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Fall 11-1-2019

## It's All About the DRD, What's Wrong with Foreign Branches, and a Few Other Things You Should Know About the New International Tax Provisions

Rebecca Rosenberg  
*Ohio Northern University Pettit College of Law*

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### Recommended Citation

Rebecca Rosenberg, *It's All About the DRD, What's Wrong with Foreign Branches, and a Few Other Things You Should Know About the New International Tax Provisions*, 53 Loy. L.A. L. Rev. 95 (2019).

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# IT'S ALL ABOUT THE DRD, WHAT'S WRONG WITH FOREIGN BRANCHES, AND A FEW OTHER THINGS YOU SHOULD KNOW ABOUT THE NEW INTERNATIONAL TAX PROVISIONS

*Rebecca Rosenberg\**

*This Article highlights and analyzes some important points about the new international tax rules. For example, such provisions do not create an entirely territorial system. The partial movement towards territorial objectives is accomplished largely through the new 100% dividends received deduction (DRD) for certain foreign dividends from foreign corporations. However, this new DRD is much more limited in its application than most taxpayers may realize (for example, due to a very long holding period requirement). Even when the DRD potentially applies, taxpayers may attempt to claim foreign tax credits instead.*

*In addition, some of the new tax provisions show a surprising distaste for foreign branches, which are rather broadly defined. Further, GILTI (global intangible low taxed income) is misnamed—it fails to accurately measure either intangible-related or low-taxed income. Lastly, the new international tax provisions (and their interaction with the new, 100% current year depreciation deduction) may create undesirable incentives regarding the movement of tangible assets.*

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\* Rebecca Rosenberg teaches tax law at Ohio Northern University's Pettit College of Law and formerly practiced international tax law. She would like to thank her research assistants: Nathan Bunch, Milica Pavlovic, and Katrina Sutherly. She would also like to thank her tax students for their focus and great attitude.

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## I. INTRODUCTION

The Tax Cuts and Jobs Act<sup>1</sup> (TCJA) made major changes to the U.S. international tax system, with the stated goals of encouraging production in the U.S. and creating a territorial tax system (which generally means a system that does not tax foreign-earned amounts and allows tax-free repatriation of funds from foreign subsidiaries to their U.S. parents).<sup>2</sup> This Article attempts to de-code and translate some of the complex new international tax provisions, in order to analyze whether they are consistent with the stated goals of the legislation.<sup>3</sup> To that end, the Article explores several themes in the new U.S. international tax rules: intangible-related income, foreign-source low-taxed income, and foreign branches—all of which are disfavored (with the exception of foreign-derived intangible income (FDII) of U.S. corporations).<sup>4</sup> But it isn't clear that these emphases actually implement the stated goals of encouraging production in the U.S. and creating a territorial system. Also, these targeted elements

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1. Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, 131 Stat. 2054 (2017). “Tax Cuts and Jobs Act” is the colloquial name for the Act, rather than its official short title. *See* David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 Minn. L. Rev. 1439, 1441 n.2 (2019). The IRS has published numerous regulations and proposed regulations regarding the international tax provisions of the TCJA. *See, e.g.*, Prop. Treas. Reg. § 1.904-4(f), 83 Fed. Reg. 63,200, 63,210 (Dec. 7, 2018). After this Article was written, several of the proposed regulations discussed in this Article were finalized. *See, e.g.*, Treas. Reg. § 1.904-4(f) (2019). Regulations that were published after this Article was written are generally not reflected in this Article.

2. *See* Michael Graetz, *Foreword: The 2017 Tax Cuts: How Polarized Politics Produced Precarious Policy*, 128 YALE L.J.F. 315, 328 (2018); Joshua D. Harms, *Legislative Foundation of the United States' New International Tax System*, 42 SEATTLE U. L. REV. 211, 235 (2018); Rebecca M. Kysar, *Critiquing (and Repairing) the New International Tax Regime*, 128 YALE L.J.F. 339, 342 (2018); Stephen J. Pieklik et al., *Deducting Success: Congressional Policy Goals and the Tax Cuts and Jobs Act of 2017*, 16 PITT. TAX REV. 1, 21 (2018); Stephen E. Shay, *The U.S. International Tax Reforms: Competition and Convergence, Pay-Offs and Policy Failures*, 46 INTERTAX 905, 906 (2018).

3. Not all of the new international tax provisions in the TCJA are discussed in this Article. *See* Kamin et al., *supra* note 1 (discussing multiple international provisions of the TCJA); Rebecca Rosenberg, *More Generous than Accurate: The GILTI Foreign Tax Credit and Coordination of the Foreign Tax Credit Rules with the New International Tax Provisions of the TCJA*, 83 ALB. L. REV. (forthcoming 2020) (discussing the interaction of various newly enacted provisions with the foreign tax credit rules); Daniel N. Shaviro, *The New Non-Territorial U.S. International Tax System Part 2*, 160 TAX NOTES 171, 183 (2018) (discussing additional tax provisions).

4. *See* I.R.C. § 250(a)(1)(A) (Supp. V 2013–2018). Other themes include a distrust of hybrid payments or entities (i.e., payments or entities viewed differently by the U.S. and a foreign tax system) and an increase in anti-earnings-stripping rules (rules aimed at restricting deductions for payments to certain foreign related persons, which would otherwise reduce the taxable income of the U.S. payor). *See, e.g.*, I.R.C. § 59A (2012 & Supp. V 2013–2018); I.R.C. §§ 245A(e), 267A (Supp. V 2013–2018). These additional themes are beyond the scope of this Article.

are not accurately measured. For example, intangible income is computed in reverse, as if it equals all income except an imputed, imaginary return to tangible assets.<sup>5</sup> The disfavored “foreign branch income” is defined by cross-reference to a term of art, “qualified business unit” (QBU).<sup>6</sup> But QBU characterization may be easy to avoid, and is not clearly connected to the stated goals of the international tax amendments. Nor do the new rules directly measure, or accurately target, low-taxed foreign source income (as compared to other foreign source income).

Further, the new international tax provisions seem plagued by misnomers and misunderstandings. For example, they do not create a territorial system. This is especially true for individuals, as opposed to corporations. The partial movement in the direction of territoriality (lower or zero U.S. tax on foreign-earned income) for corporations is mostly accomplished by means of a 100% deduction for dividends received by corporate U.S. shareholders from certain foreign subsidiaries. But this “DRD” (dividends received deduction) has serious limits: it requires a more-than-year-long holding period, and it applies only for U.S. corporate shareholders (not individuals) that own at least 10% of the foreign dividend payor.

In addition, the TCJA imposed a new tax on U.S. shareholders on the active (non-subpart F) income of certain foreign subsidiaries.<sup>7</sup> This is truly a new thought in U.S. tax, and directly contrary to the concept of territoriality (which would instead impose zero tax on foreign-earned income). But this new tax is reduced by means of a 50% deduction and by possible foreign tax credits, at least for corporations.<sup>8</sup> Further, this new tax provision does not accurately target either intangible or low-taxed income, despite its name: global intangible low-taxed income (GILTI).

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5. See I.R.C. §§ 250(b)(1), 951A(b)(1) (Supp. V 2013–2018).

6. See *id.* § 250(b)(3)(A)(i)(VI); I.R.C. § 904(d)(2)(J) (2012 & Supp. V 2013–2018).

7. See I.R.C. § 951A (Supp. V 2013–2018).

8. See *id.* §§ 250(a)(1)(B), 960(d). Individuals can also apply such deduction and such foreign tax credits, if they make an election under section 962. See I.R.C. § 962 (2012 & Supp. V 2013–2018); Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3), 84 Fed. Reg. 1,874, 1,874–75 (Feb. 5, 2019); Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income, 84 Fed. Reg. 8,188, 8,188–234 (proposed Mar. 6, 2019) (to be codified at 26 C.F.R. pt. 1) (preamble to the proposed regulations under section 962); Nathan Boidman, *Proposed U.S. Regs Narrow GILTI Exposure on Canadian CFC Operations*, 94 TAX NOTES INT’L 995, 995 (2019); Andrew Velarde, *Individuals Score Big Win with GILTI Deduction Eligibility*, TAX NOTES (Mar. 5, 2019), <https://www.taxnotes.com/tax-notes-today-international/global-intangible-low-taxed-income-gilti/individuals-score-big-win-gilti-deduction-eligibility/2019/03/05/296dr>.

The interlocking web of new tax rules—including faster depreciation,<sup>9</sup> the GILTI rules,<sup>10</sup> and the FDII provision<sup>11</sup>—may also affect the movement of tangible assets between U.S. and foreign corporations, and between different foreign jurisdictions. The Internal Revenue Service (IRS) has addressed this issue in recent proposed regulations,<sup>12</sup> but only partially.

## II. IT'S ALL ABOUT THE DRD: THE NEW DRD EXEMPTS CERTAIN FOREIGN EARNINGS FROM U.S. TAX, BUT HAS SERIOUS RESTRICTIONS

### A. Importance and Impact of the New 100% DRD for Foreign Dividends

Descriptions of the new U.S. international tax rules<sup>13</sup> enacted by the Tax Cuts and Jobs Act sometimes refer to such rules as creating a territorial system,<sup>14</sup> or as encouraging U.S. shareholders to receive dividends from foreign subsidiaries.<sup>15</sup> But the new 100% DRD for foreign dividends<sup>16</sup> is the driving force behind the new, tax-free treatment for many amounts that U.S. shareholders earn through foreign subsidiaries. (Imagine, for example, income that Pepsi earns

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9. See I.R.C. § 168(k) (2012 & Supp. V 2013–2018).

10. See I.R.C. § 951A (Supp. V 2013–2018).

11. See *id.* § 250.

12. See Prop. Treas. Reg. § 1.951A, 83 Fed. Reg. 51,072, 51,091 (Oct. 10, 2018).

13. “International tax” is a commonly used term that can be somewhat of a misnomer: it means (in the context of U.S. tax rules, and as used in this Article) the U.S. tax rules regarding international transactions (foreign transactions of U.S. persons and U.S. transactions of foreign persons)—not the tax laws of various other countries. See, e.g., Harms, *supra* note 2, at 235.

14. See generally J. Clifton Fleming, Jr. et al., *Expanded Worldwide Versus Territorial Taxation After the TCJA*, 161 TAX NOTES 1173, 1187 (2018) (analyzing and disagreeing with arguments that the U.S. now has a territorial tax system); Shaviro, *supra* note 3 (discussing the debate over whether the new rules create a territorial system); Kamin et al., *supra* note 1, at 1490 (“The need for an anti-abuse regime like GILTI partially arises because the new tax legislation’s switch from a worldwide system (whereby the income of foreign subsidiaries earned abroad was merely deferred) to a territorial system (whereby this income is exempted altogether) would exacerbate profit shifting.”); *infra* Part V (for further discussion).

15. See, e.g., Tripp Mickle, *Apple to Pay \$38 Billion in Taxes on Cash Overseas, Build New U.S. Campus*, WALL STREET J. (Jan. 17, 2018, 9:42 PM), <https://www.wsj.com/articles/apple-to-pay-38-billion-in-repatriation-tax-plans-new-u-s-campus-1516215419>; Daisuke Wakabayashi & Brian X. Chen, *Apple, Capitalizing on New Tax Law, Plans to Bring Billions in Cash Back to U.S.*, N.Y. TIMES (Jan. 17, 2018), <http://www.nytimes.com/2018/01/17/technology/apple-tax-bill-repatriate-cash.html>.

16. See I.R.C. § 245A (Supp. V 2013–2018); see also Jasper L. Cummings, Jr., *The Foreign Dividends Received Deduction*, 158 TAX NOTES 1487 (2018); Libin Zhang, *The Discreet Charms of the Dividends Received Deduction*, 161 TAX NOTES 815, 823 (2018).

through a Japanese subsidiary, or that General Motors earns through a Brazilian corporation.) The DRD provides a 100% deduction for dividends received by a U.S. shareholder from a foreign subsidiary, with some requirements.<sup>17</sup> This deduction applies only to the “foreign source portion” of the dividend, which is defined very broadly as the part of the dividend paid from any earnings of the foreign corporation that have not already been taxed by the U.S.<sup>18</sup>

In other words, almost any foreign dividend (subject to the DRD’s requirements) is 100% deductible—i.e., free of U.S. tax.<sup>19</sup> Assume, for example, that U.S. multinational Acme Co. receives a \$3 billion dividend from its wholly owned Swiss subsidiary, Acme Swiss. That dividend is now 100% free of U.S. tax, due to the 100% DRD, if all of the DRD’s requirements are met. That tax-free treatment is an enormous sea change for U.S. tax law, which formerly taxed U.S. shareholders on their receipt of both U.S. and foreign dividends (subject to other DRDs that applied mostly to U.S. dividends).<sup>20</sup>

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17. See I.R.C. § 245A (Supp. V 2013–2018).

18. Technically, the foreign source portion of the dividend is determined by reference to all of the earnings of the dividend-paying foreign subsidiary *other than*: (a) amounts that are effectively connected with the conduct of a U.S. trade or business and subject to U.S. tax; and (b) certain dividends received by such foreign subsidiary from an 80%-owned U.S. corporation. See *id.* § 245A(c). Note that this “foreign source” term has a different meaning than the usual sourcing rules. Compare *id.* § 245A(c), with I.R.C. §§ 861, 862, 863 (2012). For simplicity, this Article assumes that dividends from foreign corporations consist entirely of a “foreign source portion,” except where otherwise stated.

19. Subpart F and GILTI only apply with respect to the income of CFCs (controlled foreign corporations): foreign corporations in which a U.S. shareholder owns at least 10%, by vote or value, and all of such U.S. shareholders together own more than 50% of the vote and value. I.R.C. §§ 951(a), 957 (2012 & Supp. V 2013–2018); I.R.C. § 951(b) (2012); I.R.C. § 951A (Supp. V 2013–2018). But the DRD applies to any 10% U.S. shareholder that is itself a corporation. See I.R.C. § 245A (Supp. V 2013–2018). Income earned by U.S. shareholders through a 10/50 company (a foreign corporation that has at least one 10% U.S. shareholder but is not a CFC) is thus completely free from U.S. tax: the DRD applies, but subpart F and GILTI do not. See I.R.C. § 245A (Supp. V 2013–2018); I.R.C. § 951 (2012 & Supp. V 2013–2018); I.R.C. § 951A (Supp. V 2013–2018). See generally Rebecca Rosenberg, *Partial Repeal of Foreign Tax Credits by the Tax Cuts and Jobs Act: Resulting Behavioral Incentives, Self-Help, and New Mechanics for Some Remaining Portions of the Credit*, 38 VA. TAX REV. 64, 115–19 (2018) (comparing U.S. tax on income earned through CFCs and 10/50 companies).

20. See generally I.R.C. § 61(a) (2012) (“[G]ross income means all income from whatever source derived . . .”). There is a DRD of 50%, 65%, or 100% available for dividends received by a U.S. corporation from a U.S. subsidiary. See I.R.C. § 243(a), (c) (2012 & Supp. V 2013–2018). These rules pre-date the TCJA, although the exact percentages have changed. Compare I.R.C. § 243(a), (c) (2012), with I.R.C. § 243(a), (c) (Supp. V 2013–2018). The percentage of such a DRD depends on the shareholder’s percentage ownership of the dividend-paying corporation. See I.R.C. § 243(a), (c) (2012 & Supp. V 2013–2018). There are also limited DRDs, already in existence before the TCJA, for dividends paid by foreign subsidiaries from certain amounts that are already subject to U.S. tax. See I.R.C. § 243(e) (2012); I.R.C. § 245 (2012 & Supp. V 2013–2018).

Under the new rules, if the earnings of a foreign subsidiary are not taxed currently to the U.S. shareholder through the subpart F or GILTI regimes,<sup>21</sup> then such earnings are never taxed to the U.S. shareholder, even when distributed—if the DRD applies. For example, assume that in 2020 a U.S. multinational earns \$100 million in Iowa, and also earns \$100 million through its wholly owned Zambian subsidiary. Further assume that the Zambian income generates neither subpart F nor GILTI inclusions for the U.S. shareholder. In that case, the U.S. does not tax the U.S. multinational on the Zambian income when such income is earned by the subsidiary in 2020. Nor is such income subject to U.S. tax when it is actually paid to the U.S. multinational as dividends (which could occur in any year, for example in 2021 or 2025), if the DRD applies. In other words, if subpart F and GILTI do not apply, the \$100 million earned by the U.S. multinational through its foreign subsidiary is never subject to U.S. tax: not when it is earned, and not when (and if) it is paid to a U.S. shareholder, assuming the DRD applies.

In contrast, the \$100 million earned in Iowa is taxed at a 21% tax rate.<sup>22</sup> This is reduced to an effective rate of 13.125% if all of such income is FDII because 37.5% of FDII is deductible.<sup>23</sup> Even this lower FDII effective rate is considerably higher than the U.S. tax on income earned through a foreign subsidiary, which (if the DRD applies) is zero percent (other than for GILTI or subpart F).

Sometimes this tax free treatment of dividends is referred to as a “participation exemption system.”<sup>24</sup> But that terminology, in other

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21. See I.R.C. § 951 (2012 & Supp. V 2013–2018) (providing for subpart F inclusions); I.R.C. § 951A (Supp. V 2013–2018) (requiring inclusions of GILTI). For simplicity, this Article generally ignores the PFIC (passive foreign investment company) rules, which can also require current inclusion by a U.S. shareholder of certain income earned through a foreign subsidiary. See I.R.C. §§ 1291–1298 (2012).

22. See I.R.C. § 11(b) (Supp. V 2013–2018) (providing corporate tax rate). If the U.S. multinational earned \$100 million through a wholly owned Iowa subsidiary, rather than directly, such subsidiary would be subject to tax at a rate of 21% (less for FDII). Dividends of such income from the Iowa subsidiary would be eligible for a 100% DRD in the U.S. parent’s hands, under the pre-existing DRD for dividends from U.S. corporations (rather than the new DRD for foreign dividends). I.R.C. § 243(a) (2012 & Supp. V 2013–2018).

23. See I.R.C. § 250 (Supp. V 2013–2018) (describing FDII and providing for a 37.5% deduction of FDII).

24. See STAFF OF J. COMM. ON TAXATION, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 372 (Comm. Print 2018) (referring to a “participation exemption system created by the Act”); Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, tit. I, subtit. D, pt. I, subpt. A, 131 Stat. 2054, 2189 (2017) (heading entitled “Establishment of Participation Exemption



contexts, means that income taxed to a corporation when earned (in this case the foreign corporation) is not again taxed to its shareholder when distributed. In other words, such income is only taxed once to the combined unit of the corporation and the shareholder, not taxed in the hands of both corporation and shareholder.<sup>25</sup> The 100% DRD creates a more generous effect than such a system: the U.S. tax applies to income (other than subpart F or GILTI) earned through a foreign subsidiary in either the hands of the foreign corporation or the hands of the U.S. shareholder. This is not the single layer of tax created by classic participation exemption systems. It is instead zero layers of U.S. tax—complete freedom from U.S. tax, if the 100% DRD applies.<sup>26</sup>

When a U.S. multinational considers whether to earn income directly, through a U.S. subsidiary, or instead, through a foreign subsidiary, it will presumably take these different U.S. tax outcomes into account. One could theorize that U.S. shareholders' ability to move income and assets in order to reduce U.S. tax under the new rules might be limited. For example, one could argue that a foreign subsidiary's income that escapes both the subpart F and GILTI regimes (for the U.S. shareholder) must necessarily be active and

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System for Taxation of Foreign Income”); H.R. REP. NO. 115-466, at 595, pt. A (2017) (Conf. Rep.) (heading entitled “Establishment of Participation Exemption System for Taxation of Foreign Income”).

25. See generally Kyle Pomerleau & Kari Jahnsen, *Designing a Territorial Tax System: A Review of OECD Systems*, TAX FOUND. 4-5 (July 2017), <https://files.taxfoundation.org/20170822101918/Tax-Foundation-FF554-8-22.pdf> (describing participation exemption systems). A participation exemption system can be accomplished by allowing a deduction or credit to either the dividend-paying corporation or its shareholder, at the time that a dividend is paid, for the previously taxed income amount or for the tax previously paid by the dividend payor on the earnings that form the dividend, respectively. See generally *id.* (discussing participation exemption systems).

26. One missing element in this fact pattern is the amount of foreign tax. Even if amounts earned through foreign subsidiaries are now free of U.S. tax (for U.S. shareholders, if the 100% DRD applies but GILTI and subpart F do not), a foreign country (or more than one) may tax the foreign subsidiary on its earnings and may also tax the U.S. shareholder on the receipt of a dividend. The converse of U.S. tax-free treatment is that the new international tax rules reduce or eliminate foreign tax credits for non-subpart F, non-GILTI income (absent some hybrid fact patterns) and prohibit foreign tax credits if the DRD is allowed. See I.R.C. § 960 (2012 & Supp. V 2013–2018) (limiting deemed paid foreign tax credits to subpart F and GILTI); I.R.C. § 960(d) (Supp. V 2013–2018) (restricting GILTI-related foreign tax credits); I.R.C. § 245A(d) (Supp. V 2013–2018) (denying foreign tax credits with respect to dividends for which the DRD is allowed). See generally Rosenberg, *supra* note 19 (arguing that foreign taxes become a real cost in the absence of foreign tax credits and discussing possible ways to claim credits, including the use of hybrids and reverse hybrids); Rosenberg, *supra* note 3 (describing GILTI-related foreign tax credits and their restrictions).

relatively less easy to move (either outside of the U.S. or from a higher- to a lower-taxed foreign country) in response to tax incentives. But that's not always the case: passive income of a controlled foreign corporation (CFC) can avoid the subpart F and GILTI rules by various mechanisms, and all income of a non-CFC evades the subpart F and GILTI regimes in the U.S. shareholder's hands.<sup>27</sup> Further, the difference between a 21% (or even 13.125%, for FDII) U.S. tax rate and a zero percent U.S. tax rate could be quite motivating.

Two important points are sometimes missing from the description of the new treatment of income earned through foreign subsidiaries. First, zero U.S. tax imposition on non-GILTI, non-subpart F amounts earned through certain foreign subsidiaries<sup>28</sup> is caused by the DRD—not by GILTI<sup>29</sup> or other new provisions. It is the DRD that affirmatively allows a 100% deduction for qualifying dividends from a foreign subsidiary.<sup>30</sup> If a foreign dividend does not qualify for the DRD, then it is subject to U.S. tax in the U.S. shareholder's hands when received or accrued.<sup>31</sup> In that case, a foreign subsidiary's non-subpart F, non-GILTI earnings would be included in the U.S. shareholder's income (and could generate U.S. tax) if and when the shareholder receives or accrues such amounts as dividends.<sup>32</sup>

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27. See I.R.C. §§ 951, 954 (2012) (providing rule for subpart F income); I.R.C. § 951A (Supp. V 2013–2018) (defining GILTI). A CFC is a “controlled foreign corporation,” meaning that U.S. shareholders (U.S. persons who each own at least 10% of the vote or value) together own more than 50% of the vote or value of such foreign corporation. See I.R.C. §§ 951(b), 957 (2012 & Supp. V 2013–2018).

28. GILTI inclusions and subpart F income are subject to tax in the U.S. shareholder's hands in the year that such income is earned by such shareholder's CFC. See I.R.C. § 951 (2012 & Supp. V 2013–2018); I.R.C. § 951A (Supp. V 2013–2018). But GILTI and subpart F inclusions are not again included in income when actually paid to the U.S. shareholder. See I.R.C. § 951A(f)(1)(A) (Supp. V 2013–2018) (cross-referencing section 959); I.R.C. § 959 (2012 & Supp. V 2013–2018) (preventing further U.S. tax when subpart F inclusions are actually paid to the U.S. shareholder).

29. See I.R.C. § 951A (Supp. V 2013–2018) (requiring inclusions of GILTI in the U.S. shareholder's income).

30. See *id.* § 245A.

31. See generally I.R.C. § 61(a) (2012) (“[G]ross income means all income from whatever source derived . . .”).

32. U.S. tax would also apply to interest, service fees, or other non-dividend payments received by the shareholder from its foreign subsidiary, because these amounts are not eligible for the DRD (which is limited to dividends). See I.R.C. § 245A (Supp. V 2013–2018). This may lead to increased pressure on arguments about which payments are dividends and which are other kinds of distributions and payments. Cf. I.R.C. § 482 (2012 & Supp. V 2013–2018) (requiring that payments between commonly controlled persons must “clearly . . . reflect the income,” which could make it harder to recast other payments as dividends).

Because of the DRD, there is no U.S. tax on non-subpart F, non-GILTI income earned through a CFC or 10/50 company *even if* such income is distributed to a U.S. shareholder.<sup>33</sup> Such tax-free income includes all amounts earned through a 10/50 company (because subpart F and GILTI can be generated only by a CFC)<sup>34</sup> if the DRD's requirements are met. Previously, active (non-subpart F) income could not be brought back to the U.S. (i.e., paid to the U.S. shareholder) without U.S. tax.<sup>35</sup> Now, because of the DRD, U.S. corporations can earn income through foreign subsidiaries without ever paying U.S. tax, if they can avoid GILTI and subpart F. Thus, the partial territoriality aspects of the new international tax system are largely due to the DRD.

Secondly, despite its importance, the DRD does not create an affirmative incentive to repatriate amounts from foreign subsidiaries. Due to the intersection of the various new international tax rules, the zero U.S. tax result applies regardless of whether the foreign subsidiary pays dividends to its U.S. shareholder or not—it does not require repatriation. There is no U.S. tax on a U.S. shareholder with respect to the non-GILTI, non-subpart F earnings<sup>36</sup> of its foreign subsidiary when the subsidiary earns such amounts in the absence of a dividend or other payment to the shareholder. That was already the case before the TCJA's new international tax rules. But before the TCJA, U.S. tax did apply to the U.S. shareholder when such previously un-taxed earnings were actually received or accrued by the U.S. shareholder.<sup>37</sup> After the TCJA, if the DRD applies,<sup>38</sup> there is no U.S. tax *regardless* of whether not such earnings are paid to the U.S. shareholder as dividends.

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33. Non-GILTI, non-subpart F amounts earned in a CFC include: (a) an amount of the CFC's tested income that equals 10% of the relevant asset bases used to generate such income; and (b) amounts described in section 952(b) or excluded under section 954(b)(4), dividends received from related persons, and foreign oil and gas extraction income. *See* I.R.C. § 951A(b)(1) (Supp. V 2013–2018) (reducing net CFC tested income by 10% of relevant adjusted bases, reduced by certain interest expense, in order to compute GILTI); *id.* § 951A(c)(2)(A)(i) (listing types of income excluded from the “tested income” that is used to determine GILTI).

34. For a 10/50 company, all income is non-GILTI, non-subpart F income. *See* I.R.C. § 951 (2012 & Supp. V 2013–2018) (subpart F income is certain income earned by a CFC); I.R.C. § 951A (Supp. V 2013–2018) (GILTI is computed based on certain income earned by a CFC).

35. *See id.* §§ 245, 246 (2012 & Supp. V 2013–2018).

36. *See id.* § 951; I.R.C. § 951A (Supp. V 2013–2018). For simplicity, this Article generally ignores the possible application of the PFIC (passive foreign investment corporation) rules, which can cause a U.S. shareholder to pay U.S. tax on certain passive-type earnings of its foreign subsidiary for the year in which the subsidiary earns such income. *See* I.R.C. §§ 1291–1298 (2012).

37. *See* I.R.C. § 61(a) (2012).

38. *See* I.R.C. § 245A (Supp. V 2013–2018).

Thus, the DRD does not provide an affirmative benefit for repatriating: U.S. tax is not lower after receipt of a foreign dividend, as compared to the same shareholder's U.S. tax before receiving the dividend.<sup>39</sup> Instead, the DRD makes receiving dividends tax-neutral from a U.S. tax perspective by eliminating the U.S. tax that would otherwise apply to foreign dividends in the U.S. shareholder's hands. If the DRD applies, then the U.S. shareholder's U.S. tax is the same with or without receipt of a foreign dividend. The DRD is necessary only if dividends are received—at which point it becomes crucial.

For example, assume that a U.S. corporation owns 100% of an Irish subsidiary, which earns \$50 million of non-subpart F, non-GILTI net profit in 2021. Assuming that the requirements for the 100% DRD are met, the U.S. shareholder will pay no U.S. tax on such \$50 million if such earnings remain outside the U.S., and no U.S. tax if such earnings are repatriated to the U.S. shareholder as a dividend. The U.S. tax is the same amount (zero) either way, with or without the dividend. Thus, the 100% DRD removes U.S. tax disincentives for paying a dividend,<sup>40</sup> but does not create an affirmative U.S. tax incentive: the U.S. shareholder is not better off, from a U.S. tax perspective, if it receives the dividend from its Irish subsidiary than if it receives no dividend. In theory, from a purely U.S. tax perspective, U.S.

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39. Taxpayers have, however, sometimes described the new 100% DRD (in combination with other rules) as creating an actual incentive to pay dividends back to the U.S. See, e.g., Mickle, *supra* note 15; Wakabayashi & Chen, *supra* note 15. However, as explained above, the DRD (and other provisions) do not tax repatriated earnings of foreign subsidiaries more lightly than non-repatriated earnings. See I.R.C. § 245A (Supp. V 2013–2018). Instead, such provisions simply do not apply U.S. tax to U.S. shareholders with respect to the non-GILTI, non-subpart F earnings of foreign subsidiaries at any time, whether repatriated or not.

