Arnold & Porter

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VIA FEDERAL eRULEMAKING PORTAL

Internal Revenue Service
CC:PA:LPD:PR (REG-104390-18)
Room 5203
PO Box 7604
Ben Franklin Station
Washington, DC 20044

Re: **Comments to Proposed Regulations under Section 951A of the Internal Revenue Code**

To Whom It May Concern:

We are writing on behalf of our client, the Ministry of Finance of the Government of Israel, to comment on the U.S. Department of the Treasury (the "**Treasury**") regulations recently proposed under Section 951A (the "**Global Intangible Low-Taxed Income**" or "**GILTI**" rules) of the U.S. Internal Revenue Code of 1986, as amended (the "**Code**"),[1] as enacted by Congress in P.L. 115-97 (the "**2017 Tax Act**"), which were published in the Federal Register on October 10, 2018, at 83 Fed. Reg. 51072 (the "**Proposed Regulations**").

1) Executive Summary of Recommendation

The preamble to the Proposed Regulations[2] and Prop. Reg. § 1.951A-2(c)(1) suggest that high-taxed income of a CFC (as defined below) will only be excluded from "gross tested income" under the so-called "high tax kick out" or "HTKO" exception of Section 954(b)(4) if such income would have been characterized as Subpart F income but for the application of the HTKO exception. In other words, high-taxed *active* income of a CFC, which generally is *not* characterized as Subpart F income, will be included in CFC

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[1] All references to a "**Section**" or a "**§**" herein are to a section of the Code and all references to a "**Prop. Reg. §**" are to a section of the Proposed Regulations.

[2] *Preamble to Guidance Related to Section 951A (Global Intangible Low-Taxed Income),* Fed. Reg. Vol. 83, No. 196 at 51072 (the "**Preamble**").

tested income and subject to current U.S. federal income taxation as GILTI in the hands of U.S. shareholders of a CFC.

The apparent interpretation in the Proposed Regulations of the application to GILTI of the HTKO exception would be inconsistent with the intent of the GILTI and Subpart F rules, as expressed in the legislative history to the 2017 Tax Act and to the legislation that enacted, and subsequently amended, the original Subpart F rules. As detailed below, the legislative history to GILTI indicates that Congress enacted GILTI to combat the trend of multi-national U.S.-owned corporate groups to shift business activities, and related profits, to low-tax jurisdictions. This legislative history indicates that Congress intended that income of a CFC only should be taxed as GILTI in the hands of the U.S. shareholders of the CFC if such income is subject to low non-U.S. tax, regardless of whether such income were active or passive income.

Moreover, the apparent interpretation in the Proposed Regulations of the application to GILTI of the HTKO exception would lead to extremely harsh tax consequences for U.S. *individual* taxpayers, and would be particularly harsh for dual U.S. citizens/Israeli tax residents, who generally are subject to worldwide taxation both in the United States and in Israel. As illustrated in the example below, a dual U.S. citizen/Israeli tax resident that is a shareholder of an Israeli CFC would be subject to an overall effective income tax rate of at least 74.59 percent on income of the Israeli CFC. Dual U.S. citizens/Israeli tax residents live, work, invest, and develop active businesses in Israel that are subject to Israeli taxation. Congress did not intend to subject such U.S. citizens to this extreme level of taxation under the GILTI rules.

In order properly to reflect the intent of Congress and to prevent unfair taxation of U.S. individuals, we recommend that the Treasury revise Prop. Reg. § 1.951A-2(c)(1) to clarify that the HTKO exception of Section 954(b)(4) should apply so as to exclude from "gross tested income" and, therefore, from "net CFC tested income," any item of income subject to a high effective non-U.S. tax rate. This would mean that U.S. shareholders of a CFC that is subject to a non-U.S. effective tax rate of at least 18.9 percent would not be subject to U.S. federal income tax under the GILTI rules on income of that CFC.

