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In this article, the author explores how subpart F can be beneficial to U.S. multinationals when considered against the potential future state of the global intangible low-taxed income regime.

I. Introduction

In May Treasury released the green book.[1] As expected, the international proposals include significant changes to the global intangible low-taxed income provisions[2] of section 951A.

The effect of the proposed changes combined with the more unpleasant aspects of GILTI in its current state could result in some very unfavorable consequences for taxpayers. If the first iteration of GILTI had U.S. multinationals kicking the tires on converting tested income to subpart F, the proposed changes, if enacted, should have them revisiting their analyses.

This article examines how subpart F can be beneficial to U.S. multinationals when considered against the potential future state of the GILTI regime.

II. GILTI Proposal

The green book proposals keep the general premise of the GILTI regime intact, at least in computing the underlying tested income. But the changes at the U.S. shareholder level are significant.

First, the 10 percent return on qualified business asset investment will be repealed. Second, the deduction for GILTI under section 250(a)(1)(B) is slated to be reduced from 50 percent to 25 percent. This change, combined with the proposed 28 percent U.S. corporate tax rate, will increase the GILTI effective rate to 21 percent. Because the 20 percent reduction to creditable foreign taxes in section 960(d) is unchanged, the break-even foreign effective tax rate (ETR) is increased to 26.25 percent with a 28 percent corporate tax rate. In the case of a 25 percent corporate tax rate (as suggested by some moderate Democrats in Congress), the break-even foreign ETR is roughly 23.5 percent. Third, the total inclusion at the shareholder level and the underlying foreign tax credit limitation will be computed jurisdiction-by-jurisdiction (or "country-by-country"). The inclusion of a jurisdictional component is intended to prevent cross-crediting between high- and low-tax jurisdictions, as well as prevent the use of tested losses in one country from offsetting tested income in another.

This jurisdictional computation could result in stranded tested losses in jurisdiction A being

[1] Treasury, "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" (May 1, 2021).

[2] The proposal does not refer to the new regime as GILTI. Rather, it states that the change is to a global minimum tax. For simplicity, this article will continue to use GILTI.

unable to offset income in jurisdiction B. Further, while a CbC FTC limitation is not new to the IRC,[3] the previous iterations of a per-country FTC did not exist in conjunction with a regime like GILTI that requires a yearly inclusion, which is almost a certainty in most fact patterns if jurisdictional losses are potentially stranded across dozens of countries. Many open issues remain, especially in the mechanics of sections 861 and 904.[4] Finally, the proposal will revoke the ability to make a GILTI or subpart F high-tax election.

In addition to significantly increasing the overall complexity of the United States' international tax regime, the changes to GILTI will have a negative effect on most, if not all, U.S. multinational corporations.

III. Subpart F

What is notable about the green book proposals is that the only change to subpart F is the inability to make a high-tax election, placing that aspect at least in parity with the identical GILTI proposal. However, there are no proposals that require the per-country calculation of subpart F or the related FTC.[5]

This dichotomy could lead to some proactive structuring to convert GILTI to subpart F income. This planning is not new. Shortly after enactment of GILTI as part of the Tax Cuts and Jobs Act, taxpayers realized that in many cases, subpart F income was preferable to GILTI, especially before the Treasury regulations providing for the GILTI high-tax exception were finalized in 2020.[6] Taxpayers could make a high-tax election on subpart F income, turning foreign base company income into earnings and profits generally eligible for a 100 percent section 245A dividends received deduction on repatriation. While it may no longer be possible to make a high-tax election on subpart F income under the green book proposal, the differences between subpart F and GILTI may still make subpart F preferable in many cases.

IV. Senate Finance Proposals

On August 25 the Senate Finance Committee issued its own proposals for both GILTI and subpart F.[7] Those proposals are similar to the ones in the green book, but they include a few notable exceptions. First, they would exclude high-taxed income from GILTI completely. High-taxed income is income taxed at a foreign effective tax rate in excess of the GILTI effective tax rate (for example, the section 11 rate * GILTI after the section 250 deduction). For that purpose, foreign taxes are determined after the reduction in section 960(d), which is to be determined.

Of more importance for this article however are the proposals for subpart F. Specifically, subpart F is revised to be mechanically like GILTI, including a high tax exclusion and CbC grouping of income.

If enacted as proposed, with a mandatory high tax exclusion and CbC calculation, the results of the following examples will be similar, if not identical, to the GILTI results.

