

Subpart F Losses

By Lowell D. Yoder

With the recent downturn in the global economy, it will be more common for a controlled foreign corporation (“CFC”) to incur operating losses for 2020 than has generally been the case. This article discusses the treatment of CFC losses for purposes of applying the Subpart F income rules.

General Treatment of CFC Income and Losses

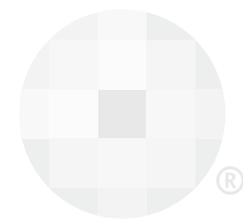
As background, a CFC generally is not subject to U.S. taxation on the income it derives from carrying on business outside the United States.¹ Likewise, the operating losses of a CFC generally are not available to reduce U.S. taxable income.

Income derived by a CFC that falls within the definition of a category of Subpart F income, however, generally is included in the gross income of its U.S. shareholders.² For corporate U.S. shareholders, Subpart F income is subject to a U.S. tax rate of 21%. A corporate U.S. shareholder is allowed a credit for foreign income taxes it is deemed to pay on the Subpart F income, subject to limitation.³ On the other hand, any loss of a CFC arising in a Subpart F income category is not allowed as a deduction to the U.S. shareholders.

The business income of a CFC that is not Subpart F income generally is included in the gross income of the U.S. shareholders as global intangible low-taxed income (“GILTI”).⁴ The amount of GILTI subject to U.S. taxation is reduced by 10% of a U.S. shareholder’s aggregate *pro rata* shares of qualified business asset investment (“QBAI”) of its CFCs.⁵ For a corporate U.S. shareholder, GILTI is generally subject to an effective U.S. tax rate of 10.5%.⁶ A corporate U.S. shareholder also is entitled to claim a credit for 80% of the foreign income taxes that it is deemed to pay on the amount of its GILTI inclusion, subject to a limitation.⁷ Like Subpart F losses, GILTI losses generally do not reduce other taxable income of a CFC’s U.S. shareholders; however, such losses can reduce a U.S. shareholder’s GILTI inclusions from other CFCs.⁸

Calculation of Subpart F Income

Subpart F income generally includes foreign base company income.⁹ Such income includes foreign base company sales income, foreign base company services income, and foreign personal holding company income.¹⁰ Foreign personal



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holding company income is further subdivided among several categories, including dividends, interest, rents and royalties; gains from the sale or exchange of property; commodities gains; and foreign currency gains—with exceptions provided for each category.¹¹

To calculate the amount of Subpart F income included in the income of a CFC's U.S. shareholders, the amount of gross income of the CFC that falls within each category of foreign base company income and foreign personal holding company income is first determined. The gross amounts in each category are reduced by the deductions allowable in calculating a CFC's Subpart F income, which generally are determined by applying the rules of Code Sec. 63 as they would apply to a domestic corporation.¹² The CFC's allowable deductions are allocated and apportioned among each category of the CFC's gross foreign base company income and each category of the CFC's foreign personal holding company income under the rules of Code Secs. 861, 864 and 904(d).¹³

If after allocating and apportioning expenses the amount remaining in any separate category of foreign base company income or in any separate category of foreign personal holding company income is less than zero, the loss in that category may not reduce income in any other foreign base company income or foreign personal holding company income category.¹⁴ A loss with respect to activities and transactions that would not give rise to Subpart F income likewise cannot reduce Subpart F income, *e.g.*, a tested loss.¹⁵

For example, assume a CFC has a \$100 loss in its foreign base company sales income category and has \$25 of interest income that is foreign personal holding company income. The CFC has no other income or losses. Under the general rules, the U.S. shareholder would include in its gross income the \$25 of foreign personal holding company income, even though the CFC has a \$75 loss for the year, because the loss in the foreign base company sales income category cannot reduce the interest income in the foreign personal holding company income category.

Current Year Earnings and Profits Limitation

The Limitation

The amount of Subpart F income included in the gross income of a CFC's U.S. shareholders for any taxable year cannot exceed the CFC's total earnings and profits for such taxable year.¹⁶ For this purpose, dividends distributed by the CFC during the year generally are not taken into account

as a reduction in calculating the CFC's current year earnings and profits.¹⁷ The earnings and profits of a CFC are increased by the amount of dividends received during the year that are not previously taxed earnings and profits.¹⁸

Accordingly, while a loss in one category of Subpart F income cannot reduce income in another Subpart F income category, such loss can result in reducing the amount of a CFC's Subpart F income included in the gross income of its U.S. shareholders for the current year.¹⁹ There is no similar earnings and profits limitation on the amount of a U.S. shareholder's GILTI tested income, and therefore Subpart F losses do not reduce the amount of a CFC's income included in a U.S. shareholder's income as GILTI.

