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by Stephen E. Shay

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In this article, Shay argues that the proposed high-tax exception election should not be adopted in the final regulations under the global intangible low-taxed income provisions.

This article was originally submitted as a public comment letter to Treasury and the IRS. It has been edited slightly. The views expressed in it are made in the author's individual capacity and do not necessarily represent the views of any university with which he is associated, any organization for which he serves as an officer or trustee or of which he is a member, or any client for which he acts or has acted on a compensated or pro bono basis.

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This article responds to the Notice of Proposed Rulemaking under Sections 958 and 951A published in the *Federal Register* on June 21, 2019 (the "Proposed Regulations").¹ The proposed expansion of the high tax election should not be adopted for the reasons set out in this article,

¹REG-101828-19, "Guidance Under Section 958 (Rules for Determining Stock Ownership) and Section 951A (Global Intangible Low-Taxed Income)," 84 *Fed. Reg.* 29114 (June 21, 2019).

including most importantly that the statute does not provide a basis for the interpretation proposed to be adopted.

I. Summary

The background that follows in Part II sets out the interactions between different elements of the U.S. international tax rules after amendment by the colloquially named Tax Cuts and Jobs Act ("TCJA").² This background provides important context for the arguments in this article.

Following the background in Part II, this article makes the following arguments, each of which is developed in subsequent parts of this article:

1. The Proposed Regulations would expand the global intangible low-taxed income ("GILTI") high tax exclusion, applicable in the statute to income that is excluded from Subpart F foreign base company income or insurance income "by reason of" the election under section 954(b)(4),³ on an elective basis, to all of a controlled foreign corporation's ("CFC's") high-foreign taxed income (the "GILTI High-Tax Exclusion Election" or "GHTEE"). The Proposed Regulations' GHTEE is inconsistent with the unambiguous language of the statute and should not be adopted (Part III).

²Pub. L. No. 115-97, 31 Stat. 2054 (Dec. 2017) (the "Act" or "TCJA"). The formal title of the Act is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," but it is known informally as the Tax Cuts and Jobs Act or TCJA. Readers who do not want to read the details of the background analysis in Part II.A. may refer to Table 1 at the end of that section for a tabular summary.

³Section 951A(c)(2)(A)(i)(III). By its terms, the exclusion applies to income excluded from foreign base company income (as defined in section 954) and insurance income (as defined in section 953) by reason of the election of the high tax exception of section 954(b)(4).

2. Making this alternative interpretation of the statute elective effectively makes the interpretation exclusively pro taxpayer⁴ and largely immunizes the interpretation from challenge for lack of an adversely affected taxpayer with standing. While using the device of an election may protect the interpretation from scrutiny, it does not relieve the agency from its obligation to faithfully interpret the statute. Moreover, the adoption here of an election, which is to choose one of two alternative interpretations of the statute (a narrow interpretation of its text or a broader purpose-infused interpretation), itself is not provided for in the statute. If the asserted legislative rationale for the GHTEE is to be credited, it would be more consistent with that rationale, and would reduce complexity, to make the GILTI high tax exclusion mandatory and not elective (Part III).
3. If the statute were found to be ambiguous and require interpretation, the reasons provided in the Proposed Regulations' preamble for adoption of the GHTEE are either demonstrably incorrect or do not withstand scrutiny. Accordingly, they fail to justify the GHTEE as a reasonable interpretation of the statute (Part IV).
4. If notwithstanding the preceding comments, the GHTEE were found to be a permissible but not required interpretation of the statute, it should not be the interpretation adopted because it would expand an unjustified subsidy for foreign investment that does not advance United States welfare (Part V).
5. The observations made in this article, apparently not made in others' comments to the Treasury and the IRS, have been the talk of practitioners and participants in the policymaking process and are not original to the author. This points to systemic weaknesses in the Administrative

Procedure Act (APA) notice and comment process. Moreover, it is unclear what role OIRA review is playing in relation to assuring compliance with APA standards of agency rulemaking. Consideration should be given to how to redress this lacuna in process (Part VI).

Part VII concludes that the GHTEE should not be adopted. If, notwithstanding the analysis of this article, the underlying regulatory interpretation is accepted, it should be implemented as a mandatory not an elective rule.

II. Background on GILTI, United States Shareholder Expense Allocation, and the Foreign Tax Credit

A. Post-TCJA International Tax Rules for a Domestic Corporate Shareholder in a CFC

The TCJA shifted United States taxation of a domestic corporation operating abroad through a CFC⁵ from a system of deferring U.S. tax on the CFC's active foreign income to a hybrid system. The hybrid system imposes different effective rates of U.S. tax on three categories of a CFC's gross income.⁶ The three categories are gross income taken into account in determining (i) Subpart F income, (ii) GILTI, and (iii) income eligible for the foreign dividends received deduction ("FDRD") income ("FDRD income"), each in the hands of a domestic corporation that is a United States shareholder of the CFC.

The next section describes and analyses for each of the three categories of CFC income: (i) the pre-foreign tax credit approximate U.S. effective tax rate (before allocation of United States shareholder expenses) applicable to the income, (ii) the applicable foreign tax credit limitation categories applicable to the income and rules for carryovers of excess foreign tax credits in the

⁴ See Heather M. Field, "Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System," 47 *Harv. J. on Legis.* 21, 30-31 (2010) ("Accordingly, a well-advised rational taxpayer will almost always exercise the election in a way that minimizes its tax liability, at the expense of the fisc.").

⁵ As amended by the TCJA, a CFC is a foreign corporation that is more than 50 percent owned, by vote or value, directly or indirectly under constructive ownership rules, by a United States shareholder. A United States shareholder is a U.S. person that owns at least 10 percent by vote or value of the stock of the foreign corporation. Sections 957, 958, and 951(b). This article only discusses rules applicable to a United States shareholder that is a domestic corporation. Unless otherwise indicated, the term "United States shareholder" is only used in relation to a United States shareholder that is a domestic corporation.

⁶ These three categories of gross income should be distinguished from the separate foreign tax credit limitation categories of income also discussed later.

category, and (iii) the applicable rules for allocation of United States shareholder expenses to these categories of income.

1. Subpart F income.

Subpart F income inclusion effective U.S. tax rate (before foreign tax credits and allocation of United States shareholder expenses). A CFC's "Subpart F income"⁷ is currently included in the United States shareholder's income under Section 951(a)(1)(A). Subpart F income is subject to U.S. tax in the hands of a United States shareholder that is a domestic corporation at the full 21 percent corporate tax rate.⁸

Foreign tax credit limitations and carryovers: The U.S. tax on Subpart F income may be reduced by allowable foreign tax credits, which are subject to separate foreign tax credit limitations for foreign taxes attributable to income in the passive and general categories.⁹ The foreign tax credit limitation for each relevant category of foreign income restricts the allowance of the credit for foreign taxes to the amount of U.S. tax paid on the foreign source taxable income in that category as measured under U.S. tax principles.

The limitation amount is determined by multiplying the U.S. taxpayer's total U.S. taxes (before reduction by the foreign tax credit) by a fraction. The numerator is foreign source taxable income in the category and the denominator is the taxpayer's worldwide taxable income. The numerator and denominator each are net income (not gross income) amounts and require reduction for allocable United States shareholder expenses. Excess foreign taxes on an item of income in a category may be blended with other foreign taxes on other items of income in the same category and thereby used to reduce U.S. tax on foreign income in the same category. This is referred to as "cross-crediting," but is restricted to income within a category. Excess foreign taxes in

the general (and foreign branch) limitation categories may be carried back one year and carried over ten years.¹⁰

Allowance of United States shareholder expenses: Subpart F income is a net income amount at the level of the CFC. The gross income of the CFC is categorized for purposes of determining Subpart F income as prescribed in Section 954 and is reduced by expenses at the level of the CFC under Section 954(b)(5). Subpart F income is included in U.S. income and subject to tax at the full U.S. corporate rate (before foreign tax credits). United States shareholder expenses are allowed in full.¹¹

Allocation of United States shareholder expenses to foreign source income: For determining the share of total pre-foreign tax credit U.S. taxes of the United States shareholder attributable to the net income in the Subpart F income's separate general and passive limitation categories, it is necessary to determine the foreign source taxable income in the general and passive limitation categories. For this purpose, it is necessary to allocate and apportion United States shareholder-level deductions to those foreign tax credit limitation income categories to reach foreign source taxable income for the numerator of the foreign tax credit limitation fraction.

