Feedback for REG-127732-19: Guidance under Section 954(b)(4)[1] Regarding Income Subject to a High Rate of Foreign Tax

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Prop Regs. §1.954–1	**Foreign base company income**			
Prop Regs. §1.954–1(d)	**High-tax exception**	Single HTE election	Do not combine the GILTI HTE and the subpart F income HTE into a single election	Section 954(b)(4) plainly excludes from a CFC's foreign base company income certain items of income that are subject to specific effective foreign tax rate and does not condition such exclusion on additional conditions established in Treasury regulations. Section 954(b)(4) provides as follows: Exception for certain income subject to high foreign taxes. For purposes of subsection (a) [defining foreign base company income] and section 953 [defining insurance income], foreign base company income and insurance income shall not include any item of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11. By its terms, §954(b)(4) provides only one condition for a taxpayer to exclude an item of income from foreign base company income or insurance income: the taxpayer must establish to the satisfaction of the Secretary that the income was subject to a foreign effective tax rate in excess of 18.9% (under current law).

[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

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				Notwithstanding the unambiguous language of the statute, the proposed regulations would exclude income items from foreign base company income or insurance income only if additional conditions – with no basis in the statute or legislative history – are met. First, by virtue of combining the subpart F income high-tax exception election and the GILTI HTE into a single election, Treasury and the IRS impermissibly require a taxpayer to make the GILTI HTE in order to benefit from a statutory exclusion that is subject to no such condition. Second, the proposed regulations would, for purposes of calculating the effective foreign tax rate, group general category items of income attributable to a tested unit that would otherwise be tested income, foreign base company income, or insurance income into a single item. As a result, high-taxed foreign base company income or insurance income may be inappropriately included in subpart F income solely because certain tested income happens to have been subject to a low effective foreign tax rate. There is no basis in the statute or legislative history for conditioning the subpart F income high-tax exception on the effective foreign tax rate imposed on *unrelated* income items. In support of the unified election, the Preamble to the proposed regulations indicates that combining general category foreign base company income, insurance income, and tested income items into a single income item poses administrative benefits in the form of reduced complexity. This statement is true only because it is based on a premise – a unified election – that is inconsistent with the plain statutory language of Section 954(b)(4). Beyond the lack of authority, however, this rationale is unpersuasive. This unique grouping poses no meaningful reduction in complexity, because those items

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				continue to be treated separately for other purposes. That is, a taxpayer must separately allocate expenses to its subpart F income and GILTI. Similarly, determining the amount of foreign taxes deemed paid by a US shareholder under Section 960 requires taxpayers to separate tested income and subpart F income items. In sum, the purported reduction in complexity described in the Preamble does not justify the unified election.
		Application of the consistency requirement to the subpart F high tax exception	Final regulations should not incorporate the consistency requirement proposed with respect to the subpart F high tax exception.	The language of §954(b)(4) providing for the subpart F high tax exception applies to income received by a controlled foreign corporation (CFC) on an item-by-item basis.[2] The proposed regulations, in contrast, would require that the subpart F high tax exception be made with respect to all of the CFCs that are members of a CFC group. The change in the proposed regulations is accordingly incompatible with the statutory language which provides for the subpart F high tax exception and should not be retained in any final regulations.
		Undefined or negative foreign tax rates	Final regulations should provide that a tentative net item for which there is a negative or undefined effective rate of foreign tax should not be considered a high-taxed tested income item excluded under the HTE.	Under the proposed regulations, if a CFC has even a single dollar of foreign tax paid in a year in which it has a tested loss (which could occur, for example, as a result of timing differences between U.S. and foreign law or as a result of a mismatch in U.S. and foreign tax years), then such item is excluded under the HTE if such an election is made.

[2] "For purposes of subsection (a) and section 953, foreign base company income and insurance income shall not include any item of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11."