2) <u>Law and Analysis</u>

a) CFC Regime, Subpart F Income and GILTI

A U.S. person who owns equity in a non-U.S. corporation generally is taxable on the earnings of such corporation only when those earnings are distributed to such person as a dividend. Under the Subpart F rules, however, a U.S. person who owns at least 10 percent of the vote or value (a "**U.S. shareholder**") of a "controlled foreign corporation" ("**CFC**") is currently taxable on its pro-rata share of, among other things, certain passive income (*e.g.*, rents, royalties, interest) and certain related-party income (*e.g.*, sales or service income earned from related parties) generated by the CFC (generally referred to as "**Subpart F income**") even if such income has not been distributed.[3] A non-U.S. corporation is a CFC if more than 50 percent of the vote or value of the non-U.S. corporation is owned, directly or indirectly (and applying certain constructive stock ownership rules) in the aggregate by one or more U.S. shareholders.[4]

There are numerous exceptions to the characterization of income of a CFC as Subpart F income. One exception, under Section 954(b)(4), is the "high-tax kick out" or "HTKO" exception. The HTKO exception generally provides that income of a CFC that would otherwise be treated as Subpart F income will not be so treated if such income is subject to non-U.S. tax at a rate that equals at least 90 percent of the highest U.S. federal corporate income tax rate in effect in the year in question.[5] Based on the current U.S. federal corporate income tax rate of 21 percent, a non-U.S. tax rate of at least 18.9 percent is sufficient for an item of CFC income to qualify for the HTKO exception.

Under the 2017 Tax Act, the above-described Subpart F rules were expanded to include GILTI, a new, broader, category of CFC income that is includable in the U.S. federal taxable income of a U.S. shareholder of a CFC.[6] GILTI generally is equal to a U.S. shareholder's "net CFC tested income" less a specified amount.[7] A shareholder's "net CFC tested income" generally is the sum of the shareholder's pro-rata share of the net income or loss of each CFC with respect to which such shareholder is a U.S. shareholder, but excluding the following items:

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3 §§ 951-954.

4 § 957(a).

5 § 954(b)(4).

6 § 951A(a), (f).

7 More specifically, to calculate GILTI of a U.S. shareholder, such shareholder's net CFC tested income is reduced by the shareholder's "net deemed tangible income return." Under Section 951A(b)(2), a shareholder's "net deemed tangible income return" generally is an amount equal to the excess of 10 percent of the shareholder's pro-rata share of the "qualified business asset investment" ("**QBAI**") of each CFC with respect to which such shareholder is a U.S. shareholder, reduced by certain interest expense of the CFCs. Under Section 951A(d), QBAI generally is the aggregate of the shareholder's pro-rata share of the quarterly average of each CFC's adjusted bases in depreciable tangible property used to generate the CFC's tested income.

1. income that is effectively connected to a U.S. trade or business;
2. income taken into account in determining the Subpart F income of the CFC;
3. ***income excluded from foreign base company income and the insurance income of the CFC by reason of the HTKO exception to Subpart F income***;[8]
4. dividends received from a related person; and
5. foreign oil and gas extraction income of the CFC.[9]

b) Proposed Regulations Guidance On Application of the HTKO Exception to GILTI

The guidance in the Proposed Regulations with respect to the potential application of the HTKO exception to GILTI is quite limited. The Preamble merely states that:

> [i]n response to comments, the proposed regulations ***clarify*** that this exclusion applies only to income that is excluded from foreign base company income and insurance income solely by reason of an election made to exclude the income under the high-tax exception of section 954(b)(4). Accordingly, the exclusion does not apply to income that would not otherwise be subpart F income.[10]

The only reference in the body of the Proposed Regulations to the HTKO exception is in Prop. Reg. § 1.951A-2(c)(1), which provides that:

> [t]he term gross tested income means the gross income of a controlled foreign corporation for a CFC inclusion year determined without regard to…gross income excluded from the foreign base company income (as defined in section 954) or the insurance income (as defined in section 953) of the corporation ***solely*** by reason of ***an election made under*** section 954(b)(4) and § 1.954-1(d)(5). (Emphasis added).