40. There could still be *foreign* tax imposed on the U.S. shareholder regarding such dividend payments so that there could theoretically be a foreign tax disincentive for such dividends. Some (but not all) U.S. bilateral tax treaties drastically reduce foreign withholding rates on dividends—but not all of such treaty rates are zero. See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gain, U.K.-U.S., art. X, ¶¶ 2–3, *ratified* Mar. 7–28, 2003, T.I.A.S. NO. 13,161 (entered into force Mar. 31, 2003) [hereinafter U.K. Tax Treaty]; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Japan-U.S., art. X, ¶¶ 2–3, *ratified* Mar. 24–26, 2004, T.I.A.S. NO. 04-330 (entered into force Mar. 30, 2004) [hereinafter Japan Tax Treaty]. Nor can the foreign tax credit make the U.S. shareholder indifferent to such foreign taxes, if the DRD is applied: if the U.S. shareholder claims the DRD, it cannot claim U.S. foreign tax credits for foreign taxes on such dividends. See I.R.C. § 245A(d) (Supp. V 2013–2018); see also Rosenberg, *supra* note 3.

corporations should now be indifferent as to whether they repatriate cash from foreign subsidiaries, if the 100% DRD applies.<sup>41</sup>

However, the TCJA has also removed a countervailing incentive to pay dividends from foreign subsidiaries, in some circumstances. Under now-repealed section 902, dividends from a foreign corporation to a corporate U.S. shareholder formerly could generate foreign tax credits for such shareholder, for a portion of such subsidiary's foreign taxes.<sup>42</sup> Thus, before the TCJA, a dividend from a foreign subsidiary could actually cause a net benefit to such a U.S. shareholder, depending on the facts: the U.S. tax on the dividend could be more than offset by the accompanying foreign tax credit.<sup>43</sup> Now that section

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41. In contrast to the neutral U.S. tax effects of repatriation (the decision of whether to actually bring money back into U.S. from offshore subsidiaries) when the DRD applies, the TCJA does (arguably) create incentives about where to earn money in the first place. In many circumstances, the TCJA places a finger on the scale for earning income overseas: GILTI (subject to a 50% deduction, for an effective rate of 10.5%) plus tax-free repatriation is taxed more lightly for U.S. tax purposes than FDII (subject to an effective U.S. tax rate of 13.125%), and much more favorably than the default U.S. corporate tax rate of 21%. See I.R.C. §§ 11(b), 250, 951A (Supp. V 2013–2018); see also Kimberly A. Clauging, *Profit Shifting Before and After the Tax Cuts and Jobs Act*, SSRN, Oct. 29, 2018, <https://ssrn.com/abstract=3274827>; Jason Furman, *The 2017 Tax Law: A Boost to Growth or a Missed Opportunity?*, CAPITALISM & SOC'Y, No. 13, 2018, at 2, 14 (discussing possible impact of the TCJA provisions); Martin A. Sullivan, *Economic Analysis: Where Will the Factories Go? A Preliminary Assessment*, 158 TAX NOTES 570 (2018); Madeleine Burnette-McGrath, Note, *Reagan-Era Economic Theory in the Tax Cuts and Jobs Act: Trickle-Down Economics Through Increased International Mobility of Certain Corporate Income*, 18 FLA. ST. U. BUS. REV. 57, 69 (2019); Fleming et al., *supra* note 14. One could, however, debate the impact of 100% first-year depreciation for assets used in U.S. trades or businesses (although that depreciation percentage is lower for assets placed in service after 2022). See I.R.C. § 168(k)(1) (2012 & Supp. V 2013–2018); I.R.C. § 168(k)(6) (Supp. V 2013–2018). Further, the comparison of effective U.S. tax rates in this footnote does not consider the impact of foreign tax credits, or of (possibly non-creditable) foreign taxes, which also affect taxpayers' location decisions. See Rosenberg, *supra* note 19, at 84–94.

42. See I.R.C. § 902(a) (2012) (repealed 2017). Mechanically, this was accomplished by deeming the U.S. shareholder to pay the same percentage of such foreign corporation's foreign taxes as the percentage that the dividend bore to such foreign corporation's total post-1986 undistributed earnings. See *id.* This is a serious simplification, however. Among other details, the computations of such deemed paid amount, such foreign taxes of the foreign corporation, and such earnings and profits were done separately for each foreign tax credit "basket," and multi-year post-1986 pools of taxes and earnings were maintained (with exceptions). See I.R.C. § 902 (2012) (repealed 2017); I.R.C. § 904(d) (2012 & Supp. V 2013–2018) (as in effect before the TCJA, requiring that section 902 be applied separately for each basket). Further, section 902 credits were available only for U.S. corporations that owned at least 10% of the voting stock of the foreign dividend payor. See I.R.C. § 902(a) (2012) (repealed 2017).

43. Foreign tax credits that exceed the U.S. tax on the relevant foreign source income can generally be used to reduce U.S. tax on other foreign source income in the same "basket," and can also potentially be carried over as credits to other years, with some limitations and exceptions. See I.R.C. § 904(a) (2012) (foreign tax credit calculation); I.R.C. § 904(c) (2012 & Supp. V 2013–2018) (carryovers to other years); I.R.C. § 904(d) (applying the foreign tax credit limitation of section 904(a) separately to separate categories of income, which are colloquially called "baskets").

902 has been repealed, foreign taxes are deemed paid only with respect to GILTI or subpart F inclusions, not by reason of dividends.<sup>44</sup> This potential foreign tax credit incentive for paying dividends (entirely fact-dependent in any event) has vanished.<sup>45</sup>

Before the TCJA, the U.S. imposed tax on a U.S. shareholder's pro rata share of the subpart F income of such shareholders' CFCs in the year in which such income was earned, levying such tax directly on the U.S. shareholder.<sup>46</sup> Dividends (and other amounts received by a U.S. shareholder from its foreign subsidiary, such as service fees or interest) served as the point for collecting U.S. tax on all other income earned by U.S. shareholders through foreign corporations. DRDs were available for dividends from U.S. subsidiaries,<sup>47</sup> but DRDs for dividends from foreign corporations were essentially limited to the portion of such dividends that were already subject to U.S. tax.<sup>48</sup>

The rationale for the DRD for dividends from U.S. corporations is essentially the avoidance of more-than-double tax: once on the U.S. corporation earning the income, a second time on its corporate shareholder, a third level of U.S. tax on that shareholder's corporate shareholder, and so on.<sup>49</sup> Thus, (taking the DRD into account) the income was taxed fully at the level of the income-earning U.S. corporation, and taxed again when it finally reached a non-corporate shareholder, yielding a full two levels of tax, without the need for full U.S. tax on an intermediate corporate shareholder. For income earned through a foreign corporation, there was formerly one level of U.S. tax—on the U.S. shareholder, either at the time of a subpart F inclusion

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44. See I.R.C. § 902 (2012) (repealed 2017); I.R.C. § 960 (2012 & Supp. V 2013–2018) (deemed paid foreign taxes).

45. See *infra* Section II(A) for discussion of potential foreign tax credits for foreign taxes imposed on the dividend recipient, rather than on the foreign corporation. However, U.S. taxpayers cannot claim both the DRD and a foreign tax credit with respect to the same foreign dividend. See I.R.C. § 245A(d) (Supp. V 2013–2018) (no foreign tax credits are available regarding dividends for which the DRD is allowed).

46. See I.R.C. § 951(a) (2012 & Supp. V 2013–2018). U.S. tax could also apply, under some circumstances, to a U.S. person owning stock in a passive foreign investment company (PFIC), with respect to certain earnings of the PFIC. I.R.C. § 1293 (2012). PFICs are generally outside the scope of this Article.

47. I.R.C. § 243 (2012 & Supp. V 2013–2018). The percentage that was deductible varied, depending on the dividend recipient's ownership percentage in the dividend payor. See I.R.C. § 243(a), (c) (2012 & Supp. V 2013–2018).

48. See I.R.C. §§ 245, 246 (2012 & Supp. V 2013–2018).

49. See, e.g., STAFF OF J. COMM. ON TAXATION, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 348 (Comm. Print 2018) (“To limit multiple levels of corporate tax in the case of tiered corporate structures, corporations are allowed a dividends received deduction . . .”).

or (for non-subpart F amounts) when dividends were received. Now, if the DRD applies, there are no levels of U.S. tax on such foreign-earned income, because such DRD effectively exempts the U.S. shareholder from tax by eliminating all of the relevant foreign dividend from income.<sup>50</sup>

The new 100% DRD for foreign dividends is more generous than the DRD available for U.S. dividends, in some ways. For dividends paid from a U.S. corporation to its U.S. corporate shareholder, the shareholder's DRD is 50% of the dividend if the shareholder owns less than 20% of the payor corporation.<sup>51</sup> Such DRD increases to 65% of the dividend if the shareholder owns between 20% and 79% of the dividend payor,<sup>52</sup> and reaches 100% if the recipient corporation owns at least 80% of the U.S. payor corporation (directly or indirectly).<sup>53</sup> In contrast, a corporate U.S. shareholder only needs to own 10% or more of a foreign corporation in order to deduct 100% of a qualifying foreign dividend.<sup>54</sup> Much higher ownership percentages (80% or more) are required to claim such a high DRD for dividends from a U.S. corporation.<sup>55</sup>

The 100% DRD for foreign dividends may have some interesting side effects. First, it may change the calculus regarding choice of entity, i.e., the question of whether a U.S. shareholder obtains a better tax result by earning income through a foreign corporation or instead through a foreign flow-through entity (a partnership or disregarded entity). When a U.S. person earns foreign income through a foreign flow-through entity, all of such income is potentially subject to U.S. tax in such U.S. person's hands in the year that the income is earned

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50. See I.R.C. § 245A (Supp. V 2013–2018).

51. I.R.C. § 243(a)(1) (2012 & Supp. V 2013–2018).

52. *Id.* § 243(c).

53. *Id.* § 243(a)(3), (b).

54. See I.R.C. § 245A(a), (b) (Supp. V 2013–2018); see also I.R.C. § 951(b) (2012) (defining “United States shareholder”). There were very limited DRDs available for foreign dividends before the TCJA was enacted. Such rules essentially allowed a DRD for the portion of a foreign dividend corresponding to the portion of the payor foreign corporation's earnings that were subject to U.S. tax (for example, such earnings that were effectively connected with the conduct of a U.S. trade or business). See I.R.C. § 243(e) (2012); I.R.C. § 245 (2012 & Supp. V 2013–2018). Such rules remain in the Internal Revenue Code of 1986 (the “Code”) and can apply to the non-“foreign source portion” part of a dividend from a foreign subsidiary, i.e., to the portion that is not eligible for the new 100% DRD.

55. I.R.C. § 243(a) (2012 & Supp. V 2013–2018).

by the entity.<sup>56</sup> That income inclusion is subject to such U.S. person's usual U.S. tax rate, which is 21% for corporations.<sup>57</sup> But foreign taxes imposed on the flow-through entity's income (or on payments from such entity to its owner) can potentially be claimed by such owner as foreign tax credits, reducing U.S. tax.<sup>58</sup> In contrast, when a U.S. shareholder earns non-subpart F, non-GILTI amounts through a foreign corporation, such income is now free of U.S. tax (if the 100% DRD applies).<sup>59</sup> However, no foreign tax credits can be claimed for foreign taxes imposed on either the foreign corporation's earning of such income or the U.S. shareholder's receipt of the dividend (if the DRD is allowed).<sup>60</sup> The tax-free treatment of certain foreign source income earned through a foreign subsidiary (by reason of the DRD) may thus make foreign subsidiaries relatively more attractive than foreign flow-through entities in some circumstances, although the relative amount of foreign tax may have a big influence on a taxpayer's final choice of entity.<sup>61</sup>

Second, the new DRD may actually be unappealing in some circumstances, if the foreign tax credit is more beneficial, because U.S. shareholders cannot claim both the DRD and foreign tax credits

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56. See I.R.C. § 702(a), (c) (2012) (partners take their distributive share of a partnership's income into account for U.S. tax purposes); Treas. Reg. § 1.7701-(a)(6) (2012) (partners take into account their share of the partnership's creditable foreign taxes); Treas. Reg. § 301.7701-2(c)(2)(i) (2018) (a DE is disregarded as an entity separate from its owner). Each partner would take into account their distributive share of the partnership's income, rather than all of the partnership's income. See I.R.C. § 702(a), (c) (2012).

57. Such income is not eligible for the FDII deduction, which does not apply to "foreign branch income." See I.R.C. § 250(b)(3)(A)(i)(VI) (Supp. V 2013–2018) (excluding foreign branch income from FDII). Recent proposed regulations would define foreign branches broadly, in such a way as to include many partnership activities. Prop. Treas. Reg. § 1.904-4(f), 83 Fed. Reg. 63,200, 63,210 (Dec. 7, 2018).

58. See I.R.C. § 901 (2012 & Supp. V 2013–2018); Treas. Reg. § 1.901-2(f)(4) (2018) (foreign taxes imposed on a flow-through entity are treated as paid or accrued by its owner or owners for foreign tax credit purposes).

59. See I.R.C. § 245A (Supp. V 2013–2018) (dividends received deduction for dividends from certain foreign corporations).

60. See *id.* § 245A(d) (prohibiting foreign tax credits for foreign taxes imposed on a dividend to which the DRD is applied); I.R.C. § 960(a) (2012 & Supp. V 2013–2018); I.R.C. § 960(d) (Supp. V 2013–2018) (providing deemed paid treatment only with respect to foreign taxes related to either subpart F income or GILTI); see also Rosenberg, *supra* note 19, at 106–108 (describing ways to "build your own 902 credit" for certain foreign taxes imposed on non-subpart F, non-GILTI income).

61. See generally Leo N. Hitt, *Rethinking the Obvious: Choice of Entity After the Tax Cuts and Jobs Act*, 16 PITT. TAX REV. 67, 96–100 (2018) (discussing the impact of the TCJA on the analysis of which type of entity is preferable for tax purposes); Rosenberg, *supra* note 19, at 98–113 (discussing possible use of hybrid and reverse hybrid entities).



with respect to the same dividend.<sup>62</sup> (At issue are credits for any foreign taxes imposed on the dividend recipient, rather than foreign taxes on the payor corporation.)<sup>63</sup> The Code literally prohibits such foreign tax credits for any dividend for which the DRD is “allowed.”<sup>64</sup> However, there is an argument that if the DRD *could* apply, but the taxpayer does not claim the deduction, then the DRD is “allowable” but not “allowed,” and therefore foreign tax credits are not prevented.<sup>65</sup> The Code does provide that the DRD “shall be allowed,” if certain requirements are met.<sup>66</sup> But there is a serious argument that a DRD that is not claimed has not technically been “allowed,” and therefore does not prohibit foreign tax credits.

Congress may not have intended this result.<sup>67</sup> But a statutory change (e.g., from “allowed” to “allowable”) may be required, if

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62. I.R.C. § 245A(d) (Supp. V 2013–2018).

63. This is different from deemed payment by the U.S. shareholder of foreign taxes that are paid or accrued by the foreign corporation. Such deemed payment is now limited to foreign taxes that relate to GILTI or to subpart F amounts. *See* I.R.C. § 960(a) (2012 & Supp. V 2013–2018); I.R.C. § 960(d) (Supp. V 2013–2018). In contrast to pre-TCJA rules, such deemed payment no longer occurs with respect to dividends paid from a foreign corporation, regardless of whether a DRD is claimed or not. *See* I.R.C. § 902 (2012) (repealed 2017) (allowing, before repeal by the TCJA, deemed payment of a portion of a foreign corporation’s foreign taxes when a dividend was paid to a U.S. shareholder). Deemed payment may be allowed, in limited circumstances, upon actual payment to the U.S. shareholder of amounts previously included in income as GILTI or subpart F income. *See* I.R.C. § 960(b) (Supp. V 2013–2018).

64. I.R.C. § 245A(d)(1) (Supp. V 2013–2018).

65. The IRS has made a similar distinction between “allowed” and “allowable” in a different context, relating to the statute of limitations for changing from credits to deductions for foreign taxes. *See* I.R.S. Chief Counsel Advisory 201330031 (July 26, 2013) (reasoning that foreign tax credits that were not claimed were “allowable” but not “allowed” within the meaning of section 6511(d)(3)); I.R.S. Chief Counsel Advisory 201204008 (Jan. 27, 2012) (applying similar reasoning regarding foreign tax credits that were “allowable” but not “allowed”). The IRS could point out that foreign tax credits require an election by the taxpayer, unlike the DRD for foreign dividends. *Compare* I.R.C. § 245A(a) (Supp. V 2013–2018) (allowing DRD without requiring a taxpayer election), *with* I.R.C. § 901(a) (2012) (allowing DRD “if the taxpayer chooses to have the benefits of this subpart”).

66. I.R.C. § 245A(d)(1) (Supp. V 2013–2018) (“In the case of any dividend received from a specified 10-percent owned foreign corporation by a domestic corporation which is a United States shareholder with respect to such foreign corporation, there shall be allowed as a deduction an amount equal to the foreign-source portion of such dividend.”).

67. The Conference Report to the TCJA describes the rule as follows: “No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any portion of a distribution treated as a dividend that *qualifies* for the DRD.” H.R. REP. NO. 115-466, at 596, 598, 600 (2017) (Conf. Rep.) (emphasis added) (describing, in turn, the House Bill, the Senate Amendment, and the Conference Agreement); *see also* STAFF OF J. COMM. ON TAXATION, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 350 (Comm. Print 2018) (describing the rule as providing that “[n]o foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any dividend that qualifies for the DRD,” but giving an example in which the DRD is

Congress wants to alter taxpayers' possible current ability to choose between the DRD and foreign tax credits (subject to the DRD's and foreign tax credit's requirements, of course). Furthermore, the resulting choice between the DRD and any applicable foreign tax credits—if valid—appears to be available separately for each dividend. The statutory language does not appear to mandate that taxpayers choose the same tax benefit (DRD or instead foreign tax credits) for all qualifying foreign dividends, or for each taxable year.<sup>68</sup>

Whether the foreign tax credit is more valuable than the DRD depends on the amount of the foreign tax and the U.S. shareholder's ability to use excess foreign taxes to offset U.S. tax on other income, either for the current year or for possible carryover years.<sup>69</sup> The ability to use excess foreign taxes depends, in turn, on the foreign tax credit limitation fraction in the relevant basket<sup>70</sup> and the shareholder's total

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actually claimed). That phrasing makes it sound as if Congress intended to disallow foreign tax credits with respect to any dividend for which the new DRD is allowable, regardless of whether the shareholder actually claims such DRD. In other words, the Conference Report description does not sound as if the U.S. shareholder can choose between the foreign tax credit and the DRD. But the statutory language is more authoritative than the legislative history. *See, e.g.,* *Milner v. Dep't of the Navy*, 562 U.S. 562, 572 (2011) (declining the approach of “allowing ambiguous legislative history to muddy clear statutory language”); *Arlington Cent. Sch. Dist. Bd. of Educ. v. Murphy*, 548 U.S. 291, 304 (2006) (no need to follow legislative history's description if legislative language is unambiguous); *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 508–09 (1989) (examining whether legislation was “ambiguous” before looking to legislative history). The Code language clearly says “allowed.” I.R.C. § 245A(d)(1) (Supp. V 2013–2018). In addition, Congress used the term “allowable” in the next subparagraph, indicating that it recognized the difference between “allowed” and “allowable.” *See id.* § 245A(d)(2) (“No deduction shall be allowed under this chapter for any tax for which credit is not *allowable* under section 901 by reason of paragraph (1) (determined by treating the taxpayer as having elected the benefits of subpart A of part III of subchapter N).” (emphasis added)).

68. *See* I.R.C. § 245A(d) (Supp. V 2013–2018). In contrast, taxpayers must choose either deductions or credits for all of their foreign taxes for the same year, with limited exceptions. *Compare* I.R.C. § 275(a)(4) (2012 & Supp. V 2013–2018) (taxpayers cannot claim deductions for foreign taxes if they also claim foreign tax credits for the same taxable year), *with* I.R.C. § 901(k)(7) (Supp. V 2013–2018) (certain foreign taxes allowed as deductions even if the taxpayer claims credits for other foreign taxes), I.R.C. § 901(l)(4) (2012) (same), *and* I.R.C. § 901(m)(6) (2012 & Supp. V 2013–2018) (same).

69. *See generally* I.R.C. § 901 (2012 & Supp. V 2013–2018) (allowing credit for foreign taxes); I.R.C. § 904(a) (2012) (foreign tax credit limitation); I.R.C. § 904(c) (2012 & Supp. V 2013–2018) (carryover of excess foreign taxes); I.R.C. § 904(d) (basketing rules).

70. *See* I.R.C. § 904(a) (2012) (limiting foreign tax credit to the lesser of foreign tax or the product of U.S. tax times the limitation fraction); I.R.C. § 904(d) (2012 & Supp. V 2013–2018) (applying section 904(a) separately to each basket). The foreign-source portion of dividends to a U.S. corporation that is at least a 10% shareholder of the dividend-paying foreign corporation is not included in the numerator or denominator of the foreign tax credit limitation fraction. I.R.C. § 904(b)(4) (Supp. V 2013–2018). Under the statutory language, this result apparently applies

pre-credit U.S. tax for both the current year and potential carryover years.<sup>71</sup> U.S. shareholders could potentially claim the DRD for low-foreign-taxed dividends and foreign tax credits for foreign taxes on higher-taxed foreign dividends, even in the same year.<sup>72</sup>

The DRD should be more beneficial than foreign tax credits (for the foreign taxes imposed on a dividend) if such foreign taxes are imposed at an effective rate of less than 21%.<sup>73</sup> Each dollar of DRD effectively reduces U.S. tax by 21 cents, and the new DRD should exactly ameliorate the U.S. tax on the relevant foreign dividend by removing such dividend from taxable income. In contrast, every dollar of foreign tax credit reduces U.S. tax by one dollar. Therefore, the DRD is more valuable than the foreign tax credit if foreign taxes are less than 21% of the dividend. In that case, such credits yield less than the 21% (times the amount of the dividend) U.S. tax reduction generated by the 100% DRD. For example, assume that a foreign subsidiary pays a dividend of \$100,000 to its U.S. shareholder, and that such dividend is subject to \$5,000 of foreign tax (i.e., foreign tax of 5%). The DRD (if available) will completely eliminate the U.S. tax on the foreign dividend (by allowing deduction of the entire dividend). But the foreign tax credit will only offset a maximum of \$5,000 of U.S. tax, leaving \$16,000 of residual U.S. tax on the dividend (U.S.

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regardless of whether the shareholder claims the available DRD or not. (The heading of section 904(b)(4) reads “Treatment of Dividends for which Deduction is Allowed under section 245A,” but the text of section 904(b) does not contain either the word “allowed” or “allowable.” See *id.*) Therefore, in order to use foreign tax credits, a taxpayer would need *other* foreign source income in the relevant foreign tax credit basket, in order to successfully apply the foreign tax credit limitation fraction. See I.R.C. § 904(a) (2012) (foreign tax credit limitation fraction); I.R.C. § 904(d) (2012 & Supp. V 2013–2018) (applying limitation fraction separately to each basket). However, the regulations on removing foreign dividends from the foreign tax credit limitation fraction refer to “any dividend for which a deduction is allowed under section 245A.” Treas. Reg. § 1.904(b)-3(a)(1)(i) (2019). Thus, the regulatory language specifically uses the word “allowed,” and also is not limited to the foreign source portion of the dividend, unlike the statutory language. Compare *id.* with I.R.C. § 904(b)(4) (Supp. V 2013–2018).

71. Excess foreign taxes can be carried back one year and then forward ten years, in that order. See I.R.C. § 904(c) (2012 & Supp. V 2013–2018).

72. Perhaps a statutory amendment is worth considering, to require that each year, with respect to dividends for which the DRD is allowable, U.S. shareholders must choose either the DRD or foreign tax credits, without the ability to claim credits for foreign taxes on some of such dividends and the DRD for other such dividends. A more severe approach could provide that foreign tax credits are not available for foreign taxes on any dividend for which the DRD is “allowable” (rather than the current term “allowed”). See I.R.C. § 245A(d) (Supp. V 2013–2018) (referring to dividends for which the DRD is “allowed”).

73. The example in the text assumes that such foreign taxes are creditable, under all of the U.S. foreign tax credit rules. See *generally* Treas. Reg. § 1.901-2 (2018) (providing rules regarding creditability of foreign taxes).

tax of 21%, or \$21,000, less the credit of \$5,000). In that case, the DRD is the better choice for the U.S. shareholder.

However, the foreign tax credit should generally be more valuable than the DRD if the effective foreign tax rate on the U.S. shareholder's receipt of a dividend is more than 21% (and if the shareholder can use the excess foreign tax credits). For example, assume that the foreign tax on the \$100,000 dividend described above is \$30,000 (i.e., 30%). The DRD would completely eliminate the U.S. tax on the dividend (by entirely removing such dividend from U.S. taxable income). But the foreign tax credit would not only offset the entire \$21,000 U.S. tax on such dividend, but would also create \$9,000 of potentially usable excess foreign tax credits, which could reduce the U.S. tax on unrelated foreign source income.<sup>74</sup> Thus, the foreign tax credit can create a better result than mere tax-free treatment for the dividend, and can yield an affirmative benefit by actually reducing U.S. tax (rather than just leaving the shareholder in a tax-neutral position for U.S. purposes). In these circumstances, the foreign tax credit is the better choice, if the U.S. shareholder has sufficient limitation in the appropriate basket and can use the excess credits. Foreign tax credits (if sufficient limitation exists) are no worse than the DRD's U.S. tax result, even if such excess credits cannot be used. In circumstances like this, where the DRD's benefits are outweighed by the resulting inability to claim foreign tax credits, U.S. shareholders may be carefully considering whether or not to claim the DRD and for which foreign dividends.

### *B. Major Restrictions on the Applicability of the DRD*

In all of the discussion of the supposedly territorial new system, and the DRD's significant impact, and even in the above analysis of the possible downsides of claiming a DRD (if the foreign tax credit is more beneficial), taxpayers also need to remember the severe restrictions on the DRD's availability. There may be many circumstances in which the new DRD for foreign dividends simply does not apply. The new 100% DRD, and its effect of U.S. tax exemption for a foreign subsidiary's non-GILTI, non-subpart F earnings, are available only if all of the following facts are present.

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74. This is somewhat of an oversimplification. For example, the excess foreign taxes could only offset U.S. tax on other foreign source income in the same foreign tax credit "basket." See I.R.C. § 904(a), (d) (2012).

First, the U.S. shareholder must be a corporation, not an individual.<sup>75</sup> Second, the shareholder must own at least 10% of the dividend-paying foreign corporation. Corporate shareholders that own less than 10% get no DRD for dividends from a foreign subsidiary, and pay full U.S. tax on foreign dividends received (absent one of the very limited DRDs for foreign dividends that are paid from earnings already taxed by the U.S.).<sup>76</sup> For example, a U.S. corporation that owns 8% of a large European corporation gets no benefit from the DRD, and pays full U.S. tax on dividends received from such foreign corporation. Third, the DRD obviously applies only to dividends—not to interest, rent, royalties, or payments for goods and services, even if such non-dividend amounts are paid from a foreign subsidiary to its U.S. shareholder. Corporate U.S. shareholders thus may often want to characterize payments from their foreign subsidiaries as dividends, and the IRS may sometimes push back, arguing for non-dividend characterization.

Lastly, and perhaps most surprisingly, the DRD has a very long holding period requirement: it is only available for U.S. shareholders who have held the dividend-paying foreign stock for more than 365 days within a specified period, of which the middle day is the ex-dividend date.<sup>77</sup> That is not a typo: the U.S. shareholder must hold the foreign corporation's stock for more than a year.<sup>78</sup> A U.S. shareholder who holds a foreign corporation's stock for only six months, for example, is not eligible for the DRD for dividends from such foreign corporation, and pays the full U.S. tax rate on any such dividends.<sup>79</sup>

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75. See I.R.C. § 245A (Supp. V 2013–2018). However, a lower-than-usual U.S. tax rate applies to foreign dividends received by individuals, if the dividend-paying corporation is a resident of a foreign country with a qualifying tax treaty and if a holding period is met. See I.R.C. § 1(h)(11) (2012 & Supp. V 2013–2018).

76. See I.R.C. §§ 245, 246 (2012 & Supp. V 2013–2018).

77. See I.R.C. § 246(c)(5) (2012). More specifically, the holding period must consist of more than 365 days within the 731-day period of which the middle day is the ex-dividend date. See I.R.C. § 246(c)(1) (2012 & Supp. V 2013–2018); I.R.C. § 246(c)(5) (2012).

78. I.R.C. § 246(c)(5) (2012). Also, the Code requires *more than* 365 days. Thus, 366 days is sufficient, but exactly 365 days is not. See I.R.C. § 246(c)(1) (2012 & Supp. V 2013–2018); I.R.C. § 246(c)(5) (2012).

79. Because the required more-than-365-day period can include dates after the dividend payment date, the U.S. shareholder might not be sure, at the time the dividend is paid, of whether the holding period will be met. See I.R.C. § 246(c)(1) (2012 & Supp. V 2013–2018); I.R.C. § 246(c)(5) (2012). This 100% DRD is also not available for hybrid dividends. See I.R.C. § 245A(e) (Supp. V 2013–2018).

One can easily imagine many circumstances in which, for valid non-tax business reasons, a U.S. shareholder owns a foreign corporation's stock for less than a year within the required period. For example, perhaps the foreign corporation's product loses market share, or the U.S. shareholder needs cash for other ventures, or new regulatory requirements no longer allow the U.S. shareholder to hold such stock or to invest in the foreign corporation's type of product. But there are no business purpose, good faith, reasonable expectation, or unexpected circumstance exceptions to the holding period requirement.<sup>80</sup>

There is no obvious reason for such a long holding period—a holding period might well be justified, but why is the holding period 366 days? The holding periods for other DRDs (e.g., for dividends from U.S. corporations, or for certain U.S.-taxed portions of foreign dividends) are much shorter: to qualify for such other DRDs, the shareholder must hold the dividend-paying stock for more than forty-five days during the ninety-one-day period of which the ex-dividend date is the middle date, or (for preferred stock) ninety days during the 181-day period of which the ex-dividend date is the middle day.<sup>81</sup> Is there a policy reason for encouraging U.S. corporate shareholders to hold foreign stock for more than a year? The more-than-twelve-month holding period matches the holding period for long term capital gains, but the policy reasons for the latter do not seem to apply to the new DRD for foreign dividends. Such a long holding period, with such serious consequences<sup>82</sup> for losing the DRD (which is the difference

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80. See I.R.C. § 246(c)(1) (2012 & Supp. V 2013–2018); I.R.C. § 246(c)(5) (Supp. V 2013–2018).

