ARE YOU FEELING GILTI, OR JUST BEAT? SOME (UNINTENDED?) INTERSECTIONS OF THE NEW INTERNATIONAL TAX RULES

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Report No. 1388

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTION 965

February 6, 2018

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I. Introduction

A. Background

This Report[1] ("Report") makes recommendations for guidance addressing the application of section 965[2], as amended by "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 (the "Act"). This Report also addresses Notice 2018-07 (issued December 29, 2017)[3] and Notice 2018-13 (issued January 19, 2018) (the "Notices"). Each of the Notices announced that the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service") intend to issue regulations for determining amounts required to be included in gross income by United States shareholders under section 951(a)(1) pursuant to section 965.

We commend Treasury and the Service for taking these thoughtful and significant first steps in providing guidance under section 965. In this Report, we suggest some improvements and recommend areas in which we believe additional guidance is required.

B. Overview of New Section 965

Section 965 requires U.S. shareholders that own 10 percent of the voting stock of controlled foreign corporations ("CFC") and all foreign corporations in which a domestic corporation owns a 10 percent voting interest to include in their income their shares of the undistributed post-1986 earnings and profits of such corporation, as specially determined. It is clear from the statutory framework that the objective of section 965 is that a U.S. shareholder's share of such undistributed earnings be included in income but it is also clear that it was only intended to be included in income once. Although section 965 provides a number of detailed rules to assist in its operation, the drafters appeared to have expected that the mechanics of the Subpart F regime would fill in many of the gaps.[4] Unfortunately, the Subpart F regime cannot fill many of the gaps due to the specialized nature of many of the provisions of section 965 and what appears to be the implicit assumption

[1] The principal drafters of this Report were Edward Gonzalez, Brian Krause, and Jay Cosel, with contributions from William Alexander, Neil J. Barr, Kimberly S. Blanchard, Andrew H. Braiterman, Loren R. Lembo, Jeffrey Maddrey, Michael Mollerus, Yaron Z. Reich, Michael Schler, Karen G. Sowell, Shun Tosaka, and Gordon E. Warnke. 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] Unless otherwise indicated all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury Regulations issued thereunder.

[3] 2018-4 I.R.B. 317, modified by, Notice 2018-13, to be published in 2018-06 I.R.B.

[4] For example, the Subpart F regime is an income inclusion regime whereas section 965 provides for both an income inclusion and a deduction.

of the drafters that the ownership of a "specified foreign corporation" would remain static during the inclusion year.

Consequently, as described below, section 965 raises many interpretative issues. Unlike other provisions of the Act, section 965 generally has an impact that is short-lived because taxpayers' income inclusions pursuant to the statute will occur exclusively in 2017 and 2018. Immediate guidance from Treasury and the Service is, nevertheless, critical because of the impact that these rules have on taxpayers' 2017 and 2018 financial statements. Given the uniqueness of section 965, and its short-lived nature, we urge Treasury and the Service to exercise their regulatory authority to fill the interpretative gaps in a manner consistent with the legislative intent to subject the income to tax only once at the favorable corporate rates specified in the statute.

II. Need for Guidance Providing for Simplifying Conventions Generally

Section 965 requires taxpayers to obtain a substantial amount of information from specified foreign corporations, including the foreign corporation's "accumulated post-1986 deferred foreign income" (hereinafter referred to as "deferred E&P") as of the November 2, 2017 and December 31, 2017 measurement dates and the corporation's foreign cash position as of three different dates. Many taxpayers are required to gather information relating to their specified foreign corporations ("SFCs")[5] for periods that pre-date their ownership of such SFCs in order to comply with section 965.

In some cases, foreign corporations and their U.S. shareholders will have maintained similar information for purposes of complying with the Code's international provisions as in existence prior to the Act (including the Subpart F regime, the passive foreign investment company rules, and the deemed-paid foreign tax credit). In other cases, however, section 965 compliance requires a completely new and potentially daunting administrative burden for taxpayers. The difficulties are compounded by the fact that SFCs, particularly those that are not controlled by U.S. shareholders, may be quite reluctant—or even completely unwilling—to assist their U.S. shareholders in this task, particularly in the time frame required in order to comply with section 965.[6]

[5] "Specified foreign corporation" is generally defined to mean any CFC or any foreign corporation (other than a non-controlled passive foreign investment company) that has a U.S. shareholder that is a domestic corporation. § 965(e).

[6] The Act's repeal of section 958(b)(4) results in even more U.S. taxpayers, including individuals, that are 10% U.S. shareholders of majority foreign-owned foreign corporations being subject to the transition tax. As in effect prior to repeal, section 958(b)(4) provided that subparagraphs (A), (B), and (C) of section 318(a)(3) were not to be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person. The subparagraphs of section 318(a)(3) generally attribute stock owned by a person to a partnership, estate, trust, or corporation in which such person has an interest (so-called "downward attribution"). For example, stock of a corporation owned by a person that owns 50 percent or more in value of the stock of another corporation is treated as owned by such other corporation.

In recognition of the administrative burdens posed by section 965, section 3.02 of Notice 2018-13 announced that Treasury and the Service intend to issue regulations providing that taxpayers may make an election to determine an SFC's deferred E&P as of a measurement date using an "alternative method." The purpose of the alternative method is to eliminate the need for taxpayers to determine an SFC's deferred E&P as of a date that does not fall on the last day of a month. An SFC (other than an SFC with a 52-53 week taxable year) would thus be permitted to do an interim closing of the books on October 31, 2017, rather than on November 2, 2017, compute a daily earnings amount for the stub period through October 31, and add two days' worth of earnings and profits to the earnings and profits as of October 31 in order to determine the SFC's earnings and profits as of November 2, 2017.

Recommendations

We believe Section 3.02 of Notice 2018-13 represents a significant first step in easing the compliance challenges that section 965 presents for taxpayers. Nevertheless, we suggest that Treasury and the Service issue further guidance that makes additional simplifying conventions available to taxpayers.

With respect to SFCs that were not either CFCs or "section 902 corporations" within the meaning of section 909(d)(5) under pre-Act law (*i.e.*, SFCs that may not have had any reason for determining earnings and profits under U.S. federal income tax principles or furnishing their U.S. shareholders with any information), taxpayers should be able to determine deferred E&P and cash positions as of the various dates required under section 965 based on financial statements and statements of retained earnings that are filed with a governmental entity or audited by an independent accountant. In many cases, we believe this is the only information regarding their SFCs to which minority U.S. shareholders will have any access.

We believe additional conventions should also be available for measuring deferred E&P in order to avoid potential distortionary effects of determining deferred E&P as of a mid-year date. These are discussed below.

III. Need for Guidance Regarding Measurement of Post-1986 Earnings and Profits and Deficits

A. Mid-Year Measurement Dates

Pursuant to section 965(a), an SFC's deferred E&P is required to be determined on November 2, 2017 and December 31, 2017. An SFC with deferred E&P on at least one of the measurement dates is treated as a "deferred foreign income corporation" ("DFIC"). A DFIC's Subpart F income is increased by the greater of the two amounts in its last taxable year beginning before January 1, 2018.

As other commenters have pointed out, the requirement to measure a foreign corporation's earnings and profits on a date that does not correspond to the end of the corporation's taxable or fiscal year will cause distortionary effects in many cases.[7] It also represents a substantial compliance burden for taxpayers.

Taxpayers often have significant items of expense for the year that do not arise until at or close to the end of the year. Accordingly, the deferred E&P of a DFIC as of the November 2 measurement date may overstate earnings and be inconsistent with economic reality, because it includes income accrued through that date with respect to the measurement year, but not the deductions that are properly allocable against the income.[8] For example, foreign income taxes are generally not treated as accruing until the end of a corporation's foreign tax year.[9] Depending upon the jurisdictions in which a DFIC operates, foreign income taxes may constitute a very substantial expense. This expense clearly relates to income that is earned over the DFIC's foreign tax year, and in other contexts Treasury and the Service have provided rules apportioning foreign taxes between periods falling within the same tax year in order to achieve a proper matching of income with the associated foreign taxes.[10] Another potential mismatch occurs in the case of DFICs that pay a significant portion of annual compensation in the form of bonuses that do not become fixed until sometime in December (after the November 2 measurement date).

The "alternative method" proposed in Notice 2008-13 does not address this issue.

Recommendations

7 *See* Letter to Department of the Treasury from The Securities Industry and Financial Markets Association (Dec. 22, 2017), 2018 TNT 2-8.

8 In the case of foreign income taxes that may not accrue until year-end, this problem is compounded by section 78, which would effectively require a U.S. shareholder to include in income an amount equal to its indirect foreign credits related to its section 965 inclusion, even though a portion of the underlying foreign income taxes did not reduce the deferred E&P.

9 For an accrual method taxpayer, a foreign tax liability accrues when the "all events" test is satisfied. *See* Reg. §1.446-1(c)(1)(ii). To satisfy the all events test, in general, a liability must have arisen in fact; the amount of the liability must be susceptible to reasonably accurate determination; and economic performance must have occurred. *See* § 461(h); Treas. Reg. § 1.446-1(c)(1)(ii). In the case of a foreign income tax liability, however, economic performance occurs when the requirements of the all events test other than economic performance (*i.e.*, payment) are met. Treas. Reg. § 1.461-4(g)(6)(iii)(B).

10 *See* Treas. Reg. § 1.338-9(d) (allocating foreign taxes of a target in a stock sale in connection with which a section 338 election is made if the foreign taxable year of target does not close on the acquisition date); Treas. Reg. § 1.901-2(f)(4) (allocating foreign taxes of a partnership or disregarded entity that is a foreign taxpayer in cases where a change in ownership occurs during the entity's foreign taxable year and such taxable year does not close as a result of such change).

We recommend that Treasury and the Service issue guidance permitting taxpayers to use a ratable allocation of the earnings and profits for the entire year or other reasonable method in order to calculate earnings and profits on the measurement dates, in order to mitigate the distortionary effects of an interim closing approach and ease the administrative burden on taxpayers. The ratable allocation method should exclude income or loss from extraordinary transactions, which can be taken into account in the appropriate period.

This recommendation is consistent with other areas of U.S. federal income tax law. For example, Treasury Regulation section 1.1502-76(b) provides that items (other than extraordinary items) may be ratably allocated between a separate return and the consolidated return when a corporation joins or leaves a consolidated group based on a day count.

Alternatively, some other rules need to be adopted to permit items of expense that accrue at year end but relate to the entire year to be taken into account, particularly with respect to the November 2 date. For example, the alternative method of Notice 2018-13 could be retained but with the additional feature that items that accrue at year-end[11] (and were not taken into account in closing of the books) are allocated over the measurement period. We believe it is especially important to address the treatment of foreign income taxes, which represent a substantial expense for many DFICs and should be treated as accruing with the related income for this purpose.

B. Sales, Redemptions and Distributions During the Transition Year

Section 965(d)(3) provides that the deferred E&P of SFCs are determined "… without diminution by reason of dividends distributed during the taxable year … other than dividends distributed to another specified foreign corporation" (the "no-diminution" rule). This provision presents a number of issues because parties could have undertaken transactions both before and after any meaningful details regarding tax reform were known and the consequences as a result of section 965 may be very different from those that they reasonably anticipated.

Example 1.

(i) Facts. USP owns CFC 1, which as of December 31, 2016 had $50 post-1986 earnings and profits, $20 of which was previously taxed income within the meaning of section 959 ("PTI"), and $50 of cash. The equity of CFC 1 had a fair market value of $100 and USP had a tax basis of $20 in the stock of CFC 1. CFC 1 had a December 31 tax year. In February 2017, CFC 1 distributed all of its cash of $50 to USP and in March 2017, USP entered into a binding agreement to sell the stock of CFC 1 to USCo, an unrelated U.S. corporation, for $50. The transaction closed in June

[11] As mentioned above, foreign taxes do not generally accrue until the end of a foreign corporation's tax year, which may differ from its tax year for U.S. federal income tax purposes.

2017. CFC 1 earned an additional $10 of E&P in 2017, none of which was Subpart F income as defined in section 952.

(ii) Analysis. Under the law in effect at the time of the transactions, USP expected to recognize dividend income of $30 and gain of $50 from the sale of the CFC 1 stock, $10 of which would be treated as a dividend from CFC 1 under section 1248(a). USCo expected that it would not recognize any income on account of CFC 1's pre-acquisition E&P and that CFC 1 would have $10 of PTI attributable to USP's section 1248(a) amount.

Under section 965(a), it appears that USCo is required to include in income $40 of CFC 1's deferred E&P, because it is the owner of the CFC 1 stock on December 31, 2017 and the amount of CFC 1's deferred E&P is generally determined without reduction for distributions made during its 2017 tax year (subject to application of section 965(f), discussed below). However, it appears that USP is also required to include in income that $40 of E&P as a result of the February 2017 dividend distribution and the section 1248(a) amount recognized on the sale of the CFC 1 stock. The $40 of E&P would not be attributable to PTI described in section 959(c)(2) by reason of section 965(a) with respect to USP, protected by the gain-reduction rule set forth in the Notices (discussed below), because USP was not the U.S. shareholder of CFC 1 on December 31, 2016 that recognized the section 965(a) inclusion. Note that the deferred E&P inclusion would be more distortive if the distribution to USP had been, in whole or in part, a distribution of property that triggered gain under section 311(b). It should also be noted that this treatment will create a built-in loss with respect to the stock of CFC 1 held by USCo because USCo can never get the cash that was distributed to USP.

Section 965(f) could be used as a basis for reducing USCo's section 965(a) inclusion. Under section 965(f), a U.S. shareholder's section 965(a) inclusion is reduced based on distributions made by the SFC during the inclusion year to shareholders that were not U.S. shareholders on the last date of the year under principles similar to section 951(a)(2). We note, however, that section 951(a)(2) requires pro-rating distributions made during the year to other shareholders based on their holding period during the year. Because section 965(a) requires multiple years of income to be recognized, this pro rata allocation method could still result in an acquirer of SFC shares recognizing a section 965(a) inclusion on E&P that accrued before its holding period started that was previously distributed to other shareholders. In the case of USCo, it would still have a $20 section 965(a) inclusion because it owned the CFC 1 stock for half the year. Alternatively, in light of the fact that section 965(d)(3) requires that only periods during which a foreign corporation was an SFC be taken into account, it might be possible to argue that in this context the principles of section 951(a)(2) should be interpreted as allowing a proration between shareholders over the period that the entity was an SFC.

Similar issues could arise with respect to redemptions during the inclusion year, particularly redemptions that are treated as dividends under section 301. In such cases, the remaining

U.S. shareholder may have to include in income the redeemed shareholder's share of the deferred earnings.

Recommendation

As an initial matter, there should be clarification of how the seller in Example 1 or a redeemed shareholder should be treated. Does section 965(a) alter their treatment or is section 965(a) solely affecting the treatment of the taxpayer who holds the SFC shares on the last day of the inclusion year? We believe that the most appropriate rule is that the no-diminution rule under section 965(d)(3) was only intended to be factored in computing deferred E&P and should not affect the treatment of transactions during the inclusion year for former shareholders of the SFC.

With respect to the holders of the shares of the SFC at the end of the inclusion year, there are a number of potential solutions to the over-inclusion issue. None of the potential solutions are perfect from the standpoint of both solving the issue and clearly coming within the applicable statutory language. We believe that the purpose of the no-diminution rule was to prevent taxpayers from engaging in transactions that could reduce the deferred E&P. Based on this likely motivation, we believe that some of the over-inclusion issues could be solved by providing that if the stock purchase involves a qualified stock purchase under section 338, the no-diminution rule would not apply to pre-sale distributions paid to the selling shareholders. Situations involving a qualified stock purchase are less likely to be motivated solely by tax planning and the terms would be arm's length. Similarly, distributions prior to sales between unrelated parties, but which involve sales of less than 80% of the stock, could also be given effect. It is also possible to limit this special rule to transactions occurring before the date of the first release of the text of section 965.

In cases involving related parties, such as a redemption, a possible solution is to permit a reduction of E&P by the redeemed shareholder's allocable share of E&P based on their relative stock ownership. In such a case, the reduction of E&P would not be the full amount that is treated as a dividend under section 301, but the U.S. shareholder at the end of the inclusion year would not be including in its income another shareholder's E&P, which it could never get.

C. Application of E&P Deficit Rules to SFCs with PTI and E&P Deficits

Section 3.01 of Notice 2018-13 contains rules for determining whether an SFC is a DFIC or an E&P deficit foreign corporation. This determination is significant because if the SFC is an E&P deficit foreign corporation, then its E&P deficit will be available to reduce its U.S. shareholders' income inclusion under section 965 with respect to other SFCs of the U.S. shareholder. Example 2 of Notice 2018-13 illustrates that when the same SFC has PTI and a deficit in E&P described in section 959(c)(3), the deficit is required to be netted against the PTI. Specifically, in the example FS has 100u of PTI and an E&P deficit of 90u. The example concludes that the 100u

of PTI and the 90u E&P deficit are netted, resulting in FS having positive E&P of 10 and not qualifying as an E&P deficit foreign corporation.

Recommendation

Under Notice 2018-13, assuming an identical amount of positive non-PTI E&P in its DFICs, a U.S. shareholder of an SFC with PTI and an E&P deficit will pay more transition tax than a U.S. shareholder of an SFC with no PTI and the same sized E&P deficit. It will also pay more transition tax than a U.S. shareholder whose PTI is in an SFC with positive non-PTI E&P.[12] The methodology of the Notice can create significant and unjustified differences between similarly situated taxpayers based merely on the existence and location of PTI among affiliated SFCs. It is also inconsistent with the result that would have been obtained if affiliated SFCs were treated as a single corporation, which is a base of comparison that Treasury utilized to determine the appropriate treatment of intercompany payables and receivables among affiliated SFCs in Notice 2018-07. Had Treasury issued this guidance last November, the result could have easily been avoided had the SFC with the E&P deficit and PTI merged with a DFIC before the E&P measurement dates. The result could also have been avoided had an SFC with an E&P deficit distributed its PTI to its U.S. shareholders prior to the E&P measurement dates.

Congress specifically excluded PTI from the definition of "accumulated post-1986 deferred foreign income," which reflects an intent to exclude PTI from the computation of deferred E&P under section 965. Congress granted Treasury broad authority under section 965 to issue "necessary or appropriate" regulations.[13] Section 965 itself does not define "deficit," and we urge Treasury to exercise its regulatory authority to exclude PTI from this calculation as well.[14]

[12] It appears that in this situation the deficit is not required to be allocated against the PTI in the DFIC.

[13] We note that Treasury and the Service may be assuming by negative inference that the definition of "post-1986 earnings and profits" for purposes of section 965 includes earnings attributable to PTI, because the definition in section 965(d)(2) of "accumulated post-1986 deferred foreign income" provides that "post-1986 earnings and profits" are reduced by the amount of a DFIC's PTI and effectively connected income. A more natural reading of the term "post-1986 earnings and profits," however, excludes PTI altogether, because section 965(d)(3) is based almost verbatim on section 902(c), which has always reduced post-1986 undistributed earnings and profits by PTI. Significantly, such a reading is specifically mandated by the longstanding regulation interpreting that same language. *See* Treas. Reg. § 1.902-1(a)(9).

Thus, it is at least equally reasonable to conclude that the reference to PTI in section 965(d)(2) is intended to clarify and resolve any ambiguity regarding whether PTI (and ECI) is to be subjected to additional tax under section 965. Given the clear policy objectives of section 965 described above and the ambiguous, at best, statutory scheme, and in light of Treasury's and the Service's interpretation of section 902(c), Treasury and the Service should consider exercising their regulatory authority (as they did under section 902(c)) to exclude PTI from all relevant computations under section 965.

[14] Notice 2018-13 does not address whether the PTI and E&P deficit in FS continue to be available after they are netted for purposes of determining whether FS is a DFIC or E&P deficit foreign corporation. We believe that they should continue to be available and that Treasury should confirm that in regulations.

D. Hovering Deficits and Related Foreign Income Taxes

Section 3.03 of Notice 2018-13 states that Treasury and the Service intend to issue regulations "clarifying that all deficits related to post-1986 earnings and profits, including hovering deficits, are taken into account for purposes of determining the post-1986 earnings and profits (including a deficit) of" an SFC. We believe this is an appropriate result, clearly contemplated by the legislative history of section 965. In its discussion of deficits, the Conference Report includes the following passage:

> For example, assume that a foreign corporation organized after December 31, 1986 has $100 of accumulated earnings and profits as of November 2, 2017, and December 31, 2017 (determined without diminution by reason of dividends distributed during the taxable year and after any increase for qualified deficits), which consist of $120 general limitation earnings and profits and a $20 passive limitation deficit, the foreign corporation's post-1986 earnings and profits would be $100, even if the $20 passive limitation deficit was a hovering deficit. Foreign income taxes related to the hovering deficit, however, would not generally be deemed paid by the U.S. shareholder recognizing an incremental income inclusion. However, the conferees expect the Secretary may issue guidance to provide that, solely for purposes of calculating the amount of foreign income taxes deemed paid by the U.S. shareholder with respect to an inclusion under section 965, a hovering deficit may be absorbed by current year earnings and profits and the foreign income taxes related to the hovering deficit may be added to the specified foreign corporation's post-1986 foreign income taxes in that separate category on a pro rata basis in the year of inclusion.[15]

Recommendation

While section 3.03 of Notice 2018-13 allows taxpayers to take hovering deficits into account in determining deferred E&P, it is silent on the treatment of related foreign income taxes that are otherwise suspended under Treasury Regulation section 1.367(b)-7(d)(2)(ii). We recommend that Treasury and the Service consider issuing guidance on the treatment of such foreign income taxes. In general, we believe that it may be appropriate to treat those taxes as being included in a DFIC's post-1986 foreign income tax pool. Allowing these taxes to be claimed as credits in connection with the transition tax is consistent with treating the separate corporations

[15] H.R. Rep. No. 115-466, at 490 (footnotes omitted).

that engaged in a section 381 transaction giving rise to a hovering deficit as a single DFIC—if foreign operations had historically been conducted in a single DFIC rather than through two or more separate corporations, then there would be neither a hovering deficit nor any suspended foreign income taxes.

E. Potential Double Counting of Earnings and Profits of SFCs With Inclusion Years Ending November 30, 2018

Section 3.02 of Notice 2018-07 provides rules that would seem to obviate most issues related to double counting of E&P. One exception, however, may be distributions by a first-tier November 30 SFC to its U.S. shareholder occurring between November 2 and December 1, 2017 (because such distributions occur after the November 2 measurement date, and thus may not reduce the section 965 inclusion, but prior to the SFC's inclusion year, and thus would seem not to be PTI).

Recommendation

We recommend that Treasury and the Service consider issuing guidance regarding the proper treatment of distributions by November 30 SFCs occurring between November 2, 2017 and December 1, 2017, either by treating such distributions as PTI, or by providing that the deferred E&P as of November 2, 2017 is reduced by such distributions, to the extent necessary to prevent double counting.

IV. Need for Guidance Regarding Measurement of Cash Position

A. Notional Cash Pooling Arrangements

1. Cash Pooling Arrangements Generally

Corporate groups frequently take a centralized approach to managing the deployment of cash within the group and to hedging risks associated with the group's treasury and finance functions. In a cash pooling arrangement, the treasury center, typically together with a third-party financial institution, centrally manages the group's cash. In all pooling arrangements, the participating group members will typically each enter into a separate account agreement with the financial institution operating the pool. In addition, the participating members typically enter into an agreement among themselves specifying the key terms of the pooling arrangement, including the frequency of sweeps and the mechanism for calculation and payment of interest among the participating members.

There are two basic types of cash pooling arrangements: (i) physical cash pooling and (ii) notional cash pooling. There are some differences between these two types of arrangements.

In a physical cash pooling arrangement (also sometimes referred to as a zero balance arrangement, or a cash sweep), several group members will open accounts with the same financial institution. At pre-established frequent intervals (usually daily, although in some cases weekly, monthly or quarterly intervals might be used), the bank automatically moves cash from the accounts of group members that have positive account balances to the account of the treasury center (this account is sometimes called the pool leader's account or the header account). The bank then automatically moves cash from the header account into the accounts of group members that have negative account balances. If, after this process, the header account has a positive balance, the financial institution pays interest on that balance; or, if the header account balance is negative, the treasury center is charged interest. These cash movements typically are automated rather than manual, as automation provides significantly greater efficiency and limits possibilities for error.

The second basic type of cash pooling arrangement is often referred to as notional or virtual cash pooling. Such an arrangement resembles physical cash pooling, in that participating group members typically all establish accounts with the same financial institution, and the treasury center acts as the pool leader. However, in a notional pooling arrangement, cash is not swept out of, or deposited into, any group member's account by the financial institution. Each group member retains its own account relationship with the bank and its own deposit or overdraft balance. On each measurement date, the financial institution determines whether each group member has a positive or negative balance in its account and aggregates the account balances. If the aggregate is positive, then the financial institution pays the treasury center an amount of interest on that positive amount; if the aggregate is negative, then the treasury center must borrow either from the financial institution or from some other corporation in the group (*e.g.*, the parent) in order to increase the negative amount to zero. Absent such borrowing, participants in the pooling arrangement with negative balances generally cannot have an aggregate negative balance in excess of the aggregate positive balance of those participants with positive balances.

Group members participating in notional pooling may separately account for the absence of interest payable to the financial institution on members' negative account balances; the absence of interest receivable from the financial institution on members' positive account balances; and payments of interest to, or by, the pool header on the notional aggregate balance. Therefore, the total amount of interest income and expense recorded by participants in physical and notional pools should be similar; any variance should be attributable to differences between the interest rates paid/charged by the financial institutions and the transfer pricing policies implemented by group members, rather than to the difference in counterparty described above.

2. General Treatment of Cash Pools for U.S. Federal Income Tax Purposes

Physical and notional pooling arrangements are economically similar insofar as each pool member has the right to access cash on a demand basis as needed. Nevertheless, the overall amount of liquid assets (*i.e.*, net cash) held by a group of related corporations is the same regardless of whether they are members of a physical or notional pooling arrangement. Nevertheless, because of the formal structure of the rights and obligations under each arrangement, the characterization of physical and notional pooling arrangements for U.S. federal income tax purposes may be different.

For U.S. federal income tax purposes, a physical cash pooling arrangement like the one described above is typically viewed as creating loans to the treasury center from the other group members with positive balances, and from the treasury center to the group members with negative account balances. Interest typically is accrued on these loans. Loans are repaid automatically through the sweep mechanism as cash becomes available to the borrower, with balances shifting each time a periodic sweep occurs.

In a notional pooling arrangement, the parties to the relationship for U.S. federal income tax purposes might be viewed as including the facilitating financial institution. Because group members typically each continue to have their own individual overdrafts and deposits directly with the bank, it could be argued that notional pooling should be treated for U.S. and foreign tax purposes as loans from the financial institution operating the pool to group members that have negative account balances, and to the financial institution from group members that have positive account balances. For purposes of the section 385 regulations, Treasury and the Service have indicated that they generally view notional cash pooling arrangements as in substance loans directly between and among the affiliated group members, rather than loans between the members and the financial institution, in circumstances where the financial institution is merely acting as an intermediary administrative clearing house to facilitate cash movements among members of the affiliated group.[16]

3. Application of Section 965(c)(3) and Notice 2018-07

Section 965(c)(3)(B)(ii) provides that the "aggregate foreign cash position" of a specified foreign corporation includes that corporation's "net accounts receivable." Notice 2018-07 recognizes that if there are accounts receivable or short-term obligations between related SFCs, this may "inflate the aggregate foreign cash position of a U.S. shareholder relative to the actual aggregate amount of liquid assets (other than the intercompany receivables) owned by the specified foreign

[16] T.D. 9790 (October 21, 2016) ("For example, a notional cash pool in which the cash received by a nonmember cash pool provider from expanded group members is required to equal or exceed the amount loaned to expanded group members will generally be treated as a loan directly between expanded group members, even though the interests may be in form documented as debt between an expanded group member and a nonmember facilitator").

corporations of the United States shareholder." The Notice then goes on to reason that intercompany receivables would inflate the measure of liquid assets because "if the specified foreign corporations were treated as a single corporation, the liquid assets of the specified foreign corporations would have been reduced."

To address this concern, Notice 2018-07 takes the position that receivables and payables between SFCs that are related within the meaning of section 954(d)(3) will be disregarded. Specifically, the Notice clarifies that for purposes of applying section 965(c)(3)(B)(ii), Treasury and the Service "intend to issue regulations providing that, with respect to a United States shareholder, any receivable or payable of a specified foreign corporation from or to a related specified foreign corporation will be disregarded to the extent of the common ownership of such specified foreign corporations by the United States shareholder."[17]

We agree with the underlying policy position of Notice 2018-07, which is that the appropriate measure of liquid assets for purposes of computing the aggregate foreign cash position under section 965(c)(3) should be based on the total net liquidity of an affiliated group of SFCs. We believe that those policies apply equally to both physical cash pooling and notional cash pooling and thus they should be treated in the same manner for purposes of section 965. The reasoning can be illustrated with the following example.

Example 2.

US1 is a U.S. corporation that is the 100% owner[18] of five specified foreign corporations: CFC1, CFC2, CFC3, CFC4, and CFC5. CFC1, CFC2, CFC3, and CFC4 are operating companies that participate in a pooling arrangement with CFC5, which is a corporate treasury center dedicated to the management of any cash pooling arrangement. Without regard to any pooling arrangement, the cash balance of each CFC would be as follows:

- CFC1: $100
- CFC2: $50
- CFC3: ($50) (*i.e.*, it has a cash deficit)
- CFC4: ($25)

[17] Notice 2018-07 § 3.01(b).

