



# *Overview of Outbound International Tax Rules*

HBA Tax Section

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# Subpart F Income

## Subpart F – Applicability

- Every U.S. shareholder of a controlled foreign corporation (“CFC”) who owns CFC stock on the last day of the year in which it is a CFC shall include:
  - his pro rata share of the CFC's subpart F income, and
  - the § 956 amount with respect to such shareholder.
- A “U.S. Shareholder” for this purpose is a U.S. person who owns 10 percent or more of the voting power or *value* of the foreign corporation’s stock.
- A CFC is a foreign corporation if more than 50 percent of the voting power or value of the stock is owned by United States shareholders *on any day* during the taxable year.
- Both of the foregoing definitions are determined with the application of attribution principles under Sec. 958.

## Subpart F Income – Definition

- Subpart F income means the sum of:
  - insurance income (as defined in section 953),
  - foreign base company income (as determined in section 954), and
  - Certain other categories including boycott income and income from countries with which the U.S. does not have diplomatic relations.
- Foreign base company income means the sum of:
  - foreign personal holding company income (“FPHCI”);
  - foreign base company sales income (“FBCSal”); and
  - foreign base company services income (“FBCSel”).

# Subpart F Income – Exclusions

- Subpart F income does not include United States effectively connected income (unless exempt or subject to reduced rate of tax under a treaty). § 952(b).
- Subpart F income is limited to current earnings and profits. § 952(c)(1)(A).
- Certain prior year deficits may be taken into account, including deficits of certain members of the same chain of corporations. § 952(c)(1)(B).
- In addition, if subpart F income is reduced by reason of the earnings and profits limitation, any excess of the earnings and profits of such corporation for any subsequent taxable year over the subpart F income is recharacterized as subpart F. § 952(c)(2).

## Subpart F Income – Exclusions

- De minimis rule. If the sum of foreign base company income and the gross insurance income is less than the lesser of-
  - 5 percent of gross income, or
  - \$1,000,000,no part of the gross income for the taxable year is treated as foreign base company income or insurance income.
- Full inclusion rule. If the sum of the foreign base company income and the gross insurance income exceeds 70 percent of gross income, the entire gross income shall be treated as foreign base company income or insurance income (as appropriate).
- High Tax Exception. Foreign base company income and insurance income shall not include any item of income received by a CFC if such income was subject to a foreign effective rate of income tax greater than 90 percent of the maximum corporate tax rate.

## Subpart F Income – FPHCI

- FPHCI includes:
  - Dividends, interest, royalties, rents, and annuities;
  - The excess of gains over losses from the sale or exchange of certain kinds of property, including:
    - Property which gives rise to FPHCI;
    - Interests in a trust, partnership, or REMIC, or
    - Property which does not give rise to any income.
      - However, gains and losses from the sale or exchange of capital assets (defined in sec. 1221(a)(1)) are not taken into account.

## Subpart F Income – FPHCI

- FPHCI includes:
  - The excess of gains over losses from transactions in any commodities, with certain exceptions.
  - Foreign currency gains.
  - Income from notional principal contracts.
  - Payments in lieu of dividends which are made pursuant to a securities lending arrangement.
  - Personal service contracts.



# Subpart F Income – FPHCI Exceptions

- Active Rents:

- FPHCI does not include rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person.
- Rents are considered to be derived in the active conduct of a trade or business if such rents are derived by the CFC from leasing:
  - Property that the lessor has manufactured or produced, or has added substantial value to;
  - Real property for which the lessor regularly performs active and substantial management and operational functions while the property is leased;
  - Property that is leased as a result of marketing functions performed by such lessor, if the lessor maintains and operates an organization in such country.

## Subpart F Income – FPHCI Exceptions

- Active Royalties:

- Royalties are derived in the active conduct of a trade or business if derived by the CFC from licensing-
  - Property that it has developed, created, or produced, or acquired and added substantial value to;
  - Property that is licensed as a result of the performance of marketing functions by such licensor, if the licensor maintains and operates an organization in such foreign country.

## Subpart F Income – FPHCI Exceptions

- Same Country Rents and Royalties:
  - FPHCI does not include rents or royalties if-
    - The payor is a related corporation; and
    - The rents or royalties are for the use of property within the same country where the recipient CFC is organized.
  - Relatedness is defined under section 954(d)(3) as ownership of more than 50 percent of the voting power or value of stock.
  - Exception. Rents or royalties may not be excluded from FPHCI of the recipient to the extent that such payment was deductible against subpart F income of the payor.

