GILTI High Tax Exception Considerations

Since the introduction of the Global, Intangible, Low-Taxed Inclusion ("GILTI") in the 2017 Tax Cuts and Jobs Act ("TCJA"), taxpayers have eagerly awaited the Treasury's position on whether the High Tax Exception Election ("HTE Election") under IRC §954(b)(4) would apply. On July 23, 2020, the Treasury released final and proposed regulations providing taxpayers the option to affirmatively elect to apply the high tax exception to exempt both subpart F (under IRC §951) and GILTI inclusions (Under IRC §951A) from US federal income tax if the effective tax rate on that income stream was greater than 90% of the corporate income tax rate (90% of corporate tax rate is currently 18.9%). However, determining the effective tax rate is not as simple as it once was. It is important to determine the effective tax rate of Subpart F and GILTI separately as their eligibility for the HTE Election is determined using different accounting methods. Earnings and Profits ("E&P") have been historical used for determining deemed dividends such as Subpart F and IRC §956 inclusions. However, GILTI introduced a new concept for CFCs referred to as "net CFC tested income"[1] which largely mirrors US taxable income principles. This brings into play certain adjustments, such as officer's compensation and §163(j) interest limitations, which previously were not necessary to consider. Therefore, it is possible to end up with a scenario where either Subpart F income or GILTI tested income qualifies for the HTE Election, but the other does not.

While electing the HTE Election and excluding income from the US tax net may seem to be a very simple decision, the complications in the GILTI regime make it far less clear cut than it seems on the surface. In this article, we will walk through some of the key benefits and pitfalls to consider in making the HTE Election.

Benefits of the HTE Election

Tax-Free Repatriation of Foreign Earnings

The HTE Election is a significant benefit for owners of foreign corporations, including the potential to earn and repatriate foreign earnings back to the United States in a tax-free manner for C corporations. This favorable result may be accomplished through the combination of the HTE Election and the IRC §245A Dividends Received Deduction ("DRD").

Example 1:

US Holdco, a United States C Corporation, is a holding corporation, whose only source of income in Year 1 is GILTI from its investment in CFC 1 of $1,000,000. Assume CFC 1 has an effective tax rate of 30% and is therefore eligible for the HTE Election in Year 1.

[1] See IRC §951A(c)

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	Scenario 1: **No Election**	**Scenario 2:** **HTE Election**
GILTI Inclusion	$1,000,000	$0
50% IRC §250 GILTI Deduction	($500,000)	$0
US Taxable Income	$500,000	$0
US Income Tax Liability	**$105,000**	**$0**

As illustrated above, making the HTE Election creates Year 1 tax savings of $105,000, but does leave $1,000,000 of untaxed E&P at the CFC. This amount will be taxable to an individual US shareholder[2] upon distribution, but it allows the US shareholder to pay the tax after receiving the cash. As illustrated further below, a C corporation would not have to pay tax following a distribution.

Example 1 (Continued):

CFC 1 makes a $1,000,000 cash distribution to US Holdco in Year 2. Under prior law, the untaxed E&P in Scenario 2 would be taxed as a dividend when distributed in Year 2. However, coupled with the deduction under IRC §245A, the E&P is distributed with a full deduction permitted.

	Scenario 1: **No Election**	**Scenario 2:** **HTE Election**
Dividend Income from Distribution of Foreign Earnings	$0	$1,000,000
IRC Section 245A Dividends Received Deduction	$0	($1,000,000)
Taxable Dividends	$0	$0
US Income Tax Liability	**$0**	**$0**

In both scenarios, the actual cash distribution has no impact on U.S. taxable income for the year of distribution. When no election is made in Scenario 1, the $1,000,000 is Previously Taxed

[2] Per IRC §951(b), "US shareholder" is defined as a US person (as defined in IRC §957(c)) who owns (within the meaning of IRC §958(a) or IRC §958(b)) at least 10% of the total voting power or value of all classes of stock of a foreign corporation.

Earnings & Profits ("PTEP") under IRC §959 since the income was already taxed under the GILTI regime so it is distributed without further U.S taxable Income impact. In Scenario 2 when the HTE Election is made, the $1,000,000 is also distributed without further U.S taxable Income impact[3] due to the deduction allowed under IRC §245A. Unlike Scenario 1 however, the distribution income is not taxed as it is earned in Year 1, resulting in permanent tax savings

Generating Net Operating Losses ("NOLs")

Although GILTI has no direct carryover attributes, the HTE Election can provide benefits to taxpayers even when no current year tax savings are expected. It is easy at first glance to think that because GILTI does not carry to the next year, there is no reason to spend time on the HTE election when a US loss exceeds the GILTI inclusion. While it may not impact the current year taxable income, failing to make the election may leave money on the table in the form of missed NOLs.

