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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE GILTI PROVISIONS OF THE CODE

May 4, 2018

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I. Introduction

This Report[1] discusses the so-called "GILTI" provisions of the Code added by the legislation informally known as the Tax Cuts and Jobs Act (the "**Act**").[2] The GILTI provisions are primarily in new Code Section 951A (income inclusion) and Section 250 (deduction), although the Act made conforming changes to other Code provisions.[3] In general, the GILTI provisions require a U.S. shareholder (a "**U.S. shareholder**")[4] of a controlled foreign corporation ("**CFC**")[5] to pay, on a current basis, a minimum aggregate U.S. and foreign tax on its share of the earnings of the CFC. The GILTI rules, along with other changes to the international tax rules made by the Act, are the most far-reaching changes made to these rules in many decades.

Part II of this Report is a summary of our recommendations. Part III is a summary of the GILTI rules. Part IV is a more detailed analysis of certain of the GILTI provisions and discussion of our recommendations. Appendix 1 contains diagrams and more detailed calculations concerning some of the Examples in the Report.

The Report discusses the issues under the GILTI rules that we have identified so far and that we consider most significant. As a consequence, there are many issues that are beyond the scope of the Report. In most cases we comment on the statute as written without proposing far-reaching revisions to it, although we make some specific suggestions for statutory changes to make the GILTI regime work better.

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[1] The principal authors of this report are Kara Mungovan and Michael Schler. Helpful comments were received from Neil Barr, Kimberly Blanchard, Nathan Boidman, Andy Braiterman, Peter Connors, Charles W. Cope, Michael Farber, Kevin Glenn, Peter Glicklich, David Hardy, David P. Hariton, Monte Jackel, Shane Kiggen, John Lutz, Jeffrey Maddrey, Alexey Manasuev, Teddy McGehee, David Miller, Michael Mollerus, Jose E. Murillo, John Narducci, Richard M. Nugent, Amanda H. Nussbaum, Cory John O'Neill, Paul Oosterhuis, Alexander Pettingell, Vasujith Hegde Rajaram, Yaron Z. Reich, Richard L. Reinhold, Robert Scarborough, Stephen Shay, David R Sicular, Eric B. Sloan, Andrew P. Solomon, Karen G Sowell, David Stauber, Chaim Stern, Ted Stotzer, Joe Sullivan, Jonathan Talansky, Marc D. Teitelbaum, Shun Tosaka, Richard R. Upton, Philip Wagman, Andrew Walker, Gordon E. Warnke and Robert H. Wilkerson. This report reflects solely the views of the Tax Section of the New York State Bar Association (***"NYSBA"***) and not those of the NYSBA Executive Committee or the House of Delegates.

[2] The Act is formally known as "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*", P.L. 115-97.

[3] Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended.

[4] A U.S. shareholder is defined in Section 951(b) as a U.S. person that actually or constructively owns 10% or more of the vote or value of the stock in a foreign corporation. Prior to the Act, the test was based solely on voting power.

[5] A CFC is defined in Section 957(a) as a foreign corporation if stock with more than 50% of the total vote or value of its shares is actually or constructively owned by U.S. shareholders on any day during its taxable year.

II. Summary of Principal Recommendations

A. Purpose of the GILTI Regime

1. The GILTI regime contains elements of both a flat rate of tax on foreign income and the treatment of GILTI as an imperfect add-on to the existing rules for foreign source income. We believe that to the extent consistent with the statutory language, regulations should give significant weight to the theory that Congress intended to adopt the former approach. *See* Part IV.A.

B. Aggregation of Members of a Consolidated Group

2. Members of a group filing a consolidated U.S. Federal income tax return (a "**consolidated group**") should be treated as a single corporation for purposes of (a) the taxable income limitation under Section 250(a)(2), *see* Part IV.B.2, (b) the Section 904 foreign tax credit ("**FTC**") limit on the GILTI basket, *see* Part IV.B.3, and (c) the amount of the GILTI inclusion and the "inclusion percentage" (defined below), *see* Part IV.B.4.

3. We do not recommend applying aggregation principles to CFCs held by U.S. members of a controlled group that do not file a consolidated return, except perhaps as an anti-abuse rule if a principal purpose of having multiple owners of multiple CFCs is to avoid the purposes of the GILTI rules. *See* Part IV.B.4(b).

4. If this approach for the GILTI inclusion is adopted, Treasury and the Internal Revenue Service ("**IRS**") (Treasury and IRS referred to collectively as "**Treasury**") should consider whether the same rule should apply to CFCs held by a partnership where a specified percentage of the partnership is owned by group members. *See* Part IV.B.4(b).

C. Deductions Allowed in Calculating Tested Income

5. Regulations should clarify the method for calculating the tested income of a CFC. In general, we do not see a policy justification for deductions not allowed to a U.S. corporation to be allowed to a CFC in calculating tested income. We recommend that regulations adopt as a starting point either U.S. taxable income or the existing rules for Subpart F (which are largely based on GAAP income). In either case, Treasury should have the ability to make adjustments to bring the result closer to the other, and in the latter case the existing rule under Subpart F that the result should not be materially different than U.S. taxable income should be retained. *See* Part IV.C.2.

6. To the extent a U.S. corporation would be entitled to carry over a loss or deduction to a future year, we believe the same should be true of a GILTI loss. Therefore, if a CFC has a tested loss that is not utilized currently by its U.S. shareholders, regulations or a statutory amendment should permit the loss to be reattributed to the shareholders and carry over at the shareholder level to offset future GILTI inclusions, under rules similar to rules for domestic net operating losses ("**NOLs**"). Permitting carryovers of tested losses at the CFC level presents many complex issues and is likely not feasible. *See* Part IV.C.3(a).

7. If regulations apply Section 163(j) to CFCs, a CFC should be permitted to carry forward interest deductions disallowed under Section 163(j) in the same manner as a domestic corporation. *See* Part IV.C.3(b).

D. Other Computational Issues for GILTI Inclusions

8. Regulations should confirm that tested income of a CFC is determined before Section 956 inclusions. *See* Part IV.D.1.

9. When stock of a first tier or second tier CFC is sold, amendments made by the Act in some cases will cause the portion of the Subpart F income and Section 951A inclusions of the CFC for the taxable year of sale and attributable to the selling shareholder to permanently avoid inclusion in the U.S. tax base. We take no position on whether these results should be changed by legislation or regulations. However, we point out some possible approaches if a change is desired. *See* Part IV.D.2.

10. Regulations should clarify that under Section 951A(e)(3), while there is no minimum period of time that a CFC needs to qualify as a CFC in order for it to be a CFC during its qualification period, it is only a CFC during its qualification period rather than for the entire taxable year in which it is qualified for any period of time. *See* Part IV.D.2.

11. Regulations should address the order in which Section 163(j) and Section 250 are to be applied. The deduction in Section 250(a)(1) could come first, then the limits under Section 163(j) could apply, and then the taxable income limit for the Section 250 deduction under Section 250(a)(2) could apply. *See* Part IV.D.3.

12. Regulations should clarify that for purposes of the taxable income limit in Section 250(a)(2), taxable income includes all Section 951A, Subpart F, Section 78, and FDII inclusions, without regard to the Section 250(a)(1) deduction. In addition, regulations should clarify whether the Section 250(a)(2) carve-back applies to a Section 78 gross-up amount for a Section 951A inclusion. *See* Part IV.D.4.

13. Regulations should provide that typical nonconvertible preferred stock in a CFC is not allocated any tested income of the CFC in excess of accrued and unpaid dividends, and should clarify whether any allocation in excess of such dividends is made to convertible preferred stock. *See* Part IV.D.5.

14. Regulations should clarify whether the gross interest expense of a CFC with a tested loss reduces the NDTIR (defined below) of the U.S. shareholder without any adjustment for any notional QBAI return (defined below) of the CFC in question. *See* Part IV.D.6.

15. Regulations should address a number of issues involving tax basis and earnings and profits (“**e&p**”) that arise from GILTI inclusions. *See* Part IV.D.7. The Tax Section will be submitting a separate Report discussing these issues in more depth.

E. Foreign Tax Credit Issues

16. Principles from Treas. Reg. § 1.904-6 should be applied to determine whether foreign taxes paid by a CFC are "properly attributable" to tested income of the CFC. Once such a connection is made, the foreign taxes should not need to be traced to particular dollars of tested income in order to be considered properly attributable to tested income. *See* Part IV.E.1(a).

17. When income accrues in a different year for U.S. and foreign tax purposes, foreign taxes on that income should still be treated as tested foreign income taxes eligible for FTCs. In addition, regulations should confirm that Section 905(c)(2)(B) applies to audit adjustments relating to tested income, and clarify the application of that provision. Finally, the principles of Section 905(c)(2)(B) should be extended so that, in as many situations as possible, the foreign tax will be deemed to arise in the same year as the U.S. inclusion rather than in the taxable year in which the tax is paid or accrued. *See* Part IV.E.1(b).

18. Regulations should confirm that withholding tax on a distribution of tested income that is previously taxed income ("**PTI**") is not subject to the 20% cutback on GILTI FTCs or to cutback by the inclusion percentage (defined below). *See* Part IV.E.1(c).

19. If Treasury determines that no expenses of the U.S. shareholder are "properly allocable" to income in the GILTI basket, Treasury could issue regulations that no allocation of expenses to that basket should be made. However, arguments can be made that such an interpretation would be inconsistent with the structure and purpose of the statute.

In any event, as a policy matter, we do not believe that no shareholder expenses should be allocated to the GILTI basket. Rather, we believe the existing regulatory framework for allocating expenses should not be applied wholesale to GILTI, and consideration should be given to modifying certain of the existing allocation rules to minimize allocations to GILTI inclusions that are not economically justified.

In particular, certain aspects of the allocation rules for research and development expenses should be reconsidered, and regulations should clarify that Section 864(e)(3) does not apply to stock giving rise to dividends eligible for the Section 245A deduction. In addition, regulations should determine whether expenses should be allocated to a CFC based on the exempt CFC return of the CFC for the year or based on the Section 245A dividends actually paid by the CFC during the year. Moreover, when allocations of expenses are now based on gross income rather than assets, possibly these allocations should be based on net GILTI rather than gross GILTI. *See* Part IV.E.2(a).

20. Regulations should clarify the application of new Section 904(b)(4), and in particular whether it results in the calculation of FTC baskets by disregarding all exempt income from a CFC and shareholder expenses related to such exempt income, without any reallocation of such expense to other income or assets. *See* Part IV.E.2(b).

21. Regulations should confirm that the portion of the Section 250 deduction that is allocable to the GILTI inclusion is allocated to the GILTI basket. *See* Part IV.E.2(c).

22. Regulations should specify that the Section 78 gross-up for foreign taxes deemed paid under Section 960(d) is in the GILTI basket. If this position is rejected, so the gross-up is in the general basket, regulations should provide that the portion of the foreign tax allocable to the gross-up is also in the general basket. *See* Part IV.E.2(d).

23. Regulations should confirm that interest, rent and royalties received by a U.S. shareholder of a CFC from the CFC should be treated as non-GILTI inclusions for Section 904(d) purposes. *See* Part IV.E.2(e).

24. Legislation should be adopted to treat foreign taxes on items that are not in the U.S. tax base as being in a basket determined on the basis of the facts and circumstances, rather than always being in the general basket as in the past. If this recommendation is rejected, a statutory amendment should be adopted to correct a drafting error that now puts these residual taxes in the branch basket. *See* Part IV.E.2(f).

25. Regulations should provide that withholding tax on distributions of tested income that is previously taxed income is in the GILTI basket. In addition, regulations or legislation should extend the principles of Section 960(c)(1)(A) to such withholding tax, so that excess limitation in the year of the inclusion of the underlying tested income would be available to allow FTCs for such withholding tax in the year the tax is imposed. *See* Part IV.E.2(g).

26. Regulations should clarify issues that arise in 2018 and later years from an overall foreign loss or overall domestic loss under Sections 904(f) and (g) in 2017, in light of the fact that the Section 904(d) baskets have changed in 2018. *See* Part IV.E.2(h).

27. Regulations should clarify issues involving FTCs that arise because the concept of tested income did not exist before 2018. Part IV.E.2(i).

F. U.S. Partnership as a U.S. Shareholder in a CFC

28. If a CFC is held through a U.S. partnership, the GILTI inclusion and the Section 250 deduction should be determined at the partner level. However, Section 163(j) should not apply at the partnership level in a manner that allows a greater interest deduction than if Section 250 and Section 163(j) applied at the same level. We propose two methods to achieve the latter result. *See* Parts IV.F.1 through IV.F.3.

29. If regulations determine instead that the GILTI inclusion and deduction should be made at the partnership level, they should clarify how the rule applies to certain ownership situations, whether the Section 250(a)(2) limit is determined at the partner or partnership level, and how the Section 250 deduction is to be modified at the partnership level to reflect partners (such as individuals) that are not eligible for such deduction, in order to calculate the Section 163(j) limit at the partnership level. *See* Part IV.F.4.

G. Other Issues

30. Regulations or legislation should allow a Section 250 deduction based on the deemed GILTI inclusion under Section 962, and should clarify whether a dividend from the CFC is to be treated as qualified dividend income **("QDI")**. We also support the positions on Section 962 taken in Notice 2018-26.[6] *See* Part IV.G.1.

31. We take no position on whether Treasury should adopt anti-abuse rules to deal with fiscal year 2017-2018 transition issues under GILTI. If Treasury determines to do so, we suggest various standards it might consider. If it believes anti-abuse rules are necessary but that the statutory grant of authority is too limited, it should request legislation to conform the statute to the scope of anti-abuse authority referred to in the Conference Report. *See* Part IV.G.2.

32. The consequences of the repeal of Section 958(b)(4) should be limited, by regulations or a statutory amendment, to the intended scope of repeal as reflected in a colloquy on the floor of the Senate. However, any such regulations or amendment should only be adopted after taking into account its effect on other Code provisions. *See* Part IV.G.3.

33. Regulations should address the overlap between Section 250(a)(2) (limiting the Section 250 deduction to a percentage of taxable income) and Section 172(d)(9) (stating that the deduction cannot be used to create an NOL). *See* Part IV.G.4.

34. Regulations should clarify whether GILTI inclusions are investment income under Section 1411 (*see* Part IV.G.5), clarify the extent to which GILTI inclusions are qualified income for REIT purposes (*see* Part IV.G.6), clarify the rules for a RIC having a GILTI inclusion (Part IV.G.7), and confirm that GILTI inclusions are not UBTI to a tax-exempt U.S. shareholder (*see* Part IV.G.8).

35. Legislation should be enacted to treat all CFCs related to a particular U.S. shareholder as a single corporation for purposes of the GILTI calculations for that shareholder. The existing rules that treat each CFC separately are unjustified as a policy matter, are very unfair to taxpayers, and invite restructurings solely for tax purposes. *See* Part IV.H.

III. Summary of GILTI Rules

A. Income Inclusion

Section 951A requires each U.S. shareholder of a CFC to include in its gross income each year its share of "global intangible low-taxed income" or "**GILTI**" for the year.[7]

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[6] 2018-16 IRB (April 2, 2018).

[7] Section 951A(a).

GILTI is calculated on a U.S. shareholder-by-U.S. shareholder basis. It is the excess, if any, of the U.S. shareholder's "net CFC tested income" for the year over its "net deemed tangible income return" ("**NDTIR**") for the year.[8] GILTI cannot be negative.

In addition, if the U.S. shareholder is a domestic corporation that elects to receive the benefit of FTCs for a taxable year, 100% of the foreign taxes attributable to the Section 951A inclusion are included in gross income under Section 78.

References herein to the "**GILTI inclusion**" mean the inclusion under Section 951A and, where applicable when a CFC pays foreign taxes, the Section 78 gross-up of such inclusion for such foreign taxes.

1. Net CFC Tested Income

A U.S. shareholder's "net CFC tested income" for a taxable year is based on the "tested income" or "tested loss" for the year of each CFC of which it is a U.S. shareholder. (With respect to any U.S. shareholder, each such CFC is referred to herein as a "**Related CFC**"). The U.S. shareholder's net CFC tested income is the excess (if any) of the aggregate of the U.S. shareholder's *pro rata* share of the tested income of each Related CFC with positive tested income, over the U.S. shareholder's *pro rata* share of the tested loss of each Related CFC with a tested loss.[9] Net CFC tested income cannot be negative.

"Tested income" of a CFC for a taxable year is the excess (if any) of the CFC's gross income, with certain specified exceptions, over the "deductions (including tax) properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income)".[10] The specified exceptions are:

(1) effectively connected income described in Section 952(b),

(2) gross income taken into account in determining the Subpart F income of the CFC,

(3) gross income excluded from foreign base company or insurance company Subpart F income by reason of the high-tax exception in Section 954(b)(4),[11]

[8] Section 951A(b)(1).

[9] Section 951A(c)(1).

[10] Section 951(c)(2)(A).

[11] This exclusion means that high-taxed Subpart F income is excluded from GILTI, but other high-taxed operating income is included. It can be helpful to taxpayers to allow the averaging of high- and low-taxed tested income for FTC purposes, but it can also be harmful because it can "waste" high GILTI FTCs

(4) dividends received from a related person (as defined in Section 954(d)(3)), and

(5) foreign oil and gas extraction income (as defined in Section 907(c)(1)).[12]

Tested loss is the excess (if any) of the deductions described above over the income, calculated as described above.[13] Accordingly, a CFC can have tested income or tested loss, but not both. A CFC that breaks even has neither tested income nor tested loss.

2. NDTIR

A U.S. shareholder's NDTIR for a year is determined by a multi-step process. First, for each Related CFC with positive tested income for the year, its "specified tangible property" is its tangible property used in the production of tested income,[14] and its "qualified business asset investment" ("**QBAI**") is the aggregate adjusted tax basis of its specified tangible property that is used in a trade or business and subject to an allowance for depreciation.[15] If a CFC does not have positive tested income for a year, none of its tangible property for the year is taken into account and it has no QBAI.

Second, the U.S. shareholder aggregates its *pro rata* share of the QBAI for all of the Related CFCs. Third, this aggregate QBAI amount is multiplied by ten percent, which is considered a deemed return on the tangible assets that should not be subject to U.S. tax.[16] Fourth, this deemed return is reduced by any interest expense taken into account in calculating the shareholder's net CFC tested income for the year, except to the extent interest income attributable to that interest expense was also taken into account in determining the shareholder's net CFC tested income.[17] The reduction applies even if the

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that cannot be carried over as GILTI credits (*see* the discussion in Part III.D) but might be usable currently or as future carryovers in the general basket or passive basket. Note that Treas. Reg. § 1.954-1(d)(1) allows the high-tax exception from Subpart F income to be elected on a CFC by CFC basis, but the exclusion from GILTI will apply to a CFC whether or not such an election is made (under the Subpart F exclusion if no election is made or under the exclusion for high-taxed Subpart F income for which the election is made).

[12] Section 951A(c)(2)(A).

[13] Section 951A(c)(2)(B)(i).

[14] Section 951A(d)(2)(A). If property is used in the production of tested income and other income, then it is treated as specified tangible property in the same proportion as the tested income bears to the total income. Section 951A(d)(2)(B).

[15] Section 951A(d)(1). The adjusted tax basis is determined at the end of each quarter of the taxable year and then averaged.

[16] Section 951A(b)(2)(A).

[17] Section 951A(b)(2)(B).

interest expense is not in the same Related CFC as is the QBAI. The result is the U.S. shareholder's NDTIR.[18] Note that gross interest expense of a CFC (unless paid to a Related CFC of the same U.S. shareholder) reduces the U.S. shareholder's NDTIR to the extent thereof, even if the CFC has offsetting interest income from an unrelated party.

It is important to distinguish calculations that are done at the CFC level and calculations that are done at the U.S. shareholder level. Tested income is purely a CFC level concept, and NDTIR is purely a shareholder level concept. Each CFC with positive tested income has its own QBAI, but the calculation of the exempt return on QBAI is done at the shareholder level by aggregating QBAI of all Related CFCs and multiplying the total by 10%. Likewise, each CFC has its own interest expense allocable to its own tested income, but the total of such interest expenses of all Related CFCs of a U.S. shareholder (except if paid to another Related CFC of the same U.S. shareholder) is aggregated at the shareholder level in calculating the reduction to NDTIR.

Stated simply, the GILTI gross income inclusion is essentially the U.S. shareholder's share of (1) the aggregate net tested income, if positive, of all Related CFCs, with limited exceptions such as Subpart F income, minus (2) 10% of the tax basis of the tangible depreciable assets of those Related CFCs with positive tested income. However, any gross interest expense (not paid to a Related CFC of the same U.S. shareholder) will reduce the size of item (1) and automatically also reduce the size of (2), so such interest expense does not reduce the GILTI gross income inclusion except to the extent it exceeds the size of item (2).

For convenience, we use the term "**QBAI return**" of a particular CFC with tested income to refer to 10% of the QBAI of the CFC, without reduction for any interest expense. In practice, this is the amount of exempt income generated by the CFC for the U.S. shareholder, before reduction for interest expense. If a particular CFC does not have positive tested income, we use the term "**notional QBAI return**" to refer to the QBAI return the CFC would have if it had positive tested income. Unless indicated otherwise, we assume throughout that there is no interest expense that reduces QBAI return.

B. Section 250 Deduction

1. Initial Calculation

A domestic corporation is entitled to a deduction equal to the sum of (A) 37.5% of its "foreign-derived intangible income", or "**FDII**", (B) 50% of the Section 951A inclusion and (C) 50% of the Section 78 amount included in its income and attributable to GILTI (together, the "**Section 250 deduction**").[19]

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[18] Section 951A(b)(2).

[19] Section 250(a)(1). The percentages are lowered from 37.5% and 50% to 21.875% and 37.5%, respectively, for taxable years beginning after December 31, 2025. A discussion of the Section 78 amount is included below. FDII is calculated pursuant to Section 250(b), but a detailed discussion of FDII is beyond the scope of this report.

> Example 1. U.S. shareholder with no FDII has \$100 of Section 951A inclusion solely from a CFC with no foreign taxes. The Section 250 deduction is \$50, resulting in \$50 of taxable income. The income is taxed at 21% to a corporate U.S. shareholder, for an effective tax rate of 10.5% on GILTI.

2. Carve-Back to Deduction

Under Section 250(a)(2), if the sum of the U.S. shareholder's FDII and Section 951A (and possibly Section 78) inclusions exceeds its taxable income (not taking into account the Section 250 deduction), then, solely for purposes of calculating the Section 250 deduction, those inclusions are reduced *pro rata* by the excess (the "**carve-back**").[20] In addition, the Section 250 deduction is disallowed in calculating a net operating loss.[21]

The carve-back comes into effect if the U.S. shareholder has current losses or loss carryovers to the year in question, and those losses exceed the non-GILTI, non-FDII income of the corporation. In that case, the carve-back requires that these losses be used to offset FDII and GILTI eligible for the Section 250 deduction, and the deduction is calculated by reference to the FDII and GILTI that remain (if any) after the losses have been used. As a result, the excess losses might be absorbed in the year but provide the U.S. shareholder with a tax benefit of only a fraction of the usual tax benefit of a loss.

> Example 2(a). U.S. shareholder has \$100 of operating income and \$100 of Section 951A inclusion. If the shareholder has no other income or loss, the Section 250 deduction is \$50, taxable income is \$150, and the tax is \$31.50. If the shareholder instead has a \$100 NOL carryforward to the year, the pre-Section 250 taxable income and Section 951A inclusion for the year are both \$100, so there is no carve-back. The Section 250(a)(1) deduction is \$50, the taxable income is \$50, and the tax is \$10.50. The tax savings from the NOL is \$21, as would be expected.

> Example 2(b). Same facts as Example 2(a), except the NOL is \$150. Now, the taxable income

[20] Section 250(a)(2). It is not clear if the carve-back applies to Section 78 inclusions. *See* the discussion in Part IV.D.4. The reductions in GILTI and FDII are not completely symmetrical, because expenses of the U.S. shareholder allocable to its FDII income reduce its FDII, while expenses of the U.S. shareholder allocable to its Section 951A inclusion do not reduce that inclusion.

[21] Section 172(d)(9).

> before Section 250 is $50, and the carve-back limits the Section 250 deduction to 50% of that, or $25. Taxable income is $25, and tax liability is $5.25. The tax savings from the extra $50 of NOL is $10.50 minus $5.25, or $5.25, a rate of savings of 10.5% rather than 21%.

In fact, every $100 of NOL that exceeds non-GILTI, non-FDII income reduces the GILTI and FDII inclusion in taxable income by $100, and therefore reduces the Section 250 deduction by $50. This results in a net decrease in taxable income of $50, for a net tax saving of $10.50, half the usual benefit from an NOL.[22]

C. Foreign Tax Credits

1. Calculation of the FTC

If a domestic corporation includes GILTI in income, and elects to credit foreign taxes, it is treated as having a "deemed paid" FTC equal to the product of (1) 80% of the aggregate "tested foreign income taxes" paid or accrued by the Related CFCs, and (2) the domestic corporation's "inclusion percentage".[23]

"Tested foreign income taxes" are foreign income taxes paid or accrued by a Related CFC that are "properly attributable" to the tested income of the CFC taken into account by the U.S. shareholder in calculating GILTI.[24] Accordingly, foreign taxes include taxes attributable to QBAI return, since tested income is not reduced by QBAI return. However, if a particular CFC does not have positive tested income for a year, foreign taxes paid by that CFC for that year do not give rise to tested foreign income taxes for the year.[25]

A domestic corporation's "inclusion percentage" is a fraction, the numerator of which is its Section 951A inclusion and the denominator of which is the aggregate of its share of the tested incomes of all Related CFCs with positive tested income.[26]

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[22] Under the rules for FTCs discussed below, the tax saving from the NOL is further reduced if the Section 951A inclusion carried with it a foreign tax credit, since in that case the U.S. residual tax rate on the inclusion is less than 10.5%. As a general matter, subject to various complications discussed herein, the higher the foreign tax rate (up to a point), the lower the U.S. residual tax and the smaller the benefit from the carryforward.

[23] Section 960(d)(1).

[24] Section 960(d)(3).

[25] Section 960(d)(3); Conference Report, at 643 n. 1538, describing the Senate Bill ("Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).)"

[26] Section 960(d)(2).

Note that the corporation's Section 951A inclusion is the tested income of Related CFCs with positive tested income, reduced by (1) tested loss of Related CFCs with tested loss, and (2) NDTIR based on QBAI of Related CFCs with positive tested income. As a result, these two items reduce the numerator but not the denominator of the inclusion percentage, and so they reduce the percentage.

> Example 3. U.S. shareholder owns (1) CFC1 with tested income of $100 after foreign taxes, foreign taxes of $15, and QBAI return of $20, and (2) CFC2 with tested loss of $30 after foreign taxes and foreign taxes of $10. The Section 951A inclusion is $100 (tested income of CFC1)) minus $20 (NDTIR) minus $30 (tested loss of CFC2), or $50, and the tested foreign income taxes are $15. The inclusion percentage is $50 (the Section 951A inclusion) divided by $100 (the positive tested income of CFC1), or 50%. The allowed FTC is therefore 80% times 50% times $15, or $6.

2. GILTI Basket

For FTC purposes, GILTI is a separate basket, with no carrybacks or carryforwards.[27] Any income that is GILTI is not general category income.[28]

3. Section 78 Amount

As noted above, if a domestic corporation elects to receive the benefit of FTCs for a taxable year, 100% of the foreign taxes deemed paid by the domestic corporation are counted in the deemed dividend, or "Section 78 amount".[29] The Section 250 deduction is allowed against the full grossed-up amount.[30]

> Example 4(a). In Example 3, the U.S. shareholder would have a Section 78 amount of $7.50, for total GILTI inclusion of $50 plus $7.50, or $57.50.[31]

[27] Section 904(c) and (d)(1)(A).

[28] Section 904(d)(1)(A) and (2)(A)(ii).

[29] Section 78.

[30] Section 250(a)(1)(B)(ii).

[31] The U.S. shareholder's allowed FTC was 80% times 50% times $15, or $6. Its inclusion under Section 78 is the same as the allowed FTC, but without the 20% cutback, so it is 50% times $15, or $7.50.

> We assume hereafter that the gross-up goes in the GILTI FTC basket.[32]
>
> Example 4(b). Consider the simple case where the U.S. shareholder owns a single CFC with $100 of pre-tax tested income, no QBAI return, and $13.125 of foreign taxes. The tested income and Section 951A inclusion are $86.875. The inclusion percentage is 100% (86.875/86.875), so it does not reduce the foreign tax credit of $13.125. The credit results in a Section 78 inclusion of $13.125. The GILTI inclusion is $100 and the allowed foreign tax credit is 80% of $13.125, or $10.50. If the full Section 250 deduction of $50 is allowed, taxable income will be $50 and the tentative U.S. tax liability is $10.50. If no expenses are allocated to GILTI income (*see* Part III.D) the FTC will exactly offset the U.S. tax.

D. Limitations on Use of FTCs

In general, a taxpayer's FTC for a year is limited to (1) the taxpayer's foreign source taxable income for the year, multiplied by (2) the effective U.S. tax rate on the taxpayer's worldwide taxable income for the year.[33] This determination is made separately for each FTC basket, including the GILTI basket.[34] The U.S. shareholder must therefore determine which items of gross income belong in the GILTI basket, and then allocate and apportion its deductions to determine net income in the GILTI basket.[35]

Under preexisting law, deductions that are "definitely related" to gross income are generally allocated and apportioned to that gross income, and other deductions are generally ratably allocated and apportioned.[36] Following the Act, interest deductions are

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[32] *See* Part IV.E.2(d).

[33] Section 904(a). The formula in the text assumes no U.S. source losses. The statutory formula is that the allowed FTC cannot exceed the same proportion of total U.S. tax liability (before FTCs) that foreign source taxable income bears to worldwide taxable income. Mathematically, this is equivalent to the rule that the allowed FTC cannot exceed (1) total U.S. tax liability, multiplied by (2) foreign source taxable income, with the product divided by (3) worldwide taxable income. Since (1) divided by (3) is the effective U.S. tax rate on worldwide taxable income, the formula is equivalent to that in the text. New Section 904(b)(4), discussed below, modifies this formula in certain cases.

[34] Section 904(d).

[35] Various re-sourcing rules under Section 904 must be taken into account but are beyond the scope of this discussion.

[36] *See generally*, Sections 861(b), 862(b), 863(a) and Treasury Regulations thereunder.

generally allocated and apportioned on the basis of the tax basis of assets, rather than the value of assets or income.[37]

> Example 5(a). Same facts as Example 4(b). U.S. source income is $0, foreign source income (after Section 250 deduction) is $50, U.S. tax before FTC is $10.50, and effective U.S. tax rate is 21% ($10.50/$50). The Section 904 limit is $50 (foreign source income) multiplied by 21% (effective U.S. tax rate), or $10.50, so the full credit is allowable.

> Example 5(b). Same facts as Examples 4(b) and 5(a), except that U.S. shareholder also has U.S. source business income of $10 (before interest deductions) and $10 of interest deductions. Assume the interest deductions are all treated as U.S. source deductions. The result is the same as in Example 5(a).

> Example 5(c). Same facts as Example 5(b), except $5 of the interest deductions are allocable to the foreign source GILTI inclusion. Then, nothing changes except the FTC limit under Section 904(a). That limit is now $45 (foreign source GILTI inclusion of $50 minus interest expense of $5) times the effective U.S. tax rate of 21%, or $9.45. Thus, only $9.45 of FTC is allowed, and there is U.S. tax of $10.50 minus $9.45, or $1.05. Note that this loss of credits has the same tax cost ($1.05) as would the allowance of the full FTC and the disallowance of the $5 of foreign source interest deductions. The same result would arise for any other deductions allocable to the GILTI inclusion.

Members of an affiliated group, whether or not they file a consolidated return, must allocate and apportion interest expense of each member as if all members of the

[37] Section 864(e)(2), Temp. Treas. Reg. § 1.861-9T(a). Prior to the Act, Section 864(e)(2) allowed an allocation based on the basis or value of assets, but now basis is required. There are exceptions to this general rule, including that (i) interest expense is directly allocated to income generated by certain property acquired, constructed or improved with proceeds of qualified nonrecourse indebtedness, (ii) interest expense is directly allocated to certain investments funded with amounts borrowed in connection with certain integrated financial transactions and (iii) third party interest expense must be directly allocated to certain separate foreign tax credit limit categories in certain circumstances where the U.S. shareholder's debt is much greater than its CFCs' debt. Temp. Treas. Reg. § 1.861-10T(a), (b), (c), Treas. Reg. § 1.861-10(e).

group were a single corporation.[38] A similar rule applies for purposes of allocating and apportioning certain other expenses that are not directly allocable or apportioned to any specific income producing activity.[39] For affiliated groups filing a consolidated return, all foreign taxes paid by group members are aggregated, and a single Section 904 limit is calculated for the group.[40]

IV. Discussion and Recommendations

A. Purpose of the GILTI Regime

As can be seen from the description above, the GILTI regime creates a tax system for the United States that is a hybrid between a territorial system and a world-wide system. Like a world-wide system, a significant amount of income of a U.S. shareholder that is earned through CFCs is subject to immediate U.S. tax if the foreign tax rate is insufficient. Moreover, gains on a sale of CFC stock are taxable if they exceed previously taxed income in the CFC. While the territorial system in most countries does not tax foreign operating income at all, the GILTI regime taxes GILTI income at a significantly lower rate than domestic income. Moreover, NDTIR is permanently exempt from U.S. tax, and dividends from foreign subsidiaries are exempt from U.S. tax.[41]

In addition, to the extent that GILTI is a world-wide tax system, it results in yet another hybrid between (1) a flat minimum domestic and foreign tax rate on a U.S. shareholder's non-NDTIR GILTI inclusions earned through CFCs[42] (the "**flat-rate theory**"), and (2) the imperfect adding of the GILTI regime onto the existing tax regime for foreign source income, particularly Subpart F income (the "**add-on theory**").

