Executive summary

On 13 September 2018, the United States (US) Treasury Department and Internal Revenue Service issued highly-anticipated proposed regulations (REG-104390-18) under the global intangible low-taxed income (GILTI) regime. The regulations package also includes proposed amendments and additions to the “subpart F income” and consolidated return regulations (collectively, the Proposed Regulations).

The Proposed Regulations include provisions:

- Describing the manner of calculating the fundamental elements underlying the GILTI inclusion (e.g., “tested income” and “QBAI”)
- Revising the definition of “pro rata share,” for purposes of inclusions of both GILTI and subpart F income
- Setting out anti-abuse rules in respect of certain basis “step-up” transactions for purposes of the GILTI regime
- Adopting a hybrid “aggregate/entity” approach to US partnerships and their partners for purposes of the GILTI regime
- Generally requiring a consolidated group to compute its GILTI inclusion as a group, rather than member-by-member
This EY Tax Alert contains:

- Background information on the GILTI regime, including the relevant statutory provisions (immediately following)
- A detailed discussion of the Proposed Regulations
- Notable implications of the Proposed Regulations

This EY Tax Alert does not address the proposed changes to the consolidated return regulations. A forthcoming Tax Alert will analyzes that topic in detail.

Background

The GILTI regime was enacted as part of the law commonly known as Tax Cuts and Jobs Act (the Act) in December 2017. More specifically, the Act added new Sections 250 and 951A to the Internal Revenue Code; it revised Section 960. Section 951A requires a “United States shareholder” (US shareholder) of any “controlled foreign corporation” (CFC) to include the US shareholder’s GILTI for each tax year – computed based on the CFC’s attributes – currently in gross income. The GILTI inclusion is similar in certain respects to an inclusion of “subpart F income” under Section 951.

Section 250 generally permits a corporate US shareholder a deduction equal to 50% of its GILTI inclusion (resulting in an effective US federal income tax rate of 10.5%). Section 960 treats a corporate US shareholder as paying itself a portion of the non-US income taxes paid by its CFCs, and therefore allows the US shareholder to take those taxes as a credit against its GILTI tax liability under Section 901 (subject to certain other limitations).

The Proposed Regulations do not address Sections 250 and 960; additional regulations (forthcoming) will do so. The Proposed Regulations also do not address many of the questions left open under the statute regarding the interplay between the GILTI rules and other code sections, although some of these questions are raised in the preamble. Treasury notes that taxpayers have raised questions on the application of the dividends received deduction under Section 245A, the anti-hybrid rules of Section 267A and the interest limitation in Section 163(j) to the calculation of tested income and tested loss. Rather than resolve these questions in the Proposed Regulations, Treasury has noted that these items will be addressed in future guidance.

Consistent with the definition of tested income under Section 951A(c)(2), the Proposed Regulations exclude from tested income any subpart F income of a CFC that is excluded from foreign base company income or insurance income solely by reason of the high-tax exception. Accordingly, the Proposed Regulations do not exclude (or permit an exclusion) from tested income any non-subpart F income that is subject to a high amount of tax.

Section 951A

This Section describes the provisions of Section 951A. As described in greater detail in the next section, the Proposed Regulations modify some of these provisions.

Under Section 951A, a US shareholder’s GILTI inclusion (the amount of which the Proposed Regulations refer to as the “GILTI inclusion amount”) for a tax year equals the excess (if any) of the US shareholder’s “net CFC tested income” over its “net deemed tangible income return.” Thus formulated, GILTI represents an amount deemed to be “excessive” as compared to a specified return.

A person is treated as a US shareholder of a CFC only if that person owns (directly or indirectly) stock in the CFC on the last day in the tax year of the foreign corporation on which the foreign corporation is a CFC. A foreign corporation is treated as a CFC for any tax year if the foreign corporation was a CFC at any time during that tax year.
**Net CFC tested income.** A US shareholder’s “net CFC tested income” for a tax year equals the excess (if any) of: (i) the US shareholder’s aggregate “pro rata share” of the “tested income” of each of its CFCs for the tax year over; (ii) the US shareholder’s aggregate pro rata share of the “tested loss” of each of its CFCs for the tax year. (For purposes of Section 951A, a US shareholder’s “pro rata share” of a relevant item of a CFC is determined under Section 951(a)(2) “in the same manner” as that Section applies to subpart F income, taken into account in the tax year of the US shareholder (the “US shareholder inclusion year” under the Proposed Regulations) within or with which the tax year of the CFC (the “CFC inclusion year” under the Proposed Regulations) ends.) By definition, a CFC in a CFC inclusion year can have “tested income” or a “tested loss,” but not both:

- A CFC has “tested income” for a CFC inclusion year to the extent: (i) the CFC’s gross income for the tax year (“gross tested income” under the Proposed Regulations), excluding items of gross income in certain categories (“excluded gross income”), exceeds; (ii) the deductions (including taxes) “properly allocable” (under rules similar to those of Section 954(b)(5)) to the gross tested income (“allowable deductions” under the Proposed Regulations). A CFC with tested income in a CFC inclusion year is a “tested income CFC” for that year under the Proposed Regulations.

- A CFC has a “tested loss” for a tax year to the extent: (i) its allowable deductions exceed; (ii) its gross tested income. A CFC with a tested loss in a CFC inclusion year is a “tested loss CFC” for that year under the Proposed Regulations.

The categories of excluded gross income (ignored in calculating the tested income or loss of a CFC for a CFC inclusion year) are:

- US-source items of income that are effectively connected with the CFC’s conduct of a trade or business within the United States, provided that the rate of US federal income tax to which the item is subject is not reduced by treaty

- Gross income “taken into account in determining the part F income” of the CFC

- Gross income excluded from “foreign base company income” or “insurance income” (within the meaning of Sections 954 and 953, respectively) under the so-called high-tax exception of Section 954(b)(4)

- Dividends received from “related persons” (within the meaning Section 954(d)(3))

- “Foreign oil and gas extraction income” (within the meaning of Section 907(c)(1))

Section 951A also provides a coordination rule that is intended to deny a double benefit resulting from tested losses. Under that coordination rule, a tested loss CFC increases its “earnings and profits” (E&P) by the amount of its tested loss for purposes of applying the subpart F current year E&P limitation contained in Section 952(c)(1)(A) (the “tested loss add-back”). There is no indication that tested loss must offset tested income to be subject to this rule.

**Net deemed tangible income return.** A US shareholder’s “net deemed tangible income return” for a US shareholder inclusion year equals the excess of: (i) 10% of the US shareholder’s aggregate pro rata share of the “qualified business asset investment” (QBAI) of each of its CFCs (for the CFC’s inclusion year ending with or within the US shareholder inclusion year) over; (ii) the amount of interest expense of each of the US shareholder’s CFCs that constitutes an allowable deduction in the US shareholder inclusion year, to the extent that the interest income attributable to the expense is not taken into account in determining the US shareholder’s net CFC tested income. The Proposed Regulations generally refer to the amount in item (ii) as “specified interest expense.”

**QBAI.** A CFC’s QBAI for a tax year means the average of its aggregate adjusted bases (for US federal income tax purposes, as measured as of the close of each quarter of the tax year) in “specified tangible property” used by the CFC in a trade or business and for which a deduction is allowable under Section 167. “Specified tangible property” generally means any tangible property “used in the production of tested income.” Tangible property used by a CFC in the production of tested income and income that is not tested income is treated as specified tangible property in the same proportion as the tested income produced “with respect to” the property bears to the total gross income produced “with respect to” the property. The adjusted basis in any property is determined by using the alternative depreciation system under Section 168(g) and by allocating the depreciation deduction ratably to each day during the period in the tax year to which the depreciation relates.

If a CFC holds an interest in a partnership at the close of a CFC inclusion year, the CFC includes as part of QBAI its “distributive share” of the partnership’s adjusted basis in tangible property held by the partnership to the extent the property:

- Is used in a trade or business of the partnership

- Is of a type for which a deduction is allowed under Section 167 (depreciation)

- Is used in the production of tested income

If a CFC holds an interest in a partnership at the close of a CFC inclusion year, the CFC includes as part of QBAI its “distributive share” of the partnership’s adjusted basis in tangible property held by the partnership to the extent the property:

- Is used in a trade or business of the partnership

- Is of a type for which a deduction is allowed under Section 167 (depreciation)

- Is used in the production of tested income
A CFC’s distributive share of the adjusted basis of any property of a partnership is the CFC’s “distributive share of income with respect to such property.”