[18] We have used a single U.S. shareholder with 100% ownership for ease of illustration. The underlying analysis and policy rationale should not be different in cases where there are multiple U.S. shareholders and/or unrelated owners. We also note that in general, it is typical for all members of a cash pooling arrangement (whether physical or notional) to be part of the same controlled group of corporations (as such term is used in section 1563(a)).

- CFC5: $0 (*i.e.*, it is solely a treasury center and so would not exist without a pooling arrangement)[19]

Regardless of whether CFCs 1-5 are participants in a physical or notional pooling arrangement, the net liquid assets held by US1's CFCs is $75.

In a physical cash pooling arrangement, CFCs 1-4 would be treated as having receivables from (or payables to) CFC5 of $100, $50, ($50), and ($25), respectively. Under Notice 2018-07, these would all be disregarded. CFC5 would have a cash balance with the financial institution of $75 (*i.e.*, cash pooled from CFC1 and CFC2, less cash advanced to CFC3 and CFC4). Therefore, the aggregate foreign cash position of US1 would be $75.

Under the policy rationale of the Notice, the result should be identical under a notional pooling arrangement.[20] However, if the notional pooling balances would otherwise be treated as receivables/payables directly between the financial institution and CFCs 1-4, CFC5 would not, in this example, have a receivable or payable with the financial institution (setting aside any interest paid or other extraneous transactions). In that case, as currently promulgated, Notice 2018-07 would not permit US1 to reduce the cash position of CFC1 and CFC2 by the cash deficits of CFC3 and CFC4. Therefore, US1 would have an aggregate foreign cash position of $150, which overstates the liquid assets of its group of CFCs.

<u>Recommendation</u>

We request that Treasury clarify that both physical cash pooling and notional cash pooling arrangements will be treated in a similar manner under section 965. We believe that a straightforward allocation approach can be used to achieve the policy objectives of Notice 2018-07. Under this approach, where related-party SFCs are participants in a notional cash pooling arrangement, SFCs that have positive cash balances would reduce their aggregate foreign cash position in respect of any negative balances of related-party SFC's that are participants in the pooling arrangement. The net positive cash balance of the SFC pool participants would then be allocated pro rata to each SFC in proportion to such SFC's share of the positive balances in the pool.

Applying this approach to the example above, the net positive cash balance of the participants in the pooling arrangement is $75 (*i.e.*, 100 + 50 - 50 - 25). That $75 net positive balance would be allocated between CFC1 and CFC2—the only entities with positive balances—based on each such entity's proportionate share of the gross positive balances of such pool participants.

[19] The treatment of CFC5 as a dedicated treasury center entity is solely for ease of illustration. We do not believe that the analysis should be different if CFC5 had its own operations and cash balance.

[20] An SFC's cash position should be the same whether it participates in a notional cash pooling arrangement or a physical cash pooling arrangement.

CFC1 would thus be allocated a positive cash balance of $50 (*i.e.*, $75 x (100 ÷150)). And CFC2 would be allocated $25 (*i.e.*, $75 x 50 ÷ 150).

We believe that this approach is consistent with the approach in Notice 2018-07 as it applies to physical cash pooling arrangements, is consistent with the treatment of notional cash pooling under section 385, and is consistent with the policy of avoiding double counting of liquid assets when determining the aggregate foreign cash position for purposes of section 965(c)(3).

B. Definition of "Accounts Payable"

Notice 2018-13's definition of "accounts payable" likely creates unfavorable results for a wide variety of taxpayers, raising significant policy questions as well as factual difficulties.[21] Section 3.04(a) of the Notice provides that "the term 'accounts payable' means payables arising from the purchase of property described in section 1221(a)(1) or 1221(a)(8) or the receipt of services from vendors or suppliers." Section 1221(a)(1) describes inventory, while section 1221(a)(8) describes supplies. Noticeably and surprisingly absent is any reference to payables arising from property described in Section 1221(a)(2) (depreciable property or real property used in a trade or business), or any reference to payables accrued to license intellectual property. To illustrate the scope of this extremely limited definition, accounts payable incurred by a manufacturer (i) to acquire equipment, (ii) to license intellectual property rights or (iii) to pay employees would all fail to qualify as "accounts payable."

These results are particularly surprising when one realizes that cash payments for any of the foregoing items would clearly reduce the "cash position" under section 965(c)(3)(B). No explanation is provided for why a purchase of supplies is viewed as creating an account payable while a license of IP is not. Similarly, it is challenging to explain why a purchase of machinery should be regarded differently from a purchase of inventory. The Notice articulates a rationale of trying to measure liquidity; whether liquidity is impacted by a purchase of inventory versus a purchase of equipment, for example, would seem irrelevant.[22]

[21] We note that section 965(c)(3)(C)(ii) refers to a "corporation's accounts payable (determined consistent with the rules of section 461)." The meaning of the parenthetical is not entirely clear. Section 461 and the Treasury Regulations thereunder are timing provisions, but do not expressly refer to accounts payable. The parenthetical may simply mean that only accounts payable that have accrued in accordance with section 461 principles are taken into account. We do believe, however, that the inclusion of the parenthetical supports the argument that "accounts payable" should not be construed narrowly for purposes of section 965(c).

[22] In addition to the foregoing, this definition appears to depart from existing guidance on what constitutes an "account payable" for U.S. federal income tax purposes. For example, Rev. Proc. 99-32 defines the payable/receivable that may be created via a transfer pricing adjustment as an "account payable" and an "account receivable," fostering a rationale of allowing cash payments to match transfer pricing adjustments without incremental tax consequences. Under Notice 2018-13, however, accounts payable created by virtue of such

Recommendation

We recommend that Treasury and the Service further consider the appropriate definition of "accounts payable".

C. Treatment of Non-Corporate Entities as SFCs

Section 965(c)(3)(E) provides that an entity (other than a corporation) is required to be treated as an SFC of a U.S. shareholder for purposes of determining such U.S. shareholder's aggregate foreign cash position if any interest in the entity is held by an SFC of the U.S. shareholder, and the entity would be an SFC of the U.S. shareholder if it were a foreign corporation.

Under this rule, certain partnerships in which SFCs own interests will themselves be treated as SFCs for purposes of determining the relevant U.S. shareholders' aggregate foreign cash positions. Notably, however, rather than functioning as a look-through rule that treats an SFC as owning its allocable share of the liquid assets of a partnership in which the SFC owns an interest, section 965(c)(3)(E) instead simply treats a partnership as an SFC. As a consequence, under the plain text of the statute, a U.S. shareholder would be required to take into account not only the cash position of a partnership that is attributable to an SFC's interest in the partnership, but also the cash position that is attributable to any interest in the partnership held by the U.S. shareholder itself.

Example 3. Partnership Owned by U.S. Shareholder and its SFC.

USP, a domestic corporation, owns 100% of CFC 1. USP owns 5%, and CFC 1 owns 95%, of PRS, a foreign partnership. PRS's cash position as of each of the relevant measurement dates is $100.

Under section 965(c)(3)(E), PRS is treated as an SFC because if PRS were a corporation, it would be 100% owned (directly and indirectly) by USP. In the absence of any guidance to the contrary, the full $100 of cash held by PRS would be taken into account by USP in determining its aggregate foreign cash position.

As a policy matter, a U.S. shareholder's allocable share of the cash position of a partnership should not be taken into account in determining the shareholder's aggregate foreign cash position. The purpose of measuring a U.S. shareholder's aggregate foreign cash position is to impose the

adjustments would not be "accounts payable" for purposes of assessing liquid assets under section 965(c)(3). We can discern no rationale for distinguishing between account payables based on the asset that gave rise to the account payable. Forcing taxpayers to make such distinctions will potentially impose onerous requirements on taxpayers.

transition tax at a higher rate on the portion of a foreign corporation's deferred E&P that is attributable to liquid assets.[23] Accordingly, only liquid assets that are held by foreign corporations—directly, or indirectly through a partnership—should be taken into account.[24]

Importantly, the Conference Report states that the conferees anticipate that Treasury and the Service will issue guidance addressing the application of section 965(c)(3)(E) in these circumstances.[25]

Recommendation

We recommend that Treasury and the Service issue guidance providing that a U.S. shareholder's share of the cash position of a non-corporate entity that is treated as an SFC pursuant to section 965(c)(3)(E) is disregarded. Under this principle, in Example 3 above, USP would take into account $95 of the cash of PRS in determining its aggregate foreign cash position, and not the full $100.

We also recommend that Treasury and the Service issue guidance clarifying that the term "entity" in section 965(c)(3)(E) does not include an entity that is disregarded as an entity separate from its owner for U.S. federal income tax purposes (a "DRE"). For purposes of applying section 965(c), we believe DREs should simply be disregarded and liquid assets held by a DRE should be considered as being held directly by the entity's owner.

V. Need for Guidance Regarding PTI and Basis Adjustments

Section 965 gives rise to a number of issues regarding distributions made by DFICs during and after their inclusion year and basis adjustments that are made in connection with U.S. shareholders' inclusions under section 951(a)(1) pursuant to section 965. We believe section 3.03 of Notice 2018-07 and section 4 of Notice 2018-13 address several of these issues and commend Treasury and the Service for their efforts. Nevertheless, additional guidance is needed to clarify a

[23] *See* Senate Budget Committee Explanation, p. 358;

[24] There may be partnerships that are jointly owned by U.S. shareholders and their SFCs and to which the relevant SFC has contributed a disproportionate share of cash and cash equivalents compared to the U.S. shareholder (which may have contributed operating assets, for example). In situations where the SFC's contribution of liquid assets was undertaken with a principal purpose of reducing its cash position, the anti-abuse rule in section 965(c)(3)(F) permits the Service to disregard the transfer. Outside this context, in non-abusive transactions in which an SFC has contributed liquid assets to a bona fide partnership in exchange for a partnership interest, we do not believe it is generally appropriate to "trace" specific partnership property back to the contributing SFC.

[25] *See* H.R. Rep. No. 115-466, at 492.

few remaining interpretative questions and correct certain adverse consequences arising from the application of section 965.

Generally, section 961 provides rules for adjusting a U.S. shareholder's basis in stock of SFCs[26] and other property to account for inclusions pursuant to section 951(a) and distributions of PTI. Section 961(a) provides for positive basis adjustments to account for inclusions in gross income under section 951(a), while section 961(b)(1) provides for negative basis adjustments to reflect distributions of PTI. To the extent the amount of a distribution of PTI exceeds the U.S. shareholder's basis in the SFC stock, the U.S. shareholder is required to recognize gain under section 961(b)(2).[27]

A U.S. shareholder's pro rata share of the increase in Subpart F income of an SFC required by section 965(a) is included in the gross income of the U.S. shareholder for its taxable year in which or with which the taxable year of the SFC beginning before January 1, 2018 ends.

Thus, for a December 31 DFIC, a U.S. shareholder with respect to such DFIC included an amount in income under section 951(a)(1) pursuant to section 965 for its taxable year that included December 31, 2017. The deferred E&P that gave rise to this inclusion became PTI on December 31, 2017, and the distribution of this PTI results in the application of section 961(b).

Section 965(b)(1) provides that, if a taxpayer is a U.S. shareholder with respect to at least one DFIC and at least one E&P deficit foreign corporation,[28] then the portion of deferred E&P which would otherwise be taken into account under section 951(a)(1) by a U.S. shareholder with respect to each DFIC is reduced by the amount of such U.S. shareholder's aggregate foreign E&P deficit that is allocated to such DFIC.

Section 965(b)(4)(A) states:

> For purposes of applying section 959 in any taxable year beginning with the taxable year described in [section 965(a)], with respect to any United States shareholder of a deferred foreign income corporation, an amount equal to such shareholder's reduction under [section 965(b)(1)] which is allocated to such deferred foreign income corporation under this subsection shall be treated as an amount

[26] Although section 961 refers to CFCs, section 965(e)(2) provides that, for purposes of sections 951 and 961, an SFC shall be treated as a CFC for purposes of taking into account Subpart F income of such corporation for purposes of section 965(a) (and for purposes of applying section 965(f)).

[27] § 961(b)(2); Treas. Reg. § 1.961-2(c).

[28] Under section 965(b)(3)(B), "E&P deficit foreign corporation" means, with respect to any taxpayer, any SFC with respect to which such taxpayer is a U.S. shareholder, if, as of November 2, 2017, (i) such specified foreign corporation has a deficit in post-1986 earnings and profits, (ii) such corporation was an SFC and (iii) such taxpayer was a U.S. shareholder of such corporation.

> which was included in the gross income of such United States shareholder under section 951(a).

Thus, under section 965(b)(4)(A), the amount by which a shareholder reduces its section 951(a)(1) inclusion with respect to a DFIC as a result of the allocation of a deficit is treated as PTI. Section 965(b)(4)(A) does not, however, by its terms expressly treat the allocation of a deficit as an amount which was included in income under section 951(a) for purposes of applying section 961(a). Thus, section 965(b) may have the effect of creating PTI in DFICs that is not matched by corresponding basis adjustments. Consequently, as illustrated in Example 5 and Example 6 below, the operation of section 965(b) may result in a U.S. shareholder being in a position where it is not possible to make a distribution from a foreign subsidiary without triggering unfavorable U.S. federal income tax consequences, including during tax years following the inclusion year when the participation exemption under section 245A is applicable.

Under section 959(e), distributions made during the taxable year are generally treated as first made from PTI and thereafter from E&P that is not PTI. Accordingly, distributions made by a December 31 DFIC during its tax year that ended December 31, 2017 in many cases are retroactively treated as distributions of PTI. If the U.S. shareholder did not have sufficient basis in the stock of the DFIC at the time of the distribution, then the U.S. shareholder would have recognized gain under section 961(b)(2). As a result, the E&P that was distributed may have been subject to U.S. federal income tax at rate of up to 50.5%, *i.e.*, the section 965(a) inclusion at the 15.5% effective rate and the section 961(b)(2) gain at the 35% corporate rate in effect in 2017. In light of the fact that section 965(a) was introduced in November and enacted at the end of December, the taxpayer may have reasonably expected that under the law in effect at the time of the distribution, the distribution would be treated as a dividend (and not a distribution of PTI), and that foreign tax credits would be available.

For a November 30 DFIC, a U.S. shareholder with respect to such DFIC will include an amount in income under section 951(a)(1) pursuant to section 965 for its taxable year that includes November 30, 2018. The deferred E&P that gives rise to such inclusion will constitute PTI when distributed, with the distribution resulting in the application of section 961(b). Accordingly, if the U.S. shareholder does not have sufficient basis in its stock of the DFIC at the time of the distribution, then the U.S. shareholder would recognize gain under section 961(b)(2).

As discussed above, one important Congressional purpose in enacting section 965 was to encourage U.S. multinationals to repatriate heretofore untaxed foreign earnings and to do so as soon as possible, including during the inclusion year. The statute on its face, however, may discourage repatriations before the last day of a DFIC's taxable year if a U.S. shareholder does not have basis in its DFIC stock that is sufficient to offset distributions occurring on an earlier date. The rule in section 3.03 of Notice 2018-07 attempts to resolve this issue. It provides that if a U.S. shareholder receives distributions from a DFIC during the inclusion year that are attributable to

PTI described in section 959(c)(2) by reason of section 965(a) ("Section 965 PTI"), the amount of gain recognized by the U.S. shareholder with respect to the stock of the DFIC under section 961(b)(2) will be reduced (but not below zero) by the "section 965(a) inclusion amount"[29] (the "gain-reduction rule"). Notice 2018-07 does not expressly apply the gain-reduction rule to distributions to a U.S. shareholder from an entity (an "upper-tier entity") that is not a DFIC (for instance, an E&P deficit foreign corporation) that has received distributions from a DFIC (a "lower-tier DFIC") attributable to Section 965 PTI. Notice 2018-07 could, moreover, be interpreted to provide that even when the upper-tier entity is a DFIC, the amount of gain recognized by the U.S. shareholder that is reduced by reason of the gain-reduction rule is limited solely to the section 965(a) inclusion amount of the U.S. shareholder with respect to the upper-tier entity, rather than also including the section 965(a) inclusion amount with respect to the lower-tier DFIC from which such upper-tier entity has received distributions attributable to Section 965 PTI.

Notice 2018-13 addresses some of these issues. It states that Treasury and the Service intend to issue regulations providing that the gain-reduction rule will also apply to distributions received from a DFIC through a chain of ownership described in section 958(a).[30] Specifically, Section 4 of Notice 2018-13 states that such regulations will provide that if a U.S. shareholder receives distributions through a chain of ownership described under section 958(a) from a DFIC during the inclusion year that are attributable to Section 965 PTI, the amount of gain recognized under section 961(b)(2) by the U.S. shareholder with respect to the stock or property of any entity in the ownership chain described in section 958(a) through which the distribution is made will be reduced (but not below zero) by the section 965(a) inclusion amount of the U.S. shareholder with respect to such DFIC. The gain-reduction rule will apply similarly to reduce the amount of gain that would otherwise be recognized under section 961(c) by any CFC in the ownership chain described in section 958(a) through which the distribution is made to a U.S. shareholder for purposes of determining the amount included under section 951(a)(1) in the gross income of the U.S. shareholder.

Recommendation

While the Notices address many of the issues raised by distributions made by DFICs during their inclusion year, we believe further guidance is necessary.

[29] The term "section 965(a) inclusion amount" is defined as the portion of the section 965(a) earnings amount that is taken into account under section 951(a)(1) by a U.S. shareholder with respect to each DFIC reduced by the amount of such U.S. shareholder's aggregate foreign E&P deficit that is allocated to such DFIC under section 965(b)(2) (the "Section 965 inclusion amount"). Notice 2018-13, § 4, modifying Notice 2018-07 § 3.03.

[30] *See* Notice 2018-13, § 4.

A. PTI Ordering Rule and Timing of Basis Adjustments

Section 4 of Notice 2018-13 only applies to distributions "that are attributable to" a U.S. shareholder's Section 965 PTI. It is not clear under this Notice how to determine what portion, if any, of a distribution is "attributable to" Section 965 PTI if the distributing DFIC also earns, or otherwise has, other Subpart F income during the inclusion year.

To achieve the section 965 policy objective of encouraging U.S. multinationals to repatriate untaxed foreign earnings, distributions received by a U.S. shareholder from a DFIC during the inclusion year should first be treated as attributable to Section 965 PTI and then to other Subpart F income.

Example 4.

(i) Facts. USP, a domestic corporation that is a calendar year taxpayer, owns all of the stock of CFC, a DFIC with an inclusion year that ends on November 30, 2018. The functional currency of CFC is the U.S. dollar. USP's adjusted basis in the stock of CFC is zero. CFC has deferred E&P of $100 as of December 31, 2017 (the applicable measurement date). USP therefore has a section 965(a) inclusion amount of $100 with respect to CFC on November 30, 2018. On March 1, 2018, CFC earns $30 of Subpart F income (as defined in section 952) which will be included in the gross income of USP under section 951(a) in its taxable year ending December 31, 2018. On March 15, 2018, USP causes CFC to make a cash distribution of $100 to USP.

(ii) Analysis. Under Treasury Regulation section 1.961-1(a)(1),[31] the increase to USP's tax basis in its CFC stock for its section 965(a) inclusion and other Subpart F income earned during the inclusion year may not be effective until November 30, 2018, the last day of the CFC's taxable year. In such case, on March 15, 2018, the date of the distribution, USP's basis in the CFC stock would be zero, and absent the application of the Notices' gain-reduction rule, USP would recognize $100 of gain as a result of the distribution.

Since neither of the Notices nor section 965 include an ordering rule, it is not clear how the distribution received by USP on March 15, 2018 should be treated. One possibility is that it should be sourced first from Section 965 PTI to the extent thereof, and then from non-Section 965 PTI (*i.e.*, the PTI attributable to the $30 of Subpart F income earned during CFC's inclusion year).

[31] Treasury Regulation section 1.961-1(a)(1) provides, in pertinent part, that "[t]he basis of a United States shareholder's… [s]tock in a controlled foreign corporation… shall be increased under section 961(a), *as of the last day in the taxable year of such corporation on which it is a controlled foreign corporation*, by the amount required to be included with respect to such stock or such property in such shareholder's gross income under section 951(a) for his taxable year in which or with which such taxable year of such corporation ends." (Emphasis added.) This regulation has created some uncertainty as to whether the basis increase would be available for mid-year distributions of E&P that subsequently become PTI.

Alternatively, it could be sourced first from non-Section 965 PTI, or proportionately from both Section 965 PTI and non-Section 965 PTI.

If the distribution is first treated as being attributable to Section 965 PTI, then the gain-reduction rule would apply to the entire $100 distribution. Under this scenario, USP would not recognize any taxable gain as a result of the distribution.

If, on the other hand, any part of a distribution is treated as being attributable to the $30 of Subpart F income earned during the inclusion year, then the gain-reduction rule would not apply to that portion of the distribution and the distribution may result in USP recognizing gain pursuant to section 961(b)(2).[32]

Recommendation

We recommend that guidance be issued that clarifies that distributions received by a U.S. shareholder from a DFIC, either directly or through a chain of ownership, during an inclusion year are first treated as attributable to Section 965 PTI and then to non-Section 965 PTI. We also recommend that guidance be issued clarifying that to the extent gain under section 961(b)(2) is reduced by the section 965(a) inclusion amount, such amount is excluded from the calculation of the basis increase under section 961(a).

As an alternative to the gain-reduction rule, we recommend that Treasury and the Service consider an ordering rule for basis adjustments due to section 965 inclusions and distributions as follows.

Treasury and the Service could replace the gain-reduction rule with basis adjustment rules analogous to the rules applicable in the S corporation or partnership context. Similar to the basis adjustment rules under section 961, section 1367(a) provides that the basis of a shareholder's stock in an S corporation is increased by the shareholder's pro rata share of the income of the S corporation and is decreased (but not below zero) by distributions made to the shareholder. Generally, a shareholder recognizes gain to the extent a distribution exceeds the shareholder's basis in its stock.[33] For purposes of determining whether a distribution exceeds basis, section 1368(d)(1) and

[32] Under section 959 and the applicable regulations, the $30 portion of the distribution treated as attributable to the current year Subpart F income, however, would otherwise be excludable from USP's gross income when distributed because such amount represents earnings and profits attributable to amounts which are included in USP's gross income for the taxable year of the distribution under section 951(a). § 959(a); Treas. Reg. § 1.959-1(b) Example.

[33] § 1368(b)(2).

applicable regulations further provide that a shareholder of an S corporation increases its basis in its S corporation stock for its share of income before taking distributions into account.[34]

Similarly, section 705(a) provides that a partner's basis in its partnership interest is increased by the partner's distributive share of partnership income and is decreased (but not below zero) by distributions by the partnership. To the extent that the amount of money distributed to a partner exceeds the partner's basis in its partnership interest, the partner recognizes taxable gain. Under the partnership rules, advances or drawings of money or property against a partner's distributive share of income are treated as current distributions made on the last day of the partnership taxable year with respect to such partner.[35] By treating such distributions of money as occurring on the last day of the partnership taxable year, income allocations to the partner will increase the partner's basis in its partnership interest before taking the distribution of money into account.

In lieu of the gain-reduction rule, we recommend that Treasury and the Service consider adopting a basis adjustment ordering rule analogous to the S corporation rule and provide that a U.S. shareholder of a DFIC takes into account its section 965(a) inclusion amount for purposes of adjusting its basis in its DFIC stock before taking into account any distributions from the DFIC during the inclusion year. In the alternative, Treasury and the Service could adopt a rule similar to the partnership rule and provide that Section 965 PTI distributions are treated as current distributions made on the last day of the DFIC's taxable year. Under either alternative, a U.S. shareholder would get the benefit of increasing its basis in the DFIC stock for its section 965(a) inclusion amount before taking the Section 965 PTI distribution into account and thereby avoid recognition of gain to the extent of the basis increase.

B. PTI Adjustments in Excess of Basis Increases May "Trap" Earnings and Profits

Under the Notices, the "section 965(a) inclusion amount" means the portion of the deferred E&P that is taken into account under section 951(a)(1) by a U.S. shareholder with respect to each DFIC *reduced* by the amount of such U.S. shareholder's aggregate foreign E&P deficit that is allocated to such DFIC under section 965(b)(2). As described above, under section 965(b)(4)(A), the amount by which a shareholder reduces its section 951(a)(1) inclusion with respect to a DFIC as a result of the allocation of a deficit is treated as PTI. Nevertheless, section 965(b)(4)(A) does not provide for a corresponding increase in basis under section 961(a).

If a U.S. shareholder's inclusion amount with respect to a DFIC is reduced by an E&P deficit allocated from another SFC, a distribution by such DFIC of all of its E&P may exceed the

[34] § 1368(d)(1); Treas. Reg. § 1.1368-1(e)(2).

[35] Treas. Reg. § 1.731-1(a)(1)(ii).

U.S. shareholder's section 965(a) inclusion amount, resulting in taxable gain to the U.S. shareholder. Such gain would not be subject to the gain-reduction rule.

Example 5.

(i) Facts. USP, a domestic corporation, owns all of the stock of CFC1 and all of the stock of CFC2, each with an inclusion year ending December 31, 2017. The functional currency of CFC1 and CFC2 is the U.S. dollar. As of December 31, 2016, CFC1 did not have any E&P described in section 959(c)(1) or (c)(2), and USP's adjusted basis in the stock of CFC1 was zero. As of each of the measurement dates, CFC1 has post-1986 E&P of $100. CFC2 is an E&P deficit foreign corporation with a specified E&P deficit of $50. On July 1, 2017, USP caused CFC1 to make a cash distribution of $100 to USP that USP anticipated would be treated as a dividend from CFC1's E&P described in section 959(c)(3).

(ii) Analysis. Although USP reasonably anticipated that the July 1 distribution by CFC1 would be treated as a dividend (and would allow USP to claim indirect foreign tax credits in accordance with section 902), the subsequent enactment of section 965 alters USP's tax treatment. Under section 965(a), CFC1's Subpart F income is increased by its deferred E&P of $100 for its 2017 tax year. USP's section 965(a) inclusion amount is $50, determined by reducing its section 951(a)(1) inclusion of $100 by the E&P deficit allocated to it in the amount of $50. Under section 965(b)(4), USP has a PTI account of $100 with respect to CFC 1.

The July 1, 2017 distribution by CFC1 is retroactively recharacterized as a distribution of $100 of PTI. Under the gain-reduction rule, the amount of gain recognized by USP with respect to its CFC1 stock under section 961(b)(2) will be reduced (but not below zero) by $50, USP's section 965(a) inclusion amount. Accordingly, USP is required to recognize $50 of taxable gain as a result of CFC1's distribution.

Example 6.

(i) Facts. The facts are the same as in Example 5 above, except that CFC1 did not make any distributions during 2017.

(ii) Analysis. As of January 1, 2018, CFC1 has $100 of PTI and $0 of E&P described in section 959(c)(3). USP's adjusted basis in its CFC1 stock is $50, because it was increased by the amount of USP's section 951(a)(1) inclusion with respect to CFC1. Distributions by CFC1 occurring after December 31, 2017 are not subject to the Notices' gain-reduction rule, since the gain-reduction rule only applies to distributions during a DFIC's inclusion year.

It may not be possible for USP to receive any future distributions from CFC1 without triggering unfavorable U.S. federal income tax consequences. Because CFC1 has $100 of PTI but USP has only $50 of basis in its CFC1 stock, and distributions made by a CFC during its taxable

year are generally treated as first made from PTI, the first $50 of distributions from CFC1 would result in USP recognizing gain under section 961(b)(2).

Significantly, this situation persists even if CFC1 has earnings following its inclusion year, the distribution of which would qualify for the 100% dividends-received deduction under section 245A. Because distributions by CFC1 will be treated as first made from PTI, the first $50 distributed by CFC1 will result in USP recognizing taxable income on a dollar-for-dollar basis. Effectively, post-2017 E&P will be "trapped" by the PTI.

Recommendation

We recommend that Treasury and the Service consider issuing guidance that would allow U.S. shareholders to repatriate Section 965 PTI in full without triggering taxable gain under section 961(b)(2), including by applying the gain-reduction rule to the full extent of a U.S. shareholder's section 951(a)(1) inclusion of deferred E&P (without reduction for any deficit allocated against the inclusion pursuant to section 965(b)). Because it is common for U.S. shareholders to own foreign corporations with substantial deficits in earnings and profits, we believe that a regime that creates PTI that is not matched by corresponding basis adjustments will impede the repatriation of deferred E&P as well as future earnings in many cases, and will also have unduly harsh—and what at the time may have been unforeseeable—consequences for taxpayers that received distributions in 2017 prior to the introduction of the new legislation.

On the other hand, adopting this approach could potentially be viewed as overly generous. Many aspects of section 965, including section 965(b), seem to be premised (at least in part) on the principle that U.S. shareholders that divided foreign operations among multiple corporations should be treated similarly to U.S. shareholders that consolidated their foreign operations in a single corporation (a "one-CFC" approach).

Returning to Example 5 and Example 6 above, if CFC 1 and CFC 2 had been combined into a single corporation, USP would have included the same net $50 of deferred E&P in income pursuant to section 951(a)(1), and would have adjusted its basis in the stock of its CFC by $50 under section 961(a) as a result of the inclusion. Thus, absent further transactions affecting its tax position, USP would not have sufficient basis in its CFC stock to receive a $100 distribution without triggering gain. On the other hand, a single CFC would only have had $50 of PTI, rather than the $100 of PTI that is created in CFC1 in the examples; consequently, unlike the examples, post-inclusion year foreign earnings would not be "trapped" behind $50 of excess PTI and could be repatriated tax-free with the benefit of section 245A.

