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More Anti-Simplification: How PTI and GILTI Override the Section 245A Exemption and the U.S. Territorial Tax System

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I. INTRODUCTION.[1]

In December of 2017, the United States (U.S.) enacted tax reform commonly known as the "Tax Cuts and Jobs Act" (TCJA),[2] which was initially thought to "establish[] a territorial tax system for multinational companies."[3] Over time, however, tax professionals began to understand that the TCJA layered a territorial tax system that exempted foreign earnings from the U.S. income tax (exemption tax system) on top of a residence-based worldwide tax system that used a foreign tax credit (FTC) to protect against juridical double taxation (worldwide tax system).[4] Furthermore, the U.S. exemption tax system

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1. In this Article, all references are to the Internal Revenue Code (Code) unless stated otherwise.

2. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (codified as amended in scattered sections of 26 U.S.C.) [hereinafter TCJA of 2017].

3. Stephen K. Cooper, David van den Berg, & Asha Glover, *Eyes Turn Toward 2018 Tasks as Tax Reform Becomes Law*, 158 TAX NOTES 28 (Jan. 1, 2018).

4. J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, *Expanded Worldwide Versus Territorial Taxation After the TCJA*, 161 TAX NOTES 1173, 1175 (Dec.

is severely limited by the worldwide tax system.[5] This Article continues an analysis developed in a companion paper, *Is the Tax Cuts and Jobs Act GILTI of Anti-Simplification?*, which demonstrates that previously taxed income (PTI) is the keystone used to determine whether dividends are taxed as part of the worldwide or exemption tax system.[6]

Historically, PTI was used to prevent a United States shareholder from paying taxes twice on certain earnings of its foreign corporations. Without a method to track income taxed by the United States, a U.S. shareholder would potentially pay taxes twice on the same earnings—once as an inclusion required by Subpart F (Subpart F) and again as a payment of dividends. Section 959 tracked previously taxed earnings and profits to ensure that earnings taxed as a Subpart F inclusion were excluded from gross income when actually distributed to the U.S. shareholder.[7] Prior to the 2017 tax reform, § 959 implemented the policy goals of "avoiding double taxation and allowing United States persons to receive the full benefit of their PTI at the earliest possible time."[8] However, when the TCJA effected an exemption for the foreign source portion of dividends distributed to corporate U.S. shareholders,[9] the actual distribution of earnings was no longer a taxable event. This precipitated the question: Does the United States still need the concept of PTI after the TCJA?

This Article examines the operation of previously taxed income rules after enactment of the TCJA and whether PTI is still a necessary part of the U.S. international tax system. This paper is organized as follows: Part II summarizes the statutory law related to previously taxed income before and after the TCJA. Part III presents a hypothetical multinational corporation and demonstrates how the PTI rules affect the determination of U.S. corporate income tax. Part IV considers whether tax policy historically supporting PTI is still valid. Part V demonstrates how the post-TCJA laws function to override the U.S. exemption tax system and effectively create a pure worldwide tax system without deferral for multinational corporations with a large amount of PTI. Part VI concludes.

3, 2018); Christine A. Davis, *Is the Tax Cuts and Jobs Act GILTI of Anti-Simplification?*, 38 VA. TAX REV. 315 (2019).

5. Davis, *supra* note 4, at 392–93.

6. *Id.* at 393.

7. I.R.C. § 959(a) (2020).

8. Exclusion From Gross Income of Previously Taxed Earnings and Profits, and Adjustments to Basis of Stock in Controlled Foreign Corporations and of Other Property, 71 Fed. Reg. 51,155, 51,156 (proposed Aug. 29, 2006) [hereinafter 2006 Proposed PTI Regs].

9. I.R.C. § 245A(a) (2020).

II. PTI BEFORE AND AFTER THE TAX CUTS AND JOBS ACT.

A. Statutory Law Related to PTI Before the TCJA.

The concept of previously taxed income, also referred to as "previously taxed earnings and profits" (PTEP), was included in and was an integral part of the original 1962 enactment of Subpart F.[10] Prior to January 1, 2018, a U.S. shareholder generally paid U.S. income tax on its foreign corporation's foreign source earnings only upon a realization event, such as when it received a dividend or sold stock for a gain.[11] As a result, a U.S. multinational corporation (MNE) could defer paying U.S. income taxes on its foreign subsidiary's earnings so long as the entity did not distribute its profits as dividends.[12] Because of the time value of money, this ability to defer paying income taxes conferred a significant economic benefit, which was often subject to abuse.[13] Subpart F curtailed this abuse for certain income.

When a "U.S. Shareholder" (USSH) directly or indirectly owns "Controlled Foreign Corporation" (CFC) stock on the last day of the CFC's taxable year, Subpart F requires that the USSH include specific types of the CFC's earnings in gross income without a realization event, thereby eliminating the benefit of deferral in these limited situations.[14] A U.S. Shareholder is a U.S. person, which includes U.S. citizens, residents, and domestic corporations, that directly, indirectly, or constructively owns 10% or more of a foreign corporation's stock.[15] A Controlled Foreign Corporation is a foreign corporation in which USSHs directly, indirectly, or constructively own more than 50% of its stock on any day during its taxable year when measured by the "total

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10. Revenue Act of 1962, Pub. L. No. 87-834, §12(a), 76 Stat. 960, 1006, 1019–20 (1962) (codified at I.R.C. § 959).

11. OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY ix (Dec. 2000) [hereinafter DEFERRAL POLICY STUDY]; J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L.J. 79, 85, 89 (2009) [hereinafter *Worse Than Exemption*].

12. DEFERRAL POLICY STUDY, *supra* note 11, at ix.

13. *Id.* at ix, 12–13.

14. I.R.C. § 951(a)(1) (2020). Prior to the TCJA, Subpart F inclusion only applied if the foreign corporation satisfied the conditions for CFC status for an "uninterrupted period of 30 days or more during any taxable year." I.R.C. § 951(a)(1) (2016). The TCJA eliminated this holding period requirement. I.R.C. § 951(a)(1).

