International Tax Reform in a Second Best World: the GILTI Rules

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As tax academics, professionals and policymakers considered reform of the U.S. system of international corporate taxation over the last two decades, they confronted a basic dilemma: analysis of economic efficiency in the international context requires consideration of tax policy instruments along several different margins simultaneously. As has often been discussed, the capital export neutrality (“CEN”), capital import neutrality (“CIN”) and capital ownership neutrality (“CON”) criteria often point in different directions in the design of policy instruments. Thus, as two of the most prolific commentators on international tax policy have noted, international tax policy making in the context of our basic income tax system inevitably involves a familiar “Second Best” problem.¹

In a “Second Best” world, as has been noted, optimization of economic efficiency in the context of international taxation of any particular type of investment depends on which alternative investments the investment competes with. Some investments are highly mobile, serving a worldwide market, with many possible alternative locations. Others are more closely tied to a given location because of the importance of being close to a customer base in a particular country. Some investments compete with U.S. production while others compete with low tax production abroad. Moreover, the financing associated with these business activities can be located in multiple alternative locations. No single policy instrument deals perfectly with all this business activity, and
the key is to strike the right balance. In this paper, I will focus on the GILTI rules, which perform a central function in the balancing act exemplified by the 2017 tax legislation.

In formulating the particular balance of international tax provisions in the 2017 Tax Act, Congress and the Trump administration concentrated, in particular, on the taxation of intangibles giving rise to high returns, a subject that had been very much on the minds of tax policymakers. One of the professional economics articles that received attention in Trump administration circles during the summer of 2017, for example, was an article that sought to explain the apparent lack of growth in productivity in the U.S. economy in recent years.\(^2\) The authors analyzed the hypothesis that much of the productivity from technological growth is actually being diverted offshore for tax reasons and thus the gain is not showing up in the U.S. economic statistics. Capturing the gains from such intangibles for the tax jurisdiction of the United States was an important objective of the international provisions of the 2017 tax legislation, including the GILTI rules.

This paper will be divided into three parts. First, I will discuss both the policy approach exemplified in the GILTI provisions and several core operational aspects of the rules in some depth. Because the GILTI rules, or a derivation thereof, are likely to be a core part of the U.S. international tax system for years to come, a relatively full assessment is warranted, even at this early juncture. In this connection, I will also consider, significantly more briefly, the FDII rules, in the context of an international tax regime that contains the GILTI rules. Although I will discuss a few of the technical issues relating to FDII, my focus in this part of the paper will be on the role of the FDII rules as a complement to the GILTI rules.
Second, I will consider the application of section 163(j) to the GILTI regime. The operation of the new international tax regime ultimately cannot be understood without understanding the treatment of debt in that regime, and new section 163(j) could play an important role in the operation of the overall regime.

Third, I will address the allocation of interest expenses with respect to foreign tax credits. Rather than being focused on the technical application of current law, this part will principally be concerned with what the law should be. Until the government releases proposed regulations on this subject, it is difficult to analyze the relevant current law issues productively.

At the outset, I should note that I am fundamentally sympathetic with four basic policy choices made with respect to the GILTI regime by Congress. First, I believe a “minimum tax” of some kind should be a permanent feature of the new “hybrid” U.S. international tax regime. Second, taking into account the competing considerations, I believe the level of the tax should be relatively modest, much closer to the nominal statutory rates mandated by the 2017 legislation than the 19 percent proposed by the Obama administration, which of course was proposed in a context in which the maximum corporate tax rate would be 28 percent. Third, I believe the “overall” (or “one-CFC”) approach is, on balance, a better approach to a minimum tax regime than a per-country approach. Although I recognize a number of conceptual issues must be addressed to implement such an approach fully and reasonably, I believe it will be possible, over time, to rationalize the statute in this respect. Fourth, I am broadly supportive of some cutback of foreign tax credits: something in the range of the 80 percent rule adopted in the 2017 legislation or the 85 percent rule proposed by the Obama administration is generally
appropriate from my perspective. But ultimately the percentage adopted should be
determined by reference to the overall balance of the international business tax
provisions. I understand fully that the issues relating to each of these four policy choices
could merit a full paper, but I will not discuss them here.

Rather, I will take these policy choices as a given, and concentrate on a few
aspects of the GILTI and related rules that, in my view, merit systematic examination.
The purpose of this paper is to begin to undertake that examination.

I. The GILTI Regime and the FDII Complement.

A. Policy Background of GILTI.

The GILTI provisions in effect have two separate features, which are coordinated
in the same set of provisions. The first is what most would call a minimum tax. In this
context, a “minimum tax” is the assessment of a minimum level of tax on foreign income,
subject to a credit based on foreign taxes imposed on such income. The objective is to
require the U.S. taxpayer to pay a minimum rate of tax on foreign business income
earned through controlled foreign corporations (or branches if the system includes
branches in the territorial system), in the form of either U.S. taxes or foreign taxes. The
second feature is a distinction in the treatment of foreign income depending on the
amount of (and return from) tangible assets invested abroad by a controlled foreign
corporation of the U.S. headquartered multinational group. As discussed further below,
an amount equal to the “deemed tangible income return” is exempted from the GILTI
rules. There appears to be a significant level of consensus (albeit not unanimity) that
some level of basic minimum tax on foreign earnings is appropriate, and I personally
strongly believe that a minimum tax should be part of the U.S. international corporate tax system going forward. There is more controversy, however, as to the second element, the bifurcated treatment of the foreign income of controlled foreign corporations, at least as this feature operates under the statutory provisions of the GILTI regime enacted in 2017, and this aspect of the 2017 legislation will receive a full treatment in this paper.

1. The Base Minimum Tax.

The “minimum tax” aspect of the GILTI represents the culmination of thinking over a multiyear period. In the early years during which U.S. policymakers began to consider a movement to a territorial tax system, a number of commentators proposed consideration of a simple minimum tax on foreign earnings, a topic that was discussed in depth at the University of Chicago Tax Conference several years ago. A pure “territorial” system can be viewed as one in which the operating income of controlled foreign corporations (and perhaps foreign branches, depending on the design of the system) is fully exempt, and there is in addition a participation exemption applicable to repatriation. Thus, a “pure” territorial system exempts or largely exempts both the operating income earned abroad and its repatriation to the parent company in the home country. A minimum tax, it was thought, would among other things have the effects of constraining the transfer pricing issues exacerbated by a pure territorial system, and deterring large-scale profit shifting from the U.S. to foreign jurisdictions. Under a foreign minimum tax, as conceived by its early supporters, foreign earnings of a CFC would be subject to a minimum U.S. or foreign tax of, say, 15-20 percent. To the extent that foreign taxes on the income were less than the minimum percentage amount a U.S. top up tax would be imposed so that in aggregate the “minimum” was imposed.
number of international tax reform proposals coming from both political parties have had such a feature. Thus, in recent years, in reality, the focus has been on consideration of “hybrid” systems rather than fully territorial regimes. A minimum tax was a central part of the hybrid regimes considered.

At an early stage, policymakers focused on two relatively basic design questions with respect to a minimum tax. First was whether the minimum tax should be imposed on a per country basis (the “per country” approach) or on an overall worldwide basis (the “one CFC” approach). As will be discussed later, the regime enacted in the 2017 Tax Act approaches a one CFC approach; but the statute includes certain economically puzzling features inconsistent with such an approach. The second basic design issue was the appropriate level of minimum tax. Naturally, those who emphasized capital export neutrality (“CEN”) tended to support relatively high minimum taxes; those supporting capital import neutrality (“CIN”) or capital ownership neutrality (“CON”) approaches favored a low minimum tax, or even no minimum tax at all. Most of the discussion before 2017 contemplated a minimum tax rate in the 15-20 percent range. At least one of the policy options suggested for discussion by House Ways and Means Committee Chairman Dave Camp and included in draft legislative language in 2014, contemplated different levels of minimum tax depending on the destination of goods sold. Although the actual operation of the 2017 Tax Act is quite complex in this regard, the “minimum tax” is nominally 10.5 percent for CFCs controlled by U.S. corporations, a relatively low rate. As I have noted, I believe a relatively modest rate like that nominally imposed statutorily in 2017 is appropriate, balancing all the relevant considerations. There is a major question, however, whether the rate will, in actual operation, be significantly
higher after allocation of expenses for foreign tax purposes is taken into account, as I will discuss later.

2. Returns From Intangible Income.

At the same time that policy commentators were discussing such general minimum tax approaches to base erosion in a hybrid territorial system, policy proposals were also being developed that focused on the specific issue of returns from intangibles held abroad. Early harbingers of the type of thinking that ultimately was reflected in the GILTI provisions were relatively early Obama administration proposals. Under one such early proposal, if a U.S. person transferred an intangible to a foreign affiliate, income from or connected to such intangible would be subject to Subpart F income treatment if subject to an effective rate of foreign taxation of 10 percent or lower, to a gradually lower rate of imputation if subject to a rate between 10 and 15 percent and not subject to a special tax if subject to a higher than 15 percent foreign rate.

The original Camp discussion drafts issued in late 2011 contained similar proposals. So-called Option A was very similar to the early Obama proposal described here, and Option B applied a more general rule taxing income from intangibles irrespective of whether there was a cognizable transfer of intangible property.


The link between a minimum tax and a special treatment of different types of income, particularly large supernormal returns from intangibles, was directly and comprehensively made in a seminal article by economists Roseanne Altshuler and the
late Harry Grubert in 2013. Before delving into a description of their proposal, it is
worth delineating four different types of returns from a capital investment: first, the risk
free return from the investment (analogous to the return on a U.S. Treasury note), which
has sometimes been referred to as “the return to waiting”; second, the risk adjusted return
to reflect the risk associated with the investment; third, the inframarginal return,
sometimes described by commentators as “supernormal” or “excess returns”; and, fourth,
an adjustment for inflation. Importantly, for purposes of this paper, I will refer to the
second type of return, the risk adjusted return (as adjusted for inflation), as the normal
return, even though some seem to refer to the risk free return as “normal” and any return
above the risk free rate (as adjusted for inflation) as “supernormal.” An inframarginal
return or supernormal return for purposes of this paper is a return above the risk adjusted
normal return. Note in this regard that ex post returns in excess of normal returns may
not represent true inframarginal returns as opposed to the probalistically possible risk
adjusted returns representing the high end of the range of possible returns. An important
characteristic of an inframarginal return in assessing a tax instrument is that expectation
of such a return ex ante is not required for an investor to be induced to invest capital;
thus, a reasonable level of tax on such a return should not deter investment because
alternative investments available to the investor, by definition, only yield a lower
“normal” return. A key concept relating to the distinction between normal and
inframarginal or supernormal returns is that expensing of equity financed capital
investments for tax purposes generally yields a result equivalent to exemption of the
“normal” return.
This concept underlies one variation of the minimum tax policy alternatives suggested for consideration by Altshuler and Grubert. Under that alternative, for purposes of determining the minimum tax, the taxpayer is permitted to expense current capital investment in tangible assets in computing the earnings and profits that would in general be subject to the 15 percent minimum tax suggested by the authors. This expensing was explicitly intended by the authors to permit differentiation between taxation of “normal returns” and the taxation of “inframarginal returns”: “The expensing under the minimum tax is intended to make the forward-looking U.S. effective tax rate (ETR) on the normal return to investment zero while the forward looking ETR on the excess return bears a total tax, including both the foreign and U.S. components, of at least 15 percentage points.” Thus, Altshuler and Grubert use a methodology for distinguishing between normal and inframarginal returns similar to that employed by the Treasury Department in its (now) well-known study on corporate tax incidence. As will be discussed later, Congress used a somewhat different mechanism with respect to the GILTI rules, analogous to that employed in the “dual income tax” Nordic systems, for making the distinction between “normal” and “inframarginal” returns. In distinguishing between normal and supernormal returns in the international tax policy context, Altshuler and Grubert were following a long line of modern tax policy literature on the subject.

Importantly, the type of minimum tax proposed by Altshuler and Grubert can be viewed as consistent with capital import neutrality for international business investment. Altshuler and Grubert stated the rationale for such an approach succinctly in this regard:

Taxing the excess return would not put U.S. companies at a competitive disadvantage in making foreign investments and acquisitions. They will still make the investments if they are more efficient than their rivals. If
the intangible that is the source of the excess return is mobile, such as a patent used to produce a good sold on the worldwide market, the tax may just change where the investment is made.\textsuperscript{7}

In presenting their proposal, Altshuler and Grubert specifically addressed the so-called “runaway plant” problem:

There may be some concern that allowing expensing against the minimum tax on foreign income, but not on domestic income, will result in runaway plants. The simulations show that this fear is unwarranted. Even with expensing the minimum tax results in a much higher effective tax rate in the low-tax country than under current law.\textsuperscript{8}

Of course, Altshuler and Grubert were proposing a 15 percent tax rate, a rate somewhat higher than the nominal minimum tax rate that was enacted in 2017.

The Obama administration minimum tax proposals incorporated an adjustment to a minimum tax, which appeared to reflect an approach somewhat similar to the approach of Altshuler and Grubert and also consistent with policy thinking receiving increased attention among international tax policy scholars. The Obama administration generally proposed a supplemental per-country minimum tax of 19 percent, with a credit for 85 percent of the per country foreign effective tax rate. The tax base would, however, be reduced by an allowance for corporate equity (“ACE”), a term also used with respect to proposals being studied and discussed by scholars and tax policy makers in the OECD context. The ACE allowance “would provide a risk free return on equity invested in active assets,” which, under the proposal were defined as assets other than those giving rise to foreign personal holding company income. Note that a “risk free” return was allowed, rather than a “normal” return. This feature of the Obama administration minimum tax proposal tax proposal was, according to the administration, intended to exempt from the minimum tax a return on actual in-country business activities. I would
have thought the relevant return should be more than a “risk free” return. But the ACE allowance proposed by the Obama administration would, if enacted, probably have had the effect of targeting actual in-country investment for exempt return, consistent with its articulated purpose. Former Obama administration officials continue to advocate this lower level of exempt return.

The concept proposed by Altshuler and Grubert, based on a risk adjusted return, was more fully reflected in H.R.1, the comprehensive draft of legislative language introduced by Chairman Camp in 2014. This approach was in turn then ultimately incorporated in the GILTI provisions enacted in 2017. Indeed, whether or not their article itself actually influenced Congress in 2017, the work of Altshuler and Grubert can be viewed as a direct conceptual antecedent to the GILTI regime enacted in 2017. The Altshuler and Grubert article is still worth reading today for its discussion of design issues inherent in such an approach to a minimum tax. In fact, some of the design issues relating to the GILTI provisions that I will discuss in this paper were presaged by Altshuler and Grubert in their 2013 paper.

More broadly, the type of thinking evidenced in the GILTI provisions was a pervasive influence in the formulation of the 2017 tax legislation as a whole. As Professor Christopher Hanna has recently noted:

As part of the 2017 tax reform, a tax on supernormal returns was thought to be efficient and therefore desirable. As a result, Congress permitted expensing of certain capital or investment by businesses, thereby taxing only the supernormal return on investment. In addition, Congress substantially changed the U.S. international tax regime generally imposing no U.S. tax on the normal rate of return from a foreign investment but imposing a tax on the supernormal return.⁹
Professor Hanna himself was directly involved in the 2017 legislative effort as an advisor to the Senate Finance Committee.

