Bloomberg Tax

Daily Tax Report®

Reproduced with permission from Daily Tax Report, 14 DTR S-15, 1/22/18. Copyright © 2018 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

CFCs

Lowell D. Yoder, David G. Noren, and Elizabeth R. Chao of McDermott Will & Emery LLP discuss the significant expansion of Subpart F by the recently enacted tax reform legislation and provide an overview of the taxation of income derived by controlled foreign corporations owned by U.S. corporations under the new law. The authors say that many longstanding planning issues remain under the new law, including most Subpart F and Section 956 considerations. In addition, taxpayers will need to contend with significant complexity, unanswered questions, and traps for the unwary under the new ''global intangible low-taxed income'' (GILTI) and ''base erosion and anti-abuse tax'' (BEAT) regimes.

Tax Reform: Taxation of Income of Controlled Foreign Corporations

BY LOWELL D. YODER, DAVID G. NOREN, AND ELIZABETH R. CHAO

Subpart F requires U.S. shareholders of a controlled foreign corporation (CFC) to include in their gross incomes each year their pro rata shares of the CFC's Subpart F income and investments in U.S. property. The recently enacted tax reform legislation, Pub. L. No. 115-97 (12/22/2017) (Tax Act), significantly expanded the application of Subpart F, including by adding a new inclusion rule for non-routine CFC income, termed ''global intangible low-taxed income'' (GILTI). The Tax Act also subjects historic CFC earnings to immediate taxation at reduced tax rates under a transition tax, but going forward provides a 100% deduction for the foreign source portion of dividends received from a CFC. This article provides an overview of the taxation of income derived by CFCs owned by U.S. corporations under the Tax Act.

Lowell D. Yoder is a partner and Elizabeth R. Chao is an associate with McDermott Will & Emery LLP in Chicago, and David G. Noren is a partner with McDermott Will & Emery LLP in Washington, D.C. Yoder is a member of the Bloomberg Tax U.S. International Advisory Board.

Definition of U.S. Shareholder and CFC

Subpart F applies to a foreign corporation that is owned more than 50% (by vote or value) by U.S. shareholders. A U.S. shareholder had been defined as a U.S. person that owns 10% or more of the *voting* stock of a foreign corporation. The Tax Act expanded the definition of U.S. shareholder to also include U.S. persons that own 10% or more of the *value* of the stock of the foreign corporation. For example, a U.S. person that owns stock in a foreign corporation with 6% of the votes and 15% of the value would be a U.S. shareholder under the new definition.

For purposes of the above ownership tests, stock owned directly, indirectly, and constructively is taken into account. Under prior law, stock in a foreign corporation owned by a foreign person was not treated as constructively owned by a U.S. person; the Tax Act removed this limitation. For example, a U.S. subsidiary of a foreign based multinational will be considered as owning stock in a foreign subsidiary of the foreign parent, not just prospectively but also retroactively for the last taxable year of foreign corporations beginning before Jan. 1, 2018.

The new rules expand the range of foreign corporations that are classified as CFCs and the U.S. owners that are classified as U.S. shareholders. However, the amount of a CFC's income that is included in the income of a U.S. shareholder is limited by that U.S. share-

holder's ownership interest directly and indirectly through another foreign corporation. For example, while the foreign subsidiary of the foreign parent in the above example would be a CFC, no portion of its Subpart F inclusions would be subject to taxation under Subpart F. Nevertheless, the U.S. shareholder would have to comply with all the CFC reporting requirements with respect to the foreign parent's foreign subsidiary.

One potentially unintended result of the expanded ownership rules is that foreign joint venture corporations that are minority-owned by U.S. persons arguably might become CFCs, even though the legislative history suggests that this is not the intent of the provision. For example, assume a foreign joint venture corporation is owned 30% by a U.S. corporation and 70% by an unrelated foreign publicly traded company. The foreign owner also has a U.S. subsidiary, which under the modified constructive ownership rules would be considered as owning its 70% interest in the foreign joint venture. This structure does not involve any CFC de-control planning, and yet it appears possible as a technical matter that the foreign joint venture might be a CFC. The legislative history specifically disclaims any intent to treat a foreign corporation as a CFC with respect to a U.S. shareholder (such as the 30% owner in this example) as a result of attribution of ownership to a U.S. person that is unrelated to such U.S. shareholder, but it is not clear that the statutory language fully effectuates that intent. Guidance and/or technical corrections legislation on this point would be useful.