This provision of the Proposed Regulations generally restates the language of Section 951A, but adds that CFC income must be excluded from Subpart F income "solely" by

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8 Foreign base company income, defined in Section 954, and insurance income, defined in Section 953, are the two categories of income that comprise Subpart F income. However, certain additions are made to Subpart F income if, for example, a CFC does business in a country on bad terms with the United States, pays illegal bribes or kickbacks to government officials, or participates in an international boycott.

9 § 951A(c)(2)(A).

10 Preamble, Fed. Reg. Vol. 83, No. 196 at 51075. Emphasis added.

reason of "an election made under" the applicable section of the Code and the Treasury Regulations. These additions to the statutory language of Section 951A(c)(2)(A)(i)(III) fall short of providing meaningful clarification of the application of the HTKO exception to GILTI.

Our concern is that the above provisions of the Proposed Regulations suggest that high-taxed income of a CFC will only be excluded from CFC tested income under the HTKO exception if such income would have been characterized as Subpart F income but for the application of the HTKO exception. In other words, high-taxed *active* income of a CFC, which generally is *not* characterized as Subpart F income, will be included in CFC tested income and subject to current U.S. federal income taxation as GILTI in the hands of U.S. shareholders of a CFC. This interpretation of the statutory language of Section 951A is inconsistent with the legislative history to GILTI and to the original Subpart F rules. Moreover, this interpretation leads to extremely harsh tax consequences for U.S. *individual* taxpayers who, unlike corporate shareholders, do not benefit from the 50 percent GILTI deduction under Section 250 or indirect foreign tax credits attributable to CFC tested income under Section 960(d).

c) Applicable Legislative History

The original Subpart F anti-deferral regime was enacted by Congress pursuant to P.L. 87-834 (the "**Revenue Act of 1962**") and has been amended several times since. The legislative history to the Revenue Act of 1962 indicates that the CFC and Subpart F rules were enacted to combat the shifting of profits of U.S.-owned businesses to non-U.S. subsidiaries organized in so-called "tax haven" jurisdictions, where such profits would be subject to little or no tax. Such businesses benefited from deferral of taxes on their income until such income was actually distributed to the U.S. owners. Originally, the Kennedy Administration had proposed a version of the Subpart F rules that would have generally eliminated U.S. tax deferral with respect to all income earned indirectly through non-U.S. corporations. Congress, mindful of the need to balance the goals of preventing U.S. tax avoidance, while maintaining the ability for U.S.-owned businesses to remain competitive abroad, rejected this broad approach in favor of a narrower anti-deferral regime. This regime targeted *low-taxed* passive and related party income, thus maintaining the ability to defer U.S. federal income taxes on active business income earned through non-U.S. subsidiaries that are subject to tax in their local jurisdictions.[11]

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[11] S. Rep. No. 1881, 87th Cong., 2d Sess. 78-79 (1962). The Subpart F rules ultimately enacted "did not eliminate tax deferral generally, but instead was concerned primarily with what had been referred to as 'tax haven' devices."

As originally enacted in 1962, Section 954(b)(4) included a subjective test for excluding adequately taxed CFC income from being treated as Subpart F income. Under this rule, any item of income of a CFC would be excluded from treatment as Subpart F income if it could be established to the satisfaction of the Treasury that the creation or organization of the CFC receiving such income did not have the effect of a substantial reduction of income, war profits, or excess profits taxes or similar taxes.[12] Thus, as originally enacted, the Subpart F anti-deferral regime was not intended to apply to income of a CFC unless there was a substantial reduction of *both* U.S. and non-U.S. taxes.