Section 951A(d)(4) directs the Treasury Department to issue such regulations or other guidance as it determines appropriate “to prevent the avoidance of the purposes of” Section 951A(d) (defining QBAI), including regulations or other guidance providing for the treatment of property if: (i) the property is transferred, or held, temporarily; or (ii) the “avoidance of the purposes of” Section 951A(d)(4) is a factor in the transfer or holding of the property (the QBAI anti-abuse direction of Section 951A(d)(4)).

Treatment as subpart F income for certain purposes. A GILTI inclusion amount will be treated “in the same manner” as subpart F income for purposes of certain enumerated Sections, including (among others) Sections 959, 961, 1248(b)(1), and 1248(d)(1). (The Treasury Department is directed to provide rules treating a GILTI inclusion amount as subpart F income for other provisions of the Internal Revenue Code in which the determination of subpart F income must be made at the CFC level.) For the purposes of the enumerated sections, if an amount from a CFC is taken into account in determining a US shareholder’s GILTI, then the portion of the GILTI treated as being with respect to that CFC is:
- For a CFC with no tested income, zero
- For a tested income CFC, the portion of the GILTI bearing the same ratio to the GILTI as the US shareholder’s pro rata amount of the CFC’s tested income bears to the aggregate of the shareholder’s share of the tested income of each CFC

Effective date. Under the Act, Section 951A is effective for tax years of foreign corporations beginning after 31 December 2017, and for tax years of US shareholders with or within which those tax years of foreign corporations end.

Conference Report disregard rule. In connection with the enactment of the Act, the House of Representatives passed a bill, and the Senate passed an amended version. A Committee of Conference convened to resolve the differences between the two bills. In so doing the Committee released a “Joint Explanatory Statement” on 15 December 2017 (the Conference Report). In the Conference Report, in describing the intended operation of Section 951A and under the heading of “Regulatory authority to address abuse,” the Committee stated:

The conferees intend that non-economic transactions intended to affect tax attributes of CFCs and their U.S. shareholders (including amounts of tested income and tested loss, tested foreign income taxes, net deemed tangible income return, and QBAI) to minimize tax under [Section 951A] be disregarded. For example, the conferees expect the [Treasury Department] to prescribe regulations to address transactions that occur after the measurement date of post-1986 earnings and profits under amended [Section] 965, but before the first [tax] year for which new [Section] 951A applies, if such transactions are undertaken to increase a CFC’s QBAI.

Hereinafter, this is referred to as the “Conference Report disregard rule.” Other than the QBAI anti-abuse direction of Section 951A(d)(4) – which appears limited to QBAI – Section 951A itself contains no provision authorizing or directing the Treasury Department to effect the Conference Report disregard rule.

Detailed discussion of Proposed Regulations
The following discussion describes the Proposed Regulations with a particular focus on the provisions that deviate from the statute.

Prop. Reg. Section 1.951A-1 provides general rules regarding a US shareholder’s GILTI inclusion amount; ensuing Sections include specific rules as to the calculation of tested income, tested loss, QBAI, tested interest expense, and tested interest income (each, a CFC tested item). This Section describes three important rules in Prop. Reg. Section 1.951A-1: (i) the relevant date for pro rata share determination; (ii) the calculation of a US shareholder’s pro rata share of CFC tested items; and (iii) the definition of specified interest expense.

Relevant date for pro rata share determination. Prop. Reg. Section 1.951A-1 also introduces and defines other new terms, including:
- “CFC inclusion date,” meaning the last day of a CFC inclusion year on which a foreign corporation is a CFC
- “Section 958(a) stock,” meaning stock of a CFC directly or indirectly owned by a US shareholder within the meaning of Section 958

Unlike the statute, which calculates tested income and tested loss based on the tax year of the CFC that ends with or within the US shareholder’s year, the Proposed Regulations require inclusion based on the CFC inclusion date, irrespective of the CFC’s year end.
Pro rata share rules. Consistent with the statute, the Proposed Regulations provide rules to determine a US shareholder’s pro rata share of each CFC tested item based on the pro rata share rules of Section 951(a) and the regulations thereunder (including new Prop. Reg. Section 1.951-1; the “Section 951(a)(2) rules”). Prop. Reg. Section 1.951A-1, however, modifies the application of the Section 951(a)(2) rules to CFC tested items in certain important respects. In general, a US shareholder’s pro rata share of each CFC tested item is generally independently of its pro rata share of any other CFC tested item. The amount of a US shareholder’s pro rata share of any CFC tested item is translated into US dollars using the average exchange rate for the CFC inclusion year.