V. Examples

The remainder of this article explores examples illustrating how subpart F may be advantageous. To keep the examples clear, some simplifying assumptions have been made. For all examples, the U.S. corporate tax rate is assumed to be 25 percent.

A. Example 1

To start with a simple example, assume that a U.S. corporation has one controlled foreign corporation. The CFC operates in a jurisdiction with a 17 percent tax rate. The CFC also has

[3]The exact history and mechanics of this concept are beyond the scope of this article. Suffice it to say that a per-country limitation has ranged from mandatory to elective to finally repealed. Also, to dispel the notion that a per-country limit is unique to Democratic administrations, the Reagan administration proposed reintroducing the per-country limitation as part of the Tax Reform Act of 1986. *See* White House, "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," at 389 (May 1985).

[4]Understanding how expense apportionment will work is the biggest unaddressed item, along with the treatment of separate limitation and overall foreign losses.

[5]Notably, it is also proposed that the branch basket will be done per country.

[6]T.D. 9902.

[7]Also included were changes to the branch basket, BEAT, and FDII.

$720,000 of after-tax income and pays $150,000 in tax. For purposes of the FTC limitation, the United States allocates and apportions $100,000 of interest expense and $25,000 of selling, general, and administrative expense (SG&A). The GILTI and FTC calculations are shown in Table 1.

Table 1

	GILTI
Income	$720,000
Taxes/Section 78	$150,000
Inclusion	$870,000
Interest	($100,000)
SG&A	($25,000)
Section 250 Deduction	($217,500)
Income	$527,500
Tax	$131,875
FTC	$120,000
Residual U.S. Tax	$11,875

In this case, the foreign ETR is low enough that there is residual U.S. tax on GILTI.

Assuming the same facts, except that the CFC is a full inclusion entity under section 954(b)(3)(B), the results are shown in Table 2.

Table 2

	Subpart F
Income	$720,000
Taxes/Section 78	$150,000
Inclusion	$870,000
Interest	($100,000)
SG&A	($25,000)
Section 250 Deduction	—
Income	$745,000
Tax	$186,250
FTC	$150,000
Residual U.S. Tax	$36,250

In both cases, there is residual U.S. tax, and the GILTI inclusion is preferable to subpart F because of the 25 percent section 250 deduction on GILTI. A switch to a more realistic fact pattern, however, shows how the results can change.

B. Example 2

In Example 2, the U.S. taxpayer operates in countries A and B. Country B has a tested loss for U.S. tax purposes with the assumed expense allocation shown in Table 3.

Table 3

	GILTI — Country A	GILTI — Country B
Income	$720,000	($500,000)
Taxes/Section 78	$150,000	—
Inclusion	$870,000	—
Interest	($100,000)	($100,000)
SG&A	($25,000)	—
Section 250 Deduction	($217,500)	—
Income	$527,500	($100,000)
Tax	$131,875	—
FTC	$120,000	—
Residual U.S. Tax	$11,875	—
Excess FTC	—	—
FTC C/F	—	—

Under the per-country limitation,[8] the tested loss at the Country B CFC provides no benefit to Country A's tested income. Globally, the U.S. taxpayer has $220,000 of net income, but under the proposal, the Country B loss does not reduce the Country A income or create any asset to be used in the next year.[9] Also, the $100,000 of interest expense apportioned to Country B GILTI is essentially not deductible. This result comes with one caveat: It assumes the per-country loss of $100,000 does not create a separate limitation loss (SLL) under section 904(f)(5). It seems reasonable that the loss does indeed create an SLL that reduces the Country A income, although the green book is silent on this point.

[8]The section 861 consequences between Country A and Country B are assumed to illustrate the point.

[9]*See* reg. section 1.952-2(c)(5)(ii).

If the loss is treated as an SLL, the loss most likely reduces the Country A income with the result shown in Table 4.

Table 4

	GILTI — Country A	GILTI — Country B
Income	$720,000	($500,000)
Taxes/Section 78	$150,000	—
Inclusion	$870,000	—
Interest	($100,000)	($100,000)
SG&A	($25,000)	—
Section 250 Deduction	($217,500)	—
Income	$527,500	($100,000)
SLL	($100,000)	$100,000
Adjusted Income	$427,500	—
Tax	$106,875	—
FTC	$106,875	—
Residual U.S. Tax	—	—
Excess FTC	$13,125	—
FTC C/F	—	—

While the residual U.S. tax is eliminated in this scenario, the excess FTCs in the Country A GILTI basket may not be carried forward and are lost, and the application of section 861 creates a cost of $25,000 (25 percent * $100,000 expenses). While a future SLL that can be recovered in the Country A GILTI basket could be helpful in the future, it does nothing to help with the $13,125 of lost credits in the current year. It is possible that, on a net present value basis, the $13,125 current-year cost is exceeded by the future benefit from SLL recapture in Country A. This outcome is far from certain, however, and it is likely that the SLL recapture results in lost Country B taxes. For example, assume that in year 2 Country B has $200,000 of after-tax income, and $15,000 of SG&A is allocated to Country B GILTI (see Table 5).

