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Foreign Income Regs Provide Some Clarity But Issues Remain

By **Robert Kiggins** (August 26, 2020, 1:43 PM EDT)


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Both global intangible low-taxed income, or GILTI, and foreign-derived intangible income, or FDII, are creatures of the Tax Cuts and Jobs Act enacted on Dec. 22, 2017. GILTI has been plagued with technical issues from the very start and FDII has been under criticism internationally as an illegal export incentive or harmful tax practice.

In July, final regulations were released on GILTI and FDII as well as proposed regulations unifying the treatment of high-taxed GILTI and high-taxed Subpart F income. These regulations largely address technical issues, but it would seem that more substantive problems still remain.

Final FDII Regulations

On July 9, the IRS and the U.S. Department of the Treasury released final regulations that provide guidance regarding FDII. GILTI was also discussed in the final regulations but only in a very limited context.

To put the GILTI "cart" before the FDII "horse": The coverage of GILTI in the final regulations clarified the availability of the Internal Revenue Code Section 250 deduction to persons making a Section 962 election.[1]

GILTI is generally bad news tax-wise for affected taxpayers but usually even worse for individuals than it is for corporate taxpayers. This is for a variety of reasons, one of which was the inability of persons, even those making the Section 962 election, to take the Section 250 deduction, which as to GILTI, is currently 50% of income classified as GILTI.

The final regulations grant relief by providing that individuals electing Section 962, including affected shareholders in an S corporation or partners in a partnership, are permitted to claim a Section 250 deduction against their GILTI income inclusion. This election is expected to allow an individual who is exposed to GILTI tax — where marginal federal tax rates could be 37% — to instead be taxed on GILTI at the current federal corporate tax rate of 21%.[2]

In addition, under the final regulations an individual can make the Section 962 election on an amended return for his or her 2018 tax year and subsequent years, regardless of circumstances, provided government interests are not prejudiced by the delay.[3]

So much for GILTI and the final regulations. Let's get back to the FDII "horse," which is the main game in the final regulations. For starters, qualifying for FDII treatment will generally be a goal for many U.S. C corporation taxpayers as very favorable U.S. federal tax rates are available.[4]

One of the keys, however, is that FDII applies only to property sold, licensed or leased to a person who is not a U.S. person. Many very close questions arose as to what kinds of transactions qualified for FDII treatment under this rubric and what documentation was required to prove such qualification. Hence, the need for additional FDII regulations.

An overarching takeaway is that the final regulations generally eliminate the requirement that had been in earlier proposed regulations to obtain specific types of documents to establish (1) foreign person status, (2) foreign use with respect to sales of certain general property that are made directly to end users, and (3) the location of general services provided to consumers.

However, it remains important in any given transaction to comply with the documentation requirements for that type of transaction. The devil still very much remains in the details in many situations.

The final regulations do provide relief for smaller businesses by modifying the threshold amount to qualify for exception from specific documentation rules from $10 million of gross receipts received by the seller of general property or renderer of services in the prior taxable year — the standard used in the proposed regulations — to $25 million in gross receipts received by the taxpayer and all related parties.

Perhaps of some note is that a so-called ordering rule was not adopted on the final regulations. The Treasury and the IRS determined that further study was required to determine the appropriate rule for coordinating Internal Revenue Code Sections 250(a)(2), 163(j), 172 and other IRC provisions — including, for example, Sections 170(b)(2), 246(b), 613A(d), and 1503(d) — that limit the availability of deductions based, directly or indirectly, upon a taxpayer's taxable income.

So, in the absence of any guidance taxpayers can use any reasonable method to compute their limitation on FDII deductions if the method is applied consistently for taxable years beginning on or after January 2021. Although this will likely be a very complicated calculation, it should open opportunities for well advised taxpayers to maximize their FDII deduction.

Parts of the final regulations deal with computation of FDII, more specifically: financial services income, foreign branch income, cost of goods sold allocation — for which any reasonable method may be used, expense allocations, foreign derived ratio and partnership reporting requirements.