Prop. Reg. Section 1.951-1(e). Current Treas. Reg. Section 1.951-1(e) specifies that a US shareholder’s pro rata share of subpart F income of a CFC for a particular CFC tax year is determined consistently with a “hypothetical distribution” of the CFC’s E&P in that year (current-year E&P) in which all shares of stock of the CFC participate. For a CFC with multiple classes of stock (including preferred stock), special rules — largely mechanical — apply to calculate the extent to which each class participates. Prop. Reg. Section 1.951-1(e) retains the hypothetical distribution rule. It replaces the special, mechanical rules, however, with a “facts-and-circumstances” test and a “principal purpose” anti-abuse rule.

Further, Prop. Reg. Section 1.951-1(e) changes the total amount deemed distributed in the hypothetical distribution. Prop. Reg. Section 1.951-1(e) determines not only a US shareholder’s pro rata share of a CFC’s subpart F income, but also its pro rata share of the CFC’s tested income and loss. Tested income and loss are taxable income concepts that, unlike subpart F income, are not limited by current-year E&P. In view of this fact, to permit the hypothetical distribution rule to operate simultaneously and consistently with respect to subpart F income (on the one hand) and tested income and loss (on the other), Prop. Reg. Section 1.951-1(e) specifies that the amount of the hypothetical distribution is the greater of: (i) the CFC’s current-year E&P (determined under Section 964); and (ii) the sum of the subpart F income (increased by reason of any tested loss add-back) and the CFC’s tested income for the year.

Tested income. Generally, a US shareholder’s pro rata share of tested income from a tested income CFC is determined in the same manner as its pro rata share of subpart F income under the Section 951(a)(2) rules. However, tested loss that has been allocated to any class of stock in a prior CFC inclusion year generally is first allocated to each such class to the extent of the prior tested loss allocations.

QBAI. A US shareholder’s pro rata share of QBAI of a tested income CFC for a CFC inclusion year generally bears the same ratio to the CFC’s total QBAI for that year as the US shareholder’s pro rata share of tested income of the CFC to the total tested income of the CFC for that year. However, a special rule applies in case of “excess QBAI,” namely, the amount by which a CFC’s QBAI in a particular CFC inclusion year exceeds 10 times the amount of the CFC’s tested income in that year. Excess QBAI is allocated pursuant to a special rule solely to the CFC’s common stock.

Tested loss. A US shareholder’s pro rata share of tested loss of a tested loss CFC is generally determined by treating the amount of the tested loss as the current-year E&P of the CFC under the Section 951(a)(2) rules and applying the hypothetical distribution rule such that only the common stock of the CFC participates. Preferred stock can be allocated a portion of a tested loss, however, to the extent (in general) that the tested loss has reduced the CFC’s E&P below the amount necessary to satisfy any accrued but unpaid dividends with respect to the preferred stock.

In addition, common stock with a “liquidation value” (determined as of the beginning of the CFC inclusion year) of zero does not participate in the hypothetical distribution if there is at least one other class of equity with a liquidation preference relative to the common stock. In such instances the next most junior class of stock participates to the extent of its (positive) liquidation value, then the next most junior class, and so on.

Tested interest expense and tested interest income. A US shareholder’s pro rata share of a CFC’s tested interest expense is the amount by which the tested interest expense reduces (as an allowable deduction) the US shareholder’s pro rata share of tested income (or increases the US shareholder’s pro rata share of tested loss, or both). A US shareholder’s pro rata share of tested interest income is the amount by which the CFC’s tested interest income increases (as an item included in gross tested income) the US shareholder’s pro rata share of tested income (or reduces the US shareholder’s pro rata share of tested loss, or both).