Subpart F Income Inclusions

Subpart F income is defined generally as including insurance income and foreign base company income. Foreign base company income includes foreign personal holding company income (e.g., dividends, interest, rents, royalties), foreign base company sales income, and foreign base company services income. The definitions of these categories of Subpart F income were not changed. The foreign base company income category for oil related income, however, was removed.

Congress has extended the look-through exception several times in the past, and it appears likely that the exception will be extended again.

An important temporary exception for foreign personal holding company income is provided under tax code Section 954(c)(6) for dividends, interest, rents and royalties received by one CFC from a related CFC. The application of this look-through exception expands with the expansion of the definition of foreign corporations that are classified as CFCs. While the House bill and the Senate bill would have made Section 954(c)(6) permanent, that proposal ultimately was not adopted, presumably due to revenue considerations as opposed to any policy concern. Thus the exception remains scheduled to expire for taxable years beginning on or after Jan. 1, 2020. Congress has extended the look-through exception several times in the past, and it appears likely that the exception will be extended again. As discussed below, the exception is no longer necessary for dividends received from CFCs, because they should be excluded from Subpart F income under the dividends received deduction provided in Section 245A.

If the look-through exception is not extended in the future, interest may qualify for the more limited exception that applies to amounts received from a related foreign corporation organized in the same country as the recipient. Rents and royalties may qualify for the exception that applies to amounts received from a related foreign corporation for the use of property in the recipient's country of organization. Alternatively, the two companies may be organized in a disregarded entity structure that causes such payments to be disregarded for U.S. tax purposes.

The full inclusion rule, high tax exception, and *de minimis* rule were not modified. The computation of the high tax exception, however, is affected by two other changes. First, lowering the corporate tax rate from 35% to 21% reduces the threshold for high taxed income from 30.5% to 18.9%. Second, the foreign taxes associated with an item of income will be determined no longer on the basis of post-1986 pools of earnings and taxes (because those rules were repealed), but rather on the basis of actual taxes attributed to the income. As discussed below, Section 960 deemed-paid foreign tax credits are available for the foreign taxes associated with Subpart F inclusions, and a novel foreign tax credit approach applies with respect to GILTI inclusions.

Under prior law, Subpart F income earned by a CFC was not subject to U.S. taxation if the foreign corporation was not a CFC for an uninterrupted period of at least 30 days. For example, if a CFC was formed during the last month of its taxable year, any Subpart F income earned during that short year would not be taxable under Subpart F. This rule was repealed.

Amounts included in the income of U.S. corporate shareholders are entitled to deemed paid tax credits under Section 960. The Tax Act eliminated the post-1986 pool rules for earnings and taxes. Thus, apparently taxes are traced on a current-year basis to the Subpart F income that is included. Treasury is expected to issue regulations describing how such taxes should be traced. The general and passive foreign tax credit baskets continue to be relevant, though new baskets were created for non-passive GILTI (discussed below) and foreign branch income. As under current law, any excess taxes (except taxes attributable to non-passive GILTI) may be carried back one year, and forward ten years. The Section 78 gross-up continues to apply to deemed paid tax credits under Section 960.

As under prior law, the amount of Subpart F income included in the gross income of a U.S. shareholder becomes previously taxed income. In addition, the basis the U.S. shareholder has in the first-tier CFC is correspondingly increased.

The New GILTI Inclusion and GILTI and FDII Deductions

After a CFC calculates its Subpart F income, it must then apply the GILTI inclusion rules provided in new Section 951A. Such amount is included in the income of the U.S. shareholders in the same manner as Subpart F income inclusions, but is then reduced by certain deductions.

 COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884

In general, the new GILTI provision is designed to impose a minimum residual U.S. tax on above-routine CFC earnings, with the exempt routine return being defined generally as a 10% return on the CFC's tangible property (''qualified business asset investment,'' or ''QBAI''). This tax is reduced by a special deduction and a partial foreign tax credit, as described below.

While Subpart F income is determined on a separate CFC basis, GILTI is determined on an aggregate basis at the U.S. shareholder level. The relevant amounts for each CFC in which a U.S. corporation is a U.S. shareholder are attributed to the U.S. shareholder for purposes of the GILTI calculation. Thus, although the general approach is to aggregate CFCs for GILTI purposes, this aggregation apparently applies separately for each U.S. shareholder chain in a structure in which multiple (even consolidated) U.S. shareholders own CFCs, such that there may be multiple GILTI groups under a single U.S. consolidated group (contrary to the consolidation approach that was taken under Notice 2018-7 for purposes of the transition tax).

> The formula for GILTI calculated at the shareholder level is:
>
> GILTI = Net Tested Income – [(10% of QBAI) – interest expense].

To arrive at a U.S. shareholder's Net Tested Income, the aggregate amount of its pro rata share of Tested Income from each CFC is reduced by the aggregate amount of its pro rata share of Tested Loss from each CFC. The Tested Income of a CFC is the excess of its gross income over deductions (including taxes) properly allocable to such income. The Tested Loss of a CFC is the excess of allocable deductions over gross income. For purposes of determining Tested Income and Tested Loss, gross income does not include the amount of Subpart F income, income which would have been Subpart F income if the high-tax exception had not been elected, income taxed as effectively connected with a U.S. trade or business, and dividends received from a related person.

In calculating GILTI, the Net Tested Income is reduced by 10% of QBAI less interest expense. QBAI means the average of the aggregate of a CFC's adjusted bases, determined as the close of each quarter, in specified tangible property used in a trade or business, of a kind subject to depreciation under Section 167. Only tangible property used in the production of Tested Income is taken into account (and QBAI of a CFC with a tested loss is not taken into account). This amount is reduced by interest expense taken into account in calculating the U.S. shareholder's Tested Income to the extent the corresponding interest income is not taken into account in determining such shareholder's Net Tested Income.

There is no high tax exception or *de minimis* rule. Thus, income that is high taxed but is not Subpart F income (and is not excluded from Subpart F by the high tax exception) would be included in GILTI.

New Section 250 provides a deduction of 50% of GILTI and 37.5% of foreign derived intangible income (FDII) (these deductions are scheduled to decrease in 2026). FDII is the corporation's deemed intangible income multiplied by the ratio of its foreign-derived deduction eligible income to its total deduction eligible income. Deemed intangible income is deduction eligible income over a deemed tangible income return (similar to QBAI). Deduction eligible income is gross income (not including any inclusions for Subpart F income or Section 956 investments in U.S. property, GILTI inclusions, dividends from CFCs, or foreign branch income) over deductions (including taxes). Deduction eligible income is foreign derived if it is derived in connection with property sold by the corporation to a foreign person for foreign use; services provided by the corporation to foreign persons; and services provided by the taxpayer with respect to property not located in the United States. Sales to related foreign parties can generate eligible income if the taxpayer can establish that the foreign affiliate ultimately sells the property to an unrelated party for foreign use. Royalty and rental income also can qualify as deduction eligible income if the licensed or leased property is used in connection with the provision of goods or services to foreign customers.

The effect of the 50% GILTI deduction is that GILTI is effectively taxed at a 10.5% rate (which tax, as discussed below, the legislative history indicates would generally be reduced to zero with foreign tax credits if subject to foreign tax at a rate of at least 13.125%). The effect of the 37.5% FDII deduction is that income derived from providing sales, services or rights to foreign persons is effectively taxed at 13.125%. The taxation of GILTI and the low tax rate on FDII are intended to encourage U.S. taxpayers to own their intangible property in the United States.

New Section 250 provides a deduction of 50% of GILTI and 37.5% of foreign derived intangible income (FDII)—these deductions are scheduled to decrease in 2026.