One alternative for addressing these issues that we recommend Treasury and the Service consider would be providing rules that permit taxpayers to appropriately utilize basis in the stock of E&P deficit foreign corporations in order to offset section 961(b)(2) gain resulting from distributions of Section 965 PTI. For example, the gain-reduction rule could be expanded so that it also

operates to reduce section 961(b)(2) gain by the basis in the stock of an E&P deficit foreign corporation to the extent a deficit of such E&P deficit foreign corporation was allocated to reduce the taxpayer's section 951(a)(1) inclusion in respect of the relevant DFIC. This is consistent with a "one-CFC" approach; if CFC1 and CFC2 in Example 5 and Example 6 were a single CFC, then USP's basis in the combined entity would generally be equal to its aggregate basis in the stock of CFC1 and CFC2. In order to address the issue of "trapped" PTI illustrated in Example 6, if Treasury and the Service were to adopt such a rule, it should apply to DFICs' inclusion year as well as succeeding tax years in order to avoid the "trapped" E&P issue illustrated by Example 6.

C. Effective Date of Gain-Reduction Rule

The gain-reduction rule applies to a "U.S. shareholder that receives a distribution during the inclusion year," but the Notices state that the implementing regulations will be "effective beginning the first taxable year of a foreign corporation (and with respect to United States shareholders, the taxable years in which or with which such taxable years of the foreign corporation ends)" to which section 965 applies. Under this effective date provision, distributions made during December 2017 by a November 30 SFC to a December 31 U.S. shareholder would not be entitled to the gain-reduction rule, notwithstanding that the U.S. shareholder received the distribution during the SFC's inclusion year.

Recommendation

We recommend that guidance be issued clarifying that distributions made to a U.S. shareholder during the inclusion year are within the scope of the effective date provisions of the Notices and any regulations promulgated pursuant thereto.

VI. Need for Guidance Regarding Election Under Section 965(n)

A. Clarification of Section 965(n)(1)(A)

Section 965(n)(1) provides that if a United States shareholder of a DFIC makes an election for the taxable year described in section 965(a), then the section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)) shall not be taken into account (A) in determining the amount of the "net operating loss deduction under section 172 of such shareholder for such taxable year" or (B) in determining the amount of taxable income for such taxable year "which may be reduced by net operating loss carryovers or carrybacks to such taxable year under section 172."[36]

[36] We note that the references to "taxable year" in section 965(n)(1) are somewhat ambiguous. Section 965(n)(1) first refers to "the taxable year described in subsection (a)." The only reference to a taxable year

Clause (B) is clearly meant to permit a taxpayer to elect to exclude the section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)) in determining the amount of net operating loss carryovers and carrybacks from other taxable years to the inclusion year. However, the use of the term "net operating loss deduction" in clause (A) makes the intended effect and purpose of clause (A) unclear. Section 172(a) states that "for purposes of this subtitle" the term "net operating loss deduction" means the deduction allowed by section 172(a). Section 172(a) permits a deduction for the taxable year in an amount equal to the aggregate of (i) the net operating loss carryovers to such year, and (ii) the net operating loss carrybacks to such year. (By contrast, section 172(c) defines the term "net operating loss" for purposes of section 172 as the excess of the deductions allowed by chapter 1 over gross income, computed with the modifications specified in section 172(d).)

If the term "net operating loss deduction" as used in clause (A) means the amount of the deduction, in the inclusion year, equal to the aggregate net operating loss carryovers and carrybacks from other taxable years to the inclusion year, then clause (A) has exactly the same effect as clause (B), and thus is superfluous. There is absolutely no indication that Congress intended this result. Although there is nothing in the legislative history that explicitly describes the purpose of section 965(n),[37] we believe that the purpose of section 965(n) is to permit a taxpayer to elect to have taxable income in the inclusion year at least equal to its aggregate section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)), the tax on which could then be reduced by allowable foreign tax credits. In the absence of section 965(n), a taxpayer's aggregate section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)) might be reduced, in whole or in part, by either a current year net operating loss (computed without regard to section 965) or one or more net operating loss carryovers or carrybacks. Either would prevent the taxpayer from utilizing, in whole or in part, foreign tax credits which would otherwise be allowable in the absence of such net operating losses (which foreign tax credits, given the participation exemption deduction in section 245A and other changes made by the Act, might never be used in the future). In light of this purpose, it should make no difference whether the net operating loss at issue is a

in section 965(a) is to the "last taxable year of a [DFIC] which begins before January 1, 2018." The later references to "taxable year" in section 965(n)(1)(A) and (B), however, only make sense as references to the taxable year of the U.S. shareholder of such DFIC. Congress presumably meant to refer to the taxable year of the U.S. shareholder of such DFIC in which the U.S. shareholder has a section 965(a) inclusion amount with respect to which DFIC. We assume for purposes of this discussion that this is in fact how section 965(n) should be interpreted and applied, although clarification to that effect would be welcome.

[37] H.R. Rep. No. 115-466, at 486.

current year net operating loss (computed without regard to section 965) or a net operating loss carryforward or carryback.

Recommendation

We recommend that Treasury issue guidance that provides that, if a taxpayer makes the election under section 965(n)(1) with respect to a taxable year, the amount described in section 965(n)(2) shall not be taken into account in determining the amount of the net operating loss under section 172 of such shareholder for such taxable year.

B. Consolidated Groups

The consolidated return rules adopt the principles of section 172. A consolidated net operating loss ("CNOL") occurs when the aggregate of the members' deductions exceeds their income.[38] A CNOL can be carried back or carried forward, subject to limitations.

On its face, the election in section 965(n) does not seem applicable to consolidated groups because the CNOL is determined at the group level, and carried over at the group level, rather than by any particular member of the group has a section 951(a)(1) inclusion pursuant to section 965.

Recommendation

We recommend that Treasury and the Service issue guidance providing that a consolidated group is permitted to make an election under section 965(n), which election would exclude the impact of section 965 on the members of the consolidated group from the calculation of the CNOL and in determining the amount of consolidated taxable income which may be reduced by a CNOL carryover or carryback.

VII. Need for Guidance Regarding Treatment of Individuals Who Are Subject to the Transition Tax

Under section 965(c), a U.S. shareholder of a DFIC is allowed a deduction in the taxable year in which it is required to include amounts in gross income under section 951(a)(1) pursuant to section 965. The deduction is intended to result in a 15.5% rate of tax on deferred E&P that is attributable to the cash position, and an 8% rate of tax on all other earnings.[39] The amount of the deduction is the sum of the "15.5 percent rate equivalent percentage" of the inclusion amount that is attributable to the aggregate foreign cash position, plus the "8 percent rate equivalent percentage" of the portion of the inclusion amount (if any) that exceeds the aggregate foreign cash

[38] *See* Treas. Reg. § 1.1502-21(e).

[39] H.R. Rep. No. 115-466, at 491.

position. The "15.5 percent rate equivalent percentage" and the "8 percent rate equivalent percentage" are calculated based on the corporate tax rate.

Because the deduction is calculated in the same manner for individual taxpayers, it results in individuals being subject to the transition tax at higher effective tax rates, as illustrated by the following examples.[40]

Example 7. Tax Rate Imposed on Corporate Taxpayer's Deferred E&P Attributable to Cash

USP owns 100% of the stock of CFC 1. Both are calendar year taxpayers. CFC 1 is the only DFIC in which USP owns an interest. On December 31, 2017, USP has a section 951(a)(1) inclusion pursuant to section 965 of $100. CFC 1's cash position is $100 on each of the relevant measurement dates; accordingly, USP's aggregate foreign cash position is $100.[41]

Under section 965(c), USP is entitled to a deduction of $55.71 (*i.e.*, $100 x (35% - 15.5%) ÷ 35%). USP has a gross income inclusion of $100 and an offsetting deduction of $55.71, resulting in net income of $44.29. Imposing the 35% corporate tax rate on this amount results in a tax liability of $15.50—equivalent to taxing the full $100 of deferred E&P at a 15.5% rate. If CFC 1's inclusion year ended on November 30, 2018 instead of December 31, 2017, so that USP's inclusion is in 2018 when the corporate tax rate is 21%, then USP would be entitled to a deduction of $26.19 (*i.e.*, $100 x (21% - 15.5%) ÷ 21%), again resulting in an effective tax rate of 15.5%.

Example 8. Tax Rate Imposed on Individual Taxpayer's Deferred E&P Attributable to Cash

The facts are the same as in Example 7, above, except that individual A, a U.S. citizen, owns 100% of the stock of CFC 1. Assume that in 2017, A is subject to the highest marginal U.S. federal income tax rate applicable to individuals, 39.6%.

Pursuant to section 965(c), A is entitled to a deduction in the same amount as USP, *i.e.*, $55.71. Subjecting Individual A's net income of $44.29 (*i.e.*, $100 - $55.71) to income tax at the 39.6% rate results in a U.S. federal income tax liability of $17.54. Thus, A's effective U.S. federal income tax rate on A's inclusion of CFC 1's deferred E&P is 17.54%, rather than 15.5%.[42] The rate disparity is exacerbated if the inclusion year of CFC 1 ends on November 30, 2018, because the difference between the corporate and individual rates is even more pronounced in 2018. If

[40] Significantly, while the transition tax applies to individual U.S. shareholders and corporate U.S. shareholders alike, individuals are not entitled to the benefits of the Act's transition to a quasi-territorial system. *See* § 245A.

[41] In the interest of simplicity, Examples 7–9 ignore the potential availability of indirect foreign tax credits.

[42] Individual A may also be subject to the Medicare tax of 3.8% on this net income.

CFC 1 had a November 30 taxable year, A would be subject to an effective U.S. federal income tax rate of 27.31%, rather than 15.5%, on A's inclusion in 2018.

The Conference Committee recognized this anomaly. The Conference Report states:

> The use of rate equivalent percentages is intended to ensure that the rates of tax imposed on the deferred foreign income is similar for all U.S. shareholders, regardless of the year in which section 965 gives rise to an income inclusion. Individual U.S. shareholders, and the investors in U.S. shareholders that are pass-through entities generally can elect application of corporate rates for the year of inclusion.[43]

At the end of the passage cited above, the Conference Report includes a footnote which states: "Sec. 962 allows individuals to make the election for a specific taxable year, subject to regulations provided by the Secretary." It is not clear whether by the reference to section 962 Congress intended to incorporate only the corporate rate election of section 962(a) or all of section 962.

Generally, a section 962 election is available to individuals who are U.S. shareholders of foreign corporations and are required to include amounts in gross income under section 951(a). The election can be made each year.[44] An election pursuant to section 962 has a number of consequences. First, the electing individual's gross income inclusions under section 951(a) are subject to U.S. federal income tax at corporate rates.[45] In addition, the election allows the individual to benefit from the indirect foreign credit under section 960 (which is otherwise unavailable to non-corporate U.S. shareholders).

For purposes of applying section 962, the corporate tax rate applies (i) to all amounts required to be included in the individual's gross income under section 951(a) for the taxable year, plus (ii) all amounts which would be required to be included in his gross income under section 78 for such taxable year with respect to the amounts referred to in clause (i) if such shareholder were a domestic corporation.[46] For purposes of section 962, the amount that is subject to taxation at the

[43] H.R. Rep. No. 115-466, at 491.

[44] *See* Section 962(a).

[45] Section 962(a)(1).

[46] Treas. Reg. § 1.962-1(b).

corporate tax rate cannot be reduced by any deduction of the U.S. shareholder even if his deductions exceed his gross income.[47]

The applicability of the corporate tax rate and the availability of indirect foreign tax credits are generally favorable tax consequences for an individual that makes the election under section 962. A section 962 election also involves unfavorable consequences. Section 962(d) overrides the normal application of section 959, by providing that when earnings and profits attributable to amounts that were included in income and subject to a section 962 election are distributed, those earnings and profits are required to be included in gross income to the extent they exceed the amount of U.S. federal income tax paid on such earnings and profits.[48] Additionally, under section 961(a), the increase in CFC stock basis that a U.S. shareholder ordinarily receives in respect of a section 951(a)(1) inclusion is limited for an individual who makes a section 962 election to the amount of U.S. federal income taxes the individual pays with respect to the section 951(a)(1) inclusion. The general effect of section 962 is to put the individual taxpayer in roughly the same position with respect to Subpart F income subject to the election as if the individual owned its CFC stock indirectly through a U.S. corporation that has a section 951(a)(1) inclusion in respect of such stock.

Thus, a section 962 election has the potential to result in double taxation of earnings and profits. Moreover, contrary to the statement in the Conference Report, a section 962 election may not result in deferred E&P being subject to the same 15.5% and 8% tax rates that are imposed on actual corporate taxpayers. While a section 962 election may have seemed a simpler way to create parity between corporations and individuals, it was not designed for the provisions of section 965. The following example illustrates these issues.

Example 9. Consequences of Section 962 Election

The facts are the same as in Example 8 above, except that individual A elects the application of section 962 in 2017. In addition, CFC 1 distributes $100 to A on January 1, 2018.

In 2017, Individual A has a gross income inclusion of $100 under section 951(a)(1) pursuant to section 965, and is entitled to a deduction of $55.71 pursuant to section 965(c). Under one interpretation of section 962(a)(1), it seems A would be subject to the 35% corporate tax rate on the $100 inclusion, prior to any available deduction, and the application of section 962 would not alter the treatment of the deduction to which A is entitled pursuant to section 965(c). Accordingly, assuming that A is able to offset other taxable income with the $55.71 deduction, the tax benefit

[47] Treas. Reg. § 1.962-1(b).

[48] Treasury Regulation section 1.962-3 contains detailed ordering rules on the allocation of distributions from a CFC among the various earnings and profits accounts in cases where a U.S. shareholder has made a section 962 election.

of the deduction would be $22.06 (*i.e.*, 39.6% x $55.71). Netting this tax benefit against the $35 of tax liability imposed on A's income inclusion, A's effective tax rate on the $100 of deferred E&P of CFC 1 would be 12.94%, rather than the 15.5% rate that applies to corporate taxpayers.

This interpretation of section 962 is clearly inconsistent with the legislative history of section 965, which suggests that Congress intended for the same effective tax rates to apply to individuals and corporations. Section 962 was enacted as part of the original Subpart F regime, and was tailored for net income inclusions since that is how Subpart F operates. The interplay of section 962 with section 965 raises an interpretative question: because section 965 operates by requiring a U.S. shareholder to include an amount in gross income, but permits a deduction that partially offsets the gross income inclusion in order to reach the effective tax rate that was intended to apply by Congress, should section 962, alternatively, be interpreted as applying to A's <u>net</u> inclusion of $44.29 so that the cash tax liability of A is equivalent to the tax liability of a corporation?[49]

Turning to A's tax treatment in 2018, when Individual A receives a distribution of $100 of Section 965 PTI, A would be required to include a portion of the distribution in income, because, under section 962(d), the amount of Section 965 PTI would be excluded from gross income only to the extent of the amount of tax paid by A in respect of his inclusion in 2017. Thus, depending upon which of the two interpretations of section 962(a) set forth above is correct, either $65 (*i.e.*, $100 - $35) or $84.50 (*i.e.*, $100 - $15.50) of the distribution would be included in A's gross income. In any case, A's aggregate U.S. federal income tax liability in 2017 and 2018 combined would, as a result of the application of section 962, exceed what it would have been had A not elected under section 962 (*i.e.*, $17.54, as illustrated in Example 8 above).

Finally, we note that the election under section 962 is generally only available to U.S. shareholders.[50] The passage from the Conference Report excerpted above states: "Individual U.S. shareholders, *and the investors in U.S. shareholders that are pass-through entities* generally can elect application of corporate rates for the year of inclusion." (Emphasis added.) Unless the individual investors that own an interest in a DFIC indirectly through a pass-through entity that is a U.S. shareholder of the DFIC also qualify as U.S. shareholders of the DFIC, however, the election would seem to be unavailable to them.

[49] We note that a similar issue arises in the application of section 962 to individuals' inclusions of global intangible low-taxed income (GILTI) pursuant to section 951A. Although it appears from the language of section 962 and the Treasury Regulations thereunder that the deduction allowed under section 250 does not apply in determining the amount of income subject to taxation at the corporate rate, applying the deduction appears to be more consistent with the statutory scheme of putting the individual U.S. shareholder in the same position as if the individual owned the CFC shares indirectly through a U.S. corporation.

[50] *See* Section 962(a); Treas. Reg. § 1.962-2(a).

Example 10. Tax Rate Imposed on Investors in a Pass-Through Entity That is a U.S. Shareholder

The facts are the same as in Example 7, above, except that LLC 1, a Delaware limited liability company treated as a partnership for U.S. federal income tax purposes, owns 100% of the stock of CFC 1. LLC 1, in turn, is owned by a number of U.S. individuals, each of whom owns less than 10% of the interests in LLC 1.

Under the plain language of the statute, it is not clear that the individual members of LLC 1 are eligible to make an election under section 962 because none of them owns a large enough interest in LLC 1 to qualify as a U.S. shareholder of CFC 1. Like individual A in Example 8 above, the members of LLC 1 will be subject to an effective U.S. federal income tax rate of 17.54% on their respective distributive shares of CFC 1's deferred E&P.

Recommendation

We recommend that Treasury and the Service consider what relief can be provided for individuals under the authority granted under section 965(o) so that the taxes paid on the section 965(a) inclusion amount (after taking into account the participation exemption deduction under section 965(c)) are no greater than those of a corporation. We recognize that it may be difficult as a matter of statutory construction to apply section 962 solely to equalize rates on section 965(a) inclusions for individual and corporate taxpayers, as section 962 clearly contemplates providing an individual with an indirect foreign tax credit while providing for a second level of tax on distributions. We believe, however, that it may be possible to interpret the reference to section 962 in the legislative history as only referring to the rate election in section 962(a), which would be consistent with recognizing that section 965 is not an identical regime to Subpart F because it provides for both an income inclusion and a deduction. The desired result would be that individual taxpayers be entitled to treat the full amount of their section 951(a)(1) inclusions as PTI (notwithstanding section 962(d)), and to make adjustments to their basis in their stock in the relevant DFICs in an amount equal to the amount included in gross income under section 951(a)(1) (notwithstanding the special rule in section 961(a) that generally limits basis adjustments for U.S. shareholders that make section 962 elections). The guidance should also ensure that electing individuals are subject to the corporate tax rate on the net amount of their income inclusions in order to achieve parity with corporate taxpayers.

VIII. Need for Guidance Regarding Section 965(h)(1) Election to Pay Transition Tax Liability in Installments

A. Treating Taxpayers as Having Made Section 965(h)(1) Elections by Default

Under section 965(h)(1), a U.S. shareholder may elect to pay the net tax liability resulting from the application of section 965 in eight annual installments (the "Section 965(h)(1) Election").

Under the election, the payments for each of the first five years equal 8 percent of the net tax liability, the sixth installment equals 15 percent of the net tax liability, the seventh installment equals 20 percent of the net tax liability, and the eighth installment equals 25 percent of the net tax liability. The timely payment of installments does not incur an interest charge.

Section 965(h)(2) provides that if a Section 965(h)(1) Election is made, then the first installment is required to be paid by the due date (determined without regard to any extension of time for filing the return) for the tax return for the taxable year described in section 965(a) (*i.e.*, the inclusion year for an SFC), and each succeeding installment is required to be paid by the due date for the tax return for the taxable year following the taxable year with respect to which the preceding installment was made. Section 965(h)(5) states that the Section 965(h)(1) Election shall be made not later than the due date for the return of tax for the taxable year described in section 965(a) and shall be made in such manner as the Secretary shall provide.

Because the Section 965(h)(1) Election does not result in any interest charge, we believe most (if not all) eligible taxpayers will desire to make the election. For calendar year corporate taxpayers with income inclusions in 2017, the first installment payment pursuant to a Section 965(h)(1) Election will be due on March 15, 2018. As described above, gathering all of the information necessary to compute the transition tax liability represents a substantial administrative burden for taxpayers. Failure to pay any installment under section 965(h) on a timely basis may trigger an acceleration of the remaining payments.[51]

Recommendation

We recommend that future guidance provide that all eligible taxpayers will be treated as having made a Section 965(h)(1) Election in the absence of an affirmative election to the contrary. Taxpayers that choose not to pay their transition tax liability in installments could "elect out" of this treatment by attaching a statement to their tax returns for the years that includes the relevant section 951(a)(1) inclusions. This approach should also eliminate the administrative burden the Service is otherwise likely to face from taxpayers flooding it with requests for relief for failure to make the election in a timely manner.

B. Certain Transactions Should Be Treated as Qualifying for the Exception to the Acceleration Rule

Under section 965(h)(3), generally, in the event of certain transactions or occurrences, any remaining transition tax installment payments of a taxpayer that has made a Section 965(h)(1) Election are accelerated and no longer eligible to be made annually over the remainder of the eight year period (the "Acceleration Rule"). The triggers for the acceleration rule are: (1) an addition to

[51] *See* section 965(h)(3) discussed *infra*.

tax for failure to pay any installment required under section 965(h) on a timely basis; (2) a liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case); (3) a cessation of business by the taxpayer; or (4) any similar circumstance.

The acceleration rule does not apply, however, to the sale of substantially all of the assets of a taxpayer to a buyer if the buyer enters into an agreement with the Secretary under which such buyer is liable for the remaining installments as if such buyer were the taxpayer.[52]

Where the acceleration rule applies, the remaining installments are due on the date that the triggering event occurs (or in the case of a title 11 or similar case, the day before the petition is filed).

The transactions Congress included in the Acceleration Rule suggest that Congress was focused on situations where payment of the remaining installments becomes less certain, including as the result of a loss in the credit quality of the U.S. shareholder. By providing the exception for certain dispositions of substantially all of a U.S. shareholder's assets, Congress recognized that, in a situation where a transferee acquires such assets and agrees to "step into the shoes" of the U.S. taxpayer with respect to any remaining installment payments, it is inappropriate to apply the Acceleration Rule.

Against this backdrop, we believe that certain transactions that would otherwise trigger the Acceleration Rule should potentially be viewed as falling under the exception to the rule because there is a successor taxpayer (a "buyer") that is legally liable to make any remaining installment payments and acquires substantially all of the U.S. shareholder's assets.

The first such transaction is the liquidation of a U.S. shareholder that is a member of a consolidated group (other than the common parent).[53] A liquidation[54] generally triggers the Acceleration Rule under section 965(h)(3). Nevertheless, in the case of a liquidation of a member of a consolidated group (other than the common parent), other members of the consolidated group generally receive assets of the liquidating member comprising at least 80% of the net value of its aggregate assets. Pursuant to Treasury Regulation section 1.1502-6, the other members of the consolidated group also remain liable for the U.S. federal income tax liabilities of the liquidating member. The second category of transactions are section 381 transactions where the transferee

[52] Section 965(h)(3).

[53] The discussion focuses on liquidations of a U.S. shareholder. However, we believe that other intragroup transactions in which substantially all of the relevant U.S. shareholder's assets remain within the consolidated group (such as a merger of a U.S. shareholder into another member of the same consolidated group) should be similarly treated.

[54] We refer to actual liquidation of the legal entity, as well as deemed liquidations pursuant to an entity classification election under Treasury Regulation section 301.7701-3.

succeeds to the tax attributes of the transferor and in most cases assumes all of the liabilities of the transferor.

The third category of transactions with respect to which guidance is needed is the application of the Acceleration Rule to transfers of stock of a C corporation in connection with which an election under section 338(h)(10) or section 336(e) is made. Section 338(h)(10) elections are available in connection with certain sales of stock of a domestic C corporation, and section 336(e) elections are available in connection with certain sales and distributions of stock of a domestic C corporation. In the case of both elections, for U.S. federal income tax purposes, a hypothetical new corporation ("new target") is considered to purchase the assets of the existing corporation ("old target") in a taxable transaction, and old target is deemed to liquidate. Significantly, the same legal entity remains in existence following the transaction, and "new target" generally remains liable for the U.S. federal income tax liabilities of "old target."[55]

In considering the Acceleration Rule it should be noted that when the U.S. shareholder is a member of a consolidated group, it is not clear whether the tax liability created by section 965 is the liability of the member or the group as a whole.

Section 108(i)(5)(D) sets forth an acceleration rule that is similar in some respects to the Acceleration Rule in section 965(h)(3) (although section 108(i) addressed the deferral of income inclusions rather than payments of tax, and section 108(i)(5)(D) expressly dealt with partnerships and likely involved companies in some financial difficulties). Treasury Regulation section 1.108(i)-1 provides guidance under section 108(i)(5)(D) which may, in appropriate circumstances, serve as a model for guidance with respect to the Acceleration Rule.

Recommendation

We recommend that guidance be issued providing that certain transactions qualify for the exception to the acceleration rule whereby a successor to a U.S. shareholder that has not made all of its installment payments pursuant to a Section 965(h)(1) Election effectively steps into the shoes of the U.S. shareholder with respect to the remaining installment payments. In many of these circumstances, we do not believe it should be required for the successor to enter into an agreement with the Service to be liable for the predecessor U.S. shareholder's remaining installment payments.

In particular, we recommend that the guidance provide that the Acceleration Rule is not triggered by the liquidation of a U.S. shareholder that is a member of a consolidated group (other than the common parent). Instead, the other members should be responsible for making any remaining installment payments of the U.S. shareholder that liquidated on the same schedule.

[55] *See* Treas. Reg. § 1.338-1(b)(3)(i); Treas. Reg. § 1.336-2(f).

Similarly, Treasury and the Service should consider issuing guidance providing that the exception to the Acceleration Rule is available in transactions in which a person acquires substantially all of a U.S. shareholder's assets in connection with either a merger (whether or not it qualifies for tax-free treatment under section 368(a)) or any other asset reorganization described in section 368(a). In a merger, the transferee generally assumes the liabilities of the merged corporation by operation of law, so an express agreement on the part of such transferee to be liable for the remaining section 965(h) installment payments may be superfluous. On the other hand, in asset reorganizations where the U.S. shareholder actually liquidates (or merges into a disregarded entity of the acquiror), it may be appropriate to require that the person acquiring substantially all of the U.S. shareholder's assets enter into such an agreement with the Service.

Guidance should also be provided regarding transactions involving section 338(h)(10) elections or section 336(e) elections in respect of a U.S. shareholder that is a member of a consolidated group. Although these transactions are treated as asset sales for U.S. federal income tax purposes, it is not clear that it is appropriate to trigger the Acceleration Rule because under applicable law both the selling consolidated group and the target potentially continue to be liable for the tax. It is important to provide clarity on whether in such a case the liability remains with the consolidated group, the target, or both. We believe that it might be preferable to have the liability, contrary to the provisions of Treasury Regulation sections 1.338-1(b)(3)(i) and 1.336-2(f), remain with the selling group. Such a result is more consistent with the treatment of these transactions as asset sales. The selling consolidated group is also more aware of the scope of the liability and can continue to make the installment payments.

We note that Treasury Regulation section 1.108(i)-1(b)(2)(ii)(B)(2)(iii) provides for an additional acceleration event, the "net value acceleration rule." We do not believe that in light of the statutory language of section 965(h) it would be appropriate to add such a concept as an additional acceleration event in the context of Section 965(h)(1) Elections. Nevertheless, we believe that satisfying a similar financial requirement may be an appropriate condition to granting additional exceptions to the Acceleration Rule.

In any case, we believe the transactions discussed above do not implicate the concerns underlying the Acceleration Rule, because after the transaction another person (or persons) continues to be legally liable for the U.S. federal income tax liability of the U.S. shareholder and has acquired the assets of the U.S. shareholder, just as a buyer that enters into an agreement with the Service as contemplated by section 965(h)(3) would.

In addition, we recommend that Treasury and the Service issue guidance providing that for purposes of the exception to the triggering rule in section 965(h)(3), an appropriate statement (or form) signed by the buyer and furnished to the Service should ordinarily be treated as an "agreement" with the Service. Because a triggering event generally causes unpaid transition tax installments to become due immediately, a simple and expedient procedure is necessary.

C. Partners in Partnerships Should Be Eligible to Make Section 965(h)(1) Elections

Section 965 does not address the treatment of partnerships with respect to amounts required to be included in gross income under section 951(a)(1) pursuant to section 965, nor with respect to the election to pay the tax in installments. Section 965 references a "U.S. shareholder" as the person that is required to include the deferred foreign earnings in income and then states that the United States shareholder may elect to pay the tax liability in installments. A partnership is a U.S. shareholder but it is not the actual taxpayer.

In the case of a partnership this presents a number of issues. For example, a Delaware partnership may have an interest in a specified foreign corporation that, as a result of the ownership by the partnership, is a CFC. The partners in the partnership are the taxpayers who must include their pro rata share of the deferred E&P in income. Nevertheless, the U.S. shareholder is the partnership. Thus, there is an unresolved issue of whether the election to pay the tax liability in installments is made by the partner, the partnership, or not at all because the U.S. shareholder is not the party directly liable for the tax. There is nothing in the statute or the legislative history indicating that a taxpayer that has an inclusion amount under section 965 should be disadvantaged because the inclusion flows from its interest in a partnership rather than from direct ownership. Accordingly, the installment election should be made available, directly or indirectly, to a partner in a partnership that is the U.S. shareholder. The next question is whether the election should be made by the partnership or the partner.