## Subpart F Income – FPHCI Exceptions

- Same Country Dividends and Interest:
  - FPHCI does not include dividends and interest received from a related corporation which:
    - is organized under the laws of the same foreign country in which the CFC is organized, and
    - has a substantial part of its assets used in its trade or business located in such same foreign country.
  - Relatedness defined under section 954(d)(3).
  - This exception does not apply to dividends out of e&p earned prior to the shareholder's ownership.

# Subpart F Income – FPHCI Exceptions

## CFC Look-Thru Rule:

- Dividends, interest, rents, and royalties received by a CFC from a related CFC are not be treated as FPHCI if allocable to income which is neither subpart F nor ECI.
- This exception does not apply to the extent such payment creates (or increases) a deficit which may reduce the subpart F income of the payor.
- The CFC look-through rule applies to tax years beginning before January 1, 2026.

## Subpart F Income – FPHCI Exceptions

- Partnership Sale Look-Thru Rule:
  - If a CFC sells an interest in a partnership in which it is a 25-percent owner, the CFC is treated as selling a proportionate share of the partnership's assets.
  - The term "25-percent owner" means a CFC which owns directly 25 percent or more of the capital or profits interest in a partnership.

# Subpart F Income – FBCSaI

## Foreign Base Company Sales Income:

- Income derived in connection with the purchase of property from a related person and its sale to any person, the sale of property to any person on behalf of a related person, the purchase of property from any person and its sale to a related person, or the purchase of property on behalf of a related person where-
  - the property which is purchased (or sold) is manufactured, produced, grown, or extracted outside the country where the CFC is organized, and
  - the property is sold for use outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use outside such foreign country.

## Subpart F Income – FBCSaI

- Property sold by a CFC will generally be considered to be the same property that was purchased regardless whether it is sold in the same form in which it was purchased or as a component part of a manufactured product.



# Subpart F Income – FBCSaI

## Exceptions:

- The personal property purchased by the CFC is substantially transformed prior to sale.
  - If purchased property is used as a component part of property which is sold, the sale will be treated as the sale of a manufactured product if the assembly or conversion of the component parts into the final product involves activities that are substantial in nature.
  - Under a safe harbor, assembly will be considered to constitute manufacturing if the conversion costs account for 20 percent or more of the total cost of goods sold.

# Subpart F Income – FBCSa1

## Exceptions, cont'd:

- The CFC makes a substantial contribution to the manufacturing of the property.
- Regulations approve of the consideration of the following activities in determining whether a CFC made a substantial contribution to manufacturing:
  - Oversight and direction of the activities or process pursuant to which the property is manufactured, produced, or constructed.
  - Activities that are considered in, but that are insufficient to satisfy, the substantial transformation test.

## Subpart F Income – FBCSaI

- Exceptions, cont'd:
  - Material selection, vendor selection, or control of the raw materials, work-in-process or finished goods.
  - Management of manufacturing costs or capacities.
  - Control of manufacturing related logistics.
  - Quality control.
  - Developing, or directing the use or development of, product design and design specifications and intellectual property.

## Subpart F Income – FBCSa1

- Branch Rule: In situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, the income attributable to the carrying on of such activities of such branch shall be treated as income derived by a wholly owned subsidiary of the CFC for purposes of applying the FBCSa1 rules.

## Subpart F Income – FBCSeI

### Foreign Base Company Services Income:

- Income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which
  - are performed for or on behalf of any related person, and
  - are performed outside the country under the laws of which the CFC is organized.

## Subpart F Income – FBCSel

### Substantial Assistance:

- In addition, FBCSel includes assistance furnished by a related person to a CFC, including direction, supervision, services, know-how, financial assistance, and equipment, material, or supplies.
- Under Notice 2007-13, IRS limited the types of activities that constitute substantial assistance to assistance provided by a related U.S. person that satisfies an objective cost test.
- The cost test will be satisfied if the cost to the CFC of the assistance equals or exceeds 80 percent of the total cost to the CFC of performing the services. The substantial contribution/principal element test is eliminated.

# Subpart F Income – Investment in U.S. Property

- Section 956 provides that if a CFC makes certain investments in U.S. property, its U.S. shareholders are required to include an amount of the CFC's earnings and profits in income equivalent to the lesser of its earnings or its tax basis in U.S. property.
- The amt of the CFC's earnings and profits taken into account is the lesser of:
  - The average tax basis of its U.S. property (reduced by liabilities to which such it is subject) as of the close of each quarter over previously taxed income; or
  - Such shareholder's pro rata share of the applicable earnings of such controlled foreign corporation.
- Applicable earnings means the sum of a CFC's current and accumulated profits, reduced by distributions made during the year and by previously taxed income.
  - Distributions made by a CFC for any taxable year are considered first made out of earnings and profits other than § 952(b) earnings and profits (U.S. source ECI).<sup>23</sup>

# Subpart F Income – Investment in U.S. Property

- U.S. property is defined as including:
  - tangible property located in the United States;
  - stock of a domestic corporation;
  - an obligation of a United States person; or
  - any right to the use in the United States certain intangible property which is acquired or developed by the controlled foreign corporation for use in the United States;
- Certain direct and indirect pledges and guarantees;
  - Often a source of contention in financing arrangements.