If United States shareholder expenses are under-allocated (or not allocated) to foreign income for determining the foreign source income in the numerator of the foreign tax credit limitation fraction, then the numerator will be inflated and it will appear that a larger share of total U.S. tax is paid on the Subpart F income than should be attributed to that income. This would allow more foreign taxes to be credited, but would violate the principle of the foreign tax credit limitation that foreign taxes should not offset U.S. tax on U.S. taxable income.

The misstatement of foreign income from under-allocation of United States shareholder expenses may be seen with a simple example.

⁷ Subpart F income is defined in Section 952. The rules for inclusion of Subpart F income in the income of a United States shareholder are at Section 951.

⁸ Section 11. The tax rates used in this article do not take account of U.S. state and local taxes or foreign taxes that are not creditable for U.S. Federal income tax purposes.

⁹ Sections 901, 904(d), 951, and 960. A 10 percent domestic corporate shareholder is eligible for an indirect foreign tax credit for corporate level foreign income tax paid by the CFC with respect to earnings included as a Subpart F income inclusion and income included as GILTI income. Section 960.

¹⁰ Section 904(c). Because of the high tax kick-out rule of Section 904(d)(2)(B)(iii)(II), passive income generally will not carry excess foreign taxes.

¹¹ Because there is no difference in tax rate on a United States shareholder's Subpart F income and other income, concerns regarding allowance of deductions allocable to Subpart F income do not arise in the same way as for GILTI and FDRD income (as discussed later).

Example 1. Assume that a U.S. MNE has \$250 of revenue (\$125 of domestic income and a \$125 foreign source Subpart F income inclusion from its wholly-owned CFC subsidiary) and \$50 of United States shareholder overhead expense properly apportioned equally across all gross income. The resulting post-apportionment net income is \$100 of U.S. and \$100 of foreign taxable income. If the expense is not allocated and apportioned to foreign income, the U.S. MNE would have \$75 of U.S. income and \$125 of foreign income. In the first case, the foreign tax credit limit would be \$21 ($\$100/\$200 \times \$42 = \21) and in the second case, the foreign tax credit limit would be \$26.25 ($\$125/\$200 \times \$42 = \26.25) because of the under-allocation of \$25 of overhead expense to foreign income. In this case, if foreign taxes were at least \$26.25, overstating foreign income would eliminate U.S. tax on \$25 of U.S. taxable income ($\$5.25/21 \text{ percent} = \25.00).

It is correct (and intended) that if both countries in this example impose nominal tax at 21 percent statutory rates, the United States will not give a credit for the full amount of foreign tax. This result is because the tax base for foreign tax purposes (\$125) is larger than the tax base for U.S. tax purposes (\$100). Against the U.S. tax base in this example, the relevant effective foreign tax rate is 26.25 percent ($((125/100) \times 21 \text{ percent} = 26.25 \text{ percent})$). Under-allocating expense to foreign income subsidizes the higher effective foreign tax rate by having the United States reimburse the multinational enterprise for the foreign tax at a higher rate than the U.S. taxes the same income. This goes beyond avoiding double taxation of the same income to subsidizing the additional foreign tax on the income. Subsidizing foreign income taxes is subsidizing the foreign investment that gives rise to that income.

Accordingly, expenses of the United States shareholder, most commonly those for interest, research and experimentation, and overhead, must be allocated to foreign source income (under the allocation rules applicable to those expenses) for purposes of determining the applicable foreign tax credit limitation for Subpart F income (as well as for other limitation categories). This is clearly required by the statute and is for the long-agreed policy reasons described.

2. GILTI.

GILTI income inclusion and effective U.S. tax rate (before foreign tax credits and allocation of United States shareholder expenses): GILTI¹² is determined at the United States shareholder level and is included currently in a United States shareholder's income. GILTI is measured as the shareholder's share of all of its CFCs' "tested income" (which excludes Subpart F income) reduced by all its CFCs' "tested loss,"¹³ but is only the amount of this net CFC tested income that exceeds a 10 percent return on its share of its tested income CFCs' qualified business asset investment ("QBAI"). After a GILTI Section 250 deduction equal to 50 percent of the GILTI inclusion, GILTI would be taxed at an effective U.S. rate of 10.5 percent.¹⁴

Foreign tax credit limitations and carryovers: A corporate United States shareholder is allowed a foreign tax credit based on no more than 80 percent of foreign taxes paid by a CFC attributable to the GILTI inclusion.¹⁵ The foreign taxes on the GILTI inclusion are subject to a separate foreign tax credit limitation for foreign taxes on the CFC's GILTI inclusion that is not in the passive limitation with no carryovers of foreign taxes on such non-passive GILTI.¹⁶ The statutory denial of any carryover of excess GILTI foreign tax credits is a significant pressure point driving taxpayer desires to mitigate the effects of United States shareholder expense allocations that create excess GILTI foreign tax credits.

Allowance of United States shareholder expenses: Net CFC tested income is net only of CFC-level deductions and tested losses of CFCs; it is not reduced by allocable expenses of the United States shareholder, subject to an overall taxable income

¹² Section 951A.

¹³ This is the United States shareholder's "net CFC tested income." Section 951A(c)(1). The determination of a CFC's tested income and loss can be summarized as follows: CFC's gross income, less exclusions from tested income, less CFC's deductions allocable to this gross income, equals CFC's tested loss.

¹⁴ All Section 250 deduction and tax rates used in this article are for taxable years beginning before January 1, 2026.

¹⁵ Section 960(d).

¹⁶ Sections 904(c) (last sentence), 904(d)(1)(A) and (C).

limitation on the Section 250 deduction.¹⁷ The Section 250 GILTI deduction will be reduced if the combined Section 250 deductions for GILTI and foreign-derived intangible income (FDII) exceed the United States shareholder's taxable income.¹⁸ In substance, the United States shareholder expenses that are properly allocable to the GILTI income do not reduce the Section 250 deduction and are allowed as deductions that offset income taxed at a full U.S. 21 percent rate, notwithstanding that they are the cost of earning income that is effectively taxed at one-half of the full rate, until the 21 percent rate income is exhausted.¹⁹

Allocation of United States shareholder expenses.

While deductions of the United States shareholder are not taken into account in determining the Section 250 GILTI deduction, United States shareholder deductions are allocated to GILTI income to determine the appropriate foreign tax credit limitations.²⁰ The numerator of the GILTI foreign tax credit limitation category is foreign source net income attributable to GILTI (other than passive income) and the denominator is worldwide taxable income.²¹ Both the numerator and denominator are determined under U.S. tax accounting rules and reduced by all properly allocable deductions, including the United States shareholder expenses.

Under December 2018 proposed regulations ("FTC proposed regulations"), which are not the immediate subject of this article, the GILTI income and attributable Section 78 dividend (and assets

attributable to that income) offset by the Section 250 deduction would be disregarded as though that income were exempt for purposes of allocating expenses.²² There is no statutory basis for this rule (either).²³

Under this proposed rule, the general effect will be to reduce the allocation of United States shareholder expense to GILTI income for foreign tax credit limitation purposes. An example is helpful to understand the implication of this rule.

Example 2. Assume that a U.S. MNE has \$250 of revenue (\$125 of domestic income and a \$125 foreign GILTI income (and associated Section 78) inclusion from its wholly-owned CFC subsidiary) and \$50 of United States shareholder overhead expense properly apportioned equally across all gross income. The Section 250 GILTI deduction is 50% of \$125 or \$62.50. Without the treatment of the Section 250 deduction income as exempt, half of the overhead expense would be allocated to GILTI and the post-apportionment net income after a Section 250 deduction would be \$100 of U.S. income and \$37.50 of GILTI taxable income for the GILTI foreign tax credit numerator.

No Gross Income Adjustment	Total	U.S.	Foreign
Gross income	250	125	125
Reduction for 250 deduction	-62.5	0	-62.5
Overhead allocated on gross income	<u>-50</u>	<u>-25</u>	<u>-25</u>
Net income	137.5	100	37.5

¹⁷ See Michael Caballero and Isaac Wood, "Restoring 'Not GILTI' for High-Taxed Income," *Tax Notes*, Oct. 8, 2018, p. 189 at 190 (the TCJA does not allocate deductions to GILTI for taxable income purposes, but it does for determining the foreign tax credit limitation for GILTI).