Recommendation

The rationale for providing that the partner can make the election with respect to its allocable portion of the inclusion is that the partner is the taxpayer. It is more appropriate for a partner to make the "with and without" calculations because that calculation is supposed to be made by the taxpayer, which the partnership is not. Consideration must also be given to the new partnership audit procedures that ordinarily make adjustments at the partnership level. In this case because the adjustment affects the liability of the person who was a partner at the close of the inclusion year, any increased tax should only be borne by the person who was the partner at the close of the inclusion year; requiring such adjustment to be paid by a person who was not a partner in the inclusion year is inconsistent with the section 965 concept of adjusting the subsequent installments that are to be paid by the taxpayer at the end of the inclusion year. The original taxpayer, and not the partnership or someone who was not a partner during the inclusion year (including a subsequent purchaser of an interest in the partnership), is the appropriate party to comply with adjustments to the installments provided in section 965(h)(4). If the partner is the proper party to make the installment election, consideration must be given to what are the appropriate acceleration events. The major question in this context is whether, in addition to the acceleration events set forth in section 965(h)(3), the sale or disposition of the partnership interest that gives rise to the inclusion

should be an acceleration event. We note that the disposition of the shares of the SFC is not otherwise an acceleration event. As noted above, the acceleration events relate to events that could call into question whether the deferred tax liability would be paid and not an issue of the taxpayer's liquidity. Accordingly, we believe that the acceleration events should be limited to the events enumerated in section 965(h)(3). We note, however, that the sale of a partnership interest is an acceleration event for purposes of section 108(i).

IX. Treatment of Section 965(a) Inclusions by Regulated Investment Companies

Sections 965 expressly deals with the treatment of section 965(a) inclusions by real estate investment trusts but does not address the treatment of regulated investment companies ("RICs"). RICs are subject to similar tests regarding the nature of their income and assets. A section 965(a) inclusion is a specialized item of income which is unlikely to be treated as a dividend. Thus, it is not certain that it would be treated as a dividend or "other income" for purposes of section 851(b)(2)(A). Treasury and the Service have taken the position in Proposed Treasury Regulation section 1.851-2(b)(2)(i) that amounts included in income under section 951(a)(1)(A)(i) are not treated as a dividend or "other income" for purposes of section 851(b)(1)(A) unless the earnings attributed to such amounts are distributed.[56] A RIC may be subject to section 965 with respect to DFICs that it does not control so that it cannot force the payment of a distribution.[57] Thus, it may have a section 965(a) inclusion without receiving any distribution in respect of such income.

Recommendation

Regardless of Treasury's and the Service's position in the proposed regulation, we recommend that Treasury and the Service make clear that section 951(a)(1) inclusion pursuant to section 965 is a dividend or other income with respect to its investment business within the meaning of section 851(b)(2)(A).

X. Application of Section 958(b)(4) Repeal in Accordance with Congressional Intent

The Act amended the stock ownership attribution rules of section 958(b) so that the stock of a foreign corporation owned by a foreign person is attributed "downward" from a foreign parent to a 50% owned U.S. corporate subsidiary (determined based on value) or to a partnership in which

[56] We have previously recommended in NYSBA Tax Section Report 1359 that section 951(a)(1)(A) inclusions be treated as "other income" under section 851(b)(2)(A).

[57] Note that in the case of a foreign company that is not a CFC, a RIC may hold a more than 10% voting interest without being required to include amounts in its income under section 951.

the foreign corporation owns equity. The effect of this amendment is to turn many foreign companies that were not previously CFCs into CFCs. According to the Conference Report, the amendment was intended to render ineffective "de-control" transactions, in which the foreign parent corporation of a U.S. shareholder of a CFC causes the foreign corporation to lose its CFC status by acquiring more than 50% of the foreign corporation's stock in exchange for the contribution of cash or property.[58] The repeal of section 958(b)(4) applies retroactively to "the last taxable year of foreign corporations beginning before Jan. 1, 2018, and each subsequent taxable year of such foreign corporations," and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.[59] In effect, the amendment is retroactively effective to the first day of the last taxable year that begins before January 1, 2018 (*e.g.*, January 1, 2017 for calendar year foreign corporations and November 30, 2017 for November 30 foreign corporations). As a result, the amendments to section 958(b) will cause additional foreign corporations to be considered SFCs for purposes of section 965.

Section 958(b) was apparently intended to have a more narrow scope than the statutory language suggests. According to the Senate Finance Committee explanation of the Senate bill, it was the intent of Congress that downward attribution should not apply to cause a foreign corporation to be treated as a CFC with respect to a U.S. shareholder that is not related to the U.S. person to whom ownership of the foreign corporation's stock was attributed within the meaning of section 954(d)(3).[60] The Conference Report further confirms that it was the intent of the conferees that the Senate interpretation apply.[61] According to a discussion on the Senate floor that is part of the Congressional Record, a technical amendment was proposed to codify this explanation, but was rejected as unnecessary to reflect the intent of the Senate Finance Committee or the conferees and that "the Treasury Department and Internal Revenue Service should interpret the stock attribution rules consistent with this explanation of the bill."[62]

Example 11.

FC, a foreign corporation that is not a CFC, is the 100% owner of US1, a U.S. corporation. FC also owns 50% of the stock of FC2, a foreign corporation that, prior to the repeal of section 958(b)(4), was not a CFC. US2 is a U.S. corporation that is unrelated to FC and US1. US2 owns 10% of the stock of FC2.

[58] H.R. Rep. No. 115-466, at 508.

[59] *Id.*

[60] S. Prt. 115-20, at 378.

[61] H.R. Rep. No. 115-466, at 508.

[62] 207 Cong. Rec. S8110 (daily ed. Dec. 19, 2017) (statement of Sen. Purdue).

Read literally, the amendment to section 958(b) appears to cause FC2 to become a CFC with respect to US2. FC's 50% ownership of the stock of FC2 would be attributed downwards to US1, causing FC2 to become treated as if more than 50% of its stock was owned by U.S. shareholders. However, according to the Congressional Record, it was Congress' intent that FC2 should not be treated as a CFC with respect to US2 because US2 is not related to US1 within the meaning of section 954(d)(3).

Recommendation

The Senate's and Conference Committee's instructions to Treasury and the Service regarding the proper interpretation of amended section 958(b) raises questions as to the role of legislative history when interpreting a statute. Furthermore, it is not clear to us whether the specific grant of regulatory authority in section 965(o) would provide Treasury and the Service with the authority to interpret section 958(b) consistent with the legislative history. We note that narrowing the number of taxpayers subject to section 965 as a result of this retroactive amendment to section 958(b) is desirable given the compliance issues described in this Report. We encourage Treasury and the Service to consider this further, particularly with respect to section 965. We recommend adding clarifying language on this point to any technical corrections bill that is considered by Congress.

Report No. 1393

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTION 163(j)

March 28, 2018

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REPORT OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION ON AMENDMENTS TO SECTION 163(j)

This report ("**Report**") of the New York State Bar Association Tax Section comments on Section 163(j)[1] as amended by "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 (the "**Act**")[2].

We thank the Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") for considering our comments on Section 163(j). In this Report, we recommend that Treasury and the IRS issue guidance to address some uncertainties surrounding the application of the statute.

This Report is divided into four parts. Part I summarizes our recommendations for future guidance. Part II describes Section 163(j) as in effect before and after the Act. Part III provides a detailed discussion of our recommendations. Part IV sets forth some additional issues that we have identified, but regarding which we have not yet developed a formal recommendation.

I. Summary of Recommendations

We recommend that Treasury and the IRS issue guidance providing for the following:

A. General Recommendations

1. It should be confirmed that "interest" for purposes of Section 163(j) includes any item of income or expense that is treated as interest under the Code. In addition, it should be considered whether administrative guidance (or a statutory amendment) should provide that items economically equivalent to interest will be treated as such for purposes of Section 163(j). Particularly if the government seeks to address this issue through administrative guidance, we recommend that the guidance apply only to a limited set of specifically identified types of transactions (in all of which one party secures the use of funds for a period of time and makes payments that are determined solely or almost solely by reference to the time value of money). Such guidance also should take a symmetrical approach for

[1] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the "**Code**") and the Treasury Regulations promulgated thereunder.

[2] The principal drafters of this report are John T. Lutz and Philip Wagman with contributions from William Alexander, Daniel Z. Altman, Kimberly S. Blanchard, Peter H. Blessing, Andrew H. Braiterman, James R. Brown, Robert Cassanos, Peter Connors, Daniel M. Dunn, Timothy J. Devetski, Lucy W. Farr, Phillip J. Gall, Marcy G. Geller, Kevin Glenn, Edward E. Gonzalez, David Hardy, Andrew M. Herman, Monte A. Jackel, Robert Kantowitz, Shane J. Kiggen, Stephen B. Land, John P. MacMaster, Jeffrey Maddrey, Michael T. Mollerus, Richard M. Nugent, Deborah L. Paul, James M. Peaslee, Elliot Pisem, Michael L. Schler, David Schnabel, Peter F. G. Schuur, Michael B. Shulman, David R. Sicular, Eric B. Sloan, Andrew P. Solomon, Karen G. Sowell, Shun Tosaka, Adina T. Wagman, Gordon E. Warnke and Sara B. Zablotney. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

purposes of identifying income and expenses equivalent to interest under Section 163(j).

2. All interest income of a corporation (other than interest income attributable to a business exempt from Section 163(j)) should be treated as "business interest income" under Section 163(j)(5), and all interest expense of a corporation (other than interest expense attributable to an exempt business) should be treated as "business interest" under Section 163(j)(6). In the case of a noncorporate taxpayer, all interest income other than investment income as defined in Section 163(d) (and interest income attributable to an exempt business) should be treated as "business interest income," and all interest expense other than investment interest under Section 163(d) and personal interest under Section 163(h) (and interest expense attributable to an exempt business) should be treated as "business interest."

3. "Adjusted taxable income" of a corporation should include all items of income and expense that are included in its taxable income, other than those specifically excluded by Section 163(j)(8)(A)(ii), (iii) and (v) (i.e., business interest income, business interest, the net operating loss deduction and, beginning in 2022, deductions for depreciation and amortization) or that are attributable to exempt businesses. In the case of a non-corporate taxpayer, adjusted taxable income should include (a) all of the taxpayer's non-interest income, other than items that are investment income under Section 163(d), are attributable to exempt businesses or (for a taxpayer that is not a business entity) are clearly personal in nature (such as interest income imputed under Section 7872 on a gift loan), and (b) all of the taxpayer's non-interest deductible expenses, other than investment expenses under Section 163(d), expenses attributable to exempt businesses and (for a taxpayer that is not a business entity) specifically enumerated non-business deductions.

4. A framework should be provided for a corporation to allocate interest expense between businesses it conducts that are exempt from Section 163(j), and businesses that are not exempt. Allocation methods based on the relative assets, or the relative income, of these businesses should be considered. If an asset-based or income-based allocation method is adopted, then the government should consider also providing some exceptions from that allocation method, in order to address limited, specific cases where a particular indebtedness is clearly tied to a particular business: for example, where particular debt is taken into account by a regulatory authority that has oversight over a specific business; or where nonrecourse debt is used to finance the acquisition or construction of property that is used in a particular business.

5. Individuals should allocate interest expense between exempt and non-exempt businesses using tracing principles that are consistent with Treasury Regulation Section 1.163-8T.

6. Tracing principles also should generally apply to partnerships, for purposes of allocating a partnership's interest expense between exempt and non-exempt businesses. However, in the case of a partnership whose partners are solely or mainly corporations, it should be considered whether an allocation method should be used which corresponds to the method required for businesses that are directly owned by a corporation.

7. Section 163(j) should be applied to interest expense for which a deduction otherwise would be allowed to the taxpayer in a given year, after having taken into account all the other statutory and regulatory rules that would disallow or defer such deductions.

8. If a loss is allowed under Sections 465 and 469 which consists in part of interest expense, and a deduction for part or all of that interest expense is then disallowed for the year under Section 163(j), then Sections 465 and 469 should be re-applied after Section 163(j), so that the taxpayer is allowed to deduct additional amounts of other items and claim the full amount of loss permitted under Sections 465 and 469.

9. Interest expense that was disallowed under Section 163(j) as in effect before the Act should be carried forward and treated as interest paid or accrued by the taxpayer in the first year new Section 163(j) is effective. However, a corporation that had a carryforward of excess limitation under old Section 163(j) should lose that limitation carryforward, under the new statute.

10. It should be confirmed how the rules for computing a corporation's "adjusted taxable income" under Section 163(j) interact with Section 246(b) and Section 250(a)(2) (both of which limit specific deductions of a corporation by using formulas that are based on the amount of the corporation's taxable income).

B. **Corporate Recommendations**

1. Interest expense disallowed by reason of Section 163(j) should reduce a corporation’s earnings and profits in the year that the interest expense was paid or accrued in accordance with the corporation’s method of accounting.

2. All members of the same consolidated group should be treated as a single taxpayer for Section 163(j) purposes.

3. There should be rules that deal with disallowed business interest expense carryforwards of a corporation that joins a consolidated group, as well as apportionment of a consolidated group's disallowed business interest carryforwards to a corporation that leaves a consolidated group. These rules should generally be similar to the rules that deal with similar issues in the case of net operating loss carryforwards. However, some special rules may be appropriate, in order to deal with issues that could arise when a member

that has operations that generate applicable taxable income but little or no debt (or vice versa) leaves a group.

4. Section 163(j) should not be applied on a group basis to a Section 1504(a) affiliated group that does not file a consolidated return, or to an expanded affiliated group of the type described in the proposed regulations under old Section 163(j). In addition, a partnership among members of a consolidated group should not be treated as a single taxpayer together with the members of the consolidated group, for purposes of applying Section 163(j).

C. **Partnership Recommendations**

1. The character of a partnership's interest income and expense as business interest income and business interest expense should be determined at partnership level.

2. A partnership generally should use tracing principles to divide its interest expense between investment interest and business interest expense (and, as noted in A.6 above, between exempt and non-exempt businesses). Such allocation should not be dependent on whether the partnership distributes the borrowed funds to its partners. As indicated in A.6 above, in the case of a partnership whose partners are solely or mainly corporations, it should be considered whether an allocation method should be used that corresponds to the method required for businesses that are directly owned by a corporation.

3. A partnership's deductible business interest expense that is taken into account in the partnership's non-separately stated income for purposes of Section 163(j) should retain its character as interest for all other purposes of the Code.

4. To the extent that a partnership's business interest income is taken into account in determining the amount of interest expense allowable under Section 163(j) at the partnership level, such business interest income should be included in the partnership's non-separately stated income for Section 163(j) purposes, so that a partner cannot utilize such business interest income to support an additional interest expense deduction at the partner level.

5. It should be clarified that if a partner has excess business interest expense carryforwards, and the partner is allocated a share of the partnership's "excess taxable income" for a subsequent year, then the partner can only deduct carried forward interest equal to at most 30% (not 100%) of the allocable excess taxable income.

6. A partner should be permitted to utilize its excess business interest expense carryforwards against such partner's share of the partnership's business

interest income (net of such partnership's business interest expense) for a subsequent taxable year.

7. If a partnership has interest expense characterized at the partnership level as investment interest, a corporate partner should treat its share of that interest expense as business interest expense that is subject to Section 163(j) at the partner level; and a non-corporate partner should treat its share of the interest expense as subject to Section 163(d).

8. The statutory exemptions of certain businesses from Section 163(j), including the electing real property trade or business exemption, the electing farming business exemption, the utilities business exemption and small business exemption, should be determined at the partnership level. Elections for the first two of these exemptions should be made at the partnership level.

9. If a partner incurs interest expense at the partner level that is allocable, under the allocation principles described above in A.4 and A.5, to the partner's interest in a partnership that conducts an exempt trade or business, then such interest expense should be exempt from Section 163(j).

10. It should be clarified how Section 163(j) applies in the case of a partnership that has special allocations, as well as how Section 743 adjustments and Section 704(c) allocations impact the application of Section 163(j) to partnerships and partners.

D. **International Recommendations**

1. Guidance should confirm whether Section 163(j) applies to business interest expense of controlled foreign corporations and passive foreign investment companies, and, if it does, the manner in which it applies. If Section 163(j) applies to CFCs then, when calculating the Section 163(j) limit in connection with determining the amount of a CFC's Subpart F income, the CFC's adjusted taxable income and business interest income should be computed taking into account only items that are Subpart F income, and its business interest expense should be computed taking into account only interest expense which is allocable to Subpart F income.

2. In the case of a foreign corporation that has a U.S. trade or business, Section 163(j) should be applied in order to compute the corporation's liability for corporate net income and branch profits taxes by taking into account only adjusted taxable income and business interest income that are included in the corporation's effectively connected income, and business interest expense that is allocated to effectively connected income pursuant to the regulations under Sections 882 and 884.

II. Overview of Section 163(j)

A. Section 163(j) Prior to the Act

In general terms, prior to the Act, Section 163(j) limited the deductibility of interest paid or accrued by a corporate taxpayer[3] to a related person[4] where such interest was exempt (in whole or in part) from U.S. tax.[5] Old Section 163(j) did not apply unless the corporation's debt to equity ratio exceeded 1.5 to 1.[6] Assuming a corporate taxpayer's debt-to-equity ratio exceeded 1.5:1 as of the end of such corporate taxpayer's taxable year, old Section 163(j) denied an interest deduction for amounts paid or accrued to a related tax-exempt (generally, foreign) person [7] to the extent that the corporation's net interest expense[8] exceeded 50% of its adjusted taxable income (i.e., taxable income computed without regard to deductions for net interest expense, net operating losses, net interest expense, domestic production activities under Section 199, depreciation, amortization and depletion).[9] Net interest expense in excess of 50% of the corporation's adjusted taxable income was defined as "excess interest expense."[10] Any interest deduction disallowed under Section 163(j) was treated as interest paid or accrued in the succeeding taxable year. [11]

Under old Section 163(j), all members of the same affiliated group (within the meaning of Section 1504(a)) were treated as a single taxpayer.[12] Pursuant to proposed regulations issued under old Section 163(j), all members of an affiliated group are treated as one taxpayer for Section 163(j) purposes without regard to whether the affiliated group files a consolidated return. [13]

Old Section 163(j) was applied at the partner level. A corporate partner's distributive share of interest income paid or accrued to the partnership was treated as interest income paid or accrued

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[3] Prior to the Act, Section 163(j) applied to domestic "C" corporations and foreign corporations with income, gain or loss that was effectively connected to a U.S. trade or business, but did not apply to 'S' corporations. Proposed Regulation Section 1.163(j)-1(a)(1).

[4] For convenience, we sometimes refer to "**old Section 163(j)**" rather than Section 163(j) prior to the Act. Old Section 163(j) also applied to interest paid or accrued to an unrelated person if the debt was guaranteed by a related person and certain additional requirements were met. See old Section 163(j)(3)(B).

[5] Exempt related party interest referred to interest expense that was exempt in whole or in part from U.S. tax in the hands of the recipient, taking into account treaty benefits.

[6] Section 163(j)(2)(A)(ii) prior to the Act.

[7] Theoretically, old Section 163(j) could apply to interest paid by a taxable subsidiary to a tax-exempt parent corporation, although amendments to Section 512(b)(13) effectively limited the application of old Section 163(j) to interest paid or accrued to foreign persons.

[8] Net interest expense is the amount by which all interest paid or accrued during the taxable year exceeds the amount of interest includible by the taxpayer in gross income for taxable such year. Proposed Regulation Section 1.163(j)-2(d).

[9] Section 163(j)(1)(A), (2)(B)(i) prior to the Act.

[10] Section 163(j)(2)(B)(i) prior to the Act.

[11] Section 163(j)(1)(B) prior to the Act.

[12] Section 163(j)(6)(C) prior to the Act.

[13] Proposed Regulation Section 1.163(j)-5(a)(2). In addition, the proposed regulations would have expanded the definition of affiliated group beyond that provided in Section 1504(a).

to a corporate partner; a corporate partner's distributive share of interest paid or accrued by the partnership was treated as interest paid or accrued by a corporate partner; and a corporate partner's share of the partnership's liabilities was treated as liabilities of a corporate partner.[14]

B. Section 163(j) as amended by the Act

1. General

The Act amended Section 163(j) in several material ways. Section 163(j), as amended, applies to both corporate and noncorporate taxpayers. The debt-to-equity ratio test was removed, and Section 163(j) now applies at the partnership level rather than the partner level. Finally, new exceptions were added for electing real property businesses, electing farming businesses, utilities, certain small businesses and floor plan financing interest. The statutory provisions are described in greater detail below.

Section 163(j) provides, in pertinent part, that a taxpayer cannot deduct business interest expense for a taxable year to the extent that such interest exceeds the sum of (a) the business interest income of such taxpayer for such taxable year, and (b) 30 percent of the taxpayer's adjusted taxable income for such taxable year.[15] The statute defines "business interest expense," "business interest income," and "adjusted taxable income."

For Section 163(j) purposes, "business interest expense" means any interest paid or accrued on indebtedness properly allocable to a trade or business. It does not include investment interest (within the meaning of Section 163(d)).[16] (In this Report, we refer to business interest expense as "business interest expense," for ease of distinguishing it from "business interest income.")

The term "business interest income," for Section 163(j) purposes, means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. The term does not include investment income (within the meaning of Section 163(d)).[17]

Accordingly, the application of Section 163(j) turns on whether interest is properly allocable to a trade or business. The term "trade or business" is not defined affirmatively in Section 163(j) but the statute expressly excludes (i) the trade or business of performing services as an employee, (ii) any electing real property trade or business, (iii) any electing farming business, or (iv) the trade or business of the furnishing or sale of (a) electrical energy, water, or sewage disposal services, (b) gas or steam through a local distribution system, or (c) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or

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[14] Section 163(j)(8) prior to the Act.

[15] Section 163(j)(1). Although "floor plan financing interest" technically falls within the definition of business interest expense, such interest nevertheless is not subject to limitation under Section 163(j). Section 163(j)(1)(C).

[16] Section 163(j)(5). In very general terms, Section 163(d)(3) defines "investment interest" as interest paid or accrued on indebtedness properly allocable to property held for investment other than "qualified residence interest" under Section 163(h)(3) or interest which is taken into account under Section 469 in computing gain or loss from a passive activity of a taxpayer.

[17] Section 163(j)(6).

approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.[18]

The term "adjusted taxable income" ("**ATI**") means the taxable income of the taxpayer computed without regard to (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (ii) any business interest expense or business interest income, (iii) the amount of any net operating loss deduction under Section 172, (iv) the amount of any deduction allowed under Section 199A, and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.[19]

Any business interest expense not allowed as a deduction for any taxable year is treated as business interest expense paid or accrued in the succeeding taxable year.[20]

2. **Partnerships**

In the case of any partnership,[21] (a) Section 163(j) is applied at the partnership level and any deduction for business interest expense is be taken into account in determining the non-separately stated taxable income or loss of the partnership, and (b) the adjusted taxable income of each partner of such partnership, (i) is determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership, and (ii) is increased by such partner's distributive share of such partnership's excess taxable income.[22] For this purpose, a partner's distributive share of partnership excess taxable income shall be determined in the same manner as the partner's distributive share of non-separately stated taxable income or loss of the partnership.[23]

The amount of any business interest expense not allowed as a deduction to a partnership for any taxable year is not treated as business interest expense paid or accrued by the partnership in the succeeding taxable year, but, subject to the rules in the next paragraph, is treated as excess business interest expense which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.[24]

If a partner is allocated any excess business interest expense from a partnership for any taxable year (a) such excess business interest expense is treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income (defined below) from such partnership, but only to the extent of such excess taxable income, and (b) any portion of such excess business interest expense remaining after

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[18] Section 163(j)(7)(A).

[19] The Treasury is granted the authority to make other adjustments to ATI.

[20] Section 163(j)(2).

[21] Rules similar to the special Section 163(j) partnership rules also apply to any 'S' corporation and its shareholders. See Section 163(j)(4)(D).

[22] Section 163(j)(4)(A).

[23] Id.

[24] Section 163(j)(4)(B)(i).

applying the excess taxable income limitation, is treated as business interest expense paid or accrued in succeeding taxable years.[25] In addition, once all such excess business interest expense for all preceding taxable years has been treated as paid or accrued by a partner as a result of allocations of excess taxable income to the partner a partner by the partnership for any taxable year, any remaining excess taxable income that has been allocated to the partner will be taken into account when computing the partner's own Section 163(j) limitation with respect to any business interest expense the partner has incurred at the partner level.

The term "excess taxable income" ("**ETI**") means, with respect to any partnership, the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of (a) 30% of the adjusted taxable income of the partnership for the taxable year, over (b) the amount (if any) by which the business interest expense of the partnership exceeds the business interest income of the partnership, bears to 30% of the partnership's adjusted taxable income for the taxable year.[26]

The adjusted basis of a partner in a partnership interest is reduced (but not below zero) by the amount of excess business interest expense allocated to the partner.[27] If a partner disposes of a partnership interest, the adjusted basis of the partner in the partnership interest is increased immediately before the disposition by the amount of the excess (if any) of the amount of such basis reduction over the portion of any excess business interest expense allocated to the partner which has previously been treated as business interest expense paid or accrued by the partner. This provision also applies to transfers of a partnership interest (including by reason of death) in a transaction in which gain is not recognized in whole or in part. No deduction is allowed to the transferor or transferee for any excess business interest expense resulting in a basis increase.[28]

3. Exceptions to Section 163(j)

Section 163(j) does not apply to certain activities and certain small businesses. Each of these exceptions will be described below.

a. Electing Real Property Businesses

Section 163(j) does not apply to an "electing real property trade or business" because that phrase is carved out of the Section 163(j) definition of trade or business. The term 'electing real property trade or business' means any trade or business which is described in Section 469(c)(7)(C) that elects to be excluded from Section 163(j). Section 469(c)(7)(C) defines "real property trade or business" as "any real property development redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."

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[25] Section 163(j)(4)(B)(ii).

[26] Section 163(j)(4)(C).

[27] Section 163(j)(4)(B)(iii)(I).

[28] Section 163(j)(4)(B)(iii)(II).

The statute grants authority to Treasury to determine the time and manner of the election. Once made, the election is irrevocable.[29]

b. **Electing Farming Businesses**

Similarly, Section 163(j) does not apply to an electing farm business because that term is excluded from the Section 163(j) definition of trade or business. The term "electing farming business" means a farming business (as defined in Section 263A(e)(4)) or any trade or business of a specified agricultural or horticultural cooperative (as defined in Section 199A(g)(2)) that elect to be excluded from Section 163(j).[30] The statute grants authority to the Treasury to determine the time and manner of the election. Once made, the election is irrevocable.[31]

c. **Small Business Exception**

There is an exemption for certain small businesses. In the case of any taxpayer[32] which meets the gross receipts test of Section 448(c) for any taxable year, Section 163(j) does not apply to such taxpayer for such taxable year. In general, a corporation or partnership meets the gross receipts test of Section 448(c) for any taxable year if the average annual gross receipts of such entity for the 3 taxable year period ending with the immediately prior taxable year does not exceed $25 million.[33] In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of Section 448(c) shall be applied in the same manner as if such taxpayer were a corporation or partnership.[34]

d. **Employees**

The trade or business of performing services as an employee is not treated as a trade or business for purposes of the Section 163(j) limitation.[35] As a result, the wages of an employee are not counted in the ATI of the taxpayer for purposes of determining the interest expense limitation.[36]

e. **Utilities Exception**

The trade or business of the furnishing or sale of (a) electrical energy, water, or sewage disposal services, (b) gas or steam through a local distribution system, or (c) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been

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[29] Section 163(j)(7)(B).

[30] Section 163(j)(7)(C).

[31] Section 163(j)(7)(C).

[32] Other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under Section 448(a)(3). Section 163(j)(3).

[33] All persons treated as a single employer under Section 52(a) or (b) or Section 414(m) or (o) are treated as one person for purposes of the $25 million gross receipts test. Section 448(c)(2).

[34] Section 163(j)(3).

[35] Section 163(j)(7)(A)(i).

[36] Section 163(j)(7)(A)(i).

established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative (a "**utilities business**") is not a trade or business for purposes of Section 163(j). [37]

f. **Floor Plan Financing Interest**

Interest paid or accrued on "floor plan financing indebtedness" is not subject to limitation under Section 163(j).[38] The term "floor plan financing interest" means indebtedness used to finance the acquisition of motor vehicles[39] held for sale or lease, and secured by the inventory so acquired.[40]

4. **Effective Date**

The amendments to Section 163(j) apply to taxable years beginning after December 31, 2017.

5. **Conforming Amendments**

The Act amended Section 381(c) to include the carryover of disallowed business interest expense to taxable years ending after the date of distribution and transfer. Section 382(d) was amended to include disallowed interest expense within the definition of "pre-change loss."[41]

III. Discussion

A. Interest

Section 163(j) contains no special rules defining interest. The Conference Report, however, states that "any amount treated as interest for purposes of the Code is treated as interest for purposes of Section 163(j)." The Conference Report appears to indicate a Congressional decision to apply Section 163(j) more narrowly than old Section 163(j). Old Section 163(j), for example, took a more expansive view of interest by including substitute payments made under a

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[37] Section 163(j)(7)(A).

[38] Section 163(j)(1)(C) and (j)(9). Section 163(j)(1). The Conference report to the Act states "by including business interest income and floor plan financing interest in the limitation, the rule operates to allow floor plan financing interest to be fully deductible and to limit the deduction for net interest expense (less floor plan financing interest) to 30% of adjusted taxable income." H.R. Rep. 115-466, at 387.

In this Report, references to business interest expense are to interest that qualifies as such under Section 163(j)(5) and is not floor plan financing interest; and in all examples, the interest expense is not floor plan financing interest.

[39] The term "motor vehicle" means any (a) self-propelled vehicle designed for transporting persons or property on a public street, highway, or road, (b) a boat, or (c) farm machinery or equipment. Section 163(j)(a)(C).

[40] Section 163(j)(9)(B).