The strongest evidence that Congress intended the flat-rate theory is that the Conference Report arguably contemplates no GILTI tax if the foreign tax rate is at least 13.125%,[43] although this may have merely been intended as an illustrative rate.[44] Other

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[38] Section 864(e)(1), Temp. Treas. Reg. § 1.861-11T. Foreign corporations are excluded from an affiliated group for this purpose. Treas. Reg. § 1.861-11(d)(1).

[39] Section 864(e)(6), Temp. Treas. Reg. § 1.861-14T.

[40] Treas. Reg. § 1.1502-4(d).

[41] In the case of a U.S. shareholder that is not a domestic corporation (and assuming no Section 962 election), the GILTI regime creates a system that is even closer to a worldwide tax system. GILTI inclusions are subject to tax at the same rate as other ordinary income because neither the Section 250 deduction nor foreign tax credits are available. The discussion in this Part IV.A assumes the applicable U.S. shareholder is a domestic corporation.

[42] This approach is similar to the approach taken for pass-through income in Section 199A, where a deduction of a fixed percentage of specified categories of pass-through income results in a reduced tax rate on that type of income.

[43] Conference Report at 626-7 ("Since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed by a domestic corporation is 13.125 percent....Therefore, as foreign tax rates on GILTI range

factors that are consistent with this theory (although with the add-on theory also) are the ability to offset tested income of some CFCs with tested losses of other CFCs, and the fact that the GILTI FTC limitation is determined on a world-wide basis rather than a country-by-country basis.

Moreover, the flat rate theory is arguably more consistent with the tax rate on FDII. Aside from the deemed return on QBAI, which is fully taxable under FDII and exempt under GILTI, the FDII rules are designed to lower the U.S. tax rate on FDII export income to a rate that is approximately the rate the taxpayer could achieve by engaging in activities through a CFC. FDII income would not normally generate significant foreign tax credits except for withholding taxes on royalties from non-treaty jurisdictions. As a result, Congress could have considered the statutory FDII rate to be close to the final worldwide rate.

Thus, if Congress had not believed it was adopting the flat-rate theory, it arguably should have realized that the effective world-wide tax rate on GILTI will often be much higher than the rate on FDII, and it would not have been necessary to lower the rate on FDII as much. The fact that Congress did reduce the rate on FDII as much as it did arguably indicates that it believed the rate on GILTI inclusions would usually be 13.125% or not much higher. On the other hand, FDII is also reduced by allocable deductions such as interest and research and development,[45] so arguably Congress intended both the FDII rate and the GILTI rate to be higher than 13.125%.

Other elements of the GILTI regime support the add-on theory because they can cause a much higher tax rate on the net world-wide income of the CFCs owned by a U.S. shareholder. Under this view, the add-on theory is in effect a "minimum tax theory", namely that Congress intended the world-wide effective tax rate on GILTI to be no less than 10.5%, but U.S. tax could apply even if the foreign rate is more than 13.125%. For example, a tested loss in a CFC can cause a loss of FTCs and NDTIR exclusion, and neither unused tested losses nor unused FTCs can be carried over.[46] All interest expense of a shareholder's CFCs not reflected in tested income of a Related CFC is in substance first allocated to tax-exempt NDTIR, rather than being allocated between taxable income and exempt NDTIR. The Section 250 deduction of the U.S. shareholder is limited to its taxable income. All of these restrictions would have to be reconsidered as a legislative matter if the flat-rate theory was to be implemented.

As to the placement of GILTI FTCs in a separate FTC basket, on its face this is a neutral factor, since even a system for taxing GILTI at a fixed tax rate might prohibit

between zero percent and 13.125 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5 percent and 13.125 percent.").

[44] The quoted language is under the heading "Illustration of effective tax rates on FDII and GILTI". *Id.* at 626.

[45] Section 250(b)(3)(A)(ii).

[46] We propose in Part IV.C.3(a) that unused tested losses should be allowed to carry over.

cross-crediting of FTCs arising on non-GILTI income. On the other hand, by placing the FTC limitation in Section 904, Congress intentionally or unintentionally adopted the add-on theory, because it thereby incorporated numerous limitations on GILTI FTCs that can give rise to a combined U.S. and foreign tax rate on CFC income that is well in excess of 13.125%.

In many cases the statute is clear and Treasury would not have discretion to change a specific rule even if it wished to. However, regulations will be needed to resolve many ambiguities and unanswered questions under the statute. The resolution of many issues depends upon whether one believes that the intent of Congress was, as much as possible, to create a uniform maximum tax rate of 13.125% on foreign income, or, alternatively, to (imperfectly) lay the GILTI rules on top of the existing rules for foreign income.

There is no definitive way to resolve this dual nature of the GILTI regime. To the extent the statute provides flexibility for interpretation, we believe that regulations should give significant weight to the theory that Congress intended to create a flat tax at a 13.125% rate, even if the statute itself does so imperfectly. Many of our suggestions for regulations in this Report, such as allowing carryovers of CFC losses and modifying the existing rules for allocating expenses to FTCs, reflect this view. We also suggest some legislative changes to further achieve this result.

B. Aggregation of Members of a Consolidated Group

This section discusses the extent to which members of a consolidated group should be treated as a single corporation for purposes of the various GILTI calculations.

1. In General

Under Sections 951A and 78, each U.S. corporation must calculate its own GILTI inclusion based on its own Related CFCs. However, a consolidated group is treated as a single entity for many purposes of the Code, and in a typical group there will be more than one, and perhaps many, members that are U.S. shareholders of CFCs. It is important for guidance to state the extent to which a consolidated group is to be treated as a single corporation for purposes of the various GILTI calculations.

The statute itself provides no specific guidance. The statute[47] and the legislative history suggest similarity between Subpart F income and GILTI,[48] and consolidation principles do not apply to calculating Subpart F inclusions. However, the GILTI rules are

[47] Section 951A(f)(1)(A) lists the Code sections for which GILTI is to be treated in the same manner as Subpart F income.

[48] For example, in describing the Senate Amendment, the Conference Report at 641 says: “a U.S. shareholder of any CFC must include in gross income for a taxable year its global intangible low-taxed income (“GILTI”) in a manner generally similar to inclusions of subpart F income”.

different from Subpart F in many critical respects, and we discuss below the extent to which we believe that consolidation principles should apply to GILTI.

2. The Section 250(a) Deduction

Consider a consolidated group where a single member (M1) has a single Related CFC with tested income. Because consolidation principles do not change the location of items of income and deduction, the GILTI inclusion would be income of M1, and the Section 250 deduction would be a deduction of M1. However, Section 250(a)(2) limits the deduction to the taxable income "of the domestic corporation". The question is whether this refers to M1's separate taxable income or to the taxable income of the group as a whole. If more than one member of the group had a Related CFC, the issue would be whether to count the entire taxable income of the group and the entire Section 250(a)(1) deduction of the group. There is no relevant analogy to Subpart F, since income inclusions under Subpart F do not depend in any way on taxable income of the U.S. shareholder.

We believe that regulations should provide that the Section 250(a)(2) limitation is determined on the basis of the taxable income of the group as a whole. We have several reasons for this conclusion.

First, placing such importance on a particular member's taxable income would require the IRS to police the allocation of income among group members, such as intercompany pricing for transactions between group members. Separately determined taxable income of a member is rarely relevant from a nontax point of view, and so taxpayers would be incentivized to take aggressive positions with few (if any) nontax economic consequences. These issues rarely arise today.

Second, looking at the single member's taxable income would be a trap for unwary taxpayers, who would not expect this result. Well-advised taxpayers could easily avoid it, as discussed below.

Third, if the separate taxable income of the member-shareholder is the relevant test, it will be trivial for taxpayers to avoid ever having the carve-back apply. No matter how big the overall loss of the consolidated group, the CFC could be held by a member with no other items of income or deduction. In that case, the GILTI inclusion would by itself create sufficient taxable income to support the full Section 250(a)(1) deduction without the carve-back. Even in the unusual case where this was not practicable, it would not generally be difficult to locate a CFC in a corporation that was not expected to have a taxable loss without regard to the GILTI inclusion.

Fourth, in a consolidated group, losses of one member can freely be used against income of another member, and (as long as the members remain in the group), the location of losses is generally irrelevant. Consistent with this policy, it is difficult to see why the carve-back should apply if the group as a whole has positive taxable income, solely because the member that is the U.S. shareholder has a tax loss on a stand-alone basis. Likewise, if the group as a whole has a tax loss, it is difficult to see why the carve-back should *not* apply merely because the particular member that is the U.S. shareholder has positive taxable income.

Note that if the member has a loss but the group as a whole has positive taxable income, even if a Section 250 deduction is allowed, the carve-back would prevent the deduction from creating a loss in the member that could not be used by the group on a current basis. Therefore, even aside from Section 172(d)(9), the loss created by the deduction could not be carried forward outside the group even if the stock of the member was sold.

Finally, consolidated groups determine their income on a group-wide basis, and it is rarely relevant to determine taxable income on a member-by-member annual basis. It could be a considerable administrative burden for a group to have to separately calculate the taxable income of every member that had a Related CFC solely for purposes of GILTI and FDII.

We believe that Treasury has regulatory authority under Section 1502 to reach the result we propose. That section specifically authorizes consolidated return regulations "that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns." This provision was adopted in 2004, and the legislative history makes clear that it authorizes regulations to treat members of a group as a single taxpayer or as separate taxpayers, or a combination of the two approaches.[49]

We note that Section 5 of Notice 2018-28[50] applies the interest deduction limits of Section 163(j) on a consolidated basis. Those limits are based on the adjusted taxable income of the taxpayer and are analogous to the limits on the deduction under Section 250(a)(2). To be sure, the Notice relies in part on the legislative history of Section 163(j) that specifically supports the conclusion of the Notice. While there is no similar legislative history concerning Section 250, we believe the implicit logic of the Section 163(j) legislative history applies equally to Section 250.

3. Section 904 Limit on the Deemed Paid Foreign Tax Credit

Under the existing consolidated return regulations,[51] the Section 904(a) limit on foreign tax credits is determined on a consolidated basis. This is consistent with the calculation of taxable income on a consolidated basis, as discussed above. We believe that regulations should confirm that this principle continues to apply to the calculation of the limitation on the GILTI basket under Sections 904(a) and (d).

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[49] *See* Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-5-05 (2005) at 415.

[50] 2018-16 IRB (April 2, 2018).

[51] Treas. Reg. § 1.1502-4(d).

The foregoing discussion applies equally here. A separate company limitation for the GILTI basket would necessarily require a company-by-company calculation of notional taxable income and U.S. tax liability, neither of which is relevant today. In fact, for purposes of allocating research expenses, as well as most other expenses (other than interest) that are not directly allocated or apportioned to any specific income producing activity, an affiliated group is treated as a single corporation,[52] and a member-by-member allocation would be necessary solely for purposes of GILTI.

These special rules for GILTI calculations would result in enormous administrative complexity, a trap for the unwary taxpayer, and a very large tax planning opportunity for taxpayers. In fact, no matter how large the overall group losses or how many deductions the group had that might be allocated to GILTI inclusions, a group could avoid a Section 904 limitation by having a CFC be held by a member with no losses and with no expenses that might be allocated to foreign source income.

4. The Amount of the GILTI Inclusion

A more complex question is whether all members of a consolidated group should be considered a single U.S. shareholder for purposes of calculating a single GILTI inclusion for the group. If the answer is yes, then, since each Section 951A inclusion creates its own FTC inclusion percentage, the group would also have a single inclusion percentage. The result would generally be the same as if all the Related CFCs of all members of the group were owned by a single group member.

For the reasons stated below, we believe that regulations should adopt this approach. As discussed above, we believe that Section 1502 provides clear authority for such regulations. Treating all group members as a single member is referred to below as the "**aggregation approach**", while treating each member as having its own separately computed GILTI is referred to as the "**nonaggregation approach**".

(a) Why it matters

The aggregation approach can be either beneficial or harmful to taxpayers, depending on the situation. The reason is that aggregating or not aggregating particular CFCs with other CFCs in calculating GILTI can have a significant effect in determining the benefits that the group will receive from tested losses, QBAI return, and FTCs.

There are at least six distinct ways in which aggregation can be better or worse for taxpayers. The examples that follow illustrate these situations. In the examples, CFC1 is owned by group member M1, and CFC2 is owned by group member M2. If aggregation applies, M1 and M2 are together referred to as M. Unless otherwise indicated, there is no FTC or QBAI return. Charts and more detailed calculations for certain of these Examples are provided in Appendix 1.

[52] Section 864(e)(6); Treas. Reg. §§ 1.861-14T and 1.861-17(a)(3)(i).

(i) *Tested income can be offset by tested loss of another CFC*

Absent FTCs or QBAI return, aggregation is generally better for taxpayers when CFC1 has tested income and CFC2 has a tested loss. This is because tested income and tested loss can offset each other when they are included in a single GILTI calculation.

> Example 6(a) (tested income and tested loss; aggregation is taxpayer-favorable). Assume CFC1 has $100 of tested income, and CFC2 has $100 of tested loss. Under aggregation, M has a $0 Section 951A inclusion. Under nonaggregation, M1 has $100 of tested income and Section 951A inclusion, and M2 obtains no benefit from the tested loss of CFC2. The group is better off under aggregation.

However, if there is interest expense in a CFC with tested losses and QBAI return in a CFC with tested income, nonaggregation may be better for the taxpayer.[53]

> Example 6(b) (tested income and tested loss, interest expense offsets QBAI return; nonaggregation is taxpayer-favorable). CFC1 has $100 of tested income and $100 of QBAI return. CFC2 has $100 of interest expense and $50 of tested loss. Under nonaggregation, neither M1 nor M2 has any Section 951A inclusion. Under aggregation, the CFC2 interest expense of $100 offsets M's NDTIR from CFC1, so M has a Section 951A inclusion of $50.

(ii) *Tested income can be offset by excess QBAI return of another CFC*

If a Related CFC has QBAI return in excess of its tested income, such excess will reduce the Section 951A inclusion of its shareholder arising from other Related CFCs. This provides a benefit of aggregation.

> Example 7 (excess QBAI return of one CFC offsets tested income of another CFC; aggregation is taxpayer-favorable). Assume CFC1 has $100 of tested income and no QBAI return, and CFC2 has $10 of tested income and $100 of QBAI return. Absent aggregation, M1 has a Section 951A inclusion of $100, and M2 has no inclusion. With

[53] This example assumes that interest expense in a Related CFC with tested losses reduces the U.S. shareholder's NDTIR from other CFCs with QBAI return. *See* discussion in Part IV.D.6.

aggregation, M has a Section 951A inclusion of $10.

(iii) *Tested loss offsets tested income but also reduces the inclusion percentage*

As illustrated in Example 6(a), a tested loss of one CFC has the benefit of offsetting tested income of other CFCs in the same aggregation group. However, a tested loss also reduces the inclusion percentage for FTCs paid by other CFCs in the same aggregation group. Aggregation can help or hurt the taxpayer depending on whether the tested loss offsets tested income of a high-taxed or low-taxed CFC.

Example 8(a) (base case with aggregation: tested loss offsets high- and low-taxed tested income). Assume (1) CFC1 has $100 of tested income net of foreign taxes and a foreign tax rate of 13.125%, (2) CFC2 has $100 of tested income and foreign tax of $0, and (3) the group also owns CFC3 with a $100 tested loss. With aggregation, the Section 951A inclusion is $100 and the inclusion percentage is 50%, regardless of who owns CFC3.[54]

Example 8(b) (no aggregation, tested loss only offsets high-taxed income; result is worse for taxpayers than aggregation). Same facts as Example 8(a), but assume CFC3 is owned by M1. Absent aggregation of M1 and M2, M1 has no Section 951A inclusion and an inclusion percentage of 0%. M2 has a Section 951A inclusion of $100 and no FTC. The result is worse than under aggregation because the tested loss of CFC3 is "wasted" when used against high-taxed income in CFC1.[55]

Example 8(c) (no aggregation, tested loss only offsets low-taxed income; result is better for taxpayers than under aggregation). Same facts as Example 8(a), but assume CFC3 is owned by M2.

[54] The Section 951A inclusion is equal to CFC1's $100 of tested income, plus CFC2's $100 of tested income, minus CFC3's $100 of tested loss, or $100. The inclusion percentage is the $100 Section 951A inclusion, divided by the sum of CFC1's $100 of tested income and CFC2's $100 of tested income, or 50%. A portion of CFC1's foreign taxes is available to M for use as a FTC because the inclusion percentage is 50%.

[55] None of CFC1's foreign taxes is available as an FTC because M1 has no inclusion under Section 951A. M2 has an inclusion under Section 951A but no FTCs because CFC2 paid no foreign taxes.

Then, M1 has a Section 951A inclusion of $100 and a 100% inclusion percentage, so no tax is due. M2 has no inclusion, and no tax. Full use has been obtained for both the tested loss in one GILTI group, and the FTC in a different GILTI group.

(iv) *NDTIR reduces the Section 951A inclusion, which then reduces the FTC inclusion percentage*

When NDTIR reduces the Section 951A inclusion, the result is a *pro rata* cutback of FTCs based on the reduction of the Section 951A inclusion, without regard to which CFC had QBAI return. If one CFC has QBAI return and the other does not, and tax rates on the CFCs are different, the single calculation of the inclusion percentage under aggregation can be better or worse for taxpayers than the separate calculations of the inclusion percentage under nonaggregation.

In the three examples below, the FTCs are half utilized under aggregation (Example 9(a)), fully utilized under one fact pattern involving nonaggregation (Example 9(b)), and not utilized at all under another fact pattern involving nonaggregation (Example 9(c)).

<u>Example 9(a) (base case with aggregation; NDTIR reduces inclusion percentage).</u> Assume (1) CFC1 has $100 of tested income net of foreign taxes, and no QBAI return, and (2) CFC2 has $100 of tested income net of foreign taxes, and $100 of QBAI return. Also assume that either CFC1 or CFC2 has a foreign tax rate of 13.125%, and the other has a 0% rate. Under aggregation, M has $200 of tested income, a Section 951A inclusion of $100 ($200 minus $100 of NDTIR), and an inclusion percentage of 50%.

<u>Example 9(b) (no aggregation; lower foreign tax on QBAI return; result is taxpayer-favorable compared to aggregation).</u> Assume the same facts as Example 9(a), but with the foreign taxes being imposed on CFC1. Under nonaggregation, M1 has a Section 951A inclusion of $100 and an inclusion percentage of 100%, while M2 has a Section 951A inclusion of $0. This allows for full usage of FTC on the non-exempt income in CFC1, while aggregation “wastes” half of the FTC on the QBAI return in CFC2.

> <u>Example 9(c) (no aggregation; higher foreign tax on QBAI return; result is taxpayer-unfavorable compared to aggregation)</u>. Same facts as in Example 9(a), but the foreign taxes are imposed on CFC2. Under nonaggregation, M1 has a $100 Section 951A inclusion, with no FTC offset, and M2 has no Section 951A inclusion. This is worse for taxpayers than the aggregation case because the FTC in CFC2 is totally "wasted".

(v) *Interest expense reduces NDTIR of the U.S. shareholder unless paid to a Related CFC of the same U.S. Shareholder*

Gross interest expense of a CFC reduces NDTIR of the U.S. shareholder unless the corresponding interest income is taken into account in determining the U.S. shareholder's net CFC tested income. This can make aggregation or nonaggregation more favorable depending on the facts.

Suppose CFC1 has interest expense to a third party and no QBAI return, and CFC2 has no interest expense but has QBAI return. Under aggregation, the interest expense of CFC1 will reduce M's NDTIR. Without aggregation, there will be no reduction in M2's NDTIR, so aggregation is worse for the group.

Alternatively, suppose CFC1 has QBAI return and pays interest to CFC2. With aggregation, the interest will have no effect on the group's net CFC tested income or NDTIR. Without aggregation, the interest will reduce M1's NDTIR and net CFC tested income, and increase M2's net CFC tested income. Total net CFC tested income is the same in both cases, but aggregation avoids the reduction in NDTIR and is better for the group in this fact pattern.

(vi) *Investment adjustments in stock of M1 and M2 will differ depending on aggregation or nonaggregation*

Part IV.D.7 discusses issues that arise in making stock basis adjustments to M1 and M2 under the consolidated return regulations. Aggregation or nonaggregation may have different effects on allocating the GILTI inclusions to M1 and M2, even if the total inclusion is the same in both cases. These differences in stock basis could be favorable or unfavorable to the group depending on its future plans to dispose of stock of M1 or M2.

(b) Discussion

These examples illustrate some of the ways in which aggregation of members of a group in calculating GILTI helps taxpayers in certain circumstances and hurts taxpayers in others. As a policy matter, we do not believe the substantive tax results in these examples should differ so dramatically depending on where in a group a particular CFC is held. The statute already provides for a single calculation of the GILTI inclusion for all Related CFCs held by a single group member. Logically, the rule should also apply to all Related CFCs held by all members of a group.

It is often quite arbitrary where in a group a particular CFC is held, and it would be quite unusual for significant tax consequences to depend upon the location of the CFCs within a group. At a minimum, this would create an enormous trap for the unwary taxpayer who simply assumes that it would not make a difference where a particular CFC is held within a group.

Moreover, if regulations do not provide for mandatory aggregation for all Related CFCs held by members of a group, the result will be an effectively elective regime. In many if not most cases, it will make little or no business difference to taxpayers where in a group any particular CFC is held.[56] As a result, in the absence of mandatory aggregation, taxpayers can be expected to obtain aggregation for whichever CFCs it is desirable, by having the relevant CFCs held by a single group member, and to avoid aggregation for whichever CFCs it is desirable, by having individual CFCs each held by a separate group member.

Elaborate computer programs would likely be designed to determine, on an annual basis, the groupings and non-groupings of CFCs that will minimize the overall tax liability of the group for the following year. Likely the only reason a well-advised group would not reach the optimal structure every single year would be if their predictions for the following year were inaccurate. Query whether the use of such a computer program would even violate any anti-abuse rule, given the rather arbitrary nature and murky purpose of some of these rules.

For example, a group could restructure today to cause every member with a Related CFC that it directly holds to transfer it to a single newly-formed U.S. group member ("**CFC Master Holding**") in a series of transfers that qualify for non-recognition of gain and loss under Section 351. Aggregation of all the Related CFCs would therefore apply absent further action.

At the end of this year, the group would determine whether separate treatment of any CFC (along with its CFC subsidiaries) would likely be favorable for next year. If so, CFC Master Holding would transfer each of those CFCs to a new separate wholly owned U.S. subsidiary of CFC Master Holding (each, a "**CFC Subsidiary Holding**"). If a separate grouping of two or more CFCs was desirable, those could be contributed together to a separate CFC Subsidiary Holding.

At the end of each year thereafter, the group would make a new determination for the following year. Depending on the results, any CFC Subsidiary Holding can either be retained as such or else liquidated into CFC Master Holding in a transaction that qualifies for nonrecognition of gain and loss under Section 332. Any CFC already held by CFC Master Holding could either be retained there, or transferred to a new CFC Subsidiary

[56] An exception might be CFCs that are regulated entities, which may be required by law to be held within or outside of specified structures.

Holding or to an existing CFC Subsidiary Holding. The result is a practical election on an annual basis whether each CFC (along with its own CFC subsidiaries) will be treated on a separate or aggregated basis for GILTI purposes, and what the aggregation groups will be for the year.

In reality, this type of structuring would often have little or no business purpose. While existing or newly created anti-abuse doctrines or rules might be employed to attempt to stop the most blatant structuring, such doctrines or rules will be extremely difficult to enforce for a multinational corporation with hundreds if not thousands of CFCs.[57] A lot of pressure will also be put on the ability to make retroactive check the box elections, in order to retroactively combine or separate out companies based on results that are different than the expected results.

As a policy matter, these transactions do not carry out the purposes of the statute and we are not aware of any other reason why they should be permitted. Thus, the statute should not be allowed to distort taxpayer behavior and incentivize these transactions. Moreover, we are not aware of any policy reason why taxpayers should have adverse tax consequences solely because they hold CFCs through multiple members for good business reasons.

More broadly, there is no reason that consolidated groups should obtain significantly different tax results under GILTI depending on where CFCs are held within the group. Indeed, given the statutory aggregation among CFCs owned by a single group member, the single entity principle of consolidated returns supports aggregation among CFCs owned by different group members.

We acknowledge that Section 951A reflects a general similarity between GILTI and Subpart F, and that there is no aggregation of group members in Subpart F. Each U.S. group member calculates its own Subpart F inclusion solely by reference to the CFCs for which it itself is a U.S. shareholder. However, under Subpart F, the U.S. shareholder takes account of each CFC separately, without regard to any other CFCs of which it is a U.S. shareholder. As a result, it would not make a difference whether all group members were aggregated.

On the other hand, the GILTI calculation for a single member of the group already involves considerable aggregation of the tax attributes of the Related CFCs of that member, and it is a logical extension of that procedure to extend the aggregation to CFCs owned by all group members. As a result, we do not find the Subpart F analogy persuasive.

The administrative aspects of aggregation do not appear to add undue complexity. It is true that the group would often have a different Section 951A inclusion than the sum of the separate Section 951A inclusions in the absence of aggregation, but this is the proper result. The overall inclusion would logically first be allocated to members in

[57] None of this restructuring would be affected by Section 367, since the stock of the CFCs remains within the U.S. consolidated group.

proportion to the net CFC tested income that each member would have from its own Related CFCs in the absence of aggregation. This method would disregard members' NDTIR that would reduce their respective Section 951A inclusions on a stand-alone basis. However, it is consistent with the second step of the process based on Section 951A(f)(2), which allocates a member's own Section 951A inclusion (as determined in the first step) among its own Related CFCs with positive tested income in proportion to such income.

Alternatively, the overall inclusion could be allocated to members in proportion to the separate Section 951A inclusions or GILTI inclusions they would have had in the absence of aggregation, although the second step would still be on the basis of tested income. A number of issues under the basis adjustment rules of Treas. Reg. § 1.1502-32 would also arise and are discussed in Part IV.D.7.

In principle, aggregation could be applied to CFCs held by U.S. members of a controlled group that do not file a consolidated return. We do not recommend the expansion of aggregation in this manner, except perhaps as an anti-abuse rule if a principal purpose of having multiple owners of multiple CFCs is to avoid the purposes of the GILTI rules. We note in this regard that Section 5 of Notice 2018-28 states that Treasury does not anticipate that affiliated groups not filing a consolidated return would be aggregated for purposes of Section 163(j).

Even setting aside the question of the government's authority to aggregate more broadly, we think aggregation among consolidated group members is correct because these members are already treated as a single entity for most tax purposes. This is not true for each member of a controlled group that does not file a consolidated return. As a result, there is less policy justification for aggregation. Moreover, mandatory aggregation would be difficult to justify, and elective aggregation does not seem justified. The mechanics of aggregation would also be very difficult to apply, since each U.S. shareholder would have its own taxable income and other tax attributes.

If aggregation among consolidated group members is required, consideration should also be given to whether the same rule should apply to CFCs held by a partnership where a specified percentage of the partnership is owned by group members. For example, if a CFC is held by a partnership and two group members are each a 50% partner, the issue is whether the group's overall GILTI calculation should be made as if the CFC were held directly by group members, or whether the partnership should be respected and the usual rules for partnerships holding CFCs (discussed below) should apply.

In the absence of a look-through rule, it would be possible for a group to take particular CFCs out of its aggregation groups by putting them into a partnership that is wholly or largely owned by group members. Treasury could either adopt an automatic look-through rule, or it might conclude that existing anti-abuse rules such as economic substance and partnership anti-abuse are adequate to police this structure.[58]

C. Deductions Allowed in Calculating Tested Income

1. The Issue

Assume that all the gross income of a CFC is included in tested income. The threshold question is which expenses of a CFC should be allowed as a deduction in calculating tested income.

The statute provides that tested income is "gross income" determined without regard to certain specified items,[59] less deductions (including taxes) "properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income)".[60] Section 954(b)(5) contains the same reference to deductions "properly allocable" to Subpart F income. However, it refers to the method to allocate known deductions to different categories of income, not the method to determine whether an expense is properly counted as a deduction.[61]

In the absence of guidance from either the statute or the legislative history, we consider three possible methods for determining which expenses of a CFC should be allowed as a deduction from its gross income:

(1) The "**modified taxable income method**". All costs that would be allowable as a deduction to a U.S. corporation would be allowed, except as specifically identified otherwise by Treasury. The CFC must in effect file a hypothetical U.S. tax return reporting taxable income and loss, with any specified adjustments, but only for gross

[58] In our recent report on Section 163(j), we recommended that a partnership among members of a consolidated group be respected as such, although a minority supported the view that aggregate principles should apply. *See* NYSBA Tax Section, "Report on Section 163(j)", Report No. 1393, March 28, 2018 (the "**Report on Section 163(j)**"), Part III.G.5. Arguably Section 951A presents a better case for aggregation because, as noted in that Report, Section 163(j)(4)(A)(i) specifically says that Section 163(j) is to be determined at the partnership level and does not distinguish a partnership among group members.

[59] Section 951A(c)(2)(A)(i).

[60] Section 951A(c)(2)(A)(ii).

[61] Treas. Reg. § 1.954-1(c)(1)(i)(B) refers to allocating expenses under the principles of Sections 861, 864, and 904(d). It appears the drafters of the Act intended Section 954(b)(5) principles to apply for purposes for allocating deductions, rather than determining deductibility: "For purposes of computing deductions (including taxes) properly allocable to gross income included in tested income or tested loss with respect to a CFC, the deductions are allocated to such gross income following rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income)." Conference Report at 644.

income that is tested income and deductions allocable to tested income.

(2) The "**Subpart F method**". All costs of the type deductible for Subpart F purposes would be allowed. Allowed deductions are generally amounts deductible under U.S. generally accepted accounting principles ("**GAAP**") for a domestic corporation, unless the use of those principles would have a "material effect" as compared to a calculation under U.S. tax principles.[62] This calculation incorporates by reference the rules for determining e&p of the CFC.[63]

(3) The "**modified Subpart F method**". The Subpart F method would apply, but with the disallowance of particular deductions specified in regulations that are disallowed for U.S. tax purposes.

Under any of these methods, foreign taxes are permitted as deductions in calculating tested income if they are "properly allocable" to gross Section 951A inclusions.[64] The question of what taxes are properly allocable to Section 951A inclusions is discussed in Part IV.E.1(a).

2. Choice of Method

Each of these methods could produce very different outcomes, depending on the particular facts. For example, a nondeductible fine or penalty,[65] a payment under a hybrid instrument,[66] a loss on a sale to a related party,[67] an interest deduction that exceeded the limits under Section 163(j), and a nondeductible business entertainment or meal expense[68] would likely be allowed under the Subpart F method and the modified Subpart F method absent a regulatory exception, but not under the modified taxable income method. "Interest" expense on an instrument treated as debt for GAAP purposes

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[62] Treas. Reg. § 1.952-2(b)(1), (c)(2).

[63] *Id.* These rules are in Treas. Reg. § 1.964-1. *See also* Proposed Treas. Reg. § 1.163(j)-8, which provides rules for applying Section 163(j) to a foreign corporation that has "effectively connected income", or "ECI". Arguably this regulation contains a negative inference that Section 163(j) must not apply to a foreign corporation unless it has ECI.

[64] Section 951A(c)(2)(A)(ii).

[65] Section 162(f).

[66] Section 267A.

[67] Section 267.

[68] Section 274.

but not for U.S. tax purposes because of its riskiness might even be allowed under the same circumstances.[69]

(a) The modified taxable income method

We believe that the modified taxable income method is the preferable method as a theoretical matter. Under either of the theories of GILTI discussed above, GILTI is in substance a partial world-wide tax system, with nonexempt income of a CFC effectively taxed at a reduced rate of U.S. tax (in the case of a corporate U.S. shareholder) or at the regular rate of U.S. tax (in the case of all other U.S. shareholders in the absence of a Section 962 election and Section 250 deduction).