The Subpart F rules were amended by P.L. 99-514 (the "**Tax Reform Act of 1986**"), which expanded such rules to target income from additional types of transactions. In connection therewith, Section 954(b)(4) was amended to include the current, objective, HTKO exception, *i.e.*, CFC income is not treated as Subpart F income if it is taxed at a non-U.S. tax rate that is at least 90 percent of the highest U.S. federal corporate tax rate.[13] In this connection, the legislative history to the Tax Reform Act of 1986 provided that if:

> …in a particular case no U.S. tax advantage is gained by routing income through a foreign corporation, then the basic premise of subpart F taxation is not met, and there is little reason to impose the subpart F tax. Thus, since the scope of transactions subject to subpart F will be broadened, and may sweep in a greater number of non-tax motivated transactions, the committee expects that the flexibility provided by a readily applicable exception for such transactions will become a substantially more important element of the subpart F system.[14]

As this legislative history indicates, due to the expansion of the Subpart F rules to target additional types of transactions, it was determined that an objective rule was needed more easily to identify income earned by a CFC that should not be subject to tax under the Subpart F rules. Under this objective test, income subject to a minimum level of non-U.S. tax was excluded from taxation under the Subpart F rules because (1) the Subpart F rules are intended to capture income from transactions structured to reduce taxes and (2) it follows that high-taxed income should not be viewed as resulting from such transactions.

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12 § 954(b)(4), as originally enacted by the Revenue Act of 1962.

13 P.L. 99-514, Tax Reform Act of 1986, § 1221(d).

14 H. Rep. No. 99-426, 99th Cong., 1st Sess. 401 (1985).

As noted above, the GILTI rules were incorporated into the existing framework of the Subpart F rules. GILTI generally constitutes an expansion of the Subpart F rules because GILTI encompasses a broader category of undistributed income (generally all active business income, subject to a limited reduction) that a U.S. shareholder of a CFC must include in his or her U.S. federal taxable income than the types of income so includable under the pre-existing Subpart F rules. The legislative history to the GILTI rules indicates that Congress was concerned primarily with the trend of multi-national U.S.-owned corporate groups to shift high-value functions and assets of their enterprises to low-tax jurisdictions in order to generate low-taxed profits offshore and benefit from deferral of taxes. The House Committee Report noted that this expansion of the Subpart F rules was necessary, in part, because the existing Subpart F rules did not adequately address this trend.[15]

That Congress was concerned with shifting of income to low-taxed jurisdictions is evident in the following:

> …the Committee does not believe the concentration of high returns abroad by itself is a sufficient indicium of erosion of the U.S. tax base. Where those returns are subject to a low effective tax rate that achieves significant tax savings, however, the Committee believes base erosion may have been a consideration and that U.S. taxation is appropriate.[16]

In other words, consistent with the legislative history to the original Subpart F rules, the House Committee Report is clear that current U.S. federal income taxation under the expanded GILTI anti-deferral rules only was intended to apply to non-U.S. income that is subject to no or low tax. In considering the alternatives to ensure that the new GILTI anti-deferral rules are limited to low-taxed income, the House Committee Report stated that "the Committee believes that relying on the framework of existing law can mitigate complexity."[17] Thus, there is every indication in the legislative history that the HTKO

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[15] H. Rep. No. 115-409, 115th Cong., 1st Sess. 388-389 (2017) (the "**House Committee Report**"). We note that the anti-deferral provision originally proposed by the House of Representative included a tax on a so-called "Foreign High Return Amount" or "FHRA," which conceptually is the same as GILTI, and the enacted version of Section 951A included a number of provisions from the FHRA provision. We also note that the FHRA provision included the concept of "net CFC tested income" and a statutory exclusion from such income that incorporated Section 954(b)(4) that is identical to that of the enacted GILTI provision.