From the perspective of this background, the GILTI rules, taken alone, can be viewed as attempting to strike a balance between two objectives. To the extent of normal returns from investment in hard assets, the GILTI rules provide a pure territorial tax treatment that is consistent with capital import neutrality. Thus, for returns up to the normal return, U.S. multinationals whose businesses utilize significant tangible assets can compete with foreign multinationals with respect to business activities in low tax countries, unimpeded by an incremental U.S. tax burden. At the same time, inframarginal returns from foreign business activities, like those frequently associated with highly valuable and mobile intellectual property, continue to be subject to a significant level of U.S. taxation, albeit at a rate lower than domestic corporate rates. The Republicans in Congress and the Trump administration implicitly made the judgment that returns from high value intangibles could be preserved for taxation by the U.S. tax regime, consistent with economic efficiency considerations, and that otherwise U.S. multinationals should be able to compete internationally unfettered by a U.S. tax burden, in keeping with the rationale for a territorial regime.

One matter that is not explicitly addressed in the GILTI minimum tax mechanism adopted in 2017, unlike the statutory mechanism that was contained in the draft Camp legislative language, is the issue of round tripping. The “round tripping” at issue here is the location by a U.S. based multinational group of production associated with intangible rights in a low tax foreign jurisdiction, and the sale of the produced goods back into the U.S. Should the favorable treatment of international production extend to round tripping?
This issue was addressed in so-called Option C introduced by Chairman Camp and the 2014 draft Camp statutory language, higher differential tax treatment of round tripping. The same competition with foreign competitors is involved, however, whether the goods are sold abroad or back into the U.S. Does it matter whether that competition is with respect to U.S. markets? Should it matter whether the group is U.S. parented or foreign parented? I will return to these questions when I discuss the background of the FDII rules.

B. Overview of the GILTI Provisions.

New section 951A contains the operative provisions taxing U.S. shareholders on “global intangible low-taxed income,” or GILTI. Section 951A(a) states that each person who is a “United States shareholder” of any “controlled foreign corporation” for a taxable year should include such shareholder’s “global intangible low-taxed income” for such year. Section 951A(b)(1) defines GILTI as the excess of such shareholder’s “net CFC tested income” for the taxable year in question over the shareholder’s “net deemed tangible income return” for the year.

The crucial term “net deemed tangible income return” is defined in section 951A(b)(2). This amount constitutes the excess of 10 percent of the shareholder’s pro rata share of “qualified business asset investment” (“QBAI”) over the amount of the interest expense taken into account in determining the shareholder’s tested income under section 951A(b)(2)(A) “to the extent the interest income attributable to such expense is not otherwise taken into account in determining such shareholder’s net CFC tested income.” Such interest is referred to as “specified interest” in the proposed GILTI
regulations; and as discussed below, the proposed GILTI regulations contain detailed rules on this aspect of the GILTI calculation. Net deemed tangible income return will be referred to herein as the “net QBAI return.”

The definition of “net CFC tested income” is contained in section 951A(c). The income taken into account in determining tested income is the aggregate of the U.S. shareholder’s pro rata share of the gross income of each CFC in which it is a U.S. shareholder over the subpart F income, effectively connected income and certain other income of such CFC. In general, then, the income subject to tax under the GILTI provisions is a residual amount. After adoption of section 951A, a U.S. shareholder of a CFC will generally be potentially subject to current taxation under either the GILTI rules or Subpart F on all the CFC’s income other than income equal to the net QBAI return and income subject to certain special exceptions that are generally not of broad applicability.

To determine “net” tested income of a CFC, allocable deductions are subtracted from the gross income so determined. Section 951A(c)(2)(A)(ii) defines such amounts as “the 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 gross income.)” The proposed GILTI regulations explicitly incorporate by reference Treasury Regulation Section 1.954-1(c) for purposes of this determination. The Explanation of Provisions to the proposed GILTI regulations states the general concept for determination of tested income and loss: “only items of deduction that would be allowable in determining the taxable income of domestic corporation may be taken into account for purposes of determining a CFC’s tested income or loss.” The government, however, asked for comments “as to whether these rules should allow a
CFC a deduction, or require a CFC to take into account income, that is expressly limited to domestic corporations under the Code.” As discussed further below, a number of important questions remain unanswered after the proposed GILTI regulations.

As compared to the Subpart F rules, the ultimate determination of the GILTI inclusion takes place much more at the U.S. shareholder level. As noted in the Explanation of Provisions to the proposed GILTI regulations, “a GILTI inclusion is determined in a manner fundamentally different from that of an inclusion under section 951(a)(1)(A).” While the GILTI calculation starts with determinations of certain items at the CFC level, the overall calculation potentially depends on how the items interact at the U.S. shareholder level. Losses from a loss CFC may be netted against the U.S. shareholder’s share of income from a CFC with income; and QBAI is an aggregate concept determined at the shareholder level.

Consistent with this general approach to determining a CFC’s income on an aggregate basis, the proposed GILTI regulations, as expected, do provide rules for determining GILTI items and inclusions on an aggregate basis for consolidated returns. The proposed regulations, in effect, mandate a two-step procedure. First, the pro rata shares of each U.S. shareholder in the group of items such as tested income, tested loss, and QBAI are aggregated. Second, a portion of each item is allocated to a U.S. shareholder member based on the member’s pro rata share of tested income. The overall effect of this regime is to enhance a group’s ability to combine losses and QBAI for purposes of computing the GILTI inclusion.
Although a significant amount of blending across CFCs is permitted within a given period, the statutory language of the GILTI rules generally appears to contemplate a year-by-year computation of the GILTI inclusion, at least in terms of explicit statutory language. As will be discussed later in this paper, it is at least arguable that some modification of that year-by-year approach is possible with respect to specific items, such as net operating loss carryovers and carry forwards of disallowed interest under section 163(j). However, other items, such as foreign tax credits, are statutorily explicitly treated on a year-by-year basis.

Once GILTI is computed, section 250(a)(1)(B) provides, for domestic corporations, a deduction (the “GILTI deduction”) equal to 50 percent of the sum of the GILTI included in the corporate shareholder’s income for the taxable year and (ii) the amount treated as a dividend under section 78 which is attributable to such amount of GILTI income. This deduction could be viewed as basically a means for establishing the overall corporate tax rate applicable to GILTI income, as discussed further below. In fact, one of the key conceptual points I make in this paper is that this deduction should in general be viewed as a means of establishing a corporate tax rate for GILTI income when addressing how other tax rules operate with respect to the GILTI rules, including the foreign tax credit rules. This view is generally consistent with the proposed GILTI regulations relating to consolidated returns.12

The basic GILTI inclusion and deduction provisions are accompanied by several foreign tax credit provisions. Section 951A(f)(1) provides, among other things, that GILTI income is to be treated in the same manner as inclusions under section 951(a)(1)(A) for purposes of sections 904(h)(1) and 959. New section 960(d) provides
that a domestic corporation with an inclusion under section 951A shall be deemed to have paid 80 percent of the “inclusion percentage” of the “tested foreign income taxes” of the relevant CFCs. Pursuant to section 960(d)(2), the inclusion percentage is based on the ratio of includible GILTI income to aggregate tested income. Under section 960(d)(3) the “tested foreign income taxes” are the foreign taxes of the CFCs “properly attributable” to the tested income. A new basket is created under section 904(d)(1)(A) for non-passive income included under section 951A. Because this basket is applicable on a U.S. shareholder by U.S. shareholder bases, cross-crediting within the GILTI regime is generally allowed. However, as noted above, section 904(c) provides that credits paid or accrued with respect to GILTI income cannot be carried back or forward, a very important limitation in the overall operation of the regime and one of the most debatable. The GILTI foreign tax credit computations were not addressed in the proposed GILTI regulations, and will be the subject of a separate regulation package, or perhaps more than one separate package.

C. Other Relevant Statutory Changes.

Although the focus of this paper is on the GILTI provisions, a number of changes to the Code have an impact on the overall effect of the GILTI provisions. First, significant changes were made to section 367(d). Among other things, the new rules provide that workforce in place, goodwill (both foreign and domestic) and going concern value constitute intangible property for purposes of the section 367(d) rules. The revised statutory provision also allows the Treasury to apply the aggregate approach for purposes of valuation. Second, for specified periods of time, and subject to phasedown, expensing is permitted for a significant amount of tangible property used domestically. Third, a
number of punitive provisions are applied to inverting companies. Finally, under the base erosion and anti-abuse tax (the “BEAT”), significant new rules apply with respect to what may be called inbound base erosion, deductible payments from a U.S. person to a foreign person that reduce U.S. tax. I will return to the BEAT (briefly) when I discuss round-tripping.

In addition to these provisions, the so-called FDII rules and the section 163(j) interest limitations loom large. The interaction between those provisions and the GILTI rules will be discussed at some length in this paper.

D. The Basic Plumbing: Net Deemed Intangible Return; Qualified Business Asset Investment; Deduction for Interest Expense; and Other Issues.

The threshold topic for detailed consideration here is the basic mechanism contained in the GILTI rules for distinguishing between exempted returns and the amounts potentially subject to current U.S. tax under the GILTI regime. As noted above, the statutory mechanism for determining the distinction between amounts of return is somewhat different than the expensing approach suggested by Altshuler and Grubert and resembles, in significant ways, the approach (or approaches) that have been employed under the Nordic “dual income tax” regimes.

My own view is that the basic decision by Congress to distinguish between normal and supernormal or “inframarginal” returns represents a reasonable conceptual approach to balancing competing international tax policy considerations if a legislative mechanism can be designed that actually works consistently with the basic objectives of that conceptual approach. However, there are at least some significant questions as to
whether the GILTI statutory provisions enacted in 2017 actually achieve the goals of such a conceptual approach. Perhaps more importantly, it is an open question for me whether in the real world such an approach can be made to work well enough to justify both the complexity entailed and the potential distortive effect on business planning. The long-run question is whether a simpler straight minimum tax approach should replace the current bifurcation approach providing an exemption for net QBAI return, assuming that such a change is coupled with other changes that adjust the overall balance of the legislation. From my perspective, further experience and thinking are necessary before that decision is made.

Under the new GILTI rules, there are three basic steps in determining the exempted amount. First, the amount of shareholder’s share of QBAI is computed. Under section 951A(d) this amount is equal to the average of a corporation’s aggregate adjusted bases as of the close of each quarter of the relevant taxable year of “specified tangible property” used in “a trade or business of the corporation” and “of a type with respect to which a deduction is allowable under section 167.” With the exception of dual use property, “specified tangible property” generally means tangible property used in the production of “tested income.” The statute mandates that adjusted basis for this purpose be determined, pursuant to section 951A(d)(3), by using the alternative depreciation deduction system under section 168(g) and allocating the depreciation deductions so determined ratably for the year. The proposed GILTI regulations provide detailed rules implementing the statutory provisions relating to “specified tangible property.”

Consistent with the (questionable) legislative history of the 2017 legislation, the proposed
GILTI regulations provide “[N]one of the tangible property of a tested loss CFC is specified tangible property.”¹⁴

Second, the 10 percent return is applied to this QBAI. Note that this deemed gross return from QBAI is a simple, fixed return, which does not vary according to current conditions such as interest rates, inflation, etc. By contrast, for example, the House side passthrough and minimum tax (“FHRA”) provisions passed by the House in 2017 specified a “deemed rate of return” equal to the Federal short-term rate (determined under section 1274(d)) plus 7 percent points, for purposes of determining the “normal” return on capital.” The original Norwegian dual income tax mechanism contained a rule that took an approach similar to that taken by the House.

Third and finally, the amount of specified interest expense taken into account in computing the shareholder’s net tested income (other than interest that gives rise to income taken into account in the shareholder’s tested income) is subtracted from the gross amount determined in the second step to determine the “net” deemed intangible return, the net QBAI return as I have termed it. This adjustment represents one of the two different ways that the incurrence of liabilities could be taken into account in determining the exempted return and itself poses a number of technical and policy issues, as discussed further below. The proposed GILTI regulations make clear that specified interest is taken into account irrespective of whether the interest is incurred by a loss CFC, the tangible assets of which do not, under the regulations, count for QBAI purposes. In the second part of this paper, I will discuss the policy question whether interest disallowed under section 163(j) should be treated as “specified interest” under the statute.
1. The Amount of Return: the Rate and Base.

The determination of the gross amount of exempted return is obviously a very sensitive aspect of this mechanism. I will discuss two important questions that may reasonably be raised in this regard. The first question is whether the rate of return has been set too high. In their paper, Altshuler and Grubert utilized a 10 percent return for purposes of analysis, and 10 percent was used in both the Camp language and the GILTI rules. Several commentators have suggested, however, that the return has, in fact, been set too high, and a ten percent return does, in fact, seem somewhat generous. The second and, in my view, far more serious question is whether the base upon which the exempted return is computed is the most appropriate one.

The operation of the mechanism for determining normal return depends on the interrelationship between the specified return and whether and how the base upon which such returns is adjusted over time. The QBAI base for determination of the return under the GILTI rules is subject to depreciation, albeit at the rate determined by the ADS depreciation system. Mechanisms for teasing out normal return differ in their treatment of depreciation with respect to the base. Under some alternatives the base is fixed and does not depreciate, as was true for the House passthrough provisions; this approach was also adopted, for a much more limited reason, in the section 199A passthrough rules as ultimately enacted. However, the approach taken by the GILTI rules seems, in this respect, to be a reasonable one overall. This approach is based on the blunt assumption that assets economically depreciate at the rate specified under the ADS system, and assumes a 10 percent return on the continuing deemed value of that depreciating...
investment. In any case, in assessing the rate, we must keep in mind the nature of the base employed.

a. The Rate.

In assessing the rate utilized in the GILTI rules, it is also important to remember that the amount in question is intended to be the return taking into account risk. This risk-adjusted return is analogous to the cost of capital of corporations. Thus, given published cost of capital statistics of major companies, it may be expected that a return substantially above a risk free return is warranted. Moreover, the fact that the return in the GILTI statute is not self-adjusting, either for inflation or, more broadly, for current interest rates (which would reflect in part inflation) may explain some of the apparent generosity of the statute.

Several examples of the returns used in other contexts may give a sense of reasonable range. In the early years of the Norwegian dual income system, the rate was based on Norwegian five-year governmental bonds plus six percentage points, which was applied to aggregate tax basis (apparently taking into account full periodic adjustments to tax basis). The House legislation applicable to passthroughs and the international minimum tax would have used short-term interest rates as defined in section 1274(d) plus 7 percentage points.

The 10 percent rate adopted in the GILTI provisions strikes me as somewhat on the high side but not by much, at least for current levels of interest rates and inflation. As has been pointed out, the 10 percent return approximates that for the S&P equity over a decade. A mechanism similar to the House bill that adjusts for current interest rates (and
thus indirectly for inflation) would put less pressure on adopting a high fixed rate in the statute. If such an approach were adopted, I would suggest mid-term rates be used for the base, as they more clearly will reflect inflation.

When assessing the statutory rate, it is also important to take into account the overall operation of the GILTI mechanism. For example, as will be discussed later in this paper, the GILTI calculation is very much a year-by-year calculation, with no carryovers (or carrybacks) of unused net QBAI return, and that fact can affect the level of the appropriate rate. Moreover, one’s view of the appropriate rate could depend on whether net operating losses can be taken into account under the GILTI rules in computing net QBAI return.

17 Note in this regard that, if the statutory rate of 10 percent somewhat overshoots the amount of normal return, it should in theory not have a significant effect on investments in plant and equipment priced to achieve a normal return that is somewhat lower (say 8 percent). It may be assumed such investments would only earn the “normal return,” or something approximating the “normal return.” Thus, the principal effect of setting the exempt return somewhat too high is to dilute the amount of the intended assessment of a minimum tax on inframarginal returns from intangibles and other assets giving rise to such returns. Moreover, the possible distortions arising from the treatment of debt in determining the net QBAI return may be exacerbated, as discussed further below.
b. The Base.