A foreign tax credit is permitted for 80% of the foreign taxes associated with GILTI (the inclusion is increased under Section 78 by 100% of the taxes). A separate basket is provided for non-passive GILTI taxes, and any excess credits may not be carried forward or back (i.e., the computation is carried out on a purely annual basis). It appears that the U.S. tax consequences are calculated by treating all non-passive GILTI the same. This allows for cross-crediting between non-passive GILTI that is subject to tax at different rates, but taxes associated with non-passive GILTI may not be used to offset income in other baskets. Because non-passive GILTI is in a separate basket, a U.S. shareholder that has built up overall foreign losses in its general basket under prior law will not be prevented from using foreign tax credits in the GILTI basket to reduce U.S. tax on its GILTI income going forward.

For example, assume a CFC has $900 of GILTI and the income was subject to $100 of foreign tax. The CFC's U.S. shareholder would be subject to a 21% U.S. tax on $500 [$1,000 ($900 GILTI plus $100 gross-up) – 0.5*($1000)], which would be $105. The U.S. shareholder would receive a foreign tax credit of $80 [80% of $100 foreign taxes], and have a net GILTI tax liability of $25.

If instead GILTI were $850 and the income were subject to $150 of foreign tax, U.S. tax would be imposed

on $500 [$1,000 ($850 GILTI plus $150 gross-up) – 0.5*($1000)], which would be $105. The U.S. shareholder would receive a foreign tax credit of $105 [80% of $150 foreign taxes is $120, but GILTI inclusion cannot be reduced below zero] and have a net U.S. tax liability of $0 (the excess credits of $15 would disappear). Thus, as emphasized in the legislative history, foreign income subject to a tax rate of 13.125% generally should not be subject to incremental U.S. taxation (80% of 13.125% is 10.5%, the rate of U.S. tax that applies after taking into account the 50% GILTI deduction).

As noted above, the Section 904 foreign tax credit limitation applies to foreign taxes associated with GILTI. To the extent that expenses are allocated to the GILTI inclusion, some portion of the foreign tax credits may be disallowed, which indirectly results in U.S. taxation. In addition, the treatment of the GILTI deduction for purposes of determining the Section 904 limitation is not expressly addressed. Depending on how expense allocation and the GILTI deduction are addressed, it is possible that the GILTI rules could result in the imposition of significant residual U.S. tax even in situations in which the overall foreign effective tax rate is well above 13.125%, contrary to the clearly expressed legislative intent. Further guidance on these issues (and potentially technical corrections) should be a high priority.

As with Subpart F income inclusions, the amount of GILTI included in the income of a U.S. shareholder (before the 50% deduction) becomes previously taxed income. In addition, the basis the U.S. shareholder has in the first-tier CFC is correspondingly increased.

Dividends Received from CFCs (and Taxation of Historic Earnings)

Under prior law dividends received by a U.S. shareholder from a CFC generally were included in income. The amount subject to taxation was reduced by the CFC's previously taxed income. Such previously taxed income included amounts for current year and prior year Subpart F income inclusions and for prior year inclusions as investments in U.S. property.

The taxable portion of the distribution was accompanied by deemed paid foreign taxes which could be claimed as a credit against U.S. taxes. The foreign taxes were computed on a post-1986 pool basis and determined separately for the passive and general limitation baskets.

The legislation retains the special foreign tax credit rules that provide credits for taxes imposed on distributions of previously taxed income and for which a credit hasn't already been provided.

Distributions of previously taxed income continue to be excluded from income (such amounts are not treated as dividends). Previously taxed income includes income included in the U.S. shareholder's gross income as Subpart F income, GILTI and investments in U.S. property, and income subject to the transition tax under Section 965. The basis in the CFC stock that was increased for such inclusions must be reduced for distributions of previously taxed income, and as under prior law, the amount of a distribution in excess of basis would be subject to tax as capital gain (except to the extent the gain would be recharacterized as a dividend under Section 1248 taking into account earnings of lower-tier CFCs).