Example 2:

US Holdco, a United States C Corporation, has a taxable loss before GILTI of $1,000,000 and GILTI Inclusion from its investment in CFC 1 of $1,000,000.

	Scenario 1: **No Election**	**Scenario 2:** **HTE Election**
GILTI Inclusion	$1,000,000	$0
US Taxable Loss Before GILTI Inclusion	($1,000,000)	($1,000,000)
US Taxable Loss	$0	($1,000,000)
US Income Tax Liability	$0	$0
NOL Carryforward	**$0**	**($1,000,000)**

In Scenario 1, we see that there is no tax liability because the US losses eliminate the GILTI inclusion for the year. The taxpayer probably saved some time and money not having to prove out effective tax rates or creating the HTE Election statement. However, as a result of making the HTE Election in Scenario 2, the taxpayer generates an NOL totaling $1,000,000, creating a permanent long-term tax savings of $210,000 at the current rate (possibly more depending on the tax rate when the NOL is utilized). A taxpayer may benefit even more from amending tax

[3] We advise discussing with tax counsel the implications of local country withholding taxes on PTEP distributions and potential FTC available on your US federal return. Depending on the nature of the E&P to which the withholding taxes apply, there are special rules which require deeper planning and analysis around certain items, such as timing of distributions and treaty application.

returns for tax years 2018[4] or 2019 due to the CARES act, which allows for a carryback to years when the tax rate was 35%.

Eliminating Foreign Tax Credit ("FTC") Limitation Exposures

In the General Explanation of Public Law 115-97, the Joint Commission on Taxation explains that the objective of the combination of the IRC §250 GILTI deduction and the GILTI FTC limitations is to create an effective worldwide tax rate on GILTI of at least 13.125% (set to increase after 2025) for C corporation US shareholders. In theory, this should mean GILTI Inclusion from any CFC paying more than 13.125% tax in the foreign country would be effectively eliminated using the IRC §250 GILTI deduction and FTCs. As any international practitioner has experienced, this is rarely the case in practice due to IRC §250 deduction and IRC §904 FTC limitations. Due to these limitations, it is possible that even GILTI Inclusion from a CFC with a local tax rate far exceeding 13.125% would still result in an increase in tax liability. Electing the HTE Election in a scenario where there are potential IRC §250 deduction and IRC §904 FTC limitations eliminates the "leakage" of tax liability resulting from the inability to fully utilize an IRC §250 deduction or FTC.

Potential Pitfalls of the HTE Election

While it may seem making the HTE Election is obvious, there are a few items to consider which may result in the HTE Election being detrimental to the taxpayer. Below we will explore a few federal concerns as well as potential state and local considerations which may result in a worse tax position under the HTE election.

Attributes Which Can Offset Tested Income from Low-Taxed CFCs

When a taxpayer is deciding whether to make the HTE Election, it is important to consider the overall effect that removing the attributes of a single CFC may have on the aggregate tax impact of the entire group. If a taxpayer is a US shareholder of multiple CFCs, the GILTI determination requires netting the pro-rata share of income, losses, net Deemed Tangible Income Return ("DTIR"), and foreign income taxes. As a result of this netting, there may be instances where it is more favorable not to make the HTE Election from a U.S. income tax perspective and allow the attributes of a high-taxed CFC to remain in the tested income group. For example, the DTIR from a high-taxed CFC may be enough to eliminate tested income of both the high-taxed CFC and a low-taxed CFC in the same aggregate group.

[4] Note that amending for the HTE Election is only available for 24 months from the un-extended tax deadline unlike the normal 36 months. Therefore, the majority of 2018 amendments will be **due April 15th, 2021** (it is unclear at this time if the IRS decision on March 17, 2021 to extend the April 15, 2021 deadline for individuals will apply to amendments). Additionally, keep in mind larger refunds ($2 million for individuals, $5 million for C corporations) will have to undergo an approval process by both the Joint Committee on Taxation and the IRS.

