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H.R. 1865 and the Look-Through Treatment of Payments Between Related Controlled Foreign Corporations

The House amendment to the Senate amendment to H.R. 1865, the Further Consolidated Appropriations Act, 2020, extended certain expiring provisions, including a number that were last extended through 2019 by the Consolidated Appropriations Act of 2016 (P.L. 114-113). This legislation was signed into law on December 20, 2019 (P.L. 116-94). Among these provisions are the look-through rules, which allow certain payments between related corporations to be excluded. The Joint Committee on Taxation estimates that extending the look-through rules for a year will cost $0.7 billion.

The look-through rules were originally enacted in the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222), for 2006 through 2008, and subsequently extended.

General Rules for Taxing Foreign Subsidiaries of U.S. Parents

Income earned abroad by foreign-incorporated subsidiaries is taxed in full, not taxed at full rates, or not taxed at all. For passive income (such as interest income) and certain types of payments that can be easily manipulated to reduce foreign taxes, tax rules require this income earned by controlled foreign corporations (CFCs) to be taxed currently. This income is referred to as Subpart F income, reflecting the part of the tax code where treatment is specified. Credits against the U.S. tax imposed are allowed for any foreign taxes paid on this income, and are applied on an overall basis (so that unused foreign taxes in one country can offset taxes paid on income in another country). Other income earned abroad by CFCs is subject to the global intangible low-taxed income (GILTI) provision, which taxes this foreign-source income at half the corporate tax rate (10.5%), after allowing a deduction for a deemed return of 10% on tangible assets. Credits are allowed for 80% of foreign taxes paid. This rate is scheduled to rise to 13.125% after 2025.

Thus, some income (Subpart F) is taxed at full rates, some income (GILTI) is taxed at partial rates, and some income (the deemed return from tangible assets) is not taxed. (For a more extensive discussion of international tax rules, see CRS Report R45186, *Issues in International Corporate Taxation: The 2017 Revision (P.L. 115-97)*, by Jane G. Gravelle and Donald J. Marples.)

Subpart F Rules

Unless an exception applies, Subpart F income includes dividends, interest, rent, and royalty payments between related firms. These items of income are subject to Subpart F because affiliated firms can use them to shift income and avoid tax. For example, without Subpart F a U.S. parent's subsidiary (first-tier subsidiary) in a country without taxes (e.g., the Cayman Islands) could lend money to its own subsidiary (second-tier subsidiary) in a high-tax country. The interest payments would be deductible in the high-tax country, but no tax would be due in the no-tax country. Thus, an essentially paper transaction shifts income out of the high-tax country. A similar effect might occur if an intangible asset is transferred to the no-tax subsidiary, and then licensed in exchange for a royalty payment by the high-tax subsidiary. Subpart F taxes this income at full rates.

Check-the-Box

Methods of avoiding Subpart F taxation were made easier in 1997, when U.S. entity classification rules (to be a corporate or noncorporate entity) were simplified by simply checking a box on a form. These "check-the-box" regulations provided a way to avoid treatment of payments as Subpart F income under certain circumstances by allowing firms to elect treatment as an unincorporated entity. They were originally intended to simplify classification issues for domestic firms and the IRS, but their usefulness in international tax planning quickly became evident. The Treasury issued regulations in 1998 to disallow their use to avoid Subpart F, but, after protests from firms and from some Members of Congress, withdrew them.

In the example above, if the high-tax subsidiary is not a direct subsidiary of the U.S. parent but is a subsidiary of the Cayman Islands subsidiary (i.e., a second-tier subsidiary), the Cayman Islands (first-tier) subsidiary can elect to treat the high-tax subsidiary as if it were a pass-through entity. This treatment would effectively combine the two subsidiaries into a single firm. This outcome can be achieved simply by checking a box, making the high-tax subsidiary a disregarded entity under U.S. law. Because there are no separate firms, no income is recognized by the Cayman Islands firm, although the high-tax subsidiary (second tier) is still a corporation from the point of view of the foreign jurisdiction in which it operates and can deduct interest in the high-tax jurisdiction.

The Look-Through Rules Expand the Scope of Check-the-Box

The check-the-box rules do not work in every circumstance. For example, if the related firms do not have the same first-tier parent, check-the-box does not apply. In some cases, because of foreign countries' rules about corporate and noncorporate forms, the check-the-box regulations' classification of some entities as *per se* corporations made this planning unavailable. In addition, other undesirable tax consequences (from the firm's point of view) could occur as a side effect of check-the-box.

The look-through rule effectively puts this check-the-box type of planning into the tax code, rather than as a regulation (which could be altered without legislation), but disconnects it from the regulations' creation of a disregarded entity. Related firms do not have to have the parent-child relationship; they can be otherwise related as long as they are under common control.

Arguments For and Against the Look-Through Rules

The main argument against the look-through rules (and check-the-box as well) is that they undermine Subpart F's purpose, which is to prevent firms from using passive and easily shifted income to avoid tax.

The main argument for the provision is to allow firms the flexibility to redeploy earnings from one location to another without having U.S. tax consequences (foreign tax rules are unchanged). Firms could, for example, accomplish much of the treatment of look-through rules (even in the absence of check-the-box), but that may involve complex planning and inconvenience. An argument can also be made that in some cases (for example, with the payment of interest), the profit shifting is not harming the U.S. Treasury, but rather reducing taxes collected by foreign governments, as income is shifted out of high-tax countries into low-tax ones. Some might view this last argument as a "beggar-thy-neighbor" argument, as it facilitates U.S. firms in using tax planning to reduce taxes paid to other countries.

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