A second major issue relating to the computation of the exempted return is whether the QBAI base, as specified, is appropriate for the full range of taxpayers. As noted above, my own view is that this is a much more serious issue than the precise level of the specified rate.

In their initial exploration of the bifurcated minimum tax approach, Altshuler and Grubert noted that the issue whether assets beyond tangible assets should be expensed under their proposed system could be an issue of particular concern for financial businesses.\(^{19}\) The relative absence of QBAI in the banking business has been noted by banks and other commentators since enactment of the GILTI provisions. In general, the banking business entails less investment in hard assets such as structures and equipment, particularly internationally. Moreover, the intangibles associated with the banking business are generally customer based intangibles, including goodwill associated with specific locations, rather than highly mobile patent rights and similar intellectual property that may give rise to large infra-marginal returns of the type that was the focus of Congress. Despite this fact, most of the income of the foreign subsidiaries of banks is likely to be GILTI.

More broadly, it may be questioned whether capital investment in the tangible assets qualifying for QBAI treatment is today an appropriate base for computing normal return in a relatively large range of businesses in the so-called “new” economy. A burgeoning economics literature,\(^ {20}\) recently discussed in the mainstream press, deals with the growing trend for firms to invest in processes and methods rather than hard assets such as plant or equipment or even intangibles like patents and other similar intellectual
property. That type of investment in processes and methods in the new economy could be viewed as the basic foundational investment that plant and equipment represents in the “old” economy. But these expenditures will not be represented in the QBAI base from which inframarginal returns are determined under the GILTI rules. Thus, a “normal” return on this kind of investment may, under the GILTI rules, look like a “supernormal” return on a limited base of plant and equipment.

One question that arises in this regard is whether the discrimination against certain types of business inherent in the QBAI system is partially alleviated by the fact that many of the expenditures in question may be expensed for tax purposes under current law. As discussed above, there is a theoretical parity between expensing the cost of a capital investment and exemption of the normal return. In practice, a significant portion of the expenditures of certain types of businesses on what an economist may view as “capital” investments are likely deductible rather than capitalizable under current legal norms. Does that fact compensate for some of the apparent discriminatory effects of the QBAI rules? This issue merits further analysis.

More fundamentally, it is actually not clear to me that purchased intangibles should be excluded from the base for determining the exempted return. Assume, for example, a simple case in which a business is started in a country by a U.S. multinational by acquiring the licenses, business names and other rights to do business in the country as well as making modest tangible investments in offices and computer equipment. For purposes of determining whether inframarginal returns are being made (through, for example, exploitation of an intangible owned by the multinational), “normal” return would be understated if all the basic investments necessary to do business are excluded.
from the computational base. With respect to this case, expensing under current law clearly does not compensate for the lack of QBAI treatment for the assets in question.

Another important conceptual issue relating to the specification of the QBAI base is whether acquisitions of corporate control (or of substantially all the assets) should give rise to a step up in the notional QBAI basis for purposes of computation of the net QBAI return that is exempted from GILTI. In other words, the question is should there be a notional section 338 transaction, whether or not an election is actually made, similar to what is permitted under Notice 2003-65 with respect to application of section 382. Recall in this regard that the concept of net QBAI return is simply a device for distinguishing normal returns from supernormal or inframarginal returns. Viewing the statutory mechanism that way, it is not at all clear that actual U.S. tax recognition on the seller side should be necessary for the notional basis adjustment. In some cases, such as the purchase of less than 80 percent of the stock of target, there will be no practical ability to achieve a step up in basis. In fact, U.S. tax recognition on the seller side is not necessary to establish basis under the existing QBAI rules. The treatment of acquisitions was also discussed by Altshuler and Grubert in their seminal paper.21

Some administrative concerns would be raised by modification of the GILTI rules in this respect. The value assigned to different assets for purposes of determining notional basis can be expected to be somewhat less realistic when there is no actual tax event on the seller side. However, the purpose of the statutory mechanism is being frustrated by the lack of a step up for purposes of determining QBAI. If it is ultimately concluded that this kind of adjustment cannot be made because of administrative
concerns, there is one more reason to believe the overall regime cannot be appropriately
implemented.

Finally, the reliance on QBAI under the statute raises issues with respect to the
financing decision inherent in the decision whether to lease or buy business assets. If the
assets are purchased, the basis thereof will be included in QBAI for purposes of GILTI.
If leased, the assets will not be included in QBAI. Does this distinction distort the
operation of the statute? This is a potentially complicated issue, and the comparative
analysis depends in part on whether the purchased assets are debt financed. At this point
in my own thinking, however, I see no reason to believe that leased assets are treated
neutrally with purchased assets under the GILTI regime. Equipment leasing is discussed
further in other parts of this paper.

One question that naturally arises with respect to all these difficulties with
determining the appropriate base for computing normal return is whether we should
simply adopt an approach based on expensing as originally suggested by Altshuler and
Grubert but perhaps on a broader scale. The advantage of such an approach could be that
greater neutrality in treatment among businesses. Not all issues, including the treatment
of the buy versus lease issue, would be solved. In fact, ironically, we would have to
consider a number of the issues considered by commentators when the radical Ryan-
Brady proposals was still on the table. Moreover, under such an approach, interest
deductibility would be denied, which raises its own issues. Nonetheless, further analysis
of this alternative is merited.
2. Reduction By Interest Expenses.

In addition to the mechanism for determining gross amount of exempted return, another central question with respect to this type of bifurcated minimum tax mechanism is how to adjust the exempted return for liabilities. The treatment of debt looms large, as it always does in tax law. As has been discussed in the literature relating to the dual income Nordic tax systems, there are basically two approaches to adjusting for debt financing of assets: netting liabilities against basis, or reduction of the gross return by allocable interest expenses. The GILTI provisions adopt the latter approach, as do the Nordic dual income tax rules. The House also took that approach with its passthrough and international minimum tax provisions. The original Camp draft of statutory language did not adjust for liabilities, but this issue received more attention during the development of the 2017 legislation.

Although the reason for making some type of adjustment (either netting by liabilities or deducting interest) may be intuitively obvious, discussion of the relevant issues may be made more clear by considering a few simple examples.

Example 1. Assume that the expected normal return on assets is 10 percent. USP1 forms CFC with an investment of 1,000 in cash used to acquire QBAI, and will own all the common stock of CFC. If CFC earns exactly 120, of that amount 100 will be exempt from the GILTI tax as net QBAI return, and 20 taxable as a GILTI inclusion to USP1.

Example 2. Assume instead that USP1 decides to “finance” the assets of the CFC with equity financing by bringing in an outside investor, USP2. USP1 contributes 500 to
CFC, and USP2 contributes 500. The 1,000 is again used to invest in QBAI. Again, CFC earns exactly 120. In this case, USP1 would have 60 of tested income, its pro rata share of CFC’s income. Its share of the QBAI would be 500, and its share of the net QBAI return would be 50. Thus, USP1 would have 10 of GILTI inclusion. The return on the 500 of QBAI attributable to USP2 would be allocated to USP2. USP1’s net QBAI return is not affected by the “financing” of 500 of additional assets. Its share of QBAI is 500, and its net QBAI return (50) is computed on that base.

Example 3. Now assume that, instead of equity financing, USP1 finances 500 with debt from Bank, on which it pays interest of 8 percent. There is again a total of 1,000 basis of assets. In this case, USP1 is the sole owner of the stock of CFC, as in Example 1. Again, CFC earns 120, but pays Bank 40 of interest. All the return of CFC would, in this case, be viewed as attributable of USP1, and USP1 would benefit from the 40 of interest deducted in computing the net return. CFC would thus have 80 of tested income. But it clearly would not be appropriate if the exempted net QBAI return were determined by multiplying 10 percent times the full 1,000 of basis of the QBAI assets. If that were the way exempted return were computed, up to 100 of return would be exempt, and USP1 would have no current inclusion. In many ways, however, this example resembles Example 2 economically, in which the 500 of the QBAI was “equity financed” via a joint venture investment by an outside party and that party was compensated for financing by earning an equity return.

One way some people in government articulated the issue during the legislative process is that there is a potential “double counting” problem with Example 3 in which the assets are debt financed unless the liability is accounted for. If no adjustment is made
for the debt in computing net QBAI return, USP1 would be benefitting from both a significant portion of the income from the financed assets being diverted for tax purposes to the financing party (the lender) through the interest deduction and the exemption of the return on the full QBAI asset base (the 1,000 in this example).

There are, as noted above, basically two types of adjustments that can be made to achieve a reasonable result in Example 3. Under one approach, liabilities could be netted against the basis of QBAI to determine the base to which is imputed the normal return. Under that approach the exempted return would be \( .10 \times (1,000 - 500) = 50 \). During the process of formulating the 2017 legislation, some in government suggested this approach. Under the other approach, which was ultimately adopted in the GILTI provisions, interest on the debt relating to the QBAI would be subtracted to determine the net exempted return. Under that approach the exempt return would be \( .10 \times (1,000) - 40 = 60 \). The interest deducted is the “specified interest” addressed in the proposed GILTI regulations.

Three characteristics of the statutory approach adopted in the GILTI regime with respect to netting by interest are notable. First, under the netting by interest approach, the U.S. shareholder in effect benefits by the extent to which the deemed return (10 percent in the case of the statute) exceeds the borrowing cost for QBAI (8 percent in Example 3). In a sense, there is an arbitrage between the risk adjusted equity return and the risk adjusted debt return. This aspect of the mechanism can put more pressure on getting the specified normal return right, as discussed further below.

Second, the statute, in effect, stacks all borrowing against QBAI, reducing all the net QBAI return by the specified interest, irrespective of whether the QBAI was actually
financed by the debt associated with the tested income. The debt of the CFC could easily partially economically relate to other income producing assets of the CFC even when concepts of economic fungibility are applied. While I can understand the reason for this relatively blunt approach, it does have an impact on operation of the statute, which will become clearer later.

Third, as has often been noted, although the treatment under the statute is not absolutely clear, pursuant to the proposed GILTI regulations, specified interest of loss CFCs is deducted even if the assets of such CFCs do not give rise to QBAI. I will discuss the policy issues related to treatment of the QBAI of loss CFCs later in this Part.

No approach is perfect, and the adoption of the basic interest netting approach in the GILTI rules was, in my view, a reasonable decision. Nonetheless, the mechanism utilized for adjusting for liabilities does inevitably give rise to several types of problems.

a. Stuffing of Debt Financed QBAI.

QBAI stuffing is potentially facilitated if the statutorily computed normal return is relatively high in relation to actual normal returns from tangible asset investments and the associated cost of borrowing; this will be particularly true with respect to relatively low risk investments. The literature with respect to the Nordic dual income tax systems discusses this issue.23 Again, a simple example may illustrate the point.

Example 4. Assume that the statutory rate of return is 10 percent, that the economically expected normal return (before interest deductions) from relatively low risk net leased equipment is actually 8 percent and that such equipment can be financed with debt with a 6 percent rate, reflecting the relatively low level of risk of debt secured by
such an asset. In that case, USP could be induced economically to attempt to build up the aggregate exempt return of the U.S. shareholder by low risk ownership and leasing of assets in the CFC to outside parties. Assuming that the equipment is viewed as “used in a trade or business” of the CFC under the statute, the Subpart F rules are not applicable, and the rental of the equipment thus gives rise to “tested income,” USP would have the ability to shield inframarginal returns from other assets of CFC; the deemed net QBAI return from the assets would be 10 percent, 2 percent more than the actual return and the total exempted return available to shelter other income would be increased by that 2 percent of the basis of the equipment.

This example illustrates one difficulty with setting the exempted specified normal return exempted normal rate too high. Stuffing is more constrained the more realistic the specified normal return. But in any case the normal return is set to reflect an aggregate risk; because of variations in risk among investments, some stuffing will always be possible, although potential application of the Subpart F rules to some types of stuffing constrain this planning. Time will tell as to planning developments in this respect. To date, I personally have not seen significant activity in this regard.

b. Location of Incurrence of Debt and Tracing.

More importantly, the GILTI regime may have a significant effect on the location where debt is incurred. Assume in the examples discussed above that, instead of borrowing at the level of CFC, USP1 borrowed the 500 at the level of USP1 and then contributed the 500 to CFC to be used to acquire QBAI. Unless the interest incurred at the USP level is traced to CFC and deducted in determining the exempted net QBAI income, the determination of the net QBAI return of CFC is arguably distorted. Assume,
for example, that 1,000 of QBAI is acquired in CFC, half with equity and half with debt. Without tracing, if the debt is incurred by USP1 and the proceeds contributed to CFC, CFC would be viewed as having, in aggregate, 1,000 of QBAI (500 from actual equity and 500 from borrowed equity) and net QBAI return of 100. This type of problem is also one explanation for the rule that requires specified interest to be deducted even if it is incurred by a “loss CFC.” Otherwise, debt could be incurred at a CFC one level above the CFC making a QBAI investment, and contributed down into the lower tier CFC with the QBAI.

If there are no tracing rules whatsoever, one would expect significant tax planning relating to the location of debt, even if locating the debt at the shareholder level is marginally less efficient than incurring it in the CFCs with the QBAI. Note that a similar problem could arise under a net-of-liabilities approach. Understandably, given the structure of the statute, Treasury and the Internal Revenue Service did not address this type of planning in the proposed GILTI regulations. My own expectation, however, is that this issue will, in the long run, prove to be an important one for the viability of the bifurcation approach adopted in the 2017 minimum tax rules.

c. Nonneutral Treatment of Intragroup Financing.

In addition to these two issues that are common to all similar regimes, the specific legislative language of the GILTI rules appears to create a potential nonneutrality with respect to intragroup financing. As described above, the statute provides, in section 951A(b)(2)(B), that the interest deducted in computing net QBAI return is interest expense taken into account in determining the shareholder’s net CFC tested income “to the extent interest income attributable to such expense is not taken into account in
determining such shareholder’s net CFC tested income.” As discussed further below, this rule has been made subject to a further gloss in the proposed GILT regulations so that interest income from outside sources is also taken into account. In any case, it appears clear, conceptually, that this proviso should also include interest taken into account more directly by the U.S. shareholder.

To see this point, let us first consider a simple example that illustrates the reason for the statutory language.

Example 5. Assume that USP owns all the stock of two CFCs, CFC1 and CFC2. Assume that neither CFC1 nor CFC2 have any indebtedness to unrelated parties and that each have 500 of QBAI. In addition, CFC1 has loaned 250 to CFC2 at an interest rate of 8 percent. Assume further that each of CFC1 and CFC2 has 100 of net tested income before taking into account interest on the intercompany loan. Assuming that the interest income from intercorporate debt is included in tested income under the statute, CFC1 would have 120 of tested income, and the GILTI inclusion from CFC1 would be \[100 + 20\] - 50 = 70. The income of CFC2 would give rise to a GILTI inclusion to USP of \[100 - 20\] - 50 = 30. The 50 of exempt net QBAI return of CFC2 would not, under the statute, be reduced by the 20 of interest payable to CFC1 because the 20 was included in CFC1’s tested income. The total inclusion of USP would be 100.

This result can be compared with the result under economically similar facts. Consider the following variation.