¹⁸ Section 250(a)(2)(A).

¹⁹ This is in contrast to the Section 250 FDII deduction, which is based on deduction eligible income (in excess of the deemed tangible income return), where deduction eligible income is reduced by properly allocable deductions of the U.S. taxpayer, including interest, R&D, and overhead. Section 250(b)(3)(A)(ii). In order for the FDII incentive to be parallel with GILTI, as some have asserted, GILTI also should be reduced by all allocable deductions before determining the Section 250 GILTI deduction. In this important respect, in addition to the treatment of the deemed tangible income return, GILTI is more favorable than FDII.

²⁰ Sections 904(a), (d)(1); and 862(b). See REG-105600-18, Notice of Proposed Rulemaking, "Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act," 83 *Fed. Reg.* 63200-63201 (Dec. 7, 2018).

²¹ Passive income is a separate foreign tax credit limitation category that takes precedence over the GILTI category. Section 904(d)(1)(C).

²² Prop. Reg. Section 1.861-8(d)(2)(ii)(C)(1), (d)(2)(ii)(C)(2)(ii). This same allocation rule is applied to the Section 250 deduction allocable to FDII for foreign tax credit limitation purposes. Prop. Reg. Section 1.861-8(d)(2)(ii)(C)(1), (d)(2)(ii)(C)(2)(i). As noted above, however, the FDII Section 250 deduction itself is determined net of the U.S. corporation's deductions allocable to that income. See Section 250(b)(3)(A)(ii). This statutory rule requiring allocation of expenses for determining the FDII Section 250 deduction (at least) is followed in the proposed regulation. Prop. Reg. Section 1.861-8(d)(2)(ii)(C)(4).

²³ The preamble to the foreign tax credit proposed regulation's treatment of the Section 250 deduction is based on the addition of Section 904(b)(4)(B), which by its terms only applies to Section 245A. Not only is there no suggestion in the statute of such a rule, Congress has evidenced its ability in Section 864(e)(3) to draft an exactly comparable rule to that proposed to be added by the FTC proposed regulations. Congress did not do so notwithstanding that it amended the adjacent subparagraph 864(e)(2). An important distinction between Sections 243 and 245(a) and Section 245A is that the former deductions are in respect of income that has been subject to full U.S. tax and are designed to alleviate double U.S. corporate taxation.

If the Section 250 deduction income is treated as exempt, the overhead expense allocated to GILTI is reduced and the foreign tax credit numerator is increased.

With Gross Income Adjustment	Total	U.S.	Foreign
Gross income	250	125	125
Reduction for exempt amount (250 deduction)	<u>-62.5</u>	0	<u>-62.5</u>
Gross income adjusted for exempt amount	187.5	125	62.5
Overhead allocated on gross income (adjusted)	-50	-33.3	-16.6
Net income	137.5	91.6	45.8

Consequently, the foreign source taxable income in the numerator of the foreign tax credit limitation fraction for the GILTI category is increased and foreign taxes allowable as a credit also increase. This generally is the effect of the regulatory allocation rule proposed in the FTC proposed regulations. A note of caution is warranted about strong generalizations because the results depend on the taxpayer attributes in each case and the interactions of the rules are such that modelling is required in each case.

3. CFC income eligible for FDRD when distributed.²⁴

Income eligible for the Section 245A 100 percent FDRD. A CFC's current year income that is not Subpart F income or net tested income included in GILTI, when distributed as a dividend, is eligible for a Section 245A 100 percent FDRD.²⁵ This will result in an effective U.S. rate of zero on this FDRD income.

Foreign tax credit limitations and carryovers: Foreign taxes attributable to dividends that give rise to the FDRD are not allowed as a credit.²⁶ They do not carryover and are not otherwise taken into account.

Allowance of United States Shareholder expenses: FDRD income is net of CFC-level deductions but is not reduced by allocable expenses of the United States shareholder prior to determining the FDRD. Accordingly, the U.S. shareholder expenses that otherwise would be allocable to the dividend income are allowed as deductions in full, notwithstanding that they are the cost of earning income that is offset in its entirety by the FDRD.²⁷ In the simple case used in Example 2, the results before foreign tax credits of changing the income from GILTI to FDRD income are dramatic. The entire overhead expense is shifted to the United States.

Example 3. Assume that a U.S. MNE has \$250 of revenue (\$125 of domestic income and a \$125 FDRD income from its wholly-owned CFC subsidiary) and \$50 of United States shareholder overhead expense properly apportioned equally across all gross income.

FDRD Income Adjustment	Total	U.S.	Foreign
Gross income	250	125	125
FDRD deduction	-125	0	-125
Overhead allocated on gross income	<u>-50</u>	<u>-50</u>	0
Net income	75	75	0

In this example, \$25 of expense is shifted from foreign income bearing a zero U.S. effective tax to U.S. income taxed at 21 percent rate for a \$5.25 tax benefit.

Allocation of United States shareholder expenses. The FDRD income and expenses otherwise allocable to the FDRD income (and stock attributable to FDRD income) are not taken into account for purposes of expense allocations to other foreign income categories.²⁸

The following table summarizes the relevant attributes described for the three categories of income described above and relevant foreign tax credit limitation categories:

²⁴ Section 245A.

²⁵ *Id.* There is no requirement that FDRD income be distributed in the current year.

²⁶ Section 245A(d).

²⁷ In other words, in the simple zero foreign tax case, the deduction incurred to earn income taxed at an effective 0 percent U.S. Federal tax rate is allowed to offset income taxed at a 21 percent U.S. Federal tax rate.

²⁸ Section 904(b)(4). See Prop. Reg. Sections 1.904(b)-3, 1.861-13.

Table 1: Variations in Foreign Tax Credit Limits by Income Category

Category of Foreign Source Income (FSI)	U.S. Tax Effective Rate	Credit Allowed	Separate Limit (SL) or Cross-Credit (CC)	Expenses Allocated	Carryover (Back/ Forward)
General category FSI					
Sub F and other FSI	21%	100%	CC	Yes	1 and 10
Foreign-source FDII ^a	13.125%	100%	CC	Yes*	1 and 10
Passive FSI (w/high tax kick-out)	21%	100%	SL	Yes	NA
GILTI	10.50%	80%	SL	No for Section 250, yes for FTC ^b	None
FDRD Income	0%	0%	N/A	No	N/A (None)
^a This row is included for completeness because foreign-derived intangible income, as defined in Section 250, also can give rise to foreign source general limitation income, but its effective U.S. Federal tax rate after the Section 250 deduction is 13.125% and not the 21% corporate rate as is the case for most general limitation income.					
^b Under proposed regulations, amounts offset by the Section 250 deduction are treated as exempt.					

B. The Context of the Proposed GHTEE

The gross income that is the starting point of GILTI “tested income” is defined as all of the CFC’s gross income excluding certain income items.²⁹ The issue at the heart of this comment is whether, consistent with the statute, (i) the language describing the exclusion from tested income for high-taxed Subpart F base company and insurance income can be interpreted to also include any other CFC income if it is subject to high enough foreign tax and thereby also be eligible for exclusion from tested income, and (ii) whether this can be on an elective basis.³⁰

The discussion in this Part II.B. explains implications of the proposed expansion of the GHTEE from what absent a Section 954(b)(4) election would be Subpart F base company income and insurance income under the rules of Subpart F to all tested income potentially subject to GILTI. The differences in the treatment of the categories of income described in Part II.A. above in relation to United States shareholder expense

allocation and foreign tax credits are important to understand why taxpayers would use the election.