Table 5

	GILTI — Country A	GILTI — Country B
Income	$720,000	($500,000)
Taxes/Section 78	$150,000	—
Inclusion	$870,000	—
Interest	($100,000)	($100,000)
SG&A	($25,000)	—
Section 250 Deduction	($217,500)	—
Income	$527,500	($100,000)
SLL	($100,000)	$100,000
Adjusted Income	$427,500	—
Tax	$106,875	—
FTC	$106,875	—
Residual U.S. Tax	—	—
Excess FTC	$13,125	—
FTC C/F	—	—

The result here is not taxpayer friendly. All the Country A taxes are credited, but there is residual U.S. tax because of the low tax on the Country A income. Country B also has excess credits of $31,250, proving the SLL recapture in year 2 does not even out the results over time.

Back to year 1 though. Assume that it is possible to restructure so that the gross income at both Country A and Country B is foreign base company income.[10] The U.S. taxpayer also restructures the share ownership and moves the Country B CFC under the Country A CFC and makes a check-the-box election effective on

[10] While certainly not necessary to get some benefit, full inclusion under section 954(b)(4)(B) would generally maximize the benefit of converting tested income into foreign base company income.

January 1 of the current tax year.[11] The following result may be possible (see Table 6).

Table 6

	Subpart F
Income	$220,000
Taxes/Section 78	$150,000
Inclusion	$370,000
Interest	($200,000)
SG&A	($25,000)
Section 250 Deduction	—
Income	$145,000
Tax	$36,250
FTC	$36,250
Residual U.S. Tax	—
Excess FTC	$113,750
FTC C/F	$113,750

The change in results is obvious. The current U.S. tax on the foreign operations is zero. Further, the U.S. taxpayer has an FTC carryforward of $113,750. It is possible that a valuation allowance will be necessary in this fact pattern. However, if the U.S. taxpayer has low-taxed foreign-source income from royalties or interest, for example, the excess FTCs generated can be used to reduce the cost of that income.

The subpart F result is possible because the green book does not provide for a per-country limitation for subpart F, thereby allowing for the income and taxes of the CFC and the disregarded entity to be blended. Of course, this result is achieved through simplification of the facts in this case. For example, if the CFC also had some tested income (that is, not full inclusion), the allocation and apportionment of deductions and taxes between the CFC's tested income and subpart F income could make the result less (or possibly more) favorable.

C. Example 3

Example 3 builds on Example 2 with the addition of another CFC in Country C. The Country C CFC has an ETR of 15 percent, based on the pillar 2 rate being discussed by the G-7. Country B is higher taxed with a tax rate of 25 percent, while Country A's tax rate is 17 percent. For simplicity, section 861 is applied pro rata to the $200,000 of interest and $50,000 of SG&A.[12] (See Table 7.)

Table 7

	GILTI — Country A	GILTI — Country B	GILTI — Country C
Income	$720,000	$1,500,000	$850,000
Taxes/Section 78	$150,000	$500,000	$150,000
Inclusion	$870,000	$2,000,000	$1,000,000
Interest	($44,961)	($103,359)	($51,680)
SG&A	($11,240)	($25,840)	($12,920)
Section 250 Deduction	($217,500)	($500,000)	($250,000)
Income	$596,298	$1,370,801	$685,401
Tax	$149,075	$342,700	$171,350
FTC	$120,000	$342,700	$120,000
Residual U.S. Tax	$29,075	—	$51,350
Excess FTC	—	$57,300	—
FTC C/F	—	—	—

The results here are $80,425 of residual U.S. tax, $57,300 of lost excess credits, and a cost of about $32,300 caused by the cost allocation and apportionment to Country B.[13] This result is certainly bad, and the example illustrates how the per-country limitation can compound the issues as more countries are added. In this case, the two low-tax countries (A and C) result in the U.S. taxpayer having residual U.S. tax that would otherwise not exist if the tested income at all the

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[11] This transaction is most likely a reorganization under section 368(a)(1)(D). Carrying out this transaction during the tax year may lessen the benefits as some of the loss will end up in the target's last tax year and create a hovering deficit. *See generally* section 381(c)(2) and reg. section 1.367(b)-7(d)(2).