[16] *Id*. at 390

[17] *Id*.

exception was intended to apply broadly so as to exclude from GILTI any high-taxed item of income.

d) Application to Certain Israeli Businesses and Taxpayers

We acknowledge that U.S. taxation of U.S. taxpayers on income earned abroad should be applied uniformly to income earned from all countries. These comments have been submitted on behalf of the State of Israel because Israel believes it has a special interest in the interpretation by the Treasury of the application of the GILTI rules. In particular, Israel is home to a very large population of U.S. citizens living abroad. These U.S. citizens live, work, invest, and develop businesses, in Israel. Israeli businesses owned by such U.S. citizens have a meaningful presence within Israel, with significant business operations there. In addition to the significant population of U.S. citizens residing in Israel, a substantial number of U.S. individuals and U.S. companies invest in active businesses conducted within Israel. U.S. individuals or businesses move to, or invest in, Israel for various reasons, including, among other things, because of the technological expertise and innovation present in Israel. They do not do so in order to avoid U.S. federal income tax.

The following is a brief summary of the Israeli income tax system and an example of how the GILTI rules, if a broad HTKO exception is not applied to GILTI, would apply to certain shareholders of Israeli companies in a manner yielding unfair results that are inconsistent with the legislative history discussed above.

The State of Israel has a robust tax system.[18] An Israeli corporation generally is subject to tax at a rate of 23 percent on its worldwide corporate income.[19] An Israeli individual is subject to net income tax on his or her worldwide income at graduated rates ranging from 10 percent to 50 percent. For example, an Israeli individual earning between approximately $46,257 and $63,940 is subject to Israeli tax at a rate of 31 percent.[20] An individual earning above approximately $171,351 is subject to Israeli tax at a rate of 50 percent. Certain types of income earned by individuals are subject to fixed tax rates. For example, certain interest income, capital gains and dividends are subject to

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[18] We are not Israeli lawyers and are not rendering Israeli legal advice. These comments include our understanding of the application of Israeli law as indicated to us in consultation with the Ministry of Finance of the Government of Israel.

[19] Certain Israeli corporations benefit from reduced tax rates under preferential regimes.

[20] Income ranges are based on converting Israel shekels to U.S. dollars based on the 2017 average exchange rate of 3.746.

tax at a rate of 25 percent (or 30 percent in the case of dividends if the recipient owns at least 10 percent of the distributing corporation), regardless of the taxpayer's income tax bracket. If an individual earns above approximately $171,351, the tax rates in the preceding sentence are increased by three percent. In general, Israeli taxpayers are allowed a credit against their Israeli tax liability in the amount of non-Israeli income taxes paid, but only with respect to income that is sourced *outside of* Israel.

The following example illustrates the potentially harsh tax consequences to a dual U.S. citizen/Israeli tax resident of not applying a broad HTKO exception to GILTI. David is a U.S. citizen by virtue of being born in the United States, but has lived in Israel for the bulk of his life and is an Israeli tax resident as a result. Thus, David is subject to worldwide taxation both in the United States and in Israel. David wholly owns an Israeli corporation ("**DavidCo**") that is a software development company earning active income that is not Subpart F income. Under U.S. federal income tax rules, DavidCo is a CFC and David is a U.S. shareholder of DavidCo. Assume that, in 2018, DavidCo generates corporate taxable income of $100x, which is subject to Israeli corporate tax of $23x. Although the $100x income of DavidCo is subject to a non-U.S. tax rate well in excess of 18.9 percent, without a broad HTKO exception applying to GILTI, David will be taxed on the remaining $77x net profits, as GILTI, at a rate of 37 percent, resulting in $28.49x of U.S. federal income tax.[21] If, in 2020, DavidCo makes a distribution of the $77x to David, this will be treated as a taxable dividend to a controlling shareholder for Israeli tax purposes, subject to an Israeli tax rate of 30 percent, resulting in tax of $23.1x.[22] Under Israeli tax law, the $28.49x of U.S. federal income taxes paid on the GILTI is not creditable against the Israeli tax imposed on the DavidCo dividend because such dividend is Israeli-source income. Accordingly, David's overall effective tax rate on the $100x of DavidCo income is 74.59 percent.[23]

Alternatively, if, as we recommend, the HTKO exception operates to exclude from CFC tested income any item of income that is subject to a non-U.S. tax rate of at least 18.9 percent, the $77x undistributed net profits of DavidCo would not be taxable as GILTI to David, resulting in the imposition of only the Israeli corporate tax at a rate of 23

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[21] Because of the nature of its business, DavidCo has no material depreciable tangible property, and thus, no QBAI.