15. I.R.C. §§ 951(b), 957(c), 958(a)–(b), 318(a), 7701(a)(30) (2020). Prior to the TCJA, the ten-percent ownership standard was measured by the "total combined voting power of all classes of stock entitled to vote." I.R.C. § 951(b) (2016). The TCJA expanded the criteria to allow ownership standard to be measured also by the "total value of shares of all classes of stock." I.R.C. § 951(b).

combined voting power of all classes of stock . . . entitled to vote," or the "total value of the stock."[16] Prior to the TCJA, Subpart F applied to Subpart F income (Subpart F Income) and § 956 investments in U.S. property (U.S. Property Investments).[17]

In general, Subpart F Income was derived from earnings that could be easily manipulated to avoid taxes, or earnings from activities that the U.S. government discouraged.[18] Subpart F Income included: (a) passive and investment income, such as dividends, interest, rents, royalties, annuities, and foreign currency gains (Foreign Personal Holding Company Income or FPHCI); (b) certain insurance income; (c) income from certain sales or service transactions involving related parties (foreign base company sales income and foreign base company services income respectively); and (d) certain income that the United States government discouraged, such as income associated with illegal bribes or kickbacks, countries on the U.S. international boycott list or countries with whom the U.S. did not have normal diplomatic relations.[19] Notwithstanding the foregoing, Subpart F Income did not include any income "effectively connected with the conduct of a trade or business within the United States" (ECI with a USTB), and Subpart F Income could not exceed the CFC's current earnings and profits (E&P) for any taxable year.[20] Subpart F Income was calculated at the level of the CFC and then divided pro rata among its USSHs.[21]

In addition, U.S. Property Investments were currently included in a USSH's gross income without a realization event.[22] Although some exceptions applied, U.S. property generally included tangible property

16. I.R.C. § 957(a).

17. I.R.C. §§ 951(a)(1), 956 (2020). A detailed description of Subpart F inclusions is beyond the scope of this paper. For a more detailed summary of these inclusions, please see Davis, *supra* note 4, at 326–28.

18. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 69.1 (Thomson Reuters Tax & Accounting March 2019).

19. I.R.C. §§ 952(a), 954(a), (c)–(e) (2020).

20. I.R.C. §§ 864(c), 952(b), (c)(1)(A) (2020).

21. I.R.C. §§ 951(a)(1)(A), (2) (2016); I.R.C. §§ 951(a)(1)(A), (2).

22. I.R.C. §§ 951(a)(1)(B), 956 (2016); BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 69.11.1 (Thomson Reuters Tax & Accounting March 2016). In attempt to only allow deferral for earnings "invested in active business operations," from 1993 to 1996, the United States currently taxed USSHs "on earnings accumulated from active business operations if excessive amounts of a CFC's assets were passive" (Excess Passive Assets). I.R.C. §§ 951(a)(1)(C), 956A (1995); BITTKER & LOKKEN, *supra* note 22, at ¶ 69.11.2. Generally, these Excess Passive Assets were treated like U.S. Property Investments for purposes of PTI analysis. I.R.C. § 959(a), (c), (f) (1995); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 495–98 (1993).

located in the U.S., the right to use intangible property in the U.S., as well as debt and stock instruments issued by U.S. corporations and other entities (collectively U.S. Property).[23] A U.S. Property Investment occurred when a CFC utilized its E&P to obtain U.S. Property. Currently taxing U.S. Property Investments prevented the USSH from using its CFC's earnings as if it received a dividend without paying tax on the distribution.[24] Thus, Subpart F required that a USSH include in its gross income a pro rata share (PRS) of the average adjusted basis of U.S. Property directly or indirectly held by its CFC at the close of each quarter of the taxable year, less any earnings previously taxed as a U.S. Property Investment, where the total inclusion was limited by undistributed E&P reduced by the earnings previously taxed as a U.S. Property Investment.[25] Thus, whereas Subpart F Income was limited to current E&P, the U.S. Property inclusion was constrained by the aggregate of current and accumulated E&P reduced by distributions and income previously taxed as U.S. Property Investments.[26]

Thus, prior to the TCJA, a USSH included in its gross income, without a realization event, a pro rata share of its CFC's Subpart F Income and U.S. Property Investment.[27] In each case, the USSH did not receive an actual distribution of income from the CFC. Instead, the USSH was taxed on a fictitious distribution of income (phantom income) from the CFC. Without a method to track earnings taxed by the United States, a U.S. shareholder would potentially pay taxes twice on the same earnings as a result of the following two taxable events:

> Event 1: Subpart F Inclusion—USSH must pay tax on its CFC's earnings as a deemed distribution of phantom income.
>
> Event 2: Actual Distribution to Shareholder—USSH pays tax on the same earnings when it receives a dividend from the CFC or when the CFC invests in U.S. Property.[28]

Prior to the TCJA, § 959 used PTI as a mechanism to ensure that earnings taxed during Event 1 were excluded from gross income during Event 2.[29] Thus, when earnings were taxed as a Subpart F inclusion

23. I.R.C. § 956(c)(1)–(2); BITTKER & LOKKEN, *supra* note 22, at ¶ 69.11.1.

24. BITTKER & LOKKEN, *supra* note 22, at ¶ 69.11.1 & n.2.

25. I.R.C. §§ 951(a)(1)(B), 956(a)–(b) (2016).

26. I.R.C. §§ 951(a)(1)(B), 952(c)(1)(A), 956(a)–(b) (2016); Jasper L. Cummings, Jr., *Previously Taxed Income*, 163 TAX NOTES 531, 533, 535 (April 22, 2019).

27. I.R.C. § 951(a)(1)–(2) (2016).

28. 2006 Proposed PTI Regs, *supra* note 8, at 51,155.

29. I.R.C. § 959(a) (2016).

(Event 1), § 959 designated these earnings as PTI or PTEP. When these earnings were actually distributed to the USSH or invested in U.S. Property (Event 2), PTI was excluded from the USSH's gross income. This procedure functioned to prevent a second tax on the same earnings.[30] Similarly, § 959 used the concept of PTI to insulate distributions from lower to higher level CFCs in a chain of ownership from multiple Subpart F inclusions.[31]

Section 959 effected two policy goals.[32] First, § 959 tracked E&P that was taxed as a Subpart F inclusion and excluded those earnings from gross income when actually distributed to the USSH or invested in U.S. Property. This implemented the policy of preventing double taxation of the same earnings.[33] Second, § 959 established an order of priority for a CFC's distributions, which utilized previously taxed earnings before untaxed earnings. This preference ensured that PTI was excluded from gross income at the earliest possible moment.[34] This system of tracking and allocating PTI (PTI System) was implemented by assigning E&P into separate categories at the time of the Subpart F inclusion.