[41] Section 382(d)(3). Section 382(k)(1) was amended to include any corporation entitled to use a carry forward of disallowed interest.

securities loan that met the requirements of Section 1058(a) as interest for Section 163(j) purposes.[42]

We recommend that the Treasury and Service issue guidance confirming that Section 163(j) applies to all amounts treated as interest under the Code. Accordingly, under our recommendation for Section 163(j) purposes, interest would include:

- original issue discount, adjusted for any acquisition premium;
- acquisition discount;
- amounts treated as interest under Section 1286 (related to stripped bonds);
- gain treated as ordinary income on the disposition of a market discount bond;
- amounts treated as interest under Treas. Reg. Sec. 1.446-3T (related to notional principal contracts with nonperiodic payments);
- payments treated as interest under Section 483;
- amounts treated as interest under a Section 467 rental agreement;
- redeemable ground rent treated as interest under Section 163(c);
- amounts treated as interest under Section 988; and
- foregone interest treated as interest under Section 7872.

There is a reasonable policy argument that deductions for expenses that are the functional equivalent of interest ought to be limited in the same manner as interest deductions under Section 163(j). For example, if a taxpayer borrows a debt security in a Section 1058(a) transaction, substitute payments it makes on account of interest on that security logically should be subject to Section 163(j); otherwise the taxpayer could use that securities loan to generate cash which it uses to purchase a separate debt security, with interest income on the purchased debt security increasing the taxpayer's Section 163(j) limitation and substitute payments on the borrowed security not be subject to the limitation. As a similar example, if a taxpayer holds a fixed-rate debt instrument and a derivative swapping fixed for floating rate interest, then the taxpayer again may receive interest income that increases its Section 163(j) limitation and make interest-like payments under the swap that are not subject to the limitation. By comparison, if the taxpayer integrated the debt instrument with the hedge, all of the payments would be taken into account in applying Section 163(j). However, while the right answer in these examples may seem clear, we believe it becomes more difficult fairly quickly to determine where to draw the line, if a broader range of transactions

[42] The legislative history to old Section 163(j), by comparison, indicated that Congress contemplated Treasury could issue guidance, if it wished, regarding "expense items not denominated interest but appropriately characterized as equivalent to interest expense." H.R. Rep. 101-386 at 566-567 (1989).

(having some time-value element, but not solely or predominantly providing for payments that are determined by reference to the time value of money) is considered.

To the extent that certain deductible payments should be treated as interest expense for purposes of applying the statute, it would seem logical that receipt or accrual of the same types of payments should be treated as interest income for that purpose. There does not seem to be a principled justification for adopting an asymmetrical approach.

In view of the statutory language ("interest paid or accrued on indebtedness"), the legislative history, and the fact that Congress did not give any indication of following the long-established approach that was taken under old Section 163(j), it seems questionable whether there would be authority for guidance applying new Section 163(j) to interest equivalents, absent a statutory amendment. However, we note that to the extent guidance applies only to a limited set of specifically identified types of transactions, in all of which one party secures the use of funds for a period of time and makes payments that are determined solely or almost solely by reference to the time value of money (including making net payments determined taking into account a hedge of the cost of borrowing, as in the example above), such guidance would appear to be more easily defensible, as an antiabuse measure designed to protect the intended operation of the statute rather than to materially expand it. Similarly, guidance takes a symmetrical approach for purposes of identifying income and expenses equivalent to interest under Section 163(j) would seem more likely to be upheld, as applying in a relatively neutral way that is not intended to disadvantage taxpayers.

B. Business Interest Expense; Business Interest Income

Guidance should confirm that all interest expense of a corporation is business interest expense, and all interest expense of a non-corporate taxpayer, other than personal interest and Section 163(d) investment interest, is business interest expense. The goal of Section 163(j) is to limit a taxpayer's ability to use interest deductions to increase its after-tax rate of return from its activities, and thereby to curb the tax law's tendency to encourage excessive levels of debt in taxpayers' capital structures.[43] It is consistent with that goal for the concept of business interest expense to have a broad scope, with Section 163(j)(5)'s references to "trade or business" and "properly allocable" not being interpreted as imposing significant limitations. For example, a corporation should not be able to claim that, to the extent its interest expense is attributable to investment activities that do not rise to the level of a trade or business under general tax principles, or is not closely connected to a particular activity that constitutes a trade or business but instead has been incurred on debt borrowed for general corporate purposes, the interest is not subject to limitation Section 163(j). Similarly, a non-corporate taxpayer should not be able to successfully

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43 See H.R. Rep. 115-409, at 247-248 ("The Committee believes that the general deductibility of interest payments on debt may result in companies undertaking more leverage than they would in the absence of the tax system. The effective marginal tax rate on debt-financed investment is lower than that on equity-financed investment. Limiting the deductibility of interest along with reducing the corporate tax rate narrows the disparity in the effective marginal tax rates based on different sources of financing. This leads to a more efficient capital structure for firms.").

argue that it has interest expense that falls into an area uncovered by any of Sections 163(j), 163(d) or 163(h). The statute's legislative history provides direct support for such an approach.[44]

Logically, business interest income for purposes of Section 163(j) would be determined under a rule symmetrical to the one just described for business interest expense; that is, all interest income of a corporation, and all interest income of a non-corporate taxpayer other than investment income as defined in Section 163(d), would be business interest income. (In the case of a non-corporate taxpayer that is not a business entity, Treasury and the IRS could consider also excluding interest income on loans clearly made for personal reasons, such as interest income imputed under Section 7872 on a gift loan to a friend or relative of the taxpayer.) The legislative history just referenced supports such an approach.[45]

C. **Adjusted Taxable Income**

In our view, it logically follows from our recommended approach to defining the business interest income and business interest expense of a corporation, that all of its other items of income and expense (exclusive of items attributable to a business exempt from Section 163(j)) should be included in the corporation's ATI. The legislative history discussed above suggests that for purposes of Section 163(j), all activities of a corporation constitute a trade or business, with the result that all its income and expense is "properly allocable" to a trade or business. In addition, assuming that (as recommended) all of the corporation's interest expense (not allocated to an exempt business) is treated as business interest expense, it seems fair to treat all of its non-interest income (other than from exempt businesses) as ATI; otherwise, there would be the potential for arbitrary mismatches, in which a taxpayer's interest expense is subject to the Section 163(j) limitation, while the taxpayer's income from an activity financed by the relevant borrowing is not taken into account as ATI to increase the amount of the limitation under Section 163(j)(1)(B). There is no apparent policy reason for applying the statute in a manner that creates such mismatches, and the text of the statute readily lends itself to a more symmetrical approach. Moreover, our recommended approach is relatively easily administrable, as compared to an

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[44] See H.R. Rep. 115-409, at page 248 note 444 ("Section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision."); H.R. Rep. 115-466, at 386 n. 688 ("a corporation has neither investment interest nor investment income within Section 163(d). Thus, interest income and interest expense of a corporation's properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of [Section 163(j)].").

In Part III of this report, except where specifically stated, all references to a "corporation" are to a C corporation (as defined in Section 1361(a)(2)) that is not a real estate investment trust, a regulated investment company.

[45] As noted in the legislative history, if a taxpayer conducts a business that is explicitly exempted from Section 163(j), then interest income and interest expense allocable to that business is excluded from the definitions of business interest income and business interest expense, pursuant to Section 163(j)(7). We discuss further in Part III.D below recommendations for the method to be used to allocate interest expense, and other items of income and expense, to an exempt business conducted by a taxpayer.

approach that requires a fact-intensive inquiry into the connection between items of income and a trade or business of the corporation.

Similar logic should apply to a non-corporate taxpayer. As proposed above, all of a non-corporate taxpayer's interest income and interest expense, other than investment income and investment interest under Section 163(d), interest income and expense from exempt businesses, and personal interest under Section 163(h) (and, possibly, interest income on loans clearly made for personal reasons, such as interest imputed under Section 7872 on gift loans), would be treated as business interest income and business interest expense under Section 163(j). It is thus seems reasonable to treat all of a non-corporate taxpayer's non-interest income as being included in the taxpayer's ATI, other than items that are investment income under Section 163(d), or that are attributable to exempt businesses or (in the case of a taxpayer that is not a business entity) are specifically enumerated items of income that are personal in nature, such as gain on the sale of the taxpayer's home. In addition, all of the taxpayer's non-interest deductible expenses, other than investment expenses under Section 163(d), expenses attributable to exempt businesses, and (in the case of a taxpayer that is not a business entity) specifically enumerated non-business deductions including for charitable contributions, state or local property taxes not related to a business, and medical or dental expenses, should be taken into account in ATI.

D. Allocation of Interest Expense Among a Taxpayer's Activities

Application of Section 163(j) requires that interest expense be allocated among different activities of a taxpayer. Under Section 163(j)(5) and 163(j)(7)(A), interest expense allocable to a trade or business of acting as an employee, an electing real property trade or business, an electing farming business, or a utilities business is exempted from the Section 163(j) limitation. Other provisions of the Code adopt a range of different approaches to allocating interest expense to different assets or activities: tracing based on the taxpayer's use of the borrowed funds;[46] tracing based on the purpose for the borrowing;[47] and allocation rules based on the relative amounts of assets used in different activities of the taxpayer.[48]

On balance, we recommend that guidance be issued under Section 163(j) allocating interest expense of a corporation based on the relative amounts of assets used in the corporation's exempt and non-exempt businesses, or based on the relative amounts of income the businesses generate, rather than an approach based on tracing or the purpose of a borrowing. We believe that an asset- or income-based approach to allocating interest expense would be more difficult for corporate taxpayers to manipulate, and would lead to significantly less litigation based on factual disputes, than a system based on tracing or the taxpayer's purpose would. However, we recognize that the

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[46] See Treasury Regulation Section 1.163-8T; see also Treasury Regulation Section 1.108(i)-2(d)(1) (adopting certain safe harbors based on the use of borrowed funds, for purposes of determining whether debt was issued by a partnership or S corporation "in connection with the conduct of a trade or business").

[47] See Section 265(a)(2) (denying a deduction for interest on debt incurred or continued to purchase or carry tax-exempt securities; was issued by a partnership or S corporation "in connection with the conduct of a trade or business"); Treasury Regulation Section 1.265-1(c); Rev. Proc. 72-18 (describing standards, including based on objective factors, for determining whether debt in incurred for the purpose of purchasing or carrying tax-exempt securities).

[48] See Treasury Regulation Sections 1.861-9 – 1.861-12T, 1.882-5, 1.884-4.

considerations for corporate and non-corporate taxpayers are somewhat different relating to the choice of a Section 163(j) allocation method, and we acknowledge that, as a practical matter, it may be necessary to adopt a method for non-corporate taxpayers that is based largely or entirely on tracing principles.

Although we outline below multiple possible approaches to allocation for the government's consideration, we believe that guidance should provide mandatory rules, rather than taxpayer elections between allocation methods, in order to maximize the likelihood of consistent outcomes that do not unduly disadvantage the government.

1. **Corporations**

a. Asset-Based Allocation Method

Corporate taxpayers in many cases may find an asset-based approach familiar, from their calculations under Section 861 for foreign tax credit purposes. The basic principles of the Section 861 rules are well-understood and have been fairly stable over a long period of time, and it would appear those principles could be applied under Section 163(j) without undue difficulty in the case of a corporation with exempt and non-exempt businesses. A system based on tracing the use of funds or based on the purpose of a borrowing, by comparison, would be a relatively new exercise for many corporate taxpayers, and could be a complex one for large corporate groups.

Either fair market value or tax basis could be used to measure a taxpayer's assets. Fair market value could be seen as a less arbitrary metric for measuring the assets used in different businesses, than tax basis would be (for example, valuable self-developed intangibles may have a low or no tax basis); and the Code and regulations provide several other examples of determinations made based on the relative fair market values of different groups of assets.[49] However, fair market values often can be difficult to determine, thus increasing opportunities for disagreements between taxpayers and the IRS. Possibly for that reason, the Act adopted Section 864(e)(2), which eliminated taxpayers' right under prior law to allocate interest expense between domestic and foreign assets for sourcing purposes based on fair market value, and instead mandated the use of tax basis.[50]

If tax basis is used to measure a corporation's assets, there would be a natural tendency for exempt businesses to attract a relatively large share of interest expense, because those businesses tend to be capital-intensive and to involve assets with longer depreciation schedules (or non-depreciable assets). However, as a practical matter, it often would be relatively easy for taxpayers to use basis, as it would be computed for other purposes; and it would generally be difficult to manipulate basis for purposes of skewing the apportionment.[51] In addition, a number of businesses of the types that are exempted from Section 163(j) may be relatively heavily levered, for reasons

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[49] See, e.g., Section 856(c)(4) (asset tests for REIT status); Section 897(c)(2) and Treasury Regulation Section 1.897-2 (determination of a corporation's status as a U.S. real property holding corporation).

[50] See Treasury Regulation Section 1.861-9T(g) (which historically permitted taxpayers to choose to use fair market value).

[51] Congress has used basis as a way of measuring capital investment in assets in multiple other places in the Act (see new Sections 199A, 951A, and 250).

unrelated to tax; indeed, that might have been one of the reasons Congress had for exempting them from Section 163(j).

Regardless of whether basis or fair market value is used, Treasury and the IRS should consider adopting special rules that allow interest expense on a particular debt obligation to be allocated to a business, in specific cases where there is a relatively clear economic link between the business and that debt. For example, in the case of a utilities business, the regulatory authority that approves the rates the business is entitled to charge customers may have taken into account particular debt incurred by the business in the ratemaking process, permitting the business to charge rates that cover the expected debt service. This would be an objective measure of the debt attributable to the utilities business. Similarly, if a non-exempt business is subject to regulatory oversight that involves a review of particular debt owed by the taxpayer, then interest expense on that debt could be treated as allocable entirely to the non-exempt business. In addition, a taxpayer often may incur nonrecourse debt to finance the construction, improvement or purchase of real property. In a case where the lenders are looking exclusively to the property built or purchased with the borrowed funds and the cashflows generated by that property for repayment, there would seem to be reasonable grounds for allocating the interest expense on the debt to the business in which the property is used. This traditional type of financing arrangement has been taken into account in other contexts when allocating interest expense.[52] Such a rule could also apply to a future refinancing of a construction or acquisition loan; in such a case, we would propose that the rule apply only to the extent the amount of the new debt does not exceed the amount of debt being refinanced.

b. Income-Based Allocation Method

In our view, it is worth considering an income-based approach to allocation of interest expense as an alternative to an asset-based approach. We are not aware of an existing statutory or regulatory regime that provides for taxpayers to allocate interest expense on the basis of income (or cash flow) from different activities.[53] The Act has amended Section 864(e)(2), in a manner that prohibits such an allocation methodology. Nevertheless, we believe such an approach may have merit under Section 163(j). Debt capacity often is determined by lenders using income-based metrics, rather than asset values. In addition, and more importantly, an income-based approach can be seen as fitting well with the basic design of Section 163(j). As noted above, the legislative history indicates that the goal of the statute is to prevent a taxpayer from making excessive use of interest deductions to increase its after-tax rate of return from its activities.[54] The statute accomplishes this goal by limiting the extent to which each dollar of net interest expense can shield the ATI of a non-exempt business from tax. Allocating a taxpayer's interest expense between exempt and non-exempt businesses based on those businesses' relative contributions to the

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[52] See Treasury Regulations Sections 1.861-10(e), 1.861-10T(b), 1.882-5(a)(2).

[53] Prior to the Act, it was permissible to compute a controlled foreign corporation's Subpart F income, by allocating its interest expense among different activities based on the relative amounts of gross income generated by each activity. See Treasury Regulation Section 1.861-9T(j).

[54] See H.R. Rep. 115-409, at 247-248.

taxpayer's overall net income[55] fits well with the basic proposition that a dollar of interest expense is meant to shield from tax at most $0.30 of the ATI generated by a non-exempt business.[56]

2. Non-Corporate Taxpayers

For non-corporate taxpayers, the considerations relating to the choice of a Section 163(j) allocation method are somewhat different than described above. In particular, individuals have long characterized their interest expense as personal interest under Section 163(h), investment interest under Section 163(d), an expense of passive activities under Section 469, or an expense of non-passive businesses in which they materially participate, using the tracing rules of Treasury Regulation Section 1.163-8T. The most straightforward way to apply new Section 163(j) to individuals, which would require the least administrative guidance in the near term, would be for individuals simply to continue to trace interest expense under Treasury Regulation Section 1.163-8T to each of their business and non-business activities; and interest that is traced to an exempt business under these principles would not be subject to Section 163(j), while interest traced to a non-exempt business would be subject to limitation.

Treasury and the IRS might consider applying a set of rules to individuals that is based only in part on tracing. For example, as a first step, tracing could be used to divide an individual's interest expense between personal interest and other interest.[57] Then, asset-based or income-based rules like the ones described above for corporations could be applied, to allocate the other interest expense between the individual's investments and businesses, and between exempt and non-exempt businesses. This would reduce, at least to some extent, the potential for an individual to manipulate the allocation of business interest expense between exempt and non-exempt businesses, for purposes of applying Section 163(j). However, it is questionable whether such an approach would be fair, if it applied to allocate interest expense on existing indebtedness among an individual's business and investment activities for purposes other than just applying Section 163(j) – for example, for purposes of determining how much interest is allocable to a particular activity of an individual for purposes of applying Section 469. Treasury Regulation Section 1.163-8T has long been a part of the framework of rules that individuals have taken into account when planning business transactions; and many of those transactions may extend well into future periods. It appears that such an approach also would apply to a relatively limited population of individual taxpayers, in view of the exception in Section 163(j)(2) for taxpayers that have average annual gross receipts under $25 million. As a result, at least in the near term, it is questionable whether individuals should be subject to rules that depart from a tracing approach.

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[55] For this purpose, the taxpayer's overall net income would be computed taking into account income and expenses from its exempt businesses, in the same manner as ATI is computed under the statute for non-exempt businesses.

[56] By comparison, if a taxpayer's interest expense is allocated based on the relative amounts of assets used in different businesses, then the result could be that each dollar of the taxpayer's interest expense ends up sheltering more than $0.30 of income from a non-exempt business. For instance, that would be the case if a taxpayer's debt, and interest expense, was allocated largely to an asset-intensive exempt business carried on by the corporation that generated little net income, resulting in a net loss attributable to that business. That loss could be used to shelter ATI generated by the taxpayer's non-exempt businesses without the 30% limitation applying.

[57] It appears it would be difficult to use an approach other than tracing, to identify an individual's personal interest.

By comparison, in the case of a partnership, an approach not based purely on tracing principles may make more sense. In particular, if a partnership used rules based purely on tracing, then opportunities could arise for a corporation to avoid the rules described in Part III.D.1 above providing for asset-based or income-based allocation of business interest expense, simply by investing in those businesses through a partnership rather than directly. We discuss issues relating to the application of Section 163(j) to a partnership and its partners in detail in Part III.H below.

3. Additional Issues Related to the Choice of Allocation Method

a. Allocation of Income and Expenses (Other than Interest Expense) to Exempt Businesses

In order to apply Section 163(j) to a taxpayer that conducts both exempt and non-exempt businesses, it will be necessary to determine not only the amount of the taxpayer's interest expense, but also the amounts of its other items of income and expense, that are attributable to the taxpayer's exempt businesses (and thus excluded from ATI). We believe that, in general, it should be more straightforward to allocate these items than to allocate interest expense, and that such determinations are generally best made based on a practical review of the facts that link an item to an exempt business. In cases where the appropriate allocation of an item of income is not entirely clear, principles that are similar to those in Section 864(c) could be applied.[58] A reasonable rule could be developed to identify investment assets held for the reasonable present and anticipated future needs of an exempt business, income from which would be part of that business's income.[59] In addition, principles can be used to allocate a taxpayer's expenses (other than interest) to an exempt business that are similar to those used in Treasury Regulation Section 1.861-8 and Treasury Regulation Section 1.954-1(c).

b. Grouping of Taxpayers for Purposes of Allocating Interest Expense to Exempt and Non-Exempt Businesses

An additional point related to the choice of allocation method, is whether guidance will provide for grouping of different taxpayers or entities. As discussed further below, we believe grouping is appropriate for members of a consolidated group. On the whole, however, the basic approach taken by Congress in drafting Section 163(j) suggests it did not contemplate broad grouping or aggregation rules. For example, if a partner owns interests in two partnerships, one of which conducts an exempt electric power business and the other of which conducts a non-exempt trade or business, it does not appear that the assets and interest expense of those two partnerships ought to be aggregated, for purposes of determining how much of the interest expense should be viewed as allocable to the exempt electric power business; as discussed in more detail

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58 This would be consistent with the approach taken in Section 199A, a provision that could be expected to be applied in tandem with Section 163(j). See Section 199A(c)(3)(A)(i). The Tax Section intends to submit separately recommendations for guidance under Section 199A.

59 See Treasury Regulation Section 1.897-1(f) (amount of cash and investment assets considered to be business assets for purposes of applying Section 897(c)); Treasury Regulation Section 1.537-1 (principles for determining whether a corporation has accumulated earnings and profits that exceed the reasonable needs of its business).

later in this Report, Section 163(j)(4) contemplates fairly clearly that the statutory limitation (or lack thereof) will be computed separately, partnership by partnership.

E. Coordination of Section 163(j) With Other Limits in the Code on Interest Deductions and Non-Interest Deductions

1. Coordination with Other Limits on Interest Deductions

A straightforward reading of Section 163(j) indicates that it places a cap on the amount of interest for which a deduction otherwise would be allowed to a taxpayer in a given year, after having taken into account all the other statutory and regulatory rules that would disallow or defer such deductions. ("The amount allowed as a deduction under this chapter for business interest expense shall not exceed…").[60] This application of the statute is justified as a policy matter: as noted above, the statute is intended to prevent taxpayers from relying excessively on interest deductions to increase their after-tax returns;[61] and that purpose is achieved in a simple, effective manner by applying the formula for the annual Section 163(j) limit to interest expense that would otherwise be currently deductible. Consistent with that logic, the Congressional reports state that: "It is generally intended that, similar to present law, section 163(j) apply after the application of provisions that subject interest to deferral, capitalization, or other limitation. Thus, section 163(j) applies to interest deductions that are deferred, for example under section 163(e) or section 267(a)(3)(B) in the taxable year to which such deductions are deferred. Section 163(j) applies after section 263A is applied to capitalize interest and after, for example, section 265 or section 279 is applied to disallow interest." [62]

New Section 59A contains a special ordering rule, for application of the "Base Erosion and Anti-Abuse Tax" ("**BEAT**"). Section 59A generally requires that a U.S. corporation that (together with affiliates) has average annual gross receipts of at least $500 million to pay a minimum tax, equal to 10% of its "modified taxable income"; and modified taxable income, in turn, is generally defined as taxable income computed without regard to any deductible payment to a foreign related party (including interest) (a "base erosion payment"). Section 59A(c)(3) provides that for purposes of computing a taxpayer's modified taxable income, "in the case of a taxpayer to which section 163(j) applies for the taxable year, the reduction in the amount of interest for which a deduction is allowed by reason of such subsection shall be treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to such related parties." Thus, in effect, Section 163(j) is applied before BEAT, so that there is the maximum possible disallowance of interest under the former, and the imposition of the greatest possible amount of tax under the latter. Although the BEAT statute is not drafted as a limitation on the deductibility of base erosion payments, it does function in a somewhat similar manner, in effect limiting the maximum reduction in a U.S. corporation's tax liability that can be achieved through such payments; and it can be asked whether Section 59A(c)(3) should be seen as suggesting a broader approach to how Section 163(j) should be coordinated with other limits on deductibility of interest

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[60] Section 163(j)(1).

[61] See H.R. Rep. 115-409, at 247-248.

[62] H.R. Rep. 115-409, at 249; H.R. Rep. 115-466, at 228-229 (repeating this statement, in describing the House bill, and then going on to describe changes to the House bill made by the Senate and in the Conference Committee that do not impact this point).

payments (i.e., in a manner that maximizes the effect of each limit). In our view, the fact that Congress added a specific rule in the Code to achieve this result, and did so in the BEAT statute instead of in Section 163(j), indicates that Congress viewed BEAT as a special case that required a unique, and relatively harsh, rule, rather than an indication more broadly of how Section 163(j) is meant to interact with other limits in the Code. [63] Except in the case of BEAT, the approach described in the preceding paragraph – applying other limits before applying Section 163(j), and thus applying its formula only to interest otherwise allowable as a current deduction – appears preferable.

We recommend that guidance be issued confirming these conclusions.

In the case of Sections 465 and 469, if Section 163(j) is applied to a taxpayer's interest expense after those provisions, the effect may be that the taxpayer's income from a passive or limited-risk activity is not sheltered to the full extent permitted by those provisions even though the taxpayer has substantial non-interest expenses from the activity. It would seem in keeping with the purposes of Section 465 and 469 to remove the possibility for such results, by having the taxpayer re-apply the limits these provisions impose, after taking into account the Section 163(j) limitation on interest expense from the relevant activity. In addition, such an approach would not undercut the goals of Section 163(j). In this connection, we note that proposed regulations under old Section 163(j) took a contrary approach, and Congress opted to overrule those proposed regulations. [64]

The Tax Section plans to submit comments on whether Treasury Regulation Section 1.385-3 should be withdrawn or modified as a result of various changes made pursuant to Act, including the enactment of Section 163(j).

2. **Carryforwards of Disallowed Interest Under Old Section 163(j)**

Interest expense that was disallowed by reason of Section 163(j) as in effect prior to the Act should be treated as interest paid or accrued by the taxpayer in the first year new Section 163(j) is effective. Old Section 163(j)(1)(B) expressly provided for the carryforward of such interest to that year: such interest would be treated as "paid or accrued within" that year for purposes of Section 163(a), as well as for purposes of the annual limitation on the Section 163(a) interest deduction set forth in Section 163(j).

The new statute and its legislative history do not expressly state whether this carryforward will be recognized in the period following the statute's enactment. However, the Act did not amend Section 163(a); and there would seem to be no reason why Treasury and the IRS cannot simply continue to interpret the reference in Section 163(a) to "interest paid or accrued within" 2018, as including disallowed interest carried forward from 2017. Doing so would be fully consistent with the policy of the new provision, as the carried forward interest would simply become subject to

[63] We note that the BEAT, unlike Section 163(j), also applies to a corporation's gross, rather than net, interest expense.

[64] See Section 163(j)(7).

the same formulaic limitation as interest paid or accrued after the effective date of the amendments to Section 163(j).

Old Section 163(j) also provided that if a corporation's Section 163(j) limit for a taxable year exceeded its interest expense, the corporation was entitled to carry forward that excess to increase its Section 163(j) limit in the next three taxable years.[65] We recommend that guidance confirm that a corporation with such a carryforward from the last year old Section 163(j) was in effect, will simply lose the benefit of that carryforward under the new provision. The new provision includes no concept of carrying forward an unused limitation to future years. In addition, the old Section 163(j) limit was considerably different than the new one, reaching only interest paid to a related party not subject to U.S. tax on that amount, and only to the extent interest expense exceeded 50% of EBITDA; it would seem to give taxpayers a significant advantage to be able to use a carryforward designed to provide leniency under the relatively narrowly targeted former provision, in order to lessen the impact of the new, broader restriction.

3. Interaction Between Section 163(j), and Sections 246(b) and 250(a)

Under our recommendation in Part III.C above, a corporation's ATI would include dividends received by it, Subpart F income, global intangible low-taxed income ("**GILTI**") as defined in Section 951A and "foreign-derived intangible income" ("**FDII**") as defined in Section 250. The corporation's ATI also would take into account the dividends-received deductions provided by Sections 243, 245 and 245A, as well as the deductions in respect of GILTI and FDII provided in Section 250(a)(1).

Section 246(b) provides that, in general, the total of a corporation's dividends-received deductions under Sections 243(a)(1) and 245 and its deduction under Section 250 cannot exceed 50% of the corporation's taxable income, determined without regard to any Section 172 deduction for a net operating loss carryover and with certain other adjustments. It is not entirely clear how this limitation interacts with the one in Section 163(j)(1)(B), generally restricting interest deductions to 30% of ATI. If one of these limits is applied before the other (i.e., by simply disregarding the other), then a taxpayer may end up with a result that is not in literal compliance with the latter Code provision. In similar circumstances, the IRS and the courts have approved of the use of simultaneous linear equations.[66] We recommend that guidance confirm whether such an approach also applies when applying the two limits in the present case.[67]

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65 Old Section 163(j)(2)(B)(ii).

66 See Rev. Rul. 79-347, 1979-2 C.B. 122 (corporation had (i) a Section 243(a)(1) dividends received deduction, subject to the limitation in Section 246(b), and (ii) depletion deductions under Section 613A, subject to the limitation in Section 613A(d)(1) based on 65% of the corporation's taxable income; the IRS approved the use of simultaneous equations to apply these two limits); Shell Oil Co. v. Comm'r, 89 T.C. 371, 419-421 (1987) (describing situations under the Code in which use of simultaneous equations has been necessary), rev'd. in part and remanded in part, 952 F.2d 885 (5th Cir. 1992).

67 Under Section 246A, if a corporation owns "debt-financed portfolio stock," then the corporation's dividends received deduction with respect to a dividend paid on that stock generally is limited to (a) the portion of the dividend that is attributable to the part of the stock that has not been financed with debt plus (b) the excess (if any) of the portion of the dividend that is attributable to the debt-financed part of the stock over the interest

The interaction between Sections 163(j) and 250(a)(2) raises similar ordering questions. In general, Section 250(a)(1) provides that a U.S. corporation is entitled to a deduction equal to the sum of (a) 37.5% of its FDII for the taxable year and (b) 50% of (i) the GILTI amount included in its gross income under Section 951A for the taxable year. However, Section 250(a)(2) adds the limitation that, if the sum of the corporation's FDII and GILTI amounts exceeds its taxable income (computed without regard to the deduction provided in Section 250), then the corporation's deduction under Section 250(a)(1) must be reduced under a formula. Again, Treasury and the IRS should confirm whether simultaneous equations need to be used in order to apply Sections 163(j) and 250(a)(2) in tandem.