The final regulations also contain some fairly broad rules for foreign derived deduction eligible income, or FDDEI, transactions such as: definition of "general property," discussion of foreign military sales and services, reliability of documentation and reason to know standard, sales or services to a partnership, treatment of certain loss transactions and a predominant character rule.

Much of the rest of the final regulations get into very specific FDII documentation requirements for certain types of transactions — basically FDDEI sales and FDDEI services, give some added definitions and set forth some rules for related parties.[5] As noted, compliance with these specific requirements where applicable is very important. That being said, the final regulations are generally viewed as easing documentation requirements.

Generally, the final regulations apply for taxable years beginning on or after Jan. 1, 2021. However, for taxable years beginning before Jan. 1, 2021, taxpayers may apply the final regulations or rely on the former proposed regulations,[6] except that taxpayers that choose to rely on the proposed FDII regulations may rely on them[7] for documentation for all taxable years beginning before Jan. 1, 2021.[8]

Final Regulations Regarding High-Taxed GILTI Income

On July 20, the IRS and the Treasury released final regulations that provide guidance regarding, among other things, high-taxed income classified as GILTI.

Under the regulations, companies will be allowed to choose to apply a GILTI high-income exemption retroactively to taxable years back to the end of 2017. The tax on GILTI will, if the exemption is elected, exempt from GILTI so-called high-taxed GILTI income, which is foreign income that has already been taxed by foreign jurisdictions presently at rates of 18.9% or more.[9][10]

The regulations generally apply the GILTI high-tax exemption based on the gross tested income of a controlled foreign corporation, or CFC,[11] that is attributable to a tested unit.[12] The tested unit approach generally applies to the extent an entity, or the activities of an entity, are actually subject to tax, as either a tax resident or a permanent establishment, or similar taxable presence, under the tax law of a foreign country.

There is a consistency requirement that applies where the CFC is a member of a controlling domestic shareholder group. In that case, a GILTI high-tax exclusion election, or revocation, is either made with respect to each member of the CFC group or is not made for any member of the CFC group.

If an election is revoked, then under formerly proposed regulations the CFC could not have made a new election for any CFC inclusion year that began within 60 months following the close of the CFC inclusion year for which the previous election was revoked. The final regulations do not include the 60-month restriction and, subject to the consistency requirement, taxpayers may elect the GILTI high-tax exclusion on an annual basis.

U.S. shareholders[13] that are not controlling domestic shareholders of a CFC are to be informed by the controlling domestic shareholders of the CFC if they make, or revoke, a GILTI high-tax exclusion election with respect to the CFC.

The final regulations clarify that the controlling domestic shareholders must provide notice of elections, or revocations, as required by Treasury Regulation Section 1.964-1(c)(3)(iii), to each U.S. shareholder that is not a controlling domestic shareholder.

The final regulations provide that the election may be made, or revoked, on an amended federal income tax return only if all U.S. shareholders of the CFC file amended federal income tax returns — unless an original return has not yet been filed. In that case the original federal income tax return may be filed consistently with the election, or revocation, for the taxable year, and for any other taxable year in which the shareholders' U.S. tax liabilities would be increased by reason of that election or revocation.[14]

This must be done within 24 months of the unextended due date of the original federal income tax return of the controlling domestic shareholder's inclusion year with or within which the CFC inclusion year, for which the election is made, or revoked, ends.[15]

The final regulations provide that the GILTI high-tax exclusion applies to taxable years of foreign corporations beginning on or after July 23, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

The final regulations also permit taxpayers to choose to apply the GILTI high-tax exclusion to taxable years of foreign corporations that begin after Dec. 31, 2017, and before July 23, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end.[16]

Any taxpayer that applies the GILTI high-tax exclusion retroactively must consistently apply the rules in the final regulations to each taxable year in which the taxpayer applies the GILTI high-tax exclusion.