When included in a USSH's gross income, the CFC's E&P attributed to the Subpart F inclusion were designated as PTI. Consequently, three separate categories of E&P were used to track PTI: (1) earnings previously taxed as a U.S. Property Investment (Section 959(c)(1) PTI or U.S. Property PTI); (2) earnings previously taxed as Subpart F Income (Section 959(c)(2) PTI or Subpart F PTI); and (3) earnings that were not previously taxed (Non-PTI E&P or Untaxed E&P).[35] In addition, gain from the sale of corporate stock (held for at least one year) was treated as a dividend that reclassified Untaxed E&P to Subpart F PTI when the seller of the CFC was a USSH (or another CFC) at any time during the five-year period prior to the sale, but only to the extent of any Untaxed E&P[36] generated while the seller maintained USSH (or CFC) status with the subsidiary CFC.[37] (This

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30. *Id.*

31. I.R.C. § 959(b) (2016). The use of PTI to prevent multiple Subpart F inclusions from distributions among CFCs in a USSH's chain of ownership is beyond the scope of this Article.

32. 2006 Proposed PTI Regs, *supra* note 8, at 51,156.

33. I.R.C. § 959(a)–(b) (2016); 2006 Proposed PTI Regs, *supra* note 8, at 51,155–56.

34. I.R.C. § 959(c), (f) (2016); 2006 Proposed PTI Regs, *supra* note 8, at 51,155–56.

35. I.R.C. § 959(c), (f) (2016).

36. For purposes of § 1248, undistributed PTI is excluded from the CFC's E&P. I.R.C. § 1248(d)(1) (2016).

37. I.R.C. §§ 959(e), 964(e)(1), 1248(a), (d)(1), (g)(2)(C) (2016). Section 1248 only applies to USSHs that own a CFC when measured solely by voting power, and this remains true after the 2017 tax reform. I.R.C. § 1248(a)(2) (2016). Also, in certain

gain shall be referred to as "Section 1248 Gain" when the seller is a USSH and "Section 964(e) Gain" when the seller is a CFC.)

When Subpart F Income (or U.S. Property Investment) was included in the USSH's gross income, the CFC's Untaxed E&P was reduced by the earnings attributed to this inclusion and the Subpart F PTI (or U.S. Property PTI) category was increased by an equivalent amount.[38] However, because the Subpart F inclusions were not actually distributed, the earnings remained in the CFC's accounts.[39] No reduction in the CFC's PTI or Untaxed E&P occurred until earnings were actually distributed to a shareholder or otherwise utilized, such as for the purchase of an investment in U.S. Property.[40]

When a CFC subsequently distributed earnings to a USSH or invested in U.S. Property, previously taxed E&P was transferred from the CFC's to the USSH's accounts even though it was excluded from the USSH's gross income.[41] Thus, the PTI distribution was treated like a dividend and reduced the CFC's E&P (and increased the USSH's E&P) by the amount of the distribution.[42] However, the PTI distribution was not considered a dividend for any other purpose.[43]

Once a CFC's E&P was designated as "PTI," its distribution was governed by § 959, which applies the corporate income tax ordering rules set forth in section 316.[44] To determine the order of E&P allocated and whether PTI was utilized, distributions were attributed first to U.S. Property PTI, second to Subpart F PTI, and third to Untaxed E&P, utilizing current E&P before accumulated E&P in each category and using the "most recently accumulated" E&P first (collectively Last In,

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non-recognition transactions, the difference between fair market value and adjusted basis will be considered an inclusion of Subpart F Income that generates PTI. I.R.C. §§ 959(e), 1248(f) (2016).

38. Treas. Reg. §1.959-3(f) (as amended in 1983); BITTKER & LOKKEN, *supra* note 22, at ¶ 69.13.3. In addition, when available, U.S. Property Investments will preferentially be attributed to and reduce the CFC's Subpart F PTI, which will increase U.S Property PTI by the same amount. I.R.C. § 959(f)(1) (2016).

39. Treas. Reg. §1.959-3(f) (as amended in 1983); BITTKER & LOKKEN, *supra* note 22, at ¶ 69.13.3.

40. Treas. Reg. §1.959-3(f) (as amended in 1983); BITTKER & LOKKEN, *supra* note 22, at ¶ 69.13.3; Cummings, Jr., *supra* note 26, at 532–33.

41. I.R.C. § 959(a) (2016).

42. I.R.C. § 959(d) (2016).

43. *Id.*

44. I.R.C. § 959(c) (2016); N.Y. ST. B. ASS'N TAX SEC., REP. NO. 1402, *Report on Previously Taxed Earnings under Section 959*, at 5 (Oct. 11, 2018) [hereinafter *NYSBA PTI Report*], *available at* https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2018/Tax_Report_1402.html.

First Out Approach).[45] U.S. Property Investments followed the same order of attribution, but were not allocated to preexisting U.S. Property PTI because these amounts were already considered when determining the U.S. Property Investment gross income inclusion.[46] As a result, U.S. Property Investments were first attributed to Subpart F PTI and then to Untaxed E&P.[47]

The overall effect of the PTI System was to give priority to distributions of PTI. PTI is distributed first and Untaxed E&P is only allocated after all PTI is utilized.[48] Distributions in excess of the aggregate of PTI and Non-PTI E&P are not taxed to the extent of the USSH's basis in the CFC's stock.[49] Distributions exceeding basis are taxed as gain.[50] Prior to the enactment of the TCJA, distributions of PTI were excluded from the USSH's gross income, while distributions of Untaxed E&P were taxable as dividends.[51] Thus, the PTI System furthered the policy of not taxing the same E&P twice and doing so at the earliest possible time.

Section 959 served the necessary function of preventing double taxation of earnings that were initially taxed as phantom income (Subpart F inclusion) and later paid to the USSH. During the period that E&P is considered "previously taxed," the earnings are economically the property of the CFC. But from a tax perspective, this income had already been distributed to the shareholder. Because of this conflict in status, PTI must serve three additional functions during the period between the Subpart F inclusion and PTI distribution (Interim Period). First, the USSH's basis in CFC stock must be adjusted for any PTI created or distributed to prevent double taxation if the CFC's stock is sold before PTI is recovered through an actual distribution.[52] As a result, the USSH's basis in CFC stock is increased by the amount of the Subpart F inclusion and decreased by the amount of any distribution subsequently excluded from gross income as PTI.[53] Second, when a CFC's functional currency is not the U.S. dollar, changes in the exchange rate between the time of the Subpart F inclusion and the

45. I.R.C. §§ 959(c), 316(a) (2016); I.R.S. Notice 2019-01, 2019-02 I.R.B. 269, 278 (Jan. 7, 2019) [hereinafter IRS PTI Notice].