For example, assume a CFC has a \$100 loss in its foreign base company sales income category, \$150 of income in its foreign base company services income category, and \$50 of interest income in its foreign personal holding company income category. The CFC has no other income or losses for the year. The earnings and profits of the CFC for the year would be \$100 (\$150 + \$50 - \$100). Therefore, the U.S. shareholders would include in their gross income for the year only \$100 of Subpart F income.²⁰ The amount of Subpart F income reduced by the earnings and profits limitation is not included in calculating the CFC's tested income even though such income is not currently included in the gross income of the U.S. shareholders.²¹

As a general rule, losses arising in non-Subpart F income categories are taken into account in calculating a CFC's earnings and profits for the current year. The Code and regulations, however, provide that the amount of a tested loss calculated under the GILTI rules is added back to the earnings and profits of a CFC for purposes of the earnings and profits limitation on Subpart F income.²² A tested loss would generally include losses from business activities that do not give rise to income within a category of Subpart F income.²³

Assume the facts in the above example, except the CFC also has a \$75 loss from selling inventory that is not within the foreign base company sales income category (*i.e.*, a GILTI tested loss). Thus, the CFC would have current year earnings and profits of \$25 (\$150 + \$50 - \$100 - \$75). The \$75 tested loss would be added back to the CFC's earnings and profits for purposes of calculating the earnings and profits limitation, resulting in a \$100 Subpart F income inclusion.²⁴

Recapture

The amount of Subpart F income that is reduced because of the current year earnings and profits limitation is

subject to recapture in a subsequent year.²⁵ This recapture rule applies whether Subpart F income in a category was reduced by losses in another Subpart F income category or by losses that were not within a Subpart F income category. If in a subsequent year a CFC has only Subpart F income, the recapture rules would not apply for that year.²⁶

The recapture rule applies in a later year when the amount of the CFC's earnings and profits for such year exceeds its Subpart F income for that year.²⁷ Such excess amount will be recharacterized as Subpart F income in that later year to the extent of the prior reduction of Subpart F income that was not previously recharacterized.²⁸ Regulations provide rules for establishing recapture accounts for the various categories of foreign base company income and foreign personal holding company income, rules for including such amounts in later years when current earnings and profits exceed Subpart F income, and rules for reducing recapture accounts for amounts recharacterized.²⁹

Under regulations, non-Subpart F income that is recaptured as Subpart F income is not excluded from tested income.³⁰ As a result, tested income that is recharacterized as Subpart F income will also be taken into account in calculating the U.S. shareholder's GILTI inclusion, *i.e.*, such amount is included twice in the gross income of the U.S. shareholder.³¹

For example, assume a CFC in the current year has \$100 of foreign base company sales income and \$50 of income from services that is not foreign base company services income. Assume also the CFC has a recapture account of \$200 with respect to foreign base company sales income. Under the regulations, the U.S. shareholder would include in income \$150 of foreign base company sales income (\$100 for the current year and \$50 of recapture) and also have \$50 of tested income for purposes of calculating the GILTI inclusion of the U.S. shareholder. Thus, even though the CFC has only \$150 of income for the year, the U.S. shareholder would include \$200 in its gross income.³²

Accumulated and Chain Deficit Rules

As discussed above, a loss in a foreign base company income or foreign personal holding income category generally cannot offset income in a different foreign base company income or in a different foreign personal holding company income category. Such a loss also generally cannot be carried over and used in another year to reduce a CFC's income in the same Subpart F income category. Furthermore, a Subpart F loss of one CFC

generally cannot be used to reduce the Subpart F income of a related CFC.

An exception is provided for "qualified deficits." The amount of Subpart F income of a CFC that is included in the gross income of any U.S. shareholder and attributable to a "qualified activity" may be reduced by the amount of such U.S. shareholder's *pro rata* share of any prior year qualified deficit in earnings and profits of the CFC.³³

A qualified activity is any activity of a CFC that gives rise to foreign base company sales income, foreign base company services income, certain insurance income and foreign personal holding company income of a qualified insurance company or of a qualified financial institution. A qualified accumulated deficit is a deficit in the CFC's earnings and profits for prior years and attributable to the same qualified category as the activity giving rise to the income that is being offset.³⁴ Under regulations, deductions of a CFC that are allocated and apportioned to gross tested income are not taken into account for purposes of determining the amount of a qualified deficit.³⁵