High tax exclusion and United States shareholder expense allocation. In terms of allocating United States shareholder expenses (principally interest, R&D and corporate overhead expense) allocable to foreign income, the effect of expense allocation on the three categories of CFC income discussed above generally is as follows:

Table 2: Variations in United States Shareholder Expense Allocation by Income Category

Income Category	Effective U.S. Tax on Income	Expense Allocation
Subpart F income	Inclusion at 21%	Full allocation
GILTI income item	Inclusion at 10.5% (after 50% Section 250 deduction)	No allocation for GLTI deduction amount; Reduced allocation for foreign tax credit limitation through exclusion of Section 250-related income and assets ^a

²⁹ The excluded income items set out in Section 951A(c)(2)(A)(i)(I) – (V) are: (I) effectively connected income not exempted by treaty, (II) Subpart F income, (III) high-taxed Subpart F base company and insurance income, (IV) any dividend from a related person, and (V) foreign oil and gas extraction income.

³⁰ Prop. Reg. Section 1.951A-2(c)(1)(iii) and (c)(6).

Table 2: Variations in United States Shareholder Expense Allocation by Income Category (Continued)

Income Category	Effective U.S. Tax on Income	Expense Allocation
FDRD	Inclusion at 0% (after FDRD deduction)	No allocation for FDRD deduction; Expenses and assets excluded from allocation to other categories.
<p>³¹Proposed reg. section 1.861-8(d)(2)(ii)(C) would treat the portion of GILTI gross income attributable to a Section 250 deduction as "exempt" and thereby not attract allocation of expenses.</p>		

For purposes of expense allocation, the FDRD category generally will be preferable to GILTI or Subpart F income for taxpayers.³¹

High tax exclusion and foreign tax credits. If the Subpart F high tax election is made, the income is excluded from Subpart F income (under Section 954(b)(4)) and also is excluded from GILTI.³² The net income instead is FDRD income permitted the Section 245A dividends received deduction upon distribution to the U.S. shareholder. Consequently, any foreign tax credits attributable to the otherwise Subpart F income are permanently lost. Similarly, if the GHTEE is adopted and made by a taxpayer, the tested income is excluded from GILTI and falls into the FDRD income category. Any foreign tax credits attributable to the income subject to the GHTEE election also are permanently lost.³³

If Subpart F income bears an effective foreign income tax rate above the taxpayer's effective U.S. tax rate, which will be the case for much income eligible for the GHTEE, the excess foreign tax

credit can be utilized against other income in the same category and also carried over to other years if it is income in the general limitation.³⁴ If the same income is GILTI or FDRD income, however, the excess credits will be lost permanently.

Accordingly, subject to the caution about generalizations, it generally is preferable for CFC income that carries excess foreign tax credits to be Subpart F income where the credits will carryover in the general limitation category instead of being FDRD income where the excess credits will be permanently lost.³⁵

Assuming that the foreign effective tax rate ("FETR") is determined under U.S. principles, the range in which a taxpayer would prefer to make the high tax election (on what would be general limitation income after the election) is where the FETR is from 18.9 percent to and including 21 percent. Once the foreign effective rate is above the U.S. effective rate (assumed here to be 21 percent), the preference will be for Subpart F income. While expense allocations will affect these relationships, the important point is that the GHTEE is advantageous where there is a tax rate advantage that is not offset by the disadvantage of losing the ability to utilize excess foreign tax credits (and losing QBAI attributable to the GHTEE income). The following table summarizes a taxpayer's likely category preferences (from left to right), under the strong (indeed heroic) assumptions that a taxpayer can calibrate its FETR with such precision (and disregarding QBAI effects):

³⁴The New York State Bar Association helpfully explains why, absent domestic losses, the foreign tax credit limitation may be shorthanded as the U.S. effective rate on worldwide income times foreign source taxable income in the relevant category:

The statutory formula is that the allowed FTC cannot exceed the same proportion of total U.S. tax liability (before FTCs) that foreign source taxable income bears to worldwide taxable income. Mathematically, this is equivalent to the rule that the allowed FTC cannot exceed (1) total U.S. tax liability, multiplied by (2) foreign source taxable income, with the product divided by (3) worldwide taxable income. Since (1) divided by (3) is the effective U.S. tax rate on worldwide taxable income, the formula is equivalent to that in the text. New Section 904(b)(4), discussed below, modifies this formula in certain cases.

New York State Bar Association Tax Section, "Report on the GILTI Provisions of the Code," at 13 n.33 (May 4, 2018).

³⁵See Rosanne Altshuler, Fadi Shaheen, Jeffrey Colon, Michael Graetz, Rebecca Kysar, Susan Morse, Daniel Shaviro, Richard Phillips, Danielle Rolfes, David Rosenbloom, Stephen Shay, and Steven Dean, "The Future of the New International Tax Regime," 24 *Fordham J. Corp. & Bus. Law* 219, 284 (2019) (hereafter "Fordham Symposium"); and Caballero and Wood, *supra* note 17, at 197.

³¹This article does not discuss the complexities introduced by Section 904(b)(4)(B).

³²Section 951A(c)(2)(A)(i)(III).

³³An effect of the GHTEE election, separate and distinct from the effect of a Section 954(b)(4) election, is that the portion of the CFC's qualified business asset investment or QBAI associated with income subject to the GHTEE would not be taken into account in determining the 10 percent net deemed tangible income return that is excluded from GILTI.

**Table 3. CFC Income Category Preference
By FETR (Under U.S. Principles)**

FTC Effective Tax Rate	Income Category Preference By FETR	
< 13.125%	FDRD → GILTI →	Subpart F
13.125% - 18.9%	FDRD or GILTI →	Subpart F
18.9% - 21%	FDRD or GILTI →	Subpart F
>21%	Subpart F →	FDRD or GILTI

Incentives for CFCs with tested income subject to high taxes to restructure income to be Subpart F income will remain whether or not the GHTEE is available.³⁶

C. GHTEE Would Expand Unjustified United States Shareholder Expense Allocation Subsidies

The TCJA is a deeply flawed statute on multiple fronts, including at policy and technical levels. Nowhere is it more flawed than in its allowance of U.S. deductions to earn foreign income effectively exempt from U.S. tax by reason of the FDRD.³⁷ Failing to allocate and disallow these expenses means that not only is the income not taxed, but deductions are allowed for expenses incurred to earn the exempt income.

³⁶ While not a perfect measure for this analysis, the most recent IRS statistics of income data (for 2014) for all CFCs shows that profitable CFCs whose industry sectors had average foreign taxes to aggregate earnings that exceeded 21 percent included mining, machinery manufacturing, and a few other sectors. See IRS Statistics of Income, Table 1. "U.S. Corporations and Their Controlled Foreign Corporations: Number, Assets, Receipts, Earnings, Taxes, Distributions, Subpart F Income, and Related Party Transactions, by Industrial Sector and Selected Industrial Subsector of Controlled Foreign Corporation, Tax Year 2014." Because earnings distributed from one CFC to another are each counted separately (and in many countries a participation exemption would be allowed), these effective foreign tax rates would be lower than if the earnings are tracked as a single item of income through a chain of CFCs as would be the case for purposes of the foreign tax credit look-through rules of Section 904.

³⁷ For a discussion of the effects of failures to allocate United States shareholder expenses under prior law and under the TCJA's GILTI, see Patrick Driessen, "GILTI's Effective Minimum Tax Rate Is Zero or Lower," *Tax Notes Federal*, Aug. 5, 2019, p. 889 ("Expense treatment is the Bermuda Triangle of international tax policy."). Driessen finds that "taking account of expenses properly would have made the average U.S. ETR on foreign income in 2004 not +2.3 percent but -13.8 percent (the negative is not a typo), and the worldwide ETR not the positive mid-20s percent found with the asymmetric adjustment that misplaces the U.S. tax benefit of the allocable expenses but instead +6.3 percent with complete treatment of the expenses." *Id.* At 891. "Using 2014 low-foreign-taxed group CFC data from the JCT . . . show respective average U.S. ETRs on foreign income of 0.2 percent and 2 percent with and without an NDTIR imputation. The worldwide ETRs with and without NDTIR are 6.5 percent and 8.3 percent, respectively." *Id.* At 892.

Example 4. Assume that a U.S. MNE borrows \$1,000 paying 5 percent simple interest and uses the \$1000 to invest in FSub to acquire tangible business property that earns a \$100 or 10 percent return that is not Subpart F income. Assume that the earnings are not GILTI because they do not exceed a 10 percent return on tangible business investment and are FDRD earnings that will not be taxed by the United States when distributed. U.S. MNE would pay no tax on the earnings and would receive a \$50 interest deduction. Assuming sufficient U.S. income, the tax benefit from the \$50 interest deduction at 21 percent is \$10.50.

