The High-Taxed Exception and E&P Limitation to Subpart F Income

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Subpart F has long included exceptions to subpart F income for income of controlled foreign corporations ("CFCs") subject to a relatively high rate of foreign tax and limited subpart F inclusions to the current earnings and profits ("E&P") of the CFC. After the Tax Cuts and Jobs Act (the "Act" or the "TCJA"), most income of CFCs that is not subpart F income will be subject to current U.S. tax as global intangible low-taxed income ("GILTI"). GILTI incorporates the high-taxed exception, but not the E&P limitation or qualified deficit rules. Subpart F income, but not GILTI, may be reduced by certain prior year E&P deficits in accumulated E&P of CFCs attributable to same activities. This article considers how these rules may apply following the Act.

The E&P Limitation

In the case of a CFC, subpart F income of a CFC is defined to mean the "foreign base company income" of the CFC as defined in Code Sec. 954, insurance income as defined in Code Sec. 953, and certain other items.[1] Once the items of subpart F income are so determined, the subpart F income of the CFC that is taken into account by the U.S. shareholders is limited to the CFC's current earnings and profits (the "E&P limitation").[2] To the extent that the current E&P limitation reduces a subpart F inclusion in one year, a recapture account is created under Code Sec. 952(c)(2). The recapture account results in the re-characterization of non-subpart F income as subpart F income in a later year in which current E&P exceeds subpart F income. As will be seen below, the new proposed regulations on GILTI will significantly change the operation of the E&P limitation and recapture rules.

Subpart F income of the CFC is determined using the same principles that apply for computing domestic taxable income, treating the CFC as if it were a domestic corporation.[3] "Earnings and profits," by contrast, is an economic concept that takes into account the effect of transactions on the CFC's net worth. Non-deductible expenses and losses, for example, that reflect a diminution in the CFC's ability to pay dividends reduce E&P even if they would not be deductible for corporate income tax purposes by the CFC in computing subpart F income or GILTI.[4] Various E&P adjustments are also prescribed by statute in Code Sec. 312, although for purposes of applying the current E&P limitation on subpart F

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income, the E&P adjustments in Code Secs. 312(n)(4) through 312(n)(6), relating to installment sales, LIFO inventory and the completed contract method of accounting are disregarded.[5]

The TCJA left the E&P limitation intact for computing subpart F income, but did not incorporate a current E&P limitation on GILTI. Thus, a CFC may have tested income giving rise to a GILTI inclusion regardless of its E&P. For example, assume CFC1 has tested income of $100× and a loss in the subpart F income category of ($30×). Due to the apparent lack of an E&P limitation for GILTI purposes,[6] the $100× of tested income seems to be included in the computation of GILTI, whereas the $30× loss is not currently taken into account. For potential utilization of this loss in the future, see discussion below of the qualified deficit rule.

On the other hand, Code Sec. 951A(c)(2)(B)(ii) provides that any "tested loss" of a CFC is disregarded for computing the E&P limitation. Since most non-subpart F losses will constitute tested losses, the foregoing rule change significantly restricts the scope of the E&P limitation. As discussed below, there are limited circumstances in which the E&P limitation will still reduce a U.S. shareholder's subpart F inclusion after the Act.

Assume that USP owns a CFC1 that generates $20× of foreign personal holding company income under Code Sec. 954(c) and a ($50×) operating loss in active business operations that do not give rise to subpart F income. The ($50×) operating loss is a "tested loss" for GILTI purposes. Under Code Sec. 952(c), as in effect prior to the TCJA, the U.S. shareholder would not have a subpart F inclusion in year 1 due to the E&P limitation. A $20× E&P recapture account would have been created and would have been required the first $20× of non-subpart F E&P of CFC1 in a later year to be treated as subpart F income.

Under the TCJA, the $50× operating loss of the CFC now constitutes a "tested loss" under the GILTI rules. Under Code Sec. 951A(c)(2)(B)(ii) provides that the tested loss is not taken into account for purposes of applying the E&P limitation. Thus, in the Example above, the $20× of subpart F income would be included by the shareholder in subpart F income. Under the statutory provision of the $50× loss could be used, if at all, to offset tested income of other CFCs for purposes of GILTI in the year in which the tested loss was incurred.

While apparently aimed at preventing the taxpayer from using the same loss twice, the foregoing rule prioritizes use of the loss against tested income taxed at a 10.5% rate rather than subpart F income taxed at a 21% rate. Moreover, if the U.S. parent's other CFCs do not have positive tested income to absorb the tested loss in the year in which it is incurred, the tested loss would not be used at all. The tested loss would be stranded due to the lack of any tested loss carryovers in the GILTI rules.