Specified interest expense. The Proposed Regulations adopt a netting approach for purposes of determining the net deemed tangible income return. Specifically, under this approach, the net deemed tangible return is the US shareholder’s deemed tangible return (10% of QBAI) less “specified interest expense.” “Specified interest expense” means the excess (if any) of the aggregate of the US shareholder’s pro rata share of “tested interest expense” of each CFC over the aggregate...
of the US shareholder’s pro rata share of the “tested interest income” of each CFC. Prop. Reg. Section 1.951A-4 defines a CFC’s tested interest expense and tested interest income (each discussed below) for purposes of determining a US shareholder’s specified interest expense.

**Prop. Reg. Section 1.951A-2: Tested income and tested loss**

For purposes of computing tested income and tested loss, gross income and allowable deductions of a CFC are determined under the rules of Reg. Section 1.952-2. The Proposed Regulations provide that allowable deductions are allocated and apportioned to gross tested income under the same Section 954(b)(5) principles that apply in allocating and apportioning deductions for purposes of subpart F. The Proposed Regulations further provide that gross tested income is treated as a single separate category and a single item of gross income. 

**Exclusions from gross tested income under the “high-tax exception.”** Consistent with the statute, the Proposed Regulations provide that gross tested income does not include items of CFC gross income excluded from foreign base company income and insurance income by reason of electing the “high-tax exception” of Section 954(b)(4). The Proposed Regulations, along with the associated preamble, clarify that such exclusion from gross tested income only applies to income that is excluded from subpart F solely by reason of an election to exclude the income under the high-tax exception. Accordingly, the exclusion from gross tested income would not apply to any income that would not otherwise be subpart F income, or is excluded from subpart F income due to exceptions other than the high-tax exception (e.g. Section 954(c)(6) look-through).

**Nonapplication of the Section 952(c) E&P limitation in computing tested income and tested loss.** Consistent with the statute, the Proposed Regulations provide that gross tested income excludes gross income taken into account in determining a CFC’s subpart F income. In determining the amount of gross income “taken into account” in determining subpart F income, the Proposed Regulations disregard Section 952(c), which limits subpart F income to a CFC’s current E&P. As a result, subpart F income is not limited to current E&P for purposes of determining the subpart F gross income excluded from gross tested income. This also means that tested gross income can give rise to both subpart F income and gross tested income in the year the subpart F is recaptured under Section 952(c)(2).

**Anti-abuse rule in Prop. Reg. Section 1.951A-2(c)(5).**

The Proposed Regulations include an anti-abuse rule that disregards certain “deductions or losses” for purposes of determining tested income and tested loss of a CFC. In general, a deduction or loss is disallowed to the extent that it is “attributable” to basis in “specified property” resulting from certain transfers from 1 January 2018, through the close of the transferor CFC’s last tax year that is not a CFC inclusion year (the “gap period,” which exists only as to a transferor CFC with a fiscal tax year). Specified property is a type of property for which a deduction is allowable under Section 167 (i.e., depreciation) or Section 197 (i.e., amortization). That is, the anti-abuse rule in Prop. Reg. Section 1.951A-2(c)(5) is not limited to property eligible to constitute QBAI. An exception applies to basis resulting from an otherwise covered transfer, to the extent (in general) that the transfer results in gain that is subject to US federal income taxation.

**Prop. Reg. Section 1.951A-3: Qualified business asset investment**

Prop. Reg. Section 1.951A-3 restates the codified definition of QBAI as the average of a tested income CFC’s aggregate adjusted bases in “specified tangible property” that is used in the CFC’s trade or business and is a type for which a deduction is allowed under Section 167. “Specified tangible property” generally means tangible property used in the production of gross tested income. The Proposed Regulations explicitly provide that a tested loss CFC has no QBAI and that none of the tangible property of a tested loss CFC is specified tangible property for purposes of Section 951A.

Specified tangible property of a tested income CFC includes the adjusted basis of “dual-use property” based on the same proportion that the gross tested income bears to the total gross income produced (the dual-use ratio). “Dual-use property” is property that produces gross tested income and gross income that is not gross tested income – for example, subpart F income. When an item of specified tangible property produces directly identifiable income (for example, a machine packaging a specific product), the dual-use ratio is calculated using that specified tangible property’s gross tested income and total gross income. When the specified tangible property does not produce directly identifiable income (for example, an office building), the dual-use ratio is the CFC’s total gross tested income compared to its total gross income.

