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The Three Baskets of CFC Income

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Income earned by a controlled foreign corporation (CFC) generally falls within one of three baskets: Subpart F income, global intangible low-taxed income (GILTI), or residual income.¹ A CFC's Subpart F income and GILTI are included currently in the gross income of its U.S. shareholders and residual income is not.² Subpart F income is subject to a 21% corporate tax rate and GILTI is subject to an effective corporate tax rate of 10.5%.³ Repatriation of earnings arising from all three types of income generally is not subject to additional U.S. taxation.⁴

Most CFCs do not derive a significant amount of Subpart F income from their business operations. Operating structures typically are used that avoid Subpart F sales and services income,⁵ and rents and royalties received from third parties can qualify for active busi-

ness exceptions.⁶ In addition, dividends, interest, rents and royalties received by a CFC from a related CFC typically qualify for a look-through exception.⁷ A taxpayer also has the option to elect to exclude from taxation items of Subpart F income that are subject to an effective foreign income tax rate greater than 18.9%.⁸

The CFC's income that is not Subpart F income generally is tested income that is taken into account in calculating the amount of the GILTI inclusion in the gross income of the CFC's U.S. shareholders.⁹ The calculation of the amount of a U.S. multinational's GILTI inclusion is made on a group-wide basis for all of its CFCs. A U.S. shareholder's tested income generally is reduced by 10% of the aggregate adjusted bases in depreciable tangible property which is owned by the CFCs and which produce tested income giving rise to the U.S. shareholder's GILTI.¹⁰ In addition, the tested losses of one CFC reduce the tested income of another commonly controlled CFC.¹¹

The U.S. tax on foreign-source Subpart F income and GILTI included in the income of U.S. corporate shareholders may be reduced by foreign tax credits,

¹ In limited situations, a CFC may have a fourth basket of income, i.e., U.S.-source income effectively connected with a U.S. trade or business. Such income is not Subpart F income or GILTI. See §952(b), §951A(c)(2)(A)(i)(I). Cf., Reg. §1.951A-2(c)(5)(iii)(B) ("The term residual CFC gross income means gross income other than gross tested income, gross income taken into account in determining Subpart F income, or gross income that is effectively connected, or treated as effectively connected, with the conduct of a U.S. trade or business....").

All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

² §951(a)(1)(A), §951A(a). See §951(b) (definition of "U.S. shareholder").

³ §11, §250. Such amounts may also be subject to state income taxes.

⁴ See §245A (100% dividends received deduction) and §959 (exclusion for previously taxed earnings and profits).

⁵ §954(d), §954(e).

⁶ §954(c)(2)(A).

⁷ §954(c)(6). The look-through rule is scheduled to expire for taxable years beginning after January 1, 2020, but in the past the exception has been extended. *But see* Temp. Reg. §1.245A-5T(d) (purports to limit the exception to only 50% of certain amounts received that would otherwise qualify for the look-through exception).

⁸ §954(b)(4). Such high-taxed Subpart F income is not GILTI whether or not the election is made. §951A(c)(2)(A)(i)(III). See Yoder, *The Subpart F High-Tax Exception*, 48 Tax Mgmt. Int'l J. 139 (Mar. 8, 2019).

⁹ §951A(a), §951A(c)(2)(A). A CFC's tested income does not include dividends received from a related person and U.S.-source income that is effectively connected with a U.S. trade or business. Reg. §1.951A-2(c)(i), §1.951A-2(c)(iv).

¹⁰ §951A(b)(2)(A); Reg. §1.951A-1(c)(3)(i)(A), §1.951A-1(c)(3)(ii).

¹¹ §951A(c)(1)(B); Reg. §1.951A-1(c)(2)(ii).

subject to limitations. For Subpart F income, 100% of the foreign income taxes attributable to the Subpart F income is eligible to claim as a credit.¹² A foreign tax credit is allowed for 80% of foreign income taxes attributable to a GILTI inclusion.¹³ For both inclusions, the income of the U.S. shareholder is grossed up for 100% of the amount of the attributable foreign income taxes.¹⁴

The amount of foreign income taxes that can be claimed as a credit is subject to limitation, and the limitation is calculated separately for Subpart F income and GILTI.¹⁵ The limitation is essentially 21% times the amount included in taxable income (100% of Subpart F income and 50% of GILTI) reduced by the amount of expenses of the U.S. shareholder that are allocated and apportioned to the inclusions.¹⁶

Any excess credits accompanying a Subpart F income inclusion generally can be used to offset U.S. tax on other foreign-source business income, and any remaining amount can be carried back one year and forward 10 years.¹⁷ In contrast, excess credits in the GILTI foreign tax credit limitation category disappear.¹⁸

