PASS-THROUGH AND GROUP CONCEPTS AFTER THE TAX CUTS AND JOBS ACT OF 2017

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Section 163(j) and Partnerships

I. Section 163(j) and Partnerships

A. Section 163(j) provides that the limitations on the deduction for business interest expense is to be applied at the partnership level rather than at partner level.

1. Concept: All business interest expense should be subject to same limitations for deductions. Question is whether this is better achieved by applying the limitation at the partner or partnership level.

2. Imposing the limit at partnership level also imposes considerable complexity. Rules are need to integrate partnership level computing with the allocation of items of business interest income, business interest expense and other items of income or deduction that are taken into account in the computation of the of the limitation at the partnership level. In particular, rules are needed to allocate each of these various items to determine each partner's share of any deductible business interest expense, as well as certain "excess" items that are taken into account at the partner level, such as excess business interest income, excess taxable income and excess business interest expense which may be carried over to future years.

B. The statutory approach also produces some unexpected results and potential abuses.

1. Example 1: Partnership ABC has the partners A, B and C. For 2019 Partnership AB has 300 of adjusted taxable income ("ATI") and 100 of business interest expense. Because of the partnership level computation, all of the interest is deductible under section 163(j). Assume further that the business interest expense is allocated entirely to partner C, while all of the items comprising ATI are allocated equally to each of A&B.

2. Under Example 1, there is the somewhat surprising conclusion that C is entitled to deduct all of the business interest expense. This is the case not only if C has not business interest income or ATI from the partnership, but also no business interest income or ATI from any other businesses that C may conduct. While this is an extreme example, it illustrates at least some of the issues with the statutory approach.

II. Basic Rules

A. Section 163(j) requires that the partnership separately compute its ATI. For these purposes, the partnership is required to segregate its sources of all items of income and expense to determine the amounts that are considered from business activities and those items derived from exempt activities.

1. Under Treas. Reg. §1.163(j)-6(d), the partnership's ATI is computed without taking into account partner basis items and remedial items.

2. For these purposes, "partner basis" items include basis adjustments under Section 743(b) and allocations resulting from the application of Section 704(c)(1)(C)(i). Rather, these items are taken into account by the partner in computing its separate Section 163(j) limitations. Treas. Reg. §1.163(j)-6(e)(2).

3. A partnership's ATI also does not include any allocations made under the remedial method under Section 704 and Treas. Reg. §1.704-3(d). As with other partner items, these allocations are taken into account by the partner in computing its ATI.

4. A partnership's ATI however, includes items of income resulting from basis adjustment under Section 734(b).

B. Under Treas. Reg. §1.163(j)-6(e), a partner's separate ATI does not include any item taken into account in the computation of the partnership's ATI. Once interest is determined to be deductible at the partnership level it is not again subject to Section 163(j) testing at the partner level.

C. In addition to determining the amount of deductible interest, Treas. Reg. §1.163(j)-6 defines and provides rules for the determination of other items that are necessary for determination of the partnership level. Those include, the partnership's "excess business interest income," "excess business interest" and "excess taxable income."

1. Any excess business interest expense allocated to a partner is treated as business interest expense of the partner in a succeeding year. That excess business interest expense is then deductible by the partner in any future year in which that partner is allocated excess business interest income are excess taxable income.

2. The excess business interest expense in any year is not treated as a carryover of the partnership.

D. The proposed regulations also provide special rules concerning the computation of the partner's basis in its partnership interest and rules governing the treatment of dispositions of partnership interest.

1. A partner's basis in its partnership interest is reduced, but not below zero, by all interest expense allocated to the partner even if the interest is not deductible under section 163(j). Treas. Reg. §1.163(j)-6(h)(2). Note that the usual limitations under section 704(d) apply however. Treas. Reg. §1.163(j)-6(h)(1).

2. Under the regulations, a partner will increase its basis to the extent of the interest expense which has not been allowed upon a disposition of all of the partner's interest in the partnership. No such adjustment is made if the partner disposes of only a portion of its interest.