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				In the GILTI context, that would mean that such tested loss would not offset any tested income. In addition, no foreign tax credit would be allowed with respect to such taxes, nor would such taxes be counted to determine whether the income of such CFC is high-taxed in a year in which the CFC has tested income rather than a tested loss. This result is at odds with the policy structure of the GILTI regime under §951A(c) which explicitly allows tested losses to offset tested income in calculating a U.S. shareholder's GILTI liability; further, it produces an inappropriately harsh result for taxpayers who stand to lose the benefit of both a tested loss and the foreign taxes paid by such a tested loss CFC. Taxpayers are already limited in the ability to utilize QBAI of a tested loss CFC under the GILTI regime and thus there is no need to further reduce the ability of taxpayers to utilize the underlying tested loss. In the subpart F context, this rule could also have adverse consequences related to qualified deficits. For example, if a dollar of foreign tax is paid in respect of what would have been a qualified deficit able to be utilized to offset future subpart F income, this rule could result in the loss becoming a non-subpart F loss which cannot be used in future years to reduce income subject to U.S. tax. This is another punitive result which negates the very reason behind the qualified deficit rules. See further discussion of this issue below. Accordingly, any final regulations should not retain the rule in Prop. Regs. §1.954-1(d)(4)(ii).

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		The same-country combination rule does not consider units in different CFCs that are locally consolidated	The combination rule under Prop. Regs. §1.954-1(d)(2)(iii) should allow, on an elective basis, for same-country cross-CFC unit combination in order to properly calculate the effective tax rate on the combined unit.	Local country consolidation rules and group relief regimes will cause improper distortions in the tested unit effective tax rate calculation. Allowing cross-CFC same-country unit combination in these circumstances allows taxpayers flexibility in applying the effective tax rate calculation. For example, in Spain, when a consolidated tax regime is elected, all Spanish taxpayers that have indirect common ownership are required to be included in the consolidated group, regardless of direct ownership. Example: US Parent owns CFC1, a Spanish corporation and CFC2, a UK company with a Spanish branch. In year 1, the Spanish corporation earns 100 of income and the Spanish branch incurs a loss of 90. Under the consolidation regime, the branch loss is shared with the income corporation and the corporation pays 2.5 (25% x 10 (100 - 90) = 2.5). The real effective tax rate imposed on the combined income is 25% but looking only at CFC1 the rate is 2.5%. Assuming the branch income incurs at least 1 of tax (which is common with, for example, withholding tax), then under the proposed regulations, the 100 of income is included in GILTI and the loss of 90 is excluded as high tax. This inappropriate result would be prevented under the recommendation to allow, on an elective basis, same-country cross-CFC tested units to be combined for purposes of the high-tax exception.
		CFC group definition	The definition of a CFC group should be refined to better account for situations in which the CFCs in a group have different unrelated U.S. shareholders. Changing the CFC Group Definition: This could be accomplished by requiring that	Under the current proposed definition of a CFC group and controlling domestic shareholder, a minority U.S. shareholder can stop a HTE for a CFC that has no impact on such shareholder. Example: Consider a foreign corporation FP that owns (1) 100% of a U.S. corporation, US1, that in turn owns 100% of foreign corporation CFC1 and (2) 75% of foreign corporation CFC2, which is owned 25% by a minority