The tax legislation retains the special foreign tax credit rules that provide credits for taxes that are imposed on distributions of previously taxed income and for which a credit has not already been provided. These rules should apply to withholding taxes imposed on distributions to CFCs of previously taxed income, including amounts that have been subject to tax under the Section 965 transition tax or as GILTI. Withholding taxes imposed on distributions of previously taxed income from CFCs to U.S. corporations should continue to be creditable under Section 901.

Under new Section 245A, the foreign source portion of distributions received by a U.S. shareholder from a CFC out of earnings that were not previously taxed are entitled to a 100% dividends received deduction. These would include earnings that were not subject to tax under the Section 965 transition tax and earnings that were excluded from Subpart F and GILTI (e.g., routine return that does not exceed 10% of QBAI). This deduction is also available for dividends received by one CFC from another CFC. No foreign tax credits are permitted to accompany such distributions, and any foreign taxes associated with such earnings are not creditable, including withholding taxes.

To transition to the dividend exemption system, all post-1986 earnings of a CFC are subject to taxation under a Section 965 transition tax. Such earnings and profits of a CFC became taxable at either a 15.5% rate (for earnings treated as being held in the form of cash or cash equivalents) or 8% rate (for the balance) and are treated as a current Subpart F income inclusion. The 15.5% and 8% rates are achieved by including all untaxed CFC earnings in a U.S. shareholder's income and providing a deduction equal to the amount that, at the U.S. shareholder's U.S. tax rate, would yield a rate of 15.5% or 8%, as applicable, on those earnings (this cumbersome formulation being necessary due to the fact that the transition inclusion may occur in taxable years in which the general corporate rate is 35%, 21%, or a blended rate under Section 15).

Foreign tax credits can be used to offset the transition tax, but foreign taxes associated with the earnings subject to the tax are haircut: 55.7% of foreign taxes on cash earnings and 77.1% of foreign taxes on non-cash earnings are disallowed. The haircut disallows the portion of foreign tax credits associated with the earnings that, at the 35% pre-reform corporate tax rate, would be deducted in order to reach the 15.5% and 8% transition tax rates (55.7% is 1-(15.5%/35%), and 77.1% is 1-(8%/35%)). Foreign tax credit carryforwards associated with CFC earnings that have already been included in the U.S. shareholder's gross income can be fully used. Other than the haircut described above, the pre-Tax Act foreign tax credit rules apply to the transition tax. Earnings subject to the Section 965 transition tax become previously taxed income and the U.S. shareholder's basis in the CFC stock is correspondingly increased.

In practice, the Section 245A dividend received deduction may have limited application in many cases. Because of the addition of the Section 965 transition tax

 COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884

and GILTI, and the retention of the Subpart F regime, a large portion of CFC earnings will be subject to current U.S. tax, even if not distributed. As a result, Section 245A may primarily apply to distributions of returns on tangible assets.

Investments in U.S. Property

In addition to Subpart F income and GILTI, a U.S. shareholder must also include in gross income its pro rata share of a CFC's investments in U.S. property. The amount is equal to the average of the amounts of U.S. property held (directly or indirectly) by the CFC as of the close of each quarter, but limited to the amount of the CFC's earnings and profits. This amount is reduced by the amount of the CFC's earnings and profits that were previously taxed as Subpart F income or investments in U.S. property.

U.S. property is defined to include tangible property located in the United States, stock or obligations of related U.S. persons, and certain intangible property held for use in the United States (subject to a number of exceptions). In addition, a CFC is considered as holding an obligation of a U.S. person if the CFC is a guarantor or pledgor of the obligation.

While both the House and Senate bills would have repealed this inclusion rule for corporate U.S. shareholders, the Tax Act ultimately retained it. Therefore, after applying the Subpart F income provisions and GILTI, and taking into account any current year distributions, Section 956 is applied.