3. This rule leads to certain interesting results. Because the partner increases its basis by the amount of disallowed interest immediately before the disposition, it is likely that there will be an inside-outside basis disparity, with the partner's outside basis exceeding its share of inside basis. If the partner makes a nonrecognition transfer of its interest in the partnership, such as to a new partnership, the transferee will be entitled to an increase in inside basis under section 743(b). If the partnership holds depreciable property or inventory which has appreciated, the net effect of the transaction is to convert interest expense which has not been deducted into either depreciation or a reduction in income from the sale of inventory. If that is the case, is the limitation really achieving the Congressional goal?

III. Allocation of Partnership Items

A. Section 163(j) provides that deductible business will be allocated among the partners in accordance with an eleven step formula. The rules provide that deductible business interest (and other section 163(j) items will be considered allocated in accordance with the partnership's "nonseparately stated income" if and only if the eleven step formula is followed.

B. The formula is intended to serve the following goals, as set forth in the preamble to the proposed regulations.

1. Section 163(j) is applied at the partnership level.

2. A partnership cannot have both excess business taxable income (or excess business interest income) and excess business interest expense.

3. Parity must be maintained between the partnership's deductible business interest expense and other section 163(j) items so that the aggregate of each items determined at the partnership level corresponds to the allocations of such items for purposes of section 163(j).

4. If a partnership has both deductible business interest expense and excess business interest expense in a given year, a partner whose items of interest income or taxable income that were used to support the partnership's deduction should not be allocated excess business interest expense.

5. If a partnership has either excess taxable income or excess business interest income in a year, the allocation of those items should correspond to the allocations to the partners of the items comprising excess taxable income or excess business interest income.

C. The proposed rules use the following procedure to determine each partner's share of deductible business interest expense, excess business expense to be carried over, excess business interest income and excess taxable income that may be used by a partner to support deductions of business interest of the partner.

1. Under the eleven step process, the partnership first determines its Section 163(j) excess items and the amount of its deductible business interest expense.

2. Second, the partnership determines each partner's allocable share of items of income, gain, loss and deduction that are taken into account by the partnership in determining its Section 163(j) items. That determination is based upon the allocations under Section 704(b).

3. Steps three through five provide a method for determining each partner's share of the partnership's excess business interest income or excess business interest expense.

4. Step six specifies the method for determining each partner's share of the partnership's adjusted taxable income.

5. Steps 7 through 10 provide an intricate series of computations intended to determine each partner's capacity to absorb interest deductions based upon its share of the partnership's ATI.

6. Finally, in step eleven, the partnership's deductible business interest expense and excess Section 163(j) items (excess business interest income, excess taxable income and excess business interest expense) are allocated to the partners based upon the determinations made in the preceding steps.

7. These computations are then illustrated through a series of examples which, while very helpful, emphasize the complexity and intricacy of the computations required.

D. Almost all have agreed that the "eleven step process" works as a technical matter to produce a reasonable result. The issues are whether the complexity is warranted—or whether taxpayers should be required to use a spreadsheet program to compute their tax items—and whether there are simpler alternatives.

1. The eleven step formula imposes significant recordkeeping requirements. As an initial matter, the eleven step process exists solely for Section 163(j) purposes. Taxpayers must maintain a parallel set of books (and make parallel allocations simply to comply with Section 163(j)).

2. The process itself involves multiple different computations to be made for each partner, For example, the eleven step process requires that a partnership determine for each partner the following items: "allocable business income excess", and "allocable business income deficit". After these amounts are initially determined, the proposed regulations require a redetermination in accordance with a mathematical formula, resulting in each partner having a "final allocable business income excess" and "final allocable business income deficit". Similar determinations and redeterminations are also made with respect to a partner's "remaining

business interest expense" and "allocable ATI", as well as determinations of a partner's "ATI capacity excess", "ATI capacity deficit" and a computation of a partner's "priority amount".

3. Once all of these computations are made, the partners can then determine their share of deductible business interest expense and the other section 163(j) items.

4. A simplified alternative (among others) would be generally to allocate deductible business expense to each partner based upon the interest expense, ATI and business interest income allocated to each partner.