In effect, by allowing the deduction, the tax system is paying the U.S. MNE \$10.50 to earn the exempt foreign income.³⁸ Allowing a deduction for expenses used to earn income subject to the FDRD is a taxpayer subsidy for foreign investment.³⁹

And it does not stop there. Just as for the 100 percent FDRD, the 50 percent Section 250 deduction for GILTI is determined without reduction for allocable U.S. shareholder expenses.⁴⁰ The GILTI Section 250 deduction only is reduced by United States shareholder deductions if the shareholder does not have sufficient taxable income to absorb the FDII and GILTI Section 250 deductions.

These expense allocation subsidies are bad tax policy.⁴¹ The GHTEE would expand the scope of the subsidy by allowing income for which expenses would at least have to be allocated to the GILTI foreign tax credit limitation (or possibly reduce the GILTI Section 250 deduction through the taxable income limitation) to be recast as exempt income thereby preserving expenses for use against income taxed at the full U.S. rate.

³⁸ The circumstance where the government provides a net tax benefit in respect of income from an investment is sometimes described as a "negative tax rate" on the return from the investment. The same issue arises when expenses are not allocated to reduce the GILTI Section 250 deduction (as they are for purposes of the FDII Section 250 deduction).

³⁹ The Preamble's Special Analysis finds that the GHTEE "reduces the taxpayers' cost of capital on foreign investment by reducing the U.S. tax on such taxpayers' GILTI relative to the baseline" and at the margin "may increase foreign investment by U.S.-parented firms" Preamble at 29124. In other words, the GHTEE will reduce tax on this investment, which may increase as a result. That is the effect of the subsidy.

⁴⁰ See Caballero and Wood, *supra* note 17, at 190.

⁴¹ See discussion at Part V, *infra*.

Under the TCJA as passed, for current year income analysis purposes, FDRD income is comprised principally of the net deemed tangible income return (NDTIR) of a foreign corporation, and income excluded from tested income including income subject to the Subpart F high-taxed income exception. Under the statute, all other income is Subpart F or GILTI. The GHTEE would expand the expense allocation subsidy, at the election of the taxpayer, to GILTI that is subject to an effective foreign tax rate that is 90 percent or more of the highest U.S. corporate rate. If expense is not properly allocated on income that is subject to foreign tax, some of the subsidy is realized by the foreign government instead of the taxpayer.

III. The GHTEE Is an Invalid Interpretation of the Statute

A. Meaning of the Text

Section 951A(c)(2)(A) provides in part that “tested income” of a CFC starts with all its gross income excluding certain categories of income. One of the categories excluded from “tested income” is “any gross income excluded from foreign base company income (as defined in section 954) and insurance income (as defined in section 953) of such corporation by reason of section 954(b)(4).”⁴² Read in the context of this section and the surrounding sections of Subpart F, the most natural plain reading of the text would restrict the scope of the exclusion to gross income that would be taken into account in determining the two specified categories of Subpart F income, foreign base company income (as defined in Section 954) and insurance income (as defined in Section 953).

The Section 951A(c)(2)(A)(i)(III) high tax exclusion has two parts. The first part describes income that is reduced by the operation of the second part. The first part is “gross income excluded from the foreign base company income (as defined in section 954) and insurance income (as defined in section 953) of such corporation.” The reason for this formulation follows from the preceding Section 951A(c)(2)(A)(i)(II) exclusion of “any gross income taken into account in

determining the subpart F income of such corporation.” The apparent intent is to expand the preceding exclusion to cover income that would have been “taken into account in determining . . . subpart F income,” but which is not subpart F income for the operative reason specified in the second part (the application of Section 954(b)(4)). The second part of Section 951A(c)(2)(A)(i)(III) excludes from tested income so much of that income as is not Subpart F income “by reason of” Section 954(b)(4).

Section 954(b)(4) has a two-part structure parallel to that in Section 951A(c)(2)(A)(i)(III).⁴³ The first part applies “For purposes of subsection (a) and section 953, to foreign base company income and insurance income,”⁴⁴ which are the same two categories of Subpart F income named in the first part of Section 951A(c)(2)(A)(i)(III). The second part of Section 954(b)(4) specifies that these categories of income “shall not include any item of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11.”

This Subpart F high foreign tax test is comparing foreign taxes to the U.S. taxes on the same net, not gross, income. In order for the test to work, the category of gross income to which the test is being applied must be identified in order for deductions to be properly allocated and to thereby identify the relevant net income. The identified categories here are gross income that would be taken into account in determining either Section 954 foreign base company income or Section 953 insurance income.

The Treasury’s own regulations apply the Subpart F high foreign tax test to “items of

⁴² Section 951A(c)(2)(A)(i)(III).

⁴³ Section 954(b)(4) provides:

(4) Exception for certain income subject to high foreign taxes.— For purposes of subsection (a) and section 953, foreign base company income and insurance income shall not include any item of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11.

⁴⁴ Subpart F income includes other categories of income that are not subject to the Subpart F high tax exception: boycott factor income, amounts equal to illegal payments to foreign officials, and income from countries supporting international terrorism. See Section 952(a)(3)-(5).

income” defined in reg. section 1.954-1(c)(1)(iii), all of which are items of income that fall within a category of foreign base company income, after reduction for allocable deductions.⁴⁵ One would have thought that this regulation interpreting Section 954(b)(4), if validly issued, is a binding interpretation on the Treasury. Put simply, Section 954(b)(4) high foreign tax test is not applied to all of the CFC’s items of gross income.

The operative provision that is the second part of Section 951A(c)(2)(A)(i)(III), an exclusion “by reason of” Section 954(b)(4), operates in the same way and to the same categories of income as the second part of Section 954(b)(4). Under the statutory language, you do not even get to Section 954(b)(4) unless the income in question would otherwise be Subpart F foreign base company income or insurance income, so income excluded from Section 951A “by reason of” Section 954(b)(4) cannot be read to cover any other income. Nevertheless, the proposed regulation effectively would insert into the statute a new exclusion solely for purposes of Section 951A that would also exclude high taxed CFC income that would not have been taken into account in determining Section 954 foreign base company income or Section 953 insurance income. There simply is no basis in the statute for this additional rule.

The proposed regulation also would make that exclusion elective instead of mandatory. The words of Section 951A(c)(2)(A)(i)(III) make the exclusion from tested income mandatory for any income excluded “by reason of” Section 954(b)(4). Treating this second additional element of income eligible for exclusion as elective, where there is no election permitted under Section 954(b)(4), is without any foundation in the statutory language of Section 951A(c)(2)(A)(i)(III).⁴⁶

⁴⁵ Reg. sections 1.954-1(d), -1(c)(1)(iii), -1(a).

⁴⁶ There is a reasonable argument that an election under Section 954(b)(4) is not required by the statutory language, but the language is consistent with an election in a way that the language of Section 951A(c)(2)(A)(i)(III) is not. See Caballero “Comments on Section 951A Proposed Regulations (Internal Revenue Service REG-101828-19) — GILTI High Tax Exclusion,” at 5 (Sept. 19, 2019). The Caballero comment at page 6 cites 1986 Blue Book language as evidence that the amended Section 954(b)(4) was intended to be elective. However, the Secretary could adopt regulations that consider the test satisfied for any category of Subpart F income for which the ratio of foreign tax to the Subpart F income as reported on a return exceeded 90 percent of the U.S. rate. The provision does not prescribe an election.