Perhaps one of the biggest surprises of the new international tax rules enacted in 2017 is that a CFC's high-taxed non-Subpart F income can result in incremental U.S. taxation. For example, assume a U.S. corporation has foreign operations only in Mexico. Its Mexican subsidiary earns \$1,000 that is subject to \$300 of Mexican income taxes. The U.S. shareholder includes the \$700 of income in its income as GILTI, and grosses up that amount by the \$300 of Mexican taxes, with taxable income of \$ 500 ($\$1,000 \times 50\%$) and U.S. tax of \$105.¹⁹ Assume \$200 of U.S. expenses are allocated to the \$500 of taxable income. As a result, because of the foreign tax credit limitation rules, the U.S. shareholder would incur residual U.S. tax of \$42 ($\$200 \times 21\%$).²⁰ In recognition of this unintended result, proposed regulations would provide a high-tax exception for items of tested income that are

subject to a foreign income tax rate greater than 18.9%.²¹

While Subpart F income is subject to a higher U.S. tax rate, because of the unfavorable foreign tax credit rules for high-taxed GILTI, a taxpayer might consider changing certain operating structures such that a CFC's high-taxed income becomes Subpart F income. In such case, any excess foreign tax credits attributable to a Subpart F income inclusion may become valuable in reducing U.S. tax on other foreign-source business income in the current year or in carryover years.²²

Income of a CFC that is not taxable as Subpart F income or GILTI falls within the residual basket. This would include any tested income that is reduced by 10% of the aggregate adjusted bases in tangible property giving rise to GILTI and by tested losses of other CFCs. It would also include any income that is excluded from Subpart F income or GILTI under a high-tax exception.

The residual earnings generally can be distributed to a corporate U.S. shareholder without additional tax pursuant to a 100% dividends received deduction.²³ Any foreign income taxes and withholding taxes associated with such earnings are not allowed as a credit.²⁴ A distribution of earnings that were taxed as Subpart F income or GILTI also is excluded from the income of the U.S. shareholder as previously taxed earnings and profits.²⁵

In sum, the income earned by a CFC must be identified as within one of three baskets, beginning with Subpart F income, then GILTI, and the remaining income within the residual basket. For corporations,

²¹ Prop. Reg. §1.951A-2(c)(6). See Yoder, *The Proposed GILTI High-Tax Exception*, 45 Int'l Tax J. 3 (July-Aug. 2019).

²² See Yoder, *A Few GILTI Planning Tips*, 44 Int'l Tax J. 3 (Nov.-Dec. 2018); Yoder, *Taxation of CFC Income: The Paradigm*, 45 Int'l Tax J. 3 (May-June 2019).

²³ §245A. The deduction is not available for hybrid dividends. §245A(e); Prop. Reg. §1.245A(e)-1. Temporary regulations purport to limit the dividends received deduction to 50% for otherwise qualifying dividends paid out of certain residual earnings. Temp. Reg. §1.245A-5T(b). An investment of residual earnings in U.S. property can result in full taxation of the earnings under Subpart F, but regulations exclude such an amount from taxation to a corporate U.S. shareholder to the extent the amount would not be taxable under §245A if it had been distributed as a dividend. Reg. §1.956-1(a)(2).

²⁴ §245A(d). In certain situations where residual earnings are subject to a high foreign tax rate, it may be beneficial to convert residual income into Subpart F income.

²⁵ §959. Foreign income taxes paid on a distribution of previously taxed income may be claimed as a foreign tax credit. §960(b); Reg. §1.960-3; Prop. Reg. §1.960-3. See also §961(b)(2) (a distribution of previously taxed earnings and profits in excess of the U.S. shareholder's basis in the stock of the CFC generally is subject to taxation as capital gains to the extent not recharacterized as a dividend under §1248, see Reg. §1.1248-1(b)).

¹² §960(a).

¹³ §960(d).

¹⁴ §78.

¹⁵ §904(a), §904(d). Low-taxed passive Subpart F income is further subdivided for purposes of calculating the foreign tax credit limitation. §904(d)(1)(C), §904(d)(2)(A), §904(d)(2)(B).

¹⁶ Taxpayers subject to the BEAT are not entitled to claim a foreign tax credit in calculating the minimum tax. §59A(b)(1)(B)(i).

¹⁷ §904(c), §904(d).

¹⁸ §904(c) (last sentence).

¹⁹ This example assumes no reduction for depreciable tangible property.

²⁰ Only \$63 of the taxes paid to Mexico is used as a credit (\$237 is unusable as a credit).

Subpart F income and GILTI are subject to current U.S. taxation at a 21% and 10.5% rate, respectively, while residual income is not subject to U.S. taxation. U.S. tax on the amount of a CFC's taxable income can be reduced by foreign tax credits, with the foreign tax credit rules favoring Subpart F income over GILTI.

All of a CFC's earnings generally can be repatriated without additional U.S. taxation. Taxpayers are provided with some flexibility to control which category an item of CFC income falls within in seeking to achieve the optimal U.S. tax position.