# Subpart F Income – Investment in U.S. Property

- Exclusions from U.S. Property (partial):
  - Certain obligations of the U.S.;
  - Property located in the U.S. which is purchased for export;
  - Stock or obligations of a domestic corporation which is neither a U.S. Shareholder of the CFC nor owned 25 percent or more by United States shareholders of the CFC;
  - An amount of assets of the CFC equal to the earnings and profits excluded from subpart F income under section 952(b).

# Subpart F Income – Investment in U.S. Property

## New Section 956 Regulations:

- Newly-issued regulations provide that 956 amounts are reduced to the extent that the U.S. shareholder would receive a section 245A deduction if it received a distribution of the 956 amount.
- Under these regulations, due to the broad applicability of section 245A to distributions, a corporate U.S. shareholder will often not realize a 956 inclusion.
- However, section 956 will continue to apply without change to U.S. shareholders other than corporate U.S. shareholders.

# Subpart F Income – Investment in U.S. Property

## New Section 956 Regulations:

- The new section 956 regulations alleviate many of the concerns of U.S. corporate borrowers arising from indirect investments of U.S. property resulting from a pledge of CFC collateral or more than 65% of the shares of a CFC. Potentially allows corporate borrowers to increase borrowing capacity without creating a tax issue.
- On the other hand, there are situations in which a distribution of profits from a CFC to its U.S. corporate shareholder would not benefit from the section 245A DRD, including:
  - Hybrid arrangements;
  - Section 246(c) holding period not met;
  - U.S. source earnings and profits.
- Treas. Reg. § 1.960-2(b)(1) provides that no foreign income taxes are deemed paid under section 960 with respect to a section 956 inclusion.

**GILTI**

# Determining GILTI

- A U.S. shareholder of a CFC must include in income its share of the global intangible low-taxed income of the CFC.
- GILTI is defined as the excess of a shareholder's net CFC tested income for such taxable year, over such shareholder's net deemed tangible income return for such taxable year.

$$\begin{array}{r} \text{CFC Tested Income} \\ - \text{CFC Tested Loss} \\ \hline \text{Net CFC Tested Income} \\ - \text{Net Deemed Tangible Income Return ("DTIR")} \\ \hline = \text{Global Intangible Low-Taxed Income ("GILTI")} \end{array}$$

# Determining GILTI

- Net CFC tested income means the excess of—
  - the *aggregate* of such shareholder's pro rata share of tested income of each CFC, over
  - the *aggregate* of such shareholder's pro rata share of the tested loss of each CFC.
- Tested Income means the CFC's gross income (determined without regard to excluded income) less properly allocable deductions, including taxes.
- Tested Loss means the excess of deductions (including taxes) properly allocable to CFC's gross income over CFC Tested Income.

# Determining GILTI

- Income excluded from Tested Income:
  - Effectively connected income unless excluded from U.S. tax by treaty;
  - Gross income taken into account in determining subpart F;
  - Gross income excluded from subpart F by reason of the high tax exception;
  - Dividends received from a related person; and
  - Foreign Oil and Gas Extraction Income (FOGEI).

# Determining GILTI

- Excluded High Tax Exception Income
  - With the reduction in the U.S. corporate tax rate to 21%, the application of the high tax exception will be much more prevalent ( $.9 * 21\% = 18.9\%$ ).
  - *However, if the Biden proposal becomes law, corporate tax rate will increase to 28%, resulting in less high tax exception income.*



# Determining GILTI

- Apportionment of Deductions
  - For purposes of determining tested income and tested loss, the gross income and allowable deductions of a CFC are determined under the rules of §1.952-2, which generally determines gross income and loss as if the CFC were a domestic corporation.
  - Deductions of a CFC must be allocated and apportioned to gross tested income under the principles of section 954(b)(5). This section determines net FBCI by apportioning expenses to various classes of gross FBCI, such as FBCSal, FSCSel, general category FPHCI and passive category FPHCI.
  - § 1.951A-2(c)(2).