The preamble to the Proposed Regulations (the “Preamble”) justifies these interpretative sleights of hand as follows:

Nevertheless, section 954(b)(4) is not explicitly restricted in its application to an item of income that first qualifies as FBCI or insurance income; rather, the provision applies to “any item of income received by a controlled foreign corporation.” Therefore, any item of gross income, including an item that would otherwise be gross tested income, could be excluded from FBCI or insurance income “by reason of” section 954(b)(4) if the provision is one of the reasons for such exclusion, even if the exception under section 954(b)(4) is not the sole reason. Any item thus excluded from FBCI or insurance income by reason of section 954(b)(4) would then also be excluded from gross tested income under the GILTI high tax exclusion, as modified in these proposed regulations.”⁴⁷

The Preamble is misleading to the point of being disingenuous. The portion of Section 954(b)(4) quoted in the first sentence from the preamble quoted above is preceded as follows: “For purposes of subsection (a) and section 953, foreign base company income and insurance income shall not include any item of income received by a controlled foreign corporation if. . . .” (Emphasis added.)⁴⁸ From the full language of the statute, it is clear that, consistent with the Treasury’s existing regulatory interpretation, the items of income that are tested in Section 954(b)(4) are those items taken into account in determining Section 954 foreign base company income and Section 953 insurance income. It is inconsistent with the language of Section 954(b)(4) and the Commissioner’s own regulations interpreting

⁴⁷ Preamble at 29120.

⁴⁸ Section 954(b)(4) provides:

(4) Exception for certain income subject to high foreign taxes.— For purposes of subsection (a) and section 953, foreign base company income and insurance income shall not include any item of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11.

those words to say that the Section 954(b)(4) high tax test is applied to all of the CFC's gross income.

The first sentence quoted from the Preamble also is wrong as a structural matter. The Section 954(b)(4) high foreign tax test is comparing foreign taxes on net, not gross, income to the U.S. taxes on the same net income. In order for the test to work, the category of gross income to which deductions are allocated must be identified.⁴⁹ The identified categories here are Section 954 foreign base company income and Section 953 insurance income. The test is not applied to "any item of income," because the test clearly does not apply to boycott factor income, amounts equal to illegal payments to foreign officials, and income from countries supporting international terrorism from Section 952(a)(3)-(5) or other items of income, such as portfolio interest, that are not eligible for the Subpart F high tax exception.⁵⁰

Congress regularly includes regulatory authority to address issues within a provision, such as the authority provided in relation to QBAI in Section 951A(d). There is no such grant of specific authority in relation to the meaning of "net CFC tested income" in Section 951A(c).

The statute does not make the GILTI exclusion elective for income that is excluded under Section 954(b)(4). There is no statutory basis to conclude that Section 951A(c)(2)(A)(i)(III) is itself the source of authority to make the regulatory interpretation expanding its scope elective. Moreover, the Preamble makes no effort to justify making the expanded exclusion elective.

The decision to allow an election between these two interpretations of the statute (one limited to income that would be foreign base company income or insurance income, the other not so limited), so that either interpretation is acceptable at the choice of the taxpayer, is itself an important regulatory decision. Such an election requires justification if for no other reason than (on the non-heroic assumption that taxpayers will make the election that results in the least amount

of tax net of cost to implement the election), the election will always lose revenue.⁵¹

If the Proposed Regulation's interpretation of the statute is correct, the Preamble should explain why it would not be preferred to the narrower interpretation. If the broader reading were the preferred reading, it is not clear why it would be necessary or appropriate to make it elective and not mandatory since it would not rely on the elective aspect of Section 954(b)(4), which only is important to exclude that within its scope from Subpart F income.

Making the exclusion elective does not relieve the agency from providing a reasoned basis for its interpretation of the statute in the first instance. It also requires a reasoned basis to conclude that that neither of the alternative interpretations is to be preferred and that an election is consistent with the language and purpose of the statute.

To summarize, the Preamble does not provide an explanation that justifies the textual interpretation adopted in the regulation. The next section considers the Preamble's effort to justify its textual interpretation based on recourse to legislative history evidencing the Congress's intent.

B. Legislative Intent

The legislative history cited in the Preamble to justify insertion of a new high tax test cannot be read objectively to provide support for a new elective GILTI high tax exception. The Preamble provides:

The legislative history evidences an intent to exclude high-taxed income from gross tested income. See Senate Explanation at 371 ("The Committee believes that certain items of income earned by CFCs should be excluded from the GILTI, either because they should be exempt from U.S. tax — as they are generally not the type of income that is the source of base erosion concerns — or are already taxed currently by the United States. Items of income excluded

⁴⁹ Not all deductions are allocated and apportioned to a CFC's items of income pro rata to total income. See, e.g., Section 954(b)(5) (second sentence).

⁵⁰ See Section 881(c)(5)(A)(ii).

⁵¹ See Field, *supra* note 4, at 30-31 ("While the efficiency consequences of the use of explicit elections may not be entirely clear and may vary from election to election, it is virtually axiomatic to say that explicit elections reduce tax revenue.").

from GILTI because they are exempt from U.S. tax under the bill include foreign oil and gas extraction income (which is generally immobile) and income subject to high levels of foreign tax.”). The proposed regulations, which permit taxpayers to electively exclude a CFC’s high-taxed income from gross tested income, are consistent, therefore, with this legislative history.⁵²

The legislative history language quoted by the Preamble merely describes what was in the statute it was describing, namely the exclusion for income excluded from Subpart F under Section 954(b)(4). If the approach to the legislative history adopted in the proposed regulation were appropriate, then income from mining, which is as or more immobile as income from oil and gas extraction, should be excluded under the exclusion from tested income for foreign oil and gas extraction income.⁵³

What the Preamble is saying is that the change to the statute it proposes to make by regulation is *consistent with* what the Congress thought its statute was doing in relation to foreign base company and insurance income. That is different from saying, and the Preamble does not establish, that Congress thought it was doing more than what was in the text of the statute (and would agree that the Treasury should fix its drafting error by regulation).⁵⁴

The legislative history cited in the Preamble to support the broadened exclusion is inapposite to the question whether Congress intended a broader scope for a high tax exclusion from tested income.⁵⁵ The regulatory correction is not reflected in the Staff of the Joint Committee’s General Explanation description of the provision, which is suggestive that this regulatory interpretation was not in the minds of the

legislators and drafters no matter how appealing it has become to interested taxpayers.⁵⁶

If the legislative history were considered persuasive to support an exclusion for high taxed CFC income without regard to its categorization as Subpart F base company income or insurance income, the rationale, that Congress intended that “income subject to high levels of foreign tax” should be excluded from GILTI, does not supply a basis for the interpretation being elective. Once the Section 954(b)(4) election is made for income, it would not be excluded under Section 951A(c)(2)(A)(i)(II), which applies to income taken into account in Subpart income, and (but for its origin as income targeted by Subpart F) would be indistinguishable for GILTI purposes from other gross income but for its high tax characteristic. This broader interpretation of the exclusion’s scope thereby becomes untethered to the elective element of Section 954(b)(4). Indeed, if the broader interpretation were adopted, it should supersede the narrower definition limiting it to Subpart F base company income and insurance income for which there had been an election out of Subpart F. There is no reason and certainly none is provided in the Preamble for why the two categories should be separate.

The Section 954(b)(4) regulatory election was made part of the regulations when there was deferral from U.S. tax of active foreign income and not exemption and was linked to the element of proof that is not found in the language of Section 951A(c)(2)(A)(i)(III). There is no reason in the statute or in policy why the proposed regulations’ broader interpretation, if adopted, should not be mandatory. Indeed, that would be more consistent with the asserted legislative intent.

IV. Other Preamble Justifications

The Preamble provides two additional justifications for the new broader interpretation. Neither one holds up under scrutiny.

⁵² Preamble at 29120.

⁵³ See Section 951A(c)(2)(A)(i)(V).

⁵⁴ It is noteworthy that when taxpayers made a similar argument that U.S. shareholder-level expenses should not be allocated to GILTI for foreign tax credit limitation purposes, based on similarly inchoate examples in the legislative history, the Treasury and IRS correctly declined to do so.

⁵⁵ If, however, the legislative history were to be applied as the Preamble would suggest, it also is best read as supporting a mandatory and not an elective exclusion.

⁵⁶ There also is no provision for such a revision in publicly available drafts of a proposed technical corrections bill, if indeed this were within the scope of a mere technical correction. For background on the thinking of taxpayers regarding these issues, see generally Caballero and Wood, *supra* note 17, and the comments filed in favor of the Proposed Regulation’s GHTEE (none of which discuss its consistency with the statutory language).

