The Benefits of Subpart F Income

By Lowell D. Yoder

Most of the income derived by a controlled foreign corporation ("CFC") from business operations carried on outside the United States is included in the gross income of its U.S. shareholders, either as Subpart F income or as global intangible low-taxed income ("GILTI").[1] While GILTI generally is treated more favorably, under some circumstances Subpart F income provides a better tax result. The Biden Administration has proposed changes to the international tax rules that would reduce the advantages of GILTI, and thereby increase the circumstances when Subpart F income is preferred.[2]

Tax Rate. A U.S. shareholder generally deducts 50% of the amount of its GILTI inclusion, resulting in an effective tax rate of 10.5%.[3] On the other hand, Subpart F income is subject to the full corporate tax rate of 21%.[4] Thus, generally it is desirable for a CFC's income from business operations to be included in gross income as GILTI rather than as Subpart F income.

Under Biden's tax proposals, the tax rate benefit would shrink. GILTI would be subject to a 21% effective tax rate while Subpart F income would be subject to a 28% tax rate (only a 7 percentage point difference rather than the current 10.5 percentage point difference).[5]

The tax rate benefit for GILTI disappears if the U.S. shareholder has an operating loss for a year. In such case, there is no deduction for GILTI,[6] which results in an effective tax rate of 21%.[7] Under these circumstances, the Biden proposals would effectively impose a 28% tax rate on GILTI.

Amount Taxable. Under the current GILTI regime, in calculating the amount includible in gross income, a U.S. shareholder reduces its net CFC tested income (*i.e.*, non-Subpart F business income) by 10% of the aggregate adjusted bases of tangible property that generated the tested income (referred to as qualified business asset investment).[8] No similar reduction is provided for Subpart F income.

This GILTI rule is beneficial for U.S. shareholders that own CFCs with a material amount of tangible property. However, in some situations this benefit may not be material, such as for a services business that might not own a significant amount of tangible property or for CFCs with losses.

The Biden proposals would repeal this rule for reductions to the GILTI amount. If his proposal is enacted, this GILTI benefit over Subpart F income would be eliminated.

LOWELL D. YODER is a Partner in the Chicago office of McDermott Will & Emery LLP.

Foreign Tax Credits. The U.S. tax on GILTI and Subpart F income can be reduced with credits for foreign income taxes paid on the amounts included in the gross income of the U.S. shareholder.[9] The foreign tax credit rules generally favor Subpart F income.

Only 80% of the foreign income taxes attributable to GILTI can be used as a foreign tax credit, although the U.S. shareholder's income is grossed up by 100% of the foreign taxes.[10] On the other hand, all of the foreign income taxes deemed paid on Subpart F income can be used as a credit, with income grossed up by 100% of the deemed paid taxes.[11]

Any excess credits accompanying a Subpart F income inclusion from business operations generally can be used to offset U.S. tax on other foreign source business income (*e.g.*, royalties received from foreign subsidiaries), and any unused amount can be carried back one year and forward 10 years.[12] In contrast, unused credits in the GILTI foreign tax credit limitation category cannot be carried over.[13]

The disadvantage of the foreign tax credit rules for GILTI would become even greater under the Biden proposals. They would require separate country-by-country limitation calculations for tested income earned in different countries. Thus, the proposal would prevent using excess credits on high-taxed GILTI to offset U.S. tax on low-taxed GILTI, and the excess foreign tax credits would disappear.

High Tax Exception. A high-tax exception election is provided for both GILTI and Subpart F income. The threshold foreign tax rate for eligibility is the same—greater than 18.9% (*i.e.*, 21% × 90%).

The GILTI high-tax exception, however, is much more rigid in application than the exception for Subpart F income. For example, if the election is made for GILTI, it applies to all high-taxed GILTI of all commonly controlled CFCs.[14] On the other hand, the high-tax exception can be applied to separate items of Subpart F income of one or more CFCs.[15]

The high-tax exception for GILTI is provided exclusively by regulations. The Biden Administration has indicated that they are reviewing those regulations, and it is possible the regulations might be revoked. On the other hand, the high-tax exception for Subpart F income has been in the Code since 1986.

Repatriation. There generally is no material difference between the tax consequences of repatriating income subject to the GILTI rules or the Subpart F income rules. The amount of a CFC's tested income taken into account for the GILTI calculation is treated as previously taxed income which is excluded from the income of the U.S. shareholder when repatriated, even though only half of the income is subject to taxation.[16] The same exclusion applies to the repatriation of earnings that were taxed as Subpart F income. In addition, to the extent the earnings of a CFC were not included in the income of a corporate U.S. shareholder (*e.g.*, the CFC's tested income was reduced by tested losses of another CFC), those foreign earnings generally can be repatriated without additional U.S. taxation.[17]

CFC Losses. The GILTI regime permits tested losses (losses from operations that would give rise to tested income) of one CFC owned by a U.S. shareholder to offset tested income of other CFCs owned by the U.S. shareholder.[18] This rule generally allows consolidation of income and losses of the CFCs of a U.S. shareholder for GILTI purposes, and for some companies this rule provides a material benefit.