5. This could be accomplished as follows: for each partner that is allocated business interest expense, determine the portion of the interest expense allocated to such partner that would be considered deductible business interest expense taking into account only the business interest income and ATI allocated to such partner.

   i. If the aggregate amount determined for all partners is equal to, or less than, the amount of the partnership's deductible interest expense, then each partner would be allocated deductible business interest expense that each partner in the amount determined in the first step—in other words, the amount of interest expense would have been entitled to deduct under Section 163(j) if only partnership items of income and deduction are taken into account.

   ii. If the first step produced deductible interest in excess of the limitation determined at the partnership level, each partner's allocation of deductible business interest expense would equal the proportion of the partnership's total deductible business expense that the deductible amount determined in the first step for such partner constitutes of the deductible amount determined for all partners. Also, any deductible business interest expense as determined at the partnership level that is not allocated through the first step would then be allocated among the partners that have been allocated business interest deductions in proportion to the amount of interest expense of each partner remaining after the first step.

6. This approach can be illustrated by the following example. Consider first the facts of Example 14 of proposed regulations Section 1.163(j)-6(o). Partnership PRS had $140 of business interest expense, $200 of ATI and no business interest income. Accordingly, PRS has $60 of deductible business interest expense. PRS' items of ATI have been allocated such that A, B and C have income of $100, $100 and $400 respectively, while D has a loss of $400. PRS' business interest expense has been allocated $40 to B, $60 to C and $40 to D.

i. Under the suggested approach, PRS would first determine for each of B, C and D the amount of the business interest allocated to each partner that would be deductible under Section 163(j) taking into account solely the ATI and business interest income allocated to such partner. In this case, the entire $60 of interest expense allocated to C would have been deductible, $30 of the interest expense allocated to B would have been deductible and no amount of business interest expense allocable to D would have been deductible.

ii. The total amount of business interest expense determined in the first step (or $90) exceeds the total amount deductible under Section 163(j) applied at the partnership level (or $60). Under this approach the partnership would determine the proportion of the interest expense allocated to each partner that is determined to be deductible in the first step and allocate the total deduction in those proportions. Thus, C would be entitled to two-thirds of the $60 deduction (60/90) and B would be entitled to one-third (30/90) of the $60 deduction. D would not be entitled to any business interest deduction. Once the deductible business interest income is determined, the other Section 163(j) items can be computed.

IV. Tiered Partnerships

A. Among the issues for which Treasury and the IRS requested guidance is the treatment of tiered partnerships: in order words, should the statutory rule be applied at each partnership level or should it be applied by combining the tiers as is the traditional approach to tiered partnerships.

1. The issues can be illustrated by the following that are intended to illustrate the ability of taxpayers to exploit the computation of the interest limitation under Section 163(j) to increase their interest deduction.

2. The issues concern whether the statute mandates that each partnership be treated as a separate entity or whether there is regulatory flexibility to disregard separate tiers of partnerships. On its face, the statute appears to require each partnership to compute separately its deductible interest. However, there may be an abuse when the tiered partnership arrangement is used to reduce the overall tax burdens of the ultimate taxpayers, without affecting their overall economic results.

3. Example 1: Partnership A has two businesses. Business 1 has gross income of $600 and gross deductions (no depreciation or amortization) of $800. Business 2 has gross income of $1000 and gross deductions (no depreciation or amortization) of $700. Partnership A has debt of $2000 with interest deductions of $200.

i. Under these facts, Partnership A has the following results:

Gross Income:	$1600
Gross Deductions:	$1500
ATI	$ 100
Interest Allowed:	$ 30
Taxable Income:	$ 70

4. Example 2: Assume the same facts as Example 1 except that Partnership A transfers Business 2 to Partnership B in exchange for a 99% interest. The other partner, holding 1%, is a partner of Partnership A. With the lender's consent, Partnership B assumes debt of $1000 at the same interest rate and Partnership A guarantees the $1000 debt.

i. Under these facts, Partnerships A and B have the following results:
Partnership B:

Gross Income:	$1000
Gross Deductions:	$ 700
ATI	$ 300
Interest Allowed:	$ 100
Taxable Income:	$ 200

Partnership A

Business 1:

Gross Income	$ 600
Gross Deductions	$ 800
ATI	$(200)
Interest Deduction	$ 0
Taxable Income	$(200)
Share of Partnership 2	$ 198
Taxable Income	$ (2)

5. Simply by choosing to operate Business 2 through a lower tier partnership, Partnership A and its partners are able to reduce their overall taxable income by increasing the interest deduction. Economically, there is little or no difference between operating the business through one regarded entity rather than two. Indeed, to the extent that there are non-tax reasons for separating the operation of the two businesses, those can be satisfied by choosing a single member LLC as opposed to a tiered partnership structure.