# Determining GILTI

- Net DTIR is defined as the excess of—
  - 10% of the aggregate of such shareholder's pro rata share of QBAI of the CFC, over
  - Interest expense taken into account in determining net CFC tested income to the extent interest income attributable to such expense is not taken into account in determining such shareholder's net CFC tested income.
  - The Code does not specify what interest income is “attributable to” interest expense. This language could be interpreted to require a tracing approach.

# Determining GILTI

- Net Interest Expense for DTIR Purposes
  - The Treasury Department determined that a netting approach to specified interest expense was appropriate. Therefore, regulations provide that a U.S. shareholder's specified interest expense is the excess of its aggregate share of the tested interest expense of each CFC over its aggregate pro rata share of the tested interest income of each CFC.
  - Tested interest expense and tested interest income are generally defined by reference to all interest expense and interest income that is taken into account in determining a CFC's tested income or tested loss.
  - Treas. Reg. §§ 1.951A-4(b)(1) and (2).

# Determining GILTI

- Definition of QBAL
  - QBAL means the average of such corporation's aggregate adjusted bases as of the close of each quarter of such taxable year in specified tangible property used in a trade or business of the corporation, and of a type with respect to which a depreciation deduction is allowable.
  - Specified tangible property means tangible property used in the production of tested income. However, Treas. Reg. § 1.951A-3(b) provides that a tested loss CFC has no QBAL.
  - QBAL basis is determined by using the ADS system (§ 168(g)), and by allocating the depreciation deduction ratably to each day during the taxable period to which such depreciation relates.

# Determining GILTI

- Determining a Shareholder's Share of Tested Items
  - Section 952(c)(1)(A) is applied by increasing the earnings and profits of the controlled foreign corporation by the tested loss of such corporation.
  - Treasury interpreted this provision to mean that any income described in § 952(a) is “taken into account in determining subpart F income” regardless of whether the § 952(c) limitation applies.
- Concomitantly, gross income of CFC does not include any item of gross income that results in the recharacterization of earnings and profits as subpart F income of the CFC under section 952(c)(2).

# Determining GILTI

- Example.
  - In year 1, FS, a CFC, has passive FPHCI of \$100x, a general category loss in FOGEI of \$100x, and e&p of \$0. In Year 2, FS has general category gross income of \$100x and e&p of \$100x.
  - As a result of the e&p limitation, FS has no subpart F income in Year 1. However, gross income for GILTI purposes includes any item of gross income excluded from the subpart F income under section 952(c)(1). Therefore, the \$100x FPHCI of FS in Year 1 is excluded from gross tested income and FS has no gross tested income in Year 1.
  - In Year 2, under section 952(c)(2), FS's general category earnings and profits (\$100x) in excess of its subpart F income (\$0) are recaptured as passive subpart F income. Therefore, FS has passive category subpart F income of \$100x in Year 2. However, gross income for GILTI purposes does not include income that results from the recharacterization of earnings and profits as subpart F income under section 952(c)(2). Therefore, FS has \$100x of general category gross tested income in Year 2.

# Determining GILTI

- Determining a Shareholder's Share of Tested Items
  - A shareholder's pro rata share of tested income, tested loss and QBAI is determined in the same manner as section 951(a)(2) applies to subpart F income.
  - A United States shareholder's pro rata share of any CFC tested item is translated into United States dollars using the average exchange rate for the CFC inclusion year of the controlled foreign corporation.
  - A person is treated as a United States shareholder of a CFC for a taxable year if such person owns stock in the CFC on the last day in the taxable year on which such foreign corporation is a CFC.

# Determining GILTI

- Determining Pro Rata Shares of Income and Loss:
  - Section 951(a)(2) principles determine a shareholder's pro rata share of subpart F income by treating such income as if it had been distributed pro-rata to its shareholders on the last day of its tax year during which it is a CFC.
- A shareholder's pro rata share of the tested loss is determined by treating tested loss as if were an amount of current earnings and profits and applying § 951(a)(2).
- Generally, the hypothetical distribution of tested loss is made solely with respect to the common stock of the tested loss CFC.



# Determining GILTI

- Determining Pro Rata Shares of QBAI:
  - A United States shareholder's pro rata share of the QBAI of a tested income CFC generally bears the same ratio to the total QBAI as the United States shareholder's pro rata share of the tested income bears to total tested income.
  - However, QBAI in excess of 10 times tested income is allocated solely to common stock.

# Determining GILTI

- Applying Collateral Rules:
  - GILTI is treated in the same manner as an amount included in Subpart F income for purposes of applying a number of sections of the Code, including (in part):
    - Section 959, excluding earnings and profits previously subject to tax pursuant to the subpart F rules from further taxation on remittance.
    - Section 961, which increases a U.S. Shareholder's basis in a CFC by the amount of subpart income it recognized, but has not distributed.

