for the purpose of determining whether they meet the requirements of the G.I.L.T.I high tax exception is 25% (*i.e.*, greater than 18.9%) and 8.5% (*i.e.*, less than 18.9%). Accordingly, C.F.C. 1 qualifies under the G.I.L.T.I. high tax exception whereas C.F.C. 2 does not.

Alternative 1 explains the total U.S. Federal income tax liability on the G.I.L.T.I. income of X Co. if it makes the Election with respect to Tested Unit 1. Under Alternative 2, X Co. does not make the Election for Tested Unit 1. The example indicates that X Co. is better off (with a lower overall U.S. Federal income tax liability) under Alternative 2 since the taxes paid by Tested Unit 1 in Jurisdiction 1 not only fully offset U.S. tax on its G.I.L.T.I. inclusion but also fully offsets the U.S. tax on the G.I.L.T.I. inclusion of Tested Unit 2.

As a result, the net G.I.L.T.I. tax liability of X Co. from the operations of both Tested Units is $0. Unlike Alternative 2, the application of the high tax exception (via the Election) for Tested Unit 1 under Alternative 1 disallows X Co. to claim a credit of the taxes paid in Jurisdiction 1 against the G.I.L.T.I. tax arising from the operations of Tested Unit 2. As a result, X Co. is liable to pay $3.49 in incremental G.I.L.T.I. tax with respect to Tested Unit 2.

Example 1	Alternative 1 HTE Election is made		Alternative 2 HTE Election is not made	
	Tested Unit 1 (High Tax)	Tested Unit 2 (Low Tax)	Tested Unit 1 (High Tax)	Tested Unit 2 (Low Tax)
Gross Tentative Tested Income	100	100	100	100
U.S. $ Amount of Foreign Taxes Paid or Accrued	25	8.5	21	8.5
Net Tentative Tested Income	75	91.5	75	91.5
Effective Foreign Tax Rate	25%	8.5%	20%	7.83%
Eligible for HTE Election?	Yes *(the election is made)*	No	Yes *(the election is not made)*	No
Tested Income for G.I.L.T.I. Computation	N/A	100	100	100
Q.B.A.I.	N/A	20	20	20
Deemed Tangible Income Return – 10%	N/A	2	2	2
G.I.L.T.I. Inclusion before §250 Deduction	N/A	98	98	98
G.I.L.T.I. Deduction – 50%	N/A	49	49	49
Net Income Subject to G.I.L.T.I. Tax	0	49	49	49
G.I.L.T.I. Tax – 21%	0	10.29	10.29	10.29
F.T.C. Available – 80%	0	6.8	20	6.8
Net U.S. Tax Liability – Additional Tax Outflow	0	3.49	0	3.49
Excess F.T.C. Available			9.71	
Cross Credit of foreign taxes paid on the high-taxed income against the G.I.L.T.I. tax liability on the low-taxed tested income – up to $9.71				3.49
Net U.S. Tax Liability – Additional Tax Outflow	**0**	**3.49**	**0**	**0**
Unused F.T.C. (cannot be c/f)	$20.00	0	$6.22	

2. Whether Subsequent Distributions of Earnings and Profits will be Received Tax-Free in the Hands of a Corporate U.S. Shareholder Depends on Whether the Distribution is Made out of P.T.I. or Subject to Code §245A.

In case of a corporate shareholder owning 10% or more of the total voting rights or value of a C.F.C, a subsequent distribution of the income previously subject to the G.I.L.T.I. tax is treated as "Previously Taxed Income" ("P.T.I.") and not subject to

further U.S. tax under Code §959. However, dividends not previously taxed in the U.S. are not subject to U.S. Federal income tax only if they satisfy the requirements of Code §245A. Therefore, if a corporate U.S. Shareholder makes an Election, an actual dividend distribution is not P.T.I. and therefore must satisfy the requirements of Code §245A to receive a tax-free treatment in the U.S.

Unlike the P.T.I. rules, Code §245A has certain specific and complex requirements that must be satisfied before a corporate U.S. Shareholder can claim the Code §245A dividends received deduction ("D.R.D."). Some of the requirements include a minimum holding period, satisfaction of anti-hybrid rules, and determination of the foreign source portion of dividends.

"Unlike the P.T.I. rules, Code §245A has certain specific and complex requirements that must be satisfied before a corporate U.S. Shareholder can claim the Code §245A dividends received deduction."

3. The Election may Limit Eligibility of a U.S. Shareholder to Claim an Increased Amount of Foreign Tax Credit Under Code section 960(b).

Code §904 uses a formula to limit a taxpayer's use of allowable foreign tax credits. The main objective of the limitation is to ensure that a taxpayer is not allowed to claim a credit of the foreign taxes against its U.S. tax liability on U.S. source income. However, newly inserted Code §960(b)(1) increases that limit if certain conditions are satisfied. Under Code §960(b), the foreign tax credit limit may be increased in the year in which a U.S. Shareholder in a C.F.C. receives an actual distribution that is excluded from taxable income because the distribution was included in income previously under Code section 959(a) (includes the G.I.L.T.I. income). In other words, a distribution of P.T.I. can generate G.I.L.T.I. foreign tax credits where withholding and other foreign taxes are imposed on distributions of P.T.I. from a C.F.C. to its corporate U.S. Shareholder. However, distributions of earnings and profits that are eligible for the Code §245A D.R.D. are not eligible for such foreign tax credits. As a result, corporate U.S. Shareholder should consider the impact of foreign tax withholding and availability of a foreign tax credit on subsequent distributions of earnings and profits when deciding whether to elect or forego the High Tax Exception.

4. Where a Corporate U.S. Shareholder Incurs a Net Operating Loss, an Election may be Beneficial to Ensure Maximum Utilization of the G.I.L.T.I. Deduction.

