Should Companies Plan into Subpart F Following US Tax Reform?

Jessica Silbering-Meyer
Managing Editor, International Tax
Should Companies Plan into Subpart F Following U.S. Tax Reform?

Following the enactment of the US Tax Cuts and Jobs Act ("TCJA"), US multinational companies ("MNCs") are now faced with a new anti-deferral provision in the form of the global intangible low-taxed income ("GILTI") inclusion. GILTI is an additional category of income that is taxed on a current basis to US shareholders of controlled foreign corporations ("CFCs"), even though the income is not distributed.

Depending on the facts, it may be advantageous for a corporate US shareholder to have subpart F income, as opposed to GILTI, even with the 50% deduction allowed under section 250. This is especially true for banking and other financial companies, which have a higher interest expense than other industries, leading to a higher GILTI inclusion. The allocation of expenses under section 861 can reduce the taxpayer’s foreign tax credit (FTC) limitation, leading to a higher US residual tax. Finally, excess credits associated with GILTI cannot be carried forward or back.

**Background**

On December 22, 2017, President Trump signed the TCJA into law, which reduced the US corporate tax rate from 35% to 21%, while providing a 100% dividends-received deduction ("DRD") for the foreign-source portion of dividends received by US corporations from 10%-owned foreign subsidiaries (i.e., participation exemption). The TCJA also requires US shareholders of CFCs to include GILTI in their gross income; imposes a minimum tax on large multinationals that make base erosion payments ("BEAT"); and encourages the development of intangibles in the US through a reduced tax on a US corporation’s foreign-derived intangible income ("FDII").

Subpart F

In general, US shareholders of CFCs must include in gross income their pro rata share of the CFC’s Subpart F income for the taxable year. US shareholders are US persons that own (or are considered to own under attribution rules) at least 10% of the total combined voting power or at least 10% of the total value of shares, in the CFC. Following the enactment of the TCJA, a corporate US shareholder’s Subpart F income is subject to current tax at 21% minus applicable FTCs.

A US shareholder’s Subpart F FTCs are generally placed into either the general limitation or passive limitation baskets. In general, passive income is considered foreign personal holding company income ("FPHCI"), which includes dividends, interest, and royalties. Foreign taxes paid or accrued that exceed the FTC limitation are carried back to the first preceding taxable year and forward to the first ten succeeding taxable years.

Subpart F income includes a CFC’s foreign base company income ("FBCI"), which is the sum of its FPHCI, foreign base company sales income, and foreign base company services income. An exception to FBCI arises where a CFC’s income was subject to an effective rate of income tax imposed by a foreign country that is greater than 90% of the US corporate tax rate (i.e., “high-tax exception”). Therefore, with a US corporate tax rate of 21%, a CFC’s income that is subject to a foreign effective income tax rate greater than 18.9% is not subject to the Subpart F rules.

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1 §11(a)
2 §245A
3 §§951A
4 §§59A
5 §250
6 §§951(a)
7 §§951(b)
8 An individual US shareholder can make a 962 election for the taxable year to have its Subpart F income taxed at the corporate rate (i.e., 21%).
9 §904(a)(1)
10 §904(b)(2)(B)(i), §§954(c)
11 §954(a)
12 §904(c)
13 §§952(a)(2)
14 §§954(a)
15 §§954(b)(4)
GILTI

In general, GILTI impacts US shareholders of CFCs that have a large amount of intangible assets offshore. Based on the GILTI calculation, US shareholders could be subject to a minimum residual US tax on their CFC’s active foreign earnings.

GILTI is the excess of a US shareholder’s net CFC tested income across all CFCs for the taxable year over its net deemed tangible income return (i.e., excess of 10% of qualified business asset investment (“QBAI”) over interest expense\(^\text{16\text{a}}\)) for the taxable year.\(^\text{17}\) Domestic corporations are allowed a 50% deduction on GILTI.\(^\text{18}\) In addition, corporate US shareholders are allowed a deemed paid FTC of 80% (i.e., the US corporation shall be deemed to have paid foreign income taxes equal to 80% of the product of the corporation’s inclusion percentage multiplied by the aggregate tested foreign income taxes paid or accrued by CFCs).\(^\text{19}\)

The TCJA created a new FTC basket for foreign taxes associated with GILTI.\(^\text{20}\) In contrast to the treatment of excess credits for Subpart F income, GILTI credits cannot be carried forward or back.\(^\text{21}\) However, foreign taxes paid or accrued on passive category income that was included in gross income under section 951A should be in the passive limitation basket.\(^\text{22}\)

In calculating GILTI, a CFC’s tested income is its gross income without regard to Subpart F income or amounts excluded from Subpart F under the high-tax exception, and certain other income.