Example 6. Assume again that USP owns all the stock of CFC1 and CFC2. Assume again that each of CFC1 and CFC2 have 500 of QBAI and 100 of tested income
without consideration of interest on intercompany loans. Assume in this case, however, that USP has loaned 250 to CFC2 at an interest rate of 8 percent and that there is no other indebtedness in the picture. If the statute is applied literally, in this case CFC1 would give rise to 50 of GILTI [100 - 50] includible by USP; CFC2 would give rise to 50 of GILTI [(100 - 20) - (50 - 20)] includible by USP; and USP would have 20 of interest income from the loan to CFC2. There is no conceptual basis for USP having a total of 120 of income under these facts (100 of GILTI and 20 direct interest income), whereas its total inclusion under the prior example was 100.

d. Proposed Regulations on Inter-CFC Debt.

Apparently for reasons of administration, the proposed GILTI regulations adopt a somewhat different rule as to inter-CFC debt than what is, in my view, the precise legislative language. Rather than specifically tracing the interest paid by one CFC to another, the proposed regulations define specified interest expense as the excess of the aggregate pro rata share of tested interest deductions over the pro rata share of tested interest income. Thus, all interest income, including that earned on debt payable by outside parties to a CFC, reduces the interest deducted in computing QBAI income. The interaction of this rule with the rules ultimately promulgated under section 163(j) with respect to inter-CFC debt merits careful attention. At this point, though, this seems to me to be a reasonable approach to the administrative issues posed by the statutory mechanism that does not do fundamental violence to the intent of the statute.

e. Financing with Straight Preferred Stock.

The proposed GILTI regulations, however, do appear to raise the possibility that it may be significantly more tax efficient to finance a CFC with straight preferred stock
than with debt. Thus, from the perspective of the U.S. common shareholder that owns the common equity, it may be better to raise funds to finance the assets of the CFC through preferred equity than debt. To state the point abstractly before discussing it in more detail, the sacrifice in the share of QBAI from preferred stock financing under the regulations could be outweighed by the advantage of not having to deduct “specified interest” on debt in determining net QBAI return. The point can perhaps best be made using facts derived from an example in the proposed GILTI regulations relating to shares of CFC items.25

Example 7. CFC has two classes of stock, 70 shares of common stock and 30 shares of 4% nonparticipating, cumulative preferred stock with a par value of $10x per share. USP, a U.S. shareholder, owns all of the common shares. FP, the financing party, owns all the preferred shares. For the year in question, CFC gives rise to $120x of tested income, and has QBAI of $750x.

Under the proposed GILTI regulations, the shares of tested income and QBAI of the two shareholders would be determined as follows. First, under the “hypothetical distribution” approach of the proposed regulations, FP’s share of the tested income could be $12x (.04 * $10x * 30) with respect to the preferred; and USP’s share of the tested income would be $108x ($120x - 12x). As would be expected, USP would be benefitting, in effect, from a deduction of the $12x annual coupon on the preferred allocated to the preferred. Second, under the proposed regulations, each party’s share of the QBAI would be determined by computing pro rata shares based on the relative shares of specified income. Thus, FP’s share of the QBAI would be $75 ($750x * $12x/$120x), and USP’s would be $675x ($750x * $108x/$120x). USP would thus have .10 * $675x...
of net QBAI return or $67.5x, with no reduction by any specified interest. On its face, this seems like an economically reasonable result.

Compare, however, that result with the result if the preferred stock were instead debt with a 4% coupon. The tested income allocable to USP would again be $108x ($120x -12x). In that case, however, the QBAI share of USP would be $750x because there is no other shareholder. The net QBAI return would be $75x-12x or $63x, significantly less than with the use of preferred. The difference in treatment reflects in part that, under the statute, debt is stacked against the QBAI and also that the return thereon is, under the statute, in effect limited to 10 percent. Of course, the actual coupon on the preferred could be somewhat different than the interest coupon on the debt.

If Treasury and the Internal Revenue Service wished to get the same result for the straight preferred case as for the debt financing case, the approach would be relatively straightforward. To being with, for purposes of allocating QBAI between common and preferred shareholders, one would only take into account an amount of the overall income equal to a ten percent return on the QBAI; that amount is $75x. The statute, as noted, in effect assumes that is the maximum return allocable to the QBAI. Then, one would allocate the QBAI to the preferred based on the ratio of the return on the preferred ($12x) to the $75x. Thus, the QBAI allocated to the preferred would be $120x (12/75 * $750x). USP’s share of the QBAI would thus be $630x, which would yield an annual net QBAI return of $63x, the same amount as in the debt financing case.

Will there be a rush to finance CFCs with preferred stock? Not necessarily. Borrowing by the U.S. parent and contributing to the equity of the CFC, as discussed
above, may still dominate planning in this context. As a credit matter, debt and preferred stock are not identical. Moreover, there may be foreign tax issues (such as withholding) implicated by preferred stock structures.

3. QBAI and Interest of Loss CFCs.

As noted above, one of the features of the rules promulgated in the proposed GILTI regulations is that the assets otherwise qualifying as QBAI of a loss CFC do not count as QBAI for purposes of computing the exempt amount of net QBAI income of the U.S. shareholder. At the same time, all specified interest, including that attributable to loss CFCs, is, under the proposed regulations, taken into account in computing net QBAI return.

The basic rule that the tangible assets of a loss CFC do not count for QBAI purposes cannot, in my view, be justified in light of the conceptual rationale for the GILTI statutory mechanism: viewing matters from the perspective of the overall group, normal return is simply not being properly computed. The treatment of loss CFCs can also have a significant “notch” effect; one dollar of loss can lead to a very large loss of QBAI. Moreover, although as noted above there is good reason for the rule that all specified interest counts and reduces net QBAI income, that rule combined with the rule relating to loss CFCs exacerbates the distortions inherent in the basic rule that assets of a loss CFC do not count for purposes of computing net QBAI return. As a result of this rule, it may be expected that a significant amount of noneconomic planning will be induced, including particularly check the box planning. Thus, this is one respect in which the case for a statutory change is quite clear.
4. Temporary Investments; Transfer of Assets.

The treatment of net QBAI income under the GILTI regime will naturally induce taxpayers to augment the amount of QBAI in CFCs with positive tested income in ways other than the limited “stuffing” I have discussed so far. Consistent with the statute, the proposed GILTI regulations address two types of transactions with the purpose of augmenting QBAI. The first type of transaction, described in the Conference Report, involves taxable transfers of property from one CFC to another CFC before the first taxable year of the CFC to which section 951A applies in order to provide the transferee CFC with a stepped-up basis in the transferred property that would be included in the U.S. shareholder’s allocated amount of QBAI. The proposed GILTI regulations disallow the benefit of the stepped up basis with respect to transactions during this transition period.26 As regards the treatment of QBAI in the transition context, the proposed GILTI regulations in my view represent an understandable and valid exercise of the authority granted to the Treasury Department under section 951A(d)(4)(B).

Second, the proposed GILTI regulations, consistent with the statutory grant of regulation authority in section 951A(d)(4)(A), address the treatment of temporarily held QBAI. In this case the proposed regulations could be viewed as somewhat draconian. Under the general rule, property acquired and held temporarily is ignored for purposes of computing QBAI if the acquisition was for the principal purpose of reducing the GILTI inclusion. Under a conclusive presumption contained in the regulations, property held by the tested income CFC for less than a twelve month period that includes at least one quarter during the taxable year of a CFC with tested income is treated as temporarily held and acquired with the principal purpose of reducing the GILTI inclusion amount of a U.S.
shareholder if such acquisition would otherwise reduce the GILTI inclusion. In addressing a similar issue under the passthrough rules, Treasury and the Internal Revenue Service did not adopt a conclusive presumption: in that case, a temporary acquisition rule is applied “unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the section 199A deduction.”\textsuperscript{27}

Another type of planning that may be induced in certain situations with respect to QBAI involves loss CFCs the assets of which are, under the regulations, not taken into account in determining the U.S. shareholder’s QBAI. If, for example, during an anticipated startup period, the group expects one of its CFCs to continue to run losses for several years, it may be advantageous to transfer a portion of the loss CFC’s tangible assets to a profitable CFC and have the loss CFC lease back the assets. There is no reason that this type of transaction should be subject to the rules relating to temporarily held property, and I do not read the proposed GILTI regulations relating to temporary investments as being applicable to this transaction. In the real world, foreign tax and foreign law issues may impede such planning. Of course, the more important lesson of this type of planning is that the substantive rule to which such planning is responsive makes no policy sense, as discussed above.


A striking aspect of the GILTI minimum tax regime is, in general, its stark year by year approach. Thus, for example, there is no carryover of unused net QBAI return amounts from one year to the next in cases in which tested income is less than net QBAI income in a particular year. This certainly is inconsistent with how one views the income
of a business over time: the “normal” return on a capital investment is earned over a multi-year period, and it is perfectly possible that the earning of the normal return would start at a low level, increase once the business is established and perhaps even decrease a bit as the business supported by the capital investment matures. The amounts earned over the full multi-year period comprise the “normal return.”

While the statute in this respect is certainly not applying a theoretically pure result, this approach can perhaps be justified in the context of the general “one-CFC” approach of the statute, particularly given the difficulties discussed above relating to establishing the appropriate rate. If excess exemption amounts were carried forward, the result could, on the margin, distort the investment and tax calculus for new investments, perhaps investments in other countries, even if supernormal returns are expected. Moreover, as has been noted, adjustments to the statutory “normal return” might be appropriate if carryovers were permitted.28

In my view, however, there is no real policy justification for not permitting the carryover of actual net operating loss carryovers. These carryovers reflect the results of the actual conduct of the business. And the policy underlying net operating loss carryovers generally applies with equal force in the international corporate context.

There would appear to be ample statutory authority for the Treasury and Internal Revenue Service to permit carryforwards under at the CFC level, and allowance of such carryovers would appear to be consistent with the structure of the proposed GILTI regulations. The deduction for net operating loss carryovers is one that a domestic corporation would be afforded. As the New York State Bar Association Tax Section has
pointed out, there are a significant number of complications in addressing carryovers at
the level of each CFC, as opposed to addressing carryovers at the U.S. shareholder
level. However, it might be that anything other than a CFC by CFC approach would
require a statutory amendment.


As we continue to monitor and analyze the new bifurcated GILTI regime over the
years ahead, it will be important to keep the role of the exemption for net QBAI return in
perspective. The amount of net QBAI return can have a very significant effect when the
CFC is operating through a very low tax location. However, as the rates in the foreign
locale become larger, the operation of the foreign tax credit mechanism begins to
dominate economically. This point will become clearer in Part III of this paper.

E. FDII As a Complement to GILTI.

Although the focus of this paper is on the GILTI rules, it would not be possible to
understand the ultimate operation of GILTI regime without some understanding of what
many view as its complement, the foreign-derived intangible income rules (“FDII”). To
understand the origin of those rules, once again the background in the Camp legislative
language is instructive.

Let us begin first with where we started in the discussion of the Altshuler and
Grubert approach as reflected in the GILTI rules. If we simply applied the bifurcated
minimum tax regime to income earned through a CFC, we would have a regime with
several basic (and interesting) characteristics. First, income earned through the CFC that
involved sales to foreign customers located abroad would be subject to a bifurcated regime, under which “normal” returns would be exempt from the U.S. tax net, and supernormal returns would be subject to U.S. tax, albeit at a rate half the U.S. corporate rate or higher, depending on the operation of the foreign tax credit. Second, if nothing else were adopted, so-called “round tripping” income, income from sales into the U.S. by CFCs of U.S. parents, would have exactly the same tax burden as income falling into the first category, i.e., income from sales abroad. And third, there would be no particular incentive, and arguably there would be a disincentive relative to selling through a CFC, to sell abroad from a U.S. base because the domestic corporate tax rate is potentially significantly higher than the rates applicable to income earned from selling abroad through a CFC.

By contrast, the 2014 draft Camp language (and Option C before it) took a different approach; most importantly, it discriminated against round tripping income by denying the special deduction (analogous to the Section 250 GILTI deduction) that provided the lower rate for foreign-derived income. In addition, it provided the special favorable treatment to U.S.-based non-round-tripping export activity with respect to what we have called the “supernormal income.”

Although the details are, of course, more complex, the 2017 tax legislation approach differed in one major respect. Under the GILTI provisions enacted in 2017, there is no discrimination against round tripping under the base GILTI regime. However, through the FDII rules, there remains a discrimination in favor of U.S.-based export income that does not represent in whole or part round-tripping income. Interestingly though, that discrimination in favor of such income only applies to the supernormal part
of the income. This overall regime (including both GILTI and FDII) raises a number of fascinating (and perplexing) policy issues. I will first discuss a couple of gating conceptual or policy issues; then I will discuss a few of the operational issues with the FDII statutory provisions that go to the potential effectiveness of the statute in achieving its objectives.

1. Should Roundtripping Have Been Explicitly Addressed By Denying the Net QBAI Return Exemption and the Section 250 Deduction With Respect to Roundtripping Income?

Before we begin our discussion of the FDII rules, it is worth discussing briefly the threshold decision to permit roundtripping to receive the benefits of the exemption for net QBAI income and the Section 250 deduction for GILTI inclusions. The policy issues relating to round-tripping received a tremendous amount of attention in respect of the Camp effort, and a prominent tax commentator has raised it again recently.

While the issue is certainly not a cut and dried one, I ultimately have come to the conclusion that the relatively punitive treatment of roundtripping under Camp Option C was not the best policy solution, and thus I am broadly supportive of the decision made in the 2017 legislation not to deny the benefits of the net QBAI income exemption and Section 250 deduction to round tripping. At bottom, my views are grounded in what may be called capital ownership neutrality (“CON”) considerations. Under the structure of our international tax regime, the affiliate of a foreign-parented group is able to produce goods in a foreign country, including a low-taxed country, sell those goods into the U.S. and largely avoid U.S. tax with respect to a significant portion of the gain on those sales.
I do not see why it is in the interest of the United States to limit a U.S.-parented group from doing the same thing. Among other things, full taxation of round tripping income would favor foreign acquirors of companies exporting into the U.S. over foreign acquirors.

My own view is that the most significant issue is the appropriate U.S. tax treatment of the inbound business activity itself, whether conducted by a subsidiary of a foreign-parented group or a U.S.-parented group. At the end of the day, the BEAT did not materially solve those issues, in significant part because of the cost of goods sold exception. Pending the development of further policy instruments with respect to inbound business generally, I believe it is reasonable not to specifically address roundtripping through the framework of the statutory minimum tax rules, including the GILTI rules.