A corporate U.S. taxpayer that is subject to the G.I.L.T.I. tax is also entitled to a deduction equal to 50% of its G.I.L.T.I. ("G.I.L.T.I. Deduction"). When a corporate U.S. Shareholder incurs a net operating loss ("N.O.L.") or has carried forward N.O.L.'s and is also eligible for a G.I.L.T.I. Deduction in the same tax year, specific ordering rules require it to use the N.O.L. to first offset the G.I.L.T.I. income before computing the G.I.L.T.I. Deduction. As a result, the N.O.L. is used to offset the G.I.L.T.I. income which would otherwise be taxed at a lower effective tax rate of 10.5%. In the absence of the G.I.L.T.I. income, the N.O.L.s could have been used to offset other income of the shareholder taxed at a higher rate of 21%. This undermines the tax effectiveness of N.O.L.'s since they are used offset the low-taxed G.I.L.T.I. income instead of the high-taxed ordinary income. Therefore, if eligible, a corporate taxpayer is better off making the Election with respect to a C.F.C. in the year it has incurred an N.O.L. or has carried forward N.O.L.'s

Effect of the C.A.R.E.S. Act on G.I.L.T.I. and N.O.L.'s

Prior to the T.C.J.A., a corporate taxpayer could carryback N.O.L.s for two years and carry the N.O.L.'s forward for 20 years. The T.C.J.A., however, eliminated N.O.L. carrybacks and allowed a corporate taxpayer to carry N.O.L.'s forward indefinitely. At the same time, the T.C.J.A. limited a corporate taxpayer's ability to use N.O.L.'s by permitting N.O.L.'s to offset only 80% of its taxable income in a year. The 2020 Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136 ("C.A.R.E.S. Act") allowed taxpayers to carry back N.O.L.'s incurred in Tax years 2018 through 2020 for up to five years. Further, the C.A.R.E.S. Act has eliminated the 80% limitation on use of N.O.L. carryforwards for Years 2018 through 2020. In view of the above new provision, if a corporate taxpayer carries back an N.O.L. to a year in which it was subject to G.I.L.T.I., the taxpayer my partly or fully the lose the benefit of the G.I.L.T.I. Deduction. This is explained with the help of the following example.

Example

X Co. is a U.S. corporation that owns F Co., a C.F.C. In 2018, X Co. has a G.I.L.T.I. inclusion of $100 and $50 of ordinary income. Accordingly, X Co. is entitled to a G.I.L.T.I. Deduction of $50 (50% of G.I.L.T.I. inclusion of $100). Therefore, the taxable income of X Co. in 2018 is $100 ($100 - $50 + $50).

In 2019, however, the taxpayer incurred an N.O.L. of $100 and does not make an election to forgo the carryback. As a result of the C.A.R.E.S. Act, $100 of the N.O.L. is carried back to 2018. In the absence of the ordering rules, X Co. would have $0 of taxable income in 2018. This is because X Co. reported a taxable income of $100 in 2018 and a carryback of the $100 N.O.L. should have resulted in a net income of $0.

However, because of the ordering rules, the N.O.L. will first reduce the ordinary income ($50) and then the G.I.L.T.I. Inclusion amount ($100). The taxable G.I.L.T.I. income will be reduced to $50 ($100 + $50 - $100). As a result, the taxpayer is permitted a G.I.L.T.I. Deduction of $25 (*i.e.*, 50% of $50). Consequently, X Co.'s resulting taxable G.I.L.T.I. income is $25 ($50 - $25), not the expected $0 taxable income.

5. Code §962 Election and or G.I.L.T.I. High Tax Exception Election.

In addition to considering the Election in any given year, a U.S. individual, estate or trust, should also consider an election under Code §962 (the "§962 Election"). By virtue of §962 Election, non-corporate taxpayers receive the benefit of a hypothetically interposed U.S. C corporation, meaning they enjoy a 50% Code §250 deduction with respect to G.I.L.T.I. income and pay tax at a (now) 21% corporate rate, while receiving a benefit for 80% of the associated foreign tax credits. When the underlying earnings (net of tax paid) are repatriated, the individual, estate or trust is taxed on dividend income (at a qualified rate if the paying foreign entity is a qualified entity) in addition to the 3.8% net investment income tax, potentially subject to a credit for foreign withholding taxes arising on the distribution.[19]

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[19] Subpart F and G.I.L.T.I. as well as P.F.I.C. inclusions are all considered other gross income from a trade or business subject to N.I.I.T., though taxpayers may make a special irrevocable election with respect to the C.F.C. or qualified electing fund and pay the N.I.I.T. up front at the time the income is included.

There may be circumstances where the §962 Election may obviate the need for the Election. But it's important to keep in mind that both elections may be made simultaneously; if both are made, the Election will completely remove certain tentative tested gross income from tested income (and thereby, from G.I.L.T.I.), together with associated items such as allocable and apportionable deductions and tested foreign taxes, whereas the Code §962 Election will not remove or eliminate G.I.L.T.I. but merely has consequences for how the G.I.L.T.I. that remains is taxed in the U.S. There is no hard-and-fast answer to whether an Election is appropriate – the ultimate decision must be based on careful modeling, with the answer provided by the numbers.

CONCLUDING REMARKS

This article noted features of the Final Regulations that may be beneficial, certain opportunities, as well as certain challenges to watch out for. For individuals owning significant stakes in foreign corporations' stock, important considerations include holistic assessment of each foreign corporation's tax attributes each year, including an evaluation how G.I.L.T.I. interacts with other aspects of the U.S. Shareholder's domestic tax profile. A final decision about whether to make the Election should be based upon careful numerical analysis, including side-by-side comparison with the Code §962 Election – which may be made in the alternative, or concurrently.

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