A qualified deficit may be carried forward (but not back) indefinitely. A U.S. shareholder's *pro rata* share of a qualified deficit reduces the U.S. shareholder's Subpart F income in the particular category in a future year.³⁶

In addition to the use of qualified accumulated deficits, an election may be made to reduce Subpart F income of a CFC for any taxable year which is attributable to a qualified activity by the amount of any current deficit in earnings and profits of a "qualified chain member," attributable to losses from the same qualified activity.³⁷ A qualified chain member is, with respect to the CFC, any other corporation that is created or organized under the laws of the same foreign country as the CFC, and is directly or indirectly wholly-owned by the CFC, or the corporation directly or indirectly wholly owns the CFC with the qualified deficit.

The chain deficit rule applies after application of the current year earnings and profits limitation on Subpart F income and after taking into account the deficit CFC's prior year qualified deficits.³⁸ To the extent a CFC's deficit is used by another CFC, the available deficit is reduced for purposes of carrying it forward to reduce future Subpart F income of the CFC with the deficit.

The use of a deficit in a qualified category to reduce income in such category in a future year, or to reduce income in a qualified category of a same-country CFC in the same chain of ownership, is not subject to the recapture rules. Also, the amount that a qualified deficit reduces a U.S. shareholder's Subpart F income inclusion under Code Sec. 951(a)(1)(A) does not result in a corresponding increase in the CFC's tested income for purposes of the GILTI rules.³⁹

Conclusion

In summary, a CFC's losses in a Subpart F income category cannot reduce income in a different Subpart F income category, cannot reduce the CFC's tested income, and are not allowed as a deduction to U.S. shareholders. Such losses may, however, limit the amount of the current year Subpart F inclusion as a result of the current year earnings and profits

limitation (subject to recapture), or if a loss arises from a qualified activity, such loss may be used to reduce income in the same category in a subsequent year, or reduce in the current year qualified income in a same-country CFC in the same chain of ownership. Subpart F income not taxable under these rules is not tested income for GILTI purposes, but recaptured Subpart F income is taken into account twice as Subpart F income and as tested income for purposes of the GILTI inclusion.