Moreover, "gross income", the initial component of tested income, is based on U.S. tax principles.[70] It would be most logical for the second step, namely the calculation of deductions allocable to gross income, to be calculated in the same manner so that taxable income for GILTI purposes is the same as for U.S. tax purposes generally. We note that the Subpart F rules use a consistent method for calculating gross income and deductions, because it is taxable income (not merely deductions) that is determined on a GAAP basis unless the result has a material effect as compared to the use of U.S. tax principles.[71]

We also do not see a policy justification for deductions not allowed to a U.S. corporation to be allowed to a CFC in calculating tested income. Such a rule would invite "deduction shifting", since a U.S. corporation could shift nondeductible expenses to a CFC and in effect obtain a deduction at the GILTI tax rate. For example, if Section 163(j) did not apply to a CFC, the U.S. shareholder could avoid the limitations of that section (at the cost of a reduced 10.5% tax benefit) by having its existing debt assumed by the CFC or new borrowings incurred by the CFC. To be sure, such shifting of debt could have significant business consequences, and the application of Section 163(j) might not eliminate the incentive for shifting debt to CFCs.[72] Nevertheless, we do not believe taxpayers should have an incentive to make such shifts.

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[69] Under the modified taxable income method, if the CFC makes a locally deductible payment under a hybrid instrument to the U.S. shareholder, there would not be a deduction from tested income, but the payment would be a dividend payment out of previously taxed GILTI inclusion and not taxable in the U.S. As a result, both the local tax deduction and the reduced GILTI rate would apply to the income underlying the hybrid payment.

[70] Section 951A(c)(2)(A)(i) refers to "gross income", which is necessarily used in the tax rather than accounting sense.

[71] Treas. Reg. § 1.952-2(b)(1), (c)(2).

[72] Since there is no aggregation of CFCs for Section 163(j) purposes, debt could be incurred by particular CFCs with high levels of tested income, even if the Related CFCs in the aggregate had little tested income.

We acknowledge that Section 6 of Notice 2018-28 states that Section 163(j) does not prevent the application of disallowed deductions to reduce e&p, and arguably the same reasoning would disregard Section 163(j) in calculating GILTI. However, we do not think the situations are analogous. Earnings and profits is a measure of economic income or loss, many disallowed deductions reduce e&p, and in particular interest is a true cost regardless of its deductibility. As a result, the position in the Notice makes sense. On the other hand, Section 163(j) is specifically designed to prevent income stripping, and the fact that interest deductions disallowed under Section 163(j) reduce e&p is not a justification for allowing excessive interest expense to strip income out of CFCs with tested income.

Under this method, Treasury would be given the authority to specify particular variances from U.S. taxable income that would apply. This might be done for administrative convenience, such as not requiring an add-back to tested income for disallowed travel and entertainment expenses.

A disadvantage of the modified taxable income method is that it would require a corporate group to create a separate hypothetical U.S. Federal income tax return for each CFC in the group. This could be extremely difficult, since local finance officials in the CFCs are likely unfamiliar with U.S. tax principles.[73] Moreover, even minor variances from U.S. taxable income (as adjusted) could result in audit adjustments.

This difficulty in calculation might be reduced under the Subpart F method or the modified Subpart F method. Those methods begin with U.S. GAAP income, and a U.S. group with CFCs is likely already computing its GAAP income by taking into account the income of its CFCs. On the other hand, these methods would require a determination in each case that the result was not materially different than the result under the modified taxable income method, so some knowledge of U.S. tax principles would be required in any event. In reality, the difficulties in calculation are inherent in the decision by Congress to impose a current U.S. tax on the income of CFCs.

Another disadvantage of the modified taxable income method is that it would result in tested income being calculated on a different basis than Subpart F income. This is literally consistent with Section 951A(c)(2)(A), which defines tested income as gross income not taken into account in determining Subpart F income, minus deductions allocable to such gross income under rules similar to the rules for allocating deductions under Subpart F. This language should prevent a double inclusion of gross income, or a double deduction of the same item. However, Congress may not have contemplated Subpart F and tested income being calculated on a different basis. Moreover, if deductions were allowed for one purpose but not the other, both taxpayers and the IRS would have incentives to shift deductions between the categories.

(b) The Subpart F method

[73] We also note that if U.S. tax principles are to be used in calculating the tested income of CFCs, logically other U.S. tax principles should also apply, such as allowing aggregation of Related CFCs of a U.S. shareholder as if they filed a U.S. consolidated tax return.

The Subpart F method imports Subpart F principles into the GILTI calculations. This is consistent with the general similarity between GILTI and Subpart F. Moreover, tested income is defined in substance as total taxable income reduced by Subpart F income,[74] and it would be peculiar to determine the total on a different basis than the subtraction.[75]

However, we believe that the differences between these two regimes are sufficiently great that the existing application of the Subpart F method does not strongly support the extension of that method to GILTI. GILTI is not based on or limited to e&p, so arguably consistency between Subpart F income and GILTI was not viewed by Congress as important. Moreover, GILTI involves a vastly greater amount of potential income inclusions than Subpart F.[76] Thus, the rule for Subpart F should not be applied to GILTI without an independent policy justification.

In considering whether such policy justification exists, we note that under pre-2018 law, tax on the earnings of CFCs was deferred until e&p generated by the CFC was repatriated in the form of dividends (or deemed dividends under Section 1248 upon a sale of the stock of the CFC). Subpart F represented an exception to deferral for particular categories of income,[77] and it was logically limited to the same e&p that would eventually be taxed on payment of a dividend. Moreover, the calculation of e&p is relatively similar to the calculation of GAAP income, so it made sense to use GAAP income (which would already be known) as a surrogate for e&p as long as the differences were not too great. To the extent that the GAAP calculation resulted in less Subpart F

[74] Section 951A(c)(2)(A).

[75] The Tax Section recently asked Treasury to allow items arising under Section 987 to be determined on a basis similar to GAAP profit and loss rather than U.S. taxable income. NYSBA Tax Section Report No. 1386, *Report on Notice 2017-57: Alternative Rules for Determining Section 987 Gain or Loss*, Jan. 22, 2018.

[76] On the other hand, the prevalence of Subpart F income may increase if taxpayers create it to avoid unfavorable aspects of GILTI. This would make disparities between Subpart F income and GILTI more meaningful than at present, and planning opportunities would arise to take advantages of such disparities.

[77] The Senate Finance Committee made the following comment regarding the 1962 bill that enacted Subpart F: "Under [then] present law foreign corporations, even though they may be American controlled, are not subject to U.S. tax laws on foreign source income. As a result no U.S. tax is imposed with respect to the foreign source earnings of these corporations where they are controlled by Americans until dividends paid by the foreign corporations are received by their American parent corporations or their other American shareholders. The tax at that time is imposed on the American shareholder with respect to the dividend income received, and if this shareholder is a corporation it is eligible for a foreign tax credit with respect to the taxes paid by the foreign subsidiary. In the case of foreign subsidiaries, therefore, this means that foreign income taxes are paid currently, to the extent of the applicable foreign income tax, and not until distributions are made will an additional U.S. tax be imposed, to the extent the U.S. rate is above that applicable in the foreign country. This latter tax effect has been referred to as 'tax deferral.'" The committee went on to describe the ways in which the House bill had sought to eliminate deferral only for "tax haven" devices, and the committee's amendments were "designed to end tax deferral on 'tax haven' operations by U.S. controlled corporations". S. Rep. No. 1881, 87th Cong., 2d Sess., *reprinted at* 1962-3 C.B. 703, 784-785.

income than the e&p calculation, the difference was a timing difference for income inclusion.

By contrast, tested income and GILTI are not based on e&p. If tested income of a CFC is understated under U.S. tax principles, there is a permanent exemption of income of the CFC (calculated under U.S. tax principles) from the U.S. GILTI tax. This result does not seem consistent with the intent of Congress in imposing a tax on GILTI without regard to the e&p of the CFC.

As between the modified taxable income method and the Subpart F method, the former will usually be less favorable to taxpayers because of deductions disallowed for U.S. tax purposes but allowed for GAAP purposes. However, it will sometimes be more favorable to taxpayers. For example, in cases where U.S. tax depreciation is faster than GAAP depreciation, there will be less tested income in earlier years.

We do not believe the Subpart F method should be adopted, because we believe that it is inferior to the modified Subpart F method for the reasons described below.

(c) The modified Subpart F method

In light of the practical concerns raised by general adherence to U.S. tax principles under the modified taxable income method, and the policy concerns raised by disregarding U.S. tax principles under the Subpart F method, we believe the modified Subpart F method is superior to the Subpart F method and is a realistic alternative to the modified taxable income method. The modified Subpart F method would give Treasury the flexibility, for example, to apply the Section 163(j) limits on interest deductions. Permitting departures from the Subpart F method in certain circumstances is also consistent with our position below that carryovers of losses of a CFC should be allowed.

Under the modified Subpart F method, taxpayers would begin with the same type of analysis with respect to each CFC that is already conducted for Subpart F purposes. They would then refer to a list formulated by Treasury of specific deductions that are disallowed to U.S. corporations and would also be disallowed in calculating GILTI regardless of their treatment for GAAP purposes

This method would limit adjustments to GAAP income to the elimination of those deductions that Treasury believes are most important to disallow for GILTI purposes. In particular, it would minimize the need to make minor add-backs such as (if Treasury agreed) for disallowed travel and entertainment expenses.

Under this method, we propose to continue the rule in the existing Subpart F regulations that the result could not be materially different than the calculation of taxable income for U.S. tax purposes. This would prevent abuse of the modified Subpart F method for GILTI purposes, just as for Subpart F purposes today.

Ultimately, a significant disadvantage of this method is that it involves dealing with three different tax systems. First, GAAP income must be determined as in the Subpart F method. Then, adjustments to GAAP income as required by Treasury guidance must be made. Finally, the result must be compared to U.S. taxable income with specified adjustments (the modified taxable income method) to see if the differences are material. On top of this, the statute specifically requires that the tax basis of assets for purposes of the QBAI calculation be determined quarterly under the alternative depreciation system of Section 168(g).[78] It is not clear that this process is any simpler than beginning with the modified taxable income method in the first place. It would also be peculiar for an asset to have a GAAP basis for calculating tested income and a Code-based tax basis for calculating QBAI.

(d) Conclusion

We recommend that Treasury adopt either the modified taxable income method or the modified Subpart F method. These methods are similar. The former starts with taxable income and allows Treasury to make adjustments to bring the result closer to GAAP income. The latter starts with GAAP income and allows Treasury to make adjustments to bring the result closer to taxable income. The choice of method depends upon whether, in the end, the desired result is closer to GAAP income or closer to taxable income. We do not take a position on this issue.

3. Loss and Interest Carryovers

(a) Carryover of operating losses

(i) In general

Under any of the foregoing methods of determining tested income, the question arises as to whether losses can be carried forward. Consider a U.S. shareholder with a single CFC that has no QBAI return, a tested loss in year 1, an equal amount of tested income in year 2, and no foreign tax liability. Absent a loss carryover, the shareholder would have a net GILTI inclusion and resulting tax liability in year 2, in the absence of any economic income over the two year period. This result is unfair, and inconsistent with the flat-rate theory of GILTI, assuming the flat-rate theory is intended to apply over time as opposed to only in years with profits.

As a result, to the extent a U.S. corporation would be entitled to carry over a loss or deduction to a future year, we believe the same should be true under GILTI. Moreover, we believe that rules similar to the existing rules for NOL carryovers should apply. We believe this should be true under any of the methods for determining tested income described above that might be adopted for GILTI purposes.[79]

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[78] Sections 951A(d)(1), (d)(3)(A).

[79] We do not recommend that rules similar to the e&p deficit rules apply in calculating tested income (as an alternative to loss carryovers). Many of the complexities described below relating to loss carryovers arise because of the aggregation principles inherent in the GILTI calculations, and many of the same complexities would arise in this alternative system.

The Subpart F regulations provide that net operating losses are not taken into account in calculating taxable income for Subpart F purposes.[80] However, Subpart F income is limited to current year e&p of the applicable CFC[81] and is reduced for certain prior year e&p deficits of the same CFC from Subpart F activities.[82] In some cases, e&p deficits of other CFCs in the same ownership chain may also be used.[83] As a result, in at least some cases, an NOL carryover under such a system is not needed to prevent net Subpart F income from arising in year 2 if there is a loss in year 1 and income in year 2. Moreover, Subpart F losses are not likely to arise very often, so the rule for Subpart F should not as a policy matter determine the rule for GILTI, where tested losses are likely to arise much more frequently.

We also acknowledge that under any method of allowing carryovers, the amount of the carryover is based in part on the tested loss of a CFC. Under any of the methods of determining tested loss, the tested loss might be greater than the NOL that would arise for a domestic corporation. However, because of the restrictions on those methods, the tested loss could not be materially greater. Moreover, given that the full amount of the tested loss is respected as an offset to current year tested income of other CFCs, it should logically be available in full to determine the carryover to future years.

We describe below two alternative methods to implement a system to allow the carryover of unused tested losses, one at the CFC level and the other at the shareholder level. The first method would allow a tested loss of a CFC to carry over at the CFC level to offset future tested income of the CFC, similar to an NOL carryforward of a domestic corporation. As discussed below, this gives rise to extremely complex issues because the income inclusion occurs at the shareholder rather than the CFC level, and the amount of the inclusion is affected by factors arising from other CFCs. As a result, while this approach may be the more theoretically correct one, the resulting complexities make it questionable as a practical matter.

The alternative approach is to "push out" an unused tested loss of a CFC to the shareholder and permit the shareholder to use it to reduce its GILTI inclusions in future years. We prefer this approach because it avoids many, but far from all, of the complexities of loss carryovers at the CFC level.

Both approaches raise the question of whether they could be implemented by regulation, or if legislation would be required. We take no position on this issue,[84] but

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[80] Treas. Reg. § 1.952-2(c)(5)(ii).

[81] Section 952(c)(1)(A), Treas. Reg. § 1.952-1(e).

[82] Section 952(c)(1)(B).

[83] Section 952(c)(1)(C).

[84] One issue under the existing statute for allowing losses to carry over at the CFC level is the rule that tested income of a CFC for a taxable year is gross income of the CFC for that year less deductions properly allocable to that gross income. The question is whether a tested loss carried over from a prior year,

we urge that Treasury either adopt our preferred method by regulation, or if it does not believe it has the authority, that legislation be adopted to implement this method.

(ii) Carryover at the CFC level

Under the existing rules, if a Related CFC has a tested loss, all or part of that tested loss is available to shelter tested income of the U.S. shareholder from Related CFCs.[85] To the extent the loss is in fact utilized in this manner, it obviously should not carry over to future years of the CFC.

We would apply this rule even if the U.S. shareholder did not obtain any tax benefit from the use of the tested loss to shelter tested income, either because the tested income had high FTCs or because the shareholder had NDTIR. For example, suppose CFC1 has a tested loss of $100, and CFC2 has tested income of $100. In addition, either CFC2's income is non-NDTIR income taxed at a high foreign tax rate, or else all of CFC2's income is NDTIR.

In either case, the shareholder has no GILTI tax even without regard to the tested loss of CFC1. However, both NDTIR and foreign tax credits are determined at the shareholder level, and in fact can arise from CFCs other than CFC1. Moreover, the application of a tax benefit principle would not be consistent with the normal rule that a loss is absorbed when it offsets taxable income, even if the taxpayer would not have been taxed on the taxable income for a reason such as high FTCs. Application of tax benefit principles would also be enormously complex and require a CFC to obtain far more information from its shareholder. As a result, we believe that a tested loss should be treated as "used" by the shareholder, and unavailable for carry forward by the CFC, whenever it offsets tested income of the shareholder, without regard to a "tax benefit" analysis at the shareholder level.

So far, this approach appears to be fairly straightforward. However, considerable complexity quickly arises.

First, rules would need to address how to determine which tested losses allocable to a particular U.S. shareholder are used to offset tested income of that shareholder. The shareholder might have multiple Related CFCs with tested income and tested loss.

The issue would only arise if the shareholder has a net tested loss, since only in that case are some tested losses from Related CFCs not utilized to offset tested income of other Related CFCs. In that case, the net tested loss at the shareholder level should logically be allocated to the various Related CFCs with tested losses in proportion to the tested loss of each Related CFC. A carryover of tested loss by each Related CFC would

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representing expenses in prior years that were allocable to gross income in prior years, can be considered properly allocable to gross income of the current year.

[85] Section 951A(c)(1) states that the U.S. shareholder's *pro rata* shares of tested income and tested losses of all Related CFCs for the current year are aggregated to determine net CFC tested income.

then be allowed to the extent of such allocation. This calculation would be done separately for each U.S. shareholder of a CFC with a tested loss.

Second, if there are multiple unrelated U.S. shareholders of a CFC, it would be necessary for the CFC to determine the extent to which its tested losses were actually used to offset the tested income of each U.S. shareholder. Perhaps a rule could be adopted that unless the CFC could provide proof that its loss was not utilized by a U.S. shareholder, the loss would be deemed to have been so utilized and could not carry over.

Third, suppose some but not all U.S. shareholders of a CFC can use their share of a tested loss in year 1.[86] The non-users would include, for example, all U.S. persons that are not U.S. shareholders of the CFC, all U.S. shareholders that do not have tested income from other CFCs, and all non-U.S. individual and corporate shareholders that directly hold stock in the CFC. The unused portion of the tested loss is the portion allocable to the shareholders in the non-user group.

It would be extraordinarily complicated to allocate the losses carried over to year 2 solely to the non-users in year 1. As a result, whatever portion of the loss is carried over will potentially benefit all U.S. shareholders in future years on a *pro rata* basis, not only the non-users in year 1. This will result in a partial double benefit to the shareholders that used their share of the loss in year 1, at the expense of the non-users in year 1 who can use the loss in a later year.[87]

For example, suppose a CFC has a tested loss of $100 in year 1, and the CFC is owned 50% by a U.S. corporation and 50% by a non-U.S. corporation.[88] If the U.S. corporation can use $50 of tested losses in year 1, then $50 of tested losses would carry over to year 2. The U.S. corporation would obtain 50% of the benefit of this $50 carryover if either (i) the CFC had $50 of tested income in year 2, or (ii) the CFC had no tested income in year 2 but the U.S. corporation had $25 of unrelated tested income in year 2.

In either case, the U.S. corporation obtains 75% of the benefit of the $100 tested loss in year 1. This result might be considered particularly surprising, if, say, the non-U.S. corporate shareholder owned 100% of the U.S. corporate shareholder. In that case, 75% of the tax benefits would be shifted to the 50% U.S. shareholder. The same allocation of 75% of the tax benefits to a related U.S. party would arise if a U.S. individual owned a U.S. corporation, each owned 50% of the CFC, the CFC had a tested loss of $100 in year 1, and either the U.S. individual or the U.S. corporation, but not both, could use $50 of tested losses in year 1.

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[86] For simplicity, disregard shareholders who can use part but not all of their share of the tested loss.

[87] The shifting of tested losses among possibly unrelated shareholders would also raise complex basis and e&p issues similar to those discussed in Part IV.D.7 where the shareholders are related.

[88] Fifty percent U.S. ownership is used for simplicity. The CFC might be a CFC because the non-U.S. corporation has a U.S. subsidiary, or because the U.S. corporation owns 50.01% of the stock or holds stock with over 50% of the vote.

The results can be even more extreme. In the example, assume the U.S. corporation can use unlimited tested losses, the other shareholder cannot use any tested losses, and the CFC has $0 tested income in each year after year 1. As above, the U.S. shareholder uses $50 of tested losses in year 1. Then, of the $50 that carries over to year 2, the U.S. shareholder uses its $25 share. Then, the remaining $25 of tested loss carries over to year 3, the U.S. shareholder uses $12.50 of that loss, and so on literally forever.

One possible way to avoid these results in some cases would be to limit the carryover of tested losses of a CFC to losses allocable to U.S. corporate shareholders that could not use their share of the tested losses, or to U.S. individuals that could not use their share and were not related to a U.S. corporate shareholder. This would prevent the shifting of the benefit of tested losses from non-U.S. persons to U.S. persons, or among individuals and related U.S. corporations.

However, this approach could give uneconomic results for U.S. shareholders that could not use their share of the loss in year 1. They would obtain no benefit in year 1 and might receive only a *pro rata* share of a reduced tested loss in year 2.

Consider the example above with a 50% U.S. corporate shareholder and 50% non-U.S. corporate shareholder. If the U.S. corporate shareholder could use $50 of the $100 tested loss in year 1, no tested loss would carry over and the result seems correct. However, if the U.S. corporate shareholder could not use any of the tested loss in year 1, only its $50 share of tested loss would carry over, and the U.S. corporate shareholder could obtain the benefit of only $25 of that amount in year 2.

This result seems unfair. However, arguably it is justifiable on the ground that the U.S. corporate shareholder is in no worse a position than if the other shareholder was another U.S. corporate shareholder that could use its $50 share of the tested loss in year 1.

Fourth, under current law, NOL carryforwards to a taxable year can offset only 80% of taxable income for the year.[89] Tested loss carryforwards should likewise be limited to offsetting only 80% of tested income in future years. However, consider the case where in the future year the CFC has QBAI return:

> <u>Example 10(a): Carryover of tested loss to year with QBAI return</u>. A U.S. shareholder owns 100% of a single CFC, and the CFC has a tested loss of $100 in year 1. In year 2, the CFC has $100 of tested income, of which $20 is QBAI return. Absent the loss carryover, the shareholder would have a Section 951A inclusion of $80.

If the loss carryover is allowed in the amount of 80% of the year 2 tested income, the shareholder's net CFC tested income will be $100 minus $80, or $20, and its Section

[89] Section 172(a).

951A inclusion will be $20 of net CFC tested income minus $20 of NDTIR, or $0. Thus, the loss carryover eliminates 100% of the Section 951A inclusion.

The elimination of 100% of the Section 951A inclusion for year 2 is arguably inconsistent with the purpose of the 80% limitation for domestic corporations. That rule does not allow a carryover to year 2 to eliminate 100% of the taxable income in year 2. Under this theory, the carryover should be limited to 80% of the Section 951A inclusion in year 2.

On the other hand, allowing a carryover of $80 only reduces tested income in year 2 by 80%, consistent with Section 172(a). Moreover, tested income is determined on a completely separate basis than are NDTIR and Section 951A inclusions. As a result, if the goal is to reduce the Section 951A inclusion to the U.S. shareholder by no more than 80%, it is impossible even in theory to determine at the CFC level how much of a carryover should be allowed. For example, another CFC held by the same U.S. shareholder might have QBAI return that offsets the tested income of this CFC, or might have interest expense that offsets the QBAI return of this CFC. If the CFC has more than one U.S. shareholder, then any loss carryover allowed at the CFC level will likely result in different percentage reductions to each U.S. shareholder's Section 951A inclusion.

The allowance of the loss carryover equal to 80% of tested income in year 2, without regard to QBAI return, is helpful to the taxpayer in Example 10(a). However, it can also be very adverse to taxpayers.

> Example 10(b): Carryover of tested loss to year with QBAI return. Same facts as Example 10(a), but in year 2, the CFC has $100 of tested income, of which all $100 is QBAI return. Even without the loss carryover, the Section 951A inclusion is $0. If $80 of the loss carryover is allowed in year 2, it has been absorbed with no tax benefit to the U.S. shareholder.

The avoidance of the 80% limitation in Example 10(a), and the wasting of loss carryovers in Example 10(b), would not arise if the loss carryover is limited to 80% of the excess of tested income over QBAI return in the carryover year. In that case (i) the carryover utilized in Example 10(a) will be 80% of ($100 minus $20), or $64, (ii) tested income and net CFC tested income will be $36, (iii) the Section 951A inclusion will be $36 minus $20, or $16, and (iv) $36 of the $100 of tested loss from year 1 will be carried forward to year 3. The Section 951A inclusion is reduced by 80%, arguably the correct result. No carryover would be utilized in Example 10(b), and the entire $100 carryover would be available in future years.

However, as discussed above, this limitation on carryovers could reduce the Section 951A inclusion by either more or less than 80% if the U.S. shareholder had other CFCs whose attributes were included in the Section 951A calculation. Moreover, the structure of the statute seems to contemplate that tested losses will be absorbed with no tax benefit in a situation such as Example 10(b) where they shelter QBAI return. It would be peculiar (and an opportunity for tax planning) if loss carryovers gave a more favorable result.

Finally, a rule for carryovers would normally treat a carryover in the same manner as a loss realized in the subsequent year.[90] However, this principle does not resolve the present issue. The ability to use carryovers to offset only 80% of current-year income necessarily means that a carryover is not as beneficial as a current year loss. Rather, the issue here is 80% *of what*, *i.e.*, tested income or tested income reduced by QBAI return.

Fifth, even in the absence of QBAI return, the 80% limit on carryovers raises uncertainties if the U.S. shareholder has more than one Related CFC. For example, as illustrated in Examples 6 and 7 above, the shareholder's Section 951A inclusion is determined by reference to net CFC tested income and NDTIR, which take into account not only the tested income and QBAI return of a particular Related CFC, but also the tested income and losses, QBAI return or interest expense of other Related CFCs.

> <u>Example 11. NOL carryover to year in which tested income is offset by tested loss of another CFC.</u> In year 1, CFC1 has a tested loss of $100 that is not used by its 100% U.S. shareholder. In year 2, CFC1 has tested income of $100, and the U.S. shareholder also owns CFC2 that has a tested loss of $20. Assume there is no NDTIR. The Section 951A inclusion aside from the loss carryover is $80.

If the loss carryover to year 2 is allowed to offset 80% of the $100 of tested income of CFC1, then CFC1 will have tested income of $20 in year 2 and the Section 951A inclusion will be reduced from $80 to $0 as a result of the carryover. Arguably this is inconsistent with the 80% limitation on loss carryovers, although it can be argued that the carryover is at the CFC1 level and any attributes of CFC2 are irrelevant. Allowing this result would also put a premium on shifting tested income from CFC2 to CFC1 in year 2 (and, depending on the rule adopted in Example 10, shifting QBAI return from CFC1 to CFC2 in year 2), in order to maximize the utilization of the loss carryover.

Alternatively, a rule could be considered that all loss carryovers from all Related CFCs of a particular U.S. shareholder should only be allowed to offset 80% of the net Section 951A inclusion of the particular U.S. shareholder, taking into account all tested

[90] *See, e.g.*, the discussion of Example 12 in Part IV.3.C(2) below, where we state that carryovers of disallowed interest under Section 163(j) to a year with QBAI return should not be treated more favorably than interest expense actually incurred in the later year. The distinction is that Section 163(j) treats current and carryover interest the same in limiting the deduction to a percentage of adjusted taxable income of any taxable year, while Section 172(a) only limits NOL carryovers to a percentage of taxable income in the carryover year.

income, tested loss, and NDTIR of that shareholder. This rule would be simple when there was a single U.S. shareholder.

However, this rule would not work when there were multiple U.S. shareholders with different Section 951A inclusions from different CFCs. The reason is that only a single specified amount of the carryover can be used to offset tested income of CFC1 in year 2, and that reduction in tested income would flow through *pro rata* to all shareholders. That *pro rata* amount would normally cause a different percentage reduction of the Section 951A inclusion for different U.S. shareholders with different holdings in other CFCs.

Sixth, if carryovers of tested loss are allowed, presumably Section 382 would apply to limit loss trafficking just as it does to domestic losses. This would introduce another layer of complexity, particularly among CFCs with multiple non-affiliated owners.

Finally, the allowance of carryover of tested losses at the CFC level might be quite disadvantageous to taxpayers in some situations, especially if the law is changed in the future so that NOL carryovers can offset 100% of taxable income. If this rule was applied to allow tested losses of a CFC to offset 100% of tested income of the CFC in future years, the benefits of FTCs and QBAI return of the CFC in the future year would be eliminated, just as they are today for a CFC with no positive tested income. Such a result could be much worse for taxpayers than the disallowance of the loss carryover, since the FTCs and QBAI return in a particular CFC could be more valuable than the tax cost of the tested income in the CFC.[91]

This issue would not arise or would be less significant under the current rule limiting the reduction in tested income by 80%, to 20% of tested income. This would always leave *some* positive tested income, which would allow full retention of FTCs and QBAI return of the CFC. However, the FTC inclusion percentage could be reduced because of the reduction in positive tested income, *e.g.*, because the QBAI return would be a greater percentage of the total positive tested income.

(iii) Carryover at the US shareholder level

We consider now the alternative approach of having tested losses arising from a CFC carry over at the shareholder level. As a reminder, tested losses of a CFC are taken into account in reducing the U.S. shareholder's income inclusion under Section 951A(a). A U.S. shareholder's Section 951A inclusion is the excess (if any) of the shareholder's net CFC tested income for the year over its NDTIR for the year.[92] Net CFC tested income is the excess (if any) of the aggregate of its *pro rata* shares of its Related CFCs'

[91] Presumably losses from pre-2018 years would not carry over into 2018 because the expenses giving rise to the losses were not attributable to tested income in those years.

[92] Section 951A(b)(1).

tested income over the aggregate of its *pro rata* shares of its Related CFCs' tested losses.[93]

We propose that in the first instance, all tested losses of a CFC move up to the U.S. shareholder and be taken into account by the U.S. shareholder, whether or not this gives the shareholder a net negative tested loss. These tested losses then become tax attributes of the U.S. shareholder, and are treated just like other tax attributes for all purposes, such as Section 381. The possible consequences to the U.S. shareholder's tax basis in the CFC are briefly discussed in Part IV.D.7.

Then, the question is how the tested losses that move up to the shareholder are "absorbed" in the current year and affect the amount of the carryover to future years (or are absorbed in future years and unavailable for further carryover).

The following example illustrates two methods for calculating carryovers. Assume a U.S. shareholder has two CFCs ("**CFC1**" and "**CFC2**"), CFC1 has $100 of tested income and $150 of QBAI return. CFC2 has $100 of tested loss. Under the statute, the U.S. shareholder has $0 tested income and $150 of NDTIR. As will be seen below, the two approaches give carryovers from year 1 of $0 and $150.

Under one approach (the "**tested loss carryover approach**"), $100 of tested losses would be absorbed by the $100 of tested income, and there would be no carryover of tested loss. More generally, the carryover amount would be the "**net CFC tested loss**", which would be defined in the same manner as net CFC tested income, except tested losses of some CFCs could exceed tested income of other CFCs. Likewise, in future years, the carryover would reduce, and be reduced by, the net CFC tested income, subject to the 80% limit. This approach is consistent with carrying over tested losses at the CFC level, since as discussed above tested losses would logically offset future tested income of the CFC without any adjustment for QBAI return in the future year.

The alternative approach (the "**shareholder calculation carryover approach**") applies the entire calculation at the shareholder level. If the Section 951A formula for inclusion would result in a negative number, aside from the prohibition of a negative result, that amount could be carried over, just like any excess of taxable expenses over taxable income. In the example, the Section 951A formula would result in minus $150 in year 1 (net tested income of $0 and NDTIR of $150), and this could be carried over.

This approach allows NDTIR not only to offset net CFC tested income, but also allows NDTIR to create its own carryover if it exceeds net CFC tested income. Specifically, the carryover of the negative amount in the GILTI formula is equal to net CFC tested income minus NDTIR, to the extent this number is negative and without regard to whether it exceeds aggregate tested losses of loss CFCs for the year. This approach, like the tested loss carryover approach, does not provide any benefit from shifting income and deduction among CFCs, since only net CFC tested income (or loss) is relevant.

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[93] Section 951A(c)(1).

This approach in effect treats NDTIR as exempt income earned on tangible assets, whether or not that is true in fact. It assumes that, say, a CFC with $100 of tested income and $150 of QBAI return *really* had a $50 tested loss on intangible assets and $150 of income on tangible assets, whether or not that is true as a factual matter. The shareholder obtains "credit" for the deemed $50 loss on intangible assets by being allowed a loss carryover of $50.

On the other hand, even aside from carryovers, the statute does a poor job of treating NDTIR as exempt income, such as by not providing any current year tax benefit for NDTIR when tested loss equals tested income. Moreover, this discussion began with the idea that tested losses of a CFC should be allowed to carry over if they are not utilized currently by the shareholder. It is a considerable leap from that position to the idea that the Section 951A calculation should be allowed to become negative and result in a loss carryover even in the absence of a net CFC tested loss. As a result, this approach would be a more significant conceptual change from the existing statute.[94]

We turn now to a separate issue. Either of the approaches for allowing a loss carryover at the U.S. shareholder level would raise a number of questions.

First, a U.S. shareholder could have a regular NOL carryover and a GILTI NOL carryover (aside from any Section 163(j) carryover from its own activities). GILTI NOLs would not offset non-GILTI income, just like a negative GILTI inclusion for the current year cannot offset non-GILTI income of the shareholder. However, non-GILTI loss carryovers should be available to offset GILTI inclusions, just like current non-GILTI losses can offset GILTI inclusions.

As a result, an ordering principle would be needed to establish which losses are used first. For example, current year losses are typically used before loss carryforwards. However, if the current year has a GILTI inclusion and a non-GILTI loss, and there is a GILTI loss carryforward, arguably the carryforward should be used first since it is of more limited use. Likewise, loss carryovers are usually utilized earliest year first. However, if there is a GILTI inclusion in the current year, arguably all GILTI carryovers should be used before any non-GILTI carryovers, for the same reason.

Second, the GILTI loss carryover (however defined) would presumably be subject to the same 80% limit for use against future GILTI income as are regular NOLs. There is no reason that these carryovers should be exempt from the rule. Suppose that there is both a GILTI inclusion and non-GILTI income in the year, and sufficient carryovers of

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[94] We considered a third, intermediate, approach under which NDTIR would offset tested income from CFCs with positive tested income, freeing up such amount of tested losses from CFCs with tested losses to be used currently against remaining tested income or to carry over. Only tested losses could carry over. However, this approach would allow the benefit of NDTIR to increase through the shifting of income and deduction within the group. In fact, if income and deduction items were shifted so that CFCs with positive tested income had total tested income equal to NDTIR, the group would achieve the result of the shareholder calculation carryover approach.

both types. The question is whether each type of carryover should be limited to offsetting 80% of its respective income type.