Example 3:

US Holdco, a United States C Corporation, is a holding corporation with 100% IRC §958(a) ownership in CFCs 1 & 2. CFC 1 generates $1,000,000 of pre-tax tested income, pays $300,000 of tax in its local country, and has a net DTIR of $2,000,000. CFC 2 generates tested income of $3,000,000 with no DTIR or foreign income taxes.

	Scenario 1: **No Election** (CFC 1 & CFC 2 are taxed)	**Scenario 2:** **HTE Election** (Only CFC 2 is taxed)
Net Tested Income (After Taxes)	$3,700,000	$3,000,000
Less: Deemed Tangible Income Return	($2,000,000)	($0)
GILTI Inclusion	$1,700,000	$3,000,000
IRC §78 Gross Up	$300,000	$0
GILTI Inclusion and IRC §78 Gross Up	$2,000,000	$3,000,000
50% IRC §250 GILTI Deduction	($1,000,000)	($1,500,000)
Net GILTI Inclusion	$1,000,000	$1,500,000
US Income Tax Liability	**$210,000**	**$315,000**

In the above example, CFC 1 had an effective tax rate on tested income of 30% ($300,000 of taxes related to tested income divided $1,000,000 of pre-tax tested income) and CFC 2 had an effective tax rate on tested income of 0% ($0 of taxes related to tested income divided $3,000,000 of pre-tax tested income). Therefore, only CFC 1 was eligible for exclusion when the HTE Election is made. Because CFC 1 no longer has tested income and is now treated as a tested-loss CFC under Treas. Reg. §1.951A-2, the excess DTIR which eliminates CFC 1's net tested income was not available for use against the tested income of CFC 2. Ultimately, the result is that the HTE election increased the tax due by $105,000.

In addition to DTIR, the taxpayer should also consider the effect of the Election on foreign tax credits. The foreign income taxes paid by one CFC may allow for enough FTC to partially or fully offset the GILTI inclusion generated by another CFC.

Example 3 (Continued):

Continuing from the previous example and assuming the foreign tax credit from CFC 1 is not limited:

	Scenario 1: **No Election** (CFC 1 & CFC 2 are taxed)	**Scenario 2:** **HTE Election** (Only CFC 2 is taxed)
US Income Tax Liability	$210,000	$315,000
Foreign Tax Credit (80% GILTI Foreign Income Taxes)	($240,000)	($0)
GILTI Tax Liability	**$0**	**$315,000**

Because effective rate of the group after DTIR is higher than 13,125% ($300,000 / $2,000,000 = 15% ETR), the foreign tax credit fully covers the tax liability for an ultimate tax liability difference of $315,000. This example demonstrates that with multiple CFCs, the potential attributes from the high-taxed entities may be more useful included in the GILTI determination rather than removing the tested income with the HTE Election

IRC §956 Returns

Thought to be a thing of the past when the House version of the TCJA bill eliminated it, IRC §956 survived the cut and ended up being included in the final law. Even then, most practitioners viewed it as only applying in narrow circumstances due to the expectation that most E&P would be converted to PTEP under GILTI, leaving no significant untaxed E&P to be exposed to IRC §956. The allowance of the HTE Election by the final regulations can significantly broaden the application of IRC §956 due to the increase in E&P which will not become GILTI PTEP. While GILTI is generally viewed as detrimental, it does allow for a lower effective tax rate than the other deemed dividend regimes of Subpart F and IRC §956. Additionally, it allows for the netting of income and loss CFCs, compared to Subpart F and IRC §956 which looks at each CFC in isolation.

In the below example, we will show how allowing the E&P to run through the GILTI regime may be more beneficial than electing the HTE Election, even when the value of the investment in US property is less than the GILTI inclusion.

Example 4:

US Holdco, a United States C Corporation, is a holding corporation whose only source of income in Year 1 is deemed dividend income from its investment in CFC 1. CFC 1 generates $1,000,000 of pre-tax tested income, pays $300,000 of tax in its local country, and has a note receivable due from US Holdco outstanding with a consistent balance $300,000 throughout the entire tax year. In this example, assume the FTC is not limited.