6. One approach to limiting this situation would be to apply a rule disregarding tiered partnerships in situations in which there is substantial common control. For these purposes, the rule could apply if the same persons own (directly or indirectly) 80% or more of the interests in both

partnerships. The abuse is most likely to arise in this circumstance since the use of tiered partnerships in this instance is unlikely to change the partners' ultimate economic position.

7. It should be noted that this approach would be applicable not just for situations involving tiered partnerships, but would apply as well to tiered arrangements involving other entities. For example, the technique of separating out the business activities could be used by a corporation to increase its interest deduction by conducting a portion of its business through a partnership with an affiliated partner holding a small interest.

V. Section 706 and Section 163(j) Interaction

A. The following examples are intended to present certain issues concerning the application of Section 163(j) and its interaction with the rules of Section 706. The basic question that need to be addressed is the following: should the limits of Section 163(j) be applied to each separate segment of the year or should the computation be made for the partnership's entire year with an allocation of the interest amount to each of the separate periods?

B. Example 1: Assume Partnership ABC has three partners, A with a 50% interest, B with a 30% interest and C with a 20% interest. All items of income and deduction are shared in accordance with the partners' respective percentage interests. In the first segment of the year, ABC has gross income of 600, gross deductions of 700 and business interest expense of 100. At the end of the first segment, C sells its 20% interest to D. In the second segment, ABC has gross income of 900, gross deductions of 400 and no interest expense.

1. If the partnership's Section 163(j) limit is computed separately for each segment of the year, no interest would be deductible. There is negative ATI for the first segment (and no business interest income) and there is no business interest expense in the second segment. That result is likely unfair to A and B, although the unfairness can be partially mitigated by treating their share of the first segment's interest expense as excess business interest expense.

2. If the partnership's limitation is computed for the entire year, all of the interest is deductible business interest because the aggregate ATI of the partnership is 400. Under this approach, all of the interest expense in the first segment would be deductible business interest, with the result that C would be entitled to deduct the full amount of its interest, even though it had negative ATI and was not even a partner when the ATI was earned.

3. There is a further complication. Assume C has a taxable year that ends with the end of the first segment and ABC has the calendar year as its taxable year. If, for example, the first segment ended in February, C

would be required to file its tax return before the partnership had determined its ATI and deductible business expense for the year.

C. Example 2: Assume Partnership XYZ with three partners has the following ATI and business interest expense (and no business interest income). For the first segment, Partners X and Y are each allocated income and deductions resulting in a share of ATI equal to 200 and business interest expense of 75. Partner Z is allocated income and deductions resulting in a share of ATI equal to 100 and no business interest expense. Partner Z sells its interest to Partner D. In the second segment of the year, Partners X and Y are each allocated income and deductions resulting in a loss of 50 as well as business interest expense of 25. Partner D is allocated equal amounts of income and deductions resulting in a share of ATI of zero and interest expense of 25.

1. In this example, if the Section 163(j) limit is computed using the entire year, there is ATI of 400 and an interest limit of 120. If the eleven step formula is applied to the entire year, each of the partners will have an ATI deficit, with the result that a portion of Z's excess ATI being applied to allow all of the other partners, including D, to be allocated a portion of the partnership's deductible interest expense. This is the case, even though the partnership had a loss for the period in which D was a partner.

2. Applying the section 163(j) limit to the segments separately also yields an unsatisfactory result. The Section 163(j) limit determined for the first segment would be 150, with the result that all of the interest allocated to partners X and Y would be deductible interest. The first problem with this approach is that the amount of interest allowed exceeds the amount that would be allowable if the partnership computed the limit for the entire year. The second is that the approach does not take into account the losses allocated to X and Y in the second part of the year, even though they are continuing partners.