The FDII rules also require the resolution of one additional ordering question related to Section 163(j). In general, FDII is defined as a portion of the excess of a U.S. corporation's "deduction eligible income" over a deemed return on its investment in tangible assets – specifically, the portion of such excess income that is attributable to selling property or services to foreign persons.[68] "Deduction eligible income" is defined as the excess of the corporation's gross income (computed without regard to specified items) over "the deductions (including taxes) properly allocable to such gross income."[69] Guidance should be provided regarding whether, for this purpose, "the deduction" for interest takes into account the limitation on deductibility imposed by Section 163(j).

F. Impact on Earnings and Profits

We recommend that Treasury and the IRS confirm that disallowance of a corporation's interest expense under Section 163(j) should not have an effect on the year in which the expense reduces the corporation's earnings and profits ("**E&P**"). Caselaw and rulings have established a principle that, generally, E&P should be determined in a manner that is consistent with the economic reality of a corporation's ability to make distributions in excess of a return of capital.[70] Consistent with that principle, Treasury and the IRS have concluded that when a corporation has an economic outlay in a particular year and the tax deduction or loss associated with that outlay is disallowed for the year and carried forward, the corporation reduces its E&P in the year the outlay

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deduction allocable to the dividend. Generally, debt financed portfolio stock is a minority stockholding in a corporation, to the extent there is debt that is "directly attributable" to the corporation's investment in that stock. Section 246A does not present the same kind of issue that Section 246(b) does, regarding the order of applying Section 163(j)(1)(B) and a separate deduction limitation in the Code that uses a formula based on taxable income. However, depending on what method is used to allocate a corporation's interest expense between exempt and non-exempt businesses for purposes of Section 163(j), it is possible that a different allocation method will need to be used under Section 246A to determine whether any portion of the corporation's investment in stock is considered to be debt-financed portfolio stock under Section 246A (Section 246A generally requires that debt be incurred for the purpose of investing in the portfolio stock or is otherwise directly traceable to the purchase of the stock). In addition, the portion of the interest on such debt that is deductible under Section 163(j) will need to be determined.

[68] See Section 250(b).

[69] See Section 250(b)(3)(A)(ii).

[70] See Beck v. Comm'r, 52 T.C. 1 (1969) (E&P is "an economic concept which the tax law has utilized 'to approximate a corporation's power to make distributions which are more than just a return of investment.'), aff'd, 433 F.2d 309 (5th Cir. 1970); Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders ¶8.04.

is made notwithstanding the disallowance.[71] Treasury and the IRS adopted that approach in proposed regulations under old Section 163(j);[72] and we believe it would be appropriate to do the same under new Section 163(j).

G. **Consolidated Groups**

1. **Single Taxpayer Approach**

The statute applies Section 163(j) to a "taxpayer." It appears appropriate to view a consolidated group as a single "taxpayer" for this purpose, in keeping with the consolidated group regulations' basic approach of computing a single consolidated taxable income for a group's members, which is reduced by the aggregate amount of interest expense incurred by the group's members.[73] Such an approach would make sense as a policy matter, and is consistent with Section 163(j)'s legislative history. The House report states: "In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level."[74] In addition, a similar statement appears in the Joint Committee's description of the Senate's version of the legislation; and the Conference Committee report notes this would have been the approach under the House's proposal, and then goes on to describe changes to the House's proposal made by the Senate and Conference Committee, none of which impact this point.[75]

Under a "single taxpayer" approach, a consolidated group's ATI, business interest income, and business interest expense all would be computed at the group level, by reference to items included each year in consolidated taxable income.[76] One refinement to this basic approach, is that interest on intercompany loans could be disregarded for purposes of determining the amount

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71 See Treasury Regulation Section 1.312-7(b)(1) (corporation's capital loss reduces E&P in the year recognized, even if disallowed under Section 1211, not the year to which carried forward under Section 1212); Rev. Rul. 75-515, 1975-2 C.B. 117 ("In general, the computation of earnings and profits of a corporation for dividend purposes is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions as well as those resulting from the application of tax law. Thus, losses and expenses that are disallowed as a deduction for Federal income tax purposes, charitable contributions in excess of the limitations provided therefore, and other items that have actually depleted the assets of the corporation, even though not reflected in the income computation, are allowed as deductions in computing earnings and profits."); see also Field Service Advice 1993-540 (noting that a corporation's E&P is reduced by a net operating loss in the year the loss is incurred, rather than the year to which it is carried forward under Section 172).

72 See Proposed Regulation Section 1.163(j)-1(e), 1.163(j)-8(g).

73 See Treasury Regulation Section 1.1502-11.

74 H.R. Rep. 115-409 at 248.

75 See JCT Description of Senate Finance Committee Chairman's Mark of the Tax Cuts and Jobs Act, at 71 (same statement); H. Rep. 115-466, at 228.

76 Compare Treasury Regulation Section 1.1502-24 (computing Section 170(b)(2) limit on charitable contribution deduction at the consolidated group level); Treasury Regulation Section 1.1502-26 (same for Section 246 limit on dividends received deduction); Treasury Regulation Section 1.1502-44 (same for Section 613A(d) limit on percentage depletion deductions); proposed Treasury Regulation Section 1.163(j)-5(b) (same for old Section 163(j) limit).

of the consolidated Section 163(j) limitation. This would be consistent with the basic principle here that a group is a single economic unit for purposes of Section 163(j).[77]

> **Example 1**. Parent, S1 and S2 are the members of a consolidated group. In 2018, Parent has no income or deductions; S1 has 100 of business interest expense on loans from non-group members and 10 of ATI; and S2 has 20 of business interest expense on loans from non-group members and 290 of ATI.

In Example 1, the consolidated group's ATI is 300 (= 290 + 10), and its Section 163(j) limit should be 90 (90 = 30% x 300). Thus, the group should be entitled to deduct 90 of its 120 of business interest expense for 2018, with the remaining 30 being a carryforward.[78]

For years prior to 2022, ATI is computed without reference to the taxpayer's depreciation and amortization deductions. However, gain from a sale of a depreciable or amortizable asset is included in ATI. In a case where one consolidated group member sells a depreciable or amortizable asset to another in an intercompany transaction, it is not entirely clear how these rules should apply. It would appear that, since the selling member's gain is generally taken into account under the "matching rule" in a manner designed to produce the same effect as a transaction between divisions (i.e., the character and timing of the selling member's gain will match the purchasing member's deductions), and since the purchasing member's deductions are disregarded in computing ATI, the gain also logically should be disregarded.[79] This result would be consistent with the basic principle recommended, to treat the consolidated group as a single taxpayer for purposes of Section 163(j).

More broadly, we note that in general, items from intercompany transactions either could be disregarded when computing a consolidated group's ATI, or included in the calculation. Because intercompany transactions normally should result in items of offsetting amount and the same character in a particular year under the matching rule, it appears such items normally would not result in a net change in the amount of the group's consolidated ATI, whether such items are disregarded when computing consolidated ATI or not.[80]

2. Exempt Businesses of a Consolidated Group

A logical corollary of the single taxpayer approach, and of the allocation principles recommended above, is that a consolidated group would allocate its interest expense between a trade or business that is exempt from Section 163(j), and another one that is not, based on the relative assets or income of each business – regardless of the location of each business, or of the interest expense, within the consolidated group.

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[77] Compare Treasury Regulation Section 1.385-4T (taking a similar approach for purposes of applying the debt recharacterization rules in Treasury Regulation Section 1.385-3 to consolidated groups).

[78] In Part III.G.4 below, we consider the appropriate treatment of intragroup loans when applying Section 163(j) to a consolidated group.

[79] See Treasury Regulation Section 1.1502-13(c).

[80] We discuss in the next section, however, a case where Section 163(j) might be applied differently to a consolidated group, depending on whether items from intercompany transactions are taken into account.

Example 2. Parent, S1 and S2, are the members of a consolidated group. Parent has incurred no debt, and owns no assets other than the shares of S1 and S2. S1 owns 1,000 of assets, which it uses in a non-exempt trade or business, and has 200 of ATI and 50 of interest expense on loans from non-group members in 2018. S2 owns 500 of assets, which it uses in a real property trade or business for which S2 has made an election under Section 163(j)(6)(B), and has 50 of income from that trade or business and 100 of third-party interest expense on loans from non-group members in 2018.

In Example 2, assuming that an asset-based approach is used to allocate interest expense to the consolidated group's exempt and non-exempt businesses, it appears that the consolidated group should disregard members' stock when making that allocation.[81] The group should compute a consolidated ratio of assets used in an exempt business (500) to total assets (1,500), and thus should treat 1/3 of the group's 150 of total interest expense as being allocated to S2's real property trade or business and not being subject to Section 163(j), notwithstanding that S2 has actually incurred 100 of interest expense. All of the group's remaining 100 of interest expense should be treated as being allocated to S1's trade or business and being subject to Section 163(j). For purposes of computing the group's limitation, only S1's 200 of ATI from its non-exempt business should be taken into account. Thus, the consolidated group should be limited to a deduction of 60 under Section 163(j) with respect to the group's 100 of non-exempt business interest expense, resulting in a disallowance of 40.

Alternatively, if an income-based method is used to allocate interest expense in Example 2, then the group's ratio of exempt income (50) to total group income (250) is computed, with the result that 20% of the group's 150 of interest expense (30) should be treated as not subject to Section 163(j). The Section 163(j) limitation would apply to the remaining 120 of interest expense, resulting in a disallowance of 60.

We note that, consistent with the basic approach described in Part III.G.1 above, the income that is taken into account for purposes of making an income-based allocation of interest expense between exempt and non-exempt businesses conducted by a consolidated group should take into account all items that are included in consolidated taxable income. Generally speaking, it appears that it should not make a difference whether items from intercompany transactions are taken into account. However, this may not always be the case, as when a subsidiary that conducts an exempt business has intercompany items from transactions with a subsidiary that conducts a non-exempt business. In such a case, it seems that either taking into account those intercompany items (or else, possibly, seeking to allocate income and non-interest expenses from transactions with non-group members in some fashion between the exempt and non-exempt businesses) may be appropriate.

In Example 2, if S2's business consists solely or predominantly of leasing real property to (or conducting other activities described in Section 469(c)(7)(C) for) other members of the consolidated group, it can be asked whether it is consistent with a single taxpayer approach to view S2 as conducting a real property trade or business for which a Section 163(j)(6)(B) election can be made. In other contexts, the separate existence of a trade or business that principally serves

[81] Compare Treasury Regulation Section 1.1502-91(g)(1) and 1.1502-93(b)(1) (member stock and intercompany debt is disregarded for purposes of certain consolidated group Section 382 computations).

affiliates is respected.[82] However, the basic consolidated return principle of treating members as divisions of a single corporation, and the application of that principle in the Section 163(j) context to treat a group as a single "taxpayer," suggest that S2's activities should be viewed as an indivisible part of the group's overall (non-exempt) business activity.[83] (This view has particular force, if it is the case that items from intercompany transactions are not taken into account in allocating interest expense among the group's businesses.)

3. Corporations Joining a Consolidated Group

When a corporation joins a consolidated group, in a transaction that results in a Section 382 ownership change for the corporation, the corporation's carryforward of disallowed business interest expense from a separate return year would be subject to the resulting Section 382 limitation. It would appear consistent with the treatment of other Section 382-limited attributes to allow the consolidated group to take into account the portion of the corporation's business interest expense carryforward permitted under Section 382 to be treated as incurred in a consolidated return year, and to subject that amount of interest of such corporation to the consolidated Section 163(j) limitation for the consolidated return year in the same manner as any other interest expense incurred by a group member in that year – without any special treatment or limitation as a result of the fact the interest has been carried forward from a separate return year.[84]

4. Corporations Leaving a Consolidated Group; Apportionment of Consolidated Group's Carryforwards

Although Section 163(j) generally should be applied to a consolidated group as if it were a single taxpayer, in the manner described above, it nevertheless may be appropriate to apportion among the members the effects of any disallowance and carryforward of the group's business interest expense. In particular, such apportionment may be appropriate in order to determine how

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[82] Cf. Proposed Regulation Section 1.355-3(d)(2), Example 16 (manufacturing corporation has an R&D department that develops new products for the corporation to manufacture; R&D department's activity can be transferred to a separate corporation and used to satisfy the Section 355(b) active trade or business requirement), Example 17 (corporation that sells meat products carries on activity of processing meat, which it sells to customers; meat processing activity can be held in a separate corporation from the sales function and used to satisfy the active trade or business requirement).

In addition, as noted above in the text, our basic recommended methodology recognizes intercompany transactions and takes into account items from those transactions for purposes of applying Section 163(j), rather than simply disregarding such items.

[83] Support for this approach can be found in Treasury Regulation Section 1.1502-13(c)(7)(ii), Example 2. S, a member of a group that holds land for investment, sells the land to B, a member of the group that develops the land as residential real estate and sells the developed lots to customers. In the example, the character of S's gain from its sale of land must be determined by treating S and B as a single corporation and assessing whether, based on their combined activities, the land is described in Section 1221(a)(1). By analogy, in the case described in the text above, the character of S2's rental income and activities giving rise to that income, would be determined by treating S2 and the subsidiaries to which it leases property as a single corporation.

[84] We do not analyze in this Report the proper result in a case where a corporation joins a consolidated group in a transaction not resulting in an ownership change under Section 382.

much of the group's business interest expense carryforward a member should take with it, if it leaves the group. We consider several different potential apportionment methods below.[85]

a. Method One: Apportionment Based on Each Member's Business Interest Expense on Debt Owed to Non-Group Members

One relatively simple method would be to treat each member that has business interest expense on debt owed to non-group members in the year a carryforward is generated, as having a portion of that business interest expense disallowed and carried forward, corresponding to the portion of the group's total business interest expense owed to non-group members that is disallowed and carried forward.

Under this method, if the group has any business interest expense on intercompany debt for the year in which the carryforward is generated, none of that interest expense would be considered to have been disallowed and carried forward; rather, only business interest expense on debt owed to lenders outside the group would be so treated. The rationale is that each dollar of intercompany business interest expense is matched by a dollar of intercompany business interest income and, thus, should not be viewed as causing or contributing to any disallowance and carryforward of business interest expense by the group under Section 163(j).

> **Example 3**. Parent, S1 and S2 are members of a consolidated group. Parent is a holding company that has borrowed from third parties and lent to S1 and S2, which are both operating subsidiaries. In 2018, Parent's only items of income and expense are 150 of business interest expense on a loan from an unrelated lender, 100 of business interest income from S1 and 50 of business interest income from S2. S1 has 100 of business interest expense and 200 of ATI. S2 has 50 of business interest expense and 100 of ATI. At the end of the year, Parent sells S1 to an unrelated buyer.

In this example, the consolidated group's Section 163(j) limit for 2018 would be 90 (90 = 30% x 300). Under Method One, S1's 100 of business interest expense, S2's 50 of business interest expense, and Parent's 150 of business interest income, would be disregarded for purposes of applying Section 163(j) to the group. Parent's 150 of business interest expense owed to the unrelated lender would be limited, with 60 of that interest expense being disallowed and carried forward. When Parent sells S1, none of that carryforward would go with S1; rather, the entire carryforward would remain with Parent.

Method One would be generally similar to the principles for apportionment of other group attributes to a departing member.[86]

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[85] As discussed below, each of the apportionment methods that we have considered may lead to what can be seen as distortions in some cases, and involve potential complexity. A possible alternative that could be considered, is for none of a group's business interest expense carryforwards to be apportioned to a member that leaves the consolidated group. Instead, the entire disallowed business interest expense carryforward would simply remain with the group. Cf. Treasury Regulation Section 1.1502-36(d).

[86] See Treas. Regulation Sections. 1.1502-21(b) (apportioning a consolidated net operating loss carryover based on the approach that the consolidated loss consists of a ratable portion of each loss-making member's separate

b. Method Two: Apportionment Based on Each Member's Net Business Interest Expense (Determined Taking into Account Interest on Intragroup Debt)

A second possible method would be to apportion the disallowance and carryforward of business interest expense based on each member's net business interest expense (i.e., the excess, if any, for each member of its business interest expense over its business interest income) for the year in which the Section 163(j) carryforward is generated. Under this method, a member's net business interest expense would be determined by taking into account not only interest on debt that the member has borrowed from or loaned to non-members, but also interest on intragroup debt.

Under Method Two, the consolidated group would be treated as a single taxpayer, and loans between members would be disregarded, when computing the amount of the group's consolidated Section 163(j) limit, and the total amount of business interest expense to be disallowed. However, unlike Method One, that disallowed interest would not all be apportioned to the members with external business interest expense, but instead would be spread among the members in a manner that takes into account intercompany debt.

The rationale for this approach is that often, external borrowing may be done by only one or a few holding companies in the consolidated group, which members then on-lend the funds to other group members that are operating companies (as in Example 3). If one of these operating subsidiaries ultimately leaves the consolidated group, it is that subsidiary which could generate ATI that would provide capacity to use carryforwards of disallowed business interest expense; thus, it would seem logical to choose an apportionment methodology that is relatively likely to apportion carryforwards to the operating subsidiary.

For instance, in Example 3, the consolidated group's Section 163(j) limit continues to be 90, and the total amount of interest disallowed continues to be 60, as was the case under Method One. However, the manner in which the disallowed interest expense is apportioned to the various group members would be different. In 2018 Parent's net business interest expense is 0; S1's is 100; and S2's is 50. As a result, of the 60 of business interest expense disallowed in 2018, 40 would be apportioned to S1 (40 = 60 x 100/150). When Parent sells S1, S1 would take 40 of the carryforward with it; and the remaining 20 would stay with the consolidated group.

Under Method Two, S1 would be entitled to deduct only 60 of its 100 of business interest expense on its loan from Parent in 2018. Parent, however, would have 100 of business interest income and 100 of currently deductible business interest expense. This result represents an (arguably anomalous) departure from the matching principles that would normally apply to Parent's and S1's interest income and expense on their intercompany loan.[87] However, an advantage of this method is that when S1, which (at least in 2018) possesses most of the group's

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net operating loss for the year), 1.1502-79 (applying a similar approach to apportion a consolidated group's investment tax credit carryforwards, foreign tax credit carryforwards, and excess charitable contribution carryforwards to a departing group member).

[87] See Treasury Regulation Section 1.1502-13(c).

capacity to generate ATI, leaves the group, S1 will take most of the business interest expense carryforward.[88]

An additional advantage of Method Two, is that it appears to lead to more appropriate results than Method One in cases where the group conducts both businesses that are exempt from Section 163(j), and non-exempt businesses.

> **Example 4**. Parent, S1 and S2 are members of a consolidated group. In 2018, Parent, a holding company, borrows from third parties and on-lends the funds to S1, which conducts a non-exempt business, and S2, which conducts an exempt business. Parent's interest income on these loans matches its interest expense on its third-party debt. At the end of the year, P sells S1 to a third party.

In Example 4, any carryforward of disallowed business interest expense that the consolidated group generates in 2018 logically should be attributed to S1. However, under Method One, when Parent sells S1, the entire carryforward would remain with the consolidated group – which at that point will own only an exempt business. Presumably, in 2019, the consolidated group would be entitled under Section 163(j) to deduct the full amount of the carried-forward interest assuming sufficient pre-deduction taxable income.

By comparison, under Method Two, S2 could logically be treated as not having any business interest expense in 2018, since its sole activity is an exempt business. Under that approach, none of the carryforward would be apportioned to it. In addition, Parent would have no net business interest expense. Thus, the entire amount of disallowed interest, and carryforward, would be apportioned to S1.

c. Method Three: Apportionment Based on Members' Relative Assets or Income

A third possibility would be to apportion a group's disallowed interest expense among its members using one of the asset-based or income-based methodologies described above in Part III.D. Similar to Method Two, this approach is intended to achieve suitable results in cases where the group members that have business operations (and thus have capacity to use the carryforward) are different than the ones borrowing from third parties; it also is intended to address cases where a group conducts both exempt and non-exempt businesses. This approach is also designed to eliminate a potential weakness of Method Two – that outcomes can differ depending on whether a particular group member has net business interest expense, or not.

> **Example 5**. The facts are the same as in Example 4, except that Parent does not on-lend any funds to S1 and S2. Instead, Parent makes capital contributions to S1 and S2.

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[88] Such an approach can be seen as consistent, at a practical level, with the rules for apportioning a group's NOLs to a departing member. The rules governing that issue generally have the effect of apportioning the NOLs to a group member that carries on revenue-generating activities, which activities might in the future become profitable and utilize the NOLs.

Under both Method One and Method Two, none of the group's disallowed interest expense would be apportioned to S1 when it is sold by Parent. By comparison, in Method Three, rules would be established to apportion the disallowed interest expense to the members of the group that conduct non-exempt businesses, based on the relative assets they use, or income they generate, in those businesses. Thus, in the example, the carryforward of disallowed interest expense is apportioned to S1.

As Example 5 indicates, Method Three often would impute interest expense to group members that in form have no debt. Thus, while this method achieves results that can be seen as more economically accurate, and less susceptible to manipulation, than either of the other methods, this method also would represent a substantial departure from traditional tax principles. On the other hand, this departure might be seen as appropriate given its matching of the methodology employed to determine disallowed interest during the time that S1 and S2 were members of the group.[89]

5. Captive Partnerships

It can be asked whether the single taxpayer approach discussed above should be extended to a case where a partnership that is wholly owned by members of a consolidated group incurs business interest expense. A rational argument could be made that such a partnership is part of a single economic unit to the same extent as any of the partnership's partners are, and that to refrain from subjecting the partnership's business interest expense to the consolidated group's Section 163(j) limit is at odds with economic reality. It also could be asserted that treating group members as a single taxpayer for purposes of Section 163(j) is conceptually consistent with treating a partnership wholly owned by the group as (for purposes of Section 163(j)) a disregarded entity with a single owner, rather than as a partnership with separate existence. A minority of us would propose to take this position.

However, while there may be reasonable policy arguments for such a position, it nevertheless appears it would be difficult to reconcile any guidance applying the group's Section 163(j) limit to the partnership's interest expense, with the terms of the statute. As discussed in Part III.H below, Congress clearly intended that Section 163(j) would apply at the partnership level, and that a partnership's business interest expense for which it is allowed a deduction would not then be subject to a further Section 163(j) limitation in a partner's hands.[90] See Section

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[89] If Method Three were adopted, then additional rules addressing adjustments to basis of member stock and other attributes might be required in order to explain the migration of interest expense to a non-borrower member.

In a related point, it also would be appropriate to consider whether, in a case where a departing member's business tends to be relatively heavily leveraged for non-tax reasons (e.g., a financial institution), it would be reasonable for carryforwards of interest expense attributable to debt incurred by that member to be apportioned only to that member, rather than being apportioned at least in part to non-borrower members remaining in the group. Method Three appears potentially to raise this question to a greater extent than either Method One or Method Two above.

[90] Section 163(j)(4)(A)(i) and (j)(7)(A). When it decided to apply Section 163(j) at the partnership level, it appears Congress may have been motivated, at least in part, by a belief that a business organized in the form of a partnership is as likely to try to generate large interest deductions to shelter its profits, as is a business organized in the form of a corporation. See H.R. Rep. 115-409 at 247 ("The Committee believes that it is necessary to apply the limitation on the deductibility of interest to businesses regardless of the form in which such businesses

163(j)(4)(A)(i). If a partnership had one partner that was a member of a consolidated group, and another that was not, it would seem highly difficult as a technical matter to take a bifurcated approach, computing ATI, business interest income and business interest expense at the partnership level for the non-member partner, as mandated by the statutory text, and computing these items under an aggregate approach for the partner that was a member of the consolidated group. In view of this, it appears questionable whether a special aggregate approach should be adopted for a partnership all of whose partners, in a given period, are members of a consolidated group. Such a partnership is treated as a separate entity for purposes of other provisions of the tax law; and Section 163(j)(4) gives no indication that, notwithstanding those other provisions, the Section 163(j) limit is not meant to be applied at the partnership level when the partners are all members of a group, or otherwise closely related.

While Treasury and the IRS might have authority for such an approach under Section 1502, it would appear to create significant potential for complexity, and also would entail a novel decision to disregard a partnership (at least for a limited purpose) merely because its owners are group members.[91] An approach more consistent with precedent would be to conclude that, if the partnership passes muster under economic substance, business purpose, and similar doctrines, its existence as a partnership should be respected and the normal rules applicable to partnerships should govern.[92]

6. **Application to Affiliated (Rather than Consolidated) Group**

Old Section 163(j)(6)(C) provided that the members of an affiliated group, as defined in Section 1504(a), would be treated as a single taxpayer for purposes of the interest limitation formula. The regulations that were proposed in 1991 under old Section 163(j) would have determined whether the ownership requirements of Section 1504(a) were met based not only on actual ownership, but also on constructive ownership under Section 318. Thus, for example, two

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are organized so as not to create distortions in the choice of entity."). That rationale would seem to be as relevant in a case where a partnership's owners are members of a consolidated group, as in a case where they are not.

[91] In the proposed version of the anti-avoidance rule relating to intercompany transactions, Treasury and the IRS included an example in which a bona fide partnership is owned solely by members of a consolidated group, and one of those members obtains a tax advantage by selling an asset to the partnership. (In the example, there was no subsequent transfer by the partnership, or another person, to a group member.) It was concluded in the example that the sale could be disregarded as a sale to a non-member and, instead, treated as an intercompany transaction. Proposed Regulation Section 1.1502-13(h)(2), Example 2, in 59 Fed. Reg. 18,011, 18,043 (Apr. 15, 1994). After receiving substantial criticism of this example from stakeholders, Treasury and the IRS did not include it in the final version of the regulations. Instead, they indicated in the preamble that such a transaction in an appropriate case could be attacked under other anti-avoidance rules and authorities not specifically tied to the consolidated return context. T.D. 8597, 60 Fed. Reg. 36,677 (July 12, 1995).

[92] See PLR 200252070 (partnership wholly owned by members of consolidated group, treated as preventing consolidation with subsidiaries owned by the partnership until it liquidated); PLR 9645015 (sale by a consolidated group member to an entirely captive partnership was not an intercompany transaction or subject to the intercompany transaction anti-avoidance rule); TAM 9644003 (deferred intercompany gain with respect to stock of a consolidated group member triggered when the member merged into a partnership wholly owned by two other members of the consolidated group); cf. Rev. Rul. 83-156 (respecting a partnership between parent and wholly owned subsidiary in a corporate group).

separate consolidated groups, owned by the same foreign parent corporation, would be considered a single group for purposes of applying old Section 163(j).[93]

We do not recommend that a similar approach be taken under new Section 163(j). In 2017, Congress acted with old Section 163(j) as a long-established, well-understood precedent – and did not adopt any rule similar to old Section 163(j)(6)(C) or the proposed regulations. It is difficult in such circumstances to find statutory support for application of the new interest limitation at the level of an affiliated group. Indeed, the statute provides detailed rules under which Section 163(j) must be applied separately at the partnership level, and not at the partner level using aggregate principles. That conceptual approach seems antithetical to any rule requiring aggregation of separate corporations. Even under old Section 163(j), where there was an express prompt in the statute, the affiliated group rules were viewed as highly complex; it is not warranted to attempt to duplicate those rules here.[94]

We note that one consequence of not treating an affiliated group as a single taxpayer under new Section 163(j), is that if such an affiliated group has a carryforward of disallowed interest under the old statute, it will need to allocate that disallowed interest expense among the consolidated groups, and/or separate U.S. corporations, that were components of that affiliated group. For simplicity, we recommend that such allocation be done using the existing rules in Proposed Regulation Section 1.163(j)-5(c)(2)(iii) for allocations to a member leaving an affiliated group. These rules generally allocate the impact of disallowance of a portion of the affiliated group's interest expense in a particular year among the members of the group, based on their relative amounts of interest paid or accrued to non-taxable related parties. We recognize that other approaches are possible (including allocation based on the relative amount of business assets of each group member), but do not believe it is necessary to create a new rule for this limited purpose.

H. Partnership Issues

1. Applying the Statute at the Partnership Level

The starting point for applying Section 163(j) to a partnership and its partners, is to classify that partnership's interest income, interest expense, and other income and expense at the partnership level: "In the case of any partnership (i) this subsection shall be applied at the partnership level and any deduction for business interest expense shall be taken into account in determining the non-separately stated taxable income or loss of the partnership."[95]

Generally speaking, a partnership should be treated in the same manner as other non-corporate taxpayers for purposes of identifying its business interest income, its business interest

[93] Legislative history to old Section 163(j) contemplated that, at least in some cases, the affiliated group definition might be broadened, where non-member entities had been inserted in a structure that had the effect of breaking apart what otherwise would be a single affiliated group. It was viewed as questionable, however, whether the general statutory grant of authority in Section 163(j)(7) to issue regulations under old Section 163(j) contemplated an approach as broad as that taken in the proposed regulations. See NYSBA Tax Section Report No. 701, Report on Proposed Regulations under Section 163(j), at 20 - 22 (Oct. 23, 1991).

[94] See id.