46. *See supra* text accompanying notes 22–26.

47. I.R.C. § 959(f)(1) (2016).

48. I.R.C. § 959(c), (f) (2016).

49. I.R.C. §§ 301(a), (c)(2), 316(a), 961(b)(1) (2016).

50. I.R.C. §§ 301(a), (c)(3)(A), 316(a), 961(b)(2) (2016).

51. I.R.C. §§ 61(a)(7), 301(c)(1), 316(a), 959(a) (2016).

52. I.R.C. § 961(a)–(b) (2016); *NYSBA PTI Report*, *supra* note 44, at 8–9, 11.

53. I.R.C. § 961(a), (b)(1) (2020); *NYSBA PTI Report*, *supra* note 44, at 7.

actual distribution of earnings will create an additional gross income inclusion as foreign currency gain (or deduction as foreign currency loss).[54] Third, the USSH may claim a FTC for any foreign income taxes paid on a PTI distribution.[55] These functions are discussed in more detail in the following section, which describes the statutory law related to PTI after enactment of the TCJA.

B. Statutory Law Related to PTI After the TCJA.

The TCJA made minimal changes to §§ 959 and 961.[56] As a result, the treatment of PTI after the TCJA is substantially the same as prior to its enactment. However, the TCJA introduced two new provisions that significantly affect the operation of the PTI System. Section 245A exempts the foreign source portion of certain dividends from taxation.[57] In addition, section 951A institutes the global intangible low-taxed income (GILTI), a new gross income inclusion for USSHs, which essentially applies a minimum tax to all of the CFC's taxable income excluding items already taxed by or exempt from the U.S. corporate income tax.[58] These new provisions call into question the necessity of the PTI System and potentially challenge the tax policy supporting the use of previously taxed E&P.

1. The TCJA Implemented a Dividend Exemption System, Which Challenges the Necessity of the PTI System.

The TCJA enacted the section 245A deduction.[59] This deduction potentially prevents the double taxation of PTI since, in many cases, the actual distribution of earnings from a CFC to its corporate USSH is no longer a taxable event. Thus, section 245A challenges the necessity of the PTI System as applied to corporate USSHs.[60]

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54. I.R.C. § 986(c) (2020); *NYSBA PTI Report*, *supra* note 44, at 8, 15–16.

55. I.R.C. § 960(a)(3) (2016); *NYSBA PTI Report*, *supra* note 44, at 8, 13–15.

56. I.R.C. §§ 959, 961. Except for two conforming changes, the text of section 959 was not changed by the TCJA. TCJA of 2017, *supra* note 2, at § 14301(c)(32)–(33). The TCJA modified section 961 to require a basis adjustment (decrease) for any section 245A deduction but only to determine the loss on disposition of the subsidiary's stock. *Id.* at § 14102(b)(1).

57. I.R.C. § 245A(a). The benefit of section 245A also applies to some gain that is treated like a dividend, such as the §§ 1248 and 964(e) gains. I.R.C. §§ 964(e)(4)(A)(iii), 1248(j) (2020).

58. I.R.C. § 951A (2020).

59. I.R.C. § 245A.

60. Section 245A does not apply to individuals, so the application of PTI to individual USSHs does not raise the same policy issues. I.R.C. § 245A(a).

Section 245A provides domestic corporations with a deduction equal to the foreign-source portion of any dividend from a specified 10% owned foreign corporation (STFC) when the recipient is a USSH (245A DRD).[61] A STFC is any foreign corporation, other than a passive foreign investment company (PFIC), with a domestic corporate USSH.[62] Consequently, all CFCs with a corporate USSH are STFCs.

Section 245A generally allows a domestic corporation to deduct the foreign source portion of a dividend from a STFC and thereby fully exempts these earnings from U.S. income tax. As a result, USSHs that utilize the §245A deduction cannot also claim the benefits of the foreign tax credit or foreign tax deduction.[63] In addition, through final regulations (Final 956 Regs), the U.S. Department of the Treasury (Treasury) exempts corporate USSHs from the § 956 inclusion by allowing the shareholder to reduce its U.S. Property Investment by the amount of the §245A deduction that would have been allowed if the inclusion had been a distribution from the CFC to the USSH.[64]

However, the 245A DRD is not available for all dividends. For example, dividends from a PFIC and hybrid dividends are not deductible under §245A.[65] But when available, § 245A fully exempts the foreign source portion of a dividend. In these cases, repatriation is no longer a taxable event. When the 245A DRD exempts a dividend from taxation, § 959 is unnecessary since no E&P are previously taxed. However, as will be described below, § 959 remains relevant because the order of allocating earnings to a distribution ensures that PTI is utilized preferentially over Untaxed E&P and therefore § 959 receives priority over § 245A. In addition, the greater amounts of PTI created after the 2017 tax reform makes the PTI System more powerful than before.

2. The TCJA Created New Categories of Income that Increase the PTI Available for Distributions.

Prior to the TCJA, only Subpart F Income, U.S. Property Investment, Section 1248 Gain, and Section 964(e) Gain reclassified earnings from Untaxed E&P to PTI.[66] The TCJA established new categories of income, including GILTI, the section 965 transition tax income (Transition Tax Income), and the § 245A(e) hybrid dividends (Hybrid Dividends), each of

61. I.R.C. § 245A(a).

62. I.R.C. § 245A(b)(1)–(2).

63. I.R.C. § 245A(d)(1)–(2).

64. Treas. Reg. § 1.956-1(a)(2)(i) (2019).

65. I.R.C. § 245A(b)(2), (e)–(f).

66. *See supra* Part II.A.

which reclassifies Untaxed E&P as Subpart F PTI.[67] The new Transition Tax Income and Hybrid Dividend categories are briefly described here; however, a more in depth analysis of these provisions and their effects on the PTI System is beyond the scope of this paper. This paper will primarily focus on the effect of GILTI inclusions on the PTI System.