The alternative would be an aggregate limitation on carryovers equal to 80% of total income, with a preference given to the GILTI carryovers. For example, if there was $100 of GILTI inclusion and $100 of non-GILTI income and sufficient carryovers of both types, the net result could be either (1) $20 of GILTI inclusion and $20 of non-GILTI income, or (2) $0 of GILTI inclusion and $40 of non-GILTI income.

Third, having GILTI and non-GILTI carryovers would raise issues under Section 382. Suppose a corporation had $100 of each type of carryover, and a Section 382 event occurred that limited annual use of NOLs to $20. There are at least three possibilities:

- The aggregate limit of $20 would be available for any $20 of carryovers, and if the usual priority was for GILTI carryovers, that priority would continue to apply until the entire $20 was used up.

- The annual limit of $20 would be divided up *pro rata* between GILTI and non-GILTI carryovers based on their relative size.

- The annual limit of $20 would be divided between GILTI and non-GILTI carryovers based on the relative value of the assets generating GILTI inclusions and other assets.

The third alternative is supported by the fact that the Section 382 limit is equal to a percentage of the value of the stock of the shareholder at the time of the change in ownership.[95]

Yet another issue arises because under Notice 2003-65,[96] the Section 382 limit is adjusted by "recognized built in gain and loss". The question arises if the second or third alternative in the preceding paragraph is used. In those cases, the Notice 2003-65 amount could be calculated separately to adjust the GILTI and non-GILTI carryovers, or it could be done for the corporation as a whole and then allocated between the two carryovers in the same manner as the rest of the NOL limitation.

We note that while these issues appear to be complicated, in reality they are primarily design choices. Once the choice is made by regulations or legislation, the rules appear to operate relatively simply, in contrast to the operational effects of carrying over losses at the CFC level.

(b) Section 163(j) carryovers

[95] Section 382(b)(1).

[96] 2003-2 C.B. 747.

We discuss in Part IV.C.2 the method for determining the taxable income of a CFC. Under our proposal, Treasury would have the authority to determine whether Section 163(j) applies to a CFC. If the limitations of Section 163(j) apply, we believe that all of Section 163(j) should apply, including the carryover of unused interest deductions in the same manner as for a domestic corporation. As in the case of tested loss carryovers, we urge that either regulations or legislation provide for Section 163(j) carryovers.

We have the following reasons for this conclusion. The interest deductions that are disallowed currently under Section 163(j) are for interest that would reduce tested income if it was allowed. A taxpayer should not be in a worse position if an interest deduction is disallowed under Section 163(j) than if the interest deduction was allowed and created a tested loss that was permitted to be carried over. Moreover, absent a carryover rule, a CFC could have plenty of tested income over a period of two or more years, but because the income is bunched into a few of the years, interest deductions would be permanently disallowed. This result is unfair to taxpayers, a trap for the unwary, and an incentive to engage in nonproductive activities to equalize income over a period of years.

In addition, a carryover is necessary to mitigate the consequences of "phantom income" or "phantom tested income" that can arise from a Section 163(j) disallowance for interest paid between related parties. Suppose a CFC ("**CFC1**") pays interest to a related CFC ("**CFC2**") and the interest deduction is disallowed under Section 163(j). Then, CFC2 has an increase in tested income from the receipt of the interest payment, but CFC1 does not have a reduction in tested income. The group has net positive tested income, which may result in a Section 951A inclusion, without any cash profit.[97] Similarly, if a CFC pays interest to its U.S. shareholder and the interest deduction is disallowed under Section 163(j), the U.S. shareholder has taxable interest income but the CFC does not have a reduction in tested income.[98]

Of course, this result could also arise for an interest payment between two related but nonconsolidated U.S. corporations. In that case, however, the interest disallowed under Section 163(j) can be carried forward to reduce future tax liability. A carryover at the CFC level would ameliorate the same risk in the GILTI regime.

Although we recommend applying loss carryovers at the U.S. shareholder level, we recommend applying Section 163(j) carryovers at the CFC level. This is most consistent with the language of Section 163(j)(2), which treats the carried over amount as paid or accrued in the succeeding taxable year.

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[97] Alternatively, the interest income might be foreign personal holding company income to CFC2, which could give rise to a better or worse result depending on the group's FTC position. *See* L.G. "Chip" Harter and Rebecca E. Lee, *A Brave New World—The Application of code Sec. 267(a)(3)(B) to Expenses Accrued by Controlled Foreign Corporations*, CCH Int'l Tax. J. May-June 2008, at 5.

[98] In the absence of a rule allowing carryovers in these cases, relief could only be provided by a rule treating non-consolidated affiliates as a single corporation.

Moreover, many of the difficulties that arise in the context of a carryover of tested losses at the CFC level do not arise in the context of Section 163(j) carryovers. The reason is that tested loss is determined at the CFC level but used at the U.S. shareholder level, while both Section 163(j) limitations and carryovers of disallowed interest deductions are determined and used at the CFC level. As a result, there is no need to reduce carryovers that have been used by shareholders, and no possibility of some shareholders receiving a double benefit from a carryover. Attempting to apply Section 163(j) carryovers at the U.S. shareholder level would introduce unnecessary complexity.

We note that the Code already applies Section 382 to Section 163(j) carryovers,[99] so this limitation is already built into the system and should apply equally to domestic and foreign corporations. In contrast to tested losses, no regulations or statutory amendment would be required to achieve this result.

As in the case of the 80% limit for NOL carryovers, there is a question as to how the 30% limit on Section 163(j) carryovers should apply to the tested income of the CFC that also has QBAI return in the carryover year. Consider the following variation on Example 10(a) above.

> <u>Example 12: Carryover of Section 163(j) deduction to year with QBAI return</u>. A U.S. shareholder owns 100% of a single CFC, and the CFC has an excess Section 163(j) deduction of \$100 in year 1. In year 2, the CFC has \$100 of tested income, of which \$30 is QBAI return. Absent the loss carryover, the shareholder would have a Section 951A inclusion of \$70.

If the carryover is limited to 30% of tested income, or \$30, then tested income is reduced to \$70. Then, the U.S. shareholder's NDTIR is reduced by the \$30 of allowed interest, namely to \$0, since interest expense first reduces NDTIR until NDTIR is reduced to \$0.[100] As a result, the U.S. shareholder's Section 951A inclusion is still \$70, and the \$30 interest carryover is absorbed but provides no tax benefit.

Arguably the allowed carryover should be increased by \$21, to \$51, to reduce the Section 951A inclusion by 30%, to \$49. However, if the interest expense of \$100 had actually been incurred in year 2, \$30 would be allowed under Section 163(j), tested income would be \$70, NDTIR would be \$0, and the Section 951A inclusion would be \$70. Under Section 163(j)(2), a carryover is to be treated the same as, not better than, interest actually incurred in year 2. Moreover, interest expense and QBAI return in another related CFC of the same U.S. shareholder can affect the Section 951A inclusion of the U.S. shareholder. As a result, any Section 163(j) limitation based on QBAI return

[99] Section 382(d)(3), added by the Act.

[100] Section 951A(b)(2)(B).

of the particular CFC with carryovers will have varying effects on the Section 951A inclusion depending on the attributes of the other CFCs and, in the case of a CFC with more than one U.S. shareholder, will have varying effects for different U.S. shareholders.

The combined effect of (1) limiting current or carryover interest expense to 30% of tested income, and (2) disallowing any benefit of the interest expense to the extent of NDTIR, is a rather extreme result. However, this clearly is the result under the statute if the interest expense was incurred in the current year. It would not even help materially if regulations limited the Section 163(j) current or carryover amount to 30% of the excess of tested income over QBAI return of the particular CFC, since the allowed deduction would still reduce NDTIR before providing any tax benefit.

The Section 163(j) carryover also raises the question of how to deal with a situation similar to that raised in Example 11.

> <u>Example 13: Section 163(j) carryover to year in which tested income is offset by tested loss of another CFC.</u> In year 1, CFC1 has a Section 163(j) carryover of $100 to year 2. In year 2, CFC1 has tested income of $100, and the U.S. shareholder also owns CFC2 that has a tested loss of $70. The Section 951A inclusion aside from the carryover is $30.

If the carryover to year 2 is allowed to the extent of 30% of the $100 of tested income of CFC1 in year 2, then tested income of CFC1 will be $70 and the Section 951A inclusion will be $0. The reduction in Section 951A inclusion from $30 to $0 is arguably not consistent with the intent of the 30% limitation in Section 163(j).[101]

On the other hand, it can be argued that the result is correct, since the Section 163(j) limit is properly determined at the level of the particular CFC. Moreover, attempting to limit the carryover that is used by CFC1 to 30% of the Section 951A inclusion for year 2 would raise the same issues discussed in the previous examples if the U.S. shareholder had other CFCs with interest expense, QBAI return, etc., or if CFC1 had more than one U.S. shareholder.

D. Other Computational Issues for GILTI Inclusions

1. Order of GILTI versus Section 956 Inclusions

Regulations should confirm that tested income of a CFC is determined before Section 956 inclusions.

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[101] Under this theory, the carryover is limited to 30% of the Section 951A inclusion of $30, so the allowed carryover is $9, net tested income of CFC1 is $91, and the Section 951A inclusion is $91 less $70, or $21.

It is clear from the Code that Subpart F income is determined before Section 956 inclusions.[102] Treasury Regulations confirm this result.[103] Moreover, the definition of tested income specifically excludes Subpart F income,[104] so Subpart F income must be determined before tested income can be determined.

Section 951A(f)(1)(A) states that Section 951A inclusions are to be treated as Subpart F inclusions for purposes of Section 959. Therefore, since Subpart F inclusions come before Section 956, tested income should also come before Section 956. Under this interpretation, which we refer to as "**GILTI First**", the U.S. shareholder would first report a GILTI inclusion, and this inclusion would create a PTI account.[105] Investment by the CFC in U.S. property under Section 956 would give rise to incremental income inclusions only to the extent it exceeded the PTI account and there was additional e&p available. This result avoids any double inclusion of income of the CFC into the income of the U.S. shareholder.

By contrast, if Section 956 inclusions were determined before tested income is calculated ("**Section 956 First**"), any Section 956 income inclusion (up to e&p) would first create a PTI account. Then, since tested income is not reduced by Section 956 inclusions and (crucially) is not limited to e&p, tested income would be determined completely without regard to the Section 956 inclusion. This would result in a double inclusion of the income of the CFC into the income of the U.S. shareholder.

To be sure, each inclusion would create its own PTI account and basis increase.[106] As a result, the second inclusion in income might provide a tax benefit to the U.S. shareholder on a future distribution from the CFC or on sale of the CFC stock. However, this benefit might be far in the future, and the benefit could be in the form of a future capital loss with a tax benefit of less than the current cost of ordinary income. In any event it would be quite anomalous for $1 of earnings to create $2 of PTI and $2 of basis increase.

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[102] Subpart F income is included under Section 951(a)(1)(A) and Section 956 amounts are included under Section 951(a)(1)(B). Section 956 inclusions under Section 951(a)(1)(B) are specifically limited by Section 959(a)(2), which states that e&p attributable to PTI is not included in income again either as a Subpart F inclusion or a Section 956 inclusion. Section 959(f)(1) says that amounts that would be Section 956 inclusions are attributable to PTI to the extent of prior Subpart F inclusions. By contrast, Section 951(a)(1)(A) includes no similar PTI-based limitation for Subpart F inclusions. As a result, Subpart F income causes a Subpart F inclusion, which creates PTI and (assuming the income is not distributed) thereby limits Section 956 inclusions to the extent of that PTI.

[103] Treas. Reg. § 1.959-1(a).

[104] Section 951A(c)(2)(A)(i)(II).

[105] Sections 951A(f)(1)(A), 959. We assume for simplicity that the CFC has a single U.S. shareholder and that there is no Subpart F income.

[106] Sections 951A(f)(1)(A), 959 and 961(a).

We do not believe Congress intended these results. Consequently, we believe that GILTI First is more consistent with both the plain meaning of the statute and the intent of Congress.

In principle, it would be possible for "Section 956 First" to apply, with tested income being reduced for Section 956 inclusions. However, actual distributions do not reduce tested income, so it would be inconsistent for deemed distributions from Section 956 inclusions to do so.

Moreover, in some cases taxpayers will prefer Section 956 inclusions and in other cases they will prefer tested income, in part because of very different FTC rules. This modified version of "Section 956 First" would effectively create an elective regime where well-advised taxpayers could choose between Section 956 and tested income by having CFCs making (or not making) loans to U.S. shareholders or otherwise investing in U.S. property. On the other hand, the same rule would create a trap for the unwary for less well advised taxpayers.

We observe that in applying GILTI First, a U.S. shareholder's income inclusion is based first on the CFC's Subpart F income (which is limited to e&p), then on its tested income and NDTIR (which are not based on e&p), and finally by Section 956 (which is limited to e&p). This ordering is not intuitive, but for the reasons described above, it seems most consistent with the language and purpose of the statute.

2. GILTI and Subpart F Inclusions in a Year When CFC Stock is Sold

When stock of a CFC is sold in the middle of a taxable year, in some cases the Subpart F income and GILTI inclusions allocable to the selling shareholder for the pre-sale portion of the year of the sale are permanently eliminated from the U.S. tax base. These results arise because of the enactment of Section 245A.[107] We discuss ways in which legislation or regulations could prevent these results. However, we do not take a position on whether any such legislation or regulations should be adopted.

(a) Background

The Section 951A inclusion applies only to a U.S. shareholder of a CFC that owns (directly or indirectly through a foreign entity) stock in the CFC on the last day of the taxable year of the CFC that it is a CFC (the "**last CFC date**").[108] The same rule applies to a Subpart F inclusion.[109] The U.S. shareholder's Section 951A inclusion is based on its *pro rata* share of the CFC's tested income for the CFC's taxable year.[110] The U.S. shareholder's *pro rata* share of tested income, tested loss, and QBAI is determined

[107] The Tax Section is preparing a separate report on Section 245A.

[108] Section 951A(e)(1) and (2). This rule is also expressly stated in the Conference Report at 645.

[109] Section 951(a)(1).

[110] Section 951A(a), (b)(1)(A) and (c)(1)(A).

"under the rules of section 951(a)(2) in the same manner as such section applies to subpart F income".[111]

Assume that a U.S. shareholder owns X% of the CFC stock on the last CFC date, and the CFC is a CFC for Y% of the year. Under Section 951(a)(2), the U.S. shareholder's *pro rata* share of the Subpart F income for the year is equal to:

- X% times Y% times the Subpart F income for the entire year, including periods after the last CFC date, *see* Section 951(a)(2)(A), *minus*

- actual dividends paid by the CFC during the tax year to other holders of the stock (or deemed dividends under Section 1248(a) on a sale of the stock by another holder), but not in excess of the product of (i) X% (the ownership percentage), (ii) the Subpart F income for the year, and (iii) the percentage of the year that the U.S. shareholder did not own the stock, *see* Section 951(a)(2)(B).

In other words, the *pro rata* share of the U.S. shareholder on the last CFC date is first determined as if the U.S. shareholder had held the stock for the entire period of the year through the last CFC date. That amount is then reduced by dividends to another holder of the same stock during the year, but only to the extent those dividends do not exceed the Subpart F income attributable on a *pro rata* basis to the period that the U.S. shareholder did not own the stock.

As will be seen below, these rules worked well under the prior law rules for Subpart F. However, they can now allow Subpart F income and tested income allocable to a U.S. shareholder for the portion of the taxable year before the shareholder sells its stock to avoid being a Subpart F or GILTI inclusion or ever being included in U.S. taxable income to anyone.

(b) Fact patterns and results

(i) *Sale of a CFC from one Section 958(a) U.S. Shareholder to another Section 958(a) U.S. Shareholder*

Consider first the case where a CFC is a CFC throughout the year and has 100% U.S. shareholders throughout the year that are subject to Subpart F or GILTI inclusions, *i.e.*, they are shareholders under Section 958(a) ("**Section 958(a) U.S. Shareholders**"). Assume in all cases that the relevant CFCs have no PTI as of the beginning of the year in question, there is no gain in the CFC stock on January 1 of the year in question, the U.S. shareholder's holding period for the CFC stock satisfies the Section 245A holding period

[111] Section 951A(e)(1). This section is written in a rather peculiar way because it refers separately to tested income, tested loss, and QBAI, but since these three items are in effect combined to determine the Section 951A inclusion, we assume it is intended to apply the *pro rata* rule to the Section 951A inclusion.

requirement,[112] the U.S. shareholder holds no other CFCs and none of the relevant CFCs has any QBAI return.

> <u>Example 14(a) (CFC with Section 958(a) U.S. shareholders throughout the year)</u>: A U.S. shareholder (US1) owns the CFC. During the year, the CFC has $1000 of earnings. On June 30, the CFC pays a dividend of $500 to US1, and immediately thereafter US1 sells the stock to another Section 958(a) U.S. shareholder (US2) at no gain or loss. US2 continues to own the stock until the end of the year, so the last CFC date is December 31.

Consider first this fact pattern under prior law, and assume that the $1000 of earnings is all Subpart F income. US1 did not have any Subpart F inclusion because it was not a shareholder on the last CFC date. Thus, it did not have any PTI account, and the $500 dividend it received was taxable at ordinary rates. US2 had Subpart F income of $1000 under Section 951(a)(2)(A), but this was reduced by $500 under Section 951(a)(2)(B). Thus, the total inclusion was $1000, the full amount of Subpart F income for the year.

The same result would arise if there had been no dividend, but US1 had sold the stock of the CFC to US2 on June 30 for a gain of $500. Then, the gain would be a deemed dividend under Section 1248 subject to the same rules. Section 951(a)(2)(B) is essential in these cases to avoid double taxation of $500 of Subpart F income, since otherwise $500 would be taxed to US1 and $1000 would be taxed to US2.

Consider now the same fact pattern under current law. Just as under prior law, US1 does not have a Subpart F inclusion or PTI account, US1 has dividend income of $500, and US2 has Subpart F income of $1000 minus $500, or $500. However, now the dividend of $500 received by US1 is eligible for the 100% dividends received deduction under Section 245A. Likewise, if US1 sold the stock at a $500 gain without taking out the dividend, new Section 1248(j) provides that the deemed dividend under Section 1248 is eligible for the Section 245A deduction.

In either of these cases, US2 would obtain a PTI account of $500 by the first day of the CFC's next taxable year and could withdraw that amount tax free under Sections 959(a) and (e). As a result, in both the dividend and Section 1248 cases, $500 of Subpart F income permanently goes untaxed. Section 951(a)(2)(B), which was originally intended and needed to avoid double taxation of Subpart F income, is now eliminating even a single level of taxation of Subpart F income.

Since the Section 951A rules incorporate the Subpart F rules, the same results arise if income of the CFC is tested income rather than Subpart F income. Again, since

[112] *See* Section 246(c).

US1 is not a shareholder on the last CFC date, it does not have a Section 951A inclusion. US2's *pro rata* share of tested income is $1000 minus the distribution or deemed distribution to US1 of $500, or $500. US1 has a taxable dividend or deemed dividend of $500 and a Section 245A deduction of $500. The CFC has $1000 of tested income for the year, but only $500 of it is taxable (to US2).

These results arise even if US2 is related to US1 (assuming no Section 304 transaction). In addition, an even more taxpayer-favorable result arises if the sale is near the end of the taxable year of the CFC, and so there will be tax benefits to deferring a sale until that time of year. In some cases it might also be possible for US1 to change the taxable year of the CFC to be the 12-month period ending shortly after the sale, to fix the amount of income in the previous portion of the year that would not be taxed under Subpart F or Section 951A.

This elimination of tax on Subpart F income or GILTI inclusions arises because Section 951(a)(2)(B) reduces the Subpart F inclusion (and because of the cross-reference in Section 951A(e)(1) to Section 951(a)(2), the tested income) regardless of whether the dividends to prior shareholders are subject to U.S. tax. In particular, the elimination of tax arises because Section 951(a)(2)(B) applies to dividends paid in the year of sale even if the dividends are eligible for the Section 245A deduction to the shareholder.[113]

(ii) *Sale of CFC stock from a Section 958(a) U.S. Shareholder to a Non-U.S. Shareholder; CFC ceases to be a CFC*

We now consider how existing law applies when the CFC ceases to be a CFC on the sale date.

> <u>Example 14(b) (CFC for only part of year).</u> A Section 958(a) U.S. shareholder (US1) owns the CFC on January 1. During the year, the CFC has $1000 of earnings. On June 30, the CFC pays a dividend of $500 to US1, and immediately thereafter US1 sells the stock to a non-U.S. shareholder (F1) at no gain or loss on the stock. F1 continues to own the stock until the end of the year. Assume no attribution rules apply, so the last CFC date is June 30.

In this case, US1 is a Section 958(a) U.S. shareholder on the last CFC date. As a result, US1 has Subpart F income or a Section 951A inclusion, and PTI, equal to the Subpart F income or tested income for the year, or $500, as well as a Section 250 deduction if the income is tested income. Section 951(a)(2)(B) never applies, since there is no prior shareholder of the relevant stock. The $500 dividend to US1 is out of PTI, and so there is a single inclusion of $500 of Subpart F income or a net Section 951A inclusion

[113] If the distribution to US1 is not taxable because of a preexisting PTI account, such as on account of a prior Section 965 inclusion, it is not a dividend covered by Section 951(a)(2)(B).

of $250. The statute reaches the correct result without regard to Section 951(a)(2)(B). The same result arises if there is no dividend on June 30, but instead the stock is sold at a gain of $500. There is still a Subpart F inclusion of $500 on June 30 and Section 1248(d)(1) excludes such amount from being taxed again under Section 1248.

However, there is one further issue. Section 951A(e)(3) states that for purposes of Section 951A, "a foreign corporation shall be treated as a controlled foreign corporation for any taxable year if such foreign corporation is a controlled foreign corporation at any time during such taxable year." This rule was apparently intended to conform the Section 951A rules to the repeal of the rule that had been in Section 951(a) and that had prevented the application of Subpart F to a corporation that was a CFC for less than 30 days during the year.

Yet it is possible to read this provision as stating that in Example 14(b), the CFC is treated as a CFC for the entire year even though it has no actual or constructive U.S. owners in the second half of the year. We do not think this result was intended, since it would make meaningless the rules in Section 951 that look to the last day of the year on which the CFC is a CFC. Such last day would always be the last day of the taxable year. We recommend that regulations clarify that this provision is merely stating that there is no minimum period of time for a CFC to qualify as a CFC in order for it to be a CFC during its qualification period.

(iii) *Sale of CFC Stock from a Section 958(a) U.S. Shareholder to a non-U.S. Shareholder; CFC remains a CFC*

We now turn to another case where, as in Example 14(a), the CFC remains a CFC until the end of its tax year.

> <u>Example 14(c) (CFC for whole year, taxable Section 958(a) U.S. shareholder for only part of year)</u>. U.S. shareholder (US1) owns the CFC on January 1. During the year, the CFC has $1000 of earnings. On June 30, the CFC pays a dividend of $500 to US1, and immediately thereafter US1 sells the stock to a buyer (F1) at no gain or loss. Assume F1 continues to own the stock until the end of the year, and the CFC remains a CFC through the end of the year.

Suppose the prior Subpart F rules apply, the income was Subpart F income, and there was no Subpart F inclusion for the year to any U.S. taxpayer because there was no U.S. taxpayer with Section 958(a) ownership on December 31, the last CFC date. This fact pattern would have arisen, for example, if F1 was a U.S. partnership with all foreign partners.[114] While the partnership would have the Subpart F inclusion as a U.S.

[114] This fact pattern would also have arisen as to, say, 49% of the stock of the CFC if US1 sold 49% of the stock of the CFC to a foreign corporation and retained the rest. The CFC would have remained a CFC

shareholder on the last CFC date, none of its partners would be subject to U.S. tax. Section 951(a)(2)(B) was irrelevant because it merely reduces a Subpart F inclusion. However, US1 had a taxable dividend of $500 on June 30, which was taxable because US1 had no PTI. The same is true if there was no dividend and US1 sold the stock on June 30 at a gain of $500, since Section 1248(a) would apply to the gain.

Now assume these facts arise in 2018, and the income is either Subpart F income or tested income. The CFC will remain a CFC following the sale to F1 far more often under current law than before the Act. The reason is that the Act repealed Section 958(b)(4), which prevented a U.S. corporation from being considered a U.S. shareholder by virtue of attribution from a related foreign person.[115] Now, the CFC will continue to be a CFC through the end of the year even if F1 is a foreign corporation, as long as F1 has at least one U.S. subsidiary, since the subsidiary will constructively own the CFC stock owned by F1.

As before, there is no Subpart F or Section 951A inclusion, because the last CFC date is December 31 and there is no Section 958(a) U.S. shareholder on that date.[116] Section 951(a)(2)(B) is irrelevant because it merely reduces a Subpart F (and now a Section 951A) inclusion. The dividend to US1 is included in its gross income since the CFC has e&p and there is no PTI. However, the dividend is eligible for the Section 245A deduction, so there is no net income inclusion. The same is true if there was no dividend and the stock was sold at a gain of $500, since Section 1248(j) treats the Section 1248(a) gain as a dividend for purposes of Section 245A.

Thus, the Subpart F income or tested income allocable to US1, the selling U.S. shareholder of the CFC with Section 958(a) ownership, has permanently avoided U.S. tax by being converted into a tax-free dividend.[117] Moreover, no interpretation or amendment of Section 951(a)(2)(B) will change this result, since there is no inclusion of Subpart F or tested income that is being reduced by that provision. As before, the goal of US1 would be to sell the stock shortly before the end of the tax year of the CFC, and either take out a tax-free dividend shortly before the sale or else recognize a corresponding tax-free dividend under Section 1248.

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throughout the year with a 51% U.S. shareholder, but there would have been no Subpart F inclusion on December 31 as to the 49% purchased interest.

[115] The scope of the repeal of Section 958(b)(4) is discussed in Part IV.G.3.

[116] Even if the CFC remains a CFC because F1 has a U.S. subsidiary that is a U.S. shareholder for determining CFC status, the subsidiary is not a U.S. shareholder under Section 958(a) and therefore has neither a GILTI inclusion (Section 951A(e)(2)) nor a Subpart F inclusion (Section 951(a)(1)).

[117] The converse situation would arise in Example 14(c) if F1 owned the stock in the first part of the year and sold it (without a distribution) to US1 on June 30. US1 would have a Subpart F or tested income inclusion on December 31 equal to the CFC's income for the entire year, and it is doubtful that an offset would be allowed under Section 951(a)(2)(B). The offset is only allowed for an amount included in gross income under Section 1248, and a non-U.S. person such as F1 would not have any gross income under Section 1248 or otherwise. A pre-sale dividend to F1 would avoid this problem.

As noted above, this permanent elimination of tax on Subpart F income and Section 951A inclusions will be more common in light of the repeal of Section 958(b)(4), since there will now be many more situations where a CFC remains a CFC even though it does not have a taxable Section 958(a) U.S. shareholder. However, the issue is conceptually distinct from such repeal, since the issue could arise even if Section 958(b)(4) were fully restored. For example, as in the discussion of prior law above, the same issue would arise (a) if the sale of 100% of the stock was to a U.S. partnership to the extent the partnership had foreign partners that would not be required to report their share of partnership income, or (b) as to 49% of the tested income of a CFC, if a 51% direct U.S. shareholder retained its stock for the entire year, and a 49% direct U.S. shareholder sold its stock in the middle of the year to a non-U.S. person.

(iv) *Sale of stock of second tier CFC where ownership of top CFC does not change*

Similar issues arise when a first tier CFC receives a dividend from, or sells the stock of, a second tier CFC during a taxable year, where the ownership of the first tier CFC does not change. This transaction is identical as an economic matter to the situation in Examples 14(a), (b), and (c) if the first tier CFC is a shell company, and if the buyer of the CFC stock is the same in each case. The result is in substance the same as in the previous situations.

The different fact patterns discussed above are now discussed in this lower-tier CFC context. In the examples, a U.S. shareholder ("**US1**") directly owns all the stock of a top tier CFC ("**CFC1**"), CFC1 directly owns all the stock of the lower tier CFC ("**CFC2**"), and CFC1 has no income or assets other than the stock of CFC2. As before, assume in all cases that the relevant CFCs have no PTI as of the beginning of the year in question, there is no gain in the CFC stock on January 1 of the year in question, the U.S. shareholder's holding period for the CFC stock satisfies the Section 245A holding period requirement,[118] the U.S. shareholder holds no other CFCs and none of the relevant CFCs has any QBAI return.

> <u>Example 14(d) (Second Tier: CFC2 has Section 958(a) U.S. shareholders throughout the year)</u>: During the year, CFC2 has $1000 of earnings. On June 30, CFC2 pays a dividend of $500 to CFC1, and immediately thereafter CFC1 sells the stock of CFC2 to a Section 958(a) U.S. shareholder ("**US2"**) at no gain or loss on the stock. US2 continues to own the stock until the end of the year, so the last CFC date for CFC2 is December 31.

[118] *See* Section 246(c).

Consider first this fact pattern under prior law, and assume that the $1000 of earnings is all Subpart F income. US1 did not have any Subpart F inclusion from CFC2 because it was not a shareholder on the last CFC date. US2 had Subpart F income of $1000 from CFC2 under Section 951(a)(2)(A), but this was reduced by $500 under Section 951(a)(2)(B). However, US1 would have an additional $500 of income either when CFC1 received the dividend as Subpart F income (*i.e.*, if the same country exception did not apply), or (if not Subpart F income initially) when CFC1 paid the cash to US1 or when US1 sold the stock of CFC1. Thus, the total inclusion was $1000, the full amount of Subpart F income for the year.

The same result would have arisen if there had been no dividend, but CFC1 had sold the stock of CFC2 to US2 on June 30 for a gain of $500. Under Section 964(e)(1), CFC1 would have a deemed dividend as if Section 1248(a) applied, and the foregoing results would be unchanged. Note that Section 951(a)(2)(B) is essential in these cases to reduce US2's Subpart F inclusion from $1000 to $500, since otherwise $500 would be taxed to US1 and $1000 would be taxed to US2.

Now consider the effects of the Act. The Act added new Section 964(e)(4), which provides that when CFC1 sells the stock of CFC2, the Section 1248(a) amount created by Section 964(e)(1) is Subpart F income to CFC1, is includible in the income of US1, and is eligible for the Section 245A deduction in the same manner as if the Subpart F income were a dividend from CFC1 to US1.

Return now to Example 14(d) under current law, and assume the $1000 of income of CFC2 is Subpart F income or tested income. The dividend to CFC1 would not be Subpart F income or tested income in CFC1's hands.[119] CFC1 could pass on the dividend to US1, and US1 would be eligible for the Section 245A deduction. If instead CFC1 sells the CFC2 stock at a gain of $500, under Section 964(e)(4), US1 will have a deemed Subpart F inclusion that is eligible for the Section 245A deduction.[120] In addition, in either case, US2 will continue to have $1000 of Subpart F income or Section 951A inclusion that is reduced, under Section 951(a)(2)(B), by an actual dividend of $500 paid by CFC2 to CFC1, or by "any gain included in the gross income of any person as a dividend under section 1248". If CFC2 paid an actual dividend of $500, US2's CFC inclusion would be $500, and the clear intent is that the same result arises if CFC1 sold the stock for gain of $500.[121]

[119] Under Section 951A(c)(2)(A)(i)(IV), a dividend from a related party is not tested income. The dividend might be exempt from Subpart F income to CFC1 under Section 954(c)(3) (same country exception) or Section 954(c)(6) (look-through rule). Note that the look-through rule does not apply if the underlying income is Subpart F income, but there is no exclusion if the underlying income is tested income. At least if the underlying income is Subpart F income and the same-country exception does not apply, CFC1 would apparently be entitled to the Section 245A deduction, *see* Conference Report at 599 n. 1486.

[120] Note that Section 964(e)(4) applies "notwithstanding any other provision of this title".

[121] Section 964(e)(4) does not say that CFC1's gain on the sale of the CFC2 stock is "included in the gross income of any person" as a Section 1248 dividend, but the intent is clear.

These results are similar to the results today under Example 14(a) when the stock of a first tier CFC is sold in the middle of the year to another U.S. shareholder. Here, if CFC2 has $1000 of tested income, the Section 951A inclusion reported for the year is $500. Likewise, if CFC2 has $1000 of Subpart F income, the Subpart F inclusion for the year is $500. In both the GILTI and Subpart F cases, the Act has conformed the results of the sale of stock of a second tier CFC to the results of a sale of a first tier CFC.

Next, consider the analog to Example 14(c), where CFC1 sells the stock of CFC2 to F1 and CFC2 continues as a CFC until the end of the year. Regardless of whether the $500 is paid up as a dividend or the stock is sold at a gain of $500, the results to CFC1 and US1 are the same as in the second preceding paragraph. Moreover, there is no U.S. shareholder that pays tax on any Subpart F income or Section 951A inclusions on the last CFC date. Just as in Example 14(c), $500 of Section 951A inclusion or Subpart F income attributable to US1 has avoided U.S. tax, and just as in that example, the reason has nothing to do with Section 951(a)(2)(B).