[95] Section 163(j)(4)(A)(i).

expense, and its ATI.[96] Thus, a partnership's interest income should not be treated as business interest income to the extent such interest income is treated as "investment income" under Section 163(d) (e.g., interest income from passive investment in debt securities). In addition, as discussed further below, a partnership can have interest expense that is not treated as business interest expense because such interest expense qualifies as "investment interest" under Section 163(d).

Once a partnership has computed its business interest income, business interest expense, and ATI, the partnership should first apply its business interest expense against its business interest income under Section 163(j)(1)(A).[97] The partnership will be entitled to a deduction for business interest expense to the extent such business interest expense does not exceed the partnership's business interest income. Next, any remaining business interest expense should be deducted to the extent such remaining business interest expense does not exceed 30% of the partnership's ATI.[98] Finally, to the extent the partnership has any business interest expense remaining after the deductions just described, the partnership will not be allowed a deduction for that excess interest; instead, the carryforward rules of Section 163(j)(4)(B) (discussed below) will apply to such excess. While the statute does not expressly mandate that a partnership's business interest expense will be applied in the manner described in the three preceding sentences, this is the result – for example, the provisions in Section 163(j)(4)(ii)(II) and Section 163(j)(4)(C) concerning "excess taxable income" make this clear.

2. Classification of a Partnership's Interest Expense As Business Interest or Investment Interest

In the case of a partnership whose partners are solely or mainly individuals, it would seem reasonable to allocate its interest expense between business interest expense and investment interest using the tracing principles of Treasury Regulation Section 1.163-8T, consistent with the approach recommended in Part III.D.2 above for interest expense incurred directly by individuals. In addition, tracing could be used to allocate interest expense to such a partnership's businesses that are exempt from Section 163(j), and those that are not.

This approach has significant practical advantages. Under both Section 163(d) and Section 469, current law provides that a determination is made at the partnership level whether interest expense of a partnership is attributable to a particular activity pursuant to Treasury Regulation Section 1.163-8T; and then each partner makes a determination, at the partner level, whether their distributive share of the interest expense attributable to that activity is investment interest or is an expense of a passive activity of the partner. If tracing principles are also used to determine whether interest expense of a partnership should be treated as business interest expense under Section 163(j), then the framework just described can be left unchanged. By comparison, if a partnership owned largely or entirely by individuals was required to use an asset-based or income-based allocation method to determine what portion of its interest expense was business interest expense, it would seem the partnership would need to apply consistent principles to allocate interest expense

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[96] See Section 703(a), providing that a partnership generally computes its taxable income in the same manner as an individual.

[97] If the partnership has any floor plan financing interest, this interest should be separated out from the rest of its business interest expense, and deducted in full by the partnership under Section 163(b)(1)(C).

[98] Section 163(j)(1)(B).

to all its activities (including investment activities and passive activities). This in turn would have an impact on how all the partners applied Sections 163(d) and 469 to their shares of interest expense; they would use different rules than would apply for interest expense attributable to activities that a partner conducted directly.[99] In addition, when an individual made a contribution to, or received a distribution from, a partnership, rules would need to be developed in order to coordinate between the special allocation methodology that would apply at the partnership level and the traditional tracing principles applying to individual partners. Moreover, in interest of fairness, grandfathering rules would likely need to be provided in order to exclude pre-existing partnership debt, which had already been traced to a partnership activity under Treasury Regulation Section 1.163-8T prior to the Act, from the new allocation methodology. The complexity involved in implementing such an approach, would seem to outweigh any benefits it might provide.

However, as noted in Part III.D.2, it is questionable whether the same conclusion applies, where a partnership is owned solely or mainly by corporations. In such a case, it would seem preferable for the partnership to apply an asset-based or income-based approach to allocate its interest expense between investment interest and business interest expense, and between exempt and non-exempt businesses. Such an approach would limit opportunities for a corporation to use a partnership to manipulate how much interest expense could be allocated to exempt businesses.

Whatever method is generally used by a partnership to allocate its interest expense, we believe that at least one limited departure from traditional tracing principles is appropriate. If a partnership distributes borrowed funds, we believe that for purposes of applying Section 163(j) at the partnership level (and only for that purpose), the partnership's interest expense should be allocated among the partnership's exempt and non-exempt businesses, and its investments, based on the relative assets or income attributable to each business and its investment portfolio. None of the interest should be allocated based on the distributee partners' use of funds.

By comparison, Notice 89-35 applied the principles of Treasury Regulation Section 1.163-8T to a partnership borrowing that funded a distribution, to determine how to characterize the partnership's interest expense under Section 163. In the case of the partner that received the distribution, the character of that partner's interest expense generally depended on how the partner used the borrowed funds. If a partner was allocated interest expense on a share of the debt exceeding the amount (if any) of the borrowing proceeds distributed to him, then the partner was free to allocate the interest expense on that excess debt using any reasonable method, including by reference to the nature of the partnership's expenses during the year.[100] It appears that a rule that is based on how a partner uses the proceeds of a debt-financed partnership distribution, does not

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[99] As discussed in Part III.H.7 below, the exception in Section 163(j)(3) for small taxpayers (those with average annual gross receipts of not more than $25 million) appears to apply at the partnership level rather than the partner level. Thus, if a partnership had gross receipts of at least $25 million, its methodology for allocating interest expense among its activities would impact all of its partners, large and small.

[100] In addition to the general rules described in the text, Notice 89-35 provides an optional alternative. Under that alternative, a partnership can choose to determine the character of its interest expense on debt used to fund a distribution by allocating the debt to any one or more expenditures made by the partnership during the year of the distribution. However, the portion of the debt allocated in this manner cannot exceed the amount of the selected expenditures. Any excess portion of such debt, and the related interest expense, must be allocated under the general rules described in the text.

fit well with the statutory mandate in Section 163(j)(4) that Section 163(j) should be applied separately at the partnership level. A rule that allocates the interest expense on the debt based on the assets and activities of the partnership would more fully comport with this statutory requirement.[101]

3. Treatment of a Partnership's Business Interest Expense That Is Allowed as a Deduction

Section 163(j)(4)(A)(i) states that all business interest expense of a partnership for which a deduction is allowed under Section 163(j), is taken into account in the partnership's "non-separately stated income." Although "non-separately stated income" is not defined in Section 163(j), we understand it to mean the partnership's "taxable income or loss, exclusive of items requiring separate computation under other paragraphs of [Section 702(a)]."[102]

In general, an item of income or deduction that is included in the non-separately stated income of a partnership, as determined under Section 702(a)(8), loses its tax character in the hands of the partner to whom the item is allocated.[103] In the case of a partnership's deduction for business interest expense, it is clear such deduction loses its character as interest, when applying Section 163(j) at the partner level. As a result, such deduction is not subject to any additional Section 163(j) limit at the partner level – only the limit, if any, imposed at the partnership level applies.

However, while not entirely clear, it seems very unlikely that such interest loses its character for purposes of applying other provisions of the Code. The legislative history and structure of the statute suggest that the purpose of the rule is to help coordinate the Section 163(j) limit imposed at the partner and partnership levels; there is no suggestion the rule is intended to apply more broadly. Thus, for example, the source of a partner's share of the partnership's business interest expense deduction presumably is determined under Section 861 under the normal rules that apply to interest expense.

We recommend that Treasury and the IRS issue guidance confirming that partnership business interest expense that is deductible for Section 163(j) purposes and taken into account in determining the partnership's "non-separately stated income" nevertheless retains its character for all other Code purposes.

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[101] For avoidance of doubt, this Report is not suggesting that Treasury undertake a broader re-examination of the guidance provided in Notice 89-35, for any purpose other than the application of Section 163(j) at the partnership level.

[102] Section 702(a)(8). See also Section 6225(a)(2)(A), referring to "non-separately stated income or….non-separately stated loss (whichever is appropriate) under section 702(a)(8).").

[103] See Rev. Rul. 71-278 (partnership is subject to Indiana gross receipts tax; partnership is entitled to a deduction for this tax under Section 164 when computing its taxable income and its partners' distributive shares of such taxable income; partnership's partners do not get a separate Section 164 deduction, and they are not precluded from choosing the standard deduction instead of itemized deductions); McKee, Nelson & Whitmire, Federal Taxation of Partnerships & Partners, ¶ 9.01[3][a] ("Partnership items that are not separately stated are lumped together in an undifferentiated residual hotchpot that constitutes partnership Section 702(a)(8) "bottom-line" taxable income or loss.").

Because, under our recommendation, partnership business interest expense would retain its character as interest at the partner level other than for purposes of applying Section 163(j), it could be asked whether a non-corporate partner's share of such interest expense could be subject to limitation under Section 163(d). We believe this result is not intended; rather, it would seem that under Section 702 principles a partner's share of interest expense allocable to a business of the partnership should retain that character in the partner's hands.[104]

4. **Rules Relating to a Partnership's Business Interest Income**

Section 163(j) does not provide that a partnership's business interest income is treated as part of its non-separately stated income. The statute does not contain any express rule regarding how the partnership's business interest income should be treated in the hands of its partners.

> **<u>Example 6</u>**. A owns 10% of partnership (PS) and B owns the remaining 90%. In 2018, PS has $1,000 of business interest income, $990 of business interest expense, and no other items of income or deduction. In the same year, A has 100 of business interest expense on debt that A has incurred outside PS, and $0 of ATI from sources other than PS.

The statute does not provide guidance about how A should be treated in Example 6 – in particular, whether A is allowed under Section 163(j) to claim a deduction for A's 100 of business interest expense on partner-level debt, as a result of the allocation of 100 of PS's business interest income to A.

In general, if a partnership has business interest income, it appears that under Section 702, a partner's distributive share of that income would retain its character as such; and, as a result, the partner would be able to increase the partner's Section 163(j) limitation by its share of that interest income, pursuant to Section 163(j)(1)(A).

However, in a case like Example 6, it seems logical, and consistent with the statutory scheme, to provide in administrative guidance that to the extent PS's business interest income has been taken into account in determining the amount of PS's business interest expense deduction allowed under Section 163(j)(1)(A), such business interest income cannot then be taken into account a second time, in computing the limit under Section 163(j) on A's deduction for business interest expense incurred by A on partner-level debt. Such a rule would be a reasonable interpretation of the statutory requirement that Section 163(j) must be applied "at the partnership level" (i.e., 990 of PS's business interest income should be taken into account at the PS level <u>only</u>, in computing PS's interest deduction limit under Section 163(j)(1)(A) – and not at the partner level). This result would also would be conceptually similar to the statute's express rules to ensure that, once a dollar of a partnership's ATI is used to support a deduction of the partnership's business interest expense under Section 163(j)(1)(B), that same dollar of ATI cannot then be used a second time, to support a deduction of a partner's business interest expense on partner-level debt.

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[104] This result also comports with legislative history that suggests the same dollar of interest expense is not meant to be subject to limitation under both Section 163(j) and Section 163(d). <u>See</u> H.R. Rep. 115-409, at page 248 note 444; H.R. Rep. 115-466, at 386 n. 688.

Under the guidance proposed above, A would not be entitled to use the whole $100 of business interest income allocated to A, to support a deduction under Section 163(j)(1)(A) of A's partner-level business interest expense. Instead, A would be entitled to use only $1 out of the $100 of PS's business interest income allocated to A, to deduct A's partner-level interest expense in 2018.

As a mechanical matter, a relatively straightforward way to achieve the desired results would be to require that a partnership's business interest income must be included in the partnership's non-separately stated income, to the extent such business interest income does not exceed the partnership's business interest expense for the year.

By comparison, in the absence of the proposed guidance, A would appear to have a compelling argument that the business interest income allocated to A supports a deduction of the full $100 of A's business interest expense under Section 163(j)(1)(A). In that case, the result would be that PS’s $100 of business interest income allocated to A would have supported $200 of deductions of business interest expense – a $100 deduction at the PS level, allocated to A; plus a second $100 deduction at the partner level for A. It would be difficult to justify such a result as a policy matter.

5. Business Interest Expense Disallowed at the Partnership Level: Carryforward Rules

a. In General

A partnership's business interest expense for which a deduction is not allowed at the partnership level under Section 163(j) is allocated to the partners per Section 163(j)(4)(B) as “excess business interest.” Any excess business interest of a partner may not be deducted until the partner is allocated "excess taxable income" ("**ETI**") from the partnership in futures years. When a partner is allocated ETI, it treats an equivalent amount of excess business interest as business interest expense paid or accrued by the partner in the year of the ETI allocation.

It seems clear that ETI is intended to be defined as that portion of a partnership’s ATI for a given year that is not needed to support the partnership’s deduction under Section 163(j)(1)(B) for business interest expense in that year.

> **Example 7**. C owns 10% of PS. In Year 1, PS incurs $1,000 of business interest expense that it is not able to deduct by reason of the partnership-level limitation under Section 163(j). PS allocates 10 percent, or $100, of that amount to C as excess business interest expense under Section 163(j)(4)(B)(ii).
>
> In Year 2, PS has 1,500 of ATI and 150 of business interest expense. PS allocates 150 of ATI and 15 of business interest expense to C in Year 2.

Under Section 163(j)(1)(B) and (j)(4)(i), PS uses 500 of its ATI to support PS’s deduction of 150 of business interest expense for Year 2. This leaves PS with 1,000 of ETI. Because PS allocates 10% (or 150) of its ATI to C, this means 10% (or 100) of PS's ETI is allocated to C. Logically, it is appropriate for C to be able to use the 100 of ETI to deduct only 30 of its carryforward of interest expense from Year 1. That result would put C in the same position as it

would have been in had the 100 of business interest expense in Year 1 been incurred by PS and allocated to C in Year 2 – rather than being carried forward by C from Year 1.

However, Section 163(j)(4)(B)(ii) indicates that C is entitled to deduct (at least to the extent it has excess available ATI) its carried-forward 100 of interest expense "to the extent of such excess taxable income," i.e., to the extent of the ETI that PS allocates to C in Year 2. The relevant provision reads, in full:

> If a partner is allocated any excess business interest expense from a partnership under clause (i) [requiring the allocation among partners of business interest expense for which a deduction is not allowed for a taxable year] for any taxable year—
>
> (I) such excess business interest expense shall be treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only to the extent of such excess taxable income, and
>
> (II) any portion of such excess business interest expense remaining after the application of subclause (I) shall, subject to the limitations of subclause (I), be treated as business interest expense paid or accrued in succeeding taxable years.

Under this provision, because C recognizes 100 of ETI in Year 2, all 100 of its carryforward is treated as business interest expense "paid or accrued by" C in Year 2.

We believe that the reference to "paid or accrued" should not be interpreted as providing that C is automatically entitled to a deduction under Section 163(a) for 100 of interest paid or accrued in Year 2, without any limitation under Section 163(j) applying. Instead, this provision should be interpreted to treat such business interest expense in a manner similar to any other business interest expense paid or accrued by C in Year 2. That is, because that business interest expense is treated as having been "paid or accrued by C" in Year 2, it should be subject to the same limitations under Section 163(j)(1) as other business interest expense incurred by C.

Under this approach, pursuant to Section 163(j)(4)(A)(ii)(II), C's 100 of ETI is added to C's ATI, thus supporting a deduction of 30 of the business interest expense C is deemed to have accrued in Year 2. The remaining 70 of business interest expense is treated like any other business interest expense incurred by C in Year 2; that is, C is entitled to deduct it to the extent C has sufficient ATI and/or business interest income, and C is required to carry forward to future years any portion of that business interest expense that it cannot deduct. Thus, because that business interest expense is treated as having been "paid or accrued by C" in Year 2, it ceases to be a carryforward of excess business interest that can be used only against C's share of PS's ETI pursuant to Section 163(j)(4)(B)(ii).

We recommend that guidance make clear that any excess business interest expense of a partner "freed up" as a result of an allocation of ETI must be treated like any other business interest expense of the partner paid or accrued in the same year (and thus potentially subject to limitation at the partner level). In the absence of such guidance, we believe taxpayers might argue that the statutory language entitles a partner to an immediate deduction for the full amount of business

interest expense that has been "freed up" and is treated as paid or accrued as a result of an allocation of ETI.

Even if such guidance is provided, however, Section 163(j)(4)(B)(ii) will lead to the apparently inappropriate result of each dollar of ETI allowing one dollar of excess business expense to be deducted by a partner (subject to such partner having sufficient excess ATI from other sources), even though one dollar of ATI recognized by a partnership only permits the deductibility of thirty cents of business interest expense. While we recommend that this issue be addressed, it is unclear that regulatory authority exists for preventing this result, in which case a technical correction would be appropriate.

In addition, guidance should provide a clear ordering rule under which a partner's share of ETI, to the extent such share exceeds the amount the partner needs in order to be entitled to deduct carryforwards of disallowed business interest expense, is added to the partner's ATI. Section 163(j)(4)(A)(ii)(II) indicates fairly clearly this result is intended. However, the last sentence of Section 163(j)(4)(B)(ii) may cause some confusion: the sentence states that "For purposes of applying this paragraph [i.e., Section 163(j)(4), which applies Section 163 in the partnership context], excess taxable income allocated to a partner from a partnership for any taxable year shall not be taken into account under paragraph ***(1)(A)*** with respect to any business interest expense other than excess business interest expense from the partnership until all such excess business interest expense for such taxable year and all preceding taxable years has been treated as paid or accrued" (emphasis added). Treasury and the IRS should clarify that such ETI in fact will be taken into account by the partner under Section 163(j)(1)(B).

b. **Use of a Partner's Share of the Partnership's Business Interest Income to Absorb a Carryforward**

We recommend providing guidance under which, if a partnership has business interest income in a particular year that exceeds the partnership's business interest expense for the year, then a partner will be permitted to use its share of that excess business interest income to absorb the partner's carryforwards of excess business interest from prior years.

> **Example 8**. D owns 10% of PS. In Year 1, PS has $1,000 of ATI and $1,000 of business interest expense, and 10% of this ATI and business interest expense is allocated to D. In Year 2, PS has $1,000 of business interest income and $300 of business interest expense, and again 10% of these items are allocated to D.

In Example 8, under Section 163(j)(4)(i)(A), PS is entitled to deduct $300 of its $1,000 of business interest expense in Year 1. Under Section 163(j)(4)(ii)(B), $70 out of the remaining $700 of interest is allocated to D and treated as excess business interest expense, which is carried forward to Year 2. Section 163(j)(4)(B)(ii) allows D to apply the $70 against D's share of any ETI that PS recognizes in future years. In Example 8, PS has no ETI in Year 2; but, it would seem logical, and justified as a policy matter, to allow D to apply the $70 of excess business interest expense against D's share of PS's business interest income for Year 2, as reduced by PS's business interest expense for Year 2. Under this approach, PS's business interest income of $1,000 for Year 2, net of PS's $300 of business interest expense for the year, leaves $700 of excess business interest

income, of which $70 is allocable to D; D thus would be entitled to deduct the entire $70 of disallowed interest in Year 2.

While the statute sets forth a detailed formula for the computation of a partnership's ETI, and specific rules prescribing how a partner is allowed to use its distributive share of ETI to absorb carryforwards of excess business interest expense, it does not incorporate "excess" business interest income into the formula for ETI. The statute also does not, however, expressly prohibit guidance permitting the use of excess business interest income to absorb carryforwards; and such guidance seems consistent with legislative intent. Section 163(j)'s legislative history indicates that the carryforward rules in Section 163(j) are intended to deal with the fact that, due to due to business cycles or other factors, a business might sometimes incur an amount of interest expense that is large, relative to the business' income.[105] In the partnership context, Congress dealt with the most obvious manifestation of this issue when it adopted rules allowing a partner to use the partner's share of ETI to claim deductions for excess business interest expense. Congress did not adopt specific rules for a partnership whose principal income from its trade or business in fact happens to be interest, as with a lending business, rather than (say) income from the sale of inventory or provision of personal services. Indeed, there may not be a large number of partnerships that fit this description, relative to the total number of partnerships in the United States.[106] However, the fact that Congress focused on providing relief for the most common cases that warranted it, logically should not be interpreted as precluding Treasury and the IRS from extending the principles of the statute to equally appropriate, if less mainstream, cases involving a partnership that has excess business income that happens to be interest, rather than ATI.

6. **Cases Where a Partnership Has Interest Income/Expense that is Not Treated as Business Interest Income/Expense at the Partnership Level, Or Has Other Items That Are Treated as Investment Income at the Partnership Level**

A partnership can have interest income and expense that is not treated as business interest income or business interest expense at the partnership level.

> **Example 9**. E, a U.S. corporation, and F, an individual, each own 50% of PS. PS has passive investments in securities, which it finances partially by incurring debt. In 2018, PS incurs 100 of interest expense on the debt, which it allocates pro rata to E and F.

PS's 100 of interest expense would qualify in Example 9 as investment interest under Section 163(d), if PS were an individual. Thus, such interest is not business interest expense, in PS's hands.

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105 See H.R. Rep. 115-409, at 248 (Nov. 9, 2017).

106 IRS data indicates that in 2011 through 2014, partnerships in the finance and insurance sector represented about 9% of all partnerships filing returns. IRS data also indicates that in 2011 through 2013, S corporations in that sector represented about 4% of S corporations filing returns. See IRS, Total Assets, Trade or Business Income and Deductions, Portfolio Income, Rental Income and Total Net Income; IRS, Returns of Active Corporations, Form 1120S - Table 7).

In E's hands, however, that interest should be treated as business interest expense.[107] Section 163(j)(4) does not require that such interest be included in PS's non-separately stated income. Instead, under Section 702(a)(7) and Section 702(b), the interest expense ought to be treated in E's hands in the same manner as interest on debt incurred directly by E to finance direct investments in securities by E. Such interest expense of E would be business interest expense that is subject to limitation under Section 163(j).

By comparison, if Section 163(j) did not apply to the interest expense allocated to E, that would create an opportunity for E to avoid Section 163(j) by borrowing through a partnership, rather than borrowing directly. That result appears to be contrary to the intent of the statute: the statute's drafters clearly placed emphasis on preventing the use of partnerships to avoid the Section 163(j) limit.

An approach similar to the one just described should be taken in the case of F. Thus, similar to the analysis in E's case, the 50 of interest expense allocated to F should be treated as incurred by F to finance an investment in securities. Under Section 163(d), that interest should be treated as investment interest.

In Example 9, if PS earns interest income on its securities then it seems that the same approach as described above for interest expense, should apply to that income. Thus, E's share of PS's interest income should be treated as business interest income, in E's hands. F's share of such interest should be treated as investment income as defined in Section 163(d), in F's hands.

In addition, a partnership may have items other than interest income which are treated, at the partnership level, as investment income that is not part of the partnership's ATI. For example, it would appear that dividends, Subpart F income and qualified electing fund inclusions that are included in income by a partnership should be treated as investment income at the partnership level that does not enter into its ATI.[108] Similarly, the partnership's ATI should not include any dividends received deduction claimed by a corporate partner, as such items are not partnership-level deductions but, instead, are tied to the corporate status of the partner.[109]

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[107] See H.R. Rep. 115-409, at 248 note 444 (Nov. 9, 2017) ("Section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision.").

[108] See Section 163(d)(5)(A)(i), 469(e)(1)(A)(i)(I); cf. Treasury Regulation Section 1.1411-10(c)(5), (g) (for purposes of calculating net investment income, a taxpayer can elect whether to compute his Section 163(d) investment interest limitation based on different timing for inclusion of Subpart F income and QEF amounts, than applies for regular income tax purposes).

The Tax Section plans to make a separate submission on the GILTI rules that will address, among other issues, the application of Sections 250 and 951A to partners and partnerships.

[109] If a corporate partner borrows at the partner level to finance an investment in a partnership that owns stock, the result under Section 163(j) will be different (generally less favorable) than if the borrowing had been at the partnership level. The corporate partner's ATI will take into account both its share of the dividend income and the dividends received deduction, whereas the partnership's ATI would not take into account the dividends received deduction. It could be asked whether that difference is justifiable as a policy matter. On balance, we believe it is. The difference in treatment is a direct consequence of Congress' decision in Section 163(j)(4) that

Guidance confirming the above results would be useful.

7. **Application of Exemptions/Exclusions from Section 163(j)**

a. **Election for a Real Property Trade or Business/Electing Farming Business (Section 163(j)(7)(B) & (C))**

Guidance should provide that, where a partnership conducts a real estate business of a type that qualifies for the election under Section 163(j)(7)(B), or a farming business that qualifies for the election under Section 163(j)(7)(C), the election should be made at the partnership level, rather than at the partner level.

In general, most elections affecting the treatment of partnership items are required to be made by the partnership.[110] In addition, Section 163(j)(4) specifically provides that Section 163(j) must be applied at the partnership level. It would be consistent with Section 163(j)(4), and simple as a mechanical matter, to have a partnership make the elections under Sections 163(j)(7)(B) and (C) with respect to a business it conducts. By comparison, if it is desired to give each partner the option to elect out, with respect to that partner's distributive share of income and interest expense from a partnership's real estate or farming business, the necessary mechanics for the election would be significantly more complicated. Among other things, a partner that elected out would need to take into account that partner's distributive share of depreciation deductions using a slower depreciation schedule, than a partner who did not elect out would use. In addition, it would seem hard to reconcile a partner-by-partner approach with the basic principle of applying Section 163(j) at the partnership level.

b. **Impact on the Partners Where a Partnership Conducts an Exempt Business**

If a partnership conducts an electing real property or farming trade or business, or a utilities business, then the partnership's interest expense allocable to that business, as well as all the other items of income and deduction that are allocable to such business, should retain their character in the hands of the partners to whom such items are allocated. In other words, under Section 702(a), such items should be treated as received/incurred by a partner in the conduct of a business that is excluded from Section 163(j), and so should not enter into the partner's ATI, business interest income or business interest expense.

> **Example 10**. PS conducts a business of renting real estate to third parties, for which PS makes an election under Section 163(j)(7)(B), as well as a non-exempt business. In 2018, G, a partner in PS, is allocated 3 of income from PS's real estate business and 7 of ETI from the non-exempt business. G has business interest expense allocable (under the allocation principles described in Part III.D above) to non-exempt activities unrelated to its investment in PS.

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it is appropriate to apply the Section 163(j) limit at the partnership level, rather than adopting an aggregate approach to partnerships.

[110] See Section 703(b).

On these facts, G should add its 7 of ETI to its ATI, thus increasing its Section 163(j)(1)(B) limit for purposes of deducting its business interest expense unrelated to PS. G's 3 of income from PS's real estate business, however, should not be included in G's ATI or increase G's Section 163(j) limitation.

In a case where a partner incurs debt which is allocable to its interest in a partnership that conducts an exempt business, guidance should provide that interest on the partner-level debt is exempt from Section 163(j).

> **Example 11**. PS conducts a business of renting real estate to third parties as PS's sole activity and makes an election under Section 163(j)(7)(B). H, a partner in PS, borrows and its interest expense is allocable (under the allocation principles described in Part III.D above) to H's interest in PS.

In Example 11, it is appropriate for H's interest expense to be exempted from Section 163(j), because the interest is allocable entirely to an asset (H's interest in PS) that generates income from an electing real property trade or business. Such an approach is conceptually similar to the approach taken in the statute to PS's ETI, which a partner can use to support a deduction of partner-level interest expense.

If PS in Example 11 conducts both a real estate business, and a trade or business that is not excluded from the scope of Section 163(j) (similar to Example 10), then the treatment described above would apply only for the portion of H's partner-level interest expense that is properly allocable to the real estate rental business.

c. **Small Businesses (Section 163(j)(3))**

> **Example 12**. PS conducts a business and has business interest expense. However, PS has average annual gross receipts of less than $25 million, as determined for purposes of Section 448(c). One or more of PS's partners has average annual gross receipts of over $25 million.

In Example 12, it seems clear that, at the partnership level, Section 163(j) does not apply to limit PS's interest deductions, because PS qualifies for the small business exception in Section 163(j)(3). However, a question remains as to whether, at the partner level, each partner should separately determine whether that partner is below the $25 million threshold in Section 163(j)(3).

The general principle that Section 163(j) will be applied at the partnership level indicates that, if PS is exempt by reason of the small business exception in Section 163(j)(3), then the interest expense of PS allocated to its partners should remain exempt from Section 163(j) in their hands – rather than being re-tested at the partner level. In addition, Section 163(j)(3) incorporates the $25 million threshold from Section 448(c), which by its terms clearly applies that threshold at the partnership level to allow the partnership to use the cash method of accounting, notwithstanding that the partnership may have large, accrual-method partners.

Such a result is permitted under Section 448(c) because it contains aggregation rules, pursuant to which the $25 million threshold is applied taking into account the gross receipts of all entities related under Sections 52(a) or (b) or 414(m) or (o) (broadly, all entities in a group

connected to one another through greater than 50% ownership, as well as entities that are functionally connected by conducting integrated activities). The effect of these rules is to limit opportunities for gamesmanship, by forcing a partner that has a significant relationship to a partnership to add the partner's (and its affiliates') gross receipts to those of the partnership. These aggregation rules are incorporated by reference in Section 163(j)(3), with a similar effect.

Arguably, there is not a compelling reason for a partner with a large amount of gross receipts to be able to claim deductions for its share of business interest expense incurred by small partnerships with which the partner is not closely related, without any Section 163(j) limitation on those deductions. However, on balance, that result seems to provide little opportunity for abuse, and it appears consistent with the statutory scheme. We recommend that Treasury and the IRS confirm that result is correct.

8. **Special Allocations**

Guidance should expressly confirm that special allocations by a partnership of items of ATI, ETI, business interest income and/or business interest expense do not affect the determination of the Section 163(j) limitation at the partnership level.

> **Example 13**. I and J own all of the interests of PS. In 2018, PS has no business interest income, 300 of ATI, and 60 of business interest expense. PS allocates all items comprising its ATI solely to I and its business interest expense solely to J. Assume these allocations are respected under Section 704(b).