2. The Nature of the Export Incentive: The Road Not Taken.

While the 2017 legislation did not explicitly discriminate against roundtripping, it did adopt legislative provisions, the FDII rules, that positively provide favorable treatment to U.S. based export activities other than roundtripping. But the choice of the basic form of those rules raises interesting questions. The FDII rules, in general, only provide tax relief for what I have referred to in this paper as the supernormal return, the return in excess of net QBAI income. The specific mechanism by which the FDII rules operate to achieve that result is discussed later in this Part. An important basic question is whether it make policy sense to make this distinction between the normal and supernormal return.
Assuming away the pesky issues of international norms such as those enforced through the WTO and OECD, and without regard to the longstanding economic issues relating to the actual effectiveness of tax favorable treatment of exports, one can see an argument for balancing the GILTI provisions with some sort of special tax incentive for U.S.-based export and other international income. Although I believe the “run-away-plant” concerns with respect to the exemption for net QBAI income are grossly exaggerated, there is likely at least some tilt toward foreign location of plants and equipment arising from the exemption of net QBAI income under the GILTI regime, taken alone. Moreover, although supernormal income of the type often associated with valuable intangibles is subject to a substantial level of tax under the GILTI regime, that level of tax is still potentially materially lower than the U.S. tax rate applicable to activity based in the U.S., depending on the foreign taxes and credits therefor in each particular case. The GILTI provisions, taken as a whole, are in a sense as much “carrot” as “stick” with respect to foreign location and operations, although probably more “stick” than pre-2018 law as Thomas Barthold, Chief of Staff of the Joint Committee on Taxation, has noted. Given that international tax policymaking involves a delicate balancing act, as stressed throughout this paper, one could see the argument for a provision that provided a reduced rate of income tax for both the normal and supernormal returns of U.S.-based export activities. The purest form of such an incentive would be to mirror the GILTI rules and exempt the normal returns and partially exempt the supernormal returns. But purity is not necessary to tilt the balance further in the direction of tax neutrality from where we would be under the GILTI rules taken alone. While expensing rules are in
place, the nonneutrality with respect to tangible capital may be partially alleviated. But those rules are not permanent. In any case, this was not the approach taken in 2017.

3. The FDII Regime and the Location of Intangibles.

By contrast, rather than providing a tax break for both normal returns and supernormal returns, the FDII rules are specifically, but imperfectly, geared to provide the tax break with respect to the supernormal or inframarginal component of the return for business activity. Given the concept from economics discussed at the beginning of this paper, that supernormal returns can generally be taxed consistent with economic efficiency, it is at least superficially puzzling why we would intentionally lower the rate of tax on the supernormal income. At least for multinationals with established U.S. based export activities before the 2017 legislation was enacted, the FDII rules can be viewed as providing a windfall.

The expressed purpose of these provisions relates to the “location of the intangibles.” A Senate Budget Committee report stated: “The Committee believes that offering similar, preferential rates for intangible income derived from serving foreign markets, whether U.S.-based operations or through CFCs, reduces or eliminates the tax incentive to locate or move intangible income abroad, thereby limiting one margin where the Code distorts business investment decisions.” The Deputy Assistant Secretary of the Treasury for International Tax Affairs has stated, after the enactment of the 2017 tax legislation, that the FDII rules are “designed to take away the incentive to transfer intangibles and other mobile factors out of the United States into a low-taxed subsidiary.” In the language I have earlier quoted from Altshuler and Grubert, they seem to
acknowledge that, in fact, the tax on income from intangibles may affect location of such intangible property: “If the intangible that is the source of the excess return is mobile, such as a patent used to produce a good sold on the worldwide market, the tax may just change where the investment is made.” As two economists recently put the point, “... when economic rents are mobile (i.e. are not ‘location specific’), the location of capital sensitive to taxes, even if the level of capital is not.”

But all this begs a big question, the answer to which has not really been broadly articulated: Why do we care about the “location” of the intangible? Tax commentator Martin Sullivan has recently posed this question, and at a minimum I do not believe the issue has been sufficiently addressed publicly. As discussed earlier, assuming we can tax inframarginal returns without impairing economic efficiency, we should definitely care about capturing a fair share of the potential tax revenue from intangibles for the U.S. fisc. The question is how does lowering the tax rate on supernormal returns from intangibles to induce location changes with respect to those assets serve important policy objectives.

Although I am personally very far from getting to the bottom of this question myself, I would suggest that one useful way to think about this question is in relation to two different types of cases, similar to the dichotomy discussed in the BEPs context. The first is in the context of the pure, or relatively pure, tax play in which the intangible is held for tax purposes in a location but little or no associated business activities are conducted in the same locale. This case would represent the extreme case discussed by commentators in which the taxpayer splits the QBAI from the intangible and attempts to achieve the benefits of keeping the QBAI abroad under the GILTI rules but still keeps the intangible in the U.S. and captures FDII treatment. In this case, there would be a separate
licensing of the intangible. The second type of case would be that in which the location
of the intangible and the associated activities are largely conducted in the same location,
and the intangible income reflected in the overall pricing of the goods sold.

There might be some public interest in respect of the first case that the intangible
be located in the U.S. even if we can collect the same amounts of revenues under the
GILTI rules no matter where the intangible is located. In the long run, it is in our interest
for the developmental activities relating to the production of intangibles (and the people
associated with those activities) to be based in the U.S., and with the growing tax friction
associated with movement of intangible rights, those engaged in the development process
may be more motivated to put the people where the rights will be held.

As to the second case, the case in which the location of the intangible is coupled
with business activities, including plants and employees, the interest of the U.S. is
perhaps more clear. Some who have studied the GILTI-FDII interaction after the 2017
tax legislation do believe there will be, on balance, a positive effect in this respect, and
that the treatment of QBAI will not detract from this effect significantly.31

There may be a linkage between the two cases. In other words, the determination
of the initial tax location of the intangible may, over time, affect whether associated
activities are combined with it in the same location.

In any case, we are clearly at just the beginning of assessing the operation of the
FDII rules in these respects. At this point, I remain unconvinced that the statute should
be aimed at only the supernormal component.
4. Statutory Fit.

Assuming the policy decision to provide a tax break for the solely supernormal return from outbound income of U.S. corporations, an initial question is how does the actual operation of the statute fit in that regard. A number of interesting questions have been raised by commentators in that regard.

In general terms, the FDII rules provide, under section 250(a)(1)(A) a 37.5 percent deduction for a domestic corporation’s “foreign derived intangible income” (“FDII”). FDII is in turn defined in section 250(b)(1) in relation to the “deemed intangible income,” the “foreign derived deduction eligible income” and the “deduction eligible income.”

Deduction eligible income is gross income minus certain carve outs such as GILTI and Subpart F inclusions and reduced by deductions attributable thereto. Foreign derived intangible income is, under section 250(b)(4), the part of deduction eligible income attributable to property sold to any person who is not a U.S. person and which the taxpayer establishes to the satisfaction of the Secretary is for foreign use and to any services which the taxpayer establishes to the satisfaction of the Secretary are provided to any person or with respect to any property, not located in the U.S. Deemed tangible income return is basically 10 percent of QBAI used with respect to the universe of deduction eligible income. Deemed intangible income, then, is the excess of deduction eligible income over deemed tangible income return. Note that there is no deduction of specified interest in determining deemed tangible income return. FDII itself, which is supposed to be the supernormal return attributable to foreign activities, is defined as a
portion of the deemed intangible income. Specifically, FDII is defined as the amount that bears the same ratio to the deemed intangible income as foreign derived deduction eligible income bears to the deduction eligible income.

In terms of assessing the fit between GILTI and its complement, FDII, two points are interesting. First, as pointed out by Jonathan Brenner and Josiah Child, the same amounts of QBAI and interest give rise to different answers under the two regimes. Assume the following comparative example based on facts suggested by Brenner and Child.

Example 8. Assume first a CFC wholly-owned by USP, which only owns CFC. CFC has 100 of QBAI, gross tested income of 20 and 10 of interest expense allocable thereto. Because the interest deduction reduces the net QBAI return to zero, USP would have a 10 GILTI inclusion under these facts. Now assume instead that there is no CFC but USP has the same amount of QBAI in the U.S., only sells abroad like CFC and has 10 of interest expense allocable to these activities. Thus, USP will have deduction eligible income of 10 (20-10). Because this amount does not exceed 10 percent of 100, there would be no “deemed intangible income” and thus no FDII.

A second issue relating to the “fit” between the GILTI and FDII statute concerns tax rates. The result of the 37.5 deduction (under current law) is in effect to subject to the FDII to a 13.125 percent rate. If the comparable foreign operations are in a country with significant foreign taxes (and if the foreign tax credit computation is working correctly), the rates applicable CFC based income and U.S. based income will be comparable. But if comparison is being made to operations through a true tax haven with quite low rates,
there will still be a definite, and albeit limited advantage to earning even the supernormal return through the CFC.

My own view, at this stage, is that this is not a serious issue. Other, nontax advantages relating to location may enter into the calculus. And as time goes on there may be fewer pure tax havens, so that 13.125 will be closer to the relevant rate.

5. Vertical Integration Versus Nonintegrated.

A much more serious issue, in my view, is that discussed by Martin Sullivan recently. The statutory mechanism for FDII, perhaps inevitably favors business activities conducted in the U.S. through integrated corporations or affiliated groups. If U.S. Corporation A sells raw product to Corporation B which in turn sells abroad, only the return to B will be eligible for FDII. By contrast, assuming the consolidated return FDII rules come out as expected by most commentators, the profit of both A and B would be eligible for the special treatment. While this design issue may be very difficult to do anything about, it is a respect in which the special statutory treatment may affect the organization of economic activity.

6. Where Does This Leave Us.

Unlike many commentators, I believe there are real reasons to consider adding something to the GILTI mechanism to achieve more neutrality in incentives for foreign business. But this presents a very difficult design task. Further experience with FDII will determine its effectiveness. The long run question of most importance is whether the rules are aimed at the right target.
II. GILTI Interaction With Section 163(j).

To evaluate fully the overall tax and other economic effect of the GILTI regime, it is also very important to understand precisely how section 163(j) will apply in the context of the GILTI regime. As matters developed in the 2017 legislative process, new section 163(j) is the sole new provision added that addresses leverage in the context of out-bound investment, the type of business activity most directly affected by the adoption of the new hybrid territorial regime established in the 2017 legislation. The BEAT addresses what may be called inbound financing and business from the perspective of both U.S. and foreign parented groups, and can have a peripheral impact on outbound planning with respect to the location of debt. But section 163(j) is more directly involved with respect to the issues discussed in this paper. Section 163(j) will clearly have a major impact on financing and business planning in the domestic context. If foreign investment and operations are favored in significant ways with respect to the location of debt, the overall statutory purpose of the 2017 legislation of moving toward neutrality in investment and location decisions may be at least partially frustrated. Moreover, the operation of section 163(j) context may affect how we think about the foreign tax credit issues discussed in Part III of this paper. As usual, the issues posed by the statute in operation are quite complex.

A. Related Policy Issues: Arbitrage and Apportionment; Disproportionate Leverage.

Before I examine section 163(j), however, it may be worthwhile discussing the types of policy instruments that were not adopted in the 2017 legislation. It turns out that
the nonadoption of such policy instruments affects our thinking about a number of other related issues.

One type of such policy instrument addresses what may be viewed as a species of tax arbitrage that arguably arises with any territorial system in which deductions are taken in the home country for expenses allocable in whole or part to foreign income which is exempt. This type of instrument was discussed by Marlon Risinger in a University of Chicago tax paper several years ago. Consider the following highly stylized example involving a mythical territorial regime.

Example 1. Assume USP has a Foreign Branch. USP has a total of 200 of income, 100 of which is domestic and 100 of which is foreign source income through Foreign Branch. USP is generally subject to a 21 percent tax rate on its income. Assume further that, under a pure territorial system, the 100 of foreign source income of Foreign Branch is completely exempt from U.S. tax, and that USP has 20 of interest expenses, 10 of which is allocable to the 100 of exempt income. Although the issue is not quite as easy as it seems, as Marlon Risinger has ably shown, it can be argued that 10 of the 20 of deductible interest expense should be disallowed, i.e. the portion allocable to income of Foreign Branch that is exempt under our mythical territorial regime. Assuming a tax rate of 21 percent, and taking into account the disallowance of 10 of deductions the U.S. tax would be .21 * (100-10) = 18.90. In the decade before the 2017 legislation, this type of potential tax arbitrage received a lot of attention with respect to the design of territorial regimes. In some cases, explicit anti-arbitrage limits on U.S. interest and other deductions were proposed; in other cases, second best limits on the participation exemption were proposed as a surrogate.
A second, separate policy instrument closely related to anti-arbitrage disallowance of the type discussed here is interest deduction disallowance for U.S. tax purposes for disproportionate U.S. leverage. Provisions of this type, combined with section 163(j)-like proposals, have been among the proposals made over the last decade as a territorial or hybrid territorial systems have been considered. Such a provision was contained in the Camp draft legislation, and was also proposed by the Obama administration. In the course of the 2017 tax legislation, the House passed a new section 163(n) that would have limited the amount a domestic corporation could deduct as interest based on a formula that took into account a domestic corporation’s share of the group’s worldwide share of interest income, and the Senate legislation contained a similar provision. Section 163(n) was intended to constrain over leveraging domestic affiliates subject to higher U.S. rates of tax to finance, in part, operations in foreign countries giving rise to income either exempt from U.S. tax or taxed indirectly at a lower U.S. rate under the GILTI rules.

One way of thinking about these provisions is in relation to the above example if a Foreign Branch were a CFC, and all the debt were incurred in USP. Under proposed section 163(n) U.S. interest deductions would, in the above example, simply be denied for the 10 of interest if the overleveraging standard were breached, and the result would be the same, a tax increase of 2.10 attributable to the denied deduction. The conceptual basis for the disallowance is somewhat different; but when the foreign income is completely exempt, the bottom-line result of application of the two types of tax policy instruments is either the same or very close to the same.

How does the policy analysis change if the tax rate on the foreign source income is 10.5 percent rather than zero? This, of course, is closer to where we are today after
enactment of the 2017 tax legislation. In this case, the two different types of tax instruments may give rise to different results. Consider the following example.

Example 2. USP again earns 200 of income, 100 of domestic source income and 100 of income includible from CFC, wholly-owned by USP. Assume the U.S. domestic source income is subject to a 21 percent rate, and the foreign source income includible from CFC is subject to a 10.5 percent rate. Again, USP has 20 of interest expense, 10 of which is deemed allocable to the foreign source income attributable to inclusions from CFC.

This fact situation could be addressed in either of two ways. Under the first, the “tax” arbitrage would simply be viewed as limited and the remedy fashioned accordingly: the foreign source income subject to the 10.5 percent rate is in effect 50 percent “exempt.” If so, the 20 of interest deductions of USP could be divided into three parts: 10 attributable to the 100 of the fully taxable U.S. source income, which should be viewed as fully deductible; 5 attributable to fully taxable income attributable to CFC, which should be fully deductible; and 5 of which is attributable to “tax exempt” income attributable to CFC, for which the allocable deduction would be denied. Thus, .21 * 5 or 1.05 of additional tax would be paid than in the case of full deductibility for U.S. tax purposes. The total tax would be 28.35, which is equal to (.21 * 90) + (.21 * 45). In effect, we are apportioning the deductions among income subject to different tax rates. Something similar to this apportionment approach was suggested by the Obama administration. The Obama administration described its proposal as follows:
“Under [the] proposal, a taxpayer must allocate and apportion interest expense among foreign source gross income subject to tax at the full U.S. statutory rate, foreign source gross income subject to various rates under the minimum tax and foreign source gross income on which no foreign tax is imposed. Interest income allocable and apportioned to foreign source gross income subject to the minimum tax would be deductible only at the minimum tax rate, while no deduction would be permitted for interest deductions, allocated and apportioned to income on which no U.S. tax is imposed.”

However, this type of approach was never considered in 2017.