Section 960(a) provides a basis for credits with respect to any item of income includible under Section 951(a)(1), which seems to include Section 956 inclusions (which are includible under Section 951(a)(1)(B)). However, a provision limiting the foreign tax credits for Section 956 inclusions may have been unintentionally repealed. Section 960(c) had provided that the amount of foreign tax credits with respect to a Section 956 inclusion could not exceed the amount of foreign tax credits if the same amount of cash had been distributed to the U.S. shareholder. This provision was removed in the House and Senate bills along with the removal of Section 956. When the conference agreement added back Section 956, perhaps as a last-minute decision, it did not add back Section 960(c).

It is likely that Section 956 will have a more limited scope of application in the future. For some companies the GILTI inclusions will create a significant amount of previously taxed income, which would reduce any Section 956 amount. A CFC may also have a significant amount of previously taxed income as a result of the earnings that were taxable under new Section 965. Section 956 investments would not give rise to an inclusion to the extent of a CFC's previously taxed income.

Furthermore, because dividends received from CFCs qualify for a 100% dividends received deduction, and a Section 956 inclusion would be subject to U.S. tax, it may be more advantageous to taxpayers to distribute non-previously taxed earnings rather than make an investment in U.S. property, especially when no dividend withholding tax is imposed. Unfortunately, because Section 956 has been retained, it will continue to limit a taxpayer's ability to use CFC assets to support third party loans to U.S. related persons.

Sale of a CFC

The Tax Act did not change the general treatment of the taxation of gain when the stock of a CFC is sold. The gain recognized by a U.S. shareholder on the sale of stock in a CFC would generally be subject to taxation. In addition, the gain recognized by a CFC on the sale of stock in a lower-tier CFC generally would be Subpart F income.

Section 1248 recharacterizes all or a portion of any gain on the sale of stock by a U.S. shareholder in a CFC as dividend income to the extent of the earnings and profits attributed to the selling shareholder. Such amount should qualify for the 100% dividends received deduction provided by Section 245A. Unlike current rules, no deemed paid foreign tax credits would accompany such dividend. The balance of any gain would be subject to the 21% corporate tax rate.

In addition, Section 964 provides a similar rule when a CFC sells stock in a lower-tier CFC, recharacterizing a portion of the gain as dividend income. Under current law, the dividend portion of the gain generally would not be subject to U.S. taxation under the look-through rule of Section 954(c)(6). Such dividend portion of the gain should also be excluded from Subpart F income pursuant to Section 245A.

New Section 59A imposes a base erosion and anti-abuse tax (BEAT), which effectively imposes a minimum tax on income of large U.S. corporations making a certain level of deductible payments to foreign related parties.

The Tax Act did not repeal the regulations that permit a taxpayer to change the classification of a foreign eligible entity. Accordingly, a CFC may elect to disregard a lower-tier CFC prior to its sale and treat the transaction as a sale of the CFC's assets, thus generally qualifying the gain for the exception to Subpart F that applies to gain on the sale of assets used in a trade or business. Nevertheless, such gain would be taken into account for purposes of applying the GILTI rules, and if no foreign tax is imposed, the GILTI inclusion generally would be subject to a 10.5% U.S. tax rate.

The BEAT and CFCs

New Section 59A imposes a base erosion and anti-abuse tax (commonly called the ''BEAT''), which effectively imposes a minimum tax on income of large U.S. corporations making a certain level of deductible payments to foreign related parties. The amount of the tax is the amount by which 10% of modified taxable income (5% for 2018) exceeds the regular tax liability over credits (other than certain specified credits, namely research and development credits).

The payments that are excluded as a deduction in calculating modified taxable income are deductible amounts paid to related foreign persons. Such amounts also include amortization and depreciation deductions

with respect to property acquired from a related foreign person. The BEAT does not apply unless these amounts exceed 3% of the taxpayer's total deductions (not including net operating loss deductions, deductions for GILTI or FDII, and the Section 245A 100% dividends received deduction).

A related foreign person can include a CFC. The deductible amounts that are added back when calculating modified taxable income include amounts paid to a CFC that are Subpart F income or GILTI that is included in the U.S. corporation's income.