Section 951A(d)(3) provides that the adjusted basis in any property, for purposes of Section 951A, should be determined using the alternative depreciation system (ADS) under
Section 168(g) and by allocating the depreciation deduction ratably to each day during the period in the tax year to which the depreciation relates. The Proposed Regulations clarify that ADS should be applied to all property for purposes of Section 951A, even if that property was placed into service before 22 December 2017. The rule applies as if ADS had been used from the date the property was placed in service.

The Proposed Regulations provide special rules for short tax years. When a tested income CFC has a CFC inclusion year of less than 12 months, the CFC’s QBAI is the aggregate adjusted bases in its specified tangible property at the close of each full quarter divided by four (quarters in a year), plus the aggregate adjusted bases in the specified tangible property at the close of each short quarter, multiplied by the number of days in the short quarter over 365 (days in a year).

A tested income CFC that holds a partnership interest at the end of the CFC’s inclusion year should increase its QBAI by its share of the partnership’s adjusted basis in the “partnership specified tangible property” (partnership QBAI). The CFC’s share is calculated using the partnership QBAI ratio, which, like the dual-use ratio described earlier, varies based on whether the partnership specified tangible property produces directly identifiable gross income or whether gross income is not directly identifiable. The Proposed Regulations define “partnership specified tangible property” consistent with the definition in Section 951A(d)(3). The partnership QBAI is determined using the average of the partnership’s adjusted basis as of the close of each quarter. The partnership’s adjusted basis in specified tangible property and the portion taken into account in determining a tested income CFC’s partnership QBAI is determined by applying the principles applicable to tested income CFCs described previously.

Anti-abuse rules in Prop. Reg. Section 1.951A-3(h)(1) and (2). Consistent with the QBAI anti-abuse direction of Section 951A(d)(4), Prop. Reg. Section 1.951A-3 includes two distinct anti-abuse rules. Each rule disregards certain basis amounts in specified tangible property for purposes of computing a tested income CFC’s QBAI. First, under Prop. Reg. Section 1.951A-3(h)(1), the disregarded basis amount is the entire basis in specified tangible property of a tested income CFC if the tested income CFC acquires the property with a principal purpose of reducing a US shareholder's GILTI inclusion and the property is held temporarily (but over at least one quarter-close). For this purpose, specified tangible property held for less than 12 months generally is treated as temporarily held and acquired with the relevant principal purpose. Second, under Prop. Reg. Section 1.951A-3(h)(2), the disregarded basis amount is generally basis resulting from "gap period" transfers. This second rule is very similar to the anti-abuse rule in Prop. Reg. Section 1.951A-2(c)(5) (discussed previously), although Prop. Reg. Section 1.951A-3(h)(2) applies only to property eligible to constitute QBAI. A similar exception applies to basis attributable to gain that is subject to US federal income taxation.

Prop. Reg. Section 1.951A-4: Tested interest expense and tested interest income

Prop. Reg. Section 1.951A-4 defines a CFC’s tested interest expense and tested interest income for purposes of determining a US shareholder’s specified interest expense. Tested interest expense means interest expense paid or accrued by a CFC that is taken into account to determine the tested income or tested loss of that CFC, reduced by the CFC’s qualified interest expense. Tested interest income means interest income included in the CFC’s gross tested income, reduced by the CFC’s qualified interest income.

The Proposed Regulations broadly define interest expense and interest income. Interest expense means any expense or loss treated as interest expense under the Code or its regulations, and any other expense or loss incurred to secure the use of funds when the time value of money is the predominant consideration. Interest income means any income or gain treated as interest income under the Code or its regulations, and any other income or gain recognized to secure the forbearance of funds when the time value of money is the predominant consideration.

The Proposed Regulations also provide special rules (qualified interest expense and qualified interest income) for US shareholders that own one or more CFCs engaged in the active conduct of a financing or insurance business. Under the special rules, certain interest expense and certain interest income related to a CFC’s active financing or insurance business is excluded from that CFC’s tested interest expense and tested interest income, respectively.