Finally, consider the results under the Act if the CFC2 income is either GILTI or Subpart F, CFC1 sells the stock of CFC2 to a non-U.S. person, and the CFC ceases to be a CFC. This is the analog to Example 14(b) but in the context of a sale of a second tier subsidiary. Now, US1 is a U.S. shareholder of CFC2 on the last CFC date. As a result, US1 has Subpart F income or a Section 951A inclusion of $500 on that date, regardless of whether the $500 is paid up as a dividend or the stock is sold at a gain of $500. The non-U.S. purchaser of CFC2 is not a U.S. shareholder and has no inclusion. As a result, the total inclusion is $500, just as in Example 14(b), and the result conforms to the amount of Subpart F income or GILTI allocable to the selling shareholder.

(c) Discussion

It is clear from the foregoing that on a sale of a first tier or second tier CFC in the middle of a taxable year, the Subpart F income or Section 951A inclusion attributable to the selling shareholder for the pre-sale portion of the taxable year of sale will now permanently avoid tax because of Section 245A.

Absent a stock sale, it is clear that the payment of a dividend eligible for Section 245A does not reduce the amount of Subpart F income or Section 951A inclusion for the year. The policy question is whether a dividend eligible for Section 245A should reduce the amount of the inclusion if it occurs in the year the stock of a first-tier or second-tier CFC is sold.

On the one hand, it can be argued that Congress did not intend to allow for such an easy avoidance of Subpart F income or Section 951A inclusion. In addition, the fact that the Act conforms the treatment of a first and second tier subsidiary does not mean that it intended to allow such avoidance in either case. Moreover, such an avoidance of tax on a Section 951A inclusion is inconsistent with the theory that GILTI is a flat tax on foreign earnings. This result also allows for considerable tax planning to reduce the taxation of GILTI or Subpart F income. For example, a sale can occur near the end of the year to maximize the amount of excluded income, and the sale can be made to a U.S. or non-U.S. affiliate in a manner that avoids Section 304.

On the other hand, arguably Congress was not concerned about these results. The Act adds both Section 951A and Section 964(e)(4), and both sections refer to Section 951(a)(2). Moreover, the new rule in Section 964(e)(4), combined with new Section 245A, expands the scope of tax free treatment of GILTI and Subpart F income to second tier subsidiaries. Arguably Congress must have determined that the operation of Section 951(a)(2), in conjunction with Section 245A, was consistent with its intent or at least not important enough to fix. In addition, if Congress was satisfied with the operation of Section 951(a)(2) and Section 245A when the sale of stock was to a Section 958 U.S. shareholder, presumably it was satisfied with the equivalent result when the sale was to a non-Section 958 U.S. shareholder.

Moreover, Section 951(a)(2)(B) arguably allowed the elimination of Subpart F income in the year of a sale even before the Act. Return to Example 14(b), where the CFC ceased to be a CFC on June 30. Assume in addition that the CFC paid F1 a dividend of $500 on December 31. US1 is a U.S. shareholder on the last CFC date. Under a literal reading of Section 951(a)(2)(B), US1 has a Subpart F inclusion of (i) $500 (*pro rata* share of Subpart F income for the full taxable year of the CFC) minus (ii) $500 (distribution to F1 not in excess of F1's share of Subpart F income for the year), or $0. At least one Technical Advice Memorandum from 1995 confirms this result.[122] No legislative or regulatory action has been taken to change this result.

We take no position on whether these results should be changed by legislation or, if there is authority to do so, regulations. However, we point out some possible approaches if a change is desired.

First, Section 245A could be amended to provide that when stock of a CFC is sold during a taxable year, and the CFC continues to be a CFC after the sale, dividends paid on that stock out of Subpart F income or Section 951A inclusions for that year are not eligible for Section 245A. However, this would be a basic structural change to the Subpart F and GILTI rules, as well as Section 245A, and would create other complexities.

Second, Section 951(a)(2)(B) could be modified to reduce a Subpart F inclusion only for distributions not eligible for Section 245A. This approach would result in inclusion for the full amount of Subpart F income or GILTI for the year of the stock sale if the CFC continued to be a CFC with a continuing Section 958(a) U.S. shareholder. However, it would not result in full inclusion if the CFC continued as a CFC without a Section 958(a) U.S. shareholder. Moreover, it could be viewed as unfair to the Section 958(a) U.S. shareholder that buys the stock, since it would have a Section 951A inclusion of $1000 (without reduction for the $500 distribution to the seller eligible for Section

[122] TAM 9538002 (May 16, 1995).

245A) even though it only held the stock for half the year. This is penalizing the buyer because of the under-taxation of the seller.

Third, a new rule could apply on any sale of stock by a U.S. shareholder where the tax year does not end and the CFC remains a CFC, regardless of the buyer. In that event, the taxable year of the CFC would be deemed to end, with respect to the sold stock only, on the sale date. This would result in full inclusion to the seller for the year of the sale, as in Example 14(b), regardless of whether the buyer was a Section 958(a) U.S. shareholder.

The notional ending of the tax year could, like today, result in a *pro rata* allocation of income for the full year to the periods before and after the sale date, as opposed to a factual determination of income before and after the sale date. However, if the closing of the tax year applied for all purposes, it would result in short tax years for the sold stock. This would exacerbate the tax detriments under GILTI that arise from tax years with tested losses, and the fact that FTCs do not carry over.

3. Relationship between Section 163(j) and Section 250

As indicated in Part III.E.3 of the Section 163(j) Report, regulations should address the relationship between Section 163(j) and Section 250. Notice 2018-28, relating to Section 163(j), is silent on this question. A taxpayer could first apply the Section 250(a)(1) deduction in determining "adjusted taxable income" under Section 163(j)(8), then determine allowed interest deductions under Section 163(j), and then apply the Section 250(a)(2) limitation of the Section 250 deduction to taxable income. However, a reduction in deductions under Section 250(a)(2) would "retroactively" increase "adjusted taxable income" under Section 163(j)(8), which would require re-calculating allowed interest deductions under Section 163(j), which, in turn, would require re-calculating the reduction in deductions under Section 250(a)(2), and so on and so forth. When Section 250(a)(2) applies, simultaneous equations might be required in order to replicate the effect of this iterative process.

4. Limit on Section 250 Deduction

Regulations should clarify that, for purposes of the limit on the Section 250 deduction under Section 250(a)(2), "taxable income of the domestic corporation" includes all income, including Subpart F, Section 951A, Section 78, and FDII inclusions, determined without regard to the Section 250(a)(1) deduction.

In addition, regulations should clarify whether the Section 250(a)(2) carve-back applies to the Section 78 gross-up amount for a Section 951A inclusion. For example, assume the U.S. shareholder has no income or loss except for a Section 951A inclusion of $50, a Section 78 gross-up amount of $20, and a current NOL of $60. Tentative taxable income before Section 250 is $10. Section 250(a)(2) might require the $70 base for the 50% Section 250(a)(1) deduction to be reduced to either:

(a) $10, *i.e.*, the total Section 951A and Section 78 inclusions of $70 are reduced by the excess of such inclusions ($70) over tentative taxable income ($10), a reduction of $60, resulting in a Section 250 deduction of $5, or

(b) $30, *i.e.*, the Section 951A inclusion of $50 is reduced by the excess of such inclusion ($50) over tentative taxable income ($10), a reduction of $40, to $10, but there is no reduction in the Section 78 amount of $20, resulting in a Section 250 deduction of $15.

Under alternative (a), the Section 250 deduction reduces the tentative taxable income by 50%, from $10 to $5. Under alternative (b), the Section 250 deduction eliminates all of the tentative taxable income and results in a loss of $5. Section 172(d)(9) would prevent this loss from being carried forward.

The two methods give the same result if the loss (after reduction for non-GILTI income) exceeds the sum of the Section 951A and Section 78 inclusions. In that case, any Section 250 deduction will only result in a loss that cannot be carried over because of Section 172(d)(9). The two methods also give the same result if the loss is no greater than the Section 951A inclusion, since the reduction of the Section 951A inclusion itself by the loss will give the same result as if both inclusions are reduced by the loss. The two methods only give different results if, as in the example, the loss is greater than the Section 951A inclusion but less than the sum of the two inclusions.

The uncertainty in the statute arises because under Section 250(a)(2)(A), the reduction in the GILTI amount taken into account under Section 250(a)(1) is equal to the excess of the GILTI amount "otherwise taken into account by the domestic corporation under [Section 250(a)(1)]" over the tentative taxable income of the corporation. Section 250(a)(1)(B) refers separately to the GILTI inclusion under Section 951A and the Section 78 gross-up attributable to such inclusion. It is not clear whether the reference in Section 250(a)(2)(A) is only to the Section 951A inclusion, or whether it is also intended to include the Section 78 gross-up. However, Section 250(a)(2)(B)(ii), which allocates the carve-back between GILTI and FDII, tracks the language of Section 250(a)(1)(B)(i) and implies that only the Section 951A inclusion and not the Section 78 gross-up can be cut back by Section 250(a)(2).

5. Allocation to Preferred Stock

We consider now the proper allocation of tested income to a U.S. shareholder that holds preferred stock of a CFC. Section 951A(e)(1) states that a U.S. shareholder's *pro rata* share of tested income of a CFC is determined under the rules of Section 951(a)(2). The regulations under Section 951(a)(2) determine how to allocate Subpart F income among classes of stock of a CFC.

Under those regulations, if preferred stock has a fixed term and all dividend arrearages accrue and compound at a rate at least equal to the applicable Federal rate at the time of issuance ("**fixed yield preferred stock**"), the stock is not allocated any Subpart F income in excess of accrued and unpaid dividends (referred to here as the "**fixed allocation method**").[123] However, stock that is subject to discretionary distributions, specifically including preferred stock that is perpetual or that does not provide for the compounding of dividend arrearages, is allocated Subpart F income under a different method (referred to here as the "**proportionate allocation method**").[124] Under that method, there is first an initial allocation to accrued and unpaid dividends, and any remaining Subpart F income is then allocated to each class of stock, including the preferred stock, in proportion to the fair market value of all classes of stock of the CFC.[125] The regulations do not contain any special rule for convertible preferred stock, although preferred stock with a participating dividend is subject to the proportionate allocation method.[126]

Regulations should determine the application of these rules to allocations of tested income to a U.S. shareholder holding preferred stock. If the stock is nonconvertible fixed yield preferred stock, we believe that the fixed allocation method that applies for Subpart F purposes should apply. Such stock is not entitled at any point in time to more income than its accrued dividends to date, and there is no logical reason to allocate to it a greater amount of tested income.

Contrary to the Subpart F regulations, the same logic applies to stock that would be nonconvertible fixed yield preferred stock except that it does not provide for compounding of dividend arrearages. If anything, this stock should be allocated *less* rather than more Subpart F income or tested income than fixed yield preferred stock, since the present value of its future fixed dividends will be lower than in the case of fixed yield preferred stock.[127] As a result, we believe that in determining tested income allocable to nonparticipating, nonconvertible preferred stock that would be fixed yield preferred stock except for the lack of compounding of dividend arrearages, the allocation should at least not exceed the allocation under Subpart F for fixed yield preferred stock. We believe this change could be made by regulations, at least if the regulations under Subpart F are changed accordingly.

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[123] Treas. Reg. §§ 1.951-1(e)(3)(i) (unless an exception applies, when there are multiple classes of stock, the *pro rata* share of each class for Subpart F purposes is based on proportion of the distributions that would be made to each class if all e&p for the year was distributed on the last day of the year); -1(e)(4)(ii) (an exception that applies the proportionate allocation method described below in the text does not apply to fixed yield preferred stock).

[124] *Id.*

[125] Treas. Reg. §§ 1.951-1(e)(3)(ii)(A); -1(e)(4)(ii).

[126] Treas. Reg. § 1.951-1(e)(6) Ex. 5.

[127] The Tax Section made the same point in commenting on the proposed regulations that led to these final regulations. See NYSBA Tax Section, Report No. 1079, *Report on Proposed Regulations Regarding The Determination of a Shareholder's "Pro Rata Share" Under Section 951* (Feb. 11, 2005), at 20-21 (expressing concern that an uneconomically high allocation of Subpart F income to such preferred stock could lead to abuse).

Turn now to convertible preferred stock that, absent the conversion feature, would be eligible for the fixed allocation method. It does not appear that the conversion feature causes it to be subject to the proportionate allocation method under the Subpart F regulations. Nevertheless, if the fixed allocation method applies to such stock, it would be possible to avoid Section 951A inclusions on tested income. The stock will be allocated tested income equal to the dividend paid or (apparently) accruing on the stock.[128] However, the dividend rate will be below the market rate on comparable nonconvertible preferred stock to reflect the conversion feature. In fact, assuming a purchase price at the face amount of the preferred stock, the greater the initial value of the conversion feature, the lower the dividend rate.

As a result, there may be no tested income allocated to any U.S. shareholder to reflect the "bargain" element of the dividend rate. In addition, when the stock is converted, it will represent a percentage interest in the CFC's existing assets, including PTI for which the holder has never been allocated tested income.

Taxpayers could take advantage of these rules to defer or eliminate tax on tested income. For example, a U.S. shareholder could purchase convertible preferred stock of a CFC, or exchange its common stock for convertible preferred stock with the same value. The common stock might be held by an unrelated U.S. or non-U.S. person, or by the foreign parent of the U.S. shareholder.[129] An individual U.S. shareholder might also own convertible preferred stock, with a wholly owned corporation owning common stock.

It would be possible to treat convertible preferred stock as subject to the proportionate allocation method because of its conversion feature. Alternatively, at least when the stock is "in the money", it could be treated as converted. However, any such rule could lead to widely varying results from year to year. In any event, regulations should clarify the result in these cases.

6. Interest Expense of CFC with Tested Loss

It is not clear whether the gross interest expense of a CFC with a tested loss reduces NDTIR of the shareholder. Section 951A(b)(2)(B) reduces NDTIR by interest expense taken into account under Section 951A(c)(2)(A)(ii) in determining net CFC tested income, and the tested loss of a CFC reduces net CFC tested income. However, while tested losses are calculated under Section 951A(c)(2)(B)(i) by taking into account expenses described in Section 951A(c)(2)(A)(ii), strictly speaking, the expense is taken into account under Section 951A(c)(2)(B)(i) rather than Section 951A(c)(2)(A)(ii) in reducing net CFC tested income.[130]

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[128] Treas. Reg. § 1.951-1(e)(3)(i). *See also* Treas. Reg. § 1.951-1(e)(3)(ii) (clause (i) applies to preferred stock entitled to a fixed return).

[129] This assumes no previous inversion transaction. *See* Treas. Reg. § 1.7701(l)-4T.

[130] The House bill took account of all QBAI in determining NDTIR, without regard to whether a CFC had tested income or tested loss, and it was therefore logical to reduce NDTIR by interest expense of all CFCs. The Senate amendment took into account only QBAI used in the production of tested income but

First, assume the CFC with the tested loss and interest expense does not have any notional QBAI return. For example, suppose CFC1 has $100 of tested income and $100 of QBAI return, so there is no Section 951A inclusion for income from CFC1 on a stand-alone basis. CFC2 has $100 of interest expense, $1 of tested loss, and no notional QBAI return. The question is whether the shareholder's NDTIR of $100 from CFC1 is offset by the interest expense in CFC2, so there is net CFC tested income of $99 and a Section 951A inclusion of $99.

Next, even if the interest expense in CFC2 reduces the shareholder's NDTIR in this situation, consider the above fact pattern where CFC2 also has $100 of notional QBAI return. The notional QBAI return of CFC2 does not increase the shareholder's NDTIR, because CFC2 has a tested loss. The question now is whether the shareholder's NDTIR of $100 from CFC1 is still offset by the interest expense in CFC2, even though the $100 of notional QBAI return in CFC2 is disregarded in determining the shareholder's NDTIR. If so, there would be a Section 951A inclusion of $99, the net CFC tested income from CFC1 and CFC2, with no NDTIR.

This would be a very anomalous result, and quite adverse to the taxpayer. Logically, even if interest expense in a CFC with tested losses such as CFC2 is generally required to offset NDTIR, the interest expense should *first* offset the notional QBAI return in CFC2 itself. After all, the purpose of the reduction of NDTIR for interest expense is a presumption that the debt on which the interest is paid was used to buy an asset generating QBAI return. If CFC2 has its own assets that generate notional QBAI return, there is no logical reason for that return to be ignored, and for the interest expense of CFC2 to offset the QBAI return of CFC1 without regard to the notional QBAI return of CFC2.

Regulations should clarify this point.

7. Tax Basis and E&P Issues

A number of issues concerning tax basis and e&p are raised by the GILTI rules. We only mention these briefly, since many of these issues will be discussed in a more extensive report that the Tax Section will be submitting on the subject.

Outside of consolidation, suppose US1 owns all of CFC1 and other CFCs. Assume no NDTIR, and that in year 1, CFC1 has tested income and the other CFCs break even. US1's tax basis in CFC1 will increase by the Section 951A inclusion, which is CFC1's tested income. Now suppose that in year 2, CFC1 has a tested loss equal to its

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did not reduce NDTIR by any interest expense of CFCs. The conference agreement adopted the Senate amendment with modifications, including reducing QBAI for interest expense taken into account "under [section 951A(c)(2)(A)(ii)] in determining the shareholder's net CFC tested income....". However, because the Senate provision was not amended to also take into account QBAI in a CFC with tested loss, it is not clear whether the amendment was intended to only account for interest expense of a CFC with tested income.

year 1 tested income, but US1 has another CFC with an equal amount of tested income, so there is no Section 951A inclusion in year 2.

Regulations should clarify whether US1 still has a PTI account of $100 in US1 based on the year 1 Section 951A inclusion, even though CFC1 has no net tested income over the two year period. The existence of such a PTI account would be consistent with the fact that US1's tax basis in CFC1 is apparently not reduced in year 2 notwithstanding the tested loss of CFC1 in year 2. There may be additional consequences arising from the fact that CFC1's loss in year 2 has saved US1 tax on the tested income of CFC2 in year 2.

Next, suppose US1 holds CFC1 and CFC2, CFC1 has tested income of $100, and CFC2 has a tested loss of $100. Section 951A(f)(2) states that if the Section 951A inclusion is less than the sum of the positive tested incomes of the shareholder's CFCs, the inclusion is allocated to the CFCs in proportion to the positive tested income of each CFC. Here, there is no Section 951A inclusion, no basis adjustment to the stock of CFC1 or CFC2, and no PTI is created. However, a dividend of $100 from CFC1 would apparently be eligible for the 100% deduction under Section 245A, and $100 of gain on the sale of the CFC1 stock would be exempt under Section 1248(a). Regulations should confirm these results.

Moreover, on this fact pattern, CFC2's loss has saved US1 $10.50 of GILTI tax, but there is apparently no adjustment to the tax basis of either CFC or to the e&p of the CFC with tested income. A similar issue arises if CFC2 has positive tested income but generates NDTIR in excess of that income, thereby offsetting tested income of CFC1 and causing US1 to save GILTI tax. The basis results in these examples can be uneconomic because the formula under Section 951A(f)(2) can cause a Section 951A inclusion to be allocated to a CFC that generated little or none of the actual Section 951A inclusion amount.

Finally, suppose that under our proposal in Part IV.C.3(a), the tested loss (and possibly QBAI return) of a CFC is shifted to the U.S. shareholder for carryover to future years of the shareholder. Logically there should be a basis decrease at the time of the shift, since the tested loss attribute has permanently left the CFC at that time. Regulations should clarify this point if the statute or regulations adopt this proposal for carryovers.

Many issues also arise under the consolidated return investment adjustment rules. Suppose one member (M1) owns the stock of another member (M2), and M2 has a Section 951A inclusion of $100 and a related Section 250 deduction of $50. Regulations should confirm that M1's stock basis in M2 increases by M2's Section 951A inclusion and is not reduced by M2's related Section 250 deduction. This result is supported by the rule for the dividends received deduction for dividends received by M2, by the analogous rule for partnerships discussed below that is contemplated by the Conference Report, and by the fact that the Section 250 deduction is intended as a rate reduction on GILTI inclusions rather than an economic deduction involving out of pocket costs.

Failure to give M1 a $100 basis increase in M2 would eliminate the benefit of the reduced GILTI tax rate when M1 sells the stock of M2, since M1 would then have a $50 capital gain on a sale attributable to the Section 250 deduction.

Additional issues arise under the investment adjustment regulations if, as we propose, members of a group are treated as a single corporation for purposes of GILTI inclusions and Section 250 deductions. As a result of such aggregation, members with Related CFCs may have different PTI accounts in those CFCs than in the absence of aggregation (although as discussed above, mismatches arise even in the absence of aggregation).

For example, suppose CFC1 and CFC2 are owned by different members M1 and M2, CFC1 has tested income, CFC2 has an equal amount of tested loss, and therefore there is no GILTI inclusion for the group.

For example, it is not clear if there is any tiering up or shifting of basis in the stock of M1 and M2, as there would be if CFC1 and CFC2 were domestic members of the group and the CFC2 losses were used to shelter CFC1 income. It is also not clear if any account is taken of the fact that CFC2's loss results in a loss of the Section 250 deduction for the group. The same issues arise if CFC1 has tested income, CFC2 has $1 of tested income and large QBAI return, and there is little or no GILTI inclusion as a result of the offset for NDTIR.

Finally, in a consolidated return context, the foregoing fact patterns raise questions as to how e&p is to be allocated among members of the group. Our forthcoming report will discuss both basis and e&p issues.

Additional issues also arise in the partnership context. As contemplated by the Conference Report, regulations should confirm that a corporate partner's outside basis in its partnership interest is increased by the GILTI inclusion of income to the partner, but not reduced by the Section 250 deduction. Such a reduction would mean that the deduction would represent a deferral, rather than a permanent decrease, in the tax rate on GILTI income to the corporate partner.

In addition, suppose a U.S. person is a partner in a partnership that owns a CFC, and the partner has a GILTI inclusion. Regulations should clarify whether there is an adjustment to the tax basis of the partnership in the CFC. Regulations should also address the more complex issues that can arise when interests in a CFC are held through tiered partnerships.

E. Foreign Tax Credit Issues

1. Determination of Allowed FTC

(a) Tracing versus proration

If a CFC has tested income, the foreign taxes paid by the CFC are entitled to the deemed paid FTC for GILTI purposes if they are "tested foreign income taxes". This means they must be "properly attributable to the tested income of such foreign corporation taken into account by such domestic corporation under Section 951A."[131] If the CFC has both tested income and other income, the Conference Report[132] indicates that regulations should apply principles from Treas. Reg. § 1.904-6. That regulation applies tracing if different categories of income are subject to foreign taxes imposed on different tax bases, but a *pro rata* rule based on net income if two categories of income are subject to the same foreign tax regime. We support regulations under GILTI that incorporate this aspect of the existing regulation.[133]

Once foreign taxes are determined to be attributable to tested income, regulations should clarify that it is not necessary to trace the taxes to particular dollars of tested income, as long as the items of tested income are included in the foreign tax base. For example, the CFC as a whole might have tested income, but foreign taxes might be paid by a branch or disregarded subsidiary that would have a tested loss on a stand-alone basis.

> <u>Example 15(a): Two divisions of a single CFC</u>. Assume a CFC has two divisions, A and B. Division A generates $100 of tested income, while division B generates $99 of tested loss in a business whose income would be tested income. As a result, the CFC has $1 of tested income. Assume that income of division B is subject to foreign income tax, notwithstanding the tested loss under U.S. tax principles.
>
> <u>Example 15(b): Disregarded subsidiary of a CFC</u>: Same facts as Example 15(a), but the CFC transfers division B to a newly-formed legal entity and "checks the box" to cause the entity to be disregarded.

As noted above, the FTC allowance is for FTCs "properly attributable" to tested income. As a result, it could be argued that in both of these cases, the foreign taxes borne by division B should not be eligible for the FTC. This position is arguably supported by the rule that if division B was a separate CFC, its foreign taxes would not be creditable to the U.S. shareholder.

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[131] Section 960(d)(3).

[132] Conference Report at 628 (describing House bill), 630 (stating that conference agreement follows House bill).

[133] See Part IV.E.2(f), where we suggest modification of the regulation where tax is imposed on an item of income that is not included in the U.S. tax base.

We believe, however, that regulations should confirm that the FTC is available for foreign taxes borne by division B. The statute does not provide for any "tracing" of particular taxes to particular dollars of tested income. Rather, a CFC has a single specified amount of tested income, which is taken into account by the shareholder in determining its Section 951A inclusion. Income and loss of all the assets of the CFC that can generate tested income go into the calculation of its tested income, even if some groups of assets standing alone generate a loss for U.S. tax purposes. We therefore believe that all the foreign taxes of the CFC are attributable to "the tested income" of the CFC. This position is consistent with the fact that Section 960(d)(3) (requiring that the foreign taxes be "properly attributable to the tested income") is written in a broader fashion than the item-by-item approach of Section 960(a) (requiring that the foreign taxes be properly attributable to "any item of income under Section 951(a)").

Moreover, if a CFC has an overall tested loss, no tracing is *allowed* to *permit* FTCs for taxes paid on profitable activities of the CFC. Since tracing is disallowed in that case, tracing should not be *required* so as to *disallow* FTCs for unprofitable activities of a CFC that has overall tested income. This is a matter of policy rather than administrative convenience (although we note that item by item tracing would often be very burdensome and impracticable). Thus, we believe tracing should not be required even in Example 15(b), where tracing might be relatively simple.

(b) Timing differences

Tested income will often arise in the same taxable period as the foreign taxes that are attributable to that tested income. However, timing mismatches can arise in a number of situations, including (a) tested income arises in the current year under U.S. tax principles, but the corresponding income inclusion (and therefore tax accruals) occurs in an earlier or later year under foreign tax principles, *e.g.*, because of different depreciation schedules or different taxable years under U.S. and foreign tax law, or (b) audit adjustments.

The first question in these situations is whether foreign taxes can qualify as tested foreign income taxes if they accrue in a year that is different than the year that the underlying income is included in tested income for U.S. tax purposes. Timing differences do not disqualify a tax for the foreign tax credit for purpose of the non-GILTI baskets.[134]

As noted above, a tested foreign income tax must be "properly attributable to the tested income of such foreign corporation" taken into account by the U.S. shareholder under Section 951A. The concern is that the reference to "the tested income" means "the tested income" *for the year in which the foreign tax accrues*.

[134] Treas. Reg. § 1.904-6(a)(1)(iv) (stating that timing differences do not change the basket in which a foreign tax is allocated); Rev. Rul. 74-310, 74-2 C.B. 205 (total foreign taxes of CFC imposed on profit on contract is eligible for Section 902 credit, even though timing of income was different under U.S. principles; requirement that foreign taxes be "attributable to" U.S. accumulated profits is satisfied).

Regulations should confirm that the reference to "the tested income" of the CFC is not so narrow, and that a foreign tax is a tested foreign income tax as long as the underlying income giving rise to the foreign tax is included in the tested income of the CFC for *any* year.[135]

We believe this interpretation is fully consistent with the language of the statute. Moreover, a contrary rule would require the tracing of every item of tested income to every item of foreign tax, to make sure they arose in the same taxable year. This would not be administrable and would result in large amounts of foreign taxes being disqualified as tested foreign income taxes because of minor timing differences between U.S. and foreign law. As noted above, this would also be inconsistent with the law for foreign taxes allocable to non-GILTI baskets, where timing differences are disregarded.

Assume now that a foreign tax qualifies as a tested foreign income tax. Such a tax is creditable in the year it is paid or accrued by the CFC.[136] Normally this would be the taxable year that the liability arises under foreign law, namely the year that the underlying income is taken into account for foreign tax purposes. In the case of timing differences, this year would be different than the year that the CFC had the underlying tested income. This could result in loss of the benefit of the FTC altogether, because there is no carryover or carryback of GILTI credits, even to the year in which the underlying tested income arises.

Relief from this timing mismatch is provided under certain circumstances by Section 905(c)(2)(B), as amended by the Act. That section provides that if accrued foreign taxes are not paid within two years after the end of the taxable year to which the taxes relate, or are refunded after being paid, then they are taken into account in the taxable year to which they relate. Previously the section provided that taxes in this situation were taken into account when paid. The scope of the old provision was not clear,[137] and many of the uncertainties remain.

Nevertheless, the provision is directed primarily at the situation where an audit adjustment causes foreign taxes to accrue in an earlier year, but payment does not occur until the close of the audit. Regulations should confirm that Section 905(c)(2)(B) applies to audit adjustments relating to tested income under these circumstances, and clarify the application of that provision. This is especially important because of the lack of carryovers and carrybacks of GILTI credits.

In cases where Section 905(c)(2)(B) does not apply, the Code does not provide relief from timing mismatches. Relief may not be needed for routine mismatches that

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[135] If a foreign corporation is a not a CFC in 2018 but is one in 2019, regulations should clarify whether a foreign tax payable in 2019 on 2018 income is a tested foreign income tax, given that the definition of tested income refers to income of CFCs. Section 951A(c)(2)(A).

[136] Section 960(d)(1)(B).

[137] *See* Alan Fischl, Elizabeth Nelson, and Anisa Afshar, *Section 905(c) Mysteries*, J. Int'l Tax, July 2017 at 22.

cancel each other out from year to year, or even for routine annual audit adjustments that are settled quickly after a tax return is filed.

However, consider the case of an extraordinary item that involves a timing mismatch for U.S. and foreign income inclusion. Section 905(c)(2)(B) will not apply because the tax will accrue for U.S. tax purposes at the time the foreign tax accrues for foreign purposes and is paid, even though the tested income is reported for U.S. purposes in a different year.

Given the lack of carryovers and carrybacks of GILTI FTC, a disparity between the year the tested income is reported and the year that the FTC arises may give rise to significant amounts of FTCs that become unusable. We urge that the principles of Section 905(c)(2)(B) be extended to timing differences arising from the inclusion of items in the U.S. and foreign tax base in different years. The extension could be limited to non-routine items, although this would be difficult to define. An automatic rule that is as broad as possible would be preferable to a facts and circumstances test. In any event, regardless of the scope of the new rule, it should apply without regard to the two-year minimum deferral period in Section 905(c)(2)(B), because the lack of a carryover means that even a single-year timing difference could easily result in a loss of any benefit from FTCs.

We believe that this rule is justifiable because the restriction on carryovers and carrybacks of FTCs was presumably intended to prevent taxes paid in high-tax years from being used to shelter income earned in low-tax years. There is no indication it was intended to cause a loss of the benefit of FTCs as a result of inclusion of income in different years for U.S. and foreign tax purposes.

We recognize that applying an expanded version of Section 905(c)(2)(B) on an item-by-item basis will be administratively difficult. However, we do not see any alternative that would be consistent with the rule that there is no carryover of GILTI FTCs. We believe that the result after applying Section 905(c)(2)(B) should be the same, but no better and no worse, than if the tested income arose in the same year that the foreign tax was paid.

The proposed extension of the principles of Section 905(c)(2)(B) could be limited to GILTI, on the theory that GILTI is in effect a new world-wide tax system and so all preexisting rules should be reconsidered for GILTI. Alternatively, uniform rules under Section 960 could be considered for all foreign income. The reason is that the additional new baskets and lack of GILTI carryover mean that the use of FTCs and carryovers on an overall basis is now much more restricted than before.

(c) Withholding tax on distribution of PTI

Regulations should confirm that if there is withholding tax on a distribution of PTI arising from tested income, 100% rather than 80% of the withholding tax is allowed as a credit under Section 901, and that the FTC is not cut back by the inclusion percentage. Both limitations are imposed by Section 960(d)(1), which applies to tested foreign income taxes, *i.e.*, taxes paid by the CFC on the CFC's tested income. These taxes are imposed on the U.S. shareholder rather than the CFC.[138]

2. Section 904 Issues

(a) Expense allocation

Section 904(d) creates a separate limitation basket for GILTI. As illustrated in Examples 5(a) through 5(c) above, if expenses of the U.S. shareholder are treated as foreign source expenses allocated to the GILTI basket, and if the foreign tax rate is at least 13.125%, expenses of this type cause U.S. tax to be payable on a Section 951A inclusion no matter how far above 13.125% the foreign tax rate is. As shown in Example 5(c), for every $1 of such allocated expenses, foreign source income is reduced by $1, and this reduces the FTC limit by $.21. This in turn increases the U.S. tax liability by $.21, no matter how much the foreign tax rate exceeds 13.125%. If the foreign tax rate is less than 13.125%, any allocated expenses will first increase the effective foreign tax rate (determined under U.S. principles taking the expense allocations into account) to 13.125%, and thereafter any additional $1 of allocated expenses will result in the same $.21 increase in U.S. tax liability.

This section discusses the statutory basis for the allocation of expenses, the ability of Treasury not to allocate any expenses to GILTI, the policy issues concerning allocating or not allocating expenses to GILTI, and possible modification of existing regulations for allocating expenses to GILTI.

