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The Subpart F High-Tax Exception

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A U.S. shareholder of a controlled foreign corporation (CFC) generally includes in gross income its pro rata share of the Subpart F income derived by the CFC.¹ For corporate U.S. shareholders, Subpart F income is subject to tax at a 21% rate.²

A U.S. shareholder is allowed a foreign tax credit as a reduction of the U.S. taxes on its foreign-source Subpart F income.³ For corporations, foreign tax credits include foreign income taxes paid by the CFC on the Subpart F income included in the U.S. shareholder's gross income.⁴ Any excess taxes on Subpart F income generally can be used to reduce U.S. taxes on other foreign-source income in the same foreign tax credit separate limitation category,⁵ and any unused

foreign tax credits can be carried back one year and forward 10 years.⁶

Under prior law, the amount of deemed paid taxes attributable to Subpart F income was determined on a multi-year pool basis by limitation category.⁷ This approach was changed with the 2017 tax act.⁸ Under revised §960, the amount of deemed paid foreign taxes that accompany Subpart F income is the amount of current year foreign income taxes properly attributable to the income.⁹ The U.S. shareholder grosses up its income for the amount of the deemed paid foreign tax credits.¹⁰

A U.S. shareholder is permitted to make an election to exclude from its gross income any item of Subpart F income that is subject to a high foreign income tax rate. The Subpart F high-tax exception is available if an item of Subpart F income is subject to a foreign income tax rate that is greater than 90% of the maximum U.S. corporate income tax rate (i.e., 18.9%).¹¹

To determine the availability of the high-tax exception, a CFC's income is first subdivided among each of the three foreign base company income categories: foreign base company sales income, foreign base company services income, and foreign personal holding company income. The CFC's foreign personal holding company income is further subdivided among each of the eight categories of foreign personal holding company income, and then further subdivided

¹ §951(a)(1)(A). Subpart F income includes passive income and certain sales and services income. §952(a), §954. All section references are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations thereunder, unless otherwise specified.

² §11(b). A CFC's income that is not Subpart F income generally is taken into account in calculating the amount of a U.S. shareholder's inclusion of global intangible low-taxed income (GILTI). §951A. A corporate U.S. shareholder is subject to tax on GILTI generally at a 10.5% rate. §250(a).

³ §901.

⁴ §960(a).

⁵ Subpart F income generally falls within the general limitation category. §904(d)(1)(D); Prop. Reg. §1.904-5(c)(5)(i). A Subpart F income inclusion is passive income under look-through rules to the extent the amount is attributable to passive income of a CFC. §904(d)(3)(B); Prop. Reg. §1.904-5(c)(5)(i), §1.904-5(c)(6). Passive Subpart F income that is subject to a high tax rate (i.e., a rate that exceeds 21%) is reclassified as general category income. §904(d)(2)(B)(iii)(II), §904(d)(3)(F); Prop. Reg. §1.904-4(c)(1).

⁶ §904(c).

⁷ Former §902, pre-2017 tax act §960.

⁸ Pub. L. No. 115-97 (Dec. 22, 2017). Known during the legislative proceedings as the Tax Cuts and Jobs Act (TCJA).

⁹ §960(a); Prop. Reg. §1.960-2(b).

¹⁰ §78. The gross-up and the deemed paid taxes fall within the same foreign tax credit limitation category as the corresponding Subpart F income inclusion. Prop. Reg. §1.904-4(o), §1.904-6(b)(1); *see also* Reg. §1.904-6(b)(3).

¹¹ §954(b)(4); Reg. §1.954-1(d)(1), §1.954-1(d)(5). No similar election is permitted for GILTI.

based on categories provided by the §904 regulations.¹²

Once each separate Subpart F income item has been identified, the amount of foreign income taxes attributable to an item is determined. This is the amount of taxes determined under §960(a) that would accompany the inclusion of the Subpart F income item in the gross income of the U.S. shareholder (i.e., the current year taxes properly attributable to the item).¹³

The effective tax rate for an item of Subpart F income is calculated by dividing the amount of the taxes attributable to the item by the amount of the item of income plus the attributable taxes. For example, if \$100 of Subpart F royalty income derived by a CFC is subject to \$25 of foreign income taxes, the numerator would be \$25 and the denominator would be \$100 (\$75 + \$25), yielding a 25% effective tax rate. Thus, the item of royalty income would be eligible for the Subpart F high-tax exception.¹⁴

Under prior law's multi-year pool approach for determining deemed paid tax credits, generally the effective tax rate on all general basket income was the same.¹⁵ Under revised §960(a), which determines deemed paid taxes based on current-year taxes attributable to a particular item of income, the result can be different.