81. See I.R.C. § 246(c)(1) (2012 & Supp. V 2013–2018); I.R.C. § 246(c)(2) (2012); *cf.* I.R.C. § 901(k) (2012 & Supp. V 2013–2018) (with respect to gross basis foreign taxes imposed on dividends, the foreign tax credit requires a holding period of more than forty-five days for most dividends, and more than ninety days for dividends from preferred stock). The same more-than-forty-five-day holding period is required in order to obtain the lower tax rate that can apply to dividends received by individuals (but not by corporations). See I.R.C. § 1(h)(11) (2012 & Supp. V 2013–2018) (cross-referencing section 246's holding periods). However, a more-than-twelve-month holding period applies, in effect, as a condition of the lower tax rates applicable to capital gains earned by individuals. See I.R.C. § 1(h) (2012 & Supp. V 2018) (requiring twelve-month holding period, incorporated through the use of the defined term “net capital gain”); *see also* § 1222(11) (defining net capital gain). Overall, the more-than-one-year holding period for the new 100% DRD for foreign dividends is longer (by far) than the holding periods for other DRDs in the Code, although it matches the holding period for long term capital gains. See I.R.C. § 246(c)(5) (Supp. V 2013–2018); I.R.C. § 1222(3) (2012).

82. This is a “cliff effect”: not a graduated or pro rata loss of the tax benefit, but a complete loss of the DRD if the U.S. shareholder fails the holding period.

between full U.S. tax and full U.S. tax exemption, for non-GILTI, non-subpart F amounts) may change the incentives for U.S. shareholders: even if business requirements would otherwise lead them to sell their stock in a foreign corporation, they may decide to keep the stock for at least the required over-365-day period.<sup>83</sup>

The DRD may thus indirectly favor larger over smaller U.S. corporations because the latter may find it more necessary to sell foreign stock in order to obtain funds, and the former may have more resources and better ability to hold onto such investments long enough to obtain tax-free dividend treatment. These holding periods,<sup>84</sup> and other restrictions, make it harder for the DRD to apply, perhaps encouraging U.S. shareholders who do not qualify for the DRD to leave foreign subsidiaries' earnings abroad rather than receiving dividends. This, in turn, works against the TCJA's stated goals of encouraging repatriation of funds from foreign subsidiaries to their U.S. shareholders, in order to increase the use of such funds in U.S. production and other U.S. spending.<sup>85</sup>

### C. Summary

In summary, the 100% DRD has a huge impact on enabling zero U.S. tax of certain income (non-GILTI and non-subpart F income of CFCs, and all income of 10/50 companies) earned through foreign subsidiaries—when it applies. It is the biggest single driver of the so-called territorial tax system, because it completely exempts from U.S. tax the non-GILTI, non-subpart F amounts that U.S. shareholders receive from certain foreign subsidiaries (after those amounts have also escaped U.S. tax when earned). Previously, permanent tax-free treatment could only be achieved by leaving funds offshore, but now the non-subpart F, non-GILTI earned through a CFC or 10/50

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83. Technically, a U.S. shareholder's selling of foreign stock could prevent the DRD from applying to past dividends paid on such stock because the required holding period is more than 365 days of the 731-day period of which the ex-dividend date is the middle date. *See id.* For example, assume that a U.S. shareholder receives a foreign dividend for which the ex-dividend date is June 1, 2020. The U.S. shareholder could not apply the 100% DRD unless it held the foreign stock for more than 365 days in the period that begins 365 days before and ends 365 days after June 1, 2020. Thus, selling the stock in October 2020 could affect the ability to claim the DRD for the previous dividend of June 2020, depending on when the U.S. shareholder purchased the stock.

84. Options can prevent a time period from counting towards a required holding period, *see* I.R.C. § 246(c)(4) (2012), but there may be other substance-over-form issues regarding ownership, as compared to leasing or other non-ownership arrangements.

85. *See Harms, supra* note 2, at 235.

company can reach the U.S. tax free. The DRD also makes shareholders indifferent (for U.S. tax purposes) as to whether their foreign subsidiaries' earnings are repatriated or not, if it applies. But the DRD does not affirmatively make U.S. shareholders better off, from a tax perspective, when repatriation occurs—it just ensures (if it is available) that U.S. tax is the same with or without repatriation.

However, the DRD also has very serious limitations and requirements: notably, it does not apply for individual shareholders or shareholders that own less than 10%, and requires a more-than-365-day holding period.<sup>86</sup> When the DRD does *not* apply, the consequences are drastic: the results in that case are far different from territoriality. Instead, without the 100% DRD, U.S. tax is imposed on non-subpart F, non-GILTI amounts earned through foreign subsidiaries at full U.S. tax rates, but only if such amounts are repatriated. This potentially creates disincentives for such repatriation. The Code also contains other, pre-TCJA-enacted DRDs for foreign dividends, but these are so restricted as to be of little help—they are effectively limited to the portions of such dividends that are already subject to the U.S. tax.<sup>87</sup>

### III. IT'S NOT A TERRITORIAL SYSTEM

The newly revised U.S. international tax system has sometimes been described as territorial, or at least as intending to create such a tax system.<sup>88</sup> A territorial tax generally means a national tax system

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86. Perhaps it would make more sense, from a policy perspective, to allow exceptions from the holding period for unexpected business exigencies. In such cases, a pro rata portion of the DRD could be allowed, based on the ratio of the U.S. shareholder's holding period to 366 days. Such changes would require a statutory amendment because the Code requirements for the 100% DRD are clear. *See* I.R.C. § 246(c)(5) (Supp. V 2013–2018). A similar approach applies in the far different context of the exclusion of capital gains from the sale of personal residences: the required two-year period is waived, and the exclusion is prorated if certain sympathetic fact patterns exist. *See* I.R.C. § 121(c) (2012). This is far from the dividend fact pattern, but it provides an example of prorating a tax benefit when a taxpayer fails to meet a required time period due to compelling, listed, non-tax reasons. (These fact patterns essentially show a good reason why the taxpayer failed to use the property as a principal residence for the required period, e.g., health reasons or job loss). *See id.*

87. *See* I.R.C. §§ 245, 246 (2012 & Supp. V 2013–2018).

88. *See, e.g.,* Harms, *supra* note 2, at 235 (describing the new international tax rules as creating a territorial system). *But see* Nathan Boidman, *The U.S.'s Illusionary Turn to Territoriality*, 89 TAX NOTES INT'L 619, 619 (2018) (“The new system . . . could fairly be called a variable worldwide system, but certainly not a territorial worldwide system.”); Boidman, *supra* note 8, at 995; Fleming et al., *supra* note 14, at 1184–85 (arguing that the TCJA's outbound international tax provisions



that levies tax only on income earned with the taxing country's borders, not on income earned by its residents in foreign jurisdictions.<sup>89</sup> That is not, by any means, what the new U.S. international tax system accomplishes. The new U.S. tax rules do not exempt all income that U.S. persons earn outside of the U.S., although they do lower the U.S. tax rates on some of such income, and some (but not all) categories of such foreign-earned income are now free from U.S. tax.

Essentially, through a tangled web of interwoven rules, the new U.S. international system requires the following: U.S. individuals<sup>90</sup> and U.S. corporations<sup>91</sup> are still subject to U.S. tax on all income that they earn directly (i.e., not through a subsidiary corporation), regardless of whether it is earned in the U.S. or abroad.<sup>92</sup> Also, income earned by a U.S. individual or U.S. corporation through a disregarded entity (DE), a branch, or a partnership is still subject to U.S. tax no matter where such income is earned.<sup>93</sup> However, a U.S. corporation's income from selling products to foreign persons for use abroad, and its income from services performed abroad or with respect to foreign property, is taxed (broadly speaking) at a lower U.S. effective rate of 13.125%, compared to the usual 21% corporate tax rate. This is accomplished through the new FDII rules.<sup>94</sup>

The TCJA's new lower or zero U.S. tax rates on foreign-earned income relate almost entirely to the tax imposed on U.S.

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create a blended outcome which is neither purely territorial nor purely a worldwide tax system); Shaviro, *supra* note 3, at 171 (quibbling with distinctions between territorial and other labels for various tax systems and arguing that the new post-TCJA system is not territorial but hybrid, as are most national tax systems).

89. See Kamin et al., *supra* note 1 at 1495 & n.209; see also *supra* note 2.

90. For this purpose, a U.S. individual means an individual who is a citizen or resident of the U.S. See I.R.C. § 7701(a)(30) (2012) (defining the term "United States person" as including "a citizen or resident of the United States").

91. See generally *id.* § 61(a) (gross income defined).

92. See generally *id.* (gross income defined); Kamin et al., *supra* note 1, at 1495–96 (the new U.S. tax rules do not create a territorial system because "smaller corporate shareholders and individuals are still subject to taxation on their foreign income").

93. See generally I.R.C. § 61 (2012) (gross income defined).

94. This lower effective rate is achieved by means of a 37.5% deduction for FDII (foreign derived intangible income). See I.R.C. § 250(a)(1)(B) (Supp. V 2013–2018). The description in the text is a simplification. The amount deductible under the FDII rules is computed under a formula, which includes a reduction for a percentage of relevant tangible assets' bases. See *id.* § 250(b)(2)(A).

shareholders<sup>95</sup> with respect to certain income earned by such shareholders' foreign subsidiaries.<sup>96</sup> But while some of such income (non-subpart F and non-GILTI of CFCs, and all income of 10/50 companies, unless the DRD is inapplicable) is now free from U.S. tax, U.S. tax does apply to some other types of income earned through foreign subsidiaries. For example, U.S. shareholders owe U.S. tax on the subpart F income and GILTI earned by their CFCs.<sup>97</sup> The subpart F rules were already in the Code,<sup>98</sup> but the GILTI regime<sup>99</sup> is new. The TCJA also required a one-time deemed repatriation of certain CFC and 10/50 company earnings at the end of 2017, resulting in U.S. tax imposed on the U.S. shareholders of such corporations.<sup>100</sup> The U.S. tax on such deemed repatriation applies at an effective rate of 8% or

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95. For these purposes, the term "United States shareholder" means a U.S. person who owns at least 10% of the vote or value of a foreign corporation. *See* I.R.C. § 951(b) (2012). This is a slightly more expansive definition than prior law, which defined U.S. shareholders as U.S. persons who owned at least 10% of the vote (rather than the value) of a foreign corporation. *Compare* § 951(b) (2012), *with* § 951(b) (Supp. V 2013–2018). For brevity and convenience, this Article uses the term "U.S. shareholder" rather than the Code-defined term of "United States shareholder."

96. *See, e.g.*, I.R.C. § 951A (Supp. V 2013–2018) ("GILTI"); *id.* § 245A ("DRD"). FDII is an exception: the FDII deduction applies to certain foreign sales and services income earned directly by a U.S. corporation (not through a foreign branch or subsidiary). *See* I.R.C. § 250 (Supp. V 2013–2018) (allowing a deduction for FDII).

97. *See* I.R.C. § 951 (2012 & Supp. V 2013–2018); I.R.C. § 951A (Supp. V 2013–2018). As mentioned above, this Article generally ignores the PFIC rules (which can also cause immediate U.S. tax of the U.S. shareholder on its foreign subsidiaries' earnings under some circumstances) in the interest of simplicity. *See* I.R.C. §§ 1291–1298 (2012).

98. *See* I.R.C. §§ 951–959 (2012 & Supp. V 2013–2018). *See generally* Nir Fishbien, *From Switzerland with Love: Surrey's Papers and the Original Intent(s) of Subpart-F*, 38 VA. TAX REV. 1, 57–58 (2018) (discussing the policies behind subpart F); Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation After the Check-the-Box Regulations*, 7 FLA. TAX REV. 185, 186–194 (2005) (discussing the history of subpart F).

99. *See* I.R.C. § 951A (Supp. V 2013–2018). The IRS explained:

[The TCJA] established a participation exemption system for the taxation of certain foreign income by allowing a domestic corporation a 100 percent dividends received deduction for the foreign-source portion of a dividend received from a specified 10 percent-owned foreign corporation. *See* section 14101(a) of the Act and section 245A. The Act's legislative history expresses concern that the new participation exemption could heighten the incentive to shift profits to low-tax foreign jurisdictions or tax havens absent base erosion protections. . . . For example, without appropriate limits, domestic corporations might be incentivized to shift income to low-taxed foreign affiliates, and the income could potentially be distributed back to domestic corporate shareholders without the imposition of any U.S. tax. . . . To prevent base erosion, the Act retained the subpart F regime and enacted section 951A.

Guidance Under Section 958 (Rules for Determining Stock Ownership) and Section 951A (Global Intangible Low-Taxed Income), 84 Fed. Reg. 29,114 (proposed June 21, 2019) (to be codified at 26 C.F.R. pt. 1) (preamble to proposed regulations on GILTI).

100. *See* I.R.C. § 965(a), (d), (e) (2012 & Supp. V 2013–2018).

15.5% (depending on the U.S. shareholder’s “aggregate cash position”), and is payable over eight years.<sup>101</sup> Further, the income of a foreign corporation that has no 10% U.S. corporate shareholders is not taxable to its shareholders who are U.S. persons—but neither does the new DRD apply when such earnings are repatriated.<sup>102</sup> Thus, dividends from a foreign corporation other than a CFC or a 10/50 company are subject to U.S. tax when received by a U.S. person. Similarly, U.S. tax applies to dividends that fail to meet any other requirements of the DRD, for example, the holding period or the 10% ownership requirement,<sup>103</sup> and to non-dividend payments (such as rents or service payments) from a foreign corporation to its shareholders who are U.S. persons.

Other than these rules (subpart F, GILTI, one-time deemed repatriation, or inapplicability of the DRD), and the pre-existing PFIC regime,<sup>104</sup> the U.S. no longer taxes U.S. shareholders on the earnings of their foreign subsidiaries—even when those earnings are paid as dividends (if the DRD applies). Thus, most income earned through a 10/50 company is now exempt from U.S. tax<sup>105</sup> because the subpart F and GILTI rules apply only to income earned through a CFC.<sup>106</sup> But in situations in which the DRD does *not* apply (for example because the U.S. shareholder is an individual, the DRD’s holding period is not met, or the payment from the foreign corporation is not a dividend), then the U.S. imposes tax on repatriated earnings (i.e., dividends and other payments from foreign subsidiaries) in the hands of the U.S. shareholder, and the system is clearly not territorial. Also, the GILTI, subpart F, and PFIC rules depart from territoriality. Thus, the new U.S. international rules resemble a territorial system only for certain types of U.S. shareholders, only for certain kinds of income earned through

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101. *See id.*

102. *See* I.R.C. § 245A(b) (Supp. V 2013–2018) (defining “specified 10-percent owned foreign corporation”); I.R.C. § 951(b) (2012) (defining “United States shareholder”).

103. *See* I.R.C. §§ 245A(b), 246(c)(5) (Supp. V 2013–2018).

104. *See* I.R.C. §§ 1291–1298 (2012).

105. *See* I.R.C. § 245A (Supp. V 2013–2018) (allowing the 100% DRD for certain foreign dividends). *See generally* Rosenberg, *supra* note 19, at 91, 115–119 (discussing U.S. tax consequences for income earned through a 10/50 company). Income earned through a 10/50 company is only subject to U.S. tax if the DRD fails to apply when such amounts are distributed to a U.S. owner, for example, if the shareholder is an individual, owns less than 10% of the corporation, or does not meet the holding period.

106. *See* I.R.C. § 951 (2012 & Supp. V 2013–2018); I.R.C. § 951A (Supp. V 2013–2018). The PFIC rules, in contrast, do not apply to U.S. shareholders of CFCs. *See* I.R.C. § 1297(d) (2012). *See generally* I.R.C. §§ 1291–1298 (providing rules for the PFIC regime).

foreign subsidiaries, and only if the DRD applies—hardly a real territorial approach. All of these points are discussed further below.

U.S. shareholders are still taxed on limited types of income earned through foreign corporations in the taxable year in which such income is earned, regardless of whether such income is distributed to the shareholders. First, “subpart F” (often passive)<sup>107</sup> income of a CFC<sup>108</sup> is included in such U.S. shareholders’ income for the year in which the CFC earns such subpart F amounts.<sup>109</sup> U.S. tax on the U.S. shareholder’s pro rata share of such subpart F income (earned by the CFC) applies at the U.S. shareholders’ normal U.S. tax rates and does not depend on the subpart F income being actually distributed to such shareholders.<sup>110</sup>

The Tax Cuts and Jobs Act also creates a newly defined category of CFC income: GILTI, or global intangible low-taxed income.<sup>111</sup> GILTI is computed on an aggregate basis, taking into account the relevant amounts from all of a U.S. shareholder’s CFCs.<sup>112</sup> GILTI essentially equals the U.S. shareholder’s pro rata portion of all of such CFCs’ aggregate net income (other than subpart F income and certain other exclusions) reduced by 10% of the shareholder’s pro rata share of the adjusted bases of such CFCs’ qualifying tangible assets.<sup>113</sup> Technically, each U.S. shareholder includes its pro rata share of GILTI in income for U.S. tax purposes.<sup>114</sup> GILTI is therefore taxed currently to U.S. shareholders, regardless of whether it is distributed to such

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107. Subpart F income is often thought of as passive because it includes foreign personal holding company income (FPHCI) that consists of interest, rents, dividends, royalties, and other passive types of income (if no exceptions apply). *See* I.R.C. §§ 952(a), 954(a), (c) (2012 & Supp. V 2013–2018). However, subpart F income also includes certain sales and services income, which can include active income. *See* I.R.C. §§ 952(a), 954(d), (e) (2012 & Supp. V 2013–2018). *See generally* Fishbien, *supra* note 98, at 57–58 (discussing the policies behind subpart F); Lokken, *supra* note 98, at 186–194.

108. *See* I.R.C. § 957 (2012 & Supp. V 2013–2018).

109. *See id.* § 951(a).

110. *See id.*

111. *See* I.R.C. § 951A (Supp. V 2013–2018).

112. *See id.* *See generally* Rosenberg, *supra* note 3 (describing the GILTI computation).

113. *See* I.R.C. § 951A(b)(2) (Supp. V 2013–2018). Technically, the amount of such relevant bases is reduced by the amount of certain interest expense, *see id.* § 951A(b)(2)(B), but this Article generally assumes that such interest expense is zero, for purposes of brevity and simplicity.

114. *See* I.R.C. § 951A (Supp. V 2013–2018).

shareholders or not.<sup>115</sup> The GILTI rules<sup>116</sup> actually result in *more* current U.S. tax of active income earned through CFCs (in the year that such income is earned by the CFC, without regard to distributions), compared to the situation before the TCJA.

However, U.S. shareholders who are corporations can deduct 50% of their GILTI inclusions, reducing the effective U.S. tax rate on GILTI (in such U.S. shareholders' hands) to 10.5% (half of the usual 21% corporate tax rate).<sup>117</sup> U.S. shareholders who are individuals pay the full U.S. tax rate on GILTI, unless they elect under section 962 to pay corporate tax rates on GILTI and subpart F inclusions.<sup>118</sup> Individuals who make such an election can also claim the 50% deduction for GILTI,<sup>119</sup> achieving a 10.5% effective rate for such income (the same effective rate that applies for corporate U.S. shareholders). When GILTI is actually paid to a U.S. shareholder, it is not subject to additional U.S. tax.<sup>120</sup> GILTI is thus newly taxable to U.S. shareholders when earned by such shareholders' CFCs, but bears a relatively low rate of U.S. tax, and is not taxed again when distributed to such U.S. shareholders.

In contrast, U.S. shareholders are not subject to U.S. tax on a foreign subsidiary's non-GILTI, non-subpart F, non-PFIC income

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115. See *id.* See generally N.Y. STATE BAR ASS'N TAX SECTION, REP. NO. 1394, REPORT ON THE GILTI PROVISIONS OF THE CODE 15–17 (2018) (discussing GILTI rules); Lee A. Sheppard, *GILTI as Charged*, 90 TAX NOTES INT'L 719, 724 (2018) (discussing GILTI).

116. See I.R.C. § 951A (Supp. V 2013–2018). See generally Rosenberg, *supra* note 3 (discussing the impact of the GILTI rules).

117. See I.R.C. § 250 (Supp. V 2013–2018). Limited foreign tax credits (which can reduce U.S. tax by the amount of foreign taxes paid or accrued) are also allowed to such corporate U.S. shareholders, for a portion of the foreign taxes of certain CFCs that affected the GILTI inclusion. See *id.* § 960(d). Such foreign tax credits are also available for individuals who make an election under section 962. I.R.C. § 962 (2012 & Supp. V 2013–2018).

118. See I.R.C. § 250 (Supp. V 2013–2018); I.R.C. § 962 (2012 & Supp. V 2013–2018). See generally Robert Goulder, *Beware of GILTI Self-Help: What Smith Tells Us About the Section 962 Election*, 92 TAX NOTES INT'L 943, 943 (2018) [hereinafter Goulder, *Beware of GILTI Self-Help*] (discussing section 962 elections); Robert Goulder, *Everything Old Is New Again: The Section 962 Election*, 89 TAX NOTES INT'L 771, 773 (2018) [hereinafter Goulder, *Everything Old Is New Again*] (discussing section 962); Rosenberg, *supra* note 3 (discussing section 962 elections).

119. The allowance of the 50% deduction for individuals who make a section 962 election is provided under recent proposed regulations, rather than being directly described in the statute. See I.R.C. § 962(a) (2012 & Supp. V 2013–2018); Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3), 84 Fed. Reg. 8,188, 8,229 (Mar. 6, 2019).

120. This is accomplished by treating the GILTI inclusion as a subpart F inclusion for purposes of the PTI (previously taxed income) rules. I.R.C. § 951A(f)(1)(A) (Supp. V 2013–2018). Such rules exempt the previously taxed subpart F (and, by cross-reference from section 951A, GILTI) amounts from additional U.S. tax, when such PTI is actually paid to the U.S. shareholder. See I.R.C. § 959(a) (2012).

when such income is earned by the foreign corporation (and not distributed).<sup>121</sup> This lack of current (when the income is earned by the foreign corporation) U.S. tax applies to all income earned by any non-CFC foreign subsidiary, i.e., any foreign corporation in which U.S. shareholders do not own more than 50%.<sup>122</sup> The absence of current U.S. tax for income earned through non-CFCs is consistent with prior law, as in effect before the TCJA.

The net effect of all of the above rules is that income earned through a foreign subsidiary is taxed to the U.S. shareholder—for the year in which earned by the foreign corporation—at full U.S. rates if such income is subpart F income and at a 10.5% effective U.S. tax rate (for corporate U.S. shareholders) if such income is GILTI, but is not taxed currently to the U.S. shareholder if such income is neither subpart F nor GILTI.<sup>123</sup> Such zero percent taxed income includes all income earned through a 10/50 company. When paid to the U.S. shareholder, amounts previously included in income under the subpart F or GILTI rules are not subject to additional U.S. tax.<sup>124</sup> Neither are dividends from non-subpart F, non-GILTI amounts—if the DRD’s requirements are met—even though such amounts have not previously been included in the shareholder’s income.<sup>125</sup>

Thus, the U.S. still taxes subpart F income, as well as foreign source income earned by a U.S. person either directly or through a pass-through entity, at full U.S. rates<sup>126</sup> (except for FDII earned directly by a U.S. corporation).<sup>127</sup> In addition, the U.S. now taxes

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121. The PFIC (passive foreign investment corporation) rules are an exception and can provide for current taxation on certain passive-type income. I.R.C. §§ 1291–1298 (2012). Such rules were not significantly changed by the Tax Cuts and Jobs Act and are generally outside the scope of this Article.

122. The GILTI and subpart F rules apply only to income earned by CFCs, not to income of any other foreign corporation that has lower percentages of U.S. shareholder ownership. *See* I.R.C. § 951 (2012 & Supp. V 2013–2018); I.R.C. § 951A (Supp. V 2013–2018). The PFIC rules, however, apply to lower-percentage-ownership foreign corporations that earn certain types and amounts of passive income. *See* I.R.C. §§ 1291–1298 (2012) (providing rules regarding PFICs).

123. *See* I.R.C. § 951(a) (2012 & Supp. V 2013–2018); I.R.C. § 951A (Supp. V 2013–2018); I.R.C. § 962 (2012 & Supp. V 2013–2018). PFIC inclusions are taxed at full U.S. tax rates if the taxpayer elects the QEF (qualified electing fund) regime, and otherwise are subject to rules that generally result in higher aggregate taxes than the QEF election. *See* I.R.C. §§ 1291–1298 (2012).

124. *See* I.R.C. § 951A (Supp. V 2013–2018); I.R.C. § 959 (2012 & Supp. V 2013–2018).

125. *See* I.R.C. § 245A (Supp. V 2013–2018).

126. If the taxpayer is an individual, and if the income is effectively connected with the conduct of a U.S. trade or business, it could be eligible for a 20% deduction if the taxpayer meets the requirements of new section 199A. *See id.* § 199A.

127. FDII is taxed at an effective rate of 13.125%. *See id.* § 250.

GILTI at 10.5% (for corporate shareholders)<sup>128</sup> and at full U.S. rates for individual shareholders.<sup>129</sup> The argument that this is now a territorial tax system focuses on the zero percent U.S. tax rate that applies only to non-subpart F, non-GILTI income earned through a CFC and to income earned through a 10/50 company. Although these types of income are significant, they do not represent all of the foreign source amounts earned by U.S. corporations and individuals.

In addition, even the zero percent U.S. tax rate that applies to non-GILTI, non-subpart F income is entirely a function of the new 100% DRD for dividends from CFCs and 10/50 companies. As explained above, the 100% DRD is itself subject to severe restrictions. First, it only applies to corporate shareholders<sup>130</sup>—individual shareholders completely miss out on this partial territoriality effect.<sup>131</sup> Second, it only applies to a U.S. person that owns at least 10% of the dividend-paying foreign corporation.<sup>132</sup> U.S. persons who own less than 10% of a foreign corporation will still be subject to full U.S. tax on the

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128. See *id.* § 11(b) (providing 21% tax rate for corporations); *id.* § 250 (allowing 50% deduction for GILTI); *id.* § 960(d) (deeming foreign taxes to be paid with respect to GILTI, resulting in a limited foreign tax credit). See generally Rosenberg, *supra* note 3 (discussing GILTI). Taxpayers are complaining about the loss of formerly applicable foreign tax credits. See Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act, 83 Fed. Reg., 63,200, 63,200, 63,221 (proposed Dec. 7, 2018) (to be codified at 26 C.F.R. pt. 1) (discussing taxpayer requests and comments in the preamble to proposed foreign tax credit regulations); Lynnley Browning, *Wall Street Caught in Crosshairs of 'Unforgiving' Foreign Tax*, BLOOMBERG: MKTS. (July 30, 2018, 1:00 AM), <https://www.bloomberg.com/news/articles/2018-07-30/wall-street-fears-new-international-tax-that-was-aimed-at-tech>; Alexander Lewis, *Manufacturers Seek Relief on GILTI and Foreign Tax Credits*, TAX NOTES (Sept. 13, 2018), <https://www.taxnotes.com/tax-notes-today-international/carrybacks-and-carryforwards/manufacturers-seek-relief-gilti-and-foreign-tax-credits/2018/09/13/28f3c>; Alexander Lewis & Ryan Finley, *FTC Regs Provide Minimal Relief on Expense Allocation*, 92 TAX NOTES INT'L 960, 960 (2018); see also Rosenberg, *supra* note 19, at 77–83 (discussing the repeal of section 902, which provided for deemed payment of creditable foreign taxes upon the payment of certain dividends).

129. However, individuals who elect the application of section 962 can apply the 50% deduction for GILTI, according to recent proposed regulations. See Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3), 84 Fed. Reg. 8,188, 8,229 (Mar. 6, 2019); Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income, 84 Fed. Reg. 8,188, 8,211 (proposed Mar. 6, 2019) (to be codified at 26 C.F.R. pt. 1) (proposing that individuals who make a section 962 election and include GILTI in income are eligible for the 50% deduction of GILTI that otherwise applies only for corporate shareholders); Velarde, *supra* note 8.

130. See I.R.C. § 245A (Supp. V 2013–2018).

131. Individuals can, however, apply the capital gains tax rates to dividends from qualifying foreign corporations, if holding period requirements are met. See I.R.C. § 1(h)(11) (2012 & Supp. V 2013–2018). This was already the case before the TCJA.

132. *Id.*

dividends from their foreign corporations.<sup>133</sup> Without the DRD, U.S. shareholders pay U.S. tax on non-GILTI, non-subpart F amounts earned through foreign subsidiaries (if and when received by such U.S. shareholders) at the full U.S. tax rates of 21% for corporate U.S. shareholders and a maximum of 37% for individual shareholders.<sup>134</sup>

Therefore, given all of the above, the movement towards territoriality is limited to the exemption of some types of income that are earned through foreign subsidiaries, for some shareholders, in some circumstances. Other types of U.S. persons' foreign-earned income remain subject to U.S. tax. This is hardly a completely territorial system.