General example

Facts. USS, a domestic corporation, wholly owns CFC1, CFC2 and CFC3. USS, CFC1, CFC2 and CFC3 all use the calendar year as their tax year. CFC1, CFC2 and CFC3 have the following CFC tested items for their respective 2018 CFC inclusion years:
A partner may be a US shareholder partner with respect to one partnership CFC of a US shareholder partner but not others. When this is the case, the US shareholder partner's distributive share of the GILTI inclusion amount is determined without regard to tested items of partnerships with respect to which the partner is a US shareholder partner.

The following example and analysis, based on Prop. Reg. Section 1.951A-5(g), Example 3, illustrates the application of Prop. Reg. Section 1.951A-5 to a US shareholder partnership with one US shareholder partner and one non-US shareholder partner.

**Facts.** X Corp and Y Corp are domestic corporations that own 40% and 60%, respectively, of PRS, a domestic partnership. PRS owns 20% of the single class of stock of FC1 and 10% of the single class of stock of FC2. In addition, Y Corp owns 100% of the single class of stock of FC3. FC1, FC2 and FC3 are controlled foreign corporations. X Corp, Y Corp, PRS, FC1, FC2 and FC3 all use the calendar year as their tax year. In 2018, FC1 has $100x of tested income, FC2 has $80x of tested income, and FC3 has $10x of tested loss.

**Analysis.** USS’s net CFC tested income is $250x ($100x + $200x – $50x). USS's deemed tangible income return is $15x (10% of QBAI from tested income CFCs or 10% of $150x). USS’s specified interest expense is ($5x) (tested interest expense of $20x less tested interest income of $15x). USS’s net deemed tangible return is $10x ($15x deemed tangible return less $5x specified interest expense). Therefore, USS’s GILTI inclusion amount is $240x ($250x net tested income less $10x net deemed tangible return).

**Prop. Reg. Section 1.951A-5: Domestic partnerships and their partners**

A domestic partnership is a US person under Section 7701(a)(4) and is therefore a US shareholder under the statute. However, the statute does not provide rules for the treatment of domestic partnerships that are US shareholders of CFCs.

Prop. Reg. Section 1.951A-5 adopts a hybrid approach (i.e., neither a pure entity approach nor pure aggregate approach) for a domestic partnership that is a US shareholder of one or more CFCs (a “US shareholder partnership”). Specifically, the regulations provide different rules for partners of the US shareholder partnership that are also US shareholders (as defined in Section 951(b)) of a CFC owned by the partnership and partners that are not US shareholders with respect to the CFC.

Under the hybrid approach, a US shareholder partnership determines its GILTI inclusion amount under the general rules, but generally only for purposes of determining the distributive share of that amount of a partner who is not a US shareholder partner. When the partner is a US shareholder partner with respect to a CFC, the partner takes into account its pro rata share of the CFC tested items. The partner's pro rata share is determined based on its Section 958(a) indirect ownership of the CFC, treating the domestic partnership as a foreign partnership. The same rules apply to tiered domestic partnerships.
Accordingly, Y Corp’s net CFC tested income is $2x ($12x - $10x) and Y Corp has no net deemed tangible income return. Y Corp’s GILTI inclusion amount for Year 1 is $2x. In addition, for purposes of determining Y Corp’s distributive share of PRS’s GILTI inclusion amount, Y Corp’s distributive share of PRS’s GILTI inclusion amount is determined without regard to PRS’s pro rata share of any item of FC1. PRS’s GILTI inclusion amount computed solely with respect to FC2 is $8x ($80x x 0.10). Y Corp’s distributive share of PRS’s GILTI inclusion amount is $4.80x ($8x x 0.60) in Year 1.

The Proposed Regulations require a US shareholder partnership to provide each partner its distributive share of the partnership’s GILTI inclusion amount (if any) and, with respect to a US shareholder partner, the partner’s proportionate share of each of the CFC tested items of each CFC owned by the partnership. The information is required to be provided on or with the partner’s K-1 for each US shareholder inclusion year of the partnership.

**Prop. Reg. Section 1.951A-6: Treatment of GILTI inclusion amount and adjustments to E&P and basis related to tested loss CFCs**

Prop. Reg. Section 1.951A-6 restates the statutory provision that GILTI is treated as subpart F income for certain specified Code provisions such as Sections 959 and 961. Additionally, the Proposed Regulations provide that a GILTI inclusion amount is treated in the same manner as an amount included under Section 951(a)(1)(A) for purposes of applying Section 1411 (tax on net investment income). For purposes of these rules, the Proposed Regulations use the statutory formula to allocate the GILTI inclusion amount back to individual CFCs with tested income taken into account in determining a US shareholder’s GILTI inclusion amount. The portion of the GILTI inclusion amount 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 of the tested income CFC.