The calculation of a U.S. shareholder's Subpart F income generally does not permit Subpart F losses of one CFC to offset Subpart F income of another CFC. A limited rule permits deficits of a CFC from business operations that give rise to Subpart F income to offset Subpart F income in the same category of another CFC in the same chain of ownership.[19] For example, Subpart F losses of a CFC from selling products could offset Subpart F income of another CFC in the same chain of ownership derived from selling products, but not offset Subpart F services income of the other CFC.

The Subpart F income computational rules permit carrying Subpart F deficits of a CFC from business operations forward and offset income in the same Subpart F income category in a subsequent year.[20] In the above example, Subpart F losses from selling products could be carried forward as deficits and offset Subpart F income of the CFC in a later year from selling products. In contrast, GILTI losses must be used in the current year or they disappear.

Consolidation of income and losses might be achieved for Subpart F income purposes by operating the businesses in disregarded entities under a holding company. In such situation, losses in a category of Subpart F income of one disregarded entity would reduce income in the same category of another disregarded entity.[21] Also, losses of a disregarded entity in one category of Subpart F income could offset Subpart F income of another disregarded entity in a different category of Subpart F income for the current year.[22] In the latter case, however, recapture rules apply in a subsequent year to the extent of a CFC's income that is not Subpart F income (and the amount recaptured is also tested income for GILTI purposes).[23]

Thus, the GILTI loss consolidation rule generally provides a better result for U.S. shareholders with CFCs

generating overall income and some CFCs with losses. In situations where all CFCs have losses for several years, Subpart F losses provide the benefit of being able to carry losses forward. Also, disregarded entity planning may be used to enhance the benefits of Subpart F losses, but recapture rules must be considered.[24]

Conclusion. There are circumstances when Subpart F income is preferred over GILTI, despite the lower tax rate on GILTI. These circumstances include when a U.S. shareholder has CFCs deriving business income that is subject to a high foreign income tax rate, where a U.S. shareholder has net operating losses, or where the U.S. shareholder's CFCs generate overall losses. If the Biden proposals are enacted, the benefits of GILTI would be reduced, and there would be more situations when Subpart F income provides a better result.[25]

ENDNOTES

1 Code Secs. 951 and 951A.

2 *See* The U.S. Department of the Treasury, *The Made in America Tax Plan* (Apr. 2021), *available at https://home.treasury.gov/system/files/136/MadeInAmericaTaxPlan_Report.pdf. See also* Yoder, *The International Tax Horizon*, 47 INT'L TAX J. 3 (Jan.–Feb. 2021).

3 Code Sec. 250(a)(1)(B).

4 Code Sec. 11. GILTI and Subpart F income also may be subject to state income taxes.

5 During his campaign, Biden proposed a rule that would treat business income from "round-tripping" transactions as Subpart F income and subject to a 10% sur-tax (*i.e.*, a 30.8% tax rate), which for some taxpayers might have materially reduced the amount of CFC business income even eligible for GILTI. This proposal was not included in the Treasury's recent summary of President Biden's tax proposals.

6 Code Sec. 250(a)(2).

7 *See* Yoder, *U.S. NOLs and GILTI*, 49 TAX MGMT. INT'L J. 371 (Jul. 10, 2020).

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

9 Code Sec. 901.

10 Code Secs. 960(d) and 78.

11 Code Secs. 960(a) and 78.

12 Code Sec. 904(c) and (d).

13 Code Sec. 904(c) (last sentence).

14 Reg. §1.951A-2(c)(7).

15 Code Sec. 954(b)(4); Reg. §1.954-1(d). The Treasury has issued proposed regulations that would combine the two elections and conform the Subpart F income high-tax election to the GILTI high-tax election. REG-127732-19, 85 FR 44650 (July 23, 2020). *See* Yoder, *The GILTI and Subpart F Income High-Tax Exception(s)*, 46 INT'L TAX J. 3 (Nov.–Dec. 2020).

16 Code Secs. 959(a) and 951A(f)(1)(A).

17 *See* Code Sec. 245A (100 percent dividends received deduction).

18 Code Sec. 951A(c)(1)(B); Reg. §1.951A-1(c)(2)(ii).

19 Code Sec. 952(c)(1)(C).

20 Code Sec. 952(c)(1)(B).

21 Reg. §1.954-1(c)(1).

22 Code Sec. 952(c)(1)(A).

23 Code Sec. 952(c)(2); Reg. §1.951A-2(c)(4)(iii)(B). Other tax consequences of operating in a disregarded entity structure also must be considered (*e.g.*, the Subpart F income same-country exceptions).

24 *See* Yoder, *CFC Losses: Limited Tax Benefits*, 49 TAX MGMT. INT'L J. 444 (Sep. 11, 2020); Yoder, *Subpart F Losses*, 46 INT'L TAX J. 3 (Sep.–Oct. 2020).

25 *See* Yoder, *A Few GILTI Planning Tips*, 44 INT'L TAX J. 3 (Nov.–Dec. 2018) (describing planning ideas for converting a CFC's tested income into Subpart F income).