Section 904(d)(1)(A) states that Section 904(a) and certain other sections shall be applied separately to Section 951A inclusions. Section 904(a) limits foreign tax credits based on taxable income from foreign sources, so the Section 951A limitation is based on taxable income in the Section 951A basket. Under Sections 861(b), 862(b), and 863(a), taxable income in a category is based on gross income in the category reduced by expenses "properly apportioned or allocated" to such gross income under regulations. Moreover, under existing regulations, the expenses of the U.S. shareholder must be divided between US-source and foreign-source, and then the foreign-source expenses are further divided among the applicable limitation baskets.[139]

In light of this statutory structure, if Treasury determines that no expenses of the U.S. shareholder are "properly allocable" to income in the GILTI basket, Treasury could issue regulations that no allocation of expenses to that basket should be made. Presumably such a determination would be based on the flat-rate theory of GILTI discussed above that the rules are intended as a flat tax of 13.125% on foreign income. As noted above, the Conference Report seems to contemplate no GILTI tax if the foreign

[138] Logically the same rule should apply to withholding tax on a distribution from a subsidiary CFC to a parent CFC, since the U.S. shareholder takes account of tested income of the lower tier CFC, and the distribution to the upper tier CFC creates PTI rather than tested income to the upper tier CFC.

[139] *See generally* Section 861 and Treasury Regulations thereunder.

tax rate is at least 13.125%. This statement is correct only if there are no allocations of U.S. deductions to the GILTI basket for purposes of determining FTC limitations. Moreover, there are other situations where the usual rules for allocating expenses are modified.[140]

On the other hand, arguments can be made that such an interpretation by Treasury would be inconsistent with the structure and purpose of the statute. First, such an interpretation is inconsistent with the notion that the statement in the legislative history is illustrative rather stating a definitive rule. Arguably the allocation of deductions to foreign income is integral to the structure of the FTC rules, and it should take more than this ambiguous statement in the legislative history to override that basic structure.

Second, the statute is most logically read to require that every expense should be allocable to some item of gross income. Therefore, Treasury would have to conclude that expenses otherwise allocable to Section 951A inclusions under the principles of the existing regulations are instead allocable as a matter of law to domestic income or other foreign source income. It is difficult to see how such expenses become "properly allocable" to such other income solely as a result of the enactment of the Act, since there is no more connection between such expenses and such other income after the Act than there was before. Such a nonallocation to Section 951A inclusions is in contrast to other situations where regulations create an exception to allocations of expenses to foreign income, since such exceptions are based on specific fact patterns where an allocation is likely not "proper" as a factual matter.

Third, the statute clearly contemplates a loss of GILTI FTCs in other situations,[141] so perhaps Congress was not concerned about a loss of FTCs in the context of expense allocations. In fact, when Congress desired to change the normal rules for allocations of expenses to categories of income, it has stated so explicitly.

- Section 864(e) contemplates an allocation of interest expense among assets, with a specific exception in Section 864(e)(3) that prevents an allocation of expenses to tax exempt assets (and the income they produce) and the deductible portion of dividends eligible for the DRD.

- New Section 904(b)(4), discussed below, is a special rule for allocating expenses when dividends from a CFC are eligible for Section 245A.

- New Section 965(h)(6) turns off allocation of deductions attributable to dividends from a CFC in determining the net tax liability under Section 965.

[140] *See, e.g.*, Treas. Reg. § 1.861-10T, relating to special rules for allocating interest expense.

[141] For example, FTCs are lost if the foreign taxes are paid by a CFC without tested income, and tested losses of one CFC (or NDTIR of the shareholder) can reduce the shareholder's resulting FTC allocation percentage for FTCs paid by a CFC with tested income.

There is no comparable special rule for the GILTI basket, arguably indicating an intent by Congress that no special expense allocation rules were intended for the GILTI basket. In fact, Section 904(b)(4) by its terms disregards deductions allocable to income from stock of a CFC other than amounts includible in income under Sections 951(a)(1) or 951A(a). This exception clearly implies an understanding that deductions might be allocable to Section 951A inclusions. Similarly, since shareholder level deductions clearly reduce FDII, to the extent FDII and GILTI are considered parallel systems, shareholder deductions should likewise be allocable to GILTI.

In any event, we do not believe as a policy matter that there should be a complete exclusion of shareholder expenses from the GILTI basket.

Such a complete exclusion means that expenses that would be properly allocable to Section 951A inclusions under existing principles should instead *automatically* be treated as properly allocable to other foreign or domestic source income. Yet such expenses reduce U.S. taxable income no matter how they are allocated for FTC purposes. To the extent expenses that are properly allocable to foreign income are in fact allocated to domestic income for FTC purposes, the overall effect is that FTCs are allowed to shelter U.S. tax on U.S. income. This effect also arises if these expenses are not allocated to any basket (a questionable interpretation of the statute in any event), because the full FTC is allowed as long as there is no reduction in foreign source income.

Section 904 was intended to prevent the FTC from having this effect. In addition, this reallocation of deductions encourages foreign countries to raise their tax rates at the expense of the U.S. fisc, because until the Section 904 limits are reached, 80% of the additional foreign tax is creditable.

If the taxpayer had non-GILTI foreign income, it would be possible to avoid all or part of this result by allocating the GILTI-related expenses to other baskets of foreign income, rather than to U.S. income. This may be taxpayer-favorable because it could allow GILTI FTCs to be used currently instead of being permanently lost, and FTCs in other baskets to be carried forward or backward instead of being used currently. However, it could be taxpayer-unfavorable if the taxpayer has, say, high-taxed foreign branch income and low-taxed GILTI, since there would be no effect on GILTI FTCs but the branch FTCs would have to be carried forward or backward rather than being used currently. In either case, it is difficult to see a logical reason for the reallocation of expenses to other baskets.

Moreover, there would be no justification for reallocating GILTI expenses to FDII of the shareholder. The argument for a flat rate of tax based on the Conference Report applies equally to FDII, and so it would be inconsistent with the flat rate theory to increase the effective tax rate on FDII in order to obtain a flat rate on GILTI.

Finally, allocation of GILTI expenses to other baskets of foreign income (with or without FDII) would have no effect if the taxpayer did not have any foreign income in other baskets, and no material effect if the taxpayer did have foreign income in the other baskets but such income was not subject to a material amount of foreign tax. Also, once the allocation eliminated all foreign source income in non-GILTI baskets, any additional expenses otherwise allocable to GILTI would have to be reallocated to GILTI or to U.S. source income.[142] This leads back to the original issue.

Despite these policy arguments against allocating *no* expenses to the GILTI basket, it is important to note that there are significant differences between the GILTI regime and the historic regime for taxing income of CFCs. For example, foreign tax credits in the GILTI basket cannot be carried forward or backward,[143] so the impact on taxpayers of limiting GILTI FTCs is much more severe than limiting non-GILTI FTCs. These limits on GILTI FTCs seem to undercut both theories of the nature of GILTI, since they cause worse results for taxpayers than either the Subpart F rules or the result under a flat rate of tax (at least if the flat rate of tax is intended to be based on true economic income over a period of years).

As a result, we believe that in light of these differences between GILTI and the preexisting tax rules for FTCs, even if expense allocations continue to apply to the GILTI basket under Section 904, the existing Section 861 statutory and regulatory framework should not necessarily be applied wholesale. Moreover, in light of the flat rate theory of GILTI, regulations should modify existing rules to minimize allocations to GILTI inclusions that are not economically justified. In fact, reconsideration might also be given to certain of the allocation rules for Subpart F income allocated to the general and passive FTC baskets.

For example, research expenses of a U.S. corporation are allocated to U.S. and foreign sources under various methods based on sales or gross income.[144] To the extent that gross income is the test, there was little allocation to CFCs in the past because most income of CFCs was not currently included in U.S. gross income. This result seems appropriate because research expenses of the U.S. shareholder increase the royalty or sales income of the shareholder, but the CFC does not benefit. In fact, the CFC would only have increased its income if the resulting intangibles were transferred to the CFC, which could not occur without gain recognition or Section 367(d) royalty income to the U.S. parent corporation.[145]

Now, CFCs will generate a significant amount of gross income to the U.S. shareholder as a result of GILTI inclusions. Moreover, the research expenses of the U.S. shareholder will not generally give rise to tested income to the CFC or GILTI inclusions

[142] Section 904(a) and (f)(5); Treas. Reg. § 1.904-4(c)(2)(ii). Allocations to U.S. source income would also create an overall domestic loss (“**ODL**”) to the extent they exceeded U.S. source income.

[143] This means, for example, that if a U.S. shareholder has an NOL or NDTIR that offsets its GILTI inclusion for the year, the NOL or NDTIR is absorbed in the current year and the FTC on the GILTI inclusion provides no benefit in the current year and cannot be carried to a future year.

[144] *See* Treas. Reg. § 1.861-17.

[145] For intangibles developed by cost sharing, each of the U.S. shareholder and the CFC bore its own expenses, so this issue does not arise.

to the shareholder for the reasons stated above.[146] Nevertheless, absent a change in regulations, the GILTI inclusions will result in an allocation of research expenses to the GILTI basket for purposes of Section 904. These allocations do not seem justified as a result of the enactment of the GILTI rules, and we believe these rules should be reconsidered by Treasury.

Likewise, interest expense of the U.S. shareholder is generally allocated to stock of a CFC based on the tax basis of the stock and the accumulated earnings of the CFC.[147] However, under Section 864(e)(3), no expenses may be allocated to stock that gives rise to income that is exempt, excluded, or eliminated from tax, including the portion of stock attributable to the dividends received deduction available under Section 243 or 245 for dividends on that stock.[148] It appears that this rule does not apply to stock of a CFC that gives rise to dividends eligible for the Section 245A deduction, because such dividends are initially included in gross income and the deduction is under a section not specified in Section 864(e)(3). Rather, stock giving rise to such dividends is apparently subject solely to Section 904(b)(4), discussed below. Regulations should confirm this conclusion.

Other allocation questions also arise. Allocations of some expenses such as interest are based on the tax basis of stock of a CFC. The stock may give rise to GILTI inclusions, dividends eligible for Section 245A, or Section 956 inclusions. The allocation each year could be based on the actual GILTI inclusions, Section 956 inclusions, and Section 245A eligible dividends paid during the year. Alternatively, the allocation could be based on GILTI inclusions, Section 956 inclusions, and QBAI return whether or not paid out as dividends during the year. Section 904(b)(4), discussed below, is inconclusive on this question because it contemplates that expenses might be allocable both to stock of a CFC and to exempt dividends paid by a CFC.

We note that the timing of Section 245A dividends is entirely discretionary and could be adjusted to achieve desired allocations each year. As a result, an annual allocation based on Section 245A dividends paid during the year would have little or no economic substance and would create considerable opportunity for tax planning. On the other hand, an allocation based on QBAI return could not take into account the possibility that such return could be paid out in the future as either Section 245A eligible dividends or as Section 956 inclusions. Regulations should clarify this question. In the examples that follow, we assume an allocation based on QBAI return rather than actual cash dividends, but the results would be the same in substance in either case.

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[146] An exception would be if royalty income from the CFC was considered a GILTI inclusion to the U.S. shareholder. We believe this should not be the case, as discussed in Part IV.E.2(e), but if this is the case, an expense allocation to such income would be appropriate.

[147] Section 864(e)(4); Treas. Reg. § § 1.861-9T(g), -12(c)(2); new Section 864(e)(2) (requiring use of tax basis rather than fair market value for allocating interest expense).

[148] *See also* Treas. Reg. § 1.861-8T(d)(2)(ii).

Finally, in many situations the allocation of expenses is based on gross income, including in the preceding paragraph where the allocation to categories of income in the CFC is based on different types of income of the CFC. Consideration should be given as to whether these allocations should be based on net GILTI rather than gross GILTI. It can be argued that expenses give rise proportionately to gross income regardless of the different tax rates that might apply to different items of income. However, if the CFC has $100 of passive Subpart F income and $100 of gross GILTI income, an equal allocation of expenses to both items will have a far more adverse effect on the GILTI basket than on the passive basket. This result would exacerbate the negative effect of interest allocations on the GILTI basket. Consequently, it can be argued that a *pro rata* rule based on gross GILTI is unjustified in light of the flat-rate theory of GILTI.

(b) Section 904(b)(4)

Regulations should clarify the application of new Section 904(b)(4).

As background, FTCs are not available for dividends giving rise to a Section 245A deduction.[149] As a result, deductions allocable to such dividends, or to stock giving rise to such dividends, do not cause a tax detriment to the U.S. shareholder of a CFC, since a reduction in foreign source income under Section 904 does not matter when no FTCs are available anyway. It can logically be argued that deductions allocated to such dividends should remain so allocated, as opposed to being reallocated to other baskets, and other aspects of the Section 904 calculations should be unchanged.

After all, the logic that led to the initial allocation of expenses to each FTC basket is not changed as a result of the enactment of Section 245A. For example, if a U.S. shareholder borrows to buy stock in a corporation, the interest expense would logically be allocated to the stock (or not) regardless of whether the stock happens to give rise to taxable or tax-exempt dividends. This result would also be consistent with the general approach of Section 265 , which disallows deductions for expenses allocable to exempt income, and thereby increases taxable income for all purposes of the Code, but does not reallocate any deductions to or from exempt income (the "**no-reallocation approach**").

By contrast, Section 864(e)(3), discussed above, reallocates all expenses initially allocable to tax-exempt income and assets to other income and assets for FTC purposes. This reduces foreign source income in the baskets giving rise to taxable income, and therefore reduces the ability to utilize FTCs arising on taxable income. This approach might be based on the theory that in this situation, unlike under Section 265, the expenses in question are still allowed to the U.S. shareholder as deductible expenses and therefore should still be allocated against taxable income.

Section 904(b)(4) was added by the Act as Section 904(b)(5) and later renumbered in a technical correction bill.[150] The heading is "Treatment of Dividends for

[149] Section 245A(d).

[150] Pub. Law. 115-141, § 401(d)(1)(D)(xiii) repealed former Section 904(b)(4) as deadwood and renumbered Section 904(b)(5), added by the Act, as Section 904(b)(4), effective March 23, 2018.

which Deduction is Allowed Under Section 245A." Since the provision is within Section 904, the purpose is clearly to adopt a rule to deal with the allocation of deductions to dividends that are in substance exempt from tax.

The provision states that for purposes of the Section 904 limitations, the shareholder's foreign source income and entire net income are calculated without regard to (A) the foreign source portion of all dividends from the CFC ("**clause A**"), (B)(i) deductions allocable to non-GILTI, non-Subpart F income from stock of a CFC ("**clause B(i)**"), or (B)(ii) deductions allocable to stock of a CFC to the extent income from the CFC is non-GILTI, non-Subpart F ("**clause B(ii)**"). The identification of these clauses reflects the clause references in Section 904(b)(4).

This provision is similar to Section 864(e)(3) in that it does not deny a deduction for expenses at the shareholder level. On the other hand, on its face, it does not reallocate any expenses to other baskets, as does Section 864(e)(3). Rather, it provides a formula for calculating foreign source income and entire net income for purposes of the Section 904 limitations. As is discussed below, the formula appears to achieve the same result as the no-allocation approach.

Turning to the specifics of the formula, recall that the ratio of foreign source income in a basket to entire net income is multiplied by U.S. tax liability to obtain the FTC limit for the basket. Clause A disregards all foreign source dividends from a CFC. This rule is likely based on the fact that all dividends from a CFC will either be nontaxable PTI from GILTI or Subpart F, and taken into account previously for expense allocation purposes, or else from CFC exempt income and eligible for Section 245A.

Clauses B(i) and B(ii) require the disregard of all expenses allocable to the CFC in baskets other than GILTI and Subpart F. Since a CFC will never give rise to branch income to its U.S. shareholder, the reference can only be to the general basket. However, once those expenses are disregarded, the determination of foreign source income and entire taxable income must be recalculated for purposes of all baskets, including GILTI and Subpart F.

Since the formula disregards both exempt dividend income and expenses allocable to such income, the result is the no-reallocation approach. This increases the ability of the U.S. shareholder to use FTCs when the only foreign income of the U.S. shareholder is (1) dividends from a CFC eligible for Section 245A, and (2) Subpart F income or GILTI inclusions from a CFC.

<u>Example 16(a)</u> (<u>Shareholder has no foreign income except CFC income</u>). U.S. shareholder has:

- $700 of U.S. income offset by $500 of allocable expenses, for U.S. taxable income of $200

- $300 of net GILTI income from a CFC offset by $100 of allocable expenses, for GILTI basket income of $200

- $100 of expenses allocable to QBAI return of the CFC (general basket expenses).

World-wide taxable income is $300. Absent Section 904(b)(4), the foreign tax credit fraction for the GILTI basket would initially be $200 (GILTI income) divided by $300 (worldwide taxable income). However, since there is a $100 loss in the general basket, the GILTI fraction is reduced to $100/$300.[151]

Now applying Section 904(b)(4), clause A says to ignore dividends from the CFC. Regardless of whether any such dividends are paid, they would not be in taxable income (either because they are non-taxable distributions of PTI or because they are fully offset by Section 245A deductions) and so this condition is satisfied. Clauses B(i) and B(ii) say to disregard the $100 of expenses in the general basket in determining foreign source income and entire taxable income (because these expenses are allocable to QBAI return that will give rise to exempt dividends). In calculating the new GILTI limitation, those expenses are ignored in the numerator, meaning that they no longer reduce the $200 of net GILTI income to $100. Moreover, absent those expenses, entire taxable income increases from $300 to $400. As a result, the GILTI FTC fraction becomes $200 (net GILTI income) divided by $400 (entire taxable income with addback of expenses allocable to exempt dividends).

This $200/$400 FTC fraction is an improvement over the $100/$300 fraction that arises in the absence of Section 904(b)(4). In fact, this is the same result that would arise if the expense of $100 had simply not been incurred. Consequently, this result is the same as under the no-reallocation approach.

We now consider a case where the U.S. shareholder has other foreign source income in the general basket at least equal to the expenses in that basket that are allocable to exempt income. In that case, there is no negative balance in the general basket that would reduce the balances in the GILTI or Subpart F baskets. Section 904(b)(4) still reaches the same result as the no-reallocation approach. However, in this case the application of Section 904(b)(4) increases the limitation in the general basket, and decreases the limitations in the GILTI and Subpart F baskets. The following example illustrates these results.[152]

<u>Example 16(b) (shareholder has other general basket income)</u>. A U.S. shareholder has:

- $100 of domestic source business income offset by $40 of allocable expenses,

- $600 of gross GILTI inclusion, offset by $300 of Section 250 deduction and $60 of allocable expenses,

[151] Section 904(f)(5); Treas. Reg. § 1.904-4(c)(2)(ii).

[152] Appendix 1 contains a table illustrating this example.

- $50 of foreign source business income in the general basket, offset by $10 of allocable expenses, and

- $40 of expenses allocable to exempt CFC return of the CFC giving rise to dividends eligible for Section 245A.

On these facts, before applying Section 904(b)(4), the U.S. shareholder has:

- taxable income of $300 ($150 operating income, $300 net GILTI inclusion, $150 expense),

- U.S. source income of $60 ($100 of business income and $40 of expense),

- foreign source GILTI basket income of $240 ($300 inclusion minus $60 expense),

- foreign source general basket income of $0 ($50 of business income, $10 of expense allocated to such income, and $40 of expense allocated to exempt CFC return),

- tentative U.S. tax liability of 21% of $300, or $63.00, and

- a GILTI FTC limit of $63.00 (tentative U.S. tax) times $240 (foreign source GILTI inclusion) divided by $300 (world-wide taxable income), or $50.40.

These results would not change if income from the CFC was distributed, since the GILTI inclusion would be PTI, the exempt CFC return would give rise to gross income eligible for the Section 245A deduction, and as noted above Section 864(e)(3) would not apply. As a result, no taxable income or foreign source income would be created.

In this case, the expense of $40 that is allocated to QBAI return reduces the U.S. shareholder's foreign source income in the general basket from $40 to $0. As a result, unlike in Example 16(a), there is no "negative" balance in the general basket that reduces the GILTI fraction. However, the general basket fraction is reduced from $40 (general basket income outside the CFC) divided by $300 (worldwide income) to $0 divided by $300, or $0. Therefore, no FTCs on the direct foreign source income of $50 are available.

Consider now Section 904(b)(4). It requires disregarding the expenses of $40 allocable to QBAI return in calculating the shareholder's foreign source income and entire taxable income. Therefore, similar to the result in Example 16(a), general basket expenses are calculated without regard to the $40 deduction, so general basket income is increased from $0 to $40. Stopping there, the general basket FTC fraction is $40 (foreign source income) divided by $300 (world-wide income), and the GILTI basket is unaffected.

However, Section 904(b)(4) also requires that the shareholder's "entire taxable income" be determined without regard to the $40 of expense. As a result, the foreign source GILTI inclusion remains at $240. However, the denominator of the general basket fraction and the GILTI fraction, namely world-wide taxable income, is increased by the $40 of lost deductions, to $340.

The general basket FTC fraction is then $40/$340, which is higher than the $0/$300 result absent Section 904(b)(4). The GILTI FTC fraction is then $240/$340, or .71, which is lower than the initial fraction of $240/$300, or .80. The reason for the increase in the general basket fraction is that the increase in the numerator of that fraction by the $40 of exempt expense more than makes up for the increase in the denominator by the same amount. On the other hand, there is no increase in the numerator of the GILTI fraction, only a $40 increase in the denominator. This is in contrast to Example 16(a), where the increase in the numerator of the GILTI fraction (as a result of preventing the income in the basket from being offset by the exempt loss) more than made up for the increase in the denominator of the fraction by the same amount.

In both cases, the result is the same as under the no-reallocation approach. If the U.S. shareholder had not incurred the $40 of expense allocated to the exempt dividend income, entire taxable income would be $340 and the above results would follow.

It can be argued that the initial GILTI fraction of $240/$300 is the "correct" fraction, and that the reduction in the fraction to $240/$340 has the same substantive effect as reallocating part of the $40 of exempt expenses to the GILTI basket to reduce the GILTI fraction. However, if the GILTI fraction remains at $240/$300, the U.S. shareholder has a higher limitation in the GILTI basket than if there had not been any exempt income or expense. This is not consistent with the no-reallocation approach, with the principles of Section 265 or with the statutory directive to disregard the exempt expenses.

We also note that the maximum allowed GILTI FTC is the GILTI fraction multiplied by the tentative U.S. tax liability on world-wide income, and the latter number is reduced as a result of the tax deduction of $40 that was allocated to Section 245A dividends. As a result, the GILTI FTC basket is less than if the $40 had not been incurred and additional U.S. tax had been paid. However, this is a consequence of the allowance of the deduction, unlike the disallowance of deductions allocable to exempt income under Section 265. The deduction reduces the effective U.S. tax rate on worldwide income, and the result under Section 904(b)(4) is consistent with the purpose of Section 904 to limit the credit for FTCs to the effective U.S. tax rate on worldwide income.

Treasury should clarify in regulations whether the above results are correct, and if not, how Section 904(b)(4) should be applied instead.

(c) The Section 250 deduction

Regulations should confirm that the portion of the Section 250 deduction that is allocable to the GILTI inclusion is allocated and apportioned to the GILTI basket.[153] That portion of the deduction is clearly attributable to the foreign-source GILTI inclusion, since the deduction is a percentage of the gross income inclusion and is clearly intended merely to reduce the U.S. tax rate on that income.

If this portion of the Section 250 deduction was allocated and apportioned to the general limitation basket, foreign taxes on tested income at a rate in excess of 13.125% could in effect be used to shelter U.S. tax on U.S. income. Likewise, the allocation might cause a foreign tax on general basket income such as FDII income not to be fully creditable. These results are clearly at odds with Congressional intent.

(d) Section 78 gross-up

We recommend that regulations specify that the Section 78 gross-up for foreign taxes deemed paid under Section 960(d) is in the GILTI basket.

The issue arises for the following reason. Section 78 treats the gross-up amount as a dividend to the U.S. shareholder. However, the amount of foreign tax reduces the tested income of the CFC, and therefore neither the tax nor the gross-up gives rise to a Section 951A inclusion (which is based solely on tested income and QBAI return). Consistent with this, Section 250(a)(1)(B) specifically includes, in the amount eligible for the 50% Section 250 deduction, both the Section 951A inclusion and the Section 78 gross-up of the Section 951A inclusion. Moreover, while the Senate bill explicitly provided that the Section 78 gross-up was in the GILTI basket,[154] this provision was removed in the final bill. The foregoing could potentially indicate a conscious choice by Congress not to include the gross-up as an inclusion in the GILTI basket and to reach the "right" amount of the Section 250 deduction through a separately identified deduction.

However, explicitly providing that the gross-up belongs in the GILTI basket might also have been deemed unnecessary. Section 78 does not specify the appropriate basket for gross-ups on other income, and regulations could address this point in the same manner that it is addressed under Subpart F.[155]

[153] Likewise, the portion of the Section 250 deduction that is allocable to FDII is clearly attributable to FDII and should be allocated solely to the general basket or passive income basket. If the carve-back applies, the deduction should be allocated between GILTI and FDII based on the reduced amounts of each.

[154] *See* Conference Report at 644, describing the Senate Bill ("[T]he taxes deemed to have been paid [under new Section 78] are treated as an increase in GILTI for purposes of section 78...").

[155] Section 904(d)(3)(G), implemented by Treas. Reg. § 1.904-6(b)(3), specifies that amounts included in gross income under Section 78 and attributable to Subpart F income are treated as Subpart F income for purposes of the foreign tax credit limitations. Although the statute addresses only Subpart F income, Section 904(d)(7) delegates broad regulatory authority and the principles of the regulation could be extended to Section 78 amounts attributable to GILTI.

Moreover, it is not logical for the Section 78 gross-up to be in any basket other than the GILTI basket when the underlying income giving rise to the grossed-up taxes was tested income giving rise to an inclusion in the GILTI basket. If the Section 78 amount is not in the GILTI basket, this would reduce foreign source income in the GILTI basket and thus the FTCs allowed in that basket. In fact, reducing foreign source GILTI inclusion by excluding the Section 78 gross-up has a similar effect as reducing foreign source GILTI inclusion by allocating expenses of the U.S. shareholder to GILTI inclusion.

Unless some other items were also shifted out of the GILTI basket (see below), the result is that a blended foreign tax rate of 13.125% on pre-foreign tax tested income would not itself be sufficient to eliminate U.S. tax on such income even after taking the Section 78 gross-up into account. This is so even if no expenses of the U.S. shareholder were allocated to the GILTI basket. Even stranger, the higher the foreign taxes paid, the more pronounced this effect would be because more pre-foreign tax tested income would be shifted out of the GILTI basket. This seems inconsistent with the intent of Congress.

We assume that if a Section 78 gross-up is not included in the GILTI basket, it would be in the general basket.[156] In that case, other adjustments would logically follow.[157] In particular, since the foreign tax reduces tested income, we believe that regulations should provide that the portion of the FTC allocable to the Section 78 gross-up amount (a non-tested income amount) is also in the general basket. For example, suppose the CFC has $100 of income and pays $10 of foreign tax. This results in $90 of tested income, a Section 951A inclusion of $90, a Section 78 gross-up of $10, an FTC under Section 960(d) of $8 and a Section 250 deduction of $50. If the $10 of Section 78 gross-up is in the general basket, then an allocable portion of the Section 250 deduction and shareholder expenses should logically also be allocable to the general basket rather than the GILTI basket. Moreover, the portion of the FTC allocable to the Section 78 gross-up, *i.e.*, 80% of the tax imposed on $10 of general basket income, or $0.80, would logically also be in the general basket.[158]

However, when all of the underlying income of the CFC is tested income included under Section 951A, it would be extremely peculiar for the GILTI rules to give rise to two separate and parallel tax calculations and limitations, one in the GILTI basket and one in the general basket. Illogical pro-taxpayer and pro-government mismatches could

[156] Since tested income excludes Subpart F income, if there were no GILTI basket, all tested income (except for passive income that is not Subpart F income) would be in the general basket.

[157] *See discussion in* Elizabeth J. Stevens and H. David Rosenbloom, GILTI Pleasures, Tax Notes Int’l, Feb. 12, 2018, at 615.

[158] Under principles analogous to Treas. Reg. § 1.904-6(b)(3), the Section 78 gross-up would be in the GILTI basket if the underlying taxes were paid on income in the GILTI basket. Since tested income is only $90, logically only $9 of the foreign taxes were paid on that income, and the other $1 of foreign tax was paid on the $10 of pre-tax foreign income that was paid out in foreign taxes and thereby reduced tested income from $100 to $90. Of that $9 and $1 respectively, $7.20 and $0.80 are allowed as FTCs under Section 960(d) (assuming the inclusion percentage is 100%).

arise. On the pro-taxpayer side, excess general basket FTCs could offset a low-taxed Section 78 gross-up of the Section 951A inclusion. In addition, excess FTCs could be created in the general basket that could carry over. On the pro-government side, excess GILTI FTCs from other CFCs could not offset a low-taxed Section 78 gross-up amount. In that case, GILTI FTCs could be wasted, and tax would be owed on the gross-up amount unless the taxpayer had excess FTCs in the general basket. This issue would be exacerbated if the FTCs proportionately allocated to the Section 78 gross-up income were not placed in the general basket. We do not believe that these results were intended by Congress.

(e) Interest, rent and royalty payments from a CFC to its U.S. shareholder

Regulations should confirm that interest, rent and royalties received by a U.S. shareholder from its Related CFC are not in the GILTI basket for Section 904(d) purposes.

We acknowledge that Section 904(d)(3)(C) states that interest, rents, and royalties paid by a CFC to a U.S. shareholder out of passive category income of the CFC retains its character as passive category income in the hands of the shareholder for Section 904 purposes. By analogy, this could allow these amounts paid out of tested income of a CFC to be in the GILTI basket for Section 904 purposes.

However, for the following reasons, we believe that these payments should not be in the GILTI basket.[159]

First, as a statutory matter, only Section 951A inclusions can give rise to taxes in the GILTI basket, and nothing in Section 951A turns these payments into Section 951A inclusions. Likewise, Section 904(d)(3) was not amended to include GILTI inclusions, and Congress did not include Section 904(d)(3) in the rather long list of sections for which GILTI was to be treated in the same manner as Subpart F income.[160]

Second, rent or royalty income from a CFC to its U.S. shareholder would often be eligible for the FDII deduction. This is inconsistent with those payments being treated as GILTI inclusions.

Third, these payments are deductible for U.S. tax purposes. They reduce the tested income of the CFC, and reduce the U.S. shareholder's Section 951A inclusion in the same manner as payments made by the CFC to third parties. In addition, unlike dividends, these payments are normally deductible for foreign tax purposes and therefore reduce foreign tax liability. Increasing the GILTI basket by an expense that reduces foreign taxes is arguably contrary to the purpose of the FTC baskets.

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[159] Assuming these payments are not in the GILTI basket, foreign withholding taxes on these payments should likewise not be GILTI taxes and should not be subject to the 80% limit on GILTI credits.

[160] *See* Section 951A(f)(1)(A).

Fourth, if these payments are in the GILTI basket, the U.S. shareholder of a CFC with high taxed income could use otherwise unusable FTCs to shelter these payments from U.S. tax.

> <u>Example 17 (Royalty income and FTC baskets).</u> Assume a CFC has $200 of gross income, a royalty deduction of $100 to the U.S. shareholder, tested income of $100 before foreign taxes, and foreign tax of $40 (40%). Assume the shareholder has no income other than this royalty income. Then, the shareholder has $100 of GILTI inclusion (including Section 78 gross-up), $50 of Section 250 deduction, and $100 of royalty income. Its tentative U.S. tax is $31.50 ($100 of royalty income, plus $50 of net GILTI, all multiplied by 21%).

If the royalty income is not in the GILTI basket, the Section 904(d) limit on GILTI credits is $10.50 ($50 GILTI inclusion, divided by $150 worldwide income, multiplied by $31.50 tentative U.S. tax). Therefore, the U.S. tax is $21 ($31.50 of tentative tax, less the allowed FTC of $10.50). This $21 is the full U.S. tax on $100 of royalty income.

If the royalty income is a GILTI inclusion for purposes of Section 904(d), the available FTC is 80% of $40, or $32. The Section 904(d) limit is $31.50 ($150 GILTI, divided by $150 worldwide income, multiplied by $31.50 tentative U.S. tax). Therefore, the shareholder can use $31.50 of its FTC to entirely eliminate the tentative U.S. tax of $31.50. As a result, no U.S. tax is owed on receipt of the royalty payment.

The CFC has effectively received the benefit in the foreign jurisdiction of having made a deductible royalty payment while, for U.S. FTC purposes, the U.S. shareholder has been able to treat the payment more like a non-deductible dividend payment. By adding the income to the GILTI basket it has offset the effect of the deduction taken into account in the calculation of tested income. While not actually a hybrid payment, this treatment appears to violate the principles behind anti-hybrid rules.

Finally, if these payments are in the GILTI basket, a U.S. shareholder with U.S. source income and with a high-taxed CFC would be incentivized to “sop up” the excess FTCs by converting its U.S. income into interest, rents or royalties from the CFC.[161] The

[161] For example, if the U.S. shareholder had assets earning $100 of U.S. source income, the shareholder could sell the assets to a third party and loan the proceeds to the CFC for debt paying interest of $100 per year. If the CFC could invest the proceeds and earn $100 on the purchased assets, just as the shareholder did, the foreign taxable income and tax would be unchanged. However, if the interest income to the parent was in the GILTI basket, then just as in Example 17, a sufficiently high foreign tax on the CFC would mean that the interest income would be tax-free to the parent.

result would be the conversion of U.S. taxable income to tax-free interest, rent or royalty income from the CFC.