#### IV. WHAT'S WRONG WITH FOREIGN BRANCHES?

##### A. Overview

Two of the TCJA's new international tax provisions disfavor "foreign branch income," which is an interesting policy choice. Foreign branch income is not eligible for the FDII deduction,<sup>135</sup> and is isolated in its own foreign tax credit limitation "basket" for foreign tax credit purposes.<sup>136</sup> First, the very beneficial FDII deduction of 37.5%<sup>137</sup> does not apply to foreign branch income.<sup>138</sup> Secondly, the TCJA creates a new separate limitation category ("basket") for foreign branch income, for purposes of the foreign tax credit limitation calculation.<sup>139</sup> Generally, the foreign tax credit allowable to a taxpayer

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133. There are other, limited DRDs for dividends from a foreign corporation, but such DRDs are generally restricted to the amounts of such dividends that have already been subject to U.S. tax, e.g., because such amounts are effectively connected with the conduct of a U.S. trade or business. *See* I.R.C. § 243(e) (2012); I.R.C. § 245 (2012 & Supp. V 2013–2018). Such other DRDs are thus unlikely to be of much help in achieving zero percent U.S. tax.

134. *See* I.R.C. § 1(j) (Supp. V 2013–2018) (individual tax rates through 2025); *id.* § 11(b) (corporate tax rate of 21%).

135. *See* I.R.C. § 250 (Supp. V 2013–2018).

136. *See* I.R.C. § 904(d)(1)(B) (2012 & Supp. V 2013–2018). There is also a new provision regarding foreign branch losses, which is beyond the scope of this Article. *See* I.R.C. § 91 (Supp. V 2013–2018).

137. *See* I.R.C. § 250 (Supp. V 2013–2018). For taxable years beginning in 2018 through 2025, 37.5% of FDII is deductible. For taxable years beginning after 2025, the deduction decreases to 21.875%. *See id.* § 250(a)(3).

138. *See* I.R.C. § 250 (Supp. V 2013–2018). Foreign branch income is not taken into account in any portion of the equation that computes the FDII deduction: FDII (a percentage of which is deductible) is determined by multiplying certain income by a fraction, and foreign branch income is not included in the multiplicand or in the fraction's numerator or denominator. *See id.* § 250(b)(3)(A)(i)(VI).

139. *See* I.R.C. § 904(d)(1)(B) (2012 & Supp. V 2013–2018).



for any taxable year is the lesser of: (a) the foreign tax paid or accrued; or (b) the product of the taxpayer's pre-credit U.S. federal income tax times a fraction, of which the numerator is foreign source taxable income and the denominator is taxable income from all sources.<sup>140</sup> This computation is called the "foreign tax credit limitation," and is performed separately for the foreign source taxable income and foreign taxes in each of several separate limitation categories (baskets) of income listed in the Code.<sup>141</sup> It is generally taxpayer-favorable to have fewer baskets, so that foreign source taxable income and foreign taxes from different activities and various countries can mingle together in the same limitation calculation. This often maximizes the ability to use foreign tax credits from one country and activity to offset U.S. tax on unrelated foreign source income ("cross-crediting"), including income from another country and activity.

For example, if the taxpayer has foreign taxes (but relatively little income, for U.S. tax purposes) from Belgium, Brazil, and Botswana, and foreign source taxable income (but no or low foreign taxes) from Mexico, Mongolia, and Monaco, it is generally beneficial to blend all of those income items and foreign taxes in the same basket, rather than separating them into different baskets (and different foreign tax credit limitation determinations). Ideally (from the taxpayer's perspective), the foreign taxes from Belgium, Brazil, and Botswana could be used to offset U.S. tax on the foreign source income from Mexico, Mongolia, and Monaco (through cross-crediting), if all of such amounts were in the same basket. Yet income from a U.S. taxpayer's foreign branches is now separated from the other baskets, and isolated in its own basket<sup>142</sup> for foreign tax credit limitation purposes. This is presumably an unfavorable result for taxpayers, although the exact consequences depend on the specific facts.

### *B. Broad Definition of Foreign Branch Income*

The term "foreign branch income," used in both the FDII provision and the foreign tax credit basket rule, is defined by cross-reference to the term "qualified business unit," as used in the foreign

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140. See I.R.C. § 904(a) (2012).

141. See I.R.C. § 904(d) (2012 & Supp. V 2013–2018).

142. See *id.* § 904(d)(1)(B).

currency rules of the Code.<sup>143</sup> Specifically, foreign branch income is defined as “the business profits of such United States person which are attributable to 1 or more qualified business units (as defined in section 989(a)) in 1 or more foreign countries.”<sup>144</sup> A QBU is defined in the Code and the foreign currency regulations as a “separate and clearly identified unit” of a trade or business that also keeps separate books and records.<sup>145</sup> Due to the disfavored treatment of foreign branch income (defined by cross-reference to QBUs), U.S. taxpayers can be expected to try to avoid such characterization.

The QBU concept is generally used in the foreign currency rules to determine a unit of business activities that has a functional currency (potentially a currency different from its owner’s functional currency), for the purposes of computing currency gains and losses from various transactions.<sup>146</sup> Under the foreign currency regulations, corporations and partnerships are treated as QBUs.<sup>147</sup> A QBU also includes a group of activities, including a subset of the activities of a corporation or partnership, but only if such activities “constitute a trade or business” and “[a] separate set of books and records is maintained with respect to the activities.”<sup>148</sup>

The new statutory definition of “foreign branch income” (for FDII and basket purposes) cross-references the entire one-sentence definition of QBUs from section 989(a),<sup>149</sup> discussed above. Section 989’s QBU definition is further explained in multi-paragraph section 989 regulations.<sup>150</sup> But the proposed regulations (as opposed to the Code definition)<sup>151</sup> regarding the new term “foreign branch income” cross-reference only the second part of the foreign currency rules’

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143. See I.R.C. § 250(b)(3)(A)(i)(VI) (Supp. V 2013–2018) (cross-referencing section 904); I.R.C. § 904(d)(2)(J) (2012 & Supp. V 2013–2018) (defining “foreign branch income” by cross-reference to section 989); I.R.C. § 989(a) (2012) (defining “qualified business unit”).

144. I.R.C. § 904(d)(2)(J)(i) (2012 & Supp. V 2013–2018). Foreign branch income does not, however, include passive income. *Id.* § 904(d)(2)(J)(ii).

145. See I.R.C. § 989(a) (2012); Treas. Reg. § 1.989(a)-1(b)(1) (2018). The QBU definition includes further detail, some of which is discussed later in this section of the Article.

146. See I.R.C. §§ 987, 989(a) (2012).

147. See Treas. Reg. § 1.989(a)-1(b)(2)(i) (2018) (corporations, partnerships (other than those described in Treas. Reg. § 1.987-1(b)(5)), trusts, and estates are QBUs).

148. Treas. Reg. § 1.989(a)-1(b)(2)(ii) (2018).

149. See I.R.C. § 904(d)(2)(J)(i) (Supp. V 2013–2018) (referring to QBUs “as defined in section 989(a)”).

150. See Treas. Reg. § 1.989(a)-1 (2018).

151. See I.R.C. § 904(d)(2)(J)(i) (Supp. V 2013–2018) (referring to QBUs “as defined in section 989(a)”).

QBU definition from the section 989 regulations: just the rule regarding the “*activities* of a corporation, partnership, trust, estate, or individual,”<sup>152</sup> rather than the rule that treats all corporations, partnerships (with one exception), trusts, and estates as themselves constituting QBUs.<sup>153</sup>

Under the “foreign branch income” definition in the proposed regulations, a foreign branch includes “the activities of a partnership, estate, or trust” that constitute a trade or business<sup>154</sup>—regardless of whether separate books and records are kept for such activities.<sup>155</sup> Such activities (only for partnerships, estates, and trusts) are instead deemed to meet the books and records requirement.<sup>156</sup> Under the proposed regulations, foreign branches also include the activities of a corporation or an individual, but only if such activities both constitute a trade or business and are the subject of separately maintained books and records.<sup>157</sup> Thus, under the “foreign branch income” definition in the proposed regulations, all foreign branches must conduct a trade or business, but some foreign branches can exist without the maintenance of separate books and records.<sup>158</sup>

Overall, the definition of a foreign branch, for purposes of the FDII rule and the foreign branch income basket, includes certain

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152. Treas. Reg. § 1.989(a)-1(b)(2)(ii) (2018) (emphasis added). The foreign branch income regulations also cross-reference the portion of the section 989 regulations that states, “Any activity (wherever conducted and regardless of its frequency) that produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States shall be treated as a separate QBU, provided the books and records requirement of paragraph (d)(2) of this section is satisfied.” See Treas. Reg. § 1.989(a)-1(b)(3) (2018); Treas. Reg. § 1.904-4(f)(3)(vii)(A) (2019) (cross-referencing § 1.989(a)-1(b)(2)(ii) and (b)(3)).

153. See Prop. Treas. Reg. § 1.904-4(f)(3)(iii), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018) (cross-referencing Treas. Reg. § 1.989(a)-1(b)(2)(ii), -1(b)(3), not § 1.989(a)-1(b)(2)(i) or (b)(1)).

154. See Prop. Treas. Reg. § 1.904-4(f)(3)(iii)(C)(1), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018). The regulations distinguish between various foreign branches of the same owner. See Prop. Treas. Reg. § 1.904-4(f)(4), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018) (example 1, describing a partnership that is the foreign branch owner of three different foreign branches). They also address disregarded transactions between foreign branches and their owners. See Prop. Treas. Reg. § 1.904-4(f)(2)(vi), -4(f)(3)(ii)(B), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018).

155. Prop. Treas. Reg. § 1.904-4(f)(3)(iii)(C)(1)(i), (f)(3)(iii)(C)(2), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018).

156. Prop. Treas. Reg. § 1.904-4(f)(3)(iii)(C)(1)(i), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018).

157. Prop. Treas. Reg. § 1.904-4(f)(3)(iii)(A), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018) (requiring trade or business outside the U.S. and cross-referencing the books and records requirement from the section 989 regulations on QBUs).

158. See Prop. Treas. Reg. § 1.904-4(f)(4)(i), 83 Fed. Reg. 63,200, 63,243 (Dec. 7, 2018); see also Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Job Act, 83 Fed. Reg. 63,200, 63209 (proposed Dec. 7, 2018) (to be codified at 26 C.F.R. pt. 1) (preamble language).

activities of corporations, individuals, partnerships, trusts, and estates<sup>159</sup> that might not be treated as a DE<sup>160</sup> or a classic branch. The breadth of the “foreign branch” term is caused by the statutory cross-reference to the QBU definition, and the approach taken by the proposed regulations.<sup>161</sup> The term “foreign branch income” is thus a little misleading and does not entirely reflect its relatively expansive definition.

In contrast, although a corporation is treated as a QBU under the foreign currency regulations,<sup>162</sup> subsidiaries are not treated as foreign branches of a U.S. shareholder for purposes of determining foreign branch income.<sup>163</sup> The FDII and foreign branch basket rules involve the income earned by a U.S. taxpayer itself.<sup>164</sup> Because corporations are respected as separate entities,<sup>165</sup> a foreign corporate QBU’s income is not treated as the U.S. taxpayer’s income for U.S. tax purposes.<sup>166</sup>

However, a portion of a U.S. corporation’s own activities can constitute a foreign branch of such U.S. corporation.<sup>167</sup> Thus, a U.S. corporation could have foreign branch income (for purposes of the new basket rule and the FDII computation) from foreign branches that

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159. See I.R.C. § 904(d)(2)(J); Prop. Treas. Reg. § 1.904-4(f)(3)(iii), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018).

160. See, e.g., Treas. Reg. § 301.7701-2(c)(2)(i) (2018) (a disregarded entity is generally treated like a branch and disregarded as an entity separate from its owner).

161. See I.R.C. § 904(d)(2)(J); Prop. Treas. Reg. § 1.904-4(f)(3)(iii), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018).

162. Treas. Reg. § 1.989(a)-1(b)(2)(i)(A) (2018).

163. See I.R.C. § 904(d)(2)(J)(i) (“The term ‘foreign branch income’ means the business profits of such United States person . . .” (emphasis added)); Treas. Reg. § 1.904-4(f)(3)(iii)(A) (2019); see also Chris William Sanchirico, *The New U.S. Tax Preference for “Foreign-Derived Intangible Income”*, 71 TAX L. REV. 625, 632 n.27 (2018) (“[T]he profits of a corporate QBU would not generally be the ‘business profits of [the domestic corporation]’ under § 904(d)(2)(J), and so would not be ‘foreign branch income.’”).

164. See I.R.C. § 250 (Supp. V 2013–2018); I.R.C. § 904(d) (2012 & Supp. V 2013–2018).

165. See generally *Moline Props., Inc. v. Comm’r*, 319 U.S. 436, 439–40 (1943) (treating a corporation as a separate entity).

166. The U.S. shareholder can have subpart F or GILTI inclusions computed based on its pro rata share of certain income of a CFC, but in that case, the inclusions (and not the rest of the CFC’s income) are taken into account in computing the U.S. shareholder’s income. See I.R.C. § 951(a) (2012 & Supp. V 2013–2018); I.R.C. § 951A(a) (Supp. V 2013–2018). Under the regulations, subpart F and GILTI inclusions are not foreign branch income. See Treas. Reg. § 1.904-4(f)(2)(iii)(A) (2019).

167. Prop. Treas. Reg. § 1.904-4(f)(3)(iii)(A), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018) (cross-referencing Treas. Reg. § 1.989(a)-1(b)(2)(ii)).

consist of: (a) portions of its own activities; (b) activities of its partnerships; or (c) activities of disregarded entities.<sup>168</sup>

Further, in the context of the FDII and foreign branch income basket rules, only *foreign* QBUs are relevant, because those rules define “foreign branch income” as the income of a QBU in a foreign country.<sup>169</sup> This could include, it appears, foreign activities of U.S. persons. Under the proposed regulations, foreign branch income does not include income from U.S. activities, even such activities of a foreign QBU.<sup>170</sup> In addition, only a U.S. person can have “foreign branch income” (earned through a defined “foreign branch”).<sup>171</sup> Therefore subpart F inclusions and foreign dividends cannot be classified as foreign branch income in a U.S. shareholder’s hands under the lookthrough rules, which characterize amounts received or included by a shareholder by reference to the relevant foreign payor’s income.<sup>172</sup>

But not every aspect of these distinctions is completely clear: what if a QBU conducts a trade or business using both U.S. and foreign activities? Is the determinative fact whether its foreign activities alone are sufficient to constitute a trade or business? Could a “foreign branch” be avoided by merely leaving some crucial activities in the U.S., so that the foreign activities do not include every item necessary to conduct a trade or business?<sup>173</sup>

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168. Treas. Reg. § 1.904-4(f)(1) (2019) (defining “foreign branch income”); Treas. Reg. § 1.904-4(f)(3)(iii) (2019) (defining the term “foreign branch”).

169. See I.R.C. § 904(d)(2)(J)(i) (Supp. V 2013–2018) (“[T]he business profits of such United States person which are attributable to 1 or more qualified business units . . . in 1 or more foreign countries.”); Treas. Reg. § 1.904-4(f)(3)(iii)(A) (2019) (referring to QBUs that “conduct[] a trade or business outside the United States”); Treas. Reg. § 1.904-4(f)(3)(iii)(B) (“Activities carried out in the United States . . . do not constitute the conduct of a trade or business outside the United States.”).

170. See Prop. Treas. Reg. § 1.904-4(f)(2)(ii), 83 Fed. Reg. 63,200, 63,244 (Dec. 7, 2018); see also Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Job Act, 83 Fed. Reg. 63,200, 63,200 (proposed Dec. 7, 2018) (to be codified at 26 C.F.R. pt. 1) (preamble to proposed regulations).

171. See I.R.C. § 904(d)(2)(J); see also Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Job Act, 83 Fed. Reg. 63,200, 63,200 (preamble to proposed regulations).

172. See I.R.C. § 904(d)(3) (2012); I.R.C. § 904(d)(4) (2012 & Supp. V 2013–2018); Treas. Reg. § 1.904-5 (2018).

173. See I.R.C. § 904(d)(2)(J)(i) (Supp. V. 2013–2018) (cross-referencing section 989(a)’s definition of QBUs); Prop. Treas. Reg. § 1.904-4(f)(3)(iii) (2019) (“The term foreign branch means a qualified business unit (QBU), as defined in § 1.989(a)-1(b)(2)(ii) and (b)(3), that conducts a trade or business outside the United States.”); Treas. Reg. § 1.989(a)-1(b)(2)(ii) (2018)

It also is not clear why Congress didn't just refer to activities that a U.S. person performs outside the U.S. (or perhaps non-auxiliary activities outside the U.S.), rather than cross-referencing the QBU definition, for purposes of defining "foreign branch income" under the FDII and new basket provisions. In addition, the QBU definition should be relatively easy to avoid, to the extent that it requires that separate books and records be maintained before a QBU can exist (e.g., for a U.S. corporation's activities in country X).<sup>174</sup> Under the proposed regulations, this separate books and records requirement applies in order to treat the activities of a corporation or individual as a foreign branch, but not to obtain such treatment for the activities of a partnership, trust, or estate.<sup>175</sup> Therefore, avoiding foreign branch characterization may be much easier for corporations and individuals than for the activities of partnerships.

The general impact of the foreign branch income rules is to treat differently the taxpayer's foreign trade or business income derived: (a) either through a foreign subsidiary or directly (*other than* through a foreign QBU); as compared to (b) either through: (i) a partnership; or (ii) a subset of the taxpayer's own activities (including a DE) for which separate books and records are kept. Foreign trade or business activities are thus treated differently depending on the type of entity through which they are earned, and whether (in the case of activities of a corporate or individual taxpayer) separate books and records are maintained.<sup>176</sup> Due to these distinctions, the choice of entity (partnership rather than corporate subsidiary or earning income directly) and the decision of whether to keep separate books and records (for the activities of corporations and individuals) can determine the FDII or basket treatment of an item.

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("Activities . . . qualify as a QBU if . . . [t]he activities constitute a trade or business . . ."); Treas. Reg. § 1.989(a)-1(c) (2018) ("To constitute a trade or business, a group of activities must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit.").

174. See Prop. Treas. Reg. § 1.904-4(f)(3)(iii)(A), 83 Fed. Reg. 63,200, 63,244-45 (Dec. 7, 2018).

175. See Prop. Treas. Reg. § 1.904-4(f)(3)(iii)(C)(1)(i), (2), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018).

176. See Prop. Treas. Reg. § 1.904-4(f)(3)(iii)(A), (f)(3)(iii)(C)(ii), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018).

### C. Why Is Foreign Branch Income Disfavored?

#### 1. In General

Given the definition of foreign branch income, described above, it is not entirely clear why such income is disfavored under the FDII and basket rules. Under the Code definition and the proposed regulations described above,<sup>177</sup> foreign branch income derives only from entities whose income is treated as belonging to their owners: branches, partnerships, and certain activities of U.S. taxpayers.<sup>178</sup> Income from such entities and activities is subject to tax in the U.S. taxpayer's hands in the year in which it is earned, and therefore does not appear to always present an abusive fact pattern.

The apparent discomfort with foreign branches does not appear to be caused by concerns about hybrid entities (entities treated as flow-throughs in the U.S. but as corporations in a foreign country, or vice versa).<sup>179</sup> The foreign branch income definition, for FDII and the basket rules, is not limited to hybrids.<sup>180</sup> Instead, under the new Code provisions (and proposed regulations),<sup>181</sup> foreign branches include DEs that are similarly treated as branches for foreign purposes.<sup>182</sup> The term also includes certain activities of entities that are treated as partnerships for both U.S. and foreign purposes (i.e., non-hybrids).<sup>183</sup> Nor does the concern about branches appear traceable to a worry that branch income is not subject to tax in a foreign country, and therefore does not deserve beneficial U.S. tax treatment.<sup>184</sup> If Congress had wanted to target such low- or no-foreign-tax income, it could have

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177. See I.R.C. 904(d)(2)(J) (2012 & Supp. V 2013–2018); Prop. Treas. Reg. § 1.904-4(f)(3), 83 Fed. Reg. 63,200, 63,245–46.

178. See Treas. Reg. §§ 301.7701-2(a), (c)(2)(i), 301.7701-3(b)(1)(ii) (2018).

179. See, e.g., Treas. Reg. § 1.909-2 (2018) (defining reverse hybrids in the context of section 909).

180. See I.R.C. § 904(d)(2)(J) (2012 & Supp. V 2013–2018) (defining foreign branch income).

181. See *id.*; Prop. Treas. Reg. § 1.904-4(f), 83 Fed. Reg. 63,200, 63,210–11 (Dec. 7, 2018) (elaborating on the definition of a foreign branch).

182. Cf. Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Job Act, 83 Fed. Reg. 63,200, 63,210 (preamble to regulations proposed Dec. 7, 2018) (to be codified at 26 C.F.R. pt. 1) (asking for comments about whether special rules are needed for disregarded payments to or from “true branches”).

183. See I.R.C. § 904(d)(2)(J) (2012 & Supp. V 2013–2018) (defining foreign branch income); Prop. Treas. Reg. § 1.904-4(f), 83 Fed. Reg. 63,200, 63,210–11 (Dec. 7, 2018) (defining foreign branch).

184. Cf. STAFF OF J. COMM. ON TAXATION, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 390 n.1775 (Comm. Print 2018) (referring to a U.S. branch (of a foreign person, presumably) that “lacks sufficient presence in the [U.S.] to be subject to Federal income tax”).

limited “foreign branch” treatment to foreign QBUs that are not subject to foreign tax of at least X% of the U.S. corporate tax rate, or to foreign tax of at least Y% applied by reason of residence.<sup>185</sup>

## 2. Logic of Foreign Branch Income Treatment for FDII?

Neither the Conference Report nor the Joint Committee Explanation offers a convincing explanation of the reason why foreign branch income, as defined above, is not eligible for the FDII deduction.<sup>186</sup> This exclusion of foreign branch income could be an effort to use the FDII deduction to encourage activities and employees in the U.S.<sup>187</sup> However, the FDII deduction does not exclude *all* foreign activities and employees—only those that meet the foreign

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185. Similar approaches are taken in the high-tax kickout from the passive basket, the subpart F high-tax exception, and other provisions. *See, e.g.*, I.R.C. §§ 904(d), 954(b)(2) (2012 & Supp. V 2013–2018).

186. *See* H.R. REP. NO. 115-466, at 630 (2017) (Conf. Rep.) (noting that the foreign branch income basket was contained in the Senate Bill, and that the Conference Bill adopts the Senate version); STAFF OF J. COMM. ON TAXATION, 115TH CONG., DESCRIPTION OF THE CHAIRMAN’S MARK OF THE “TAX CUTS AND JOBS ACT,” at 241 (Comm. Print 2017) (not giving a reason for the special treatment of foreign branch income); STAFF OF J. COMM. ON TAXATION, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 395–97 n.1775 (Comm. Print 2018) (describing the foreign branch rules, and stating that cross-crediting between foreign branch basket and other baskets is now prevented, without explaining why such cross-crediting was problematic).

187. *See* Jeffery M. Kadet & David L. Koontz, *Transitioning from GILTI to FDII? Foreign Branch Income Issues*, 164 TAX NOTES FED. 57 (2019) (referring to the “apparent intent of the foreign branch rule to encourage activities and employment within the United States”). Commentators have surmised that FDII is meant to “be the carrot for earning such income within the U.S.,” by applying a lower U.S. effective rate to FDII (as compared to the usual U.S. corporate tax rate). *See* Kamin et al., *supra* note 1, at 1448; *see also* Patrick Driessen, *FDII Jilted by Design Flaws, Byrd Rule, and Regs*, 164 TAX NOTES FED. 2269 (Sept. 30, 2019) (inferring from budget estimates, a Joint Committee Report example, and other factors that Congress intended FDII to cause U.S. corporations to shift income-earning locations towards the U.S. and away from foreign countries, and arguing that aggregate U.S. and foreign tax on FDII is not too much worse than such aggregate on GILTI); Sanchirico, *supra* note 163, at 632 (“One way to secure deduction eligibility, of course, is to do the work in the United States. This response, one may assume, is with what Congress intended.”); Kadet & Koontz, *supra* (discussing the foreign branch rule); *cf.* N.Y. STATE BAR ASS’N TAX SECTION, *Report on Proposed Regulations Under Section 250 (Foreign Derived Intangible Income)*, reprinted at 2019 TNT 88-17, <https://www.taxnotes.com/tax-notes-today-federal/foreign-source-income/nysba-tax-section-digs-proposed-fdii-gilti-deduction-regs/2019/05/07/29ghd> (asserting, based on the proposed regulations’ preamble, that FDII was intended to offset GILTI’s incentives to move income offshore (rather than arguing that FDII was intended to create affirmative incentives to earn income in the U.S. rather than overseas), “[t]he preamble to the Proposed Regulations (the ‘Preamble’) states that the purpose of the FDII regime is to help ‘neutralize’ the incentive that the GILTI regime provides to U.S. corporations to conduct business activities directed at foreign markets through CFCs rather than directly from the U.S. In articulating the detailed rules necessary to implement the FDII regime, we believe that it is important to keep this objective in mind”).



branch definition.<sup>188</sup> Also, the FDII deduction theoretically benefits intangible-related income,<sup>189</sup> which may involve fewer employees and activities than other types of income. Further, a focus on incentivizing U.S. activities and employees is not entirely consistent with the detriment, in the FDII calculation, for tangible, depreciable assets used in the U.S.<sup>190</sup> If the intent was to encourage U.S. jobs, the exclusion of foreign branch income from the FDII calculation is not a very targeted instrument. Congress could have asked instead whether (and to what extent) FDII was attributable to U.S. employees, activities, and assets. But unless the theory was a focus on U.S. jobs and activities, why is a foreign branch (fully taxable in the U.S.) of a U.S. corporation not given the same FDII incentives as direct activities of such U.S. corporation?

An intent to encourage U.S. rather than foreign activities, employees, and assets might be the best argument for the foreign branch exclusion from FDII. But such U.S. activities and employees are not measured or required under the FDII rules, if one argues that the foreign branch income definition (which focuses on foreign activities of a QBU) is not an accurate inverse measure of U.S. activities.<sup>191</sup> In that case, why not deny the FDII deduction to all income derived from non-de-minimis foreign activities of the U.S.

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188. See I.R.C. § 250(b) (Supp. V 2013–2018).

189. See Kamin et al., *supra* note 1, at 1248. Of course, FDII does not actually measure intangible-related income: it just starts with all of a U.S. corporation's income (less exclusions like foreign branch income), subtracts 10% of the bases of relevant tangible, depreciable assets, and applies a ratio to derive the relevant foreign-related portion of such amount. See I.R.C. 250(b) (Supp. V 2013–2018). This is clearly not an accurate calculation of intangible-related income. See Kamin et al., *supra* note 1, at 1448–49.

190. See I.R.C. § 250(b)(2)(A)(ii) (Supp. V 2013–2018). The FDII reduction for a percentage of tangible U.S. asset bases would, however, be consistent with a view that FDII offsets the incentives created by GILTI, and therefore mirrors GILTI's focus on deemed intangible income (computed by subtracting a percentage of relevant tangible assets' bases). See I.R.C. § 951A(b)(2)(A) (Supp. V 2013–2018) (taking into account 10% of relevant asset bases in GILTI computation). However, FDII is still subject to a higher U.S. effective rate (13.125%) than the GILTI effective rate of 10.5%, and such 13.125% rate may also be higher than certain foreign tax rates. See *id.* § 250(a)(1)(A), (B) (allowing deductions for percentages of FDII and GILTI). This comparison between FDII and GILTI effective rates does not take into account the impact of foreign tax credits for foreign taxes imposed on GILTI, including the benefits of cross-crediting. See generally Rosenberg, *supra* note 3 (discussing GILTI-related foreign tax credits).

191. U.S. tangible, depreciable assets are actively discouraged by reducing FDII by 10% of the bases of such assets, but that could be partially explained by FDII's asserted focus on intangible income, as indicated by its name ("foreign-derived intangible income"). See I.R.C. § 250(a)(1)(A), (b) (Supp. V 2013–2018).

taxpayer,<sup>192</sup> rather than limiting the restriction to foreign activities that qualify as QBUs (including the books and records requirement for activities of corporations and individuals, which seems relatively easy to avoid)? Congress could even have denied a FDII deduction for income for which more than X% of the taxpayer's income-producing activities were performed abroad.

Also, is it clear that a foreign branch (subject to U.S. tax and supported, perhaps, by U.S.-based employees) is less desirable than a CFC (entirely outside the U.S. tax net, except for GILTI and subpart F income)? If FDII's goal was to encourage U.S. corporations to keep their intellectual property in the U.S. (to protect U.S. tax revenues), then intellectual property in a foreign branch of the U.S. person may accomplish that goal: foreign branch income is subject to U.S. tax in its U.S. owner's hands.<sup>193</sup>

Likelihood of foreign tax also does not seem to be a persuasive distinguishing factor between direct activities of a U.S. corporation and activities performed through a foreign branch. Foreign branch income might be relatively likely to be subject to foreign tax (generating a foreign tax credit, resulting in lesser or no net U.S. tax), which could be reduced by treaty protections like the permanent establishment rules.<sup>194</sup> But direct activities of a U.S. taxpayer who

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192. The portion of the taxpayer's relevant income that is derived from its foreign activities could be determined, for example, based on the pro rata portion of the taxpayer's U.S. and foreign activities (respectively) used to generate such income, or by a facts and circumstances analysis of the relative importance of the taxpayer's U.S. and foreign activities. *Cf.* Treas. Reg. § 1.861-4(b) (2018) (taking a similar approach to the sourcing of income from services).

193. *See, e.g.*, Treas. Reg. § 301.7701-2(c)(2)(i) (2018) (income of a disregarded entity is taxed to its owner).