Section 864(c)(8) - Sales of Partnership Interests by Foreign Persons

I. Background.

A. Rev. Rul. 91-32, 1991-1 C.B. 107

1. In Rev. Rul. 91-32, IRS held that for a non-U.S. seller, gain from sale of an equity interest in a partnership is treated as effectively connected income that is taxable in the United States to the extent the gain is attributable to the partnership's assets that were used in a U.S. trade or business.

2. To reach this result, IRS applied an "aggregate" theory of partnerships, and effectively treated the non-U.S. seller as selling its attributable portion of the partnership's assets.

B. Grecian Magnesite Mining v. Comm'r, 149 T.C. 63 (2017)

1. In *Grecian Magnesite*, the Tax Court largely rejected the conclusion of Rev. Rul. 91-32, holding that Section 741 of the Code generally contemplated an "entity" theory of partnerships for purposes of determining the consequences of a sale of a partnership interest by a non-U.S. person.

2. Accordingly, the Tax Court found that gain on the sale of a partnership interest generally was not treated as effectively connected to the conduct of a U.S. trade or business on the facts of *Grecian Magnesite*, even if the partnership itself was engaged in a U.S. trade or business.

C. Section 864(c)(8)

1. Following the government's loss in *Grecian Magnesite*, Congress enacted Section 864(c)(8) in the 2017 tax reform package. Section 864(c)(8) largely codifies the holding of Rev. Rul. 91-32, treating gain from sale of an equity interest in a partnership as effectively connected income to the extent the gain is attributable to the partnership's assets that are used in a U.S. trade or business.

II. Selected Issues Under Section 864(c)(8).

A. Treatment of Nonrecognition Transactions.

1. Proposed regulations generally do not override nonrecognition provisions, although statute clearly extends regulatory authority if Treasury and IRS believed override was appropriate.[1]

2. However, preamble to proposed regulations notes that government is still considering additional guidance, particularly in the case of Section 731 distributions.

3. As illustrated through the following example, it is not entirely clear that all Section 731 transactions with base erosion potential could be attacked under either (i) the partnership anti-abuse regulations, or (ii) traditional judicial anti-abuse doctrines like step-transaction or economic substance.

i. Example. Foreign partner ("FP") and a U.S. person ("USP") hold interests partnership PRS. PRS is engaged in a United States trade or business and also holds assets that would produce foreign-source income if sold by PRS (the "Non-USTB Assets"). In a transaction qualifying as a nonrecognition transaction under Section 731 of the Code and with a specific intent to limit the

[1] Code Section 864(c)(8)(E).

extent to which FP recognizes income effectively connected with a U.S. trade or business, PRS distributes the Non-USTB Assets to FP in complete redemption of its interest in PRS.

ii. In this example, application of partnership anti-abuse regulations may prove challenging absent additional abusive facts. Even though the Section 731 distribution may have been motivated by FP's goal of reducing income subject to federal income taxes, the result is generally consistent with Subchapter K's policy of allowing flexible entry into and exit from partnerships on a tax-deferred basis, and it does not appear that a specific statute outside of Subchapter K contemplates aggregate treatment in this fact pattern.

iii. Similarly, absent additional facts suggesting that the distribution described in the Example above was part of a plan or otherwise lacked economic substance, it is not clear that either step-transaction or economic substance doctrines would present a viable line of attack for characterizing the taxpayers' selected form in the example.

III. Attribution of Gain to U.S. Office**.**

A. Because Section 864(c)(8) contemplates that a foreign partner must recognize effectively connected income based on a deemed sale of partnership assets, it is necessary for purposes of the statute to determine what portion of a partnership's gain or loss on a deemed sale is treated as U.S. source.

B. Proposed regulations as written effectively assume that partnership business assets generally give rise to U.S.-source gain or loss, except to the extent (i) no income or gain previously produced by a given asset was taxable as effectively connected income of the partnership during the ten-year period ending on the date of the transfer, and (ii) such asset was not used, or held for use, in the conduct of a trade or business within the United States by the partnership during the ten-year period ending on the date of transfer.[2]

C. Proposed regulations requested comments regarding proposed rule, perhaps recognizing that it is likely that in many cases a deemed sale of partnership assets under Section 864(c)(8) will result in a greater amount of effectively connected income than an actual sale of partnership assets might generate.