Section 965 implements a one-time tax (Transition Tax) on certain foreign corporations' (including CFCs') undistributed post-1986 foreign earnings that have not been taxed by the United States.[68] Section 965 increases the CFC's Subpart F Income by the amount of these undistributed earnings, which are therefore taxable to the USSH as a Subpart F inclusion.[69] The USSH receives a deduction, which ultimately implements a 15.5% effective tax rate on the Subpart F Income attributed to cash and 8% for that attributed to non-cash earnings.[70] Since § 965 taxes E&P through Subpart F Income, the CFC's earnings are redesignated as Subpart F PTI.[71]

Hybrid Dividends are distributions from a CFC where the USSH would qualify for the § 245A deduction but for the fact that the CFC received a deduction or other income tax benefit from a foreign country for foreign taxes attributed to the same distribution.[72] USSHs may not claim a foreign tax credit, foreign tax deduction, or § 245A deduction for any hybrid dividend.[73] Therefore, hybrid dividends are fully taxed without relief from juridical double taxation. In addition, when a CFC receives a hybrid dividend from a lower tier CFC of the same USSH, the hybrid dividend will be Subpart F Income to the recipient CFC, a pro rata share will be included in the USSH's gross income, and an equivalent portion of the CFC's Untaxed E&P will be designated Subpart F PTI.[74] Thus, although Hybrid Dividends are currently taxed and are not protected from juridical double taxation, the United States uses PTI to ensure that it does not tax this income twice.

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67. I.R.C. §§ 245A(e)(2), 951A(f)(1)(A), 965(a), (b)(4)(A) (2020); *NYSBA PTI Report*, *supra* note 44, at 5–6.

68. I.R.C. § 965(a), (d)(1)–(2), (e)(1); N.Y. ST. B. ASS'N TAX SEC., REP. NO. 1388, *Report on Section 965*, 1 (Feb. 6, 2018) [hereinafter *NYSBA Section 965 Report*], *available at* http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2018/1388_Report.html.

69. I.R.C. §§ 951(a) (2020), 965(a).

70. I.R.C. § 965(c); *NYSBA Section 965 Report*, *supra* note 68, at 28.

71. I.R.C. § 959(a); *NYSBA PTI Report*, *supra* note 44, at 5–6, n.14.

72. I.R.C. § 245A(e)(4).

73. I.R.C. § 245A(e)(1), (3).

74. I.R.C. §§ 245A(e)(2), 959(a).

In addition to Subpart F Income and U.S. Property Investments, the TCJA added GILTI as a third category of earnings that must be currently included in a USSH's gross income without a realization event.[75] GILTI is the result of a formulaic estimate of intangible income.[76] GILTI is the USSH's net CFC tested income (Net CFC Tested Income or Net CFC TI) *less* net deemed tangible income return (Net Deemed Tangible Income Return or NDTIR), where NDTIR is an estimate of the income produced by the CFC's tangible assets.[77] NDTIR is 10% of the aggregate pro rata share of the qualified business asset investment (QBAI) for each CFC less any interest expense included in the Net CFC Tested Income when the corresponding interest income is not so included,[78] where QBAI is the average value of the aggregate adjusted bases of depreciable trade or business property used to produce tested income.[79]

When the USSH owns an interest in more than one CFC, the Net CFC Tested Income includes income from multiple CFCs.[80] The Net CFC Tested Income equals the aggregate pro rata share of tested income less the aggregate pro rata share of tested loss for all of the USSH's CFCs.[81] Tested income is calculated for each CFC and equals the CFC's gross income less "properly allocated" deductions (including taxes), and then excluding ECI with a USTB; Subpart F inclusions (after adding back income excluded by the § 954(b)(4) high-tax exception);[82] dividends from related persons; and foreign oil and gas extraction income (collectively Tested Income).[83] A "Tested Loss" develops when the Tested Income calculation results in a negative number.[84] Overall, GILTI is an estimate of the taxable income that is not otherwise taxed or excluded from tax by the United States, less an

75. I.R.C. § 951A(a).

76. I.R.C. § 951A.

77. I.R.C. § 951A(b)(1)–(2).

78. I.R.C. § 951A(b)(2).

79. I.R.C. § 951A(d)(1)–(2).

80. I.R.C. § 951A(c)(1).

81. *Id.*

82. Treasury has proposed regulations that would allow a USSH to elect to exclude from GILTI all high-taxed income, which is defined as income subject to an effective foreign tax rate greater than 90% of the maximum U.S. corporate tax rate (Proposed GILTI High Tax Election). Guidance Under Section 958 (Rules for Determining Stock Ownership) and Section 951A (Global Intangible Low-Taxed Income), 84 Fed. Reg. 29,114, 29,120, 29,129 (proposed June 21, 2019) [hereinafter Proposed GILTI Regs]; Andrew Velarade, Jennifer McLoughlin & Ryan Finley, *GILTI Regs Make Room for High-Tax Exclusion*, 163 TAX NOTES 2025 (June 24, 2019).

83. I.R.C. § 951A(c)(2)(A).

84. I.R.C. § 951A(c)(2)(B)(i).

estimate of the income produced by the tangible assets of all of the USSH's CFCs. There is no E&P limit for GILTI or Tested Income.[85]

The TCJA requires that GILTI is treated "in the same manner as" Subpart F Income.[86] Section 951A states "any global intangible low-taxed income *included in gross income . . . shall be treated in the same manner as* an amount included under section 951(a)(1)(A) [Subpart F Income] for purposes of applying sections . . . 959, [and] 961."[87] Section 959 states that the E&P attributable to the gross income inclusion for Subpart F Income are excluded when subsequently distributed to the USSH.[88] Section 959(a) states:

> [T]he earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder [as Subpart F Income or U.S. Property Investment] shall not, when . . . distributed to, or [invested in U.S. Property] . . . be again included in the gross income of such United States shareholder.[89]

Based on this language, treating GILTI in the same manner as a Subpart F Income inclusion would require that the E&P attributed to GILTI be excluded from a second inclusion when distributed to the USSH. Thus, the full amount of GILTI would be considered PTI and excluded from taxation when distributed to the USSH even though GILTI currently receives a 50% deduction by section 250 and only half of GILTI is included in the USSH's taxable income.[90]

However, PTI is a portion of each CFC's earnings, while GILTI is calculated based on the aggregate data of all of the USSH's CFCs.[91] As a result, GILTI must be allocated to each of the USSH's CFCs to determine the earnings allocable to the previously taxed GILTI inclusion. This allocation is determined by formula (GILTI to CFC Allocation Formula):[92]

85. IRS PTI Notice, *supra* note 45, at 278.
86. I.R.C. § 951A(f)(1)(A).
87. *Id.* (emphasis added).
88. I.R.C. § 959(a).
89. *Id.*
90. I.R.C. § 250(a)(1)(B) (2020).
91. I.R.C. §§ 951A(a)–(d), 959(a).
92. I.R.C. § 951A(f)(2).