194. *See, e.g.*, U.K. Tax Treaty, *supra* note 40, art. V (defining permanent establishment); Japan Tax Treaty, *supra* note 40, art. V (defining permanent establishment). Under many U.S. tax treaties, income of a U.S. resident corporation from an active trade or business is not subject to tax in the treaty-signing foreign country unless such income is sufficiently connected to a permanent establishment in such foreign country. *See, e.g.*, U.K. Tax Treaty, *supra* note 40, art. VII ("The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein."); Japan Tax Treaty, *supra* note 40, art. VII ("The profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein."). Thus, active business income that is not earned through a permanent establishment can be exempt from foreign tax under a U.S. tax treaty (if one applies, and subject to the particular treaty's rules and definitions). This is, of course, a simplification of the treaty rules. Under the regulations, a permanent establishment is deemed to constitute a trade or business in the treaty partner's country for purposes of the foreign branch definition. *See* Prop. Treas. Reg. § 1.904-4(f)(3)(vii)(B), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018). But the converse is not necessarily true: not all foreign

provides services in a foreign country (eligible for FDII, if not performed through a foreign branch) are also relatively likely to be subject to foreign tax (subject to such treaty rules). Direct sales of goods by a U.S. corporation to a foreign person, for use overseas, could also be subject to foreign tax—as could such sales by a foreign branch—depending on the facts (including permanent establishment) and the applicable treaty rules (if any treaty applies).

In the FDII rules, using the QBU cross-reference to define “foreign branch income” means that only a certain subset of income from a taxpayer’s foreign activities is ineligible for the FDII deduction—not all of the taxpayer’s foreign activities. It isn’t clear why, as a policy matter, foreign activities that constitute a trade or business and keep separate books and records are less deserving of a FDII deduction than other foreign activities. The value of the QBU rules as a cross-reference does not appear to lie in providing an easy set of pre-existing mechanical rules: such QBU rules, while a long-standing set of provisions with some guidance and interpretation, are not simple, easy, or straightforward.<sup>195</sup> Further, the foreign branch proposed regulations add additional details and requirements, altering and embellishing the section 989 regulations’ QBU concept.<sup>196</sup>

FDII is apparently intended to help U.S. corporations compete *overseas* with foreign corporations (by giving such U.S. corporations a U.S. tax advantage, which reduces their overall costs), because deductible FDII is limited to a portion of the U.S. corporation’s income from sales of property to foreign persons (for use overseas) or services performed abroad or with respect to foreign property.<sup>197</sup> Given that FDII seems intended to benefit foreign sales and services of U.S. persons, what is the logic for only giving such incentives for activities that are *not* conducted through a foreign QBU? This is especially odd when QBU characterization is so easy to avoid by

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branches (as defined in the proposed regulations) are necessarily treated as permanent establishments under the relevant tax treaties. Depending on the facts, other treaty articles could also be relevant, and could potentially reduce the foreign tax on a U.S. taxpayer’s foreign QBU.

195. See Treas. Reg. § 1.989(a)-1 (2018) (defining “qualified business unit”).

196. See Prop. Treas. Reg. § 1.904-4, 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018).

197. See I.R.C. § 250(b)(4) (Supp. V 2013–2018). FDII was also apparently intended to encourage U.S. corporations to keep intellectual property in the U.S., rather than moving it offshore. See Kamin et al., *supra* note 1, at 1502 (discussing the Senate version of the FDII deduction, the deduction “intended to encourage firms to keep and develop intellectual property in the United States”).

simply not keeping separate books and records (in the case of a U.S. corporation's activities).

Further, the FDII benefit applies to income from services performed abroad, in addition to certain sales income.<sup>198</sup> How is a U.S. corporation (the only type of taxpayer eligible for FDII deductions) going to perform services abroad without a foreign QBU? Presumably such taxpayers will avoid keeping separate books and records for their foreign activities, try to avoid creating permanent establishments abroad, argue about the attribution of income to QBUs (as opposed to the other portions of the U.S. corporation), or attempt to leave part of each trade or business in the U.S. (to evade "foreign branch" treatment). FDII appears to reflect, at least partially, the U.S. tax law's intention to reward U.S. corporations for eating foreign corporations' lunch, i.e., for impinging on foreign corporations' markets, but only if such U.S. corporations engage in this competition other than through foreign QBUs (and not with tangible assets located in the U.S.).<sup>199</sup> It is unclear why performing services abroad is more deserving of encouragement if it is performed without separate books and records.

It is also interesting that disfavored foreign branches include only QBUs that conduct a trade a business—not QBUs that are more passive or whose activities do not represent every element needed to constitute a trade or business. Usually, trade or business activity is seen as less likely to be abusive or tax-motivated, and more likely to make choices shaped by actual business (not solely tax) concerns. Therefore, such activities generally receive more favorable U.S. tax treatment than passive, non-business activities.<sup>200</sup> The foreign branch income definition, in contrast, would allow FDII benefits (and more cross crediting, for example in the general basket) for income from QBUs whose activities do *not* rise to the level of a trade or business (because such QBUs would not be treated as foreign branches). Only QBUs that do constitute a trade or business are penalized. In fact,

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198. See I.R.C. § 250(b)(4)(B).

199. See I.R.C. § 250(a)(1)(A), (b)(2)(A)(ii), (b)(3)(A)(i)(VI).

200. See, e.g., I.R.C. § 162 (2012 & Supp. V 2013–2018) (deductions for trade or business expenses); I.R.C. § 199A (Supp. V 2013–2018) (20% deduction for certain trade or business income); I.R.C. § 469 (2012 & Supp. V 2013–2018) (limits on passive activity credits and loss deductions); I.R.C. § 904(d) (separating passive income from other income); I.R.C. § 1411(a)(1), (c)(2)(A) (2012) (investment tax for passive activities). Passive income is not included in either the GILTI basket or the foreign branch income basket. See I.R.C. § 904(d)(1)(A) (2012 & Supp. V 2013–2018) (excluding passive income from the GILTI basket); *id.* § 904(d)(2)(J)(ii) (excluding passive income from foreign branch income).

foreign branch income excludes passive income.<sup>201</sup> Therefore, for FDII, only active income is penalized in foreign branch income definition: passive income can be taken into account in computing the FDII deduction, even if earned through foreign branch.

### 3. Logic of Separate Basket for Foreign Branch Income?

#### *a. In general*

In the foreign tax credit context, the new “foreign branch income” basket is likely to isolate: (a) a taxpayer’s foreign source income earned either through flow-through entities (if their foreign activities constitute a QBU) or through activities of the taxpayer that rise to the level of a QBU; from (b) the taxpayer’s income earned either directly (other than through a QBU) or through a foreign subsidiary (because the latter two types of income are assigned to baskets other than the foreign branch income basket). This new basket therefore categorizes income (and associated foreign taxes) based partly on the type of entity (or lack thereof) through which it is earned.<sup>202</sup>

The legislative history does not give a clear explanation for why foreign branch income should be quarantined from other income for foreign tax credit purposes.<sup>203</sup> Nor is there an obvious policy reason

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201. See I.R.C. § 250(b)(3)(A)(vi) (Supp. V 2013–2018) (cross-referencing basket rules); *id.* § 904(d)(2)(J)(ii) (foreign branch income does not include passive income). One could argue that only foreign sales and services income is eligible for the FDII deduction, and that sales and services income is unlikely to be passive. But including passive income in both the denominator of the FDII fraction and in the multiplicand of the FDII computation, by excluding passive amounts from foreign branch income, might not necessarily have a mathematically neutral effect, even if such passive income does not derive from foreign sales or services. See *id.* § 250(b)(1) (describing a ratio).

202. In one previous instance, dividends from 10/50 corporations were placed in a separate basket for each such 10/50 corporation for foreign tax credit purposes. In later years, these separate 10/50 company dividend baskets were combined into one basket for all of such dividends. See I.R.C. § 904(d)(1)(c) (Supp. V 2013–2018) (repealed, describing former basket for dividends from 10/50 companies); see also Robert F. Hudson, Jr. & Gregg D. Lemein, *U.S. Tax Planning for U.S. Companies Doing Business in Latin America*, 27 U. MIAMI INTER-AM. L. REV. 233, 273–75 (1996) (describing baskets for 10/50 company dividends).

203. The Conference Report merely notes that the foreign branch income basket was contained in the Senate Bill, and that the Conference Bill adopts the Senate version. H.R. REP. NO. 115-466, at 630 (2017) (Conf. Rep.). Similarly, there is no reason given for the special treatment of foreign branch income in the Joint Committee on Taxation’s description of the Chairman’s Mark of the tax reform bill. See STAFF OF J. COMM. ON TAXATION, 115TH CONG., DESCRIPTION OF THE CHAIRMAN’S MARK OF THE “TAX CUTS AND JOBS ACT,” at 241 (Comm. Print 2017). The Joint Committee Explanation of the final version of the TCJA states simply that the foreign branch income basket was meant to prevent cross-crediting with other baskets (which one could note is the

for separating income earned through a DE or partnership (i.e., a flow-through entity), or through a subset of the U.S. taxpayer's activities that constitute a trade or business, from similar income earned through a U.S. or foreign subsidiary.<sup>204</sup> One possible explanation is that earning income through a foreign corporation has its own set of complex rules, after the TCJA: such foreign subsidiary earnings are subject, in the U.S. taxpayer's hands, to the one-time section 965 inclusion,<sup>205</sup> the GILTI inclusion rules,<sup>206</sup> the subpart F inclusion regime,<sup>207</sup> and the beneficial impact of the new 100% DRD.<sup>208</sup> The foreign branch income basket can be seen as a special rule, in turn, for foreign income earned directly by a U.S. taxpayer (or through a partnership), rather than through a foreign subsidiary. But this basket rule is not the equivalent of the many preexisting and new rules regarding foreign subsidiaries' income. Nor does this argument explain why income earned directly by the U.S. taxpayer is treated differently depending on whether or not it is earned through a specific type of QBU (e.g., based on whether separate books and records are kept, in some cases).

One could argue that foreign taxes (and income) are now separated into baskets based on whether they are earned directly (general and passive baskets), through a foreign corporation (GILTI

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purpose of all baskets), without further explanation of why such cross-crediting was disfavored. STAFF OF J. COMM. ON TAXATION, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 395 (Comm. Print 2018). The Joint Committee goes on to describe the foreign branch income definition, without further discussion of the reasons for this provision. *See id.* at 396–97.

204. One could point out, of course, that other sets of U.S. tax rules also apply different treatment to income earned through a flow-through entity rather than through a corporation. For example, different tax rates apply, and the timing of income can differ, for amounts earned through a corporation rather than directly or through a flow-through entity. *See* I.R.C. § 1(j), (h) (2012 & Supp. V 2013–2018); I.R.C. § 11(b) (Supp. V 2013–2018). Further, in contrast to the distrust of foreign branch income in the FDI and basket rules, one could point out that income earned through pass-through entities is eligible for the recently created section 199A deduction (and income earned through a corporation is not). *See* I.R.C. § 199A(a) (Supp. V 2013–2018) (allowing deduction for taxpayers other than corporations). However, even section 199A's new 20% deduction does not yield as favorable a tax rate (for individuals in the highest tax bracket) as the 21% rate that applies to corporations. *See id.* §§ 11, 199A.

205. *See* I.R.C. § 965(a) (2012 & Supp. V 2013–2018); *see also* Jasper L. Cummings, Jr., *The Territorial Transition Tax*, 158 TAX NOTES 1487 (2018); Lee A. Sheppard, *Troubleshooting the Proposed Repatriation Rules*, 160 TAX NOTES 1809, 1810 (2018) (analyzing the proposed deemed repatriation rule before its enactment); Libin Zhang & Joshua Rabinovits, *The End of Eternity: Anomalies in Transition to Territoriality*, 159 TAX NOTES 621, 622 (2018).

206. *See* I.R.C. § 951A(a) (Supp. V 2013–2018).

207. *See* I.R.C. § 951(a)(1) (2012 & Supp. V 2013–2018).

208. *See* I.R.C. § 245A (Supp. V 2013–2018).

basket for GILTI, general or passive for subpart F income, look-through treatment for certain dividends), or through a flow-through entity (often the foreign branch income basket). But this argument does not quite hold together: subpart F income, although earned through a foreign corporation, is allowed to mingle and cross-credit with directly earned income in the general and passive baskets. This occurs even though subpart F income is classically thought of as passive and mobile,<sup>209</sup> which is historically viewed with suspicion and disfavored. Also, the foreign branch income basket does not contain all income from foreign flow-through entities—just those (or their activities) that are characterized as “foreign branches” under the cross-reference to the QBU rules.<sup>210</sup> Further, the foreign branch income basket does not include passive income.<sup>211</sup> Therefore, the foreign branch income basket is not a logical part of a coherent scheme to categorize foreign source income (and associated foreign taxes) based on whether such income was earned directly, through a flow-through entity, or through a foreign corporation.

Alternatively, one could hypothesize that separate basket treatment for foreign taxes from foreign flow-through entities is not an extra penalty for doing business through pass-through entities, but is instead at the same level of stringency as the new restrictions on foreign tax credits for a foreign subsidiary’s foreign taxes (even if not substantively similar to such restrictions). U.S. persons’ foreign tax credits for a foreign subsidiary’s taxes are now limited to deemed paid credits associated with GILTI and subpart F inclusions.<sup>212</sup> But separation of foreign branch income into a new basket merely sets the parameters for the foreign tax credit limitation calculation, as compared to the denial of credits for a foreign subsidiaries’ foreign taxes that are paid on non-GILTI, non-subpart F income. Further, such denial apparently was predicated on the idea that the new 100% DRD

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209. See, e.g., Guidance Under Section 958 (Rules for Determining Stock Ownership) and Section 951A (Global Intangible Low-Taxed Income), 84 Fed. Reg. 29,114, 29,115 (proposed June 21, 2019) (to be codified at 26 C.F.R. pt. 1) (stating, in preamble to proposed regulations on GILTI, “Congress created the subpart F regime to limit the use of corporations organized in low-tax jurisdictions for the purposes of obtaining indefinite deferral of U.S. tax on certain earnings—generally earnings that are passive or highly mobile—that would otherwise be subject to Federal income tax. H.R. Rep. No. 1447 at 57–58 (1962); S. Rep. No. 87-1881 at 78–80 (1962)”).

210. See I.R.C. § 904(d)(2)(J) (2012 & Supp. V 2013–2018).

211. See I.R.C. § 904(d)(2)(J)(ii) (excluding passive income from foreign branch income).

212. See generally Rosenberg, *supra* note 3 (discussing narrower deemed-paid credit rules after the TCJA).

made such foreign tax credits unnecessary because the DRD removes the U.S. tax on foreign subsidiaries' non-GILTI, non-subpart F income, thus eliminating double taxation.<sup>213</sup> U.S. tax is not reduced on foreign branch income, so this rationale does not apply to foreign taxes associated with such income (nor does the separate foreign branch income basket deny foreign tax credits outright). Thus, there is no clear analogy between the foreign branch income basket and newly created restrictions on deemed paid credits for foreign subsidiary's foreign taxes.

The discussion of the foreign branch income basket by the Joint Committee on Taxation offers a half-hearted, unconvincing explanation for the separate treatment of foreign branch income: it merely says that, like the other foreign tax credit baskets, the foreign branch income basket "is intended to prevent so-called 'cross-crediting'" between different baskets,<sup>214</sup> e.g., between the passive and foreign branch income baskets. But this description does not explain *why* cross-crediting should be prohibited between foreign branch income (other than passive income) and income earned either through a subsidiary or directly (other than through a QBU).

The Joint Committee explanation then offers an example, which perversely illustrates the lack of logic behind the foreign branch basket and the ease of achieving cross-crediting despite the new basket.<sup>215</sup> In the example, a U.S. taxpayer earns high-foreign-taxed manufacturing income through a foreign branch, and also earns low-foreign-taxed royalty income directly (not through a foreign branch).<sup>216</sup> The manufacturing income is placed in the foreign branch income basket; the royalty income is placed in the general basket; and therefore, high foreign taxes on the manufacturing income cannot be used to reduce U.S. tax on the royalty income.<sup>217</sup> Cross-crediting has been successfully prevented.

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213. See H.R. REP. NO. 115-409, at 383 (2017) (Conf. Rep.) (conference report explanation that no section 902 indirect credit was needed, and therefore section 902 could be repealed, because the new 100% DRD for certain foreign dividends eliminated double taxation on such dividends).

214. STAFF OF J. COMM. ON TAXATION, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 395 (Comm. Print 2018). Because the foreign branch income basket does not include passive income, passive income from a foreign branch can engage in cross-crediting with other passive amounts from non-foreign-branch sources. See I.R.C. § 904(d)(2)(J)(ii) (excluding passive income from foreign branch income).

215. See *id.* at 395–96.

216. See *id.*

217. See *id.*



However, the example goes on to explain that if the same royalty income were instead earned through a foreign branch, then cross-crediting between the manufacturing income's high foreign taxes and the U.S. tax on the low-foreign-taxed royalty income would be allowed, because both types of income would be assigned to the foreign branch income basket.<sup>218</sup> While an accurate description of the new Code rules, this distinction between low-foreign-taxed income earned within a foreign branch and exactly the same income earned directly (without a foreign branch) seems to make very little sense. It also appears easy to move such royalty income into a foreign branch, thus achieving the very cross-crediting that the new basket was supposedly intended to avoid.

If Congress was perturbed by cross-crediting between high- and low-foreign taxed amounts, it could have more precisely (and effectively) described exactly which types of income should not be basketed with each other, using criteria that are harder to avoid or manipulate than just earning the targeted income through a foreign branch. For example, Congress could have provided that income should be basketed separately based on the effective foreign tax rate, to prevent cross-crediting between high- and low-foreign taxed items (especially from different activities and countries). A similar approach, based largely on applicable withholding tax rate, is followed by the current final regulations regarding the high-tax kickout from the passive basket: the high-tax kickout test is applied separately to otherwise-passive amounts that are subject to no foreign tax, to foreign withholding tax of more than zero but less than 15%, to foreign withholding tax of 15% or more, and to foreign tax other than a withholding tax.<sup>219</sup>

Applying the foreign tax credit limitation fraction to baskets, rather than separately to each item of income and its associated foreign taxes, is not always very accurate, due to the resulting averaging effect and cross-crediting. The number of baskets has increased and decreased over the years, as Congress has balanced and rebalanced the competing priorities of administrability, accuracy, and helping U.S.

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218. *See id.*

219. *See* Treas. Reg. § 1.904-4(c)(3) (2019). These high-tax kickout regulations thus use the foreign tax rate as a categorizing principle only for withholding taxes, not for net income taxes. *See id.* The Code also previously contained a separate basket for certain high-taxed interest income, which is another example of using the foreign tax rate as one criterion for basketing. *See* I.R.C. § 904(d)(2)(B) (2012) (repealed) (high withholding tax interest basket).

multinationals compete in the global marketplace.<sup>220</sup> If the idea behind the foreign branch income basket was to achieve greater matching of foreign tax credits with their associated income, in the service of greater accuracy, it could have been more logical and effective to go back to per country computation of foreign tax credits,<sup>221</sup> or to divide (for example) manufacturing and other active income from royalties and similar intellectual property fees by using more specific identifiers than the current general and passive baskets.

But instead, as the Joint Committee example demonstrates, manufacturing income, royalties, and their associated foreign taxes can all be cross-credited against each other in the foreign branch income basket, depending on the type of entity (or set of activities with books and records) that is used to earn such income. If one was pursuing more precise matching of foreign source income and associated foreign tax credits, the type of entity does not seem to be the ideal categorizing principle. There is no reason to think that the type of entity used to earn foreign source income (or the choice to keep separate books and records for activities of a corporation or individual) reliably correlates with either high or low foreign tax effective rates, or with the type of income (active or not, mobile or less mobile, tax-motivated or business-driven).

*b. Additional notes about the foreign branch income basket*

The foreign branch income basket includes all of the U.S. taxpayer's income from all of its foreign branches—the TCJA did not create a separate basket for each foreign branch, or even for foreign branches in each different country.<sup>222</sup> First, this allows the cross-crediting of income and foreign taxes from different types of foreign

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220. For example, the foreign tax credit limitation fraction was once applied on a per country basis. There have also been baskets for financial services income, high-taxed interest income, and dividends from 10/50 companies, all of which have been repealed. *See* I.R.C. § 904(d)(1)(C) (Supp. V 2013–2018) (repealed) (financial services income basket); I.R.C. § 904(d)(1)(D) (2012 & Supp. V 2013–2018) (repealed) (shipping income basket); I.R.C. § 904(d)(2)(B) (2012) (repealed) (high withholding tax interest basket); I.R.C. § 904(d)(2)(e) (Supp. V 2013–2018) (repealed) (basket for 10/50 company dividends from pre-2003 earnings).

221. *Cf. Shaviro, supra* note 3, at 194 (suggesting that the GILTI-related foreign tax credit might be better applied on a per country basis, with carryovers).

222. *See* I.R.C. § 904(d)(1)(B) (2012 & Supp. V 2013–2018); *see also* Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act, 83 Fed. Reg., 63,200, 63,209 (proposed Dec. 7, 2018) (to be codified at 26 C.F.R. pt. 1) (preamble to proposed regulations, explaining that there is “a single foreign branch category; there are not separate categories for each foreign branch”).

branches (DEs, foreign partnerships, and subsets of a U.S. corporation's own activities) against each other. It also allows the mingling of foreign taxes and foreign source income from different countries and different activities. Secondly, however, it reduces incentives to artificially divide activities into more than one foreign branch, or to combine activities into fewer foreign branches, in order to impact the foreign tax credit basket results. (Incentives remain, though, to seek or avoid foreign branch status—it matters, for basket categorization purposes, whether the U.S. taxpayer has a foreign branch, and is potentially less important whether a given set of activities constitutes one or instead twelve foreign branches.)<sup>223</sup>

GILTI is presumably not treated as foreign branch income, because the regulations provide that corporations are not QBUs.<sup>224</sup> Logically, this means that a shareholder's inclusion of a CFC's income (through the subpart F or GILTI rules) is not treated as income from a QBU. In addition, if GILTI were includable in the foreign branch basket, the GILTI basket would be nearly empty. Such an interpretation would be disfavored, as a matter of statutory interpretation: courts try not to read statutory language as moot or superfluous.<sup>225</sup> Indeed, the proposed regulations clarify that foreign branch income does not include GILTI or subpart F income<sup>226</sup>—both of which are items that are earned by a CFC and included currently in its U.S. shareholder's income.<sup>227</sup>

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223. However, dividing a set of activities into multiple foreign branches (rather than one foreign branch) could potentially (indirectly) affect the amount of income allocated to foreign branches rather than to such foreign branches' owner, under the proposed regulations' rules regarding disregarded transactions. *See* Prop. Treas. Reg. § 1.904-4(f), 83 Fed. Reg. 63,200, 63,213 (Dec. 7, 2018).

224. *See* Prop. Treas. Reg. § 1.904-4, 83 Fed. Reg. 63,200, 63,243 (Dec. 7, 2018).

225. *See, e.g.,* *Hibbs v. Winn*, 542 U.S. 88, 101 (2004) (“A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant . . .”); *Bailey v. United States*, 516 U.S. 137, 146 (1995) (“[E]ach term [is assumed] to have a particular, nonsuperfluous meaning.”).

226. *See* Treas. Reg. § 1.904-4(f)(2)(iii)(A) (2019) (“[G]ross income attributable to a foreign branch does not include . . . any inclusion under sections 951(a), 951A(a), or 1293(a).”).

227. *See also* Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Job Act, 83 Fed. Reg., 63,200, 63,209 (proposed Dec. 7, 2018) (to be codified at 26 C.F.R. pt. 1) (preamble to proposed regulations, explaining that only U.S. persons, not CFCs, can have “foreign branch income”).

Nor does the foreign branch income basket include any passive income, which is instead assigned to the passive basket.<sup>228</sup> Depending on the mix of the taxpayer's income, such placement in the passive basket might be preferable. Also, assignment to the passive basket raises a question regarding the high-tax kickout rule, which normally can move income (and associated foreign taxes) from the passive to the general basket.<sup>229</sup> If income that would otherwise be foreign branch income is instead placed in the passive basket, and if such income is later moved out of the passive category due to the "high tax kick out,"<sup>230</sup> can such income be transferred into the general basket (often a taxpayer-favorable result) or should it instead revert to the foreign branch income basket? The proposed regulations answer this question, opting to move such income to the foreign branch basket if it fits the foreign branch category.<sup>231</sup> But until the proposed regulations are finalized, taxpayers may have some flexibility.<sup>232</sup>

#### *D. Is Foreign Branch Treatment Essentially Elective?*

Whatever the motivating concern, the new foreign branch income rules might not actually be effective. There appears to be a risk that foreign branch treatment is essentially elective, because foreign branch status depends on whether a set of activities contains all of the elements necessary to constitute a trade or business and on whether (in the case of a corporation's or individual's activities) separate books and records are maintained.<sup>233</sup> Therefore, it may be relatively easy for the U.S. taxpayer's foreign activities to deliberately fall within or outside foreign branch characterization by meeting or failing the

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228. See I.R.C. § 904(d)(2)(J)(ii) (2012 & Supp. V 2013–2018). The Joint Committee's explanation of the foreign branch income basket says, however, that "financial services income" that would otherwise be foreign branch income cannot be assigned to the passive basket, but instead, remains as foreign branch income. See STAFF OF J. COMM. ON TAXATION, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 395 (Comm. Print 2018) ("Financial services income of a QBU shall not be treated as passive income."). The Joint Committee caveats that a technical correction to the Code might be required "to reflect this intent." *Id.* at 395, n.1793.

229. See I.R.C. § 904(d)(2)(B)(iii)(II), (d)(2)(F) (2012).

230. See *id.* § 904(d)(2)(F) (2012); Treas. Reg. § 1.904-4(c) (2019).

231. See Prop. Treas. Reg. § 1.904-4(f)(2)(ii), 83 Fed. Reg. 63,200, 63,209 (Dec. 7, 2018).

232. The proposed regulations predict that they will apply to years that begin after the regulations are finalized, rather than applying retroactively. See Prop. Treas. Reg. § 1.904-4(q), 83 Fed. Reg. 63,200, 63,248 (Dec. 7, 2018).

233. See Prop. Treas. Reg. § 1.904-4(f)(3), 83 Fed. Reg. 63,200, 63,245–46 (Dec. 7, 2018) (cross-referencing portions of Treas. Reg. § 1.989(a)-1(b)).

books and records requirement<sup>234</sup> (for activities of individuals or corporations), or ensuring that the set of foreign activities does not include each and every element of a business (or, instead, that it does). For example, the U.S. taxpayer might move the sales function out of a foreign country and into the U.S., or vice versa, to attempt to change the result on whether a set of foreign activities meets the foreign branch standard.<sup>235</sup>

In the case of FDII, the U.S. taxpayer can simply to choose to earn the eligible sales and services income directly (without keeping separate books and records for the relevant activities),<sup>236</sup> rather than (for example) through a partnership or through a unit that maintains its own books and records. Depending on the facts, avoiding a foreign branch might or might not be difficult. Such strategies could be more challenging for partnerships, given the proposed regulations' theory that a partnership's activities can constitute a foreign branch even without separate books and records.<sup>237</sup>

However, it should be relatively easy to *create* a foreign branch, and to earn income through it rather than directly, even if *avoiding* a

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234. See Sanchirico, *supra* note 163, at 633 n.30 (“It thus may be possible to avoid QBU status by rearranging how the foreign operations are accounted for—though accounting and reporting rules may separately constrain this strategy. Furthermore, it remains unclear what the minimum amount of recordkeeping is.” (citation omitted)); Kadet & Koontz, *supra* note 187.

235. See Sanchirico, *supra* note 163, at 632 (“[A]ctually moving business activity [to the U.S., as FDII may have intended] may be inadvisable for nontax reasons—it may be more efficient to handle U.K. sales with a London-based staff, and factory wages may be lower in Thailand. And so it becomes important to note that it may be possible to make relatively inconsequential changes that prevent foreign operations from being characterized as a foreign QBU. . . . [The 989 regulations’ QBU requirements] seem open to manipulation in relation to FDII. There is, in particular, a strange requirement of wholeness. To constitute a QBU ‘a group of activities must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit . . . .’” (citation omitted)); see also Kadet & Koontz, *supra* note 187 (explaining that “foreign branch” status could be avoided if a foreign hybrid entity (created by “checking the box”) performs only auxiliary functions rather than all parts of a trade or business).

236. Regulations provide that activities that would be treated as a permanent establishment (PE) under a U.S. tax treaty with the relevant country constitute a trade or business for purposes of the foreign branch income rules. See Treas. Reg. § 1.904-4(f)(3)(iii)(B) (2018). That trade or business characterization makes such activities more likely to be treated as a foreign branch under such regulations—in some cases, such treatment is sufficient to achieve foreign branch characterization. See Treas. Reg. § 1.904-4(f)(3)(iii)(B) (2018). U.S. tax treaties generally provide that a PE is created by a fixed physical location that is available to the taxpayer, other than certain auxiliary facilities like warehouses, storage places, and shipping locations. See, e.g., U.K. Tax Treaty, *supra* note 40, art. V; Japan Tax Treaty, *supra* note 40, art. V. Under most U.S. tax treaties, a PE also can be created by a “dependent agent” who has and regularly exercises the power to enter into contracts that bind the U.S. taxpayer. See, e.g., U.K. Tax Treaty, *supra* note 40, art. V.

237. See Prop. Treas. Reg. § 1.904-4(f)(3)(iii)(C)(1), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018).

foreign branch could be difficult in some fact patterns.<sup>238</sup> Once it creates a foreign branch, a U.S. taxpayer can cross-credit any foreign source income and foreign taxes that it chooses (other than passive amounts<sup>239</sup> and GILTI).<sup>240</sup> To achieve this result, the taxpayer merely needs to earn all of such income through a foreign branch (and not even the same foreign branch—the taxpayer can use multiple foreign branches in different countries).<sup>241</sup> This could be a very appealing build-your-own-foreign-branch-basket system, for creative U.S. taxpayers. In the end, U.S. taxpayers do not necessarily want more or fewer baskets—they just want the best possible foreign tax credit limitation fraction(s). (The results of each basket depend on the taxpayer’s specific facts, which determine the alternatives that yield the best foreign tax credit limitation fractions in each basket, given the cross-crediting opportunities available for each taxpayer’s mix of foreign source income and foreign taxes in each basket).