Alternatively, under an instrument like proposed section 163(n) considered in 2017, we could simply deny the deduction for the 10 of U.S. interest deemed attributable to foreign income from CFC because of U.S. overleveraging, analogous to what would have been the case if proposed section 163(n) had been enacted. Thus, we could view 10 of the interest expense deductible against the U.S. source income and 10 against the foreign source, deny the deduction allocable against the foreign income and compute the tax taking into account the different rates on such income. Under that methodology, the tax would be \[0.21 \times (100-10) + 0.105 \times 100 = 18.90 + 10.5 = 29.40\]. The difference between 29.40 and the 28.35 under the apportionment approach is that under the simple interest disallowance approach the 10 of interest disallowed for the purposes of computing the tax on U.S. source income is not re-allocated to foreign income and deducted against the income subject to a lower rate of tax.
I personally was sympathetic to the decision ultimately not to adopt section 163(n) for two reasons. First, the enactment of section 163(j) itself was a relatively massive change in tax law, which would undoubtedly require significant adjustment by taxpayers. But for a number of taxpayers, the effect of section 163(n) would have been much greater; some were, in fact, puzzled by the relatively modest revenue figures associated with Section 163(n). Second, it was not at all clear to me that section 163(n) was going to be administrable, particularly the Senate version. The fact that the approach exemplified by section 163(n), though considered in 2017, was ultimately not adopted, however, naturally affects Treasury’s views of other issues, such as the role of the section 385 regulations and the treatment of foreign tax credits, as will be discussed in Part III.

B. Section 163(j) Generally: the Statute and Policy Background.

By contrast to these two types of approaches to interest deductions that were ultimately not adopted in the 2017 legislation, section 163(j) represents what may be viewed as a debt-equity approach to interest limitation: if the amount of leverage exceeds a certain amount in relation to income of the entity, deductibility is denied. Section 163(j) by its terms does not explicitly make distinctions based on whether the debt is located in the U.S. or a foreign jurisdiction, and does not appear to be particularly directed at international investment and business activities. But my focus here will be on the impact of section 163(j) internationally and, in particular, on its effect on neutrality of location of debt.

In general terms, new section 163(j) imposes a limit on the amount of business interest deductible by a taxpayer equal to the sum of the business interest income of the
taxpayer and 30 percent of its adjusted taxable income (“ATI”). Section 163(j)(8) defines ATI for this purpose as the taxable income of the taxpayer computed without regard to, among other things, “in the case of taxable years beginning before January 1, 2022 any deduction allowable for depreciation, amortization or depletion.” Importantly, the modifications applicable for computing ATI include “such other adjustments as provided by the Secretary.” Note in this regard that although section 163(j) is in significant part intended by Congress to constrain overleveraging, the ATI base, at least in the domestic context, does not take into account tax exempt income, which would of course actually be available to service debt.

Section 163(j) includes, in section 163(j)(4), particularly complex provisions for the treatment of partnerships. Although the technical operation of these provisions is, at a minimum, far from clear, and likely simply flawed, the basic purposes of these provisions appear to be two: first, to prevent “double counting.” i.e. taking into account the same adjusted taxable income as a base supporting the interest deduction twice, once at the partnership entity level and again at the partner level; and second, to limit the partner’s deductions of interest from partnership debt to an amount determined by reference to the ATI of the partnership, as opposed to its partners. I will address the first concept in the context of GILTI later in this Part.

Two policy choices were implicitly made in enacting section 163(j). The first was to enact a provision that applied only to interest that exceeded a specified limit, 30 percent of adjusted taxable income (as defined) in the case of section 163(j). Some of those involved in the legislative process preferred instead a pro rata disallowance provision under which deductibility of a certain portion of each dollar of otherwise deductible
interest would be disallowed. A provision of this type would not have the “notch” effect inherent in section 163(j), with its attendant effect on tax and business planning, and was also thought to have the advantage of moving the domestic corporate tax system more significantly toward corporate integration. The approach exemplified in section 163(j) was, however, probably more politically palatable because more taxpayers could avoid the bite of an interest limitation, at least before the “da” is eliminated in several years. In any event, the form that section 163(j) ultimately took has a relatively large effect on the assessment of the international tax policy issues we are addressing here because some corporations may simply not be materially constrained by section 163(j).

The second big policy call was to apply section 163(j) to partnerships and other unincorporated businesses. Once full expensing was granted with respect to unincorporated entities and businesses, some interest deduction cutback with respect to unincorporated businesses was going to be necessary. But the full-blown application of section 163(j) to partnerships and other unincorporated business activity was by no means an inevitable policy choice. This decision appears, in part, to reflect the nontax concern of Congress with overleveraging.

Interestingly, I personally at least am not aware of any systematic policy discussion during the legislative process of whether and how the new limits or interest deductibility would apply to foreign corporations. And the legislative history of the 2017 legislation is basically silent on the question.
C. The Case for Application of Section 163(j) to GILTI.

Although neither the statute nor the legislative history are clear on the question, the basic case for applying section 163(j) as enacted with respect to the determination of income subject to GILTI is, on its face, quite strong. There is no question that, if section 163(j) applied only to domestic corporations and other business activities, there would be a strong impetus for more of the borrowing of multinational groups otherwise constrained by section 163(j) to be undertaken abroad. Moreover, the location decision with respect to business activity generally could be affected somewhat by differences in treatment of domestic and foreign debt under section 163(j), although the extent to which that is true is unclear.

With that said, rational application of section 163(j) in the context of the GILTI regime poses quite difficult conceptual and technical issues. I will discuss some of the basic issues here. A number of these issues (but likely not all) may be addressed in the forthcoming proposed section 163(j) regulations.

D. The Treatment of Section 163(j) Carryovers.

A threshold question relating to the application of section 163(j) in the GILTI context is how section 163(j) is going to fit into a regime that for the most part applies a rigid year-by-year approach, as discussed in Part I of this paper. By contrast, section 163(j) applies a much different approach. Unlike old section 163(j), new section 163(j) does not permit unused limitation to be carried over; in this respect, it is like the rules relating to net QBAI return discussed earlier. However, business interest deductions denied as to one taxable year because of application of the limit to 30 percent of adjusted
taxable income ("ATI") can be carried forward and treated, in effect, as interest incurred in the later years and deductible at that time, subject to the 30 percent of ATI limit in those years. The partnership rules, for example, contain elaborate rules reflecting this aspect of the section 163(n) rules, and the carried over interest is a section 381 attribute subject to section 382.

Is there any reason this carryover of interest deductions should not be permitted if section 163(j) is applied in the GILTI context? I do not think so. On balance, I believe tax neutrality is served if carryovers are permitted although one can expect a substantial amount of planning in regard to carryovers. One question that arises, however, is whether the carryover would apply on a CFC-by-CFC basis, or as to an entire group of related CFCs.

E. Related Party Debt.

One reason that a group-wide approach may be more rational is apparent when we consider related party debt. Assuming section 163(j) is applied with respect to GILTI, the application of section 163(j) will be particularly complicated with respect to debt between CFCs. A relatively simple example illustrates the basic problem, which is analogous to one of the problems discussed above with respect to specified interest and the determination of net QBAI return.

Example 3. Assume USP owns all the stock of two CFCs, CFC1 and CFC2. CFC2 has borrowed 250 from CFC1, with an annual interest rate of 8 percent. The GILTI income of both CFC1 and CFC2 will be included in USP’s income under the GILTI rules. If CFC2’s annual interest deduction of 20 is disallowed under section
163(j) for purposes of computing the tested income amount included in the calculation of USP’s GILTI inclusion, but the full amount of the 20 of interest income from the related party debt is otherwise included in CFC1’s tested income for purpose of computing the GILTI inclusion of USP, it can be seen that a distortive result is obtained. The question is whether section 163(j) should be turned off so long as there is a full GILTI related inclusion of interest income by the common U.S. shareholder. One possibility that naturally comes to mind is a relatively simple rule, analogous to that contained in section 951A(b)(2)(B), that disallows the interest under section 163(j) only to the extent such interest is not otherwise taken into account in computing the shareholder’s income under the GILTI or Subpart F rules. However, as indicated by Treasury and the Internal Revenue Service in the Explanation of Provisions to the proposed GILTI regulations with respect to specified interest, it is difficult to trace precisely the interest from intercorporate debt, particularly when ownership interests vary among CFCs.

There is an additional complication with respect to section 163(j). The treatment of intercompany debt in the foreign context under section 163(j) should not generate extra section 163(j) limitation if relief is granted in the above example. Thus, it may be necessary to ignore the inter-CFC debt for all section 163(j) purposes. Consider a somewhat more complex example.

Example 4. USP again owns all the stock of CFC1 and CFC2. Assume CFC2 would like to borrow an aggregate of 625, generating a total of 50 of annual interest deductions at an 8 percent rate. But CFC2 only has 100 of ATI (which we will assume is also the amount of GILTI tested income), which generally would only support 30 of interest deductions. Assume that to meet its own needs CFC1 has borrowed 375 on
which it pays 30 of annual interest and has only 100 of ATI. Assume now that CFC1 borrows 250 from Bank, an unrelated party, paying 20 of annual interest and unlends the 250 to CFC2 for 20 of annual interest. The 20 of interest income of CFC1 from the loan to CFC2 generates additional section 163(j) capacity for CFC1 under section 163(j)(1)(A). In this case, if section 163(j) is simply turned off as to the inter-CFC loan from CFC1 to CFC2, overall section 163(j) capacity is increased by 20. One answer is to not increase CFC1’s section 163(j) capacity for the exempted interest paid by CFC2. Should the result depend on whether CFC1 had extra capacity before the loan? Should interest on inter-CFC loans just be disregarded as the government has suggested will be the case with respect to inter-member loans under the section 163(j) consolidated return regulations? The ultimate answer may be simply to ignore inter-CFC debt for all purposes in the same manner.

In addition, it should be noted that an issue analogous to that discussed above with respect to specified interest is raised with respect to USP loans to CFCs subject to GILTI. Assume that the loan to CFC2 in question was from USP rather than CFC2. Should CFC2’s interest on the loan be disallowed under section 163(j) if the interest is fully includible to USP? Again, the fact that, in this context, the interest payable generates additional section 163(j) limitation to USP complicates the policy issue; perhaps that loan should just be disregarded for purposes of section 163(j). One can thus see the impetus for a super consolidated group approach to the application of section 163(j) in the international context. But in its notice on section 163(j), the government dismissed the possibility of a “super” consolidated approach to section 163(j).35
F. Effect of Section 163(j) on Net QBAI Return.

Another question that arises is whether the application of section 163(j) should be taken into account in computing the net QBAI return that is effectively exempt from U.S. tax under the GILTI rules. In essence, this is a question of the rate of tax that should be applied to a given amount of income earned through a CFC. The question can again be illustrated with a simple example.

Example 5. USP owns all the stock of CFC. USP contributes 500 to CFC and CFC borrows 500 from Bank, an unrelated party. Then, CFC purchases 1,000 of QBAI. Assume in Year 1 that CFC has 100 of income before interest deductions, and has 40 of interest on the loan from Bank. Assume further that 10 of the 40 of the interest is disallowed under section 163(j) so that the actual interest deduction is 30 for purposes of computing tested income. CFC clearly has 70 of tested income. The question is what is the net QBAI return that is exempt from a GILTI inclusion.

If the section 163(j) disallowance of 10 is taken into account, the net QBAI return would be (.10 * 1,000) - 30 = 70, and all 70 of the tested income would be exempt. If the section 163(j) disallowance is not taken into account, the net QBAI return would be (.10 * 1,000) - 40 = 60, and only 60 would be exempt; there would be a 10 GILTI inclusion.

A strong conceptual argument can be made that the full 40 should be deducted in computing the net QBAI return, irrespective of whether section 163(j) limits the income for purposes of computing tested income. The net QBAI return is an economic concept designed to determine the normal return from investments in assets. In this sense, net QBAI return is analogous to earnings and profits, which Treasury and the Internal
Revenue Service have stated by notice will be computed without regard to application of section 163(j). The debt utilized to finance the QBAI clearly has a 40 return to the lenders thereof, and that is the amount that should be backed out to determine the return on the QBAI allocable to the shareholder, USP. The statute, however, appears clearly to come to the opposite result by deducting an amount equal to “the amount of interest expense taken into account under subsection C(2)(A)(ii) in determining the shareholder’s net CFC tested income.” I do not expect the section 163(j) regulations to modify the treatment apparently mandated by the statute.

G. Effect of GILTI Deduction on ATI of U.S. Shareholder.

Significant issues are also raised with respect to the effect of the GILTI inclusion on the ATI of the U.S. shareholder. A policy analysis of some of the issues in this regard is affected by the fact that GILTI inclusions and net QBAI return are subject to lower tax rates than U.S. domestic income. Consider first the following simple example.

Example 6. Assume that CFC incurred no indebtedness and all indebtedness is incurred at the level of USP. Assume again CFC has 100 of ATI and GILTI, and USP has 100 of ATI generated by USP alone. USP will, as specified, have 100 of ATI, plus the ATI, if any, attributable to its GILTI inclusion from CFC. If we adopt a purely mechanical approach to computing the ATI of USP attributable to CFC, the incremental ATI attributable to USP’s inclusion from CFC would be 50 (100 of GILTI income minus 50 of GILTI deduction). Note that this is less incremental ATI than if CFC’s business were conducted through a foreign branch of USP, which would be 100. Should the 50
GILTI deduction under section 250 be taken into account in determining USP’s ATI from a GILTI inclusion?

As noted earlier in this paper, one way to think about the section 250 deduction is as simply a means for establishing the tax rate applicable to CFC’s income for corporations at 10.5 percent rather than 21 percent. Stated somewhat differently, the GILTI deduction has the effect of exempting 50 percent of the GILTI income. Should this fact affect the amount of income included in USP’s ATI for purposes of section 163(j)? Recall that tax exempt income would, under the statute, generally not be taken into account in the domestic context in computing ATI under the statute.

The principal argument for applying the GILTI deduction in determining the increase in the section 163(j) limitation for the U.S. parent in this stylized example is the lower rate of U.S. taxation applicable to GILTI as compared to U.S. domestic income. Interest deductions taken against the GILTI of a CFC have less of a tax benefit than interest deductions taken against U.S. income when viewed solely from a U.S. tax point of view. Thus, viewed from that perspective, the section 163(j) limitation relating to a certain amount of ATI of CFC is more valuable if attributed to a U.S. based company. Taking the GILTI deduction against the CFC’s GILTI income for purposes of increasing the domestic corporation’s ATI compensates for this difference, and appears to be justifiable on that basis. Thus, I expect that proposed regulations will confirm that section 250 will apply for purposes of determining the ATI of a U.S. shareholder.
H. Should ATI of CFC Include Net QBAI Income?

If the rate of U.S. taxation applicable to a CFC’s income is relevant for purposes of computing the ATI of a U.S. shareholder, should the fact that income of CFCs may now be subject to at least three different rates of U.S. tax, as a policy matter, affect the computation of ATI of a CFC for purposes of section 163(j)? Consider the following example.

Example 7. Assume CFC has 100 of income that would under general U.S. principles give rise to ATI of the same amount. Assume further that it has 500 of QBAI, and that it plans to borrow 375 at an 8 percent interest rate, giving rise to 30 of annual interest deductions.

In applying section 163(j), can CFC take into account all 100 of CFC’s adjusted taxable income even though, after application of the rules relating to net QBAI income, 20 of the income of CFC (50-30) will be exempt from U.S. taxation? As noted above, tax exempt income is not included in ATI in the domestic context. Although I am by no means certain, my expectation is that, under the regulations, all income of CFC computed under general U.S. tax principles will count for purposes of determining the amount of interest deduction permitted under section 163(j). Note in this regard that the interest thus determined to be deductible would in effect be stacked against QBAI income for purposes of computing specified interest and the exempt amount under the net QBAI rules. Thus, although the answer is a favorable one under the section 163(j) rules, the interest deductions could substantially affect the amount of exempt net QBAI income.
I. Double Counting: The Analogy to Partnerships.