D. Because a deemed sale in all cases requires some guiding principle that may or may not reflect the results of an actual deemed sale, there is unlikely to be a perfect approach to the deemed sale. However, alternative approaches to be considered may involve (1) specific rules to address assets that are particularly

2 Prop. Reg. §§1.864(c)(8)-1(c)(2)(i) and 1.864(c)(8)-1(c)(2)(ii).

likely to be the subject of distortion (e.g., goodwill or certain inventory sales), and/or (2) deemed sales based on historic recognition of income or loss as between the partnership's U.S. and non-U.S. operations.

The GILTI/BEAT Breaking Point – Choosing Between CFC and Foreign Branch Structures

I. Background.

A. In General.

1. Following tax reform, U.S. taxpayers face an entirely new set of considerations when deciding whether to hold non-U.S. operations through one or more regarded "controlled foreign corporations" (as defined in Code Section 957(a)) ("CFCs") or whether to organize non-U.S. operations in branch form (such that all domestic and foreign operations are effectively grouped and treated as earned by a U.S. entity).

2. Holding foreign operations in CFCs generally permits taxpayers to take advantage of the GILTI regime, which results in an effective tax rate on non-U.S. income that can be as low as 10.5%. Foreign tax credits ("FTCs") are usable against GILTI income under Code Section 960(d), subject to an 80% cutback. No carryback or carryforward of GILTI FTCs is permitted under Code Section 904.

3. Even though income from non-U.S. branches is generally taxable at a 21% rate, foreign branches may still offer valuable benefits over the GILTI regime, including with respect to (i) the flow-through of foreign losses to the U.S. (subject to complex limitation), (ii) full use of FTC (i.e., no 80% cutback), (iii) ability to carryback or carryforward FTCs and (iv) general non-application of base-erosion and anti-abuse tax ("BEAT") on payments between home office and branch. These advantages become even more attractive when, as illustrated below, the application of FTC expense allocation rules and/or the application of BEAT result in a substantially higher effective tax rate on foreign income earned in the GILTI regime.

II. GILTI

A. Under new Code Section 951A, U.S. corporations are generally subject to a minimum tax on so-called "global low-taxed intangible income" ("GILTI") earned by their CFCs. GILTI is generally the taxable income of all of a taxpayer's CFCs in excess of a deemed return on tangible assets, with certain limited exclusions for specified types of income (e.g., "Subpart F" income).[3]

[3] Code Section 951A(b).

B. Under Code Section 250, a taxpayer is generally permitted a deduction equal to 50% of its GILTI inclusion. Additionally, as discussed above, a taxpayer is also permitted an FTC of 80% of foreign taxes allocable to GILTI income under Code Section 960(d).

C. Accordingly, before taking into account FTC expense allocation rules (discussed below) or BEAT, GILTI regime currently results in effective tax rate on non-U.S. income of between 10.5% and 13.125% depending on availability of FTCs.

III. Foreign Tax Credit Allocation to GILTI

A. Proposed regulations under Section 904 confirm that certain expenses of U.S. taxpayers (e.g., interest expense) must be allocated to GILTI basket income.

B. The allocation of each dollar of expense to GILTI basket income effectively results in a limitation on GILTI FTCs, such that for each dollar of expense allocated to GILTI for which FTCs are otherwise available, the effective tax rate is increased by 21%.[4]

IV. BEAT

A. Code Section 59A imposes a minimum tax on large U.S. multinationals with substantial payments to foreign related persons (including foreign related persons who are CFCs). While the precise contours of BEAT are beyond the scope of this discussion, the central thrust of BEAT is to deny a deduction for certain payments made from a U.S. corporation to a related foreign person.

B. Importantly, BEAT may apply to payments from a domestic corporation to a wholly-owned CFC, even where the payment generates an inclusion at a 21% rate for the domestic corporation under Section 951 of the Code.

C. However, because payments between a domestic corporation's home office and its foreign branches are generally disregarded for U.S. federal income tax purposes, BEAT generally would not apply to such payments if non-U.S. operations are organized in branch form.