$$GILTI\ from\ CFC\ A = GILTI * \frac{USSH's\ PRS\ of\ CFC\ A's\ Tested\ Income}{USSH's\ Aggregate\ PRS\ of\ All\ CFCs'\ Tested\ Income}$$

except that the GILTI allocation is zero when the CFC has no tested income.[93] Since GILTI must be "treated in the same manner as" Subpart F Income, the amount of GILTI allocated to each CFC must be reclassified from Untaxed E&P to Subpart F PTI, and the USSH's basis in the CFC stock will be increased by the same amount.[94]

Furthermore, when the CFC distributes earnings to its USSH, the E&P and basis adjustment will be the same as that described above for distributions made prior to the 2017 tax reform.[95] The CFC's PTI and Untaxed E&P will be reduced following the § 959(c) and (f) ordering rules and the Last In, First Out Approach,[96] and the USSH's E&P will be increased by an equivalent amount even though the distribution is excluded from gross income as PTI.[97] Additionally, the USSH's basis in CFC stock will be reduced by the amount of PTI excluded from gross income.[98] Distributions in excess of the aggregate of PTI and Non-PTI E&P are not taxed to the extent of the USSH's basis in the CFC's stock.[99] However, distributions exceeding basis are taxed as gain.[100]

Thus, although the TCJA did not change the order of allocation of PTI assigned to distributions or U.S. Property Investments, the TCJA creates numerous subcategories of Subpart F PTI. PTI recategorized by the GILTI inclusion, as well as that created by the Transition Tax Income, Hybrid Dividends, Section 1248 Gain, and Section 964(e) Gain, are classified as Subpart F PTI.[101] No ordering rule exists to prioritize distributions among the various subcategories of Subpart F PTI.[102] Without further guidance, the Last In, First Out Approach likely

93. I.R.C. § 951A(f)(2)(A).

94. I.R.C. §§ 951A(f)(1)(A), 959(a), (c), 961(a).

95. *See supra* Part II.A.

96. *See supra* text accompanying notes 44 to 51.

97. I.R.C. § 959(a), (d).

98. I.R.C. § 961(b)(1).

99. I.R.C. §§ 301(a), (c)(2), 316(a) (2020).

100. I.R.C. §§ 301(a), (c)(3)(A), 316(a).

101. I.R.C. §§ 245A(e)(2), 951A(f)(1)(A), 965(a), (b)(4)(A), 959(e), 964(e)(1), 1248(a); *NYSBA PTI Report*, *supra* note 44, at 5–6.

102. *NYSBA PTI Report*, *supra* note 44, at 48, 57.

applies, with a pro rata allocation used when multiple subcategories of PTI are accumulated at the same time.[103]

However, after the TCJA, many of the subcategories of Subpart F PTI require disparate tax treatment. For example, the Hybrid Dividends do not receive the benefit of the § 245A deduction or the FTC.[104] Thus, if a foreign country applies a withholding tax to the PTI from Hybrid Dividends, these earnings would not qualify for the FTC. As a result, PTI from Hybrid Dividends may need to be separately categorized within Subpart F PTI. Similar treatment may also be required for other subcategories of Subpart F PTI.[105]

In Notice 2019-01, Treasury proposed giving priority to PTI generated by Section 965 (Section 965 Exception to Last In, First Out Approach).[106] If implemented, when a CFC makes a distribution to its USSH, the distribution will first utilize U.S. Property PTI that was originally reallocated from Subpart F PTI by the section 965(a) inclusion followed by that reallocated by section 965(b) and then any remaining U.S. Property PTI using the most recently reallocated PTI first.[107] After U.S. Property PTI is exhausted, the distribution will be

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103. IRS PTI Notice, *supra* note 45, at 278, 279–80; *NYSBA PTI Report*, *supra* note 44, at 57. *See infra* Part III.B.1 for an example of the allocation of PTI to a distribution, which requires a pro rata allocation among subcategories of Subpart F PTI.

104. I.R.C. § 245A(e)(1), (3).

105. Treasury recently released final guidance for the foreign tax credit, which address, among other issues, the allocation and apportionment of foreign income taxes and deemed paid taxes to the FTC limitation categories and PTEP. Foreign Tax Credit Guidance Related to the Tax Cuts and Jobs Act, Overall Foreign Loss Recapture, and Foreign Tax Redeterminations, 84 Fed. Reg. 69,022, 69,037-38, 69,044-47, 69,098-99, 69,107-117 (Dec. 17, 2019) [hereinafter Final FTC Regs]. These regulations utilize ten categories of PTEP. Id. at 69,046-47, 69,115. However, Treasury noted its intent to "issue more comprehensive regulations addressing the maintenance of annual PTEP accounts and the PTEP groups in a separate notice of proposed rule making under section 959," and anticipated making additional modifications to coordinate these regulations. *Id.* at 69,047. In addition, Treasury proposed additional regulations regarding the allocation and apportionment of foreign income taxes and expects to issue additional guidance in this area. Final FTC Regs at 69,038; Guidance Related to the Allocation and Apportionment of Deductions and Foreign Taxes, Financial Services Income, Foreign Tax Redeterminations, Foreign Tax Credit Disallowance Under Section 965(g), and Consolidated Groups, 84 Fed. Reg. 69,124, 69,132-34, 69,158-64, 69,168-69 (Dec. 17, 2019) [hereinafter 2019 Proposed FTC Regs]. Because of the expected changes to the FTC guidance, this paper will generally assume the law regarding foreign tax credits is that which applied without the Final FTC Regs, 2019 Proposed FTC Regs or the 2018 Proposed FTC Regs. See infra note 191 for definition of "2018 Proposed FTC Regs."

106. IRS PTI Notice, *supra* note 45, at 278, 279–80.

107. IRS PTI Notice, *supra* note 45, at 278. For purposes of determining the most recently accumulated PTI, the earnings will be segregated by year into annual accounts. *Id.*

allocated to Subpart F PTI applying the same priority, using earnings reallocated by § 965(a) first, followed by that reallocated by § 965(b) PTI and then utilizing remaining Subpart F PTI in the reverse order of accumulation.[108] Investments in U.S. Property will follow the same order, but will start with the Subpart F PTI.[109] As usual, when PTI is exhausted, the distribution or investment will be allocated to Untaxed E&P.[110] This approach would ensure that the PTI produced by the one-time § 965 transition tax will not become "trapped" indefinitely by subsequently generated PTI and require long-term maintenance accounts to track these special categories of earnings.[111] However, this approach will also be administratively difficult since the Transition Tax PTI would need to be segregated by year in order to carry out this allocation scheme. The remainder of this paper will only consider the subcategory of Subpart F PTI created by GILTI. All other subcategories of Section 959(c)(2) PTI, as well as the order of allocation of these subcategories, are beyond the scope of this Article.