Proposed Regulations Unifying Treatment of High-Taxed GILTI and High-Taxed Subpart F Income

There are material differences between the final GILTI high-tax exemption and the current Subpart F high-tax exemption rules. It was felt that these differences could motivate taxpayers to allocate income that would otherwise be subject to U.S. tax to a CFC operating in a low- or no-tax jurisdiction to take advantage of differences between the two rules.

The election for the Subpart F high-tax exception — other than with respect to passive foreign personal holding company income — is made on an item-by-item basis with respect to each individual CFC. In contrast, the election for the GILTI high-tax exclusion is subject to a consistency requirement, pursuant to which an election must be made with respect to all of the CFCs that are members of a CFC group, as discussed above.

Comments asserted that the consistency requirement would make the GILTI high-tax exclusion less beneficial to taxpayers, causing them, in certain cases, to engage in uneconomic tax planning to convert tested income into Subpart F income to avail themselves of the Subpart F high-tax exception. This would be contrary to one of the stated purposes of the GILTI high-tax exclusion to eliminate incentives to convert tested income into Subpart F income.

In response, the Treasury and IRS released proposed regulations on July 20 to provide for a single unified high-tax election for both Subpart F income and GILTI. As a result, the existing Subpart F high-tax exception would be largely conformed to the final GILTI high-tax exemption. The proposed regulations generally are not applicable until the first taxable year beginning after the date the regulations are finalized.

What Has Been Accomplished

To say that all of this, while perhaps a great intellectual achievement by those involved, is a highly complicated area of federal tax law is an understatement.[17]

These complications are further exacerbated by the fact that not all states in the U.S. conform totally, or sometimes at all, to the federal FDII and GILTI rules. So taxpayers in the U.S. trying to cope with GILTI and FDII can face a bewildering maze of inconsistent laws that may vary from state to state — and perhaps city to city as well — making planning and compliance challenging to say the least.[18]

Certainly, the — to my mind — clear congressional intent to limit GILTI so that it would not apply to income already taxed at 13.125% or higher has not been achieved. The chief bugaboo leading to rates much higher than this, for corporations up to the full 21% corporate rate, was that foreign tax credit limitations can apply, creating much higher GILTI payments for some companies than was anticipated by Congress.

However, in fairness it must be said that the GILTI high-tax exception provides some relief as, at present, it caps GILTI so that it will not apply to foreign income that has already been taxed by other jurisdictions at rates of 18.9% or more. But this is still a 5.775% difference from 13.125%.

At the international level, FDII was under attack in 2019 by the European Commission as potentially violating World Trade Organization rules by providing unfair tax export incentives for the U.S. placement of intangible assets. And there had been rumblings from the Organization for Economic Cooperation and Development that FDII could be a harmful tax practice hurting the tax base of non-U.S. countries. However, things on the anti-FDII front have been a bit quiet of late save for some reported saber-rattling from Germany.[19]

It has been speculated that perhaps the finalization of the FDII and GILTI regulations, which now seems to have been accomplished, was awaited before these bodies would take action. One would think, too, that the global focus on the COVID-19 pandemic might have diverted focus away from attacks on FDII.[20] And even the international fate of GILTI seems to be somewhat uncertain under a potential global minimum tax being developed by the OECD.[21]

The wild cards are (1) the effect of the upcoming November elections on taxation here in the U.S., and (2) what will come to pass with U.S.-world trade relations in the future. Will tax rates here, corporate or individual, be raised? Will a regime change here, if any, have a positive, negative or neutral effect on trade relations?

All the foregoing factors, and likely more, make compliance and planning for persons and businesses affected by GILTI and FDII extremely challenging and expensive.

As always with tax, stay tuned for future developments. Yes, death and taxes are inevitable but, as far as I know death is a permanent state. Not so tax law — which of late seems to be changing at an exponential rate.

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[1] IRC Section 962 elections allow individuals who are US shareholders of CFCs to be taxed on GILTI and subpart F income as if they were a domestic corporation.

[2] However, consideration apparently still needs to be given to an additional tax to individuals on taxable distributions to them from the "deemed" corporation.