[22] For U.S. federal income tax purposes, the distribution of the $77x would be a tax-free distribution of "previously taxed income" under Section 959.

[23] The overall effective tax rates noted herein do not take into account the application of the 3.8 percent "net investment income tax" under Section 1411 (the "**NIIT**"), which likely applies. If the NIIT were taken into account, such rates would be higher.

percent. The later actual distribution of the earnings would be treated as a taxable dividend for both U.S. and Israeli tax purposes. Under the income tax convention between Israel and the United States, Israel would have first right of taxation of such dividend and David would be subject to Israeli tax at a rate of 30 percent, resulting in Israeli tax of $23.1x.[24] Under U.S. federal income tax law and the Treaty, the Israeli income taxes paid on the foreign-source dividend generally would be creditable against David's U.S. federal income tax liability[25] with respect to the DavidCo dividend.[26] Accordingly, the overall effective tax rate on the net earnings of DavidCo would be 46.1 percent.

3) Conclusion

We recognize that Section 951A is a complex statute and it is critical that the statute be interpreted properly to reflect the intent of Congress. Accordingly, we urge the Treasury to revise Prop. Reg. § 1.951A-2(c)(1) to clarify that the HTKO exception applies to GILTI to exclude from "gross tested income" any item of income that is subject to non-U.S. tax at a rate that equals at least 90 percent of the highest U.S. federal corporate income tax rate then in effect.

We suggest that this can be done quite simply with the following revision to Prop. Reg. § 1.951A-2(c)(1):

> (c) Rules relating to the determination of tested income and tested loss--(1) Definition of gross tested income. The term gross tested income means the gross income of a controlled foreign corporation for a CFC inclusion year determined without regard to--
>
> (i) Items of income described in section 952(b),

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24 Article 26 (Relief From Double Taxation), Paragraph 2(b), Convention between the Government of the United States of America and the Government of the State of Israel with Respect to Taxes on Income of 1975, as amended by protocols signed May 30, 1980, and January 26, 1993 (the "**Treaty**").

25 Such Israeli taxes, however, would not be creditable against the NIIT.

26 In connection with the original example, even if DavidCo paid a dividend prior to 2020, the problem noted above is still present because it is unclear under Section 904 whether Israeli income taxes paid with respect to such dividend could be carried back as a credit to reduce U.S. federal income taxes of David imposed on GILTI included in 2018.

(ii) Gross income taken into account in determining the subpart F income of the corporation,
(iii) Gross income excluded from the foreign base company income (as defined in section 954) or the insurance income (as defined in section 953) of the corporation ~~solely~~ by reason of ~~an election made under~~ section 954(b)(4) and ~~§1.954-1(d)(5)~~ other gross income that is subject to foreign income tax at an effective rate described in Section 954(b)(4),
(iv) Dividends received by the corporation from related persons (as defined in section 954(d)(3)), and
(v) Foreign oil and gas extraction income (as defined in section 907(c)(1)) of the corporation.

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If you would like to discuss any of the items raised in this letter, please contact Paul S. Berger at (202) 942-5784 or paul.berger@arnoldporter.com or Willys H. Schneider at (212) 836-8693 or willys.schneider@arnoldporter.com or Reuven Z. Graber at (212) 836-7144 or reuven.graber@arnoldporter.com.

Sincerely,

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cc:

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