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			the group parent must be either a CFC or a U.S. shareholder, similar to the CFC group definition in Prop. Regs. §1.163(j)-7. Changing the Controlling Domestic Shareholder Definition – Largest Percentage Interest: Alternatively, if the CFC group definition is not changed, the controlling domestic shareholder for a CFC group could be defined as the U.S. shareholder who owns, within the meaning of §958(a), the largest percentage interest in any single CFC that is a member of the group. This would prevent minority U.S. shareholders from vetoing HTEs by majority U.S. shareholders. Changing the Controlling Domestic Shareholder Definition – More than 50% Interest: As yet another alternative, if the CFC group definition is not changed, the current definition of the controlling domestic shareholders for a CFC group could be tweaked to add that that if any U.S. shareholders own, within the meaning of §958(a), more than 50% of any single CFC in the group, then such U.S. shareholders would be the only controlling	U.S. investor US2. Under Prop. Regs. §1.954-1(d)(6)(v) and (d)(8)(iii), (1) CFC1 and CFC2 would be members of the same CFC group (parented by FP), (2) US1 would be the controlling domestic shareholder of CFC1, and (3) US2 would be the controlling domestic shareholder of CFC2. Under the proposed regulations, it would appear that US2 could prevent US1 from making a HTE for CFC1, even though (i) US2 is simply an unrelated minority owner of CFC2, and (ii) US2 would be unaffected by whether a HTE is made for CFC1. Similarly, it would appear that US1 could prevent US2 from making a HTE for CFC2, even though US1 is unaffected by whether a high-tax election is made for CFC2. • Changing the CFC Group Definition: In the example above, changing the CFC group definition would mean that CFC1 and CFC2 would be in separate CFC groups. This would better reflect the economic reality that whether CFC1 makes a HTE has no effect on US2 and whether CFC2 makes a HTE has no effect on US1. • Changing the Controlling Domestic Shareholder Definition – Largest Percentage Interest: In the example above, US1 would be the sole controlling domestic shareholder for the CFC group that includes CFC1 and CFC2, such that US2 would not be able to prevent US1 from making a HTE for CFC1, although oddly, US1 could “drag” US2 into a HTE for CFC2 when it has no consequence to US1. This majority rule, including the ability to “drag” minority U.S. shareholders, would be consistent with the way Regs. §1.964-1(c)(5) and Prop. Regs. §1.954-1(d)(8)(iii) currently work. • Changing the Controlling Domestic Shareholder Definition – More than 50% Interest: Thus, in the example above, US2 would not be able to veto a HTE by US1 for CFC1. However, this would also

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			U.S. shareholders of the CFC group. This would similarly prevent minority U.S. shareholders from vetoing high-tax elections by majority U.S. shareholders of the same or different CFCs.	force majority U.S. shareholders of different CFCs that may be part of the same CFC group to work together, again somewhat consistent with the way Regs. §1.964-1(c)(5) and Prop. Regs. §1.954-1(d)(8)(iii) currently require U.S. shareholders that together own a majority to work together.
		The applicable financial statement anti-abuse rule is unclear and too broad	Financial statement presentation alone should not trigger an adjustment under the anti-abuse rule if that presentation follows local country GAAP requirements.	As currently written, the anti-abuse rule is so broad that it could capture local country financial statement presentation requirements as abusive.
		Subpart F qualified deficits could be lost	Clarify that qualified deficits will not be impacted due to the high tax election and continue to be generated from qualifying activities	In the context of Subpart F, it is unclear how the proposed regulations reconcile with the statutory framework already present where certain computations are required to be done at the CFC level. This is of particular concern with respect to the determination of the amount, and the utilization of, a qualified deficit. It is unclear whether a net loss that is treated as high-taxed (because of the proposed rule for negative/undefined tax rates) would then not be treated as a qualified deficit even if otherwise attributable to a qualified activity. If not treated as a qualified deficit, it may not be available to offset in future years Subpart F income attributable to the same qualified activity.
		Time period for making or revoking the election on an amended return	The 24-month period within which the election needs to be made or revoked on an amended return should be removed.	Under the proposed regulations, taxpayers can make or revoke the subpart F income HTE on an amended federal income tax return, provided that all U.S. shareholders file the amended return with respect to the election within 24 months of the unextended due date of the original return. However, foreign tax redeterminations arising from disputes with local tax authorities may conclude outside of this 24-month period, making the rule provided in

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				the proposed regulations unworkable. Instead, the election should be able to be made on any amended return, provided the statute of limitations period for such year has not expired.