[3] A complete summary of the transition rules is beyond the scope of this article.

[4] Under current law the effective federal tax rate on FDII is 13.125% and is slated to go up to 16.406% for tax years beginning after December 31, 2025.

[5] The final rules also contain amendments to regulations issued under IRC Section 1502 (how the deduction applies to consolidated groups), IRC Section 6038 (information reporting for certain controlled foreign corporations [CFCs] and partnerships), and IRC Section 6038A (information reporting for certain foreign-owned corporations).

[6] The FDII proposed regs are found in (REG-104464-18) released in March 2019.

[7] This includes a documentation transition rule whereby a transaction may be substantiated by any reasonable documentation maintained in the ordinary course of business.

[8] Regs. Sec. 1.250(b)-2(h), containing an anti-abuse rule for certain transfers of property, applies to tax years ending on or after March 4, 2019, consistent with the FDII proposed regulations' applicability date. A transition period is provided for the QBAI anti-avoidance rule in Prop. Regs. Sec. 1.250(b)-2(h)(3) for transactions entered into before the date that the proposed regulations were issued.

[9] The GILTI high-tax exclusion is applied by comparing the effective foreign tax rate with 90 percent of the rate that would apply if the income were subject to the maximum rate of tax specified in IRC Section 11 (currently the exclusion applies where foreign taxes paid have been 18.9% or more, based on 90% of the current IRC Section 11 rate of 21%).

[10] Once the proposed High Tax GILTI/Subpart F "unification" regulations become final, then in order to use the GILTI high-tax exclusion an electing taxpayer will also be required to elect the high tax exception for subpart F income and vice versa.

[11] See IRC Section 957 (a).

[12] See Treas. Reg §1.951A-2(c)(7)(ii).

[13] See IRC Section 951(b).

[14] Or in the case of a partnership if any item reported by the partnership or any partnership-related item would change as a result of the election (or revocation).

[15] See Treas. Regs. §1.951A-2(c)(7)(viii)(A)(2) and (c)(7)(viii)(C).

[16] See Treas. Regs §1.951A-7(b).

[17] Persons dealing with FDII and GILTI for planning purposes will likely want to model out the numbers for a variety of scenarios. Ultimately this is likely to become a wildly complicated calculation in many, many cases. Compliance itself will in and of itself likely be very complicated exercise. All this means planning and compliance will also likely be very costly for many affected persons.

[18] For an idea of where the US states reportedly stood on GILTI and FDII going into 2020, see "GILTI and Other Conformity Issues Still Loom for States in 2020," Tax Foundation, Fiscal Fact, No. 682, Dec 2019 by Jared Walczak and Erika York.

[19] In February 2020, the German Ministry of Finance reportedly published a decree the impact of which could be a limitation on the deductibility under German law of certain related party royalty payments ("royalty barrier rule") for certain listed tax regimes. The notion was that the German list comported with a list of a preferential tax regimes for intellectual property that have been identified by the OECD as potentially harmful tax practices. The German list includes FDII. Seemingly the list applicability is limited to calendar year 2018.

[20] The US defense runs along the lines that GILTI and FDII must be considered as a

package, inseparable from one another, and that when taken together they balance each other out and do not create export incentives or constitute a harmful tax practice that would rob the tax base of foreign countries or violate nexus notions based on so called DEMPE functions. DEMPE stands for Development, Enhancement, Maintenance, Protection and Exploitation.

[21] The jury is still out on OECD Pillar Two — the notion of which is to set a global minimum tax. A forthcoming OECD report is to deal with how Pillar Two would work with GILTI, which like Pillar Two has a goal to ensure companies are paying a minimum tax. OECD Pillar Two has been a concern for US companies who fret over if they will be subject to two differing global minimum tax rules—a US domestic one and one from OECD Pillar Two. The hope was that consensus on the issue would be reached by the end of 2020, but here as with everything else, the pandemic has pushed back the negotiation schedule.