In general, U.S. taxpayers should prefer choice and control regarding their number of baskets and the items in each basket, rather than any particular definition of various baskets. The new foreign branch income basket may provide such choice and control: any income earned through a foreign branch (and such income’s associated foreign taxes) is placed in the foreign branch income basket (other than passive and GILTI amounts), and other income is separated from it—careful planning should be richly rewarded, and might not be overly difficult.

Other, more basic questions also arise regarding the separate books and records requirement and the ease of manipulating it. For example, should one analyze the presence or absence of a foreign branch by looking only at those activities of a U.S. corporation for which separate books and records are maintained, as the regulations seem to indicate? In that case, foreign branch characterization could potentially be defeated by leaving some foreign activities (of those

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238. See generally Jeff Maydew & Julia Skubis Weber, *Foreign Branch Incorporations after the TCJA*, 160 TAX NOTES 1871, 1872 (2018) (discussing pros and cons of foreign branch characterization).

239. See I.R.C. § 904(d)(2)(J)(ii) (2012 & Supp. V 2013–2018).

240. Foreign branch income does not include GILTI because the former consists of the income of a U.S. person (earned through a type of QBU) and the latter consists of income generated by a CFC or CFCs. See *id.* §§ 904(d)(2)(J), 951(a); Treas. Reg. § 1.904-4(f)(2)(iii) (2019) (foreign branch income does not include GILTI or subpart F inclusions).

241. See I.R.C. § 904(d)(1)(B) (2012 & Supp. V 2013–2018); *id.* § 904 (d)(2)(J) (describing foreign branch basket).

necessary to constitute a trade or business) out of the separate books and records that are maintained for the rest of such trade or business. Conversely, what if a set of foreign activities of a U.S. corporation constitutes a trade or business, but the books and records for such activities also include three tangentially related U.S. activities? Are those books and records no longer “separate,”<sup>242</sup> by reason of the poison pill of a few U.S. items? (These issues only apply to the activities of a corporation or an individual, because the activities of a partnership are deemed to meet the books and records requirement if such activities constitute a trade or business.)

The recent proposed regulations include an anti-abuse rule, which would allow the IRS to reallocate income if a “principal purpose” of including, or failing to include, an item on a foreign branch’s books and records is the avoidance of the purposes of section 250’s foreign branch rule for FDII rules or section 904 (which includes the foreign branch income basket),<sup>243</sup> or “avoidance of Federal income tax.”<sup>244</sup> But this anti-abuse rule refers specifically to the actions (recording or failing to record income or expense items) regarding a foreign branch. It might not literally address the existence or initial creation (or avoiding creation) of a foreign branch. The IRS theoretically could use the anti-abuse rule<sup>245</sup> to find that no income should be allocated to an

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242. See Treas. Reg. § 1.989(a)-1(d) (2018) (describing when the requirement for “a separate set of books and records” is met). The foreign branch income regulations imply that inclusion of some U.S. activities on the same books and records as foreign activities that constitute a trade or business would not defeat foreign branch characterization. See Treas. Reg. § 1.904-4(f)(2)(ii) (2019).

243. One difficulty with referring to the purposes of the FDII provisions, and of section 904’s foreign branch income basket, is that is not totally clear what such purposes are with respect to foreign branches, other than disallowing an FDII deduction and imposing separate basket treatment. In other words, it is not clear why such rules describe and disfavor foreign branches. In the absence of a clear rationale, it may be harder to determine when there is a principal purpose of avoiding the underlying policy.

244. See Treas. Reg. § 1.904-4(f)(2)(v) (2019). There is also an argument that a similar anti-abuse rule applies by reason of the foreign branch income proposed regulations’ cross-reference to the section 989 QBU regulations, which in turn cross-reference an anti-abuse rule (relating to books and records) in the section 987 regulations. See Prop. Treas. Reg. § 1.904-4(f)(3)(iii), 83 Fed. Reg. 63,200, 63,246 (Dec. 7, 2018) (cross-referencing Treas. Reg. § 1.989(a)-1(b)(2)(ii) (2018)); Treas. Reg. § 1.989(a)-1(d)(3) (2018) (cross referencing the anti-abuse rule of Treas. Reg. § 1.987-2(b) (2018) for purposes of determining if the books and records requirement—partially contained in Treas. Reg. § 1.989(a)-1(b)(2)(ii) (2016)—is met). However, such cross-reference to the section 987 regulations’ anti-abuse rules may have been waived, for activities of partnerships, trusts, and estates, by the foreign branch proposed regulations’ rule that such activities are deemed to meet the books and records requirement of the section 989 regulations. See Prop. Treas. Reg. § 1.904-4(f)(3)(C)(1)(i), 83 Fed. Reg. 63,200, 63,245 (Dec. 7, 2018).

245. See Prop. Treas. Reg. § 1.904-4(f)(2)(v), 83 Fed. Reg. 63,200, 63,244–45 (Dec. 7, 2018).

asserted foreign branch.<sup>246</sup> It may be harder for the IRS to use the anti-abuse rule to create a foreign branch where the taxpayer argues that there is none.

## V. GILTI: NOT INTANGIBLE, NOT LOW-TAXED

### A. Overview

GILTI (global intangible low-taxed income) is a new concept created by the TCJA.<sup>247</sup> GILTI generated by a U.S. shareholder's CFCs is taxed currently to such U.S. shareholder, but 50% of such income inclusion is deductible,<sup>248</sup> and later repatriation of such amounts is tax-free to such shareholder.<sup>249</sup> In the big picture, the new GILTI system taxes some active income of CFCs currently to their U.S. shareholders, at a low rate, and allows later repatriation tax-free by deeming such income to be previously taxed income under the subpart F rules.<sup>250</sup>

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246. See Prop. Treas. Reg. § 1.904-4(f)(2)(i), 83 Fed. Reg. 63,200, 63,244 (Dec. 7, 2018) (“[G]ross income is attributable to a foreign branch to the extent the gross income . . . is reflected on the separate set of books and records . . . of the foreign branch.”). The anti-abuse rule addresses the books and records. See Prop. Treas. Reg. § 1.904-4(f)(2)(v), 83 Fed. Reg. 63,200, 63,244–45 (Dec. 7, 2018).

247. See I.R.C. § 951A (Supp. V 2013–2018); see also Linda Pfatteicher et al., *GILTI and FDII: Encouraging U.S. Ownership of Intangibles and Protecting the U.S. Tax Base*, BLOOMBERG L., Feb. 27, 2018, at 1; Martin A. Sullivan, *More GILTI Than You Thought*, 158 TAX NOTES 845 (2018); Martin A. Sullivan, *More Than Technical Corrections Needed to Fix GILTI*, 159 TAX NOTES 939 (2018); N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 115, at 15–17 (commenting on GILTI); Sheppard *supra* note 115, at 719; Kamin et al., *supra* note 1, at 1490.

248. See I.R.C. § 951A(a) (Supp. V 2013–2018) (requiring inclusion of GILTI in U.S. shareholder's income); *id.* § 250(a)(1)(B)(i) (allowing deduction). The description of the GILTI rules in the text above is simplified for brevity and convenience. For example, the 50% GILTI deduction, like the FDII deduction, can be reduced to ensure that the sum of the GILTI and FDII deductions does not exceed taxable income. See *id.* § 250(a)(2). Further, the characterization of income as GILTI technically occurs at the level of the U.S. shareholder, rather than at the CFC level. In addition, only the U.S. shareholder's pro rata share of amounts from its CFCs is included in the GILTI computation, which takes into account such amounts from all of such shareholder's CFCs in one aggregate computation. See *id.* § 951A; Kamin et al., *supra* note 1, at 1490. See generally Rosenberg, *supra* note 3 (discussing the GILTI calculation). In particular, each U.S. shareholder takes into account its pro rata share of each of its CFCs' "tested income" or "tested loss" (both of which take relevant deductions into account) and its pro rata share of relevant asset bases from its CFCs that have tested income. The U.S. shareholder then computes one GILTI inclusion, rather than determining GILTI separately for each of its CFCs. See I.R.C. § 951A(f)(1)(A) (Supp. V 2013–2018).

249. See I.R.C. § 951A(f)(1)(A) (Supp. V 2013–2018); I.R.C. § 959 (2012 & Supp. V 2013–2018).

250. See I.R.C. §§ 250, 951A(a), (f)(1)(A) (Supp. V 2013–2018); I.R.C. § 959 (2012 & Supp. V 2013–2018).



The GILTI generated by CFCs is included in the income of such CFCs' U.S. shareholders for the year the GILTI is earned by such CFCs, regardless of whether such shareholders actually receive that income by means of dividends or otherwise. For example, assume that a CFC in Brazil accrues \$100 million of income (as measured under U.S. tax rules) in 2020, and all of such income produces GILTI (as computed at the U.S. shareholder level). Further assume that none of the CFC's U.S. shareholders owns any other CFCs. In that case, the \$100 million is included in the income of such CFC's U.S. shareholders (pro rata to each such shareholder) for 2020, even if the CFC makes no distributions to such shareholders. However, 50% of such GILTI inclusion is then deductible (if the U.S. shareholder is a corporation), leaving an effective U.S. tax rate of 10.5% (half of the corporate tax rate of 21%) on such inclusions.<sup>251</sup> The same 10.5% effective rate (by means of a 50% deduction and the corporate tax rate) also applies to individual U.S. shareholders who make an election under section 962.<sup>252</sup>

GILTI is not, despite its name, the portion of a CFC's income that is low-taxed, attributable to intangible assets, or both. Instead, GILTI is just an arbitrary percentage of the CFC's total income, other than subpart F income and the other listed exceptions.<sup>253</sup> The U.S. international tax rules, as amended by the TCJA, now tax U.S. shareholders on their CFCs' subpart F income at full U.S. tax rates, then use the GILTI regime to tax such shareholder's pro rata share of a random (in effect) portion of the remaining CFC income at half the U.S. tax rate (for corporate shareholders), and finally let the remainder of the CFC's income escape U.S. tax forever (assuming that the shareholder qualifies for the new 100% DRD).<sup>254</sup> Income that the same U.S. corporate shareholder earns in the U.S., in contrast, is taxed at 21% (or 13.125%, effectively, if the FDII deduction applies)<sup>255</sup>—

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251. See I.R.C. § 250(a)(1)(B) (Supp. V 2013–2018).

252. See I.R.C. § 962 (2012 & Supp. V 2013–2018); Prop. Treas. Reg. § 962-1(b)(1)(i), 84 Fed. Reg. 8,188, 8,204–05 (Mar. 6, 2019) (proposing that individuals who make a section 962 election and include GILTI in income are eligible for the 50% deduction of GILTI that otherwise applies only for corporate shareholders). See generally Velarde, *supra* note 8 (describing proposed regulations that would allow the 50% deduction to individuals who elect section 962); Goulder, *Beware of GILTI Self-Help*, *supra* note 118 (discussing section 962 elections); Goulder, *Everything Old Is New Again*, *supra* note 118 (discussing section 962 election).

253. See I.R.C. § 951A(c)(2)(A)(i) (Supp. V 2013–2018).

254. See *id.* § 245A.

255. See *id.* §§ 11(b), 250.

less favorable treatment than even the disfavored portion of a CFC's income that is treated as GILTI.

*B. Why Does GILTI Target Intangible-Related Income Without Accurately Measuring It?*

GILTI is an acronym for “global intangible low-taxed income,” but that is not quite an accurate description of its content.<sup>256</sup> GILTI does not actually consist of intangible or low-taxed income, although it is “global” in the sense that it consists of income earned by a foreign subsidiary. Instead, there are multiple questions about what exactly GILTI really measures, and why. First there's the question of why the GILTI regime would seek to tax intangible rather than tangible income, then the question of whether the GILTI formula successfully measures intangible-related income, and lastly, the issue of whether the GILTI rules were a good idea.

The GILTI rules seem to make an unstated assumption that the income from tangible assets can be earned overseas for virtuous, justifiable, business (non-tax) reasons, while income from intangible assets (such as intellectual property) could and should instead remain in the U.S. It is therefore immoral, such argument would hold, for U.S. taxpayers to earn intangible income outside the U.S.<sup>257</sup> According to GILTI's name (“low-taxed income”), only low-foreign-taxed intangible income is morally suspect and to be penalized, presumably because U.S. taxpayers would not subject intangible income to a high foreign tax without a good business reason.

Other international tax rules also disfavor intangible-related income, apparently on a theory that such income is mobile and may lack a valid business reason for being earned offshore rather than in the U.S.<sup>258</sup> A similar rationale supports treating passive income less favorably than active amounts.<sup>259</sup> Passive and mobile are often linked together, as co-occurring characteristics (or perhaps passive is viewed

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256. See, e.g., Kamin et al., *supra* note 1, at 1490 (discussing the GILTI regime); Boidman, *supra* note 8, at 995 (“From the words that make up the acronym, one would assume the impugned business is the development or other procurement of intellectual property and the licensing or selling thereof. But that (logical) assumption would be wrong.”).

257. Hence, perhaps, the phonetic sound of “GILTI,” which connotes moral failings.

258. See, e.g., I.R.C. § 267A(b)(1) (Supp. V 2013–2018) (no deduction allowed for certain hybrid transactions or hybrid entities); I.R.C. § 954(c) (2012 & Supp. V 2013–2018) (foreign personal holding income includes certain intangible-related income).

259. See I.R.C. § 954(c) (2012 & Supp. V 2013–2018).

as causing mobility) in tax policy discussions.<sup>260</sup> (But some intangible income, such as active royalties, is not treated as passive or as subpart F income,<sup>261</sup> and thus escapes the other mobility-targeting provisions of the Code.)

One could speculate, therefore, that perhaps intangible-related income is subject to less favorable treatment in the GILTI rules because it is passive and mobile.<sup>262</sup> The new deduction for GILTI appears in a portion of the TCJA (and is described in a portion of the Joint Committee Description) entitled “Rules Related to Passive and Mobile Income.”<sup>263</sup> But GILTI is, almost by definition, not passive: GILTI excludes subpart F income, and “passive” is defined (for other Code purposes) by cross-reference to a type of subpart F income.<sup>264</sup> Subpart F income includes the classic passive types of income items: interest, rent, dividends, royalties, and capital gains, unless certain exceptions apply<sup>265</sup> (including a high-taxed income exception).<sup>266</sup> Therefore, passive income is addressed by the subpart F rules and is excluded from GILTI.<sup>267</sup>

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260. See generally Fishbien, *supra* note 98, at 57–58 (discussing the history of subpart F); Lokken, *supra* note 98, at 186–94 (discussing Congress’s distinction between subpart F income and income that is instead active and not easily movable).

261. See I.R.C. § 954(c)(2)(A) (2012 & Supp. V 2013–2018) (active royalties exception from foreign personal holding company category of subpart F); Treas. Reg. § 1.904-4(b)(2)(iii) (2019) (describing active royalties exception from passive basket).

262. See, e.g., Kamin et al., *supra* note 1, at 1490 (“The new tax legislation imposes a minimum tax on ‘global intangible low-taxed income’ (GILTI) of controlled foreign corporations, which is intended to stop U.S. corporations from shifting profits out of the United States.”).

263. See STAFF OF J. COMM. ON TAXATION, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 368 (Comm. Print 2018) (heading of Subpart B).

264. See I.R.C. § 904(d)(2)(B) (2012) (defining passive income); *id.* § 954(c) (defining foreign personal holding company income); *id.* § 951A(c)(2)(A)(i)(II) (excluding subpart F income from the GILTI computation). High-taxed passive-type income can escape foreign personal holding company income characterization through the high-tax exception. See *id.* § 954(b)(4). Income that is subject to the high-tax exception from subpart F is also excluded from the calculation of GILTI. I.R.C. § 951A(c)(2)(A)(i)(III) (Supp. V 2013–2018).

265. See I.R.C. § 954(c) (2012 & Supp. V 2013–2018).

266. See I.R.C. § 954(b)(4) (2012) (providing high-tax exception from foreign base company income and foreign insurance company income, which are two categories of subpart F income). Under the regulations, this high-tax exception has become elective. See Treas. Reg. § 1.954-1(d) (2018).

267. See I.R.C. § 951A(c)(2)(A)(i)(II) (Supp. V 2013–2018) (excluding subpart F from GILTI); I.R.C. § 954(c) (2012 & Supp. V 2013–2018) (including passive types of income in subpart F).

Mobility has historically been a concern in the international tax rules, for example in the subpart F system.<sup>268</sup> The basic worry is that mobile income can be easily moved outside of the U.S. in order to avoid U.S. tax.<sup>269</sup> The subpart F rules (requiring immediate inclusion by U.S. shareholders of their CFCs' subpart F income) are based on attempts to reduce U.S. tax incentives to move mobile activities overseas rather than earning income in the U.S.<sup>270</sup> Active income (and presumably income earned with tangible assets) is assumed to be harder to move from one place to another. Theoretically, for example, a U.S. corporation chooses to manufacture shoes in Brazil, or to farm sunflowers in Spain, because something about the geographic location (such as local resources and materials, or proximity to markets) makes it appealing for non-tax, business reasons.

Conceptually, intangible income is often assumed to be mobile—for example, because it need not be tied to hard-to-move physical assets. For that reason, some intangible income (such as certain royalty income) is included within subpart F income.<sup>271</sup> However, other intangibles, like workforce in place or goodwill (e.g., positive public perception in a locality), or a copyright or other intellectual property that is only registered or protected in one location, might not be mobile. It is not clear why *non-mobile* intangibles would be disfavored for U.S. tax purposes, by the imposition of GILTI tax on U.S. shareholders whose CFCs earn such income.

In addition, GILTI cannot function as a surrogate for mobility because it does not really measure intangible income—or any type of mobile income. GILTI instead essentially consists of a U.S.

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268. See, e.g., Guidance Under Section 958 (Rules for Determining Stock Ownership) and Section 951A (Global Intangible Low-Taxed Income), 84 Fed. Reg. 29,114, 29,115 (proposed June 21, 2019) (to be codified at 26 C.F.R. pt. 1) (explaining, in preamble to proposed regulations on GILTI, that subpart F was intended to address “generally earnings that are passive or highly mobile”). Interest income is the classic example of mobile passive income. The idea is that a taxpayer could easily move cash from a bank account in Iowa to a bank account (possibly owned by a CFC) in Brazil.

269. See generally Fishbien, *supra* note 98, at 3 (discussing the history of subpart F); Lokken, *supra* note 98, at 186–94 (discussing Congress’s view that subpart F income is easily movable).

270. See generally Fishbien, *supra* note 98, at 21–53 (discussing the history of subpart F); Lokken, *supra* note 98, at 196–201 (2005) (noting that subpart F aimed to “curb tax haven sheltering”).

271. See I.R.C. § 954(c)(1)(A) (2012). Some types of intangible-related income, such as active royalties, are excluded from subpart F and passive basket treatment. See *id.* § 904(d)(2)(B)(i) (defining passive income by cross-reference to a type of subpart F income (foreign personal holding company income) that includes the active royalties exception); *id.* § 954(c)(2)(A) (excluding certain active royalties from foreign personal holding company income).

shareholder's pro rata share of all of the income from its CFCs (other than excluded types of income, such as subpart F amounts) reduced by 10% of the bases of certain tangible assets of such CFCs.<sup>272</sup> This is not an accurate measure of intangible income, or of mobile income. Even though tangible asset bases are taken into account, there is no proof that 10% of such bases is the correct amount to remove non-mobile income from taxable GILTI treatment (in all circumstances, for all types of income).<sup>273</sup>

Further, even if the GILTI system is meant to disfavor intangible income earned abroad, such income is still treated more favorably than U.S.-earned income (tangible or intangible). U.S.-earned income is taxed at a 21% rate for U.S. corporations<sup>274</sup> (or 13.125%, effectively, if the FDII deduction applies<sup>275</sup>). In contrast, hypothetically measured foreign-earned intangible income (GILTI), supposedly disfavored, is taxed at an effective rate of 10.5%.<sup>276</sup> Hypothetically computed, active, *tangible*-asset-related foreign earned income, on the other hand (all CFC income other than GILTI and subpart F income), is not subject to U.S. tax at all, if the 100% DRD applies.<sup>277</sup> Intangible-related, non-subpart F income of a CFC is therefore meant to be subject to higher U.S. tax than tangible-asset-related, non-subpart F CFC income, but is still taxed more lightly than the same intangible-related income earned in the U.S. How, then, does such a tax on supposed intangible-related income reduce the incentives to move intangible income out of the U.S.?

Even if income earned through tangible assets is justifiably favored over income from intangible assets, the GILTI rules fail to accurately measure these two types of income, instead using arbitrary hypothetical amounts.<sup>278</sup> The computation attempts to distinguish between income related to intangible and tangible assets by assuming that the latter generate annual income equal to 10% of their adjusted

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272. See I.R.C. § 951A (Supp. V 2013–2018); see also Kamin et al., *supra* note 1, at 1493; Rosenberg, *supra* note 3.

273. See Kamin et al., *supra* note 1, at 1447–48 (describing 10% as an “arbitrary” number).

274. See I.R.C. § 11(b) (Supp. V 2013–2018).

275. See *id.* § 250(a)(1)(A).

276. See *id.* §§ 250(a)(1)(B), 951A.

277. See *id.* § 245A. This discussion ignores income inclusions related to PFICS. See I.R.C. §§ 1291–1296 (2012).

278. See Shaviro, *supra* note 3, at 180 (the GILTI formula does not precisely measure intangible income).

bases.<sup>279</sup> The GILTI calculation then subtracts this hypothetical return from all of the CFC's income (other than subpart F and other exempted categories), and assumes that the remainder must arise from intangible assets.<sup>280</sup> Clearly, as many commentators have noted, this is not an accurate measure of intangible-asset-related income.<sup>281</sup> It is made even less accurate by including the net tested income and relevant tangible asset bases from all of the U.S. shareholder's CFCs in one GILTI calculation, so that 10% of asset bases of one CFC's assets can offset income from other CFCs to reach a final GILTI result.<sup>282</sup>

One could argue that using 10% of tangible, depreciable asset bases as an estimate of how much income is attributable to tangible assets will often underestimate (rather than overvalue) the real amount of such tangible-asset-related income because the calculation uses adjusted bases,<sup>283</sup> which are seldom an accurate measure of an asset's remaining value. Depreciation generally reduces an asset's basis, for tax purposes, faster than the actual decreases in the asset's fair market value.<sup>284</sup> This is usually a taxpayer-favorable result, accelerating depreciation deductions to earlier years. The GILTI rules use the alternative depreciation system, as described in section 168(g), to compute adjusted basis for these purposes<sup>285</sup>—but no depreciation system is likely to completely and reliably track remaining value.<sup>286</sup>

In addition, using 10% as an approximation of the relationship between an asset's adjusted basis and its income stream is completely arbitrary, and unlikely ever to be accurate (except, perhaps, by

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279. I.R.C. § 951A(b)(2)(A) (Supp. V. 2013–2018).

280. *Id.* § 951A(b)(2)(A), (b)(1). For simplicity, much of the discussion in the text ignores the interest expense reduction of asset bases in the calculation. *See id.* § 951A(b)(2)(B).

281. *See, e.g.,* Shaviro, *supra* note 3, at 180 (the GILTI formula does not precisely measure intangible income); Kamin et al., *supra* note 1, at 1494 (the GILTI computation does not necessarily reflect intangible income).

282. I.R.C. § 951A (Supp. V. 2013–2018).

283. *Id.* § 951A(d)(1), (d)(3). In contrast, section 199A uses cost basis (rather than adjusted basis) in its calculation—also not an accurate measure of an asset's current value, but different from the adjusted bases used in the GILTI computation. *See* I.R.C. § 199A(b)(2)(B)(ii) (Supp. V 2013–2018).

284. *See* I.R.C. § 168 (2012 & Supp. V 2013–2018) (providing depreciation rules for tangible assets). *But see* I.R.C. § 197 (2012) (providing a fifteen-year amortization period for certain intangibles, which is arguably slower than such assets actually deteriorate). Faster-than-accurate depreciation will especially be the case under the new 100% first-year depreciation that is available for certain assets for years 2018 through 2022 (followed by lesser, but still accelerated, depreciation for years through 2027). *See* I.R.C. § 168(k)(6) (Supp. V. 2013–2018).

285. *See* I.R.C. § 951A(d)(3)(A) (Supp. V 2013–2018).

286. *Cf.* I.R.C. § 168(b)(4) (2012) (assuming zero dollars of salvage value).

chance).<sup>287</sup> Even if adjusted basis were an accurate measure of an asset's remaining value, such value would not be a reliable sole predictor of the income stream that the asset generates—there must be many, many factors that affect the income that an asset produces (such as labor and material costs, sales prices, market trends, etc.).

Further, land is not among the assets whose bases are taken into account: the “qualified business asset investment” whose basis is taken into account consists only of depreciable property,<sup>288</sup> which does not include land or stock.<sup>289</sup> For example, if a CFC grows tulips in a foreign country, the resulting GILTI equals all income (other than subpart F and other exceptions) of the CFC, reduced by 10% of adjusted bases of depreciable assets used in the tulip farming (assuming the U.S. shareholders have no other CFCs). Tested income (and therefore GILTI) is reduced by 10% of the basis of the tractor used to farm, but not by a percentage of the basis of the land on which the farming takes place. This failure to take land into account is another way in which the approximation of tangible (rather than intangible) income is inaccurate.

GILTI can be thought of as active income, because: (1) it consists only of non-subpart F amounts<sup>290</sup> (and subpart F includes most passive income, leaving only active income for GILTI characterization);<sup>291</sup> and (2) the reduction for 10% of tangible asset bases does not accurately measure anything, and does not operate to remove active

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287. See generally Kamin et al., *supra* note 1, at 1497 (Congress arbitrarily chose 10% as the percentage of relevant tangible asset bases that would reduce tested income to compute GILTI).

288. I.R.C. § 951A(d)(1)(B) (Supp V. 2013–2018) (“of a type with respect to which a deduction is allowable under section 167”).

289. I.R.C. § 167(a) (2012) (“[A] reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) . . .”).

290. See I.R.C. § 951A(c)(2)(A)(i)(II) (Supp V. 2013–2018) (excluding subpart F income from the “tested income” that is used in the GILTI computation).

291. See I.R.C. § 954(c) (2012 & Supp. V 2013–2018) (defining foreign personal holding company income (FPHCI) as including interest, rents, dividends, and royalties, unless certain exceptions apply); see also *id.* § 904(d) (defining passive income, for purposes of the foreign tax credit basketing rules, by cross-reference to FPHCI). The interaction of subpart F and the GILTI rules may be a little more complex, and taxpayers have requested clarification to ensure that the subpart F and GILTI regimes do not accidentally take into account the same CFC income amounts in different years. See generally Marie Sapirie, *When Worlds Collide: GILTI and Subpart F*, 162 TAX NOTES 264, 264–65 (2019), [https://financedocbox.com/Tax\\_Planning/114422575-Comments-on-the-proposed-regulations-concerning-section-951a.html](https://financedocbox.com/Tax_Planning/114422575-Comments-on-the-proposed-regulations-concerning-section-951a.html) (discussing the issue of double inclusion of the same income under GILTI and subpart F in different years); Letter from Eric Solomon, Chair, Section of Taxation, Am. Bar Ass’n, to Hon. Charles P. Rettig, Comm’r, Internal Revenue Serv. 19–21 (Nov. 21, 2018) (discussing potential issue of double inclusion of income under proposed regulation section 1.951A-2(c)(4)).

income from GILTI. In theory, GILTI describes active intangible income, not other active amounts.<sup>292</sup> But because GILTI's definition is so broad (all income, other than excepted types, less 10% of certain asset bases), it is not limited to intangible income.

Is it more likely to over-measure intangible income (i.e., to include non-intangible-related active income) or to under-measure (i.e., to *exclude* some intangible-related, non-subpart F income)? That answer is not clear yet and might vary for different taxpayers (absent tax planning), because 10% is just an arbitrary number. The question of how much active, non-intangible-related CFC income is taxed to the U.S. shareholder is somewhat counterintuitive because GILTI is supposed to (as its name indicates) measure intangible income—but it does not actually do so.

### C. Not Low-Taxed

Nor is GILTI necessarily low-taxed, in contrast to its name. Instead, the GILTI rules refer to the foreign tax rate only in one narrow rule: a CFC's income that is excluded from subpart F under subpart F's high-tax exception is also excluded from tested income (and thus from GILTI).<sup>293</sup> All other CFC income is or is not part of the GILTI computation regardless of its tax rate. In the preamble to recent final regulations, the IRS doubted whether it had the regulatory authority to exclude other high-taxed income from GILTI, given the lack of such an exemption (other than for the subpart F exception) in the statutory language.<sup>294</sup> However, the IRS also issued new proposed regulations that would allow taxpayers to elect to exclude any other high-taxed income of a CFC from GILTI (i.e., in addition to income to which the subpart F high-tax exception applies, which would otherwise be

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292. As discussed above, intangible income is a part of GILTI only if such intangible income is active, because passive amounts are instead covered by subpart F. *See* I.R.C. § 951A (Supp V. 2013–2018) (excluding subpart F amounts from GILTI); I.R.C. § 954(c) (2012 & Supp V. 2013–2018) (including royalties as subpart F income, unless an active royalties exception applies). Therefore, for example, GILTI theoretically does not include passive royalties.

293. *See* I.R.C. § 951A(c)(2)(A)(i)(III) (Supp V. 2013–2018). The high-tax exception excludes a CFC's income from foreign base company income (a subpart F category) if such income is subject to an effective foreign tax rate of more than 90% of the highest statutory U.S. corporate tax rate. *See* I.R.C. § 954(b)(4) (2012).