- The election “eliminates an incentive for taxpayers to restructure CFC operations in order to convert gross tested income into [subpart F income] . . . for the sole purpose of availing themselves of section 954(b)(4) and, thus, the GILTI high tax exclusion.”⁵⁷

As stated, this reason is at a minimum misleading and at best technically correct in an unimportant respect. It implies that the GHTEE will eliminate restructuring income into Subpart F. But, read to the end, the quoted statement merely makes the tautological statement that with the GHTEE covering all income it is not necessary to plan into Subpart F categories of income in order to make the exclusion election. As explained above and practitioners know well, the more expansive foreign tax credit limitation rules applicable to Subpart F income compared to GILTI and FDRD income mean that, whether or not GHTEE is adopted, in an important range of cases taxpayers will want to plan into Subpart F income (and *not* make the Section 954(b)(4) election).⁵⁸

Once high taxed income exceeds what can be used to cross-credit against U.S. tax (assuming a full U.S. rate) and gives rise to unused excess credits, it is preferable for the income giving rise to excess credits to be Subpart F income and not GILTI. In those cases, which likely exceed cases where the GHTEE is favorable to taxpayers, taxpayers will plan into Subpart F general limitation income. The notion that the GHTEE relieves the complexities of these rules is

laughable as a reasoned explanation for the Proposed Regulation.⁵⁹ The analysis of the range of the GHTEE’s benefit highlights that even for interested taxpayers, the GHTEE is not a “have to have” but at best falls into the category of “nice to have.” I respectfully submit that this is an insufficient driver to justify the required torturing of statutory text. Moreover, the Treasury should not adopt pro-taxpayer positions merely to reduce tax planning. That rationale would support regulatory erosion of the tax base on multiple fronts. Other tools are available to frustrate tax-motivated tax avoidance planning.

Even if one accepted this restructuring cost rationale at face value, the same objective is achieved with a mandatory and not an elective rule. A taxpayer will have to engage in the analysis in any event if it is to decide whether to make the election, so whatever the ultimate conditions and scope for the election, a mandatory rule would only be more administratively burdensome to the extent that taxpayers would not in any event have undertaken the analysis for an election. Within the class of taxpayers primarily affected by these rules, namely large multinational companies with sophisticated advisors, that seems unlikely and should not outweigh the persuasive reasons that any such interpretation should be mandatory and not elective.⁶⁰

- Making the election would reduce a taxpayer’s “cost of capital on foreign investment by reducing U.S. tax on such

⁵⁷ Preamble at 29120.

⁵⁸ The language quoted in the text is from Part II of the “Explanation of Provision” section of the preamble. In fairness, Part I.C.3.a.ii. of the Special Analysis section of the Preamble, after acknowledging that it does not have the ability to quantify the benefits and costs of the “economically significant” regulation against the no action baseline, states that its qualitative analysis is that the GHTEE “reduces the incentive for taxpayers to restructure their operations to convert their high-taxed gross tested income into subpart F income for U.S. tax purposes.” Preamble at 29124. “Reduces” is not the same as “eliminates.” While this more cautious assessment is reasonable, it also raises the question of why the interpretative “stretch” (to be generous to its proponents) is necessary. I understand it already has triggered claims for comparable interpretative “flexibility” by taxpayers in other pro-taxpayer but questionable policy situations.

⁵⁹ The most effective way to reduce regulation-induced planning would be to eliminate high tax elections and make the high-tax exclusion mandatory. The Treasury could and should amend the regulations to make Section 954(b)(4) exclusion mandatory and not elective. Such a regulation could consider any category of Subpart F income for which the ratio of foreign tax to the Subpart F income as reported on a properly filed return exceeded 90 percent of the U.S. rate return as establishing the high tax condition sufficiently to cause any such income to be excluded from Section 954 FBCI and Section 953 insurance income.

⁶⁰ For a useful checklist of considerations to take into account in evaluating the wisdom of an explicit election, see Field, *supra* note 4.

taxpayers GILTI relative to the baseline," which could potentially lead to increased "foreign investment by U.S.-parented firms."⁶¹

The Special Analysis section of the Preamble attempts to provide a cost benefit analysis of the proposed regulation and is distinct from the Explanation of Provision portion of the Preamble. Accordingly, it is not clear that what is said in that section is a justification for the regulation adopted. In any event, with respect to the economic effects of the GHTEE, the discussion disavows having sufficient data to reach any quantitative conclusions for lack of data. The statement quoted above is the one solid conclusion — taxpayer tax costs will decrease. This an obscure way of saying this rule will lose revenue relative to the baseline.

The second more tentative observation made in this section of the Preamble is that it could potentially lead to increased foreign investment. There is no discussion whether this is good policy when it is discussing one of two alternative ways to interpret the statute (assuming that the GHTEE were a permissible interpretation of the statute). Nor is there discussion of the costs and benefits of making the interpretation elective versus mandatory. The Preamble fails altogether to provide a reasoned justification for the interpretation of the high tax exclusion in the proposed regulation.

V. GHTEE Would Expand an Unjustified Taxpayer Subsidy

In a properly designed dividend exemption system, expenses allocated to exempt foreign income are disallowed.⁶² The failure to do so provides an incentive to earn the exempt income, beyond the incentive of the exemption alone,

equal to the benefit from the deduction. The subsidy is easy to see in the case of a foreign corporation's income that bears no foreign tax.⁶³ The analysis is not changed if a taxpayer has to pay a foreign tax. The difference is that the taxpayer in effect has to give a part of the subsidy received from the United States to the foreign government as a tax instead of keeping it all.

Upon examination, it is obvious that the failure to allocate expenses appropriately to take account of whole or partial exemption is a poorly designed subsidy.

- First, assuming that the recipients of the subsidy's benefit are predominantly the U.S. MNE's shareholders,⁶⁴ the tax subsidy is not tied to an economic benefit to the United States from enhancing the welfare of these shareholders that demonstrably exceeds the benefit to the United States of having the additional tax revenue whether it is used for social services, defense, deficit reduction or debt reduction.
- Second, even if there were a net benefit for the United States from increased capital allocation to a non-U.S. business, there is no reason to believe that basing the subsidy on the amount of unallocated expenses would be rationally related to the benefit for the United States.
- Third, if we assume that the benefitted shareholders are the same persons who own U.S. equities generally, the preponderance of these beneficiaries who are U.S. resident would be high income, wealthy or most often both. So, the subsidy, like much else in the TCJA, is skewed to benefit the already

⁶³ See Example 4 in Part II.C. *supra*. It does not matter for U.S. tax purposes whether the zero or low foreign is because of a country's low foreign tax rate or taxpayer planning to avoid foreign tax in a high tax foreign country under the multitude of ways available to competent planners. For purposes of the issues considered in this letter it is the effective, not nominal, rate of foreign tax that is relevant.

⁶⁴ This discussion does not address the extent to which the burden of the corporate tax is borne by labor instead of shareholders. While there is a substantial literature on this question the practical observation is that the Staff of the Joint Committee on Taxation's review of the issue concludes that owners of capital bear 100 percent of the corporate income tax burden in the short run and 75 percent of corporate income tax burden in the long run, with the remainder not distributed to domestic and foreign owners of capital being borne by labor. See JCT Staff, "Modeling The Distribution of Taxes on Business Income," JCX-14-13, at 30 (2013). The JCT does not use the long run distribution for a provision enacted in the first year of a 10-year budget period until the 10th year of the budget period. *Id.* at 9.

⁶¹ Preamble, at 29124. This rationale is from the Special Analysis part of the Preamble so it is not formally a legal justification of the proposed rule. In this same section, it is observed "Further, removing high-taxed tested income from the GILTI tax base could change the incentives for the location of tangible assets." The question as to which no conclusion is reached is the effect of a reduction in QBAI and benefit of FDRD exemption and exclusion of the asset for purposes of expense allocation.

⁶² See J. Clifton Fleming, Jr., Robert J. Peroni, and Shay, "Designing a U.S. Exemption System for Foreign Income When the Treasury is Empty," 13 *Fla. Tax Rev.* 397, 448-452 (2012); and Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations," 54 *Nat'l Tax J.* 771, 783 (2001).

rich thereby worsening rather than alleviating our country's economic inequality. Moreover, based on the best available data of who owns U.S. equities, as much as 25 percent to 35 percent of the beneficiaries would not even be U.S. resident.⁶⁵

- Finally, the more the benefit goes to pay foreign tax the less it goes to U.S. persons.