Application of section 163(j) with respect to CFCs and the GILTI provisions also raises a double counting issue analogous to that addressed by section 163(j)(4), which as noted above contains the provisions under section 163(j) related to partnerships. The question is how USP’s limitation is affected by CFC’s use (or partial use) of its section 163(j) limitation. Like the rules of Subchapter K, the GILTI rules represent a type of conduit regime. The question is whether some or all of the concepts underlying the partnership rules in section 163(j) should thus be applied in the context of the GILTI regime. Consider first the following example illustrating the partnership double counting rules.

Example 8. Partnership P has two equal 50-50 partners, A and B. Partnership P incurs indebtedness the interest on which is 30 annually, and P has 100 of ATI annually. A and B each have also incurred indebtedness at the partner level. The ATI of 100 is sufficient to support fully 30 of annual interest on P’s debt. However, under the section 163(j) rules, because the 100 of ATI was fully used at the partnership level to support 30 of interest deductions, the same 100 of ATI (or any part thereof) would not be passed through to A and B (35 each) and usable by A and B as adjusted taxable income to support interest deductions on debt incurred at the level of A and B. If, by contrast, P had only 15 of deductible current interest, 50 of “excess taxable income” ("ETI") would be available at the partner level, pursuant to section 163(j)(4)(C); in other words, excess unused limitation would flow up to A and B for use to support deductibility on interest incurred at their level, the partner level.
First, consider in this regard an example involving international operations conducted in branch form.

Example 9. Assume that USP conducts foreign operations through Foreign Branch, a foreign branch for U.S. tax purposes. USP generates a total of 200 of ATI, 100 in the U.S. and 100 in Foreign Branch. USP (including Foreign Branch) is just one taxpayer for U.S. tax purposes. Thus, a total of 60 of interest deductions could be incurred, either in the U.S. or in Foreign Branch without limitation by section 163(j), and any more would not be permitted to be deducted annually.

Now, consider another example in which the foreign operations are instead conducted through a CFC wholly owned by USP.

Example 10. USP itself again has 100 of ATI, without taking into account its ownership of CFC or income therefrom. Assume that USP owns all of CFC, which itself has 100 of ATI. For purposes of this simple example, assume that CFC has no QBAI and has 100 of GILTI, before interest deductions, and 100 of ATI. Assume further that CFC incurs 375 of debt giving rise to 30 of current interest deductions. Assuming section 163(j) applies to CFC, all 30 of CFC’s interest deductions would be allowed; CFC is thus using its full limitation under section 163(j).

Now, the question is what is the limitation applicable to interest on debt incurred at the level of USP? Assuming as specified that, independently, USP has 100 of ATI from its operations, the question again is the extent to which its limitation is increased by the inclusions from CFC under the GILTI provisions. Under a simple mechanical view of the question, USP would have 35 of such income (70 as a GILTI inclusion, minus a 35
GILTI deduction under Section 250. But in effect this 35 of income sourced originally in CFC had already been taken into account at the level of CFC in determining the amount of interest deductible on the loan to CFC. Is this a double counting issue that Treasury and the Internal Revenue Service should address under the regulations? Should USP and CFC combined have more than 200 of usable ATI, which is the total amount of ATI if CFC were a branch? How much should it matter that different U.S. tax rates apply to the domestic income of USP and the foreign income of CFC? My own expectation is that Treasury and the Internal Revenue Service will ultimately apply double counting and ETI concepts in the GILTI context similar to those applicable to partnerships under section 163(j)(4).

J. Effect of Section 163(j) on Locational Incentives: Where Does This Leave Us?

At this point, it is worth considering where we are in terms of locational incentives under section 163(j), taken alone. In the absence of the section 163(j) regulations, I will make the assumptions as to those regulations that I have made thus far.

A simple threshold question is whether there is an incentive for a section 163(j) group to incur debt at the CFC level even if “double counting” rules like those applicable to partnerships are applied in the GILTI context. With respect to the rules relating to net QBAI income, we saw that there is a strong incentive to incur debt at the level of the U.S. parent. Are the incentives different under section 163(j)? Even if we confine ourselves to purely U.S. tax considerations, this question is a bit more complicated than one would expect.
Consider first an example in which no borrowing occurs at the CFC level.

Example 11. Assume again that USP has 100 of adjusted taxable income taken alone, and CFC has 100 of adjusted taxable income and GILTI. Assume further CFC has no QBAI. In this case, USP’s ATI would be $100 + (100-50) = 150$. USP’s total deductible interest capacity would be $.30 \times 150 = 45$. Thus, for example, USP could borrow 562.50 at an 8 percent interest rate. If, by contrast, USP had borrowed 750 at an 8 percent interest rate, incurring 60 of aggregate interest deductions, the deductibility of 15 of interest currently would have been disallowed, costing 3.15 in tax if the disallowance proves to be permanent.

Now assume instead that CFC borrows at its level up to its full section 163(j) capacity.

Example 12. CFC incurs debt with 30 of deductible interest. USP then incurs debt fully utilizing its limitation.

In this case USP’s ATI would be 100, because it would be unable to use any of CFC’s limitation under double counting rules, assuming they are promulgated as I have predicted. Thus, the total interest deductible under these stylized facts would be 

$.30 \times (100) + .30 \times (100) = 60$, 15 more than in Example 11.

However, even if we assume the group wanted to borrow an amount (750) giving rise to 60 of interest, there appears to be no net advantage. Viewed solely from the perspective of U.S. tax results, there is an offsetting cost. One way to think about part of that cost is that 15 of the interest deductible against 21 percent taxed income is being
moved to CFC in Example 12 and would reduce GILTI income taxed at 10.5 percent. Moreover, 15 of the incremental deduction is being taken against income taxed at a 10.5 rate. Thus, the tax cost of nondeductibility of 15 if all debt were located in USP, as in Example 11, is offset by the offsetting locational effect of lower U.S. tax rates in Example 12.

Obviously, this is a complicated subject. But preliminarily it does not appear that full application of section 163(j) will have a significant nonneutral effect on debt location decisions from the perspective of U.S. taxation, taken alone.

Is this basic calculus changed by the oft discussed methodology of using intercompany loans from USP to CFC. I don’t think so. Consider the following examples.

Example 13. Assume that CFC needs financing. Assume further that instead of borrowing from an outside lender, CFC borrows up to its full capacity from USP, paying 30 annually of deductible interest on the loan to USP. This interest in turn increases the section 163(j) capacity of USP by the amount of interest under section 163(j)(1)(A). Thus, taking into account both its 100 of ATI and the business interest income generated by the loan to CFC, USP has the ability to incur outside indebtedness with 60 of deductible interest. However, net, the aggregate outside debt of the group is still an amount giving rise to 60 of deductions (750 in our example), and the net interest deductions (after taking into account offsetting interest income) are still located in the same place (30 in CFC and 30 in USP).
Before we leave section 163(j), let us consider one more question. How much, if any, does section 163(j) alone affect the location calculus when, to maximize net QBAI return, a group wishes to move debt from the CFC level to the USP level so the reduction for specified interest is less or eliminated? I discussed this kind of planning in Part I. Consider the following example.

Example 14. To begin with, CFC has incurred debt from Bank with 30 of interest deductions, fully utilizable against 100 of ATI. Similarly, USP has incurred debt generating 30 of interest deductions, fully utilizing its 100 of ATI (which includes no amount from CFC under double counting rules). Assume again ATI is equal to tested income. However, in this case CFC has 300 of QBAI, and USP and CFC would like to move the debt to USP to avoid the reduction of the net QBAI income by the 30 of interest on the debt that CFC incurred from Bank.

If the debt is moved in full, USP’s section 163(j) limitation will, in this case, be increased marginally. USP will have 70 of GILTI inclusion from CFC (100-30) after moving the debt. This will increase USP’s limitation by 35 (70-35) because there is no longer a use of limitation by CFC and thus no double counting issue. Thus, on the margin, only 10.5 of incremental deductions to USP under section 163(j) can be supported, and USP will not be able to deduct the full 30 of incremental interest from the moved debt.

What is the overall tax effect? USP has the same GILTI inclusion in both cases (100-30), or 70: the exemption for net QBAI income in effect has the same effect as less interest deductibility against tested income. Because of section 163(j) constraints, only
10.5 of the 30 the interest deductions on the debt moved to USP will be deductible. But that marginal tax deductibility still represents a net tax savings. Section 163(j) has decreased, but not eliminated the U.S. benefit of moving the debt, at least in this case.

Of course, in addition to ignoring foreign tax deductibility, this analysis ignores foreign tax credit considerations, including importantly the effect of allocation of interest expense. We will now turn to that question.

III. Foreign Tax Credits and GILTI: Allocation of Interest and Other Expenses.

Our discussion of the treatment of interest deductions after the 2017 legislation provides a foundation for discussion of a policy question that was left incompletely addressed in the 2017 legislation: the appropriate relationship between the GILTI provisions and the foreign tax credit rules, including the section 904 limitation. In particular, substantial questions are raised as to the appropriate allocation of expenses, including interest expenses, for purposes of computing the foreign tax credit. Because the examples given in the legislative history are highly stylized and address facts that permit these issues to be ignored, little guidance has been given as to the views of Congress on these issues; in fact, the legislative history is read by some to suggest that there should be no interest allocation for purposes of foreign taxes in the GILTI basket. Moreover, the very complexity of the GILTI rules themselves – the cutback of the foreign tax credits, the section 78 gross up and the disparate treatment of different types of foreign income – can obscure the policy stakes at issue.

Two basic types of issues that were not fully developed as a policy matter in the 2017 tax legislation are implicated in trying to determine a rational treatment of expenses
with respect to the section 904 limitation relating to GILTI income. First, GILTI is, in effect, subject to a different rate of tax than corporate income generally. In the perfect world, this fact would be taken into account explicitly to adjust the section 904 fraction, as has been done in the past for other types of income such as capital gain income. But no such adjustment was made in the 2017 Tax Act. Second, and more importantly, there is a relatively underdeveloped explication of the interrelationship between the treatment of interest and other expenses generally with respect to foreign income generally, and that general treatment affects the rational design of a foreign tax credit limitation applicable to the new international tax regime.

A. Overview of Policy Context: the Role of the Section 904 Limitation

Generally and Different Rates of Taxation.

Before proceeding with a technical and policy analysis of the applicable regulations and the statute itself, it is worthwhile discussing the policy context in a very general and conceptually basic fashion. My objective here is ultimately to determine the conceptually correct result, irrespective of what Treasury and the Internal Revenue Service can do and choose to do under current law.

As it happens, we have been left with an awkward situation in which the principal tax instrument relating to interest allocation, the water’s edge approach of the section 861 regulations and the regulations thereunder, confuses the situation conceptually if made applicable. Although the issue is not free from doubt, and it may be clarified in forthcoming regulations, most practitioners assume that interest will not be allocated and apportioned under section 861 against the GILTI income, thus reducing the income in
effect subject to a tax rate of 10.5 percent. In other words, it appears that the section 861 regulations will be applied for purposes determining tested income at the CFC level but not to allocate interest at the U.S. shareholder level to the ultimate GILTI inclusion. Thus, it appears that, substantively, interest incurred by USP remains deductible against income subject to a 21 percent rate. This result does appear to be consistent with where Congress ended up in 2017, as no new tax instrument was enacted that explicitly addressed interest allocable to income subject to the new GILTI regime. But section 861 and the regulations thereunder may be made applicable by Treasury and the Internal Revenue Service for purposes of allocation interest to foreign income under the section 904 limitation, and that foreign income is either partially exempt from U.S. tax or, to a limited extent, fully exempt. In a sense, then, the potential foreign tax credit treatment of interest deductions is inconsistent conceptually with the treatment of actual deductions.

1. The Basic Role of the Section 904 Limitation.

The basic policy consideration at issue here is the policy under the section 904 limitation. Although the underlying policy of the foreign tax credit limitation can be relatively easily discerned, the concepts involved can become quite difficult when the allocation of expenses is involved, particularly under the current state of law.

The simple idea behind the foreign tax credit limitation is that the credit should be applied only against the incremental U.S. tax on foreign source income. Stated otherwise, the foreign tax credit should not be permitted to reduce the U.S. tax on U.S. domestic source income.
One question we must ultimately address is whether this basic policy is modified at all in the context of a minimum tax provision of the type exemplified by the GILTI provisions. After some reflection, I ultimately do not believe the basic policy should be modified, but its application is somewhat less than clear in this context. Moreover, in making ultimate policy decisions as the appropriate section 904 limitation, the overall operation of the entire new international tax system should be taken into account. From my own perspective, the most reasonable course of action at this point may be one that is not conceptually pure.

Let us start simply with an example illustrating the basic operation of the foreign tax credit limitation.

Example 1. USP has 100 of U.S. domestic source income and through Foreign Branch has 100 of foreign source income. To begin, assume the U.S. source income and foreign source income are both subject to a 21 percent tax rate. Assume that Foreign Branch has incurred 20 of foreign tax on its income.

The computation of the foreign tax credit limitation in this Example is straightforward. The tentative U.S. tax is .21 * (100 + 100) = 42. The section 904 limitation fraction is 100/200. Thus, the limitation is 100/200 * (42) = .5 (42) = 21. The 20 of foreign taxes would be fully creditable. The limitation applies so that only the incremental U.S. tax on the foreign source income can be credited, in this case 21, which is .21 * 100.
2. The Section 904 Limitation When Tax Rates Differ.

Now let us assume that the foreign source income of Foreign Branch is subject to a lower rate of U.S. tax than is the U.S. source domestic income of USP.

Example 2. USP has 100 of U.S. source income and, through Foreign Branch, 100 of foreign source income. The U.S. source income is subject to a 21 percent U.S. tax rate; the foreign source income is subject to a 10.5 percent U.S. tax rate. The tentative U.S. tax is \((.21 \times 100) + (.105 \times 100) = 31.5\). Assume again that Foreign Branch has incurred 20 of foreign taxes.

Conceptually, the key again to understanding the appropriate foreign tax credit limitation in this case is to identify the incremental amount of U.S. tax on the foreign source income. That amount is \(.105 \times 100\) or 10.5 in this case. The tentative U.S. tax is 21 + 10.5 or 31.5. One way to think about the foreign source income is as if it is 50 percent exempt. Thus, the section 904 limitation fraction should be computed based on only the non-exempt income in the numerator and denominator of the section 904 fraction: \(\frac{50}{100+50} = \frac{1}{3}\). Thus, \(\frac{1}{3} \times 31.5 = 10.5\) of the 20 of foreign taxes would be creditable.

The important point with respect to this example is that, one way or another, the limitation fraction must be adjusted to reflect the fact that a different rate is being applied to the foreign income than the domestic income of USP. Accommodation of rate differentials is not a new enterprise in the context of the foreign tax credit limitation. The rules of section 904(b)(2) represent an attempt to rationalize the fraction in respect of capital gains subject to a lower tax rate. Unfortunately, no explicit statutory changes of
this type were made in connection with the enactment of the GILTI provisions, and the issue was left untreated in the legislative history of the 2017 tax legislation.

In a relatively simple context, an appropriate result can be obtained by actually treating the GILTI deduction as a deductible item and adjusting the numerator and denominator of the limitation fraction by that deduction. Viewed, this way, the section 904 fraction in our example would be \((100 - 50)/100 + (100-50)\) or \(50/150\), or \(1/3\), the same fraction as computed above. However, that methodology tends to obscure the surgery that is necessary when expenses must be allocated to the numerator, as will be discussed extensively below.