# Determining GILTI

- Applying Collateral Rules:
  - Section 962, allowing an individual U.S. Shareholder to elect to be treated as a corporation.
  - Section 1248(d)(1), excluding previously-taxed income from treatment as a 1248 dividend on a disposition of CFC stock.
- IRS was also granted authority to treat GILTI as if it were subpart F income for the purposes of applying certain other provisions. In this regard, regulations provide that a GILTI inclusion amount is treated in the same manner as subpart F for net investment income tax purposes (§ 1411).

# Determining GILTI

- Reallocation of GILTI to CFC's:
  - The portion of GILTI which is treated as being with respect to a CFC is:
    - in the case of a CFC with no tested income, zero, and
    - in the case of a CFC with tested income, the portion of GILTI which bears the same ratio to such GILTI as—
      - The United States shareholder's pro rata amount of the tested income of such CFC, bears to
      - The aggregate amount of such shareholder's pro rata share of the tested income of all CFC's.

# Determining GILTI

- *Example:* USP, a domestic corporation, owns all of the stock of three controlled foreign corporations, CFC1, CFC2, and CFC3. In Year 1, CFC1 has tested income of \$100x, CFC2 has tested income of \$300x, and CFC3 has tested loss of \$50x. Neither CFC1 nor CFC2 has QBAI.
- In Year 1, USP has a GILTI inclusion amount of \$350x (\$100x + \$300x - \$50x). The aggregate amount of USP's pro rata share of tested income from CFC1 and CFC2 is \$400x (\$100x + \$300x). The portion of USP's GILTI inclusion allocable to CFC1 is \$87.50x ( $\$350x \times \$100x / \$400x$ ) and the amount allocable to CFC2 is \$262.50x ( $\$350x \times \$300x / \$400x$ ). No GILTI inclusion amount is allocable to CFC3 because it is a tested loss CFC.
- The portion of the GILTI inclusion allocated to a tested income CFC is translated into the functional currency of the tested income CFC using the average exchange rate for the CFC inclusion year.

# Determining GILTI

- Basis Reductions for Tested Losses:
  - In determining a U.S. shareholder's net CFC tested income, the U.S. shareholder's pro rata share of a tested loss of one CFC may offset the shareholder's pro rata share of tested income of another CFC.
  - Under the statute, use of a tested loss does not reduce the U.S. shareholder's basis in the stock of the tested loss CFC, increase the stock basis of the tested income CFC, or affect the earnings and profits of either the tested loss CFC or the tested income CFC.

# Determining GILTI

- Basis Reductions for Tested Losses:
  - Under proposed regulations, Treasury had determined that the lack of adjustments to stock basis of a tested loss CFC could lead to inappropriate results. In the proposed regulations, Treasury suggested that if a U.S. shareholder's basis in the stock of the tested loss CFC is not reduced to reflect the use of the tested loss to offset tested income taken into account by the U.S. shareholder, the U.S. shareholder could recognize a duplicated loss — either through the recognition of a loss or the reduction of gain — if the stock of the tested loss CFC was disposed of.
- However, this portion of the proposed regulations was not adopted in the final regulations.

# Determining GILTI

- Anti-Abuse: IRS was directed to issue such regulations or other guidance as it determined appropriate to prevent the avoidance of the purposes of the GILTI rules, including regulations or other guidance which provide for the treatment of property if—
  - (A) such property is transferred, or held, temporarily, or
  - (B) the avoidance of the purposes of this paragraph is a factor in the transfer or holding of such property.



# Determining GILTI

- Disregard of basis in temporarily held property.
  - If a tested income CFC acquires tangible property with a principal purpose of reducing the GILTI inclusion amount of a U.S. shareholder, and the tested income CFC holds the property temporarily but over at least the close of one quarter, the specified tangible property is disregarded in determining the acquiring CFC's average adjusted basis in determining QBAI.
  - Specified tangible property held by the tested income CFC for less than a twelve month period that includes at least one quarter close is treated as temporarily held and acquired with a principal purpose of reducing GILTI.
- Treas. Reg. § 1.951A-3(h)

## Biden GILTI Proposals

- Increase of corporate tax rates to 28% would narrow the application of the high tax rule.
- Double the corporate tax rate on GILTI income from the current 10.5% to 21%.
- Eliminate the exemption for QBAI. This effectively turns the GILTI provisions in a full tax inclusion rule.
- Compute GILTI tax (and related foreign tax credits) on a country-by-country basis, rather than using a worldwide average.

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