Section 267(a)(3)(B)(i) provides a similar rule for original issue discount (OID) on a debt instrument held by a related CFC. The Proposed Regulations allow a deduction under Sections 163(e)(3)(B)(i) and 267(a)(3)(B) for an item taken into account in determining the net CFC tested income of a US shareholder. Thus, to the extent that the payment is taken into account as tested income of the recipient CFC, the deduction can generally be accrued before actual payment. There is a special rule for a US shareholder that is a domestic partnership.

Consistent with the statute, the Proposed Regulations provide for an increase of the E&P of a tested loss CFC equal to amount of that CFC’s tested loss when computing the subpart F Section 952(c)(1)(A) E&P limitation amount of the tested loss CFC. Importantly, no exception limits the tested loss CFC’s E&P increase to when the tested loss is “used” to offset tested income of a related CFC.

**Basis adjustments for the use of tested losses.** The Proposed Regulations provide a complex set of rules intended to prevent corporate US shareholders from receiving a double benefit for a single tested loss that would result if a domestic corporation benefiting from the tested losses of a tested loss CFC could also benefit from those losses upon a direct or indirect taxable disposition of the tested loss CFC. The rules apply to a domestic corporation (other than a regulated investment company or a real estate investment trust) that is a US shareholder of a CFC that has a “net used tested loss amount.” Specifically, a US shareholder must reduce the adjusted basis of the stock immediately before the disposition by the amount of the domestic corporation’s net used tested loss amount with respect to the CFC that is attributable to such stock. Notably, if the basis reduction exceeds the adjusted basis in the stock immediately before the disposition, the excess amount is treated as gain from the sale of the stock and recognized in the year of the disposition.

The term “net used tested loss amount” means, with respect to a domestic corporation and a CFC, the excess (if any) of: (i) the aggregate of the domestic corporation’s “used tested loss amount” with respect to the CFC for each US shareholder inclusion year, over; (ii) the aggregate of the domestic corporation’s “offset tested income amount” with respect to the CFC for each US shareholder inclusion year. The amount of the used tested loss amount and the offset tested income amount vary depending on whether the domestic corporation has net CFC tested income for the US shareholder inclusion year.

To illustrate with an example: CFC1 has a $100 tested loss in one year that offsets $100 of tested income from CFC2 for purposes of determining a US shareholder’s net CFC tested income for that year. In the next year, CFC1 has $20 of tested
The Proposed Regulations require, for purposes of calculating a CFC’s tested income, a US shareholder to compute the CFC’s taxable income as if it were a domestic corporation. While not unexpected, this represents a significant change for many US shareholders, which have focused solely on their CFCs’ E&P for purposes of calculating the subpart F income.

The Proposed Regulations include a number of important anti-abuse provisions. In particular, the Proposed Regulations implement the QBAI anti-abuse direction of Section 951A(d)(4) with two new anti-abuse provisions. Beyond that direction, but consistent with the Conference Report disregard rule, the Proposed Regulations also include a broader anti-abuse rule to deny certain deductions (e.g., amortization) for purposes of calculating tested income and tested loss. Companies with fiscal-year CFCs that have implemented, or are considering implementing, restructuring transactions should carefully consider how the anti-abuse rules apply to those transactions.

Many of the provisions in the Proposed Regulations add substantially to the compliance obligations of US shareholders of CFCs. For example, complying with the basis adjustment rules for a disposition of a CFC with historic “used tested losses” will create significant new complexities for US shareholders in tracking attributes across their ownership period.

In some respects, the Proposed Regulations are notable for what they do not address (e.g., deemed paid taxes in connection with the GILTI inclusion amount). Accordingly, the consequences of many of the provisions in the Proposed Regulations cannot yet be fully appreciated. Nevertheless, taxpayers that may be adversely impacted by any of the provisions in the Proposed Regulations should consider submitting comments to Treasury during the 60-day comment period.

**Endnote**

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
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