Although multiple subcategories of Subpart F PTI have the potential to complicate the system of allocating E&P to distributions and U.S. Property Investments, the more significant effect of these changes is the large amount of PTI that exists after the implementation of the Transition Tax, and the large amount of PTI that will be generated annually by GILTI.[112] As will be demonstrated in the next section, the large amount of Subpart F PTI created by the GILTI inclusion may have the effect of substantially limiting the availability of the § 245A deduction for many MNEs.

3. Despite the Changes Introduced by the TCJA, the PTI System Operates Substantially the Same as Prior to the 2017 Tax Reform.

Despite the changes introduced by the TCJA, the PTI System operates substantially the same as prior to the 2017 tax reform. The TCJA did not change the order of allocating earnings to distributions or U.S. Property Investments, so generally Untaxed E&P is only distributed after all PTI is utilized.[113] For MNEs with a significant

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108. IRS PTI Notice, *supra* note 45, at 278.

109. *Id.*

110. *Id.*

111. *Id.*

112. *NYSBA PTI Report*, *supra* note 44, at 48.

113. I.R.C. § 959(c), (f). One notable exception to this general rule exists when a CFC has U.S Property PTI and no Subpart F PTI. Since U.S. Property PTI is considered when determining the amount of U.S. Property Investments, U.S. Property Investments are not attributable to U.S. Property PTI. I.R.C. § 959(f)(1); Cummings, Jr., *supra* note 26, at 535.

amount of GILTI and therefore a significant amount of Subpart F PTI from GILTI inclusions, the priority for PTI distributions may prevent the use of the 245A DRD and therefore the exemption tax system. Since PTI is not considered to be a dividend for any purpose other than reducing E&P upon a distribution and § 245A only applies to dividends, PTI distributions cannot use the § 245A deduction.[114] This has the effect of requiring distributions from a CFC to its USSH to be governed by § 959 until PTI is exhausted, and only then may distributions receive the benefit of the § 245A deduction. So, for CFCs with a significant amount of PTI, the tax consequences for distributions may be exclusively determined by the PTI System.

Since §§ 959 and 245A both exempt a CFC's distributions from the USSH's gross income, the mechanism of exclusion may not seem significant. Regardless of whether a CFC's distribution of E&P to its USSH is considered a dividend that qualifies for the § 245A deduction or a § 959 distribution of PTI, the distribution will be exempt from taxation.[115] If the distribution is a dividend, it would be included in the USSH's gross income, but the foreign source portion would be excluded by the 100% dividend received deduction provided by § 245A.[116] If, instead, it is considered a distribution of PTI, the full payment would be excluded from the USSH's gross income.[117] However, the method of exemption is critical.

The main difference between distributions that are exempt by the § 245A deduction and the § 959 PTI is that the 245A DRD makes a final determination of unrestricted E&P, while § 959 must resolve issues that occur during the Interim Period. When § 245A applies, the distribution is exempt from taxation, foreign income tax paid on this distribution is ignored, and the U.S. tax system generally does not consider these earnings again.[118]

As a result, section 959(f)(1) attributes U.S. Property Investments to Subpart F PTI first and then to Untaxed E&P. I.R.C. § 959(f)(1). Thus, when a CFC with only U.S. Property PTI and no Subpart F PTI makes an investment in U.S. Property, the investment will be attributed to Untaxed E&P despite the existence of U.S. Property PTI. In this unique situation, Untaxed E&P will be distributed before PTI. Treas. Reg. § 1.956-1(a)(2)(ii)(C), (a)(3)(iii) (2019); Lee A. Sheppard, *Changes in Final Section 956 Regs,* 94 TAX NOTES INT'L 1176, 1176–77 (June 17, 2019).

114. I.R.C. §§ 245A(a), 959(d).

115. I.R.C. §§ 245A(a), 959(a).

116. I.R.C. § 245A(a).

117. I.R.C. § 959(a).

118. I.R.C. § 245A(a). The TCJA repealed section 902, which allowed a USSH to consider foreign income taxes paid by its foreign subsidiary when determining the available FTC. I.R.C. § 902 (2016). After the TCJA, only deemed paid taxes attributed to

On the other hand, § 959 must resolve issues related to E&P between the time of the deemed gross income inclusion (Inclusion Date) and the date earnings are, in fact, distributed to the USSH (the Distribution Date).[119] During this Interim Period, the E&P remains in the CFC's accounts. When PTI is distributed, the U.S. must finally determine the tax effects of any income, gain or loss that occurs between the Inclusion Date and the Distribution Date.

Thus, as was the case prior to the TCJA, during the Interim Period the PTI System must (a) adjust the USSH's basis in the CFC stock for any gross income inclusion that reallocates Untaxed E&P to PTI and any distributions of PTI;[120] (b) account for foreign currency gain or loss resulting from changes in the foreign exchange rates when the CFC's functional currency is not the U.S. dollar;[121] and (c) determine the FTC for any foreign income taxes imposed on PTI that has not yet been credited.[122] These provisions operate largely the same as before the 2017 tax reform, although some variations ensue from the addition of GILTI and the § 245A deduction. In addition, although the FTC remains available for foreign income taxes paid or deemed paid on PTI, the mechanics are modified by the repeal of § 902 and amendments to § 960.

a. The TCJA Did Not Change the Basis Adjustment Rules, but PTI from GILTI Inclusions Necessitate Adjustments to the USSH's Basis in CFC Stock.

Section 959 protects a CFC's distribution to its USSH from double taxation when its E&P was previously included in gross income by Subpart F.[123] However, without additional protection, double taxation could still result if the shareholder sold its interest in the subsidiary before receiving PTI through an actual distribution.[124] Section 961 operates to prevent this result. Section 961 adjusts the basis of CFC stock to prevent the repeat taxation of earnings as gain when stock is sold prior to distributing PTI to the USSH.[125]

Subpart F Income, U.S. Property Investments, and GILTI may be considered when determining the availability of the FTC. I.R.C. § 960(a), (d) (2020).