These add-backs do not include payments for services that are eligible for the application of the services cost method under the Section 482 regulations (without regard to the requirement under those regulations that the services not contribute significantly to the fundamental risks of business success or failure), to the extent that the amount in question constitutes total services costs, with no mark-up component. Based on the statute and legislative history (including a floor colloquy between Senators Hatch and Portman), in many cases it may be possible to bifurcate service fees into cost and mark-up components, with the BEAT applying only to the mark-up component.

When calculating modified taxable income, the 50% deduction for GILTI inclusions, the 37.5% deduction for FDII, and the 100% dividends received deduction for the foreign-source portion of dividends received from a CFC are not added back to income. In addition, previously taxed income received is not included in modified taxable income.

As discussed above, U.S. tax on the Subpart F income or GILTI inclusions can be reduced by foreign tax credits accompanying such amounts. Such credits are not backed out for purposes of calculating the BEAT (unlike research and development credits, which are backed out for taxable years beginning before 2026), and thus may be considered as effectively disallowed to the extent of any BEAT.

For example, consider a U.S. corporation that has $1000 of gross income (including $250 of Subpart F income of its CFCs), $200 payments to third parties, $300 rental payments to a related CFC ($250 of which is Subpart F income of the related CFC), $30 of amortization with respect to intangible property purchased from a foreign related party, $15 of research and development credits, and $50 foreign tax credits. The U.S. corporation's taxable income is $470 [$1000-$200-$300-$30]. Its regular pre-credit U.S. tax liability is $98.7 [$470*21%]. After taking into account $65 credits ($15 research and development credits and $50 foreign tax credits), the U.S. corporation would have to pay tax of $33.7. The BEAT applies because the taxpayer's base erosion payments ($330) exceed 3% of its total deductions ($530). Modified taxable income is $800 [$470 + $300 + $30], and 10% of that is $80. The BEAT is $31.3 [$80 – ($98.7 regular tax liability – ($65 all credits – $15 R&D credits))]. The U.S. shareholder would have a $33.7 regular tax liability plus a $31.3 of BEAT, for total U.S. taxes of $65. Note that Subpart F income is included in calculating modified taxable income even though the rental payment giving rise to the Subpart F income is backed out in calculating modified taxable income, and that a portion of the foreign tax credits are effectively denied as a credit (and there is no carryover of such credits). Notwithstanding the loss of some foreign tax credits, the full Section 78 gross-up is apparently includible in modified taxable income and thus taxable for BEAT purposes.

Concluding Remarks

Most of the existing Subpart F rules have been retained, and new rules have been added that significantly expand the application of Subpart F. The definitions of U.S. shareholder and CFC have been expanded such that minority-owned foreign joint ventures can become CFCs. In addition, a new Subpart F inclusion rule—GILTI—was added, which will have broad application.

Distributions from CFCs now are essentially excluded from income, whether as previously taxed income or under the new 100% dividends received deduction.

Planning to minimize Subpart F income remains important despite GILTI, because only 50% of GILTI is included in taxable income of the U.S. shareholders, and there is an exclusion for 10% of the adjusted basis of tangible assets. Subpart F income can also increase the likelihood of the BEAT applying because 100% of such amounts is included in taxable income. On the other hand, taxpayers with existing operations in high-tax jurisdictions may consider electing the high-tax exception for income that would be Subpart F but for the high-tax exception, because the high-tax exception causes amounts to be excluded from both Subpart F and GILTI (there is no similar exception for high-taxed GILTI), although in certain situations the high-tax exception might not be elected, in order to permit the taxes to be claimed as a credit against lower-taxed Subpart F income.

Distributions from CFCs now are essentially excluded from income, whether as previously taxed income or under the new 100% dividends received deduction. Nevertheless, investments in U.S. property can trigger a Subpart F inclusion to the extent the investment exceeds a CFC's previously taxed income, and therefore generally it will continue to be desirable to monitor such investments.

The sale of a CFC is treated more favorably because any portion of the gain reclassified as a dividend is not subject to taxation. On the other hand, because of the GILTI tax, gain recognized by a CFC on the sale of a disregarded entity would potentially be subject to current U.S. tax, even if the gain is not Subpart F income.

 COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884