

Proposed Foreign Tax Credit Regs: the Good, the Bad and the (Sort of) Ugly

On November 28, 2018, the US Treasury and the Internal Revenue Service (IRS) released proposed regulations on foreign tax credit (FTC) issues related to the global intangible low-taxed income (GILTI) regime and other changes made by last year's tax reform legislation, known as the Tax Cuts and Jobs Act (TCJA). The TCJA repealed the Section 902 indirect FTC, in light of the enactment of new Section 245A, which provides a 100% dividends-received deduction for foreign-source dividends from 10%-owned foreign corporations. The TCJA also created two new separate-limitation baskets – one each for GILTI and foreign branch income. These changes gave rise to a need for transition rules, and guidance on a number of issues, particularly in relation to the taxation of GILTI inclusions.

The preamble to the proposed regulations delineates five areas covered by the new rules:

1. Allocation and apportionment of deductions and the calculation of taxable income for purposes of the FTC limitation
2. Rules related to the TCJA's addition of new separate limitation categories for GILTI and foreign branch income
3. Rules related to the effect of foreign tax refunds in determining whether subpart F income is excludable as high-taxed income
4. The determination of deemed-paid taxes under amended Section 960 (for subpart F and GILTI inclusions) and Section 78 (gross-up of inclusion to take deemed-paid taxes into account)
5. Rules on the FTC effect of an election under Section 965(n) regarding net operating loss carryovers or carrybacks and Section 965 inclusions

In addition, Treasury and the IRS have requested comments on certain aspects of the regulations, including the expense allocation rules. Specifically, they identified an interest in receiving comments on worldwide interest expense allocation elections under Section 864(f) that will be effective for tax years beginning after December 31, 2020.

The GILTI Rules and the FTC

New Section 951A of the Internal Revenue Code (Code) requires US shareholders of controlled foreign corporations (CFCs) to include in taxable income their GILTI inclusion amount each year, which is based on a formula that includes CFCs' income (subject to certain exclusions) in excess of 10% of investments in qualified business assets. The GILTI inclusion is reduced by 50% under Section 250 of the Code, resulting in an effective tax rate for corporate US shareholders of 10.5% (until 2026 and later years, when the reduction will decrease from 50% to 37.5%, for an effective tax rate of 13.125%).

Generally, a corporate US shareholder can take as a credit against its GILTI tax liability up to 80% of its pro rata share of the foreign income taxes "properly attributable" to the portion of positive profits of its CFCs that it included in income as GILTI. No carryover or carryback of excess FTCs in the GILTI basket is allowed.

Unlike familiar subpart F income inclusions by US shareholders that are determined on a CFC-by-CFC basis, GILTI inclusions are determined based on a formula that aggregates at the shareholder level certain "CFC tested items" of all CFCs in which the taxpayer is a US shareholder. Thus, the GILTI rules do not fit neatly into the existing and familiar architecture of the otherwise similar subpart F provisions and the deemed-paid tax credit under Section 960 regarding subpart F income inclusions.

For example, unlike the subpart F income rules (which allow a US shareholder to exclude certain income from subpart F income if the effective foreign income tax rate on the income is more than 90% of the US corporate income tax rate), the GILTI rules do not provide any exclusion for high-taxed income. This is despite the fact that GILTI stands for "global intangible low-taxed income," so one might expect an explicit high-tax income "kick out." Rather, availability of an FTC to offset GILTI inclusions is the sole means to alleviate US taxation of high-taxed GILTI. Given that the deemed-paid FTC for GILTI inclusions is limited to 80% of the relevant foreign taxes, an effective foreign income tax rate of at least 13.125% is sufficient, in the absence of US shareholder expenses allocable to the GILTI basket, to eliminate US tax at a 10.5% rate. The legislative history of the TCJA suggests that Congress did not intend to impose any residual US tax on GILTI that had been taxed abroad at an effective rate of at least 13.125%. However, Treasury and the IRS do not read the legislative history of the TCJA, taken together with what was and what was not changed in the FTC limitation area, to command that result.

Taxpayers who hoped that Treasury and the IRS would, for example, write regulations that would allocate no shareholder expenses to the GILTI basket will be disappointed by the proposed regulations. The discussion in the preamble about the FTC problems posed by GILTI is somewhat puzzling, as it appears to be premised on (i) the assumption that taxpayers were asking for rules that would allow them to use excess FTCs from the GILTI basket against foreign-source income in other baskets and (ii) an apparent misunderstanding that US tax on GILTI inclusions would always be fully eliminated by the FTC if the effective foreign tax rate were at least 13.125%. Treasury and the IRS simply did not acknowledge the possibility that allocating some US shareholder expenses, such as interest, to the GILTI basket for FTC limitation purposes would result in residual US tax liability.

On the positive side, the proposed regulations clearly confirm that the Section 78 gross-up amount attributable to foreign taxes deemed paid with respect to a GILTI inclusion is allocable to the GILTI separate-limitation basket. In addition, the proposed regulations sensibly clarify that expenses need not be allocated to the GILTI basket for FTC limitation purposes in respect of either the 50% of GILTI that is deductible under Section 250 or the value of the CFC stock attributable to that portion of the GILTI inclusions.

Transition Rules

Prior to enactment of the TCJA, there were only two separate-limitation baskets – one for passive income and one for general income. The TCJA added two new baskets for GILTI and foreign branch income. Under the proposed regulations, taxpayers with carryovers of excess FTCs from prior years are allowed to assign those FTCs to the foreign branch income basket if the FTCs would have been in that basket if it had existed when the FTCs arose. In contrast, no excess FTC carryovers can be assigned to the GILTI basket.

Carrybacks of excess FTCs from post-2017 years to pre-2018 years, from either the foreign branch income basket or the general income basket, must go into the general income basket. No carrybacks are allowed from the GILTI basket.

The proposed regulations provide similar transition rules for the recapture of overall foreign loss accounts or separate limitation loss accounts, as well as for the recapture of an overall domestic loss that offset income in a pre-2018 separate basket prior to enactment of the TCJA.

Solicitation of Comments

In the preamble, Treasury and the IRS acknowledged that, after the TCJA, “the FTC limitation and the related expense allocation rules will have a broader impact on taxpayers than before,” and have requested comments on the proposed regulations in general and on a number of specific issues identified in the Preamble to the Proposed Regulations.

In addition, Treasury and the IRS noted that, after 2020, worldwide affiliated groups will be able to allocate and apportion interest expense on a worldwide basis, and that this would “necessitate a reexamination of the existing expense allocation rules.” Comments were requested regarding “specific revisions to the regulations that should be made in connection with this review.”

The deadline for written comments is expected to be February 5, 2019 (i.e., 60 days after the anticipated publication date). Those comments will be considered by Treasury and IRS in the preparation of final regulations. The comment process provides an important opportunity for businesses and others to ensure that key issues are identified and pragmatic solutions considered by Treasury and IRS officials in the establishment of the final regulations to which all taxpayers will then be subject.

Members of our Tax Policy team, who have been actively involved in the tax reform process since the initial congressional consideration of the legislation, are available to assist businesses and others in client-specific evaluations of the Proposed Regulations, the preparation and filing of comments, and the presentation of those comments to Treasury and IRS officials in follow-up meetings, which we can help arrange.

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