V. Branch Inflection Point.

A. As highlighted through the examples below, whether and to what extent a taxpayer may prefer a foreign branch to a regarded corporation subject to GILTI is a highly complex and individualized inquiry following tax reform, but there are certain cases where a branch may prove to be more attractive than a CFC, notwithstanding the 50% deduction permitted with respect to GILTI income.

B. Example 1: Basic Operation of GILTI

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4 For an in-depth discussion of the reasons for this effective 21% increase in tax rate, see New York State Bar Tax Section Report No. 1394, p. 13 (May 4, 2018).

1. U.S. shareholder owns a single CFC with $1,000 of pre-tax tested GILTI income and no deemed return on tangible assets. CFC has paid $150 of foreign taxes, all of which are attributable to GILTI income. The GILTI inclusion on this fact pattern is $1,000 and the allowed FTC is 80% of $150, or $120.[5] Assuming the full Section 250 deduction of $500 is allowed, taxable income will be $500 and the tentative U.S. tax liability is $105 (i.e., $500 x 21%). If no expenses are allocated to GILTI income, the FTC will offset the U.S. tax in full for an aggregate tax liability of $150.

2. If U.S. shareholder held the operations of CFC through a foreign branch, U.S. shareholder would be subject to a 21% effective tax rate, with a tentative U.S. tax liability of $210 (i.e., $1,000 x 21%) and a credit of $150 for foreign taxes paid, for a total U.S. tax liability of $60 and an aggregate tax liability of $210.

C. Example 2: Operation of GILTI Regime with FTC Expense Allocation

1. Assume the same facts as in Example 1, but $300 of expenses are allocable to GILTI under the Section 904 rules. The FTC limit under Section 904(a) will be $42 (i.e., [$1000 income - $500 GILTI deduction – $300 interest expense] x 21%). Accordingly, of the $105 of tentative U.S. tax liability described in Example 1, $42 is offset by FTCs, with $63 of remaining U.S. tax liability. The aggregate tax liability with respect to the $1,000 of foreign income in this fact pattern is therefore $213 (i.e., $150 of foreign tax liability plus $63 of additional U.S. tax liability).

2. Notably, the aggregate tax liability of $213 with respect to the $1,000 of foreign income in this fact pattern would be no different if U.S. shareholder chose to organize the operations of CFC in a foreign branch. Because there is no GILTI deduction to take into account, the Section 904(a) limitation would be $147 (i.e., [$1000 income – $300 interest expense] x 21%). Accordingly, of the $210 of tentative U.S. tax liability, $147 is offset by FTCs, with the same $63 of remaining U.S. tax liability. The aggregate tax liability with respect to the $1,000 of foreign income in this fact pattern is therefore $213 (i.e., $150 of foreign tax liability plus $63 of foreign tax liability). Given the lack of a rate differential, the benefits of organizing in branch form (discussed above) may be highly attractive to U.S. taxpayer in this fact pattern.

D. Fact Pattern #3: Operation of GILTI Regime with BEAT Payments

1. Assume the same facts as in Example 1, but U.S. taxpayer makes $350 of payments that are subject to BEAT to the non-U.S. business. The BEAT payments are immediately taxable to U.S. taxpayer under Section 951, but the BEAT payments are not included in the taxable income of CFC under

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[5] As a technical matter, the GILTI inclusion is comprised of a

the laws of the jurisdiction in which CFC is organized. The results are the same as in Example 1, except that U.S. taxpayer's aggregate tax liability increases by $73.50 (i.e., $350 x 21%). Accordingly, U.S. taxpayer's aggregate U.S. tax liability is increased to $73.50 as a result of inclusions under Section 951, and U.S. taxpayer also pays $150 in foreign taxes, for an aggregate tax liability of $223.50.

2. In contrast, if U.S. taxpayer had organized the operations of CFC as a foreign branch, there would be no inclusion under Section 951 with respect to $350 of payments described above. Accordingly, U.S. shareholder would be subject to a 21% effective tax rate, resulting in a tentative U.S. tax liability of $210 (i.e., $1,000 x 21%), with a credit of $150 for foreign taxes paid for a total U.S. tax liability of $60 and an aggregate tax liability of $210. In this fact pattern, not only does the foreign branch offer a rate benefit as compared to the GILTI regime, but U.S. taxpayer can also take advantage of the other benefits of a foreign branch structure described above.