When would a CFC still have a situation in which the current E&P limitation applies despite the coordination rule noted above?

The E&P limitation may still apply where a CFC generates a loss in a category of income that is not tested income. "Tested income" is broadly defined, however, as consisting of all gross income of the CFC, other than subpart F income, income excluded from subpart F income by the high-taxed exception (more on this below), income excluded from subpart F income as effectively connected income, certain oil and gas extraction income, and related party dividend income.[7] The one example of the E&P limitation in the GILTI Proposed Regulations involves a deficit in the oil and gas extraction income category, by illustration.[8]

The E&P limitation would also apply where a CFC has a current loss in one category of foreign base company income, but positive subpart F income in another category of foreign base company income. Under existing Code Sec. 954 regulations, deficits in one category of foreign base company income generally cannot be reallocated against other categories of foreign base company income, other than through operation of the E&P limitation.[9] For example, if a CFC has a current loss in one category of subpart F income (*e.g.*, a category of foreign personal holding company income (Code Sec. 954(c)), but positive net income in a different category (*e.g.*, foreign base company sales income (Code Sec. 954(d)), then the E&P limitation would apply. The E&P limitation may also still apply if the CFC incurs an economic loss that is deductible for E&P purposes, but not for taxable income purposes. An example of this might be a CFC that incurs a capital loss that depletes current earnings, despite being limited under Code Sec. 1211.

Where the E&P limitation rule does apply, the GILTI Proposed Regulations contain a further rule coordinating the E&P limitation with the exception for subpart F income. If this rule is incorporated in the GILTI regulations when they are finalized, it would create risk of double taxation of the same economic income under GILTI.

Specifically, Proposed Reg. §1.951A-2(c)(4)(i) provides that the E&P limitation is disregarded for determining whether gross income is taken into account in determining a CFC's subpart F income. Thus, income excluded from subpart F by operation of the E&P limitation is still considered to be "taken into account" in determining subpart F income, and therefore, is excluded from tested income by Code Sec. 951A(c)(2)(A)(i)(II).

This would seem to be a favorable rule in that it permits the taxpayer to exclude net foreign base income in one income category from tax under GILTI, notwithstanding that a current loss in another category shelters this income from taxation.

This rule is a double-edged sword, however, in that it also provides that the Code Sec. 952(c)(2) recapture is also disregarded for GILTI purposes. In a later year, if the taxpayer triggers its recapture account, the same economic income appears to be taxed under both the GILTI rules and subpart F. This makes use of the current E&P limitation a potential trap for the unwary. Not only is the reduction by means of the E&P limitation recaptured in a later year; the same economic income is also taxed as GILTI! Taxpayers using the E&P limitation in the future will need to carefully monitor and defer recapturing Section 952(c)(2) accounts.

In the Example of this rule that is provided in the GILTI Proposed Regulations, in year 1, a CFC has $100× of foreign base company income and a ($100×) loss in foreign oil and gas extraction income, a category of income that is neither subpart F income nor tested income. The CFC has no other items of income, and as a result of having no current E&P, does not include the $100× of subpart F income under Code Sec. 951(a). This $100× is also not taken into account as tested income.

In year 2, the CFC has $100× of income and E&P that is neither subpart F income nor otherwise excluded from tested income. The CFC thus has $100× of E&P in excess of subpart F income and recaptures the benefit of the E&P limitation by including this $100× as subpart F income. This is the same as the result under prior law. However, the Proposed Regulations also state that the treatment of this income as subpart F under the recapture rule is disregarded for applying the tested income rules. As a result, the same $100× remains tested income and is not excluded by Code Sec. 951A(c)(2)(A)(i)(II) as income taken into account in computing subpart F income. If this is, in fact, the result of the Example, it would result in the taxpayer including the $100× in taxable income twice—once as subpart F income and once as GILTI. If this startling result obtains under the final GILTI regulations, the use of the E&P limitation may result in double tax of the excluded income.[10]

The Accumulated Deficit Rule and Chain Deficit Rule

In addition to limiting a subpart F income inclusion to the CFC's current E&P, Code Sec. 952(c)(1)(B) permits certain "qualified deficits" in accumulated E&P to be taken into account by the CFC to reduce its subpart F income. In addition, qualified deficits by other CFCs in the same chain of ownership (*i.e.*, chain deficits) may also be taken into account to reduce subpart F income.[11] In either case, the deficit must arise from the same activity producing the same type of subpart F income, and except in the case of certain financial institutions, deficits relating to the foreign personal holding company income may not be taken into account under the qualified deficit rule.[12] By contrast, the qualified deficit rule does not seem to apply for GILTI purposes. Thus, a "tested loss" that is not currently absorbed by the U.S. shareholder appears to expire without a tax benefit.