(f) Basket for base differences

Current law, as amended by the Act, treats foreign taxes on items that are not income for U.S. tax purposes as in the basket for branch income.[162] This rule is the result of a technical error in the Act,[163] and if our suggestion below is not adopted, a statutory amendment should be adopted to restore the prior rule that such taxes are allocated to the general basket.

Allocation of residual taxes to the general basket made sense when the general basket contained most types of non-passive income. However, GILTI inclusions, and FTCs allocable to GILTI inclusions, are very significant today. The same is true for branch income.[164] An allocation of all these foreign taxes to the general basket could therefore have very unjustifiable and adverse results on taxpayers. As a result, we urge that legislation be adopted to provide for an allocation to one or more baskets based on a facts and circumstances test, *i.e.*, based on the basket that the item would be in if it were subject to U.S. tax. If this question was still unanswerable, the allocation could be made to the general basket as today.

For example, the GILTI basket should apply to a foreign income tax imposed on a particular item that is part of an ordinary business that generates tested income, but that is not viewed as income for U.S. tax purposes. In the same situation, the branch basket should apply if the item relates to an underlying business that is operated in a branch. Likewise, withholding tax on exempt PTI from GILTI inclusions could logically be placed in the GILTI basket (see discussion in Part IV.E.2(g)).

We acknowledge that our proposal is arguably inconsistent with language in the Conference Report[165] indicating an expectation that taxes on items excluded from the U.S. tax base would be allocated to the general basket. However, this language is describing the current Code, and we are proposing legislation. Moreover, it is not clear

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[162] Section 904(d)(2)(H)(i).

[163] When Section 904(d)(2)(H)(i) was enacted, its cross reference to Section 904(d)(1)(B) was to general limitation income. The Act amended Section 904(d)(1)(B) to refer to the branch basket, but inadvertently neglected to change the cross-reference.

[164] Section 904(d)(1)(B).

[165] Conference Report at 628, describing the House Bill ("It is anticipated that the Secretary would provide regulations with rules for allocating taxes similar to rules in place [under Treas. Reg. § 1.904-6(a)] for purposes of determining the allocation of taxes to specific foreign tax credit baskets. Under such rules, taxes are not attributable to an item of subpart F income if the base upon which the tax was imposed does not include the item of subpart F income. For example, if foreign law exempts a certain type of income from its tax base, no deemed-paid credit results from the inclusion of such income as subpart F. Tax imposed on income that is not included in subpart F income, is not considered attributable to subpart F income." [footnote omitted])

that the drafters of the Conference Report were aware of the severe adverse consequences under the Act from base differences.

Finally, our position is supported by Section 951A(c)(2)(A)(ii), which allows a reduction in tested income for expenses (including taxes) properly allocable to gross income in the tested income category, or "to which such deductions would be allocable if there were such gross income". This language appears to contemplate a reduction in tested income for foreign taxes imposed on an item relating to tested income even if it is not in the U.S. tax base. It would be most logical for the amount of the deduction for foreign taxes attributable to tested income to be the same amount as the gross-up and FTC for foreign taxes attributable to tested income.

(g) Basket for withholding tax on PTI

If withholding tax applies to the distribution of previously taxed Subpart F income, the withholding tax appears to be in the same basket as the underlying income.[166] Regulations should provide that this treatment applies to withholding tax imposed on distributions by a CFC of previously taxed tested income attributable to GILTI inclusions.

Section 960(c)(1) increases the Section 904 limitation for the applicable FTC basket to account for such withholding tax in the taxable year in which a PTI distribution is made, to the extent there is excess limitation that was not used in prior years. However, Section 951A(f)(1)(A) does not incorporate the principles of Section 960. As a result, under existing regulations, the GILTI limitation for the year would not be increased by excess limitation from prior years.

We believe this "increase by excess limitation" rule should be extended to GILTI by regulations or a statutory amendment. Absent such a rule for GILTI, the FTCs from the GILTI withholding tax would often be unusable because of the lack of income inclusion from the distribution, and the lack of a carryback of FTCs to the year of the GILTI inclusion. Absent this rule, the FTC could only be used if the U.S. shareholder happened to have other low-taxed GILTI inclusions in the year of the PTI distribution.

Even in a GILTI system without a general carryover of FTCs, if the tax on the underlying income is low enough to create excess limitation in the years that income is earned, there is no logical reason that the excess limitation should not be carried forward and made usable against withholding tax on GILTI inclusion when it is distributed. The Section 960(c)(1) rule applies to Subpart F income even though there is also a rule allowing FTC carryovers for Subpart F. There is no logical reason that the same rule should not apply to GILTI even in the absence of GILTI FTC carryovers.

On the other hand, existing Section 960(c)(1) involves the creation of a single cumulative excess limitation account that is drawn upon when needed. That approach appears to be inconsistent with the lack of carryover of GILTI FTCs, since it can put a

[166] Treas. Reg. § 1.904-6(a)(1)(iv).

GILTI taxpayer in a better position by receiving a PTI distribution in a later taxable year than in the year the tested income was earned. As a result, in applying Section 960(c)(1) to GILTI, logically the U.S. shareholder would be required to trace a particular distribution of PTI to particular tested income for a prior taxable year and excess limitation for the same year. Then, only excess limitation from that year would be allowed to shelter withholding taxes on the PTI distribution. We acknowledge that such a rule would be administratively burdensome.

(h) 2017 overall foreign or domestic loss

Regulations should clarify issues that arise under Section 904(f), relating to recapture of overall foreign loss ("**OFL**"), and Section 904(g), relating to recharacterization of ODL, where the respective loss occurred in 2017 or prior years. The question is how recapture or recharacterization of pre-2018 OFLs and ODLs, respectively, should be applied in 2018 and subsequent years. The issue arises because the calculations are done separately for each FTC basket,[167] and most or all income items that were in the pre-2018 general basket may now be in the GILTI and foreign branch baskets that did not exist pre-2018. Also, these sections were designed to reach a proper aggregate result for FTC limits across different tax years, and did not contemplate that a significant portion of FTCs taken into account in 2017 would be eliminated under Section 965(g).

(i) FTC transition issues

Regulations should clarify transition issues involving foreign tax credits that arise because the concept of tested income did not exist before 2018.[168] For example, should foreign taxes payable in 2018 for income of a CFC that accrued under foreign law in 2018 but accrued under U.S. law in 2017 be tested foreign income taxes? What if the foreign tax was payable in 2017 but the tested income accrued under U.S. law in 2018? How should a foreign tax deficiency or refund in 2018 for a foreign tax payable in 2017 or earlier years be treated? The Tax Section expects to prepare a Report on FTC issues arising under the Act that will cover these and other topics.

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[167] Treas. Reg. § 1.904(f)-7; Section 904(g)(3).

[168] While not a GILTI question, regulations should also clarify whether excess foreign branch FTCs for 2018 can be carried back under Section 904(c) to 2017 (presumably to the general limitation basket), given that there was no foreign branch basket for 2017.

F. U.S. Partnership as a U.S. Shareholder in a CFC

1. Possible Approaches for Applying GILTI

Suppose a U.S. partnership is a U.S. shareholder of a CFC.[169] It is not clear whether the GILTI calculations are to be made at the partnership level or the partner level. We believe the most logical alternatives are the following.

Under the "**Partnership Level Approach**":

(1) A partnership that is a U.S. shareholder of a CFC calculates its Section 951A inclusion just as any U.S. shareholder. The inclusion is based only on stock in the CFCs owned directly or indirectly under Section 958(a) by the partnership, but the rule applies even if the partnership owns less than 10% directly or indirectly and is a U.S. shareholder solely by reason of owning additional stock by attribution from its partners under Section 958(b).

(2) The partnership notionally calculates a Section 250 deduction equal to the specified percentage of the Section 951A inclusion, but without regard to the nature of its partners or the taxable income limit in Section 250(a)(2). The deduction has no substantial economic effect, and must be allocated to partners in the same manner as the inclusion.

(3) Each partner, whether or not it is itself a U.S. shareholder, includes its share of the Section 951A amount in gross income. Each partner claims the corresponding share of the Section 250 deduction to the extent it is eligible at the partner level. In particular, noncorporate partners do not get the deduction, and corporate partners are subject to the Section 250(a)(2) limit based on their own taxable income, other Section 250 deductions, and FDII deductions.

(4) Section 960(d) by its terms is applied at the level of a domestic corporation. As a result, tested foreign income taxes paid by CFCs owned by the partnership would flow through to each domestic corporate partner based on the Section 951A inclusion of each such partner, whether or not the partner is a U.S. shareholder.[170] The partner calculates its own inclusion percentage, Section 78 gross-up, and Section 904 limitations. A partner can use credits in the GILTI basket not only

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[169] A domestic partnership can be a U.S. shareholder of a CFC. Section 7701(a)(30); Treas. Reg. § 1.701-2(f) Example (3). This position was recently reaffirmed in Section 3.05(b) of Notice 2018-26, which treats a U.S. partnership that is a U.S. shareholder of a deferred foreign income corporation as the shareholder required to report the Section 965(a) inclusion amount, with partners in the partnership required to report their share regardless of whether they themselves are U.S. shareholders. If this rule was changed to apply look-through treatment to domestic partnerships in the same way it applies to foreign partnerships, many of the issues in this Report involving partnerships would be avoided. However, that proposal is beyond the scope of this Report.

[170] Section 960(d) allows an FTC to a domestic corporation with a Section 951A inclusion, and does not require that the corporation be a U.S. shareholder.

against the GILTI inclusion passed through from the partnership, but also against other GILTI inclusions from the same or other CFCs or from other partnerships owning CFCs, and *vice versa*.

Alternatively, under the "**Partner Level Approach**":

(1) If the partnership is a U.S. shareholder, tested income, tested loss, QBAI and interest expense of a CFC flow through the partnership directly to the partners and are treated as the partners' *pro rata* shares of such items for purposes of applying Sections 951A(c)(1)(A) and (B) and 951A(b)(2). The flow-through applies whether or not the particular partner is itself a U.S. shareholder.

(2) Each partner combines these items with its own partner-level items in determining its own GILTI inclusion under Section 951A and Section 250 deduction.

(3) The tested foreign income taxes of the CFC also flow through the partnership to the partner. The partner calculates its own inclusion percentage, taking into account items from the partnership as well as its own partner-level items. The partner then determines its FTCs under Section 960(d) and its Section 78 gross-up. The Section 904 limits are determined at the partner level.

2. Discussion

The statute and legislative history are not conclusive on which approach should be adopted. In contrast to new Section 163(j), there is no statutory provision stating that either Section 951A or Section 250 should be determined at the partnership level. As a literal matter, Section 951A requires the U.S. shareholder of the CFC to include GILTI in income. If the partnership is a U.S. shareholder, this seems to require the GILTI inclusion to be at the partnership level.

By contrast, Section 250(a)(1) allows a deduction "to a domestic corporation" for a percentage of the amount included in its gross income under Section 951A. Similarly, Section 250(a)(2) limits the GILTI/FDII combined deduction to "the taxable income of the domestic corporation" determined without regard to this section. These provisions seem to require the Section 250 deduction to be at the level of the corporate partner of a partnership. Confusing matters further, the legislative history implies in two places that Section 250 applies at the partnership level.[171]

[171] Conference Report at 623 n. 1517, describing the Senate Bill ("The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax. Thus, for example, the deduction for global intangible low-taxed income could give rise to an increase in a domestic corporate partner's basis in a domestic partnership under section 705(a)(1)(B)."); and at 626 n. 1525, describing the Final Bill ("Due to the reduction in the effective U.S. tax rate resulting from the deduction for FDII and GILTI, the conferees expect the Secretary to provide, as appropriate, regulations or other guidance similar to that under amended section 965 with respect to the determination of basis adjustments under section 705(a)(1) and the determination of gain or loss under section 986(c).")

We believe that there are a number of advantages of the Partner Level Approach. First, it taxes a U.S. shareholder on its share of the net CFC tested income minus NDTIR determined by reference to all the CFCs in which it has an interest, regardless of whether the interest is held directly or through a partnership. In particular, this approach allows tested income from all CFCs in which the U.S. shareholder has an interest to be offset by tested loss, NDTIR and FTCs from other CFCs in which it has an interest. We believe this is the proper result.

Second, by contrast, the Partnership Level Approach would encourage tax planning to achieve very different tax results with very little change in economic position. This issue is the same as that for consolidated groups if members are not aggregated, where aggregation can then be achieved electively by restructuring. The Partnership Level Approach is comparable to nonaggregation in the consolidated return context, and the Partner Level Approach is comparable to aggregation in that context.

As discussed in Part IV.B.4(a) in the context of a consolidated group, sometimes aggregation of CFCs helps the taxpayer and sometimes it hurts the taxpayer. For example, the Partnership Level Approach would be adverse to a partner with a GILTI inclusion from a partnership with no ability to offset the inclusion with tested loss or NDTIR from CFCs held directly or through other partnerships. Likewise, a U.S. shareholder could have a GILTI inclusion from CFCs held directly with no offset for such items allocated from one or more partnerships.

In other cases, the Partnership Level Approach is more favorable for taxpayers than the Partner Level Approach. For example, a U.S. shareholder might hold a CFC with high-taxed income through a partnership, and directly hold a low-taxed CFC that generates NDTIR. Assuming the Partnership Level Approach results in a separate inclusion percentage to the corporate partner for Section 951A items from the partnership (*see* discussion below), that approach will prevent the NDTIR from reducing the inclusion percentage for the FTC on the high-taxed income from the partnership. *See* Example 9(b) for the consolidated return analog to this example.

The Partnership Level Approach in effect makes aggregation elective, except possibly for FTCs, since a U.S. shareholder with multiple CFCs could transfer some of them to (say) a 99% owned partnership and achieve very different results. Likewise, it would often be advantageous for a partnership to transfer its interest in one or more CFCs to its partners. There is no logical reason that the GILTI results should differ in these situations.

Third, the Partnership Level Approach can give rise to very counter-intuitive results. Suppose a U.S. partner directly holds 10% of the equity in a CFC and indirectly holds the same or a different class of equity in the same CFC through a U.S. partnership that is a U.S. shareholder. The partner could then have both GILTI inclusions and tested income from the same CFC, with the latter but not the former being offset by tested losses and NDTIR of other CFCs owned by the partner. This is a very peculiar result.

Fourth, the Partnership Level Approach could not apply to a foreign partnership, since it cannot be a "U.S. shareholder" of a CFC. As a result, the Partnership Level Approach results in large differences in tax treatment of tested income depending upon whether the shareholder partnership is a U.S. or foreign partnership. While this is already true to some extent today, there is no good policy reason to increase these differences even further.

Fifth, the Partnership Level Approach is necessarily a hybrid of the two approaches, because under Section 960(d), the calculation of the inclusion percentage must be made at the level of the corporate partner. This in effect requires the entire FTC calculation to be made at the level of the corporate partner.

In fact, Section 960(d)(2) is unclear as to whether any corporation can only have a single inclusion percentage or can have multiple inclusion percentages. Under the former interpretation, all partnership level items must be aggregated with all nonpartnership items of the corporation to determine a single inclusion percentage. Under the latter interpretation, a corporate partner has a separate inclusion percentage for its share of a Section 951A inclusion passed through from any particular partnership, and another inclusion percentage for any nonpartnership Section 951A inclusion. Under either interpretation, however, the Partnership Level Approach has the disadvantage of being a rather complex hybrid approach.

Finally, the Partner Level Approach is supported by analogy to other situations where regulations apply that approach. The so-called "Brown Group" regulations look through partnerships for various purposes in applying Subpart F.[172] Under the portfolio interest rules,[173] the status of being a 10% shareholder of the issuer (and thus ineligible for the portfolio interest exception to withholding tax) applies at the partner level, rather than the partnership level, when the partnership holds debt of the issuer.[174]

On the other hand, the Partnership Level Approach is consistent with Section 3.05(b) of Notice 2018-26. This section states that if a partnership is a U.S. shareholder of a deferred foreign income corporation, the Section 965 calculations are made at the partnership level. U.S. partners are required to report their share of the partnership's inclusion amount, regardless of whether they themselves are U.S. shareholders.

However, applying Section 965 at the partnership level does not involve inter-relationships with partner level items comparable to the issues in applying GILTI at the partnership level. Moreover, Section 965 is a one-time provision. As a result, we do not believe the rules under that section should control the rules that will apply permanently under GILTI.

[172] T.D. 9008, July 22, 2002.

[173] Sections 871(h), 881(c).

[174] Treas. Reg. § 1.871-14(g)(3)(i).

A benefit of the Partnership Level Approach is that, in contrast to the Partner Level Approach, it does *not* provide a U.S. shareholder in a CFC with a greater Section 163(j) limitation if the U.S. shareholder holds a CFC inside rather than outside a partnership. There is no policy justification for this distinction that arises under the Partner Level Approach. Moreover, the increased Section 163(j) limitation that arises under the Partner Level Approach is inconsistent with applying the Section 250 deduction before the Section 163(j) limitation. *See* Part IV.D.3.

To illustrate, assume that outside a partnership, the Section 250 deduction applies before the Section 163(j) limitation. The same result would arise under the Partnership Level Approach, since all calculations under both GILTI and Section 163(j) are made at the partnership level. Yet under the Partner Level Approach, Section 163(j) is still required by statute to be applied first at the partnership level, and then Section 951A and Section 250 are applied at the partner level. This allows a larger Section 163(j) limitation because the partnership taxable income is computed without taking into account the Section 250 deduction.

> <u>Example 18(a): Partner directly holds CFC and has Section 163(j) limitation.</u> Assume a corporation is engaged in business and directly owns a CFC, the CFC gives rise to $100 of Section 951A inclusion, and the corporation has $50 of interest expense and $50 of net profit (aside from the inclusion) before taking account of this interest expense. The corporation has a Section 250(a)(1) deduction of $50, leaving it with taxable income of $100 before interest expense. Under Section 163(j), the interest deduction is limited to $30, so net taxable income is $70. Section 250(a)(2) does not apply because taxable income before the Section 250(a)(1) deduction is $120.
>
> <u>Example 18(b): The business, the CFC and Section 163(j) interest are at partnership level</u>. Same facts as Example 18(a), except the business, the CFC and the debt are held through a partnership.

In Example 18(b), under the Partnership Level Approach, the partnership has $100 of Section 951A inclusion and $50 of Section 250 deduction, leaving taxable income before interest expense of $100 and a Section 163(j) limit on interest of $30. The partnership passes through $70 of taxable income to the partner, the same result as in Example 18(a).

In Example 18(b), under the Partner Level Approach, the partnership has $100 of tested income, no Section 250 deduction, and $50 of business income. The Section 163(j) limit must be applied at the partnership level and is $45. The partnership passes through $100 of tested income, $50 of business income and a $45 interest deduction to the partner. The partner has a Section 951A inclusion of $100, a Section 250 deduction of $50, and an interest deduction of $45, and business income of $50. Taxable income is $55, as compared to $70 in the other cases.

In summary, under the Partner Level Approach, Section 163(j) applied at the partnership level before Section 250 applied at the partner level. The result is that the interest allowed was 30% of $150, rather than 30% of $100, for a reduction in taxable income of $15. If this ordering rule is not allowed outside a partnership, there is no policy reason for it to be allowed merely because the CFC and debt are held by a partnership engaged in a trade or business.

3. Conclusions

We believe that regulations or legislation should adopt the Partner Level Approach. In general, this involves applying aggregate rather than entity principles to partnerships for GILTI purposes. Aggregate principles generally reach results that are more economically correct than if a partnership is treated as an entity. Here, in particular, the results make sense by avoiding arbitrary effects of the entity approach, and by preventing taxpayers from selectively grouping and ungrouping CFCs under partnerships to maximize tax benefits.

The results under Section 163(j) do not make sense under this approach, but we are reluctant to change our recommended approach to solve this narrow issue. Rather, we believe it is important to adopt, along with the Partner Level Approach, one of the approaches to Section 163(j) described below to avoid the undue benefit from applying Section 163(j) at the partnership level and Section 250 at the partner level.[175]

One way to reach a sensible result under Section 163(j) under the Partner Level Approach would be a rule that solely for purposes of applying that section at the partnership level, a notional Section 250 deduction must be applied before Section 163(j), based on the hypothetical Section 951A inclusion and resulting Section 250 deduction that the partnership would have if it was a corporation. This would limit the ability of taxpayers to increase the Section 163(j) limit merely by putting the CFC and the debt into a partnership rather than holding the CFC and being liable for the debt directly.

[175] In the Report on Section 163(j), we accepted as a policy matter the fact that if a partnership receives dividends, the DRD applies at the level of a corporate partner, yet the Section 163(j) deduction is calculated at the partnership level without regard to the deduction. We stated this result was a “direct consequence” of the decision by Congress to apply Section 163(j) at the partnership level.

There, the mismatch between DRD and Section 163(j) was clearly mandated by the statute. Here, although only corporations obtain the benefit of the Section 250 deduction, the statute does not state whether the Section 250 deduction should be at the partner or partnership level. In fact, as noted in the text, the Conference Report implies that the Section 250 deduction will be taken at the partnership level, and we can speculate that the reason was to avoid an undue benefit under Section 163(j) that would arise if the Section 250 deduction were at the partner level. We believe that in the GILTI context, the proposal in the text best carries out the intent of Congress.

If Treasury does not believe it has the authority to adopt these positions in regulations, it should request a statutory amendment. We note, however, that there is no provision in the statute mandating the Section 951A inclusion or the Section 250 deduction be at the partnership level. While the Conference Report assumes the deduction is taken at the partnership level, it does not say so directly, and the notional deduction under Section 250 at the partnership level that we propose could be viewed as a partial implementation of that legislative history.

This approach appears to us to be a reasonable way to accommodate the policies of GILTI and Section 163(j). We also note that Section 7 of Notice 2018-28 requires certain aspects of the partnership-level calculation under Section 163(j) to be taken into account by the partner in doing its own Section 163(j) calculation, to avoid a double benefit from partnership interest income. That result does not go as far as our proposal for a notional Section 250 deduction at the partnership level. However, it indicates a view that elements of a particular calculation may be relevant at both the partner and partnership levels in order to avoid unjustified results.

Another way to reach a sensible result for Section 163(j) and Section 250 under the Partner Level Approach would start with a rule that the Section 951A inclusion and the Section 250 deduction are taken entirely at the partner level. Then, a rule would be adopted that if a partnership is a shareholder owning 10% or more of the stock of a corporation, that stock would automatically be considered as held for investment rather than as a business asset, and no interest expense of the partnership on debt allocable to that stock would be considered business interest expense under Section 163(j). As a result, if the partnership was a U.S. shareholder of a CFC, any inclusion by the partnership of tested income from the CFC would be investment income, and any interest expense of the partnership allocable to stock of the CFC would not be business interest expense. As a result, Section 163(j) would apply at the partnership level without regard to either such item.

Tested income and interest expense would then presumably pass through to a corporate partner as business income and business interest expense, respectively, and would be subject to Section 163(j) at the partner level. As a result, both Section 250 and Section 163(j) would apply at the partner level, with the same result as if the partner held the CFC stock directly.[176]

This approach requires treating all 10% shareholdings by partnerships as investment assets under Section 163(j). This would be difficult to justify as a factual matter in many circumstances. As a result, a *per se* rule would be necessary to achieve the desired coordination with Section 250 in all cases. Lack of a *per se* rule would also allow considerable electivity by taxpayers who could combine or disaggregate

[176] *See* the Report on Section 163(j), at 41-42, for a discussion of the consequences under Section 163(j) when a partnership holds investment assets. This approach would also reach a similar result under the Partnership Level Approach. In that case, the Section 250 deduction would be taken at the partnership level and pass through to the partner, and Section 163(j) would also apply at the partner level because the interest expense would not be business interest expense at the partnership level.

partnership business activity and ownership of subsidiaries. In addition, there is no logical reason for the *per se* rule to apply only to 10% holdings in CFCs as opposed to holdings in any domestic or foreign corporation. Consequently, this proposal would have significance in the domestic context well beyond GILTI, and would require further consideration that is beyond the scope of this Report.

4. Related Issues

If (contrary to our proposal) the Partnership Level Approach is adopted, regulations should clarify how it is applied in certain ownership situations described below. In that connection, note that under Sections 958(b) and 318(a)(3)(A), in testing whether a U.S. partnership is a U.S. shareholder of a CFC, and in testing for CFC status, a partnership is deemed to own the stock in a foreign corporation owned by the partners in the partnership. We believe regulations should confirm the following:

(1) If a U.S. partnership owns directly (or indirectly under Section 958(a)) 10% of a CFC, then the partnership is a U.S. shareholder and its GILTI calculation should be based on such ownership in the CFC.

(2) Suppose a U.S. partnership owns directly (or indirectly under Section 958(a)) less than 10% of a CFC, but owns 10% after taking into account constructive ownership of CFC stock owned by its partners under Section 958(b). The partnership is a U.S. shareholder, but its inclusion under Section 951A is limited to its *pro rata* share of the tested income of the CFC based on its direct and Section 958(a) indirect ownership.

(3) Suppose a partnership owns 100% of a CFC, and it has two 50% U.S. partners. The partnership and each partner are U.S. shareholders of the CFC. However, as in (2), the income inclusion is at the partnership level, so the calculations should still be made at the partnership level rather than the partner level.

(4) In all of these cases, the Section 250 deduction would be available even to a corporate partner that was not itself a U.S. shareholder of the CFC. Section 250 is triggered by a Section 951A inclusion by a domestic corporation, regardless of the status of the corporation as a U.S. shareholder.

Regulations should also state whether, under the Partnership Level Approach, the Section 250(a)(2) limit is determined at the partnership level or the partner level. If it is determined at the partnership level, the partnership might obtain a Section 250 deduction and pass it through to a partner that did not itself have sufficient taxable income to be entitled to the deduction directly. In this situation, regulations should also state whether Section 172(d)(9) would apply to limit the partner from using the passed-through Section 250 deduction in calculating its own NOL carryover.

Moreover, as discussed above, under the Partnership Level Approach, regulations should clarify whether under Section 960(d), a domestic corporation with Section 951A inclusions from more than one partnership, or from one or more partnerships and from any directly held CFCs, will have a single or multiple inclusion percentages. Also, even if a corporation has only a single Section 951A inclusion from a single partnership, regulations should also clarify how the inclusion percentage is determined under the Partnership Level Approach. The Section 951A inclusion at the partnership level is based on items that go into the calculation of the inclusion percentage (*e.g.*, NDTIR, interest expense, tested income and tested losses of each CFC). Regulations should clarify whether there is a "look-through" of some or all of these items directly to the corporate partner, or whether there is a netting of any of these items (*e.g.*, tested income and tested loss) at the partnership level before the net amount is passed through to the corporate partner.

In addition, regulations should confirm certain additional aspects of the relationship between the Section 250 deduction and the Section 163(j) limit. Under our proposal for both the Partnership Level Approach and the Partner Level Approach, the Section 250 deduction would be calculated either actually or notionally at the partnership level before the Section 163(j) deduction is determined at the partnership level. However, individuals and non-U.S. corporations are not eligible for the Section 250 deduction. As a result, presumably only the usable portion of the Section 250 deduction should be taken into account in calculating the Section 163(j) limit. To illustrate, if all the partners are individuals, it would not make sense for the Section 163(j) limit to assume a 50% deduction to all partners, when none in fact are entitled to the deduction.

The partnership should therefore obtain an "extra" Section 163(j) deduction on account of its individual partners who are not entitled to a Section 250 deduction. Presumably such extra deduction would be required to be allocated to the individual partners. This would reduce the partnership's carryforward of Section 163(j) deductions.

Regulations should clarify that the partnership must limit the extra allocation of interest deduction to a partner to the interest deductions that are allowable to the partnership under Section 163(j) only because the partner's share of partnership income is not reduced by the Section 250 deduction at the partnership level with respect to that partner. The extra allocation should reduce the portion of the carryover that is allocated to the partner. Absent such a rule, a partnership could allocate a disproportionate amount of its total interest deductions to partners that could not use a Section 250 deduction, and there would not be substantial economic effect to such an allocation. Such a special allocation also seems inconsistent with the statutory requirement that the Section 163(j) limit be determined at the partnership level.

Logically, the same approach of an increased Section 163(j) allocation should apply for a corporate partner that could not use its entire Section 250 deduction because of the taxable income limit in Section 250(a)(2). However, partners of a partnership might not be willing to inform the partnership about whether their Section 250 deduction would be so limited. As to partners such as direct non-U.S. partners who would not obtain a Section 250 deduction, presumably the Section 163(j) deduction would be determined without regard to an actual or notional Section 250 deduction at the partnership level, although it would be necessary to look through a partner that is a partnership to determine the nature of the ultimate partners.

Finally, Part IV.D.7 discusses certain issues concerning tax basis in a partnership interest.

G. Other Issues

1. Section 962 Election

If an individual U.S. shareholder directly holds stock in a CFC, the individual has an income inclusion under Section 951A without a deduction under Section 250. As a result, the maximum tax rate on the GILTI inclusion is 37%. No foreign tax credit is allowed, although foreign taxes reduce tested income and therefore the GILTI inclusion. In the past, the shareholder was not taxed on current earnings except for Subpart F income, and if the CFC was in a treaty country, a dividend was QDI taxed at the rate of 20% (disregarding Medicare tax).[177] As a result, the Act imposes a significant tax increase on a U.S. shareholder in this situation.

Section 962 is designed to allow an individual U.S. shareholder of a CFC to elect to be placed in approximately the same position for Subpart F inclusions as if the CFC stock was held through a domestic corporation. Moreover, Section 951A(f)(1)(A) states that for purposes of Section 962, the Section 951A inclusion is to be included in income in the same manner as a Section 951(a) inclusion under Subpart F. Therefore, Congress clearly contemplated that an individual could obtain relief from the GILTI consequences above by making the Section 962 election.

Section 962(a) imposes tax on the electing individual shareholder at the corporate rate on the "amounts which are included in his gross income under section 951(a)" if the shareholder were a corporation. The gross income inclusion for GILTI is the Section 951A inclusion (including the Section 78 gross-up if an FTC is being claimed) without regard to the Section 250 deduction. Moreover, the regulations make clear that the corporate tax is imposed on Subpart F income without the allowance of any deductions.[178]

The no-deduction rule makes sense for purposes of Subpart F, since the tax is being imposed as if the CFC was held by a hypothetical domestic corporation having no assets other than CFC stock. However, this rationale does not apply to the Section 250 deduction, and it seems doubtful that Congress intended to require that Section 962 apply without the deduction. The deduction is intended to create a reduced effective tax rate, rather than operate as a typical deduction that involves an outlay of funds.[179] The fact that Congress chose to achieve a reduced tax rate on foreign earnings by means of a gross income inclusion and a deduction, rather than a reduced tax rate, should have no effect on

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[177] Section 1(h)(11).

[178] Treas. Reg. § 1.962-1(b)(1)(i).

[179] *See, e.g.*, Conference Report at 623 n. 1517 ("The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax.").

the policy of Section 962 of treating the shareholder as owning the CFC stock through a corporation.

To be sure, the language of Section 951A(f)(1)(A) does not itself seem broad enough to authorize the Section 250 deduction. In addition, Section 5 of Notice 2018-26 allows a shareholder making a Section 962 election to obtain the Section 965(c) deduction at the shareholder level. However, the Notice is expressly limited to Section 965 and relies in part on the fact that individuals are themselves eligible for the Section 965 deduction for dividends received directly.

Nevertheless, we believe that Treasury should issue regulations confirming that the Section 250 deduction is available for a Section 962 election. If Treasury does not believe it has the authority to do so, we recommend an amendment to the statute.

Next, when the CFC distributes PTI to the U.S. shareholder, the distribution is included in the shareholder's income under Section 962(d). Treasury should clarify whether the income is QDI. Allowing treatment as QDI is necessary to achieve the purpose of Section 962 of treating an individual shareholder of a CFC approximately the same as if the CFC stock had been held by a domestic corporation owned by the U.S. shareholder. Under this construct, the CFC's distribution of PTI to the U.S. shareholder is treated as a distribution by the CFC of PTI to the domestic corporation, followed by a dividend from the domestic corporation to the U.S. shareholder.[180] We note that resolution of this issue has broader implications than GILTI.

Finally, the statute and regulation[181] state that only an individual U.S. shareholder (*i.e.*, with 10% ownership in the CFC) can make the election. Section 5 of Notice 2018-26 states that for purposes of Section 951, only an individual that is a U.S. shareholder of a CFC, whether by virtue of directly held stock, stock held through a partnership, or both, can make the Section 962 election. In such case, the election applies both to directly owned stock in the CFC as well as the individual's share of partnership income earned through the CFC. If a U.S. partnership is a U.S. shareholder of a CFC but an individual partner is not, the individual cannot make the election. These rules automatically apply to Section 951A by cross-reference.