ENDNOTES

- ¹ Code Secs. 881, 882.
- ² Code Sec. 951(a)(1).
- ³ Code Secs. 901(a), 904(d) and 960(a); Reg. §1.960-2(b).
- ⁴ Code Sec. 951A(a); Reg. §1.951A-1(b).
- ⁵ Code Sec. 951A(b) and (d); Reg. §1.951A-1(c) and (d)(3).
- ⁶ Code Sec. 250(a).
- ⁷ Code Secs. 901(a), 904(d), and 960(d); Reg. §1.960-2(c).
- ⁸ Code Sec. 951A(c); Reg. §1.951A-1(c)(1) and (2). See Yoder, *GILTI Losses*, INT'L TAX J., July–Aug. 2020, at 3.
- ⁹ Code Sec. 952(a)(2). Subpart F income also includes certain insurance income. Code Secs. 952(a)(1) and 953.
- ¹⁰ Code Sec. 954(a).
- ¹¹ Code Sec. 954(c).
- ¹² Reg. §1.952-2(b)(1).
- ¹³ Code Sec. 954(b)(5); Reg. §1.954-1(c).
- ¹⁴ Reg. §1.954-1(c)(1)(ii). Losses arising from activities or transactions within a particular Subpart F income category can reduce income arising from other activities or transactions within the same Subpart F income category. See also Reg. §1.954-2(g)(4) (election to apply foreign currency losses to reduce other categories of foreign personal holding company income).
- ¹⁵ Reg. §1.951A-2(c)(3). A loss in a Subpart F income category cannot reduce tested income for GILTI purposes.
- ¹⁶ Code Sec. 952(c)(1); Reg. §1.952-1(e). The amount of the Subpart F income inclusion would be limited to the amount of current year earnings and profits even if the CFC has accumulated earnings and profits from prior years.
- ¹⁷ Reg. §1.952-1(c)(1).
- ¹⁸ Reg. §1.952-1(c)(3), Ex. 1; Rev. Rul. 86-33, 1986-1 CB 287.
- ¹⁹ See Proposed Reg. §1.951-1(a)(2) and (d) (July 23, 2020) (would apply the earnings and profits limitation after application of the high-tax exception).
- ²⁰ See Reg. §1.952-1(e) (rules for proportionally reducing the income in each separate Subpart F income category by the amount of the current year reduction). The denominator of the fraction for computing deemed paid foreign tax credits accompanying the Subpart F income inclusion (as reduced) would also be reduced by the amount not included in the gross income of the U.S. shareholders as a result of the current year earnings and profits limitation. Reg. §1.960-2(b)(3)(iii).
- ²¹ Reg. §1.951A-2(c)(4)(iii)(A).
- ²² Code Sec. 951A(c)(2)(B)(ii); Reg. §1.951A-6(b).
- ²³ Reg. §1.951A-2(b) and (c). This rule apparently applies even if the tested loss does not provide a benefit of reducing tested income of a U.S. shareholder from other CFCs.
- ²⁴ On the other hand, tested income increases the CFC's earnings and profits for purposes of calculating the earnings and profits limitation. If in the example the CFC had \$100 of tested income (rather than a \$75 tested loss), the earnings and profits limitation would not apply because the CFC would have \$200 (\$150 + \$50 – \$100 + \$100) of earnings and profits. This is the result even though all or a portion of the \$100 of tested income is included in the income of the U.S. shareholders as GILTI.
- ²⁵ Code Sec. 952(c)(2); Reg. §1.952-1(f)(1).
- ²⁶ Income of a CFC for the year that is not within a Subpart F income category but that is treated as Subpart F income under the full inclusion rule would not be subject to recapture. Regs. §§1.954-1(b)(3); 1.952-1(e)(4).
- ²⁷ The regulations provide that the recapture rule applies to a CFC's earnings and profits with respect to Subpart F income to which the high-tax exception is applied, and the high-tax exception cannot apply to the recharacterized amount. Reg. §1.954-1(a)(7); -1(d)(7)(ii) Ex. 1 (step 8) and Ex. 2 (step 9); see also Code Sec. 951A(c)(2)(A)(i)(III); Reg. §1.951A-2(c)(1)(iii) (income that is excluded from Subpart F income under the high-tax exception is not tested income for GILTI purposes). See also Proposed Reg. §1.951-1(a)(7) (July 23, 2020) (expressly provides that the high-tax exception does not apply to recaptured amounts).
- ²⁸ See Proposed Reg. §1.952-1(f)(4) (July 23, 2020) (would expressly provide that recapture accounts carry over in a distribution or transfer described in Code Sec. 381(a)).
- ²⁹ Reg. §1.952-1(f). Distributions in excess of a CFC's previously taxed earnings and profits are treated under regulations as distributions from a recapture account, and correspondingly reduce the recapture account. Reg. §1.952-1(f)(3)(i). Generally, a dividend received by a corporate U.S. shareholder from a CFC subsidiary paid out of earnings and profits that were not previously taxed at the corporate U.S. shareholder level is eligible for a 100% dividends received deduction. Code Sec. 245A.
- ³⁰ Reg. §1.951A-2(c)(4)(iii)(B). See Reg. §1.951A-2(c)(4)(iv), Exs 1–3.
- ³¹ The Treasury and IRS rejected comments requesting that recapture amounts be excluded from tested income. T.D. 9866, 84 FR 29,288 (June 21, 2019), at 29,295–297.
- ³² See Proposed Reg. §1.960-1(c)(2) (an item of income does not include an amount included in Subpart F income of a CFC by reason of the recharacterization of a recapture account).
- ³³ Code Sec. 952(c)(1)(B).
- ³⁴ The deficit must have arisen in a year when the foreign corporation was a CFC. Code Sec. 952(c)(1)(B)(ii).
- ³⁵ Reg. §1.951A-2(c)(3)(i).
- ³⁶ See Reg. §1.960-1(b)(3)(ii) (the denominator of the deemed paid credit fraction is not reduced by the use of an accumulated deficit in a subsequent year, but the numerator is reduced to the amount of the Subpart F income inclusion).
- ³⁷ Code Sec. 952(c)(1)(C).
- ³⁸ Code Sec. 952(c)(1)(C)(iii).
- ³⁹ See T.D. 9882, 84 FR 69,022 (Dec. 18, 2019), at 69,044 (“Under section 952(c)(1)(B), a qualified deficit reduces the amount of subpart F income of a CFC that a U.S. shareholder includes in its gross income under section 951(a)(1)(A) but does not reduce the subpart F income of the CFC. In contrast, section 952(c)(1)(A) reduces the subpart F income of the CFC at the CFC level.”). See also Code Sec. 951A(c)(2)(A)(i)(II); Reg. §1.951A-2(c)(1)(ii) (tested income excludes gross income taken into account in determining the Subpart F income of the CFC).

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