Taxpayers may argue that the allocation and disallowance of U.S. expense (not charged to the CFC) would punish the taxpayer whenever the FETR exceeds the U.S. effective tax rate. This is not a failure of the U.S. tax system. It is advantageous to locate an expense in the country where the deduction is most valuable. *Ex ante*, that generally will be the highest tax country. Incurring a higher foreign tax is a consequence of the taxpayer's (market) decision to conduct business and earn income in a high tax foreign country.

The decision where to locate investment should not be distorted by allowing a U.S. subsidy that reduces the impact of the higher foreign tax. Put differently, why should the United States subsidize a higher foreign tax rate? It is clear from the fact of the foreign tax credit limitation that the policy of the United States is affirmatively *not* to underwrite foreign tax rates higher than the U.S. rate (measured consistently — in relation to the U.S. tax base).

The Treasury has announced plans to modify the expense allocation rules for certain categories of expenses. These rules already were lobbied back in the 1980s and 1990s and should not be further weakened, which would simply expand the existing subsidy effects described by Driessen.⁶⁶ Changes to strengthen them would be welcome, though are hardly expected. Watering down expense allocation is bad policy and is a weak substitute for addressing a need for carryover of foreign taxes in the GILTI basket. One hopes there will be a robust review of

proposals including by disinterested but knowledgeable parties.

VI. A Failure of Process

It seems hardly credible that no comment has raised the interpretative challenges facing a legitimate adoption of the GHTEE. One explanation might be because the exceptional nature of tax law procedures. A regulation's elective rule normally cannot be challenged because a taxpayer who makes the election presumably is benefitted by the election, as described above (assuming the taxpayer does not make a mistake making the election). In order for a person to make a challenge of the regulation's validity, that person must have standing based on something other than a generalized harm applicable to taxpayers as a whole.⁶⁷ As a result, the regulation binds the IRS without meaningful risk of being challenged and overturned. In these circumstances, why would an interested taxpayer comment on the regulation's validity?

Of the comments filed to date that are on the regulation.gov site, apparently only one is from a non-interested person. The comments from the New York State Bar Association and the American Bar Association ("professional organizations of sophisticated tax professionals"⁶⁸), which do not appear to be on regulations.gov but are publicly available, do not comment on the statutory interpretation issue. Notwithstanding the U.S. Chamber of Commerce's profession in briefs filed with courts of appeal of its deep concerns about interpretation of tax statutes within the strictures of the APA, the pro-taxpayer statutory

⁶⁵ See Leonard E. Burman, Clausing, and Lydia Austin, "Is U.S. Corporate Income Double Taxed?" (May 4, 2017) (building on work of Steven M. Rosenthal and Austin); and Rosenthal and Austin, "The Dwindling Taxable Share of U.S. Corporate Stock," *Tax Notes*, May 16, 2016, p. 923.

⁶⁶ See American Bar Association, "Report of the Task Force on International Tax Reform," 59 *Tax Law*. 649 (2006).

⁶⁷ Mike Schler has pointed out to me that a minority United States shareholder or a purchaser of a CFC bound by an election might be adversely affected and have standing. I take these points but do not think they are material enough to alter the argument that the GHTEE is effectively immunized from challenge.

⁶⁸ See Shu-Yi Oei and Leigh Osofsky, "Legislation and Comment: The Making Of The Section 199A Regulations," at 5 (forthcoming in *Emory Law Journal*).

interpretation issues raised by this proposed regulation apparently were overlooked by the Chamber.⁶⁹

This notice and comment process has so far not fulfilled the expectations raised by administrative law proponents of applying the APA's procedures more resolutely to tax regulations. Moreover, the adoption of the April 11, 2018, Memorandum of Understanding requiring expanded review of tax regulations by the Office of Management and Budget, also appears to have not had a prophylactic effect so far against agency promulgation of an extra-legal regulation.

If finalized with the GHTEE, the regulation would fit the narrative of scholars who argue that the APA notice and comment generally is broken.⁷⁰ In a technical area of business taxation with large dollars attached, there is reason to believe that the system is especially susceptible to capture by interested parties, in part because of the lack of knowledgeable but disinterested commenters and in part because of increasing business constraints on independent comments by tax practitioners and indirectly bar and other professional associations. By adopting pro-taxpayer elections (even if extra-statutory), an agency can inoculate its action from judicial review. Legislative oversight of agency regulations generally is sparse or nonexistent.

It is left to the Treasury and the IRS to protect the interests of the members of the public who are not directly interested parties, particularly in the case of explicit elections not included in the statute itself. One possibility is to consider enlisting the offices of the National Taxpayer Advocate ("NTA") to assure that comments on regulations reflect views of taxpayers beyond

those with immediate economic interests. It may require support for a legislative change to enhance the role of the NTA.⁷¹

VII. Conclusion

The GHTEE should not be adopted. If the expansive regulatory interpretation of the proposed regulation is not eliminated, it should be implemented as a mandatory, not an elective rule.

It is my hope that the Treasury and the IRS will give the comments in this article full consideration, notwithstanding that the comment letter was transmitted after the close of the comment period. The preceding comments, including questioning the authority of the regulation's elective GILTI high tax exclusion, have not been made or discussed in the comment letters filed at regulations.gov nor in comments made by the New York State Bar Association Tax Section or the American Bar Association Section of Taxation.⁷²

Emmanuel Saez and Gabriel Zucman highlight the extent of inequality in American society and the role of taxation policy choices in contributing to it.⁷³ They are right that the failure to tax wealth and/or capital income adequately or at all is a policy decision. I would add that it is not just one big decision, but is a series of decisions that favor those with special and direct interests in matters before the government. In my view, that is the story of the proposed GHTEE. The GHTEE is very technical and its consequences are hard to discern, but it provides taxpayers the gift of an unwarranted erosion of the tax base.

A charitable interpretation of the GHTEE is that it is directed at addressing a structural issue

⁶⁹ See, e.g., Brief of the Chamber of Commerce of the United States of America as *Amicus Curiae* in Support of Rehearing *En Banc*, at 2 and 4, *Altera Corp. v. Commissioner* (9th Cir. Aug. 1, 2019), on appeal from the Tax Court ("Businesses, moreover, critically depend on the procedures and protections that the APA provides against arbitrary or otherwise unlawful agency action. Given the breadth of its membership and its long history of challenging regulations that violate the APA, the Chamber is uniquely positioned to speak to the administrative law principles implicated by this case as well as the consequences to the Nation's business community and the national economy of arbitrary agency regulatory activities that upset settled expectations." (Emphasis added.)) The brief might have added to "arbitrary agency regulatory activities" the words "that do not benefit taxpayers and."

⁷⁰ See Oei and Osofsky, *supra* note 68, at 11-15 for review of criticisms.

⁷¹ See "National Taxpayer Advocate 2016 Annual Report to Congress," at 37-39 ("Special Focus: Provide the National Taxpayer Advocate the Authority to Hire Independent Counsel, Comment on Regulations, and File Amicus Briefs in Litigation Raising Taxpayer Rights Issues").

⁷² NYSBA Tax Section, "Report on June 2019 GILTI And Subpart F Regulations," at 76 (Sept. 18, 2019) (Regarding the GHTEE: "Scope of Comments. We do not comment on the validity of this aspect of the Proposed Regulations under the Code. . . . Rather, our comments are limited to technical issues under these provisions."); ABA Section of Taxation, "Comments on Temporary Regulations Addressing Section 245A, Proposed Regulations Addressing Sections 951A and 958, and Final Regulations Addressing Section 951A" (Sept. 11, 2019).

⁷³ Saez and Zucman, "Taxing Our Way to Justice," *The New York Times*, Oct. 13, 2019.

in the statute, the lack of excess foreign tax credit carryovers in the GILTI limitation category, that is plausibly viewed as bad policy and increases multinational taxpayers' tax. Yet, the regulation exacerbate more significant structural defects in the statute, the failure to allocate deductions to FDRD income, which is a far worse tax policy that helps multinational taxpayers and loses revenue.

The revenue loss from the GHTEE, whatever it may be, could be spent in much better ways to advance the welfare of Americans than to increase after-tax profits of U.S. MNEs. If need be, use the money to reduce the deficit or pay down Federal Government debt thereby creating fiscal space for the future. ■

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