We believe these positions are reasonable. We note that an individual partner in a foreign partnership clearly looks through the foreign partnership under the usual rules, in determining whether the individual is a U.S. shareholder of the CFC eligible for the election.[182]

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[180] Treas. Reg. § 1.962-3(b)(4) achieves similar parity by treating a redemption of stock by the CFC as eligible for capital gain treatment to the U.S. shareholder, rather than being considered a partial taxable distribution of earnings and profits.

[181] Treas. Reg. § 1.962-2(a).

[182] *See* Treas. Reg. § 1.962-2(b)(1), requiring the reporting of any intermediate partnership through which the individual holds the interest in the CFC.

2. Fiscal Transition Year 2017-2018

If a CFC has a fiscal year, income earned in the 2017-2018 fiscal year is exempt from GILTI.[183] This gives rise to opportunities for avoiding Section 951A inclusions in subsequent taxable years. For example, a CFC might sell an appreciated asset to an affiliate during this period, in which case the affiliate can take depreciation or amortization deductions in future periods to reduce its tested income in those years. If the asset is a depreciable tangible asset, this transaction may also increase the overall QBAI in the system, which will increase future NDTIR. If the affiliate has a calendar year tax year, it can also take a current deduction from tested income for interest expense, royalties, etc. paid during this period to a fiscal year affiliate.

The statute[184] contemplates a broad delegation of authority to Treasury to adopt anti-abuse rules for transactions intended to increase QBAI, including during the transition period. The legislative history[185] contemplates a much broader delegation of authority to disregard all noneconomic transactions intended to minimize tax under the GILTI rules, not only during the transition period. We have been asked by government representatives to consider the possible scope of regulations to exercise this authority.

Suppose a transaction during the transition period between affiliates gives rise to exempt income in the current year, and a deduction from tested income in the current year or a future year (*e.g.*, through use of tax basis created in the transition year). Possible tests for disallowance of the deduction from tested income are the following, from the most permissive to the most restrictive:

(1) No disallowance.

(2) Presumptive allowance overcome by government showing of a bad purpose.

(3) Presumptive disallowance overcome with a showing of a good business purpose.

(4) Disallowance if "the principal purpose" of the transaction was to obtain exempt income and a deduction from tested income.

(5) Disallowance if "a principal purpose" of the transaction was to obtain exempt income and a deduction from tested income.

(6) Automatic disallowance.

[183] Section 951A applies to taxable years of a foreign corporation beginning after December 31, 2017.

[184] Section 951A(d)(4).

[185] Conference Report at 645.

Any of these standards could be enforced in the case of an asset sale by mandating a carryover basis for calculating tested income. Moreover, similar standards might apply to acceleration of income into the transition period, such as prepayments from customers or sale/leasebacks of property with third parties, or to deferral of deductions until after the transition period.

We note that in the context of transactions that reduce Section 965 tax liability, Section 3.04(a) of Notice 2018-26 adopts alternative (5) as a general matter, with several of the other alternatives applying in the case of various specified categories of transactions. In addition, Section 3.04(b) of the Notice disregards any change in method of accounting on or after November 2, 2017 for purposes of Section 965, regardless of the purpose of the change. It is not clear whether Treasury will adopt similar anti-abuse rules for GILTI, although we note that the statutory basis for anti-abuse rules under Section 951A is narrower than the broad grant of authority for anti-abuse rules under Section 965(o).

If Treasury does not believe that the statute and the Conference Report give it the authority to issue regulations of the type described in the Conference Report and that it believes are necessary to eliminate abuses during or after the transition period, it should request an amendment to the statute to conform its authority to that described in the Conference Report.

3. Effect of Section 958(b)(4) Repeal

The Act repealed Section 958(b)(4), which prohibited the "downward attribution" rules from treating stock that is owned by a non-U.S. person as being owned by a U.S. person.[186] While the repeal is unconditional, a colloquy (the "**colloquy**") on the Senate floor states that the repeal was not intended to apply to a U.S. shareholder of a CFC if the CFC qualifies as such only because of downward attribution to a U.S. person that is not related to the U.S. shareholder.[187] It further states that Treasury Regulations should interpret the provision accordingly.[188] The Senate Finance Committee's explanation of the corresponding provision in the Senate Bill is to the same effect,[189] and there is no indication that Congress intended repeal to have broader consequences.

[186] Act § 14213.

[187] 163 Cong. Rec. No. 207 (Dec. 19, 2017) at p. S8110 (colloquy between Senator Hatch, Chairman of the Senate Finance Committee and Senator Perdue).

[188] *Id.*

[189] "This provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is not a related person (within the meaning of section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4)." Committee Print, *Reconciliation Recommendations Pursuant to H. Con. Res. 71*, S. Prt. 115–20, (December 2017), p. 378, as reprinted on the website of the Senate Budget Committee, available at *https://www.budget.senate.gov/taxreform*.

The unconditional repeal of Section 958(b)(4) could create Section 951A inclusions in the following situations. According to the colloquy, such inclusions were not intended to be created by such repeal.

- A U.S. corporation or partnership (D1) owns 10% of the stock of foreign corporation (F1), and the other 90% of F1 is owned by an unrelated foreign corporation with no U.S. shareholders but with a U.S. subsidiary (D2). Then, D2 constructively owns 90% of F1, F1 would be a CFC, and D1 would have a Section 951A (and Subpart F) inclusion from F1. If D1 was a partnership, its partners would have a Section 951A inclusion and its individual partners would not have a Section 250 deduction.

- D1 owns 10% of F1, and F1 owns 100% of both a domestic subsidiary D2 and a foreign subsidiary F2. Then, D2 constructively owns 100% of F2, F2 is a CFC, and D1 has a Section 951A inclusion from F2.

We do not believe that these results should arise. There is no logic to a U.S. person being treated as a U.S. shareholder of a CFC merely because an unrelated foreign shareholder of the purported CFC happens to have a U.S. subsidiary with no direct ownership interest in the CFC.

We therefore believe that the consequences of the repeal of Section 958(b)(4) should be limited to conform to the apparent Congressional intent as expressed in the colloquy, either by regulations or an amendment to the statute. Section 3.01 of Notice 2018-26 gives very limited relief from the repeal of Section 958(b)(4) in applying the constructive ownership rules to partnerships for purposes of Section 965. This may indicate that Treasury does not believe it has the authority to further limit the consequences of repeal, in which case we recommend requesting an amendment to the statute.

Of course, limiting the consequences of the repeal would have significance well beyond GILTI. Thus, any regulations or statutory amendment should take into account the intended results not just for GILTI, but also for other Code sections that were affected by the repeal.

In addition, even as to GILTI, the colloquy does not deal with the case where the tax treatment of a U.S. shareholder depends upon the status of a corporation as a CFC (or not) before or after the U.S. shareholder became a U.S. shareholder. Return to two cases discussed in Part IV.D.2.

- Similar to footnote 117: A foreign corporation (F) has a foreign subsidiary (F1) and a U.S. subsidiary (US1). U.S. corporation (P) buys the stock of F1 from F in the middle of the year. Then, US1 constructively owned all of F1 for the period before the sale, so F1 is a CFC for the entire year. P apparently has a Section 951A or Subpart F inclusion for the entire year rather than only for the post-sale portion of the year.

- Same as Example 14(c): A U.S. shareholder (US1) of a CFC sells stock in the CFC to a non-U.S. person F, but F has a U.S. subsidiary (FSub) so the CFC remains a CFC for the entire year. As a result, there is no Section 951A inclusion or Subpart F income reported for the year of the sale.

In the first case, the overinclusion in income to P does not arise because F1 was a CFC *as to P* during the first part of the year, but rather because it was a CFC at all in the first part of the year (when P was not a shareholder). Likewise, in the second case, the underinclusion arises because the CFC remained a CFC during the second half of the year, at a time when US1 was not a shareholder. As a result, additional changes beyond the colloquy would be necessary if the intent was to change the result in these situations.

4. Overlap Between Section 250(a)(2) and Section 172(d)(9)

Section 172(d)(9) states that the Section 250 deduction is not allowed in calculating a net operating loss. Regulations should clarify the situations where this provision becomes relevant in light of Section 250(a)(2), which limits the combined GILTI/FDII deduction to a percentage of taxable income determined without regard to Section 250. On its face, Section 172(d)(9) could never become applicable, since limiting the Section 250 deduction to a percentage of taxable income (otherwise determined) would by itself prevent the Section 250 deduction from creating or increasing a net operating loss that would be limited under Section 172(d)(9). Moreover, Section 250(a)(2) must apply before Section 172(d)(9), since the former affects deductions allowed in the current year and the latter only affects carryovers to future years.

However, in Part IV.D.4, we discuss the possibility that the Section 250(a)(2) carve-back does not limit the Section 250(a)(1) deduction for the Section 78 gross-up amount, in which case the Section 250(a)(1) deduction might create a taxable loss for the year. Moreover, in Part IV.F.4, we propose a possible occasion for Section 172(d)(9) to apply in the partnership context. It is not clear whether the drafters had either of these situation in mind, so it would be helpful for regulations to clarify cases in which Section 172(d)(9) would be applicable.

5. Medicare Tax (Section 1411)

Regulations should clarify whether GILTI inclusions are investment income under Section 1411.

6. REIT Income

Regulations should clarify the extent to which GILTI inclusions are qualified income for REIT purposes.[190] There is clear statutory authority for such regulations.[191]

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[190] Section 856(c).

[191] Section 856(c)(5)(J).

The current Treasury/IRS Priority Guidance Plan already includes a project to determine whether Subpart F income is qualifying income under Section 856(c),[192] and this project should logically be extended to GILTI inclusions. Some PLRs have applied look-through treatment for passive income of a CFC that is Subpart F income.[193]

7. RIC Income

Section 951A(f)(1)(A) treats GILTI inclusions as Subpart F income for purposes of Section 851(b). Section 851(b) (flush language) states that Subpart F inclusions are not treated as qualifying dividends unless there is an actual distribution that corresponds to the inclusion. Proposed regulations state that Subpart F inclusions do not qualify as other income derived with respect to the business of investing in stock.[194] In a prior Report, we stated our disagreement with this aspect of the proposed regulations.[195] Regulations should clarify the rules for a RIC that has a GILTI inclusion.

8. UBTI

We believe that GILTI inclusions are not unrelated business taxable income to tax-exempt U.S. shareholders under the terms of Section 512. Nevertheless, we believe that published guidance to confirm this would be helpful because of the importance of the issue to tax-exempts and the lack of published guidance in analogous areas such as Subpart F. The Tax Section is preparing a broader Report on tax-exempt issues that will address this issue in greater detail.

H. Proposed Aggregation of CFCs held by a U.S. Shareholder

This section proposes legislation to treat all Related CFCs of a particular U.S. shareholder as a single corporation for purposes of the GILTI calculations. We believe that the existing rules that treat each CFC separately are unjustified as a policy matter, are very unfair to taxpayers, and invite restructurings solely for tax purposes. We acknowledge that the existing rules are clear and are supported by the legislative history of the Act. Nevertheless, we urge the Congress to reconsider these provisions and for Treasury to support such reconsideration.

Under Sections 951A and 250, if a single U.S. corporation is a U.S. shareholder in more than one Related CFC, several uneconomic results arise from the separate treatment of each CFC.

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[192] Department of the Treasury, 2017-2018 Priority Guidance Plan, as updated February 7, 2018.

[193] *See, e.g.*, PLRs 201605005 (addressing REIT qualification), 201430017 (addressing UBTI for a tax-exempt organization), and 201043041 (addressing UBTI for a charitable remainder unitrust).

[194] REG-123600-16, Sept. 28, 2016.

[195] NYSBA Tax Section Report Number 1359, *Report on Proposed Regulations under Section 851 Dealing with Imputations from CFCs and PFICs,* Nov. 29, 2016.

First, QBAI can create NDTIR only to the extent the underlying property is "tangible properly used in the production of tested income".[196] A CFC with a tested loss does not literally have tested income, and so QBAI of any CFC with a tested loss can never create NDTIR. This QBAI is "wasted" and never provides any tax benefit to a U.S. shareholder.

The mere possibility of wasted QBAI could have a significant effect on supply chain planning. For example, a business model might contemplate manufacturing in one CFC and sales by another CFC. All the QBAI is in the first CFC. If there is a risk that the first CFC will have a tested loss, this model becomes uneconomic and the taxpayer is forced to combine both CFCs, either in actuality or through check the box. It is doubtful that Congress intended this to be a result of the GILTI rules.

The statute might be read broadly to say that QBAI qualifies if it produces income that *would be* tested income if the corporation in question had positive tested income. However, the legislative history is clear that this is not the intended interpretation of the statute.[197]

Second, foreign taxes are taken into account to the extent they are "properly attributable" to tested income.[198] The legislative history is clear that this prevents the U.S. shareholder from receiving an FTC for taxes paid by a CFC with a tested loss.[199] As a result, even if a CFC has income that is treated as income for both U.S. and foreign tax purposes, and is subject to foreign tax, an offsetting loss in the CFC that produces an overall tested loss in the CFC precludes an FTC.

This result may be particularly unfair to taxpayers when a CFC has an overall tested loss, but a branch or a disregarded subsidiary has, on a stand-alone basis, tested income and pays foreign taxes. The branch income reduces the shareholder's tested loss from the CFC, which may increase the shareholder's net CFC tested income and Section 951A inclusion. The foreign taxes paid by the branch are a real cost of the increase in tested income, but no FTCs are available.

As noted above, the legislative history makes clear that the lack of FTCs for a CFC with no tested income was intended by Congress. Therefore, we do not suggest that Treasury should change this result by regulation. However, we urge Congress to reconsider these rules since they give very arbitrary results and invite restructurings solely to minimize tax liability.

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[196] Section 951A(d)(2)(A).

[197] Conference Report at 642 n. 1536 ("Specified tangible property does not include property used in the production of tested loss, so that a CFC that has a tested loss in a taxable year does not have QBAI for the taxable year".).

[198] Section 960(d)(3).

[199] Conference Report at 643 n. 1538 ("Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any)").

Moreover, these rules give extremely arbitrary results that can be very unfair to taxpayers. Consider a U.S. shareholder that holds two CFCs, CFC1 and CFC2. If CFC1 has tested income for a year and CFC2 has a tested loss, the tested loss will reduce the net CFC tested income of the U.S. shareholder. However, the U.S. shareholder will obtain no benefit from any FTCs or notional QBAI return of CFC2. This is true whether CFC2's tested loss is $1 or $1 billion.

On the other hand, if CFC2 has $1 of tested income, all of its FTCs and QBAI return would be taken into account by the U.S. shareholder. It is difficult to understand why there should be such a vastly different outcome depending on whether CFC2 has income or loss under U.S. tax principles – a distinction that could turn on less than $1.

These rules also cause very formalistic results. Turn back to Example 15(a), where CFC1 has two divisions, division 1 generates tested income, division 2 generates tested loss, there is overall net positive tested income, and division 2 bears a foreign tax. We conclude that there should not be a tracing of FTC to particular dollars of tested income, so the FTC should be allowed for division 2 even though it generates a tested loss on a stand-alone basis. Moreover, we reach the same conclusion in Example 15(b), where division 2 is transferred to a disregarded subsidiary.

Assume now that CFC1 transfers division 2 to a subsidiary entity, CFC2, that is a corporation for U.S. tax purposes. Now, CFC2 has a tested loss and bears a foreign tax. However, since it is a separate corporation, the U.S. shareholder does not receive any FTC for that foreign tax.

There is no logical reason for this distinction. Moreover, the same distinction arises if division 2 has QBAI return rather than FTC. As in Examples 15(a) and 15(b), it is clear that if a particular CFC has any tested income, the QBAI return of that CFC is not limited to the return on particular assets that generate positive tested income. Rather, the deduction for NDTIR under Section 951A(b)(1)(B) aggregates all QBAI returns of all CFCs with positive tested income, without any tracing of QBAI return of a CFC to particular tested income of the same CFC.

Similarly, suppose CFC1 has a tested loss, interest expense, and notional QBAI return, and CFC2 has tested income and QBAI return. The notional QBAI return of CFC1 is disregarded, yet it is unclear whether the interest expense of CFC1 reduces the NDTIR generated by CFC2's QBAI (*see* discussion in Part IV.D.6). If this interest expense did reduce the NDTIR, all the notional QBAI return of CFC1, and the QBAI return of CFC2 up to CFC1's interest expense, would both be "wasted". This result would make no sense at all.

Finally, suppose CFC1 has $100 of tested income and pays foreign taxes, and CFC2 has a tested loss. If CFC2's tested loss is less than $100, the U.S. shareholder will have net CFC tested income, but the inclusion percentage for the FTC will be reduced on account of the tested loss. If instead CFC2 was a branch of CFC1, the net CFC tested income would be the same, but the inclusion percentage would be 100% (assume no NDTIR), so there would be no cutback on the FTC. On the other hand, if the CFC2 tested loss was $100 or more, the U.S. shareholder would be worse off if CFC2 was a branch of CFC1 than a separate CFC, because as a branch, the disadvantages of a CFC without tested income would then encompass CFC1 as well as CFC2.

These results are arbitrary and counter-intuitive, and encourage restructuring of business organizations purely for tax reasons. In particular, Related CFCs of a U.S. shareholder will be separated or combined (including by using "check-the-box" elections) to distribute tested income among CFCs in a manner so as to minimize the likelihood that CFCs with meaningful QBAI and/or FTCs will have tested losses. It might also become desirable to artificially accelerate income at year end in particular CFCs to prevent the existence of a tax loss for the year. Taxpayers will also attempt to rely on the administrative relief to make retroactive check the box elections, if events do not turn out as expected.

The need for such tax planning would be reduced or eliminated if all Related CFCs of a particular U.S. shareholder were treated as a single corporation for purposes of the GILTI calculations. The rule would apply regardless of whether the CFCs were each directly held by the shareholder or if they were in chains of ownership. Then, the tested income or tested loss of a particular CFC would not matter, and FTCs and QBAI return of all CFCs would be available as long as there was overall tested income. This result would not be unduly favorable to taxpayers, since it can be created by self-help today if the U.S. shareholder puts all its CFCs under a single CFC holding company and checks the box on all the subsidiary CFCs. In fact, mandatory aggregation can be viewed as anti-taxpayer, because the well-advised taxpayer today has the choice of aggregation or nonaggregation by simple tax planning, and nonaggregation is often more favorable.

Such aggregation is clearly at odds with Congressional intent in drafting Section 951A. However, it is not clear that Congress realized the anomalous results created by nonaggregation and how self-help could achieve results similar to aggregation.

If this proposal was enacted, and regulations were adopted to treat all members of a consolidated group as a single corporation for purposes of Section 951A,[200] the result would be the aggregation of all Related CFCs of all members of a consolidated group. We believe this would greatly simplify the GILTI rules, be much fairer to taxpayers, and avoid the need for uneconomic tax planning by taxpayers.

We are not suggesting, however, that all Related CFCs owned by a single U.S. shareholder (or members of a single consolidated group) should be treated as a single corporation for all purposes, so that all transactions between them should be disregarded in calculating tested income. This would, for example, eliminate tested income when one CFC sells an asset to another CFC at a gain. While elements of such a rule apply under Subpart F for transactions between CFCs, such a rule would require considerably more analysis.

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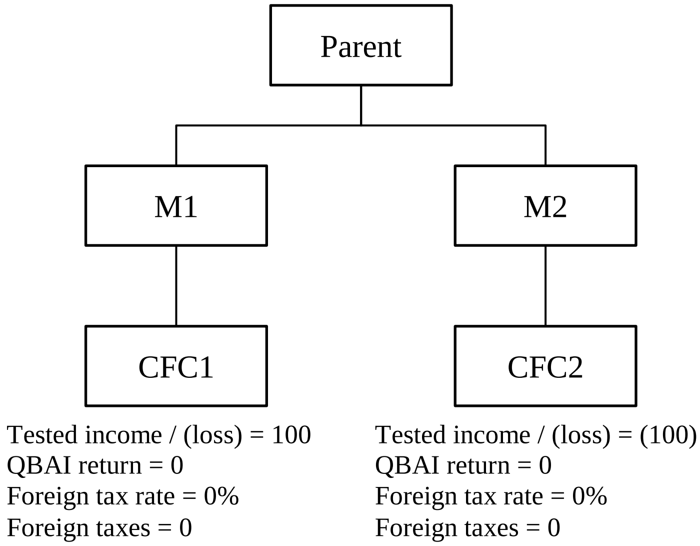
[200] *See* Part IV.B.4.

APPENDIX 1

The charts and calculations on the following pages illustrate certain of the examples in the Report.

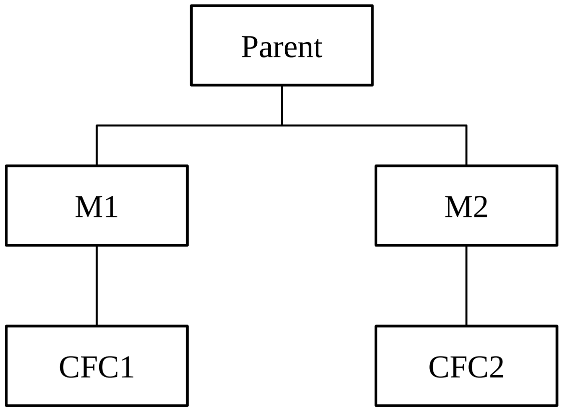
Example 6(a)



	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	0	0
NDTIR	0	0	0
Section 951A inclusion	100	0	0
Aggregate of Related CFCs' tested income	100	0	100
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	0%
Foreign tax paid by Related CFCs with tested income	0	0	0
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	0
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	0
GILTI inclusion (Section 951A inclusion + Section 78 amount)	100	0	0
US tax before FTCs (GILTI inclusion * 50%[201] * 21%)	10.50	0	0
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	10.50	0	0
Aggregate tax (Foreign tax + Incremental US tax)	10.50	0	0
Aggregate tax for consolidated group	**10.50**		**0**

[201] Assumes full Section 250 deduction for GILTI is available.

Example 6(b)[202]



Tested income / (loss) = 100
QBAI return = 100
Foreign tax rate = 0%
Foreign taxes = 0

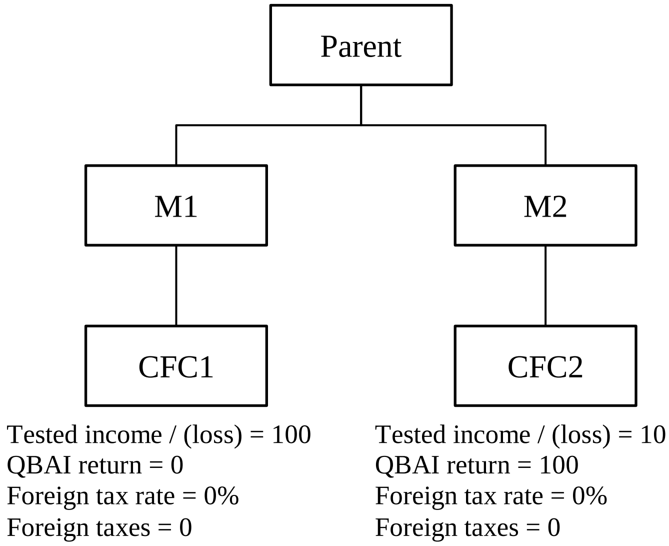
Tested income / (loss) = (50)
Interest expense = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	0	50
NDTIR	100	0	0
Section 951A inclusion	0	0	50
Aggregate of Related CFCs' tested income	100	0	100
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	0%	0%	50%
Foreign tax paid by Related CFCs with tested income	0	0	0
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	0
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	0
GILTI inclusion (Section 951A inclusion + Section 78 amount)	0	0	50
US tax before FTCs (GILTI inclusion * 50%[203] * 21%)	0	0	5.25
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	0	0	5.25
Aggregate tax for consolidated group	**0**		**5.25**

[202] This example assumes that interest expense in a Related CFC with tested losses reduces the U.S. shareholder's NDTIR from other CFCs with QBAI return. See discussion in Part IV.D.6.

[203] Assumes full Section 250 deduction for GILTI is available.

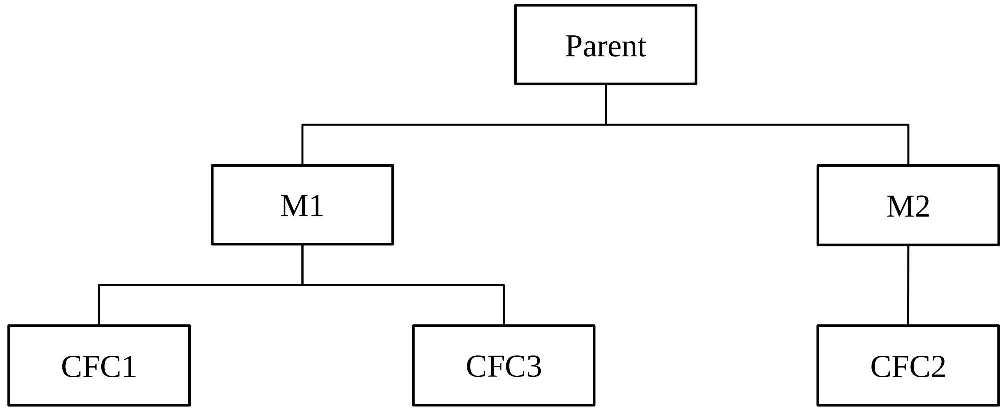
Example 7



	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	10	110
NDTIR	0	100	100
Section 951A inclusion	100	0	10
Aggregate of Related CFCs' tested income	100	10	110
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	9%
Foreign tax paid by Related CFCs with tested income	0	0	0
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	0
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	0
GILTI inclusion (Section 951A inclusion + Section 78 amount)	100	0	10
US tax before FTCs (GILTI inclusion * 50%[204] * 21%)	10.50	0	1.05
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	10.50	0	1.05
Aggregate tax (Foreign tax + Incremental US tax)	10.50	0	1.05
Aggregate tax for consolidated group	**10.50**		**1.05**

[204] Assumes full Section 250 deduction for GILTI is available.

Example 8(b)



Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 13.125%
Foreign taxes = 15.11

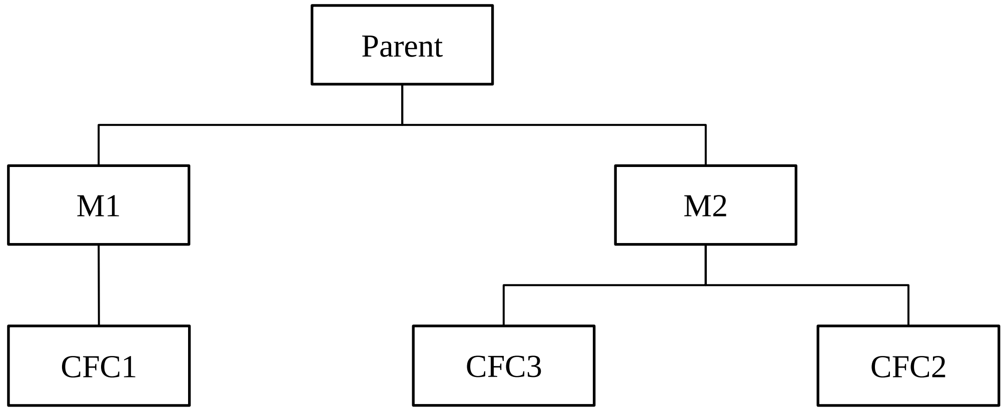
Tested income / (loss) = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	0	100	100
NDTIR	0	0	0
Section 951A inclusion	0	100	100
Aggregate of Related CFCs’ tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	0%	100%	50%
Foreign tax paid by Related CFCs with tested income	15.11	0	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	0	100	107.55
US tax before FTCs (GILTI inclusion * 50%[205] * 21%)	0	10.50	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	10.50	5.25
Aggregate tax (Foreign tax + Incremental US tax)	15.11	10.50	20.36
Aggregate tax for consolidated group	**25.61**		**20.36**

[205] Assumes full Section 250 deduction for GILTI is available.

Example 8(c)



Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 13.125%
Foreign taxes = 15.11

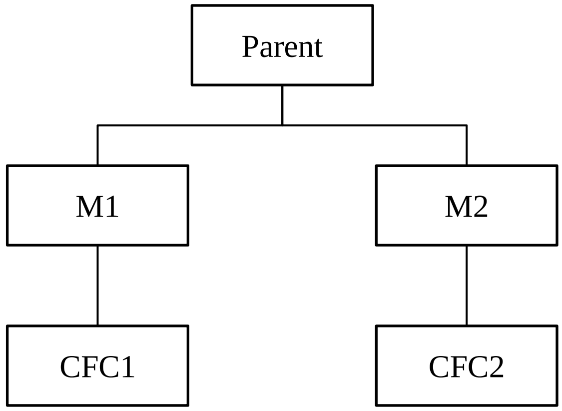
Tested income / (loss) = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	0	100
NDTIR	0	0	0
Section 951A inclusion	100	0	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	50%
Foreign tax paid by Related CFCs with tested income	15.11	0	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	12.09	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	15.11	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	115.11	0	107.55
US tax before FTCs (GILTI inclusion * 50%[206] * 21%)	12.09	0	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	15.11	0	20.36
Aggregate tax for consolidated group	**15.11**		**20.36**

[206] Assumes full Section 250 deduction for GILTI is available.

Example 9(b)

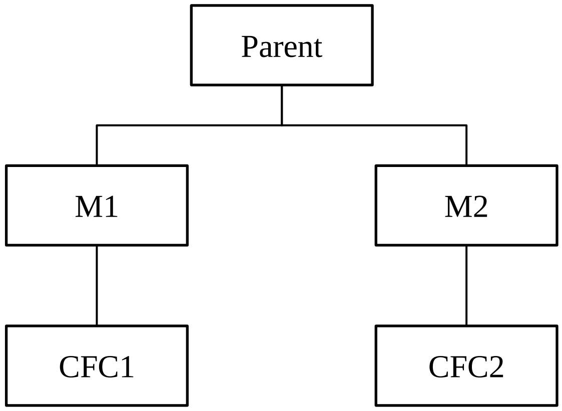


CFC1	CFC2
Tested income / (loss) = 100	Tested income / (loss) = 100
QBAI return = 0	QBAI return = 100
Foreign tax rate = 13.125%	Foreign tax rate = 0%
Foreign taxes = 15.11	Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	100	200
NDTIR	0	100	100
Section 951A inclusion	100	0	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	50%
Foreign tax paid by Related CFCs with tested income	15.11	0	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	12.09	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	15.11	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	115.11	0	107.55
US tax before FTCs (GILTI inclusion * 50%[207] * 21%)	12.09	0	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	15.11	0	20.36
Aggregate tax for consolidated group	**15.11**		**20.36**

[207] Assumes full Section 250 deduction for GILTI is available.

Example 9(c)



Tested income / (loss) = 100 QBAI return = 0 Foreign tax rate = 0% Foreign taxes = 0	Tested income / (loss) = 100 QBAI return = 100 Foreign tax rate = 13.125% Foreign taxes = 15.11

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	100	200
NDTIR	0	100	100
Section 951A inclusion	100	0	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	50%
Foreign tax paid by Related CFCs with tested income	0	15.11	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	100	0	107.55
US tax before FTCs (GILTI inclusion * 50%[208] * 21%)	10.50	0	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	10.50	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	10.50	15.11	20.36
Aggregate tax for consolidated group	**25.61**		**20.36**

[208] Assumes full Section 250 deduction for GILTI is available.

Example 16(a)

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	Direct income	Basket total
Business income	700	700	0	0	0	0
Expenses	(700)	(500)	(100)	(100)	0	(100)
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**300**	**200**	**200**	**(100)**	**0**	**(100)**

Calculate GILTI fraction without taking into account Section 904(b)(4), and by re-allocating $100 loss from foreign source general basket to GILTI basket

$$\text{GILTI fraction} = \frac{\text{GILTI basket income} - \text{Foreign source general basket loss}}{\text{Worldwide income}}$$

$$\text{GILTI fraction} = \frac{100}{300} = 0.33$$

Apply Section 904(b)(4) to disregard $100 of expenses allocable to exempt CFC income

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	Direct income	Basket total
Business income	700	700	0	0	0	0
Expenses	(600)	(500)	(100)	0	0	0
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**400**	**200**	**200**	**0**	**0**	**0**

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}}$$

$$\text{GILTI fraction} = \frac{200}{400} = 0.50$$

Example 16(b)

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	Direct income	Basket total
Business income	150	100	0	0	50	50
Expenses	(150)	(40)	(60)	(40)	(10)	(50)
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**300**	**60**	**240**	**(40)**	**40**	**0**

Calculate GILTI and foreign source general basket fractions without taking into account Section 904(b)(4)

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}} = \frac{240}{300} = 0.80$$

$$\text{Foreign general basket fraction} = \frac{\text{Foreign general basket income}}{\text{Worldwide income}} = \frac{0}{300} = 0$$

Apply Section 904(b)(4) to disregard $40 of expenses allocable to exempt CFC income

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	Direct income	Basket total
Business income	150	100	0	0	50	50
Expenses	(110)	(40)	(60)	0	(10)	(10)
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**340**	**60**	**240**	**0**	**40**	**40**

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}} = \frac{240}{340} = 0.71$$

$$\text{Foreign general basket fraction} = \frac{\text{Foreign general basket income}}{\text{Worldwide income}} = \frac{40}{340} = 0.12$$