Let’s assume the following example:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>CFC gross income</td>
<td>$100,000.00</td>
</tr>
<tr>
<td>Allocable deduction (other than tax)</td>
<td>0.00</td>
</tr>
<tr>
<td>Foreign tax rate</td>
<td>0.13125%</td>
</tr>
<tr>
<td>Foreign taxes</td>
<td>$13,125.00</td>
</tr>
<tr>
<td>CFC tested income (after foreign taxes)</td>
<td>$86,875.00</td>
</tr>
<tr>
<td>NDTIR(^\text{24}) (10% of QBAI / interest expense)</td>
<td>0.00</td>
</tr>
<tr>
<td>GILTI (net CFC tested income - NDTIR)</td>
<td>$86,875.00</td>
</tr>
<tr>
<td>Section 78 gross-up</td>
<td>$13,125.00</td>
</tr>
<tr>
<td>GILTI + Section 78 gross-up(^\text{25})</td>
<td>$100,000.00</td>
</tr>
<tr>
<td>US tax rate</td>
<td>0.21%</td>
</tr>
<tr>
<td>US tentative tax on GILTI + Section 78 gross-up (after 50% deduction(^\text{26}))</td>
<td>$10,500.00</td>
</tr>
<tr>
<td>80% deemed-paid FTC allocable to GILTI</td>
<td>$10,500.00</td>
</tr>
<tr>
<td>US residual tax (US tentative tax – FTC)</td>
<td>0.00</td>
</tr>
</tbody>
</table>

Therefore, if the foreign tax rate is at least 13.125%, there should not be any residual US tax on GILTI income. Note that this example does not include potential US expense allocations to foreign-source income, which would reduce the FTC limitation, leading to residual US tax, even when the foreign tax rate exceeds 13.125%. According to Treas Reg, “if a domestic corporation is subject to state income taxation and the state income tax is imposed in part on an amount of foreign source income, then that part of the taxpayer’s deduction for state income tax that is attributable to foreign source income is definitely related and allocable to foreign source income.”\(^\text{27}\)

\(^{16}\) §951A(b)(3)  
\(^{17}\) §951A(b)(1)  
\(^{18}\) §250  
\(^{19}\) §960(a)(7)  
\(^{20}\) §904(d)(1)(A)  
\(^{21}\) §904(c)  
\(^{22}\) §904(d)(1)(A)  
\(^{23}\) §951A(c)(2); 954(b)(4)  
\(^{24}\) Net deemed tangible income return (§951A(b)(2))  
\(^{25}\) There are ongoing discussions regarding whether the section 78 gross-up amount should be placed into a different basket (i.e., not GILTI). As amended, section 78 treats the gross up for foreign taxes attributable to GILTI as a dividend, not additional GILTI; however, the section 250 deduction is stated in terms of a percentage of GILTI plus the same percentage of the gross up.  
\(^{26}\) This deduction is reduced to 37.5% for taxable years beginning after December 31, 2025.  
\(^{27}\) Treas. Reg. §1.861-8(e)(6)
Conclusion

Pre-TCJA, US MNCs structured their operations to plan around Subpart F. With the introduction of GILTI, MNCs are going back to the drawing board, and are modeling out their tax liability for GILTI and Subpart F. For some taxpayers, it may make sense to “plan into Subpart F,” because — although the income is taxed currently at 21% — they can use excess FTCs, but credits associated with GILTI will be lost if not used in the current year.

Although it is technically possible for MNCs to reduce their residual US tax on GILTI to zero in situations where the foreign tax rate is at least 13.125% (as opposed to greater than 18.9% to qualify for the high-tax exception under Subpart F), this is not a guarantee. Since a higher interest expense can result in a higher GILTI inclusion for the taxpayer, banking and other financial companies are at a disadvantage. Furthermore, expenses allocated to foreign-source income would reduce the FTC limitation, and the taxpayer will not be able to carry over any excess credits.

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