For example, a CFC organized in country R has a services branch in Country X and a sales branch in Country Y. During the first year of operation, each branch earns \$100 of Subpart F income. The services income is subject to foreign income tax at a 10% rate and the sales income is subject to tax at a 30% rate. Under prior law, in calculating the deemed paid taxes for the services income, the \$90 of net services income would be divided by the net general basket income of \$160, and then multiplied by \$40 of foreign income taxes to arrive at the taxes deemed paid on the \$90 inclusion of \$22.50. Then, \$22.50 would have been divided by \$112.50 (\$90 + \$22.50) yielding an effective tax rate of 20%, and therefore under the prior law computational rules the services income would have been eligible for the high-tax exception (based on the current rate of 21%). Under current §960(a), the effective tax rate on the services income will be 10% [$\$10/(\$90 + \$10)$], and the high-tax exception

would not be available for the services income (but would be available for the sales income).

There is significant flexibility in electing the high-tax exception for items of Subpart F income. The election can be made for some items that qualify and not made for other items that qualify. An exception to this rule applies to passive income. If an election is made to exclude an item of passive income from Subpart F income under the high-tax exception for a CFC, the election must be applied to all items of passive income of that CFC that are eligible to be excluded.¹⁶

An election that is made for a particular year for a particular item of income does not need to be made consistently from year to year. In addition, an election can be made in a subsequent year on an amended tax return for a prior open year.¹⁷

A taxpayer will need to determine whether it is advantageous to make a high-tax election for an item of Subpart F income of a CFC. Under certain circumstances, it may be beneficial to *not* elect the high-tax exception with the result that the Subpart F income inclusion brings excess foreign tax credits that may be used to offset U.S. tax on other foreign-source income of the U.S. shareholder. Even if the taxes cannot be used currently, such taxes can be carried back one year and forward 10 years.¹⁸

Under certain situations, a U.S. shareholder may have a higher tax burden by including high-taxed Subpart F income currently in its gross income. One example is a corporate taxpayer that is subject to the base erosion anti-abuse tax (BEAT).¹⁹ The BEAT imposes a minimum tax of 10% times modified taxable income. Modified taxable income would include Subpart F income and the gross-up for deemed paid taxes, but no foreign tax credits would be allowed to reduce the BEAT. Under such circumstances, it may be beneficial to make the high-tax election to exclude the Subpart F income from the BEAT.²⁰

If the high-tax election is made for an item of Subpart F income, the foreign tax credits associated with the Subpart F income generally will not be available to claim as a foreign tax credit. Under §245A, a dis-

¹⁶ Reg. §1.954-1(d)(4)(i).

¹⁷ Reg. §1.954-1(d)(5)(i).

¹⁸ If the high-tax exception is not made, the earnings of the CFC that are included in the gross income of the U.S. shareholder become previously taxed income. §959(a).

¹⁹ §59A.

²⁰ See Yoder, Noren, and Chao, *Tax Reform: Taxation of Income of Controlled Foreign Corporations*, 14 Daily Tax Rep. S-15 (Jan. 22, 2018). Because the high-tax exception is not available for GILTI, if the high-tax election is determined to be beneficial, a taxpayer may consider restructuring such that the CFC's high-taxed income becomes Subpart F income. See Yoder, *A Few GILTI Planning Tips*, 44 Int'l Tax J. 3 (Nov.-Dec. 2018).

¹² See Reg. §1.954-1(c)(1)(iii); Reg. §1.904-4(c), §1.904-5(a).

¹³ Reg. §1.954-1(d)(3)(i). The amount of the deemed paid taxes taken into account is determined without regard to the §904 limitation rules.

¹⁴ Electing the high-tax exception for an item of Subpart F income does not cause the item to be included in GILTI tested income. §951A(c)(2)(A)(i)(III); Prop. Reg. §1.951A-2(c)(1)(iii).

¹⁵ See Yoder, *Subpart F High Tax Exception: Impact of Recent FTC Legislation*, 40 Tax Mgmt. Int'l J. 113 (Feb. 11, 2011).

tribution of the untaxed earnings generally would qualify for a 100% dividends received deduction, and foreign income taxes associated with the dividend would not be creditable.²¹ In addition, proposed regulations generally would not permit accessing any left-behind foreign tax credits by investing untaxed earnings in U.S. property.²²

²¹ See Yoder, *100% DRD for CFC Dividends*, 44 Int'l Tax J. 3 (July-Aug. 2018).

²² See Yoder, *Code Sec. 956 Proposed Regs*, 45 Int'l Tax J. 3

In summary, the high-tax exception has become more widely available with the lower 21% tax rate on corporate income. There is significant flexibility in determining whether to elect the exception for a particular item of Subpart F income. In many cases, it may not be desirable to make the election in order for a corporate U.S. shareholder to obtain foreign tax credits for the high taxes associated with an inclusion in gross income of the Subpart F income.

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