These simple stylized examples, of course, have analogues involving CFCs, which are more precisely relevant for our purposes because the new GILTI regime only applies to CFC income. Consider another simple example.

Example 3. USP owns all the stock of CFC. USP has 100 of U.S. domestic income. CFC has 100 of income subject to 20 of foreign taxes, and USP has a net inclusion of 80 (100 - 20) from CFC. The 100 of USP domestic income is subject to a 21 percent rate, and the income included from CFC is subject to a 10.5 percent rate.

In this case, the computation will be very similar but, under section 78 principles, the 80 of income from CFC is grossed up to 100 for purposes of computing foreign tax credits. Again, the section 904 fraction should be \(50/(100 + 50) = 1/3\). We should adjust both the numerator and denominator of the limitation fraction to account for the fact that the foreign income is subject to a lower rate.
B. Allocation of Interest and the Foreign Tax Credit Limitation.

With that background, let us begin to deal with the difficult issue of interest expense allocation with respect to the foreign tax credit. This issue is made more complicated by its interrelationship with the issues briefly introduced in Part II of this paper, those relating to tax arbitrage and disproportionate leveraging.

Consider first a simple example illustrating application of the rules when all income is subject to the same rate of tax and only computation of the foreign tax credit is involved. This simple example is intended to remind us of the core reason for allocating expenses with respect to the foreign tax credit.

Example 4. USP has 100 of U.S. source domestic income and, through CFC, has 100 of foreign source income (after gross up). Assume that in this case all the income is subject to a U.S. tax rate of 21 percent. Assume that USP has 20 of deductible interest expense and that 10 of the 20 is properly allocable to the foreign source income. Assume again that foreign taxes of 20 are paid on the foreign source income. The preliminary U.S. tax without taking into credits is .21 * (200 – 20) = .21 * 180 = 37.80. Applying allocation and apportionment rules for purposes of determining the foreign tax credit limitation, the limitation fraction would be 100-10/[(100-10) + (100-10)] = 90/180 = .5. Thus, the limitation would be .5 * 37.80 = 18.90. Only 18.90 of the 20 of foreign taxes would be creditable.

At this juncture, it is important to articulate why that 18.90 is the “right” answer. One way to put it is that the incremental U.S. tax on the foreign source income is appropriately viewed as .21 * 90 = 18.90. Another way of putting it is that we will allow
a credit for foreign taxes only in an amount equal to the U.S. tax rate (in this case 21 percent) applied to the relevant amount of income (90) computed under U.S. principles. Allocation of interest to the foreign source income is done because that is how we think we should determine the relevant foreign source income under our principles. To allow a credit for 20, for example, would be to allow a credit for foreign tax imposed at a 22.22 percent rate, which is 20/90, assuming that under U.S. principles there really is only 90 of foreign source income at issue.

Now let us consider a case in which the U.S. tax rate on the foreign source income is 10.5 percent, while the rate on U.S. source income remains 21 percent. This case is significantly more difficult to analyze solely from a foreign tax credit policy perspective because how we think about that question may be affected by how other substantive rules interact with the foreign tax credit rules, including those discussed in Part II which were not adopted by Congress in 2017. Consider the following base fact situation, which will serve as the continuing focus of our discussion.

Example 5. USP again earns 100 of U.S. domestic source income and 100 of foreign source income through CFC (after gross up). The U.S. tax rate applicable to the U.S. domestic source income is 21 percent and that applicable to foreign source income earned through CFC is 10.5 percent. USP has 20 of interest deductions, 10 of which are assumed to be properly allocable to the foreign source income under the relevant rules. Assume 20 of foreign taxes are paid by CFC.

How we analyze this type of fact situation depends on the precise nature of the policy instrument applicable for purposes of treating the interest viewed as allocable to
the foreign income. Let us first assume that, for all purposes of U.S. substantive tax law, full allocation and apportionment is applied, including both in determining the actual U.S. tax paid on the domestic and foreign source income and the foreign tax limitation. This is a method like that discussed in Part II above addressing tax arbitrage, and we are first assuming that it is applied for all purposes. I will call this method the full apportionment methodology. Thus, 10 of the interest deductions are not applied to reduce U.S. tax on U.S. domestic source income and that 10 is instead applied in computing the tax (imposed at a 10.5 percent rate) on the net foreign source income earned through CFC (after gross up). In that case the preliminary U.S. tax before foreign tax credits would be \(0.21 \times (100 - 10) + 0.105 \times (100 - 10) = 18.90 + 9.45 = 28.35\). The incremental U.S. tax on the foreign source income is \(0.105 \times 90\) or 9.45. What section 904 fraction gives rise to this result? Again, one way to think about the foreign source income in this example is that 50 percent of it is exempt from tax and economically 5 of the 10 of interest deductions allocable to the foreign source income are allocable to the exempt income and 5 to the nonexempt income: the incremental tax is \(0.21 \times (50 - 5) = 0.21 \times 45 = 9.45\). Computing the fraction in this way, it would be \(0.5 \times (100 - 10)/[(100 - 10) + 0.5 \times (100 - 10)] = 45/135 = 1/3\). 1/3 of 28.35 = 9.45. The total U.S. tax after credit would be 28.35 – 9.45 = 18.90.

As noted above, this full apportionment methodology, under which interest deductions are allocated both for determining the substantive tax obligation and the foreign tax credit limitation, appeared to be contemplated by the Obama administration with respect to its minimum tax proposals. The minimum tax structure proposed by the
Obama administration (at a 19 percent rate) may be viewed as analogous to the 10.5 rate imposed in our stylized examples.

Under such a system, if you believe it, in fact, reflects the correct allocation of interest expense, it is relatively easy to determine the “right” result for foreign tax credit limitation because the incremental U.S. tax being imposed on foreign source income can be easily conceptualized.

Second, as an exercise, it is worth considering another variation, one in which the U.S. deduction is reduced under these facts with respect to the interest allocable to foreign sources, but the U.S. tax on the foreign source income earned through CFC is not affected by the re-allocation of the interest deductions to foreign source income. In other words, in this case an interest disallowance provision aimed at disproportionate U.S. leverage of the type discussed above in Part II is involved, and in effect the deduction of interest deemed allocable to the foreign income is just disallowed. This hypothetical is roughly equivalent to what the situation would have been if proposed section 163(n) had been adopted, but the GILTI minimum tax calculation did not contemplate a re-allocation of the interest deductions denied under section 163(n). Under those changes to the tax treatment of our hypothetical, the preliminary U.S. tax imposed before foreign tax credits would be .21 * (100-10) + .105 * (100) = 18.90 + 10.50 = 29.40. This amount is 1.05 larger than that under the full apportionment methodology. Now, the incremental U.S. tax on the foreign source income is 10.5. In my view, in that case, there should not be any allocation of expenses to foreign source income for purposes of determining creditability. The relevant fraction would be .5 * (100)/[(100-10) + .5 * (100)] = 50/140. Thus, the limitation would be 50/140 * 29.40 = 10.5, the incremental tax on foreign
source income that we determined. Again, the total U.S. tax paid after foreign tax credits would be $29.40 - 10.50 = 18.90$. Interestingly, under my somewhat simplistic assumptions, although we get there in a somewhat different way, the total tax paid is the same as that under the full apportionment methodology which we discussed first.

Finally, let us discuss a more conceptually uncertain variation of these examples. Assume a case in which the interest deduction for substantive determination of U.S. tax is not re-allocated or denied under any rule; thus, interest paid or accrued by the U.S. taxpayer is fully deductible against income taxed at a 21 percent rate. But, at the same time, for purposes of computing the foreign tax credit limitation, expenses are allocated to the U.S. source and to foreign source income respectively. As noted above, this appears in effect to be the uneasy situation in which we apparently find ourselves under current law, depending on how Treasury and the Internal Revenue Service address allocation issues in the forthcoming regulations. For purposes of our analysis, let us assume, at this stage, that the allocation rules for section 904 purposes are the same as under the first two variations: i.e. the same amount of interest is involved.

In this case the tentative U.S. tax before credits would be $.21 * (100-20) + .105 * (100) = 27.3$. Thus, under the same basic facts, we have three different tentative U.S. tax amounts depending how interest is treated for substantive tax purposes: 28.35 if the deduction for interest is fully re-allocated to the foreign source income for substantive tax purposes; 29.40, if the deduction of the 10 of interest allocable to foreign sources is simply fully disallowed and is not instead re-allocated to reduce U.S. tax on the foreign source income; and 27.30 if the interest remains fully deductible against U.S. income taxed at the 21 percent rate.
In determining the appropriate section 904 fraction with respect to this third case, let us first ask what the “incremental” U.S. tax on foreign source income is. I do not find this to be such an easy question to answer. There are at least three different ways of thinking about that incremental amount, and the appropriate section 904 fraction would vary depending on which way we think about the issue.

Under these facts, one way to look at the incremental U.S. tax is simply as 10.50, given that for tax purposes the U.S. is not reallocating any deductions relating to the 20 of interest to determine the amount of income subject to the 10.5 percent tax rate. Under this approach, no interest would be allocable for foreign tax credit purposes. As noted above, some assume from the legislative history that Congress intended this result in 2017. I remain quite sympathetic to this approach, particularly from the perspective of legislative intent and simplicity.

A section 904 fraction for this approach would simply entail a numerator that did not reflect an allocation of interest expense. The fraction would be \(0.5 \times \frac{100}{(100 - 20) + 0.5 \times (100)} = \frac{50}{130}\). This fraction does reflect the fact that 50 percent of the foreign source income is tax exempt, but does not take into account any interest allocation in determining the numerator of the section 904 fraction. The creditable amount would be \(\frac{50}{130} \times 27.30 = 10.50\). The total U.S. tax after credits would be \(27.30 - 10.50 = 16.80\), significantly lower than the amounts computed above when we assumed different substantive limitations or interest deductibility had been adopted.

A second approach would be to view 10 of the 20 of interest expenses as allocable to foreign source income for purposes of analysis of the foreign tax credit treatment. In
that case the incremental tax would be viewed as \(0.105 \times (100-10) = 9.45\), the amount determined under the full apportionment methodology discussed above. If one viewed the “economic” net income that is foreign source as 90 from a U.S. perspective, one justification for this amount is that a foreign tax rate of 10.5 percent (the applicable U.S. rate) is being applied to the amount of net income determined under U.S. principles. One argument against this view is that it is not consistent with what is in fact happening: all 20 of the interest is, under our assumptions, actually reducing U.S. tax on U.S. source income (taxed at a 21 percent rate), and has no real effect on the U.S. taxation of the foreign source income (taxed at a lower rate).

A section 904 faction for this approach would both allocate a portion of the interest to the numerator and take into account the fact that the foreign source income is partially tax exempt. The fraction would be:

\[
\frac{0.5 \times (100-10)}{(100-20) + 0.5 \times (100)} = \frac{45}{130}
\]

The foreign tax credit limitation would be:

\[
\frac{45}{130} \times 27.30 = 9.45
\]

The total U.S. tax would be 27.30 – 9.45 = 17.85. While this is less than perfect from a purely theoretical matter, it may represent a reasonable compromise.

A third in my view at least arguably correct approach would employ a “but for” analysis. In the theoretical world, without the foreign operations giving rise to foreign income, there would, under our assumed facts, be (100-10) or 90 of U.S. source income; that is, only 10 of interest would be incurred. The U.S. tax on that income would be \(0.21 \times\)
If the foreign source operations are undertaken, both 100 of additional gross income and (theoretically) 10 more of interest deductions can be viewed as generated to finance that additional income. The total tax resulting is 27.30. The difference between 27.30 and 18.90 is 8.40. This approach thus assumes that an incremental 10 of interest expenses would not have been incurred but for the activities resulting in the earning of the foreign source gross income of 100. Consistent with that view, this approach literally assumes that the deduction benefit of an extra 10 of deductions against income taxes at a 21 percent rate would not have been realized except for the production of income generally taxed at a 10.5 percent rate, the foreign income. Although this conceptualization is arguably a bit strained, I believe it can be defended.

What would the section 904 fraction look like that generates a foreign tax credit limitation of 8.40 under these facts? Interestingly, the computation of such a fraction looks like one that views the GILTI deduction and apportionable expenses like any other deduction and expenses and does not account for lower tax rates; (100-50-10)/[(100-10) + (100-50-10)] = 40/130. The limitation would be 40/130 * 27.30 = 8.40. The total U.S. tax paid would be 27.30 – 8.40 = 18.90. On its face, this methodology is, in my view, conceptually confused. But it gives an arguably correct answer here.

A comparison of the outcome under this “but for” approach and that under the “full apportionment” methodology discussed above is instructive. Under the “full apportionment” methodology discussed first above, which assumes interest is allocated to the low-taxed income for all purposes, the actual U.S. tax before credits is 1.05 larger than under the “but for” approach: that is, the so-called tentative U.S. tax is higher because 10 of the allocable interest expenses are taken against income taxed at a 10.5
percent rate rather than 21. However, the foreign tax credit limitation under the full apportionment approach is also 1.05 higher. Conversely, the “but for” methodology under which all interest is fully deductible against 21 percent taxed income leads to a tentative U.S. tax 1.05 lower, but the foreign tax credit limitation is 1.05 lower as well. In effect, the “but for” methodology gives rise to the same result as the full apportionment methodology through application of the foreign tax credit limitation when, under the facts, the section 904 limitation is binding. Thus, assuming foreign taxes of, for example, 20, the ultimate tax due to the U.S. under the full apportionment methodology is $28.35 - 9.45 = 18.90. At the same time, the total tax due under our so-called “but for” approach when interest is all deductible against income taxed at a 21 percent rate is $27.30 - 8.40 = 18.90. Note that the same 18.90 of total U.S. tax also resulted in the case when the interest from disproportionate leverage was just disallowed, as under a regime like section 163(n), but consistent with that fact no interest was apportioned to the numerator in computing the section 904 limitation.

Of course, the discussion of these examples is unrealistic in a major respect. As noted above, the approach of the section 861 regulations to interest allocation is significantly different than, for example, the full apportionment methodology of the type proposed by the Obama administration’s. Thus, in real life, the amount of interest allocated and apportioned for purposes of the section 904 limitation may differ in significant respects under our current rules than it would under the other approaches discussed above.

But this analysis shows us something we should already know if we followed the effect of interest allocation for foreign tax credit purposes historically: interest allocation
for foreign tax credit purposes can, in effect, indirectly impose a limitation on interest
deductibility. This was pointed out forcefully by Professor James Hines of Michigan and
others years ago.

There are two things troubling about that state of affairs. First, the indirect
substantive effect only occurs at the margin where the section 904 limitation is
applicable. Thus, like it or not, the substantive effect only operates when foreign tax
credits are really at issue. So the indirect substantive effect on interest deductibility does
not apply evenly to taxpayers.

Second, the operation of the foreign tax credit limitation tends to obscure the
basic policy decision as to the appropriate system of interest deductibility. Thus,
Congress and the public may not really understand the actual result of application of all
the rules, taken together. That certainly seems to have been the case in 2017.

My own view is that, in the short and medium term, the Treasury and Internal
Revenue Service should apply a limitation, the overall results from which are most
consistent with how Congress came out in 2017. Congress did not adopt either a full
apportionment on the section 163(n) approach to the interest deduction in the
international context. It may not have known it was adopting the section 861 rules to
limit interest deductions either. In the longer term, the role of the foreign tax credit
limitation and the treatment of interest deductibility simply must be addressed in tandem.
Policies relating to the interest deduction should not be implemented through the foreign
tax credit limitation.
C. The Regulations [to come shortly.]