[12] The apportionment of interest expense can make a significant difference to the results. Accordingly, as with all post-TCJA analysis, detailed modeling is recommended.

[13] $129,199 of expenses * 25 percent.

countries was combined as under current law. Aside from possible changes to section 861 methods, no additional income or taxes from a fourth country, regardless of this additional country's ETR, will decrease the residual tax on countries A and C or the excess credits at Country B.

If, however, the income is all subpart F, the results are much different (see Table 8).

Table 8

	Subpart F
Income	$3,070,000
Taxes/Section 78	$800,000
Inclusion	$3,870,000
Interest	($200,000)
SG&A	($50,000)
Section 250 Deduction	—
Income	$2,652,500
Tax	$663,125
FTC	$663,125
Residual U.S. Tax	—
Excess FTC	$136,875
FTC C/F	—

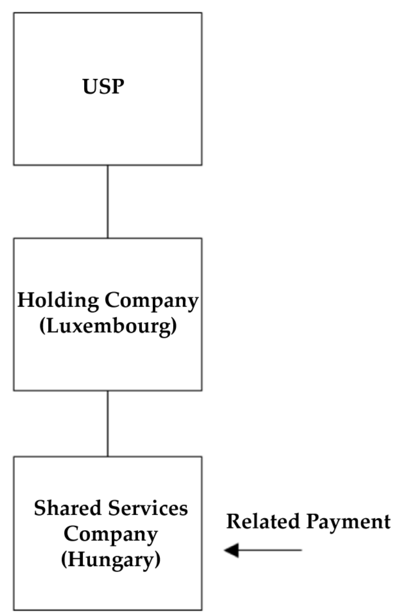
In this case, the residual U.S. income is zero, and the excess credits create a carryforward that can be used in the future. As is the case with Example 2, it is possible that a valuation allowance will be necessary against the carryforward. Some taxpayers may view this subpart F result, compared with the GILTI result, as a distinction without a difference. However, having an asset with a 10-year life with no additional U.S. cash tax seems like a more favorable position regardless of the Accounting Standards Codification Topic 740 results.

The above examples all make several simplifying assumptions (for example, assuming full inclusion at the CFC). They illustrate the point, though, that if global taxation with a per-country limitation is the direction ahead, then perhaps the best option is to consider when self-help via subpart F provides a better result.

VI. Possible Structures

If it is determined that subpart F is a more optimal solution than GILTI, the next question becomes how to generate it. With section 954(c)(6) extended through 2025,[14] related-party royalties, dividends, and interest will not constitute foreign base company income in many cases. Third-party income of this type is possible but most likely in limited amounts and possibly in the passive basket. Foreign base company sales and services income remain viable options. For example, assume a U.S. taxpayer has a shared services center that provides services for other members of the group (see Figure 1).

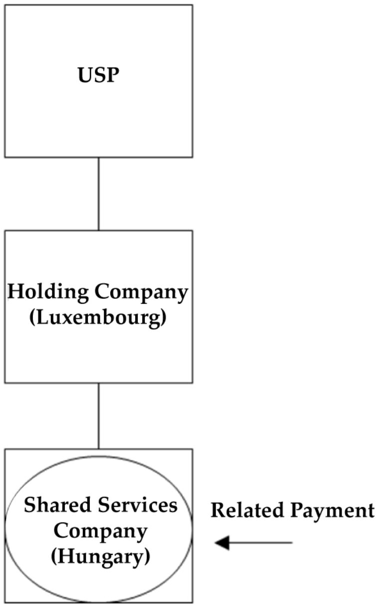
Figure 1



A simple check-the-box election can convert the Hungarian entity's services income into foreign base company services income (see Figure 2).

[14] Consolidated Appropriations Act, 2021 (P.L. 116-260).