Deficits in accumulated E&P that existed as of a CFC's 2017 taxable year generally offset deferred foreign income for computing the transition dividend under Code Sec. 965(b). To the extent the deficits reduced the transition tax dividend, the accumulated deficit in the CFC's E&P is eliminated including for purposes of the qualified deficit rule.[13]

For deficits arising in 2018 and later, however, the qualified deficit rule may have increased importance. Due to the lack of an E&P limitation in the GILTI rules, a loss in a subpart F income category would appear not to reduce tested income or GILTI. As a result, the qualified deficit rule may be the taxpayer's principal recourse to utilize such a loss. For example, assume that a CFC has a $50× loss in foreign base company income. It also earns $50× of tested income. While tested losses are shared among the U.S. shareholders' CFCs in computing GILTI, subpart F losses do not appear to create a tested loss or otherwise reduce GILTI. Thus, the $50× loss would not be available in the current year to produce GILTI, and so the best avenue towards its use would seem to be through the qualified deficit rule of Code Sec. 952(c)(1)(B).

The High-Taxed Exception

Code Sec. 954, as noted above, defines the categories of income that are generally treated as "foreign base company income" and subject to current taxation under subpart F. Code Sec. 954(b) includes several exceptions and special rules in the computation of foreign base company income. Pertinent here, Code Sec. 954(b)(4) provides that foreign base company income shall not include any "item of income" of a CFC that the taxpayer establishes has been subject to an effective rate of income tax of at least 90% of the U.S. corporate rate (*i.e.*, 18.9%, for years beginning after Jan. 1, 2018). Importantly,

GILTI also provides an exception from "tested income" for income excluded from foreign base company income under the high-taxed exception. See Code Sec. 951A(c)(2)(A)(i)(III).

As stated in the Preamble to the Proposed Regulations, this exception from GILTI only applies to income that is excluded from subpart F income solely by reason of the high-taxed exception.[14] Thus, income that is high-taxed but would not fall within the general definition of foreign base company income is not excluded from tested income by this rule. Similarly, as stated in the Preamble, high-taxed income that is eligible for another exception to foreign base company income, such as the look-through rule of Code Sec. 954(c)(6) or active finance exception, would still be considered tested income.

In identifying income that is high-taxed, the existing Code Sec. 954 regulations looked the now-repealed Code Sec. 902 E&P and tax pools that would be associated with the subpart F income inclusion. Special rules are provided for passive basket foreign personal holding company income. In other cases, the high-taxed status of foreign base company income is determined by the hypothetical indirect credit that would apply under Code Sec. 960 if the foreign base company income were included in income.[15] Given the averaging that was built into the pools, the high-taxed exception prior to 2017 could be satisfied with respect to low-taxed subpart F income, so long as the CFC's average pool rate was sufficiently high-taxed.

In applying the high-taxed exception after the TCJA, the pools have now been repealed and replaced with a single year indirect credit for the foreign income taxes "attributable to" the item of income under new Code Sec. 960(a). Recently Proposed Regulations under Code Sec. 960 adopt an annual tax approach that groups subpart F income according to each of the categories in Reg. §1.954-1(c)(1)(iii); the taxes associated with items of income in the current year are then taken into account as an indirect credit.[16] . Importantly, the Proposed Regulations require each type of foreign base company income or foreign personal holding company income to be treated as its own subpart F income group for purposes of the indirect credit.[17] Under this approach, different types of subpart F income in the general basket nonetheless are segregated for purposes of the credit and the high-taxed exception. This greater degree of tracing may affect some taxpayers in their application of the high-taxed exception. For example, assume that CFC owns two DREs that each generates $100× foreign base company income. One DRE is taxed by its home country at 25% and the other DRE is taxed at 15%. The CFC as a whole has a combined $160 of net foreign base company income in the general basket and pays $40 of foreign tax for a combined tax rate of 20%. Under prior law, the two DREs' income would be averaged for purposes of the high-taxed exception, and the test would be applied based on the general basket Code Sec. 902 pool rate. Under the new proposed regulations, the treatment would depend on whether the DREs earned the same type of subpart F income; if both DREs earned foreign base company *sales* income, averaging would be permitted; by contrast, in one earned foreign base *company sales* and the other foreign base company *services* income, only the 25% rate item would be eligible to be excluded. Together with the testing of taxes on a current year, rather than pooled basis, taxpayers relying on the high-taxed exception will need to adapt to the new rules. On the other hand, the lowering of the threshold for being high-taxed from 31.5% to 18.9% will make this exception more broadly available to taxpayers.