294. *See* Guidance Related to Section 951A (Global Intangible Low-Taxed Income) and Certain Guidance Related to Foreign Tax Credits, 84 Fed. Reg., 29,288, 29,294 (proposed June 21, 2019) (to be codified at 26 C.F.R. 1) (preamble to final regulations, discussing the IRS's decision not to include an expanded exception for high-taxed income in the final regulations).



subpart F income).<sup>295</sup> This proposed regulatory rule is applicable only after finalization.<sup>296</sup> Therefore, taxpayers cannot take this position now (before the proposed regulatory rule is finalized) without aggressive arguments that the Code language already allows the exclusion of all high-taxed income from GILTI even if such income would not otherwise fall within subpart F.

Note that taxpayers might not want to exclude high-taxed income from GILTI, given a choice: they may want to use the foreign taxes on such high-taxed income to shield other, lower-taxed GILTI from U.S. tax, using the GILTI foreign tax credit.<sup>297</sup> Or they may want to use the asset bases associated with such high-taxed income to reduce the aggregate tested income taken into account in computing GILTI.<sup>298</sup> Whether a U.S. shareholder benefits from electing to exclude high-taxed income (in addition to amounts that would be subpart F income but for the high tax exception) depends on the facts, including the mix of high- and low-foreign-taxed tested income in the shareholder's various CFCs. For example, if U.S. shareholder's CFC X must pay high foreign taxes to country X, the U.S. shareholder might be better off using those country X taxes to shield GILTI generated by CFCs in countries Y and Z from U.S. tax, using the GILTI foreign tax credit. The alternative, on that fact pattern, could be electing to remove the

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295. See Prop. Treas. Reg. § 1.951A-2(c)(1)(iii), -2(c)(6)(i), 84 Fed. Reg. 29,114, 29,129 (June 21, 2019). For this purpose, high-taxed income means income that “was subject to foreign income taxes at an effective rate that is greater than 90 percent of the rate that would apply if the income were subject to the maximum rate of tax specified in section 11,” under the testing methodology provided in the proposed regulations. *Id.* § 1.951A-2(c)(6)(i)(B), -2(c)(6)(ii)(A). The term “high-taxed income” is not the official term used in the proposed regulations’ text, but is used in this Article for convenience.

296. See Prop. Treas. Reg. § 1.951A-7(b), 84 Fed. Reg. 29,114, 29,131 (June 21, 2019) (providing effective date for expanded exclusion of high-taxed income from GILTI).

297. See I.R.C. § 960(d) (Supp. V 2013–2018).

298. Only the bases of assets that are used in generating tested income can be taken into account in reducing GILTI. See *id.* § 951A(b)(1)(B), (b)(2), (d)(2)(A). Therefore, if high-taxed income is excluded from tested income, the associated asset bases become unavailable for the GILTI computation. See Guidance Under Section 958 (Rules for Determining Stock Ownership) and Section 951A (Global Intangible Low-Taxed Income), 84 Fed. Reg., 29114, 29123 (proposed on June 19, 2019) (to be codified at 26 C.F.R. pt. 1) (“The election to apply the high tax exception of section 954(b)(4) with respect to any high-taxed income allows taxpayers to eliminate the need to use foreign tax credits to reduce GILTI tax liability on such income by removing such income from gross tested income; however, taxpayers choosing the election will not be able to use the foreign tax credits associated with that income against other section 951A category income, and they will not be able to use the tangible assets owned by high tax QBUs [of CFCs] in their QBAI computation. Therefore, taxpayers will have to evaluate their individual facts and circumstances to determine whether they should make the election.”).

tested income from CFC X from the U.S. GILTI computation, while paying GILTI tax on CFC X and Y's generation of GILTI.<sup>299</sup> If CFC X were viewed alone, without regard to its impact on the U.S. tax applicable to amounts from CFCs Y and Z, the U.S. shareholder could be indifferent to GILTI treatment, if the foreign tax credit for CFC X's taxes can be used to completely offset the U.S. tax on the portion of the GILTI inclusion generated by CFC X.

The expanded high-tax exception from GILTI would be elective, according to the proposed regulations.<sup>300</sup> This would allow taxpayers to choose whichever approach most reduces their U.S. tax, thus whipsawing the government. The proposed regulations' preamble does not provide a statutory interpretation that explains why the new rule is elective: if the expanded high-tax rule carries out the intent of Congress to limit GILTI to low-foreign-taxed amounts, shouldn't it be mandatory? The IRS may have been uncomfortable about mandating a rule that is not clearly provided or allowed in the statute. It may have anticipated fewer (or no) challenges to its regulatory authority if the rule were made elective (and thus almost always taxpayer favorable).

Subpart F's exclusion of high-taxed income, cross-referenced in the GILTI statute, is also elective (by reason of the subpart F regulations).<sup>301</sup> But if the taxpayer elects to exclude income from subpart F under the high-tax exception, exclusion of the same income from the GILTI computation appears to be mandatory.<sup>302</sup> The new proposed regulations on GILTI do not appear to change this statutory result.

For now, until the proposed regulations are finalized (which might or might not happen, in their current form), the GILTI rules do not inquire as to the foreign tax amounts imposed on CFCs' income, other than the exclusion of high-tax-exception income that would

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299. The discussion in the text is a simplification, for illustrative purposes. GILTI is not computed separately for each CFC, but instead results from an aggregate computation that takes into account all of the U.S. shareholder's CFCs. *See* I.R.C. § 951A(b), (c) (Supp. V 2013–2018). Thus, the GILTI generated by any one of a U.S. shareholder's multiple CFCs is a useful concept, but not an amount technically computed under the statute. Similarly, the GILTI foreign tax credit is computed in the aggregate, taking into account relevant amounts from all of the U.S. shareholder's CFCs. *See* I.R.C. § 960(d) (2012 & Supp V. 2013–2018).

300. *See* Prop. Treas. Reg. § 1.951A-2(c)(6)(i)(A), 84 Fed. Reg. 29,114, 29,129 (June 21, 2019).

301. *See* Treas. Reg. § 1.954-1(d) (2018) (providing that subpart F's high-tax exception is elective).

302. *See* I.R.C. § 951A(c)(2)(A)(i)(III) (Supp. V 2013–2018) (tested income does not include "any gross income excluded . . . by reason of section 954(b)(4)").

otherwise be subpart F income. Further, GILTI is computed as an aggregate amount, taking into account the income, expenses, and losses of all of the U.S. shareholder's CFCs (reduced by their excluded items of income and by 10% of the asset bases of qualifying assets).<sup>303</sup> Therefore, the income items of CFCs that are subject to vastly different foreign tax rates are all combined together, without classification based on the amount of the effective foreign tax rate.<sup>304</sup>

There have been suggestions that the U.S. foreign tax credit (as computed for GILTI) operates to eliminate U.S. tax on high-taxed GILTI, thus limiting U.S. tax to only those portions of GILTI that are subject to low foreign taxes.<sup>305</sup> The first part of that theory is arguably correct: the foreign tax credit<sup>306</sup> can completely offset U.S. tax on high-foreign-taxed GILTI. However, such a complete offset of the U.S. tax on GILTI occurs *only if*: (a) the foreign taxes are sufficiently high (viewing such taxes in the aggregate for all of the U.S. shareholder's CFCs); (b) the multi-part GILTI deemed paid tax formula<sup>307</sup> and the limitation fraction in the GILTI basket<sup>308</sup> are sufficiently favorable; and (c) the U.S. shareholder can claim any resulting foreign tax credits for the current year (which is important because there are no carryovers to other years for excess GILTI-

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303. See *id.* § 951A (Supp. V 2013–2018).

304. See N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 115; Shaviro, *supra* note 3, at 181; Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act, 83 Fed. Reg., 63,200 (proposed Dec. 7, 2018) (to be codified at 26 C.F.R. pt. 1.) (preamble to recent foreign tax credit regulations that address GILTI-related foreign tax credits); Rosenberg, *supra* note 3 (discussing computation of GILTI and the GILTI-related foreign tax credit).

305. See Browning, *supra* note 128. See generally H.R. REP. NO. 115-466, at 643–44 (2017) (Conf. Rep.) (discussing GILTI-related foreign tax credit); Shaviro, *supra* note 3, at 180–81, 182–84 (discussing mechanics of GILTI-related foreign tax credits).

306. The foreign tax credit allows U.S. taxpayers to reduce their U.S. tax by the amount of foreign taxes paid or accrued, subject to many requirements. See I.R.C. §§ 901, 904 (2012 & Supp. V. 2013–2018); I.R.C. § 903 (2012); Treas. Reg. §§ 1.901-2, 1.904-4 (2018).

307. See I.R.C. § 960(d) (Supp. v. 2013–2018). See generally Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act, 83 Fed. Reg., 63,200 (proposed Dec. 7, 2018) (to be codified at 26 C.F.R. pt. 1.) (preamble to recent foreign tax credit regulations that address GILTI-related foreign tax credits); N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 116, at 11–13 (discussing GILTI-related deemed paid foreign tax credits); Shaviro, *supra* note 3, at 183–84 (discussing foreign tax credits related to GILTI); Lewis, *supra* note 128 (discussing GILTI-related foreign tax credit rules); Browning, *supra* note 128 (discussing changes in the foreign tax credit system); Rosenberg, *supra* note 3 (describing the computation of deemed paid GILTI-related foreign taxes and the GILTI-related foreign tax credit).

308. See I.R.C. § 904(a) (2012) (describing limitation formula); I.R.C. § 904(d) (2012 & Supp. V 2013–2018) (requiring that limitation be applied separately to baskets, including the GILTI basket).

related foreign tax credits).<sup>309</sup> If any of these three conditions is not fully met, even relatively high-taxed GILTI can suffer full or partial imposition of the 10.5% effective rate of U.S. tax on GILTI.

Among other things, the U.S. taxpayer's specific fact pattern may prevent it from claiming foreign tax credits in the year of the GILTI inclusion. For example, other circumstances might push the taxpayer to claim deductions rather than credits for foreign taxes for the year.<sup>310</sup> In addition, individuals are not eligible for GILTI-related deemed paid credits unless they elect under section 962 (which many are likely to do).<sup>311</sup> Further, the foreign tax credit only applies for creditable foreign taxes—foreign taxes that have the predominant character of an income tax in the U.S. sense,<sup>312</sup> that are imposed in lieu of such an income tax,<sup>313</sup> or that are creditable under a U.S. tax treaty.<sup>314</sup> GILTI that is subject to high foreign taxes that are not creditable—such as a value added tax (VAT) or a gross basis tax that does not qualify as in-lieu-of an income tax<sup>315</sup>—does not benefit from the foreign tax credit and is fully subject to the U.S. tax on GILTI, at a 10.5% maximum effective rate.<sup>316</sup> It is not clear why GILTI subject to high non-creditable foreign taxes is morally suspect (i.e., theoretically moved offshore rather than earned in the U.S. in order to avoid U.S. tax, rather than for business reasons).

Along with other considerations regarding the reliability of the foreign tax credit as a complete remedy for higher-taxed amounts,

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309. See I.R.C. § 904(c) (2012 & Supp. V 2013–2018).

310. See *id.* § 164(a)(3) (allowing deductions for foreign income taxes); I.R.C. § 275(a)(4) (2012) (preventing taxpayers from claiming deductions for foreign taxes if they elect to claim foreign tax credits for the same taxable year); I.R.C. § 901(a) (Supp. V 2013–2018) (allowing taxpayers to elect to claim foreign tax credits for foreign income taxes).

311. See I.R.C. § 962 (2012 & Supp. V 2013–2018). See generally Goulder, *Everything Old Is New Again*, *supra* note 118, at 771–72 (explaining that individuals are now eligible for GILTI-related deemed credits if they elect under section 962); Rosenberg, *supra* note 3 (discussing the impact of the section 962 election after the TCJA).

312. See I.R.C. § 901 (2012 & Supp. V 2013–2018); Treas. Reg. § 1.901-2(a)(1)(ii) (2018).

313. See I.R.C. § 903 (2012).

314. There are also issues regarding the interaction of U.S. tax treaties with the TCJA's new international tax rules, including whether the pre-TCJA U.S. tax rules can be claimed under such treaties. These treaty-related issues are outside the scope of this Article. See generally Fadi Shaheen, *How Reform-Friendly Are U.S. Tax Treaties*, 41 BROOK J. INT'L L. 1243, 1267–89 (2016) (discussing whether proposed reforms were compatible with tax treaties); Shaviro, *supra* note 3, at 183 (discussing the new GILTI-related foreign tax credit and its interaction with U.S. tax treaties' grant of a foreign tax credit).

315. See I.R.C. § 903 (2012).

316. See I.R.C. § 250(a)(1)(B) (Supp. V 2013–2018) (allowing domestic corporations a 50% deduction for GILTI).

higher-foreign-taxed GILTI bears some of its foreign tax as a real cost, due to limitations on the GILTI foreign tax credit.<sup>317</sup> This is not unfair, because the U.S. only taxes 50% of GILTI (after the GILTI deduction).<sup>318</sup> But such non-creditable foreign tax is a non-recoverable cost (i.e., not eligible for U.S. tax benefits) that may affect taxpayer choices about where to locate their CFCs.<sup>319</sup>

Relying on the foreign tax credit, especially given the complexities and requirements of the GILTI foreign tax credit and its aggregate computation, does not reliably and completely exempt all high-taxed GILTI from U.S. tax. Rather than this indirect method of reducing U.S. tax by means of a credit, eliminating high-taxed income (however defined) from the GILTI computation in the first place would have been more direct and more effective—if Congress had intended to exempt such income from GILTI. Overall, it would have been more accurate, if the goal was to target low-taxed income, for GILTI to include only CFC income that is subject to low or zero foreign tax rates. That would have been a direct and relatively simple solution. Alternatively, Congress could have removed high-foreign-taxed income from GILTI characterization by creating a rule analogous to the high-tax exception from subpart F<sup>320</sup> or the high-tax kickout from the passive basket.<sup>321</sup> One could argue that the low-tax concept was implemented partly by excluding from GILTI any income that is removed from subpart F by reason of subpart F's high-tax exception.<sup>322</sup> But that is only a partial solution; income excluded by reason of subpart F's high-tax exception simply does not describe all of the potential kinds of high-taxed income that a CFC could earn. GILTI can include such other (non-subpart F) high-taxed income, at

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317. *See id.* §§ 951A, 960(d). *See generally* Rosenberg, *supra* note 19, at 84–94 (discussing the impact of the partial foreign tax credit for GILTI-related foreign taxes). Technically, the U.S. shareholder has one GILTI amount, computed with respect to all of such shareholder's pro rata amounts relating to all its CFCs (rather than separate GILTI amounts calculated with respect to each CFC). The discussion above refers to higher-foreign-taxed GILTI from one CFC, and lower-foreign-taxed GILTI from another, only to analyze the impact of mixing different CFCs' items in the same aggregate GILTI computation.

318. *See* I.R.C. § 250 (Supp. V 2013–2018).

319. *See generally* Rosenberg, *supra* note 3 (discussing the impact of section 960's repeal, and the new, limited foreign tax credit for GILTI-related foreign taxes, on taxpayer's location choice section 962 election).

320. *See* I.R.C. § 954(b)(4) (2012).

321. *See* I.R.C. § 904(d) (2012 & Supp. V. 2013–2018).

322. *See* I.R.C. § 951A (Supp. V 2013–2018).

least until the proposed regulations' approach of elective high-taxed income exclusion is finalized.

The high-tax exception, as broadened by the proposed regulations, may address some of these concerns. But because such expanded exception is proposed to be elective,<sup>323</sup> we can expect the Treasury to get whipsawed: taxpayers will elect to exclude or instead include high-foreign-taxed income in the GILTI computation depending on the overall reduction in U.S. tax from the combination of the GILTI inclusion (as reduced by the GILTI deduction) and the GILTI foreign tax credit. There appears to be no policy justification for making the GILTI treatment of high-taxed (non-subpart F) income elective.

Further, the second part of the hypothesis—that the potential availability of foreign tax credits functions to limit U.S. tax of GILTI to lower-foreign-taxed income earned through CFCs—perhaps does not go far enough. GILTI does not actually target low-taxed amounts, because low-taxed GILTI can also avoid U.S. tax. Not only can high-foreign taxed amounts escape U.S. tax by means of the GILTI foreign tax credit,<sup>324</sup> but low-foreign-taxed amounts can also fully or partly escape the U.S. GILTI tax using the same credit mechanism. Under the GILTI foreign tax credit computations, low-taxed CFC earnings can avoid U.S. tax on GILTI by means of effectively cross-crediting with the foreign taxes associated with higher-foreign-taxed amounts.<sup>325</sup>

Both the GILTI inclusion in the U.S. shareholder's income<sup>326</sup> and the GILTI-related foreign tax credit<sup>327</sup> (including the preliminary step of the deemed payment of foreign taxes)<sup>328</sup> are computed in the aggregate, by examining all of the U.S. shareholder's CFCs together. Up to 80% of the aggregate GILTI-related foreign taxes can be deemed paid by the U.S. shareholder, and then can potentially be used to offset the U.S. tax on GILTI (which only applies at a 50% effective

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323. See Prop. Treas. Reg. § 1.951A-2(c)(6)(i)(A), 84 Fed. Reg. 29,114, 29,129 (June 21, 2019).

324. See I.R.C. § 960(d) (Supp. V 2013–2018).

325. See *id.* See generally Rosenberg, *supra* note 3 (discussing the potential for cross-crediting regarding the GILTI-related foreign tax credit).

326. See I.R.C. § 951A (Supp. V 2013–2018).

327. See I.R.C. § 904(d)(1)(A) (2012 & Supp. V 2013–2018); I.R.C. § 960(d) (Supp. V 2013–2018).

328. See I.R.C. § 960(d) (Supp. V 2013–2018).

rate).<sup>329</sup> Low-taxed income from a CFC is thus capable of escaping U.S. tax on GILTI in the U.S. shareholder's hands, if foreign tax credits generated by higher-taxed CFCs can be used to offset U.S. tax on GILTI originating from the lower-foreign-taxed CFC.<sup>330</sup> Therefore, contrary to its apparent intent to penalize low-foreign-taxed foreign source income earned through CFCs,<sup>331</sup> the GILTI system allows such income to completely avoid U.S. tax, through cross-crediting.

Overall, the foreign tax credit is not a perfect mechanism for limiting GILTI-related U.S. tax to "low-taxed" foreign income. The proposed regulations' approach, in contrast, would effectively include high-taxed income in the GILTI computation only if such inclusion lowers the taxpayer's total U.S. tax. Even if the proposed regulations were finalized as proposed, GILTI would not be limited to low-taxed amounts, and (conversely) some low-taxed amounts would escape the GILTI tax.

#### *D. Overall Impact of GILTI: Not So Awful*

The GILTI rules can be described as applying a penalty (or taxpayer-unfavorable result), by imposing U.S. tax on active (non-passive, meaning non-subpart F) amounts earned by CFCs. It is true that such income was not previously subject to U.S. tax in U.S. shareholders' hands unless and until such amounts were distributed to such shareholders.<sup>332</sup> The GILTI regime has thus reduced U.S. shareholders' control over the timing of U.S. tax on active amounts earned by a CFC, by detaching the timing of such U.S. tax from actual distributions by the CFC.<sup>333</sup> The GILTI system also makes it harder to escape U.S. tax entirely due to current year recognition of GILTI in the U.S. shareholder's hands. However, U.S. tax on GILTI can still be reduced or avoided by offsetting the tested income of some of the U.S. shareholder's CFCs with the tested losses of other CFCs of the same

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329. *See id.*

330. *See id.* (providing deemed paid tax computation for GILTI). *See generally* Rosenberg, *supra* note 3 (describing GILTI foreign tax credit computation); Browning, *supra* note 128 (explaining that foreign tax credits completely offset U.S. tax on GILTI if the foreign taxes are at least 13.125%).

331. *Cf.* Shaviro, *supra* note 3, at 179 (commenting that the GILTI rules see low-foreign-taxed income as more appropriately subject to U.S. tax than high-foreign-taxed income).

332. For simplicity, this discussion does not include the PFIC rules, which pre-date the TCJA, continue to apply, and generally address passive-type income of certain foreign corporations. *See* I.R.C. §§ 1291–1298 (2012).

333. *See* I.R.C. § 951A (Supp. V 2013–2018).

U.S. shareholder,<sup>334</sup> and by reducing tested income by 10% of the bases of relevant assets.<sup>335</sup> Both of these tactics lessen the amount of GILTI. In addition, GILTI inclusions are subject to only a 10.5% effective U.S. tax rate.<sup>336</sup> Lastly, the resulting U.S. tax on GILTI can potentially be offset by GILTI-related foreign tax credits, depending on the facts.<sup>337</sup>

Viewed as a whole, the GILTI system (income inclusion, 50% deduction, and partial foreign tax credit), combined with tax-free repatriation,<sup>338</sup> is not overly taxpayer-unfavorable. Instead, this set of rules provides a massive benefit to U.S. shareholders of CFCs, with respect to U.S. taxation of non-subpart F income. Under the GILTI rules, non-subpart F income (conceptually, active income) of a CFC is subject to a maximum 10.5% U.S. effective tax rate<sup>339</sup> (half the usual 21% rate that applies to U.S. corporations).<sup>340</sup> That effective rate can be reduced by careful planning regarding asset bases and by timing tested losses (and expenses) to offset tested income.<sup>341</sup> The GILTI foreign tax credit<sup>342</sup> can further reduce or eliminate net U.S. tax on

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334. *See id.* The computation includes only the U.S. shareholder's proportionate share of each CFC's tested income or tested loss.

335. *See id.*

336. *See id.* § 250(a)(1)(B) (providing for 50% deduction for GILTI, which results in a 10.5% effective tax rate).

337. *See* I.R.C. § 901 (2012 & Supp. V 2013–2018); I.R.C. § 904(a) (2012); I.R.C. § 960(d) (Supp. V 2013–2018).

338. *See* I.R.C. § 250(a)(1)(B) (Supp. V 2013–2018) (allowing deduction); *id.* § 951A(a), (f)(1) (requiring GILTI inclusion, and treating GILTI as subpart F income for purposes of the previously taxed income rules); *id.* § 960(d) (Supp. V 2013–2018) (providing for deemed payment of foreign taxes); I.R.C. § 959 (2012 & Supp. V 2013–2018) (no additional tax on repatriated PTI).

339. *See* I.R.C. § 250(a)(1)(B) (Supp. V 2013–2018) (allowing 50% deduction of GILTI). The 10.5% effective rate applies by reason of the 50% deduction for GILTI, which statutorily applies only to corporations, not individuals. Recent proposed regulations would, if finalized, allow individuals to claim the 50% GILTI deduction, if such individuals make an election under section 962. *See* I.R.C. § 962 (2012 & Supp. V 2013–2018); Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3), 84 Fed. Reg. 1,874, 1,874–75 (Feb. 5, 2019) (proposing that individuals who make a section 962 election and include GILTI in income are eligible for the 50% deduction of GILTI that otherwise applies only for corporate shareholders); *see also* Velarde, *supra* note 8 (discussing proposed regulation that would allow individuals who elect under section 962 to claim a GILTI deduction). Without such an election, the 50% deduction applies only to corporations. *See* I.R.C. § 250(a)(1)(B) (Supp. V 2013–2018).

340. *See* I.R.C. § 11(b) (Supp. V 2013–2018).

341. *See generally* Rosenberg, *supra* note 3 (discussing the GILTI computation).

342. *See* I.R.C. § 960(d) (Supp. V 2013–2018).



GILTI. There is no further U.S. tax when amounts are repatriated (distributed) by a CFC to its U.S. shareholder.<sup>343</sup>

However, the results for individuals (and other non-corporate U.S. shareholders) can be harsher: unless the individual elects to apply section 962, there is a higher maximum tax rate<sup>344</sup> but no 50% deduction for GILTI and no GILTI-related foreign tax credit.<sup>345</sup> With a section 962 election, individuals can benefit from the same 50% deduction, corporate tax rate of 21%, and GILTI foreign tax credit that apply to corporations, although the rules on repatriation differ for such individual shareholders.<sup>346</sup>

Thus, in exchange for reduced control over the timing of U.S. tax on non-subpart F amounts earned through CFCs,<sup>347</sup> U.S. shareholders have gained a drastically reduced U.S. tax rate on such earnings.<sup>348</sup>

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343. When distributed to the U.S. shareholder, GILTI is treated as “previously taxed income” (PTI), and therefore (like distributed subpart F amounts) is not subject to further U.S. tax. This is accomplished by a cross-reference from the GILTI rules to the PTI rules. *See id.* §§ 951A(f)(1)(A), 959. Amounts that represent neither GILTI nor subpart F income are not taxable to the U.S. shareholder when received, if the DRD applies. *See id.* § 245A. The DRD applies only to U.S. shareholders that are corporations. *See id.* Individuals receive PTI treatment for distributions of GILTI and subpart F amounts, but are not eligible for the 100% DRD for other distributions. *See id.* §§ 245A, 951A(f)(1)(A). Individuals are also ineligible for PTI treatment of distributions of GILTI (and subpart F income) if such individuals make a section 962 election. *See* I.R.C. § 962(d) (2012 & Supp. V 2013–2018).

344. *See* I.R.C. § 1(j) (Supp. V 2013–2018).

345. *See id.* §§ 250, 960(d); I.R.C. § 962 (2012 & Supp. V 2013–2018); *see also* Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3), 84 Fed. Reg. 1,874, 1,874–75 (Feb. 5, 2019) (proposing regulations that would allow individuals who make a section 962 election to claim the 50% deduction for GILTI, which is provided in section 250 for corporations).

346. *See* I.R.C. § 962 (2012 & Supp. V 2013–2018); Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3), 84 Fed. Reg. 1,874, 1,874–75 (Feb. 5, 2019) (proposing that individuals who elect section 962 can claim 50% GILTI deduction). On repatriation, section 962 requires that individuals include an amount in income, but taxpayers can then apply the reduced tax rate that applies to all dividends of individuals (if the holding period requirement is met and if the CFC is a qualified foreign corporation within the meaning of the dividend rules). *See* I.R.C. §§ 1(h)(11), 962(d) (2012 & Supp. V 2013–2018); *see also* further discussion of section 962, *infra*.

347. A U.S. shareholder can avoid GILTI by using a 10/50 company rather than a CFC. *See* I.R.C. § 951A(a) (Supp. V 2013–2018) (GILTI is limited to amounts from CFCs, not other foreign subsidiaries). But using a 10/50 company means giving up control, because U.S. shareholders in the aggregate cannot own more than 50% of such a company without causing it to become a CFC. *See* I.R.C. § 957(a) (2012 & Supp. V 2013–2018) (defining CFC). Theoretically, depending on the facts, a U.S. shareholder could still maintain effective control with 50% ownership, if all other shareholders owned only minor percentages.

348. This is the case only for U.S. shareholders who are corporations. U.S. shareholders who are individuals must include GILTI in income, without the 50% deduction and without a GILTI-related foreign tax credit, unless they elect under section 962 to use the corporate tax rate of 21%, the partial GILTI-related foreign tax credit, and the 50% GILTI deduction. *See* I.R.C. § 250 (Supp. V 2013–2018) (GILTI deduction); *id.* § 951A (GILTI inclusion); *id.* § 951A(f)(1)(A) (treating

Fundamentally, the new Code rules (in theory) aim to tax intangible-related foreign income (earned through CFCs) at half of the U.S. corporate tax rate, tangible-asset-related foreign income earned through CFCs (and all other non-subpart F, non-PFIC income earned through a foreign subsidiary) at zero percent, and subpart F income and U.S. income at the full 21% rate for corporations. As the rules are actually written, however, they tax an arbitrary portion of the CFC's income (in the U.S. shareholder's hands) at half the U.S. corporate tax rate (subject to further reduction by the GILTI foreign tax credit), tax the subpart F income at the full corporate rate, and let the rest of a CFC's (or other foreign subsidiary's) income remain free of U.S. tax (whether or not repatriated) if the DRD applies.

In addition, the GILTI foreign tax credit can reduce or even eliminate the U.S. tax on GILTI. A corporate U.S. shareholder can be deemed to pay up to 80% of the GILTI-related foreign taxes of its GILTI-generating CFCs,<sup>349</sup> and can then (subject to many rules)<sup>350</sup> claim foreign tax credits for such deemed paid taxes.<sup>351</sup> This 80% limit is relatively generous, given that a maximum of 50% would be more consistent with the fact that the U.S. only taxes 50% of GILTI in the corporate shareholder's hands.<sup>352</sup>

Further, the U.S. shareholder is not required to meet a holding period in order to escape additional U.S. tax when GILTI is actually repatriated, unlike the more-than-365-day holding period that is needed to obtain the DRD for dividends.<sup>353</sup> GILTI is not taxed again when actually paid to the U.S. shareholder as dividends—it is treated

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GILTI like subpart F income for purposes of section 962); *id.* § 960(d) (deemed payment of GILTI-related foreign taxes); I.R.C. § 962 (2012 & Supp. V 2013–2018) (election to use corporate tax rate for subpart F income and claim deemed paid credits under section 960); Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3), 84 Fed. Reg. 1,874, 1,874–75 (Feb. 5, 2019) (proposing that individuals who make a section 962 election are eligible for the 50% deduction of GILTI).

349. See I.R.C. § 960(d) (Supp. V 2013–2018). The GILTI foreign tax credit also applies to individual shareholders who elect under section 962. See I.R.C. § 962 (2012 & Supp. V 2013–2018).

350. For example, GILTI is placed in a separate foreign tax credit “basket,” and excess GILTI-related foreign tax credits cannot be carried over to other years. See I.R.C. § 904(c), (d) (2012 & Supp. V 2013–2018).