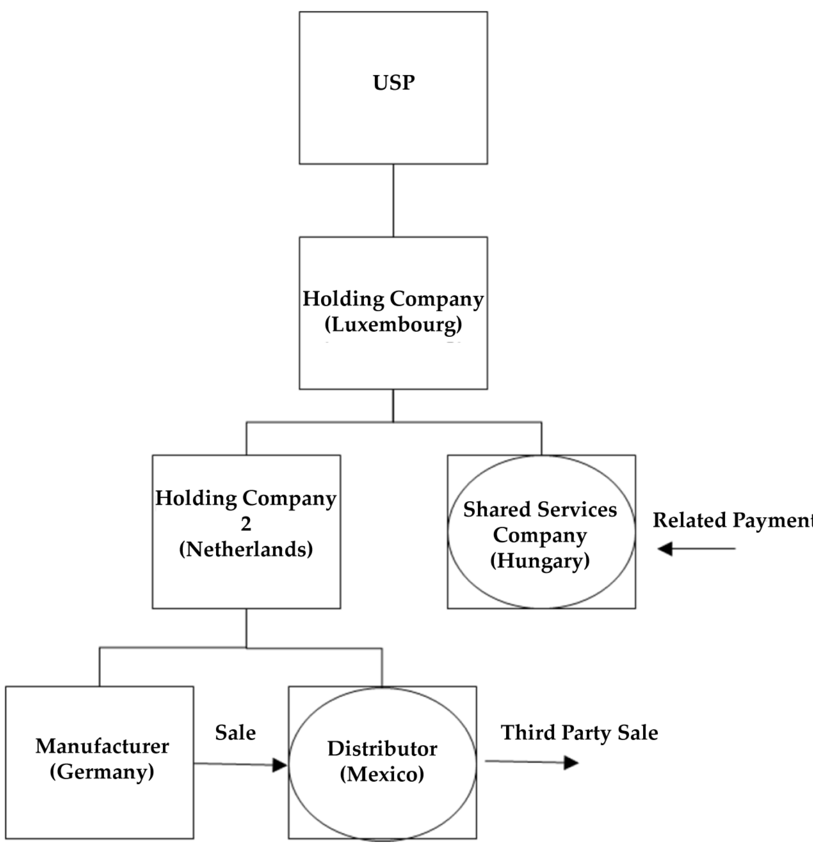
Figure 2



In this fact pattern, care must be given to determining the subpart F income's ETR. Hungary has a 9 percent statutory tax rate, leaving lots of room for incremental U.S. tax. However, if there is a distributor in a higher tax jurisdiction — a Dutch holding company with a Mexican distributor, for example — simple planning can be done to convert that income to foreign base company sales income, resulting in a more blended tax rate. The structure could look like Figure 3.

The manufacturing CFC can be anywhere. It can even be a U.S. manufacturer. The key is that the purchase is from a related party and the sale is to an unrelated party outside the Netherlands (achieved in this case via a check-the-box election). Conversely, the distributor can purchase from an unrelated party and sell to a related party. Assuming the Hungarian shared services result in pretax income of $750,000 with a 9 percent ETR,

Figure 3



the Mexican distributor has pretax income of $2 million with a 30 percent ETR, and the U.S. tax rate is 25 percent, the results could be as shown in Table 9.

Table 9

	Subpart F — Luxembourg	Subpart F — Netherlands	Total
Income	$682,500	$1,400,000	$2,082,500
Taxes/ Section 78	$67,500	$600,000	$667,500
Inclusion	$750,000	$2,000,000	$2,750,000
Interest	—	—	($150,000)
SG&A	—	—	($25,000)
Income	—	—	$2,575,000
Tax	—	—	$643,750
FTC	—	—	$643,750
Residual U.S. Tax	—	—	—
Excess FTC	—	—	$23,750
FTC C/F	—	—	$23,750

Much is dependent here on the incomes between the two jurisdictions.[15] If the Hungarian income is higher, then the excess FTC is less, and if the Mexican income is higher, the excess FTC is higher.

As with the other examples, the facts are assumed to fit the narrative. The point remains that subpart F may lessen some of the GILTI sting. Companies may also be better positioned to generate the types of subpart F income mentioned above than they realize because of the prevalence of holding companies. Supply chain realignment also provides an opportunity to evaluate the universe of possible transactions. Certainly, supply chain changes resulting from COVID-19 provide another opportunity to assess what is possible.

The options may not be endless, but they could be plentiful, perhaps including the mixing of tax rates under different holding companies to blend ETRs.

VII. Conclusion

There are many permutations to think through and model as taxpayers evaluate the merits of electing into a global subpart F regime versus the mandatory GILTI regime. To state one of Murphy's tax laws: Subpart F is prevalent except when you really need it. My examples assumed these structures were just lying around and can be tweaked with check-the-box elections. That is unlikely to be the case. However, to the extent companies considered subpart F planning previously and discarded it as not providing benefits worth the effort, that equation will change significantly with a per-country computation under section 951A. ■

[15] The foreign branch rule also needs to be considered in these fact patterns. *See* section 954(d)(2) and the accompanying regulations.