Another important rule in the existing Code Sec. 954(d) regulations coordinates the high-taxed exception and the current E&P limitation by providing that the E&P limitation is applied first.[18] An example of this rule is as follows. Assume, for example, that a CFC earns $100 of foreign base company income, and pays $15 of related taxes, and has a loss of ($50) in the non-subpart F category. Under the current regulations, the E&P limitation would be applied first, resulting in net $50 of foreign base company income and $15 of related taxes, so that the $50 of net subpart F income after the E&P limitation is high-taxed income.[19]

By providing that the current E&P limitation reduces both the numerator and denominator of the new Code Sec. 960 credit fraction, the new proposed regulations appear to retain this result from the current regulations.[20] Thus, the E&P limitation, in the limited cases where it applies, would appear to increase the rate of tax on a CFC's subpart F income for purposes of the high-taxed exception.

Conclusion

As seen from this brief discussion of the high-taxed exception, the current E&P limitation and qualified deficit rule, the Act had major effects on the basic plumbing of subpart F. The priority of tested loss treatment over the current E&P rules in Code Sec. 951A significantly limits the availability of the current E&P limitation as compared to prior law. By contrast, the high-taxed exception, as one of the few avenues to defer U.S. tax on foreign income, will have increased importance, although the

determination of taxes imposed on income for purposes of applying this exception will depend on how the foreign tax credit regulations are written. Finally, from its relative obscurity prior to the Act, the qualified deficit may end being employed more commonly in practice for deficits arising in 2018 or later years.

ENDNOTES

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1 Code Sec. 952(a).

2 Code Sec. 952(c)(1).

3 Reg. §1.952-2(a). *See also*, *e.g.*, LTR 200952031 (Sept. 23, 2009) (applying this principle to afford a CFC a dividends-received deduction for computing its subpart F income).

4 *See, e.g.*, Rev. Rul. 76-175 (loss disallowed under Code Sec. 267(a) nonetheless reduces E&P); *Inland Investors, Inc.*, 44 BTA 654, Dec. 11,842 (same for capital losses deduction of which was limited in the year in which the loss was incurred).

5 Code Sec. 952(c)(3).

6 *See* Proposed Reg. §1.951A-2(c) (providing that tested income and loss is determined based on the items of gross income and allowable expense of the CFC for the inclusion year). Apparently, the regulations do not permit a tested loss in non-tested income categories to be re-allocated to tested income or loss.

7 *See* Code Sec. 951A(C)(2)(A).

8 Proposed Reg. §1.951A-2(c)(4)(ii), Example.

9 *See* Reg. §1.954-1(c)(1)(ii).

10 The foreign tax credit consequences are not discussed. If the same income is considered to be both subpart F income and tested income, arguably any foreign income taxes "attributable to" this income should also be taken into account under both Code Secs. 960(a) and 960(d).

11 *See* Code Sec. 952(c)(1)(C).

12 Code Sec. 952(c)(1)(B)(iii) (defining qualified activity).

13 Code Sec. 965(b)(4)(B); Proposed Reg. §1.965-2(d)(2).

14 Preamble, I.C.3.

15 *See* Reg. §1.954-1(d)(3). Considerably more complex rules apply to determine whether the high-taxed exception is met for passive basket foreign personal holding company income which coordinate the high-taxed exception with the grouping rules for the high-tax kick out under Reg. §1.904-4(c). *See* Reg. §1.954-1(d)(3)(ii).

16 *See* NRPM REG-105600-18 (Nov. 30, 2018), Proposed Reg. §1.960-1(d)(2)(ii)(B) and Proposed Reg. §1.960-2(b)(3). With a limited exception not relevant here, the new Proposed Regulations otherwise leave the high-taxed exception unchanged. Proposed Reg. §1.954-1(d)(3).

17 *See* Proposed Reg. §1.960-1(d)(2)(ii)(B); *see also* Proposed Reg. §1.960-1(d)(2)(ii)(E), Example 1 (illustrating that each of foreign base company sales income and foreign base company services income is a separate FTC group/).

18 Reg. §1.954-1(d)(4)(ii).

19 *See* Example in Former Temporary Reg. §1.954-1T(d)(4)(ii), as originally published in T.D. 8618 (Sept. 6, 1995).

20 *See* Proposed Reg. §1.960-2(b)(3)(iii).