351. See I.R.C. § 960(d) (Supp. V 2013–2018). See generally Rosenberg, *supra* note 3 (describing the GILTI-related foreign tax credit). The GILTI foreign tax credit is computed in the aggregate, using a formula that takes into account tested income and foreign taxes from all of the U.S. shareholder's CFCs. See I.R.C. § 960(d) (Supp. V 2013–2018). See generally Rosenberg, *supra* note 3 (describing the computation of the GILTI-related foreign tax credit).

352. See I.R.C. § 250(a)(1)(B) (Supp. V 2013–2018) (50% deduction for GILTI).

353. See I.R.C. § 246(c)(5) (2012).

like previously taxed income (under the subpart F rules) for these purposes.<sup>354</sup> In contrast, non-GILTI, non-subpart F income must meet the DRD's holding period (more than 365 days) in order to escape U.S. tax on repatriation.<sup>355</sup>

Overall, GILTI generally bears lower U.S. tax than subpart F income, and higher U.S. tax than non-subpart F, non-GILTI earnings of foreign subsidiaries—but the differing availability of foreign tax credits for these three types of income, compared with the foreign tax amounts imposed under the specific fact pattern, may change that comparative ranking. GILTI may generally be more taxpayer favorable than subpart F income, due to the lower effective U.S. tax rate caused by the GILTI deduction.<sup>356</sup> However, the reduced GILTI foreign tax credit (compared to the foreign tax credits available for subpart F income)<sup>357</sup> may conversely cause subpart F to be more appealing for some taxpayers, depending on the facts (especially the applicable foreign tax amounts).<sup>358</sup>

Further, GILTI bears a higher U.S. tax than non-GILTI, non-subpart F amounts earned through foreign subsidiaries, and thus may be less appealing than such other amounts.<sup>359</sup> GILTI can, however, generate a partial foreign tax credit,<sup>360</sup> which non-GILTI, non-subpart F amounts cannot.<sup>361</sup> Therefore, if the taxpayer already has low-foreign-taxed GILTI that will be subject to U.S. tax, it may be helpful to have additional, high-foreign-taxed GILTI in the same year<sup>362</sup> (which would not be beneficial but for the presence of the lower-taxed GILTI).

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354. See I.R.C. § 951A (Supp. V 2013–2018); I.R.C. § 959 (2012 & Supp. V 2013–2018).

355. See I.R.C. § 246(c)(5) (Supp. V 2013–2018).

356. See *id.* § 250(a)(1)(B) (50% deduction for GILTI).

357. Compare *id.* § 960(d), I.R.C. § 904(c) (2012 & Supp. V. 2013–2018), and *id.* § 904(d)(1)(A), with *id.* § 960(a) (deemed paid foreign taxes with respect to subpart F income).

358. See Rosenberg, *supra* note 19, at 64.

359. Subpart F income may be more taxpayer favorable than GILTI in fact patterns in which the less restricted foreign tax credits available for subpart F inclusions outweigh the detriment of the higher U.S. effective tax rate for subpart F inclusions (as compared to GILTI). See Shaviro, *supra* note 3, at 184, 192 (taxpayers will need to compare the pros and cons of subpart F and GILTI treatment, including the impact of foreign tax credits); Rosenberg, *supra* note 3 (subpart F can be more favorable than GILTI, in some circumstances, due to a more generous computation of deemed paid foreign taxes, which can lead to higher foreign tax credits).

360. See I.R.C. § 960(d) (Supp. V 2013–2018) (deemed payment of GILTI-related foreign taxes).

361. See generally Rosenberg, *supra* note 3 (comparing GILTI- and subpart F-related deemed paid foreign tax credits).

362. See generally *id.* (describing the benefits of cross-crediting within the GILTI basket).

## VI. TANGIBLE ASSETS: WHERE TO MOVE THEM FOR MAXIMUM U.S. TAX BENEFIT, AND INTERACTION WITH THE NEW 100% FIRST YEAR DEPRECIATION

Tangible assets are used as a reverse proxy to compute a corporation's foreign-derived intangible-related income for the GILTI and FDII provisions. Both of such rules subtract 10% of qualified tangible asset bases from an entity's income (after excluding certain types of income).<sup>363</sup> As explained above, this is not likely to be an accurate reflection of intangible-related income, but it does make tangible, depreciable asset bases an important data point.

Tangible, depreciable assets overseas help the U.S. taxpayer in the GILTI computation, but such assets in the U.S. hurt the taxpayer's FDII computation.<sup>364</sup> Therefore, whether the use of tangible assets to generate foreign income is disfavored or favored depends on whether such income is earned by a U.S. corporation or instead by its foreign subsidiary. Generally, the use of tangible, depreciable assets reduces a U.S. corporation's FDII deduction.<sup>365</sup> This is somewhat counterintuitive, because a U.S. corporation's income earned by selling property to foreign persons for foreign use, or from the performance of services abroad, is favored (by means of a 37.5% FDII deduction),<sup>366</sup> and such activities can be expected to involve tangible

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363. See I.R.C. §§ 250(b), 951A(d) (Supp. V 2013–2018).

364. See I.R.C. §§ 250(b)(1)(B); 951A(d). Such assets are also relevant under section 199A (the 20% deduction for certain trade or business income of non-corporate taxpayers). See I.R.C. § 199A(b)(2)(B)(ii). Tangible, depreciable assets can help individuals increase their deduction under the new section 199A computation for individuals who are above the income threshold. See *id.*

365. See I.R.C. § 250(b)(2). Only such assets used to generate “deduction eligible income” are taken into account for this purpose. See *id.* at § 250(b)(2)(B).

366. Because the FDII deduction is generally available only for a U.S. corporation's income earned from selling products to a foreign person for foreign use, or from performing services abroad, this provision also creates an incentive to sell to foreign rather than U.S. persons, for use overseas rather than in the U.S., and to perform services in foreign rather than U.S. locations. See *id.* § 250(b)(4). (For this purpose, sales include leases and licenses. See I.R.C. § 250(b)(5)(E) (Supp. V 2013–2018).) Because there is a tax deduction available for such foreign-connected income, there may also be an unintended incentive for U.S. corporations to offer better prices to foreign persons than to U.S. customers. For example, assume that a U.S. corporation could sell a quantity of timber (or equipment repair services) to a U.S. customer or to a foreign customer (for use outside the U.S.). The FDII deduction applies to sales only if the buyer is a foreign person and the product is to be used outside the U.S. See *id.* The seller might be willing to offer the foreign customer a slightly better sales price than the U.S. customer, so long as the price discount is less than the expected value of the FDII deduction (which is available for sale to the foreign but not the U.S. person). Can this be a good thing for other U.S. taxpayers, and for the U.S. economy in general?

assets. Presumably, the disfavoring of tangible asset use in the FDII rules occurs because the FDII benefit is meant to benefit intangible-related income of U.S. corporations that relates to such sales or services.<sup>367</sup>

Technically, tangible assets' negative impact on the FDII deduction occurs because the amount of a U.S. corporation's income that is eligible for a 37.5% deduction is computed as the product of a fraction times a multiplicand.<sup>368</sup> The multiplicand is "deemed intangible income,"<sup>369</sup> which equals all income (with exceptions) less the deemed tangible return. Because a smaller multiplicand means a smaller deduction, and more tangible assets (measured by adjusted bases) cause a smaller multiplicand, there is an incentive to reduce the U.S. corporation's tangible, depreciable assets (as measured by adjusted basis) used in the production of the multiplicand-contained income. This can be accomplished by moving tangible assets out of the U.S. corporation (although anti-abuse regulations address some movement of assets between related entities).<sup>370</sup>

If tangible assets are actually moved out of the U.S. in order to improve the corporation's FDII deduction,<sup>371</sup> then employee jobs may

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367. See I.R.C. § 250(a) (Supp. V 2013–2018). In the GILTI computation, tangible asset bases multiplied by 10% are used as a proxy for tangible-asset-related returns, which is used to reverse engineer a measure of intangible-related income. See *id.* § 951A. The FDII calculation uses the same 10% asset bases measurement as the GILTI rules. See *id.* § 250. This basis percentage, as in the GILTI rules, presumably is meant to measure tangible-related returns in order to calculate (by examining the reverse) intangible-related returns. This computation is no more accurate in measuring intangible returns in the FDII rules than it is in the GILTI context.

368. See I.R.C. §§ 250, 951A (Supp. V 2013–2018). The statute refers to this computation as a ratio. See *id.* § 250(b)(1).

369. *Id.* § 250(b)(2)(A).

370. The proposed FDII regulations contain an anti-abuse rule regarding sale-leaseback transactions. See Prop. Treas. Reg. § 1.250(b)-2(h), 84 Fed. Reg. 1,874, 1,874–75 (Feb. 5, 2019); see also Treas. Reg. § 1.951A-3(h) (2019) (providing anti-abuse rules regarding certain transfers of property, which are relevant to FDII because the FDII code rules cross-reference the GILTI rules' definition of "qualified business asset investment." See I.R.C. § 250(b)(2)(B) (Supp. V 2013–2018)). Proposed regulations would also compute the FDII deduction by taking into account all of the relevant attributes of a consolidated group's members, see Prop. Treas. Reg. § 1.1502–50(b), 84 Fed. Reg. 8,188, 8,230 (Mar. 5, 2019) (allocation of consolidated FDII deduction among consolidated group members); Prop. Treas. Reg. § 1.1502–50(f), 84 Fed. Reg. 8,188, 8,231–33 (Mar. 5, 2019) (determination of FDII deduction by taking into account aggregate items of consolidated group).

371. FDII stands for "foreign-derived intangible income" but, as discussed above, it isn't actually measured by an examination of how much of the U.S. corporation's income is derived from intangible assets. Instead, it uses a computation of income earned by selling goods to foreign persons for use abroad, and income from performing services abroad, divided by all income of the

go with them. Alternatively, the assets could be “sold” to a cooperating party (related or unrelated), and then “leased” back from such buyer, so that the assets no longer belong to the original U.S. corporation for purposes of the FDII calculation.<sup>372</sup> It is unclear whether this would be respected, or how successful the IRS would be at challenging the validity of such arrangements for tax purposes. There is a long history of alleged sale-leaseback cases, not all of them resolved favorably for the IRS.<sup>373</sup>

Conversely, tangible assets held in a U.S. shareholder’s CFC can affirmatively help the U.S. shareholder by reducing its GILTI

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U.S. corporation (excepting certain categories). *See* I.R.C. § 250(b)(1) (Supp. V 2013–2018). That result is multiplied by an amount equal to all income of such corporation (other than such exceptions) less the deemed tangible return. *See id.* Therefore, how much income the tangible (or intangible) assets are actually generating is irrelevant to the computation—every dollar of adjusted basis of the described tangible assets (depreciable tangible assets used in the production of the U.S. corporation’s non-expected-category income) hurts the taxpayer’s FDII deduction computation. Of course, such bases may also be generating depreciation deductions, so there is a balancing of the value of the depreciation deductions (worth 21 cents for every dollar of deduction, with deductions equal to a percentage of remaining basis every year) against the value of the FDII deduction (conceptually worth 37.5% of 21 cents for every dollar of FDII), whose amount is reduced by 10% of the relevant tangible assets’ bases. Depreciation can occur at a maximum of 100% in the current year, for purposes of the U.S. corporation’s depreciation deduction, but adjusted bases are computed for purposes of FDII (and GILTI) using a straight line method, with specified class lives, under the rules of section 168(g). *See* I.R.C. §§ 168(k), 250(b)(2)(B), 951A(d)(3)(A) (Supp. V 2013–2018). Therefore, assets’ contrasting impact on FDII and GILTI continues to be possible even after the new 100% current-year depreciation rules that apply in other contexts. *See id.* § 168(k)(6) (Supp. V 2013–2018).

Conversely, as discussed below, tangible assets held by a controlled foreign corporation can reduce the GILTI inclusions that U.S. shareholders suffer from that CFC. Therefore, moving tangible assets from a U.S. corporation to its CFC can, in theory, reduce such U.S. corporation’s depreciation deductions (if such assets are not yet fully depreciated), but increase its FDII deduction and decrease its GILTI inclusion. Moving tangible assets to a foreign corporation other than a CFC would not have any effect on GILTI (because GILTI inclusions are only caused by CFCs), but is also less likely because the U.S. corporation could lose effective control over the asset in that case. Because of all of these countervailing costs and benefits, the amount of depreciation and the size of the remaining adjusted basis for any particular tangible asset will be important in influencing whether it is tax-beneficial to move that asset offshore. A tangible asset with zero remaining basis for depreciation deduction purposes (for example, in the asset’s second year, if the Tax Cuts and Jobs Act allows the asset to be entirely depreciated in the first year, *see* I.R.C. § 168(k) (2012 & Supp. V 2013–2018) (allowing 100% current year depreciation for certain assets)) could be sold to a related CFC, so that 10% of such CFC’s adjusted basis in the asset could reduce the U.S. shareholder’s GILTI inclusion. *See* I.R.C. § 951A (Supp. V 2013–2018) (reducing GILTI by 10% of bases of relevant assets). Taxpayers would need to be careful of the anti-abuse rules in the regulations, regarding transfers of assets. *See* Treas. Reg. § 1.951A-3(h) (2019); Prop. Treas. Reg. § 1.250(b)-2(h), 84 Fed. Reg. 1,874, 1,874–75 (Feb. 5, 2019).

372. Proposed regulations regarding FDII contain an anti-abuse rule regarding sale-leaseback transactions. *See* Prop. Treas. Reg. § 1.250(b)-2(h), 84 Fed. Reg. 1,874, 1,874–75 (Feb. 5, 2019).

373. *See, e.g.,* Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

inclusion.<sup>374</sup> A U.S. shareholder's GILTI inclusion starts by computing such shareholder's pro rata share of the annual income of all of such shareholder's CFCs (other than excepted categories of income, such as subpart F income).<sup>375</sup> The net of a CFC's non-excepted income is called "tested income."<sup>376</sup> Net tested income from all of such CFCs is then reduced by such shareholder's pro rata share of the deemed tangible return (10% of the bases of depreciable, tangible assets used in earning tested income) from all of such CFCs that have positive tested income.<sup>377</sup> The deemed tangible return is thus not subject to U.S. tax as part of a GILTI inclusion. When actually paid to a U.S. shareholder as a dividend, such deemed tangible return is again tax free because dividends from CFCs to U.S. shareholders are subject to a 100% deduction (the DRD)—at least for U.S. shareholders who are corporations and who meet the required over-365-day holding period for the CFC's stock.<sup>378</sup>

In the GILTI computation, as with FDII, the income related to tangible assets is not determined by a case-by-case analysis of the particular assets and the taxpayer's activities, but is instead deemed to consist of an amount equal to 10% of the adjusted basis of such assets.<sup>379</sup> The relevant tangible assets are a CFC's tangible, depreciable assets used in the production of a CFC's tested income<sup>380</sup> (i.e., all of the CFC's income other than the exempted categories). As with FDII, there is no adjustment to this calculation based on how

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374. See I.R.C. § 951A(b)(1)(B) (Supp. V 2013–2018).

375. See *id.* § 951A(b)(1)(A), (c).

376. See *id.* § 951A(c)(2).

377. Note that the GILTI provision (although its name refers to "low-taxed income") also does not inquire as to the foreign tax rate that applies to the CFC's income, unlike subpart F. Compare *id.* § 951A (describing GILTI computation), with I.R.C. § 954(b)(4) (2012 & Supp. V 2013–2018) (providing exception for high-taxed income). However, income that is exempt from subpart F treatment under subpart F's high-tax exception is also removed from the GILTI computation, and there is a limited foreign tax credit for GILTI-related foreign taxes. See I.R.C. §§ 951A(c)(2)(A)(i)(III), 960(d) (Supp. V 2013–2018); see also Prop. Treas. Reg. § 1.951A-2(c)(1)(iii), -2(c)(6)(i), 84 Fed. Reg. 29,114, 29,129 (June 21, 2019) (proposing that taxpayers can elect to exclude other high-taxed income from the GILTI computation, even if such income would not otherwise fall within subpart F).

378. See I.R.C. § 245A (Supp. V 2013–2018); I.R.C. § 246 (2012 & Supp. V 2013–2018). This particular dividends received deduction (DRD) was added by the Tax Cuts and Jobs Act. See I.R.C. § 245A (Supp. V 2013–2018). There are other versions of DRDs elsewhere in the Code. See I.R.C. §§ 243, 245 (2012 & Supp. V 2013–2018).

379. See I.R.C. § 951A (Supp. V 2013–2018).

380. See *id.* § 951A(d)(1), (d)(2).

often the assets are used, or how important they are to such income production.<sup>381</sup>

Because the adjusted basis of tangible assets (used in earning the relevant income) hurts U.S. corporations by reducing their FDII deductions, but placing such assets in a CFC helps U.S. shareholders by reducing their GILTI inclusions, there may well be (depending on the facts) an affirmative tax incentive to move tangible, depreciable assets offshore, from U.S. corporations into such corporations' CFCs.<sup>382</sup> FDII is taxed at an effective rate of 13.125%, due to a 37.5% deduction (of income otherwise taxed at a 21% corporate tax rate), while GILTI is taxed at a 10.5% effective rate (after a 50% deduction).<sup>383</sup> Preserving the FDII characterization of each dollar should be worth 7.875 cents (the difference between the 13.125% FDII effective rate and the default 21% rate), while saving a dollar of GILTI reduces U.S. tax by 10.5 cents (setting aside the impact of possible foreign tax credits). If a taxpayer could ideally both increase FDII and decrease GILTI by 10% of the adjusted bases of a particular group of tangible assets, the U.S. tax reduction could become significant. The foreign tax credit and the need to actually use the assets to generate tested income (in order to consider the asset bases in the GILTI computation) should affect these calculations, under each taxpayer's facts.

In addition, taxpayers are undoubtedly analyzing the relative impacts of the GILTI and FDII rules, on the one hand, and the new allowance of 100% depreciation (in the first year of service) for certain assets,<sup>384</sup> on the other. This new, accelerated depreciation deduction could provide a counterbalancing incentive to use tangible assets in the U.S., rather than moving them offshore to enhance FDII and GILTI

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381. However, an asset's basis would be prorated in the GILTI computation if it were used to produce both tested income and other types of income. *See id.* § 951A(d)(2)(B); Treas. Reg. § 1.951A-3(d)(3) (2019). The regulations also contain an anti-abuse rule, which includes rules for temporarily held assets. Treas. Reg. § 1.951A-3(h) (2019). There do not, though, appear to be any clear rules to address situations in which an asset is simply seldom used (not dual-use property, held for a short period, or acquired from a tested loss CFC, but single-use property that is, for example, held for a long period but only used two days each year).

382. *See, e.g.,* Fleming et al., *supra* note 14 (using revenue estimates by the Joint Committee on Taxation to analyze outcomes of the TCJA's outbound international tax provisions); Sullivan, *supra* note 41; Burnette-McGrath, *supra* note 41; Clausing, *supra* note 41.

383. *See* I.R.C. § 250 (Supp. V 2013–2018) (allowing deductions for FDII and GILTI).

384. *See* I.R.C. § 168(k) (2012 & Supp. V 2013–2018). The percentage of additional depreciation that is allowed for the first year of certain assets is reduced for years after 2022. *See* I.R.C. § 168(k)(6)(A) (Supp. V 2013–2018).



results. But the 100% immediate depreciation deduction does not apply to property placed in service before September 28, 2017—in other words, to tangible property the U.S. taxpayer has already started depreciating as of that date.<sup>385</sup> If such older, tangible property were moved overseas, it could reduce GILTI (by depreciation deductions and by 10% of adjusted asset bases) and prevent detrimental impact on the FDII calculation, without requiring the taxpayer to weigh the loss of the 100% depreciation deduction in the U.S. corporation.

For assets that are eligible for immediate 100% depreciation, the benefits of leaving an asset in the U.S. (at least for its first year of service) may weigh more heavily. Each dollar of depreciation deduction in the U.S. reduces the U.S. corporate taxpayer's U.S. tax by 21 cents.<sup>386</sup> Each dollar of depreciation by a CFC reduces the U.S. tax on GILTI by 10.5 cents (by reducing tested income, if the depreciation is allocable to tested income rather than to other amounts).<sup>387</sup> In addition, each dollar of adjusted basis (of qualifying assets) also reduces the U.S. tax on GILTI by 1.05 cents ( $\$1$  of basis  $\times$  10% of basis taken into account in the GILTI computation  $\times$  10.5% U.S. effective tax rate = 1.05 cents). The sum of the depreciation benefit and the benefit from 10% of the adjusted basis (as a reduction of GILTI), will depend largely on the size of the adjusted basis. Moving assets out of the U.S. can also increase the U.S. corporation's FDII deduction, by preventing the reduction of deemed intangible income by 10% of the adjusted basis of assets that are used in producing deduction eligible income.<sup>388</sup> The aggregate result of moving tangible, depreciable assets offshore to a CFC may be either more or (perhaps often) less beneficial than the benefit of the 100% current year depreciation deduction in the U.S., for the first year that the asset is placed in service, depending on the numbers involved.

For purposes of the FDII and GILTI rules, the 100% current-year depreciation rules do not apply to determine the adjusted bases of

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385. See I.R.C. § 168(k)(6)(A)(i) (Supp. V 2013–2018). Nor does the 100% depreciation deduction apply to buildings (which are harder to move overseas to reduce GILTI, in any event), intangibles (other than computer software), or property otherwise depreciable for twenty years or more. See I.R.C. § 168(k)(2)(A) (2012 & Supp. V 2013–2018).

386. See I.R.C. § 11(b) (Supp. V 2013–2018) (21% corporate tax rate); *id.* § 951A(c)(2)(A)(ii) (reducing tested income by allocable deductions).

387. The U.S. effective rate on GILTI is 10.5%, after the 50% GILTI deduction (and before taking into account any GILTI foreign tax credits). See *id.* § 250(a)(1)(B) (50% deduction for GILTI).

388. See *id.* § 250(b)(2).

assets, which are instead determined under the alternative depreciation system described in section 168(g).<sup>389</sup> Therefore, the asset's adjusted basis for determining depreciation by the U.S. corporation may not match the same asset's adjusted basis as taken into account for purposes of the FDII deduction or (if the asset is moved to a CFC) the GILTI inclusion.

The 100% depreciation deduction for an eligible asset's first year in service, however, is only available (obviously) for one year.<sup>390</sup> After that year, the asset's adjusted basis is zero for the U.S. corporation's depreciation purposes (barring other facts that increase such basis). In addition, the 100% depreciation deduction changes to lower percentages starting in 2023, reducing the incentive to place tangible assets in the U.S. (as opposed to overseas) after that date (although such reduced percentages are still higher, for years to come, than the pre-TCJA depreciation schedules).<sup>391</sup>

For assets eligible for 100% immediate depreciation, placement in the U.S. may be more beneficial than location overseas (at least for taxpayers without large amounts of potential FDII) for the asset's first year of service. In other words, the benefit of the depreciation deduction could outweigh the FDII and GILTI benefits of moving the asset out of the U.S. and into a CFC. Potentially, taxpayers could take the 100% current depreciation, and sell the asset a year or two later (recognizing gain equal to the full sales price, because the basis would be zero).<sup>392</sup> But such gain is almost certainly less than the amount of the depreciation deduction, assuming that the asset declines in value over time (compared to its value when it was brand new). The U.S. taxpayer could then buy a replacement (perhaps used) asset from an unrelated person (for the same amount as the gain), and either move it offshore or depreciate it at 100% also, in the year it is placed in service (until the 100% depreciation provision expires).

For example, assume that a U.S. corporation buys a tractor for \$10,000 to use in its trade or business starting in 2019. The U.S. corporation takes a depreciation deduction of \$10,000 in 2019, using

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389. See *id.* § 250(b)(2)(B) (cross-referencing GILTI rule); *id.* § 951A(d)(3) (providing that adjusted basis “shall be determined . . . by using the alternative depreciation system under section 168(g)” for purposes of measuring “qualified business asset investment” under the GILTI rules).

390. See I.R.C. § 168(k)(1) (2012 & Supp. V 2013–2018).

391. See I.R.C. § 168(k)(1)(B) (2012).

392. See *id.* § 1001.

the new current-year full depreciation rule.<sup>393</sup> In 2020, the corporation sells the tractor for \$8,000 (which is less than the depreciation of the cost basis, because the tractor's fair market value has declined). It recognizes a gain of \$8,000 (\$8,000 amount realized less adjusted basis of zero).<sup>394</sup> The corporation then buys a similar used tractor for \$8,000, and contributes the newly acquired tractor to its CFC, where the tractor is used in the production of tested income and reduces the U.S. shareholder's GILTI inclusion by an amount equal to 10% of the adjusted basis each year (and also by the depreciation of such asset's basis).

If the tractor were depreciable over five years in the CFC's hands, it would reduce GILTI in 2020 by the sum of the depreciation deduction's reduction of tested income (one fifth of the \$8,000 basis, or \$1,600) plus one-tenth of the asset's adjusted basis, or \$800 (because the GILTI formula subtracts 10% of relevant bases from tested income, to compute GILTI), for a total GILTI reduction of \$2,400.<sup>395</sup> Because GILTI is subject to tax at an effective rate of 10.5%, this results in annual U.S. tax savings of \$252 (setting aside any foreign tax credit consequences from reducing GILTI)<sup>396</sup> for the five years of depreciation. The numbers are more striking if one imagines 1,000 tractors, or assets with higher initial bases. The U.S. tax on the gain of \$8,000 (from selling the tractor) also needs to be taken into account, in considering the aggregate tax consequences over time. At 21%, that tax would be \$1,680, which is less than the sum of the tax savings from the 100% first year depreciation (\$2,100) and five years of annual savings from GILTI reduction (\$1,262). The benefit of increasing the FDII deduction (by removing asset bases from the computation of deemed intangible income) also needs to be factored in.

Multiple variations on this fact pattern are possible, and tax planners are certain to carefully weigh the unfavorable impact of tangible, depreciable assets on the FDII deduction (if such assets are used to generate deduction eligible income), the countervailing beneficial impact of reducing GILTI (if such assets can be held by a

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393. *See id.* § 168(k)(1)(B).

394. *See id.* § 1001.

395. This example ignores the "applicable convention," for simplicity. *See* I.R.C. § 168(a)(3), (d) (2012 & Supp. V 2013–2018).

396. *See generally* I.R.C. § 250 (Supp. V 2013–2018) (allowing 50% deduction for GILTI for corporate shareholders); *id.* § 960(d) (deemed paid foreign taxes with respect to GILTI inclusions).

CFC and used to produce tested income), and the one-year, quite large benefit of immediate 100% depreciation if assets are used in a U.S. trade or business. Overall, the incentives created by the TCJA regarding the preferred location for a tangible asset (inside or outside the U.S.) can vary based on whether or not the asset is eligible for 100% current year depreciation; whether the asset is (or can be) used to produce deduction eligible income (under the FDII rules), tested income (within the meaning of the GILTI rules), or neither; and whether a U.S. shareholder's CFCs produce tested income, subpart F income, or neither.

## VII. CONCLUSION: FULL EMPLOYMENT FOR TAX LAWYERS

As explained above, the new international tax rules contained in the TCJA do not create a territorial system. Instead, income earned by U.S. taxpayers directly, or through a branch or a partnership, or as subpart F income (through a CFC) is subject to tax at full U.S. tax rates when earned. GILTI, which is a subset of the active income of a U.S. shareholder's CFCs, is also subject to U.S. tax, although a lower effective rate (10.5%) applies. The U.S. tax system's partial movement towards territoriality (by means of exempting from U.S. tax certain income that U.S. shareholders earn through CFCs and 10/50 companies) is implemented largely through the new 100% DRD for foreign dividends. But that DRD has serious constraints. Among other things, it applies only to U.S. corporate shareholders (not individuals), requires a more-than-365-day holding period, and does not apply if the shareholder owns less than 10% of the dividend-paying foreign corporation. In some situations, U.S. taxpayers might abstain from claiming the new DRD, in an attempt to claim foreign tax credits instead (for foreign taxes imposed on foreign dividends).

The U.S. tax results—and taxpayer incentives—depend partly on what type of foreign income (e.g., subpart F, GILTI, or neither) is being earned, the foreign tax rate (and availability of foreign tax credits), and the U.S. shareholder's eligibility for the 100% DRD. If a U.S. shareholder can earn non-subpart F, non-GILTI income outside of the U.S., through a CFC or 10/50 company, such income can completely escape U.S. tax—if the DRD applies.

In addition, the FDII provisions make it taxpayer-unfavorable to keep certain tangible assets in a U.S. corporation, while the GILTI rules make it taxpayer-favorable to place such tangible assets in a

controlled foreign corporation. These provisions may create tax incentives to move such tangible assets out of U.S. corporations and into CFCs, a result that seems unlikely to benefit the U.S. economy or U.S. workers. Given the assumptions that are used to define tangible asset returns and (conversely) intangible income, the lack of accuracy of these measurements may lead to especially odd taxpayer behavior, as taxpayers attempt to maximize FDII deductions and minimize GILTI inclusions by optimizing the deemed amounts of tangible and intangible items. The new 100% immediate depreciation deduction (for certain tangible property used in a U.S. trade or business) may also affect taxpayers' choices of where to locate tangible assets.

Further, given the unfavorable treatment of foreign branches under both the FDII calculation and the foreign tax credit basket rules, U.S. taxpayers might be driven away from QBU structures, including partnerships and disregarded entities. It isn't obvious why: (a) income from a U.S. taxpayer's foreign activities conducted directly or through flow-through entities should be isolated in a separate basket, away from foreign source income arising from U.S. activities or earned through foreign subsidiaries; and (b) such isolation should apply only to such foreign activities that rise to the level of a "foreign branch" (keeping separate books and records and meeting the other regulatory requirements). It is also not clear why foreign branches are viewed, in these new provisions, with such disfavor.

Overall, these new international tax rules of the TCJA should provide hours of entertainment for tax lawyers.