	Scenario 1: **No Election**	**Scenario 2:** **HTE Election**
GILTI Inclusion	$1,000,000	$0
IRC §78 Gross Up	$300,000	$0
GILTI Inclusion and IRC §78 Gross Up	$1,300,000	$0
50% IRC §250 GILTI Deduction	($650,000)	$0
IRC §956 Inclusion	$0	$300,000
US Taxable Income	$650,000	$300,000
US Income Tax Liability	**$136,500**	**$63,000**
Foreign Tax Credit (80% GILTI Foreign Income Taxes)	($240,000)	($0)
Cash Tax Liability	**$0**	**$63,000**

Because the note receivable is due from a US person, it gives rise to potential IRC §956 inclusion. As we see above, despite a GILTI inclusion of $1,000,000 more than the Scenario 2 IRC §956 inclusion, the allowance of the IRC §250 deduction, and the FTC (neither of which are available for the IRC §956 inclusion) eliminate any additional cash tax liability. Additionally, we have now accumulated an extra $700,000 of PTEP at the CFC level which can be distributed or provide protection against future §956 inclusions. Naturally, it would be vital to confirm the FTC is not limited, but it would have to be limited by more than half for the HTE Election to provide a more favorable result.

State and Local Conformity and Variability

States generally adopt the IRC either on a rolling basis or a static basis, referencing a fixed date. By extension, state adoptions of the IRC, whether rolling or fixed, generally include the interpretations rendered by the applicable Treasury Regulations, such as the HTE Election regulations discussed in this article.[5]

As it currently stands, many states conform to IRC §951A but also permit full or partial subtraction of the GILTI Inclusion. For example, Alabama, a rolling conformity state, initially required its taxpayers to pay tax on GILTI by conforming to IRC §951A but permitted only a 50% deduction. However, Alabama recently enacted H.B. 170, which retroactively decouples from IRC §951A for tax years beginning after December 31, 2017, whereby Alabama taxpayers no longer pay tax on GILTI. To contrast, Georgia, a static conformity state, permits domestic C corporation taxpayers to subtract the entirety of their GILTI Inclusion as a DRD. Alternatively, Georgia does not permit the same subtraction for individuals, showing the additional need for consideration in GILTI planning.

The HTE Election thus results in the reduction of income included under IRC §951A. As discussed above, the excluded amount pursuant to the HTE Election can result in an increase in E&P that does not become GILTI PTEP. At the federal level, the IRC offsets this issue pursuant to IRC §245A's through a 100% DRD for C corporation, US shareholders of a CFC. However, many states decouple from IRC §245A and apply a reduced DRD, which would result in a portion of un-taxed repatriated E&P being included on the states' returns.

For example, New Jersey illustrates a potential pitfall. Specifically, while New Jersey is a rolling conformity state and includes GILTI in its starting point for taxable income, the state deviates from the IRC §245A deduction. To detail, New Jersey imposes the following restrictions for its reduced DRD:

1. 95% DRD – 80% or more ownership by a US company in a CFC;
2. 80% DRD – 50% or more ownership by a US company in a CFC; and,
3. 0% DRD – less than 50% ownership by a US company in a CFC.

Comparing the New Jersey 50% minimum ownership percentage with IRC §245A's 10% indicates that there may be an instance where a taxpayer receives the federal DRD but is subject to tax on the repatriated income that is not subject to a DRD, either partially or in its entirety. States with similar provisions offer additional pitfalls that taxpayers must consider given the looming April 15th deadline for taxpayers to amend any 2018 returns.

Implications of the HTE Election

We are fortunate that the HTE Election is available on a year by year basis rather than being a binding election, as it allows us to adjust depending on each situation. As mentioned in the footnotes, taxpayers are only permitted to amend an HTE Election for 24 months from the

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[5] Three states, Indiana, Kentucky, and Texas, expressly state a fixed date of conformity to the Treasury Regulations. Additionally, New Hampshire conforms to the IRC's GILTI provisions for the 2020 tax year but expressly does not conform to the Treasury Regulations.

original, un-extended tax deadline rather than the standard 36 months. Therefore, should you desire to amend a calendar year 2018 tax return, you would need to do so by **April 15, 2021**.[6]

Contact Us

Bennett Thrasher's Tax practice can help you navigate the complexities of the HTE Election and assist in the decision-making process. To learn more about the HTE Election and see whether it would benefit you, please contact Sam Heberton, Brian Sengson or Molly Johnson by calling 770.396.2200.

[6] It is unclear at this time if the IRS decision on March 17, 2021 to extend the April 15, 2021 deadline for individuals will apply to amendments.