In Example 13, the Section 163(j) limitation is applied at the partnership level, and PS's limitation is 60 with the result that PS's business interest expense should not be subject to limitation. We note that because PS's business interest expense (but not its ATI) is allocated to J, applying the limitation at the partnership level can result in a better outcome for J (i.e., full deductibility of the business interest expense allocated from PS) than had the limitation been applied at the partner level. Nevertheless, we believe that it is consistent with the plain language of the statute to apply the limitation at the partnership level only (and not again at the partner level where special allocations have effect).

Once the limitation has been applied at the partnership level, however, it is important that regulations, consistent with the statutory provision, make clear that, in then applying Section 163(j) at the partner level, the partners should take into account neither (i) their shares of the partnership's business interest expense that is deductible after application of the limitation at the partnership level, nor (ii) their share of the partnership's ATI that was used to allow its business interest expense to be deductible (and thus not included in ETI) (collectively, "**Post-Calculation Items**"). Thus, in Example 13, 200 of the 300 of ATI allocated to I and all 60 of business interest expense allocated to J would be considered Post-Calculation Items. As a result, I would be unable to use 200 of the ATI it is specially allocated to calculate its own Section 163(j) limitation. Correspondingly, the 60 of business interest expense allocated to J would be subject to no further limitation regardless of the amount of ATI and business interest income otherwise recognized by J. The remaining 100 of ATI allocated to I for 2018 would constitute ETI (and not a Post-Calculation Item), and thus would be potentially usable by I in determining its own Section 163(j) limitation.

A more challenging fact pattern would be present where a partnership specially allocates deductions that are included in its ATI in a manner that differs from how it allocates items of income that are included in its ATI.

> **Example 14**. I, J and K own all of the interests of PS. In 2018, PS has no business interest income, 300 of ATI, and 60 of business interest expense. PS's ATI consists of 500 of gross income and 200 of gross deductions. PS allocates that gross income solely to I, those gross deductions solely to J, and its business interest expense solely to K. Assume these allocations are respected under Section 704(b).

In Example 14, like in Example 13, because the Section 163(j) limitation is applied at the partnership level, PS's business interest expense should be fully deductible. Thus, the 60 of business interest expense allocated to K should be considered a Post-Calculation Item and, thus, not subject to further limitation on K's return.

In Example 14, PS will also have 100 of ETI. Because, however, PS's items of income and deduction comprising its ATI will be allocated to different partners, it is not clear how the gross items of income and deduction allocated to I and J, respectively, should be treated. We believe the simplest approach would be to (i) treat gross income included in ATI ("**ATI Income**") allocated to a partner as ETI on a proportionate basis based on the proportion of the partnership's ATI Income allocated to each partner (with any remaining ATI Income allocated to the partner treated as a Post-Calculation Item) and (ii) treat all deductions included in ATI ("**ATI Deductions**") allocated to a partner as Post-Calculation Items. Under this approach, because PS has 100 of ETI, and all 500 of PS's ATI Income was allocated to I, 100 of the 500 of ATI Income allocated to I will be ETI, with the remaining 400 of ATI income allocated to I, and all 200 of ATI Deductions allocated to J, being treated as Post-Calculation Items.

Our recommended approach to cases like Examples 13 and 14 comports with the final sentence of Section 163(j)(4)(A), which provides that a partner's distributive share of ETI must be determined in the same manner as the partner's share of the partnership's non-separately stated income or loss. Under our approach, a proportionate part of the ATI Income allocated to each partner (whether as part of an allocation of net ATI, as in Example 13, or through an allocation of gross income items, as in Example 14) is treated as ETI. The remaining proportionate part of the ATI Income allocated to each partner (i.e., the part that is a Post-Calculation Item) loses its character in the partner's hands as ATI, and so cannot be used by the partner to support deductions of partner-level business interest expense. This proportionate allocation is, in our view, contemplated by the statute.

It would be appropriate to apply a similar approach to allocations of a partnership's excess business interest.

> **Example 15**. Same facts as Example 14, except that in 2018, PS has 100 of business interest expense.

In Example 15, PS's Section 163(j) limitation is 90 (90 = 0 business interest income + {30% x 300 of ATI}). Thus, PS can deduct only 90 of its 100 of business interest expense, and has 10 of excess business interest. Under our approach, each dollar of business interest expense that is

allocated to a partner, must consist of a proportionate part of (i) business interest expense for which the partnership was allowed a deduction under Section 163(j) (a Post-Calculation Item), and (ii) excess business interest. Thus, since PS allocated all of its business interest expense to K in Example 15, the entire 10 of excess business interest must be allocated to K.

In this connection, we note that Section 163(j)(4)(B)(ii)(II) provides that excess business interest must be allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. We believe our approach, in which excess business interest is allocated among the partners in the same proportions as business interest expense for which the partnership is allowed a deduction, meets this requirement.

9. **Section 704(c) Allocations**

Where a partnership owns Section 704(c) property, it is required to allocate items with respect to that property so as to take into account any variation between the property's adjusted tax basis and its fair market value at the time of contribution (or revaluation) using a reasonable method that is consistent with the purposes of Section 704(c). The three methods that are deemed to be generally reasonable for purposes of making those allocations (the traditional method, the traditional method with curative allocations, and the remedial method) affect how partnership items are allocated among its partners and, in the case of the remedial method, may cause offsetting items of income and loss to be created and allocated among the partners.

None of the Section 704(c) methods affects the net amount of income or loss recognized by a partnership. As a result, and consistent with our discussion of special allocations above, we believe that the Section 163(j) limitation should be applied at the partnership level without regard to the manner in which partnership items are allocated among its partners under Section 704(c). While disregarding the allocation of items under Section 704(c) can result in a different amount of interest disallowance under Section 163(j) than had the limitation been applied at the partner level, we believe that it is consistent with the plain language of the statute to apply the limitation at the partnership level only by ignoring the effect of Section 704(c) on the partnership's allocations.

10. **Section 743 Allocations**

A partner's items of depreciation or amortization (or adjustment to gain or loss on sale of an asset) that results from a Section 743(b) basis adjustment appears similar, in some ways, to a special allocation. As a technical matter, basis adjustments under Section 743(b) increase or decrease the basis of partnership property. Such adjustments, however, do not enter into the partnership's taxable income or loss as computed under Section 703; instead, such adjustments affect only the adjusted partner (and have no effect on the partnership's other partners).[111] In other words, notwithstanding the fact that the basis adjustment occurs at the partnership level, the existing regulatory framework makes clear that such basis has no effect on the calculation of the partnership's taxable income. Accordingly, we recommend that regulations clarify that (i) Section 743(b) adjustments of a partnership's partners are not taken into account in applying the Section 163(j) limitation to the business interest expense of the partnership and (ii) each partner's Section 743(b) adjustments are taken into account as items derived directly by the partner in determining

[111] See Treasury Regulation Section 1.743-1(j).

its own Section 163(j) limitation. If a rule was adopted requiring that a partner's Section 743(b) adjustment be included in the computation of a partnership's ATI for purposes of applying Section 163(j) at the partnership level, then a particular partner's Section 743(b) items could impact the deductibility of partnership interest by other partners. Such a result seems inconsistent with the basic approach taken in the Section 743(b) regulations. Instead, a Section 743(b) adjustment is appropriately taken into account at the partner (rather than partnership level) in determining ATI.

Our recommended approach creates potentially significant differences between a transaction in which a partnership purchases assets (where depreciation and amortization deductions generated by the stepped-up basis of those assets will, until the end of 2021, enter into the partnership's ATI), and a transaction structured as a purchase of partnership interests (where depreciation and amortization deductions generated by the Section 743 basis adjustment will not enter into the partnership's ATI). However, we believe these differences are unavoidable consequences of the decision to exclude a partner's Section 743(b) items from the partnership's taxable income.

I. International Issues

1. Outbound Investment

We recommend that guidance be issued discussing how (if at all) Section 163(j) applies to business interest expense of a controlled foreign corporation ("**CFC**") or passive foreign investment company ("**PFIC**").

We believe the analysis for a U.S. investor in a PFIC (specifically, a PFIC for which the investor elects qualified electing fund status) is relatively straightforward. Under Section 1293(a), such an investor's annual income inclusion is limited to the investor's pro rata share of the PFIC's E&P for the year. Thus, the key point for a U.S. investor is the impact on the calculation of the PFIC's E&P of a disallowance of business interest expense under Section 163(j). As explained in Part III.F above, such a disallowance should not cause a delay in time the interest expense is taken into account in computing E&P.[112]

The picture for a U.S. shareholder of a CFC is more complicated. It appears that the U.S. shareholder's computation of its Subpart F income will be impacted by application of Section 163(j) to the CFC's interest expense, unless guidance provides relief from that result. However, it is not entirely clear that it makes sense for Section 163(j) to apply to a CFC's interest expense, for purposes of computing Subpart F income. In addition, assuming Section 163(j) should have an impact on the computation of Subpart F income, guidance could be developed in order to clarify exactly how big that impact will be.

As an initial question, it can be asked whether, as a policy matter, Section 163(j) should apply at all to interest expense of a CFC. On one hand, if Section 163(j) did not apply to CFCs, then it would be possible for U.S. taxpayers to conduct leveraged activities through a CFC and get

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[112] We note that Congress has on occasion specifically instructed that departures from the normal E&P rules be made, when computing a PFIC's E&P. See Section 1293(e)(3). It has not done so in the case of new Section 163(j).

the effect of a full interest deduction. However, the strength of this concern appears to be diluted, in cases where a CFC earns not only Subpart F income, but also material amounts of income that is not subject to Subpart F. This will particularly be the case if it is difficult to predict of the mix of Subpart F and non-Subpart F income from year to year. In addition, to the extent that a CFC's business interest expense is disallowed and then, in future years, a U.S. shareholder's percentage ownership goes below 10%, or the CFC does not have Subpart F income, the U.S. shareholder may have a limited, or no, ability to benefit from a carryforward of the interest by the CFC under Section 163(j)(2).

In the proposed regulations under old Section 163(j), Treasury and the IRS decided not to apply the statutory limitation to the interest expense of any foreign corporation (including a CFC) that did not conduct a U.S. trade or business. The Preamble stated that "The disallowance rules do not apply if the payor corporation is either an S corporation or a foreign corporation (except as provided under 1.163(j)-8, related to foreign corporations with effectively connected income)."[113] Consistent with that statement, the proposed rules for a foreign corporation with a U.S. trade or business applied only with respect to the corporation's income and expense attributable to that trade or business; and the proposed affiliated group rule referenced above applied only to U.S. corporations that were in an affiliated relationship (foreign corporations were not treated as members of the affiliated group).[114]

However, in the absence of similar guidance under new Section 163(j), it appears the provision would apply to CFCs. Pursuant to Section 954(b)(5), when a CFC has foreign base company income ("**FBCI**"), that income is reduced by "deductions…properly allocable to such income" (including interest expense) for purposes of computing the amount of a U.S. shareholder's income inclusion under Section 951.[115] For this purpose, a CFC computes the amounts of its items of income and deduction under largely the same U.S. federal income tax principles as apply to determine the taxable income of a U.S. corporation, including any applicable limits under the Code on the deductibility of particular expenses.[116] Thus, a CFC would compute its interest deduction for purposes of Section 954(b)(5) taking into account the Section 163(j) limit.

Under a straightforward reading of the rules, that limit would be computed by reference to a CFC's ATI from all its activities, other than exempt businesses, and all of its interest expense. Part of that deduction then would be apportioned to the CFC's FBCI, apparently by reference to the tax basis of the assets used to generate that income as compared to the assets of its business.[117]

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[113] See Fed. Reg. Vol. 56, No. 117, p. 27907, at 27908 (June 18, 1991).

[114] Proposed Regulation Section 1.163(j)-5(a)(3).

[115] A CFC's interest expense is allocated to foreign base company income and other income using an asset-based allocation method. See Treasury Regulation Sections 1.861-9T(f)(3), 1.954-1(c)(1)(i). Historically, allocation on the basis of gross income was permitted as an alternative to allocation based on assets. Treasury Regulation Section 1.861-9T(j).

[116] See Treasury Regulation Sections 1.952-2(b), (c).

[117] Section 864(e)(2) (as amended by the Act) requires interest expense to be allocated using the tax basis of a taxpayer's assets, for purposes of the sourcing rules (and, presumably, rules that incorporate the sourcing rules by reference, such as the Section 954(b)(5) regulations).

It would appear reasonable for guidance to reverse the order of operations here, for purposes of computing a CFC's FBCI (and other Subpart F income): that is, a CFC's interest expense first would be allocated between its FBCI and other Subpart F income on one hand, and its non-Subpart F income on the other; and the CFC then would apply Section 163(j) to its FBCI or other Subpart F income and the interest expense allocated to such income. Such an approach would avoid seemingly distortive results, in which the amount of a CFC's non-Subpart F income or loss impacts its ATI and, thus, the amount of its Section 163(j) limitation. (We have recommended a conceptually similar approach in Part III.I.2 below regarding application of Section 163(j) to a foreign corporation with a U.S. branch.)

In a related point, if business interest expense allocated to a CFC's Subpart F income is disallowed under Section 163(j), then that interest expense should automatically be carried forward and allocated against Subpart F income in future years (rather than first being allocated in those years between Subpart F income, and other income included in ATI).

The Tax Section intends to submit separate comments on the provisions of the Act that deal with GILTI. This Report thus does not address questions about how Section 163(j) should be applied to a CFC for purposes of applying the GILTI rules.

2. **Inbound Investment**

We recommend that Treasury and the IRS issue guidance confirming that new Section 163(j) applies to a foreign corporation with a U.S. trade or business in a manner similar to the methodology adopted in the proposed regulations under old Section 163(j). That is, when applying Section 163(j) in order to determine the corporation's liability for corporate income and branch profits taxes, only business interest income and ATI that are included in the corporation's effectively connected taxable income and business interest expense that is allocated to effectively connected income pursuant to the regulations under Sections 882 and 884 would be taken into account. [118] This approach properly focuses on the economic activity a foreign corporation has in the United States, for purposes of computing the applicable Section 163(j) limitation.[119]

If a foreign corporation's interest expense allocable to its effectively connected income is disallowed under Section 163(j) and carried forward to a future year, it seems to us that the carryforward should automatically be treated in such future year as interest expense properly allocable to the corporation's effectively connected income for such year. That is, the corporation

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We note that it sometimes may be difficult for a U.S. shareholder that owns a non-controlling stake in a CFC to obtain the detailed information about tax basis that will be needed in order to make an allocation of the CFC's interest expense in accordance with new Section 864(e)(2).

118 See Proposed Regulation Section 1.163(j)-8(c); Treasury Regulation Section 1.882-5(a)(5).

119 An approach could be imagined under which the limitation is computed by reference to the foreign corporation's worldwide ATI, business interest income and business interest expense; the resulting limitation is then applied to the corporation's worldwide interest expense; and the post-limitation interest expense is then allocated between the corporation's effectively connected income, and its other income. However, such an approach would appear to have the potential to lead to more arbitrary results than the one recommended.

should not be required, in the year to which the interest expense is carried forward, to allocate that interest expense between the corporation's effectively connected income and its other income.

IV. Additional Issues Under Section 163(j)

The issues addressed above do not represent all the significant issues raised by Section 163(j). A non-exclusive list of additional issues that Treasury and the IRS should consider addressing in subsequent guidance includes:

- Confirmation of whether a corporation that undergoes an ownership change under Section 382 is treated as using its carryforwards of disallowed business interest expense before it uses other tax attributes limited by Sections 382 and 383.

- An explanation of how a corporation that inherits carryforwards of disallowed business interest expense pursuant to new Section 381(c)(20) should treat those carryforwards following a Section 381(a) transaction, including confirmation whether rules analogous to those in Treasury Regulation Section 1.381(c)(1)-1 apply.

- Treatment of disallowed business interest carryforwards upon a taxable liquidation of a corporation under Section 331.

- Treatment of a non-corporate taxpayer's disallowed business interest carryforwards, upon death or other final disposition or termination of all trade or business activities.

- Application of Section 163(j) to S corporations, including (i) the treatment of shareholder carryforwards of an S corporation's disallowed business interest expense, in the event the S corporation subsequently converts to a C corporation, and (ii) the treatment of corporate carryforwards of disallowed business interest expense, in the event a C corporation converts to an S corporation.

- Application of Section 163(j) to trusts, estates and their beneficiaries.

- Whether Section 163(j) should apply, or not, to real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits.

- The scope of activities that may be treated as an electing real property trade or business, including whether making mortgage loans constitutes such a trade or business.

- The time and manner for making an election for an electing real property trade or business or an electing farming business.

- Application of Section 163(j) to tiered partnership structures.

- Whether a taxpayer that cancels a debt with accrued, unpaid interest that has been disallowed under Section 163(j) should have a reduction in its cancellation of debt income, by the amount of such disallowed interest.

- Whether, in cases where a taxpayer excludes COD income under Section 108(a), the taxpayer's carryforwards of disallowed business expense should be reduced and, if so, the appropriate ordering for reduction of those carryforwards relative to the other attributes listed in Section 108(b).

- Whether the issuer of a contingent payment debt instrument should be entitled to offset disallowed business interest expense that has accrued under Treasury Regulation Section 1.1275-4, against the income inclusion that otherwise would be required under Treasury Regulation Section 1.1275-4(b)(6)(iii)(B) when there is a negative adjustment to the projected amount of a contingent payment.

The Tax Section would be happy to submit an additional report addressing some or all of the issues listed above or any other issues on which the government would like our input.

Report No. 1394

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]

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[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]

[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]

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[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.
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> 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).
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> 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

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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).

[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.

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[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.

> Example 9(c) (no aggregation; higher foreign tax on QBAI return; result is taxpayer-unfavorable compared to aggregation). 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

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[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

[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

[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:

> Example 10(a): Carryover of tested loss to year with QBAI return. 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.

> Example 11. NOL carryover to year in which tested income is offset by tested loss of another CFC. 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

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[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.

[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

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[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.

> Example 12: Carryover of Section 163(j) deduction to year with QBAI return. 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.

> Example 13: Section 163(j) carryover to year in which tested income is offset by tested loss of another CFC. 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.

> Example 14(a) (CFC with Section 958(a) U.S. shareholders throughout the year): 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

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[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.

> Example 14(b) (CFC for only part of year). 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.

> Example 14(c) (CFC for whole year, taxable Section 958(a) U.S. shareholder for only part of year). 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.

> Example 14(d) (Second Tier: CFC2 has Section 958(a) U.S. shareholders throughout the year): 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.

> Example 15(a): Two divisions of a single CFC. 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.
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> Example 15(b): Disregarded subsidiary of a CFC: 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.

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[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

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[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]

Example 16(b) (shareholder has other general basket income). 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

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[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.

[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

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[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

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[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.

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[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.

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[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]

[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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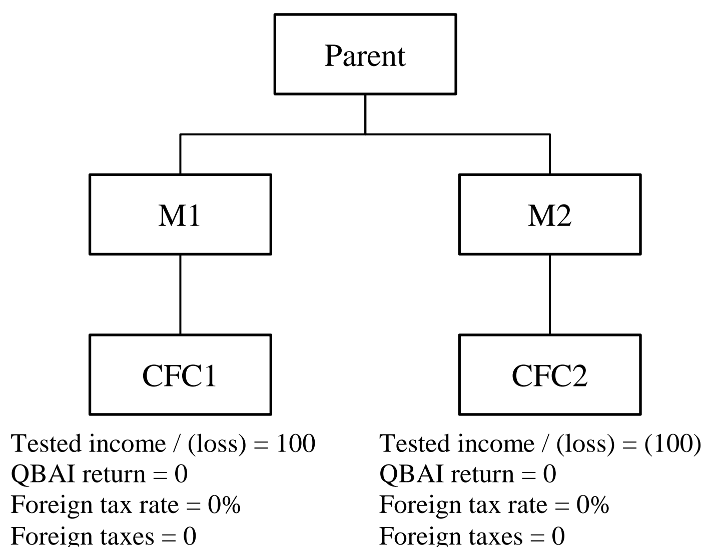
[200] *See* Part IV.B.4.

APPENDIX 1

The charts and calculations on the following pages illustrate certain of the examples in the Report.

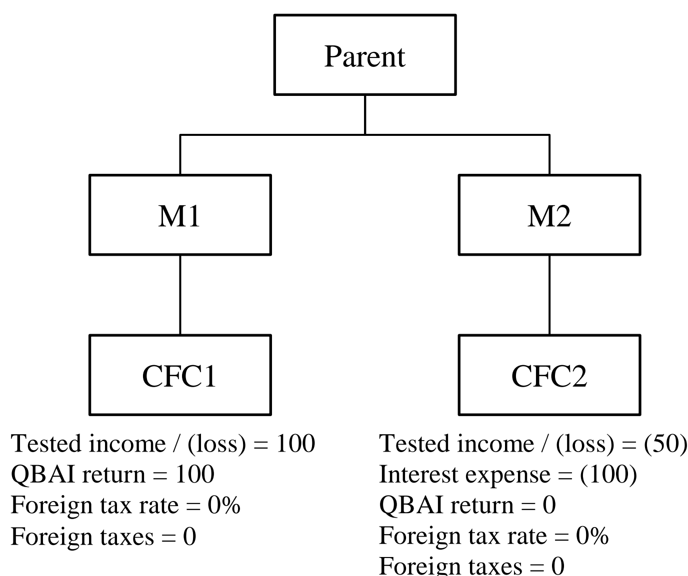
Example 6(a)



	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]

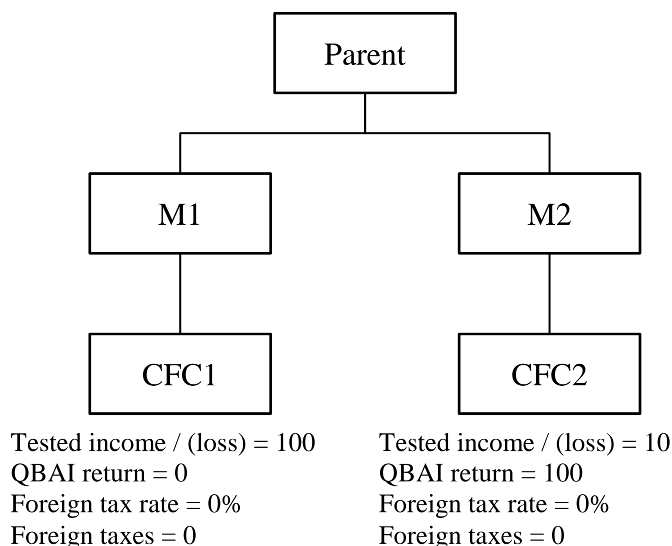


	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	0	50
NDTIR	100	0	0
Section 951A inclusion	0	0	50
Aggregate of Related CFCs' tested income	100	0	100
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	0%	0%	50%
Foreign tax paid by Related CFCs with tested 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.

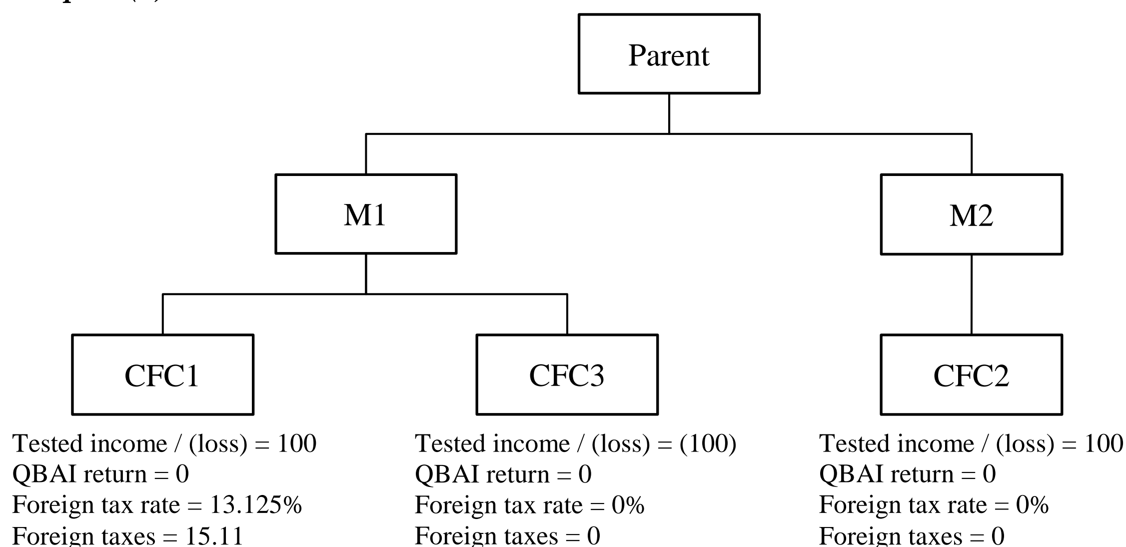
Example 7



	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.

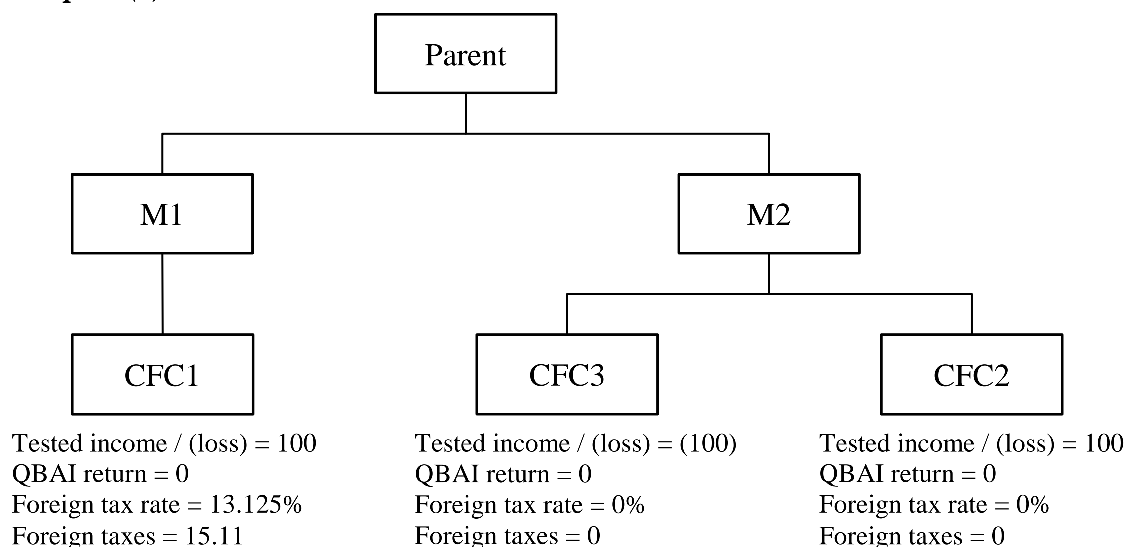
Example 8(b)



	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.

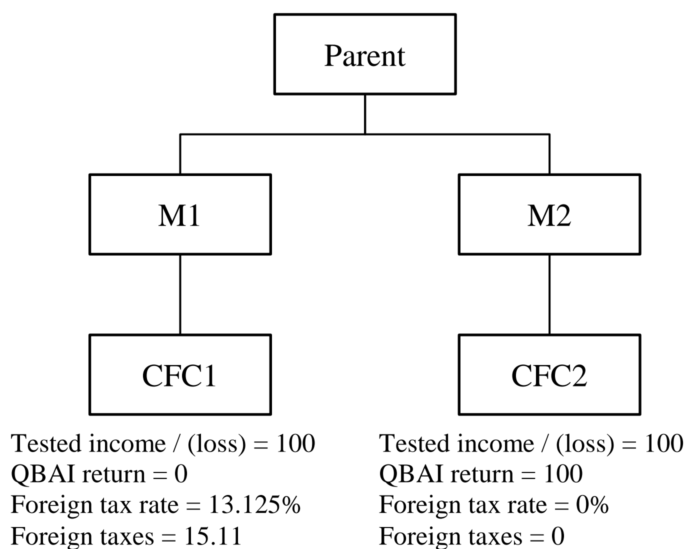
Example 8(c)



	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.

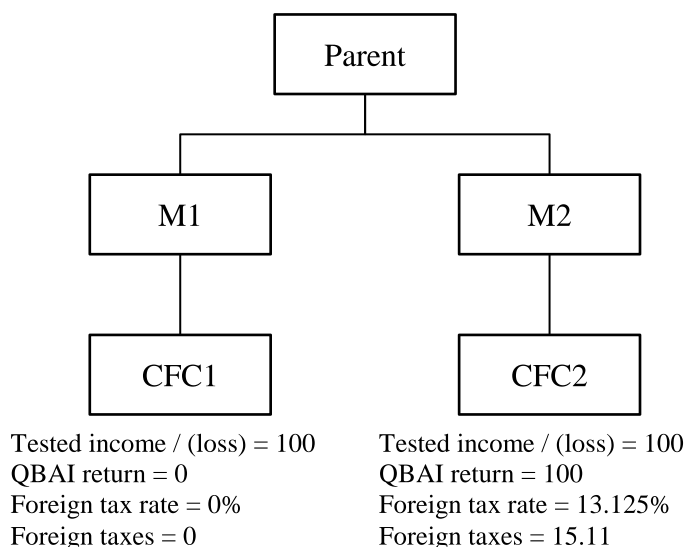
Example 9(b)



	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)



	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**

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}} = \frac{240}{340} = 0.71$$

$$\text{Foreign general basket fraction} = \frac{\text{Foreign general basket income}}{\text{Worldwide income}} = \frac{40}{340} = 0.12$$