119. Recall that the period between the Inclusion Date and the Distribution Date is referred to herein as the "Interim Period." *See supra* Part II.A.

120. I.R.C. § 961(a)–(b); *NYSBA PTI Report*, *supra* note 44, at 7–9, 11.

121. I.R.C. § 986(c); *NYSBA PTI Report*, *supra* note 44, at 15–16.

122. I.R.C. § 960(b); *NYSBA PTI Report*, *supra* note 44, at 13–15.

123. I.R.C. § 959(a).

124. *NYSBA PTI Report*, *supra* note 44, at 7.

125. *Id.*

The basis adjustment laws are the same as prior to the enactment of the TCJA. [126] However, for purposes of section 961, GILTI "included in gross income" must be "treated in the same manner as" Subpart F Income included in the USSH's gross income.[127] Thus, upon receiving a Subpart F inclusion, which now includes Subpart F Income, U.S. Property Investments, and GILTI, the USSH's basis in CFC stock must be increased by the amount actually included in the shareholder's gross income.[128] When a distribution is subsequently insulated from taxation by PTI, the USSH's basis in the CFC's stock is reduced by the amount of PTI utilized.[129] The USSH's new basis in the CFC equals its old basis less PTI utilized.[130] A negative basis is not permitted. Instead, any PTI used in excess of the USSH's basis is taxed as gain.[131]

The current PTI regulations potentially create inappropriate gain recognition from the timing of § 961 basis adjustments. The increase in basis from a Subpart F inclusion occurs on "the last day in the [CFC's] taxable year," while the decrease in basis occurs at the time the USSH receives the PTI distribution.[132] As a result, when the USSH sells its CFC stock between the time of the Subpart F inclusion and the end of the CFC's tax year, the gain recognized may not reflect the transaction's actual economic value.[133] Notwithstanding the foregoing, generally the system of basis adjustments prevents the USSH from recognizing gain that was previously taxed by Subpart F when stock in the CFC is sold before the PTI is distributed.[134]

b. Foreign Currency Gain May Result from Exchange Rate Fluctuations Between the Time of Subpart F Inclusion and PTI Distribution.

U.S. income tax must be determined based on the taxpayer's functional currency (Functional Currency).[135] Functional Currency is

126. The TCJA did add a basis adjustment rule for the 245A DRD. The basis in a subsidiary's stock is decreased by the amount of any Section 245A deduction, but only for determining loss on disposition of the subsidiary's stock. I.R.C. § 961(d).

127. I.R.C. § 951A(f)(1)(A).

128. I.R.C. § 961(a); *NYSBA PTI Report*, *supra* note 44, at 7.

129. I.R.C. § 961(b)(1); *NYSBA PTI Report*, *supra* note 44, at 7.

130. I.R.C. § 961(b)(1). In addition, Treasury regulations require that the USSH's basis be reduced by any FIT attributable to the PTI. Treas. Reg. § 1.961-2(a)(1).

131. I.R.C. § 961(b)(2); *NYSBA PTI Report*, *supra* note 44, at 7.

132. Treas. Reg. §§ 1.961-1(a)(1), -2(a)(1); *NYSBA PTI Report*, *supra* note 44, at 27.

133. *NYSBA PTI Report*, *supra* note 44, at 27–28.

134. *NYSBA PTI Report*, *supra* note 44, at 7.

135. I.R.C. § 985(a) (2020).

generally the U.S. dollar (USD),[136] but may be the currency in which a "qualified business unit" (QBU)[137] keeps its "books and records" when the QBU conducts a significant part of its activity in that currency.[138] When a CFC's Functional Currency is not the U.S. dollar, different exchange rates between the deemed and actual distribution can produce a foreign currency gain or loss on the value of PTI.[139]

Foreign currency transaction laws determine the amount of foreign currency gain and loss. Since these statutes were not modified by the TCJA, the operation of these laws are unchanged.[140] E&P is calculated in Functional Currency and then translated into U.S. dollars using the appropriate exchange rate (Appropriate ER), where Appropriate ER is determined at the time E&P is actually distributed, deemed distributed, or "otherwise taken into account."[141] Foreign currency gain equals the E&P of the actual PTI distribution converted to USD based on the spot rate on the date the distribution was actually included in income, less E&P attributed to the Subpart F inclusion converted into U.S. dollars based on the average exchange rate (Average ER) for the tax year of the inclusion for Subpart F Income (or based on the spot rate on the last day of the tax year for a U.S. Property Investment).[142] The calculation is represented by the following formula:

$$\begin{aligned}&\mathit{Foreign\ Currency\ Gain}\ = \\ &\qquad (\mathit{PTI\ Distribution\ Translated\ to}\ \$)\ \boldsymbol{less} \\ &\qquad (\mathit{Subpart\ F\ Inclusion\ Translated\ to}\ \$)\end{aligned}$$ [143]

136. I.R.C. § 985(b)(1)(A).

137. A "qualified business unit" is a "separate and clearly identified unit of a trade or business . . . which maintains separate books and records." I.R.C. § 989(a) (2020).

138. I.R.C. § 985(b)(1)(B). However, the U.S. dollar will still be the QBU's Functional Currency when (a) the QBU primarily conducts its business in U.S. dollars, or (b) the QBU elects to use the U.S. dollar as its Functional Currency, and either keeps its books and records in U.S. dollars or uses a method of accounting approximating the separate transactions method. I.R.C. § 985(b)(2)–(3).

139. I.R.C. § 986(c); *NYSBA PTI Report*, *supra* note 44, at 15.

140. I.R.C. §§ 985–989 (2020).

141. I.R.C. § 986(b)(1)–(2). Appropriate ER is defined by regulations, but no regulations exist for foreign currency gain. I.R.C. § 989(b). When not defined by regulations, the Appropriate ER is (i) the spot rate at the time the actual distribution is included in income, where a U.S. Property inclusion is treated like an actual distribution made on the last day of the tax year; (ii) the spot rate at the time the § 1248 deemed dividend is included in income for an actual or deemed sale of foreign corporation stock; (iii) the Average Exchange Rate (Average ER) of the foreign corporation's tax year for Subpart F Income or QEF inclusions; or (iv) the Average ER of a QBU's tax year for any other QBU. I.R.C. § 989(b).

142. I.R.C. §§ 986(c)(1), 989(b).

A foreign currency loss exists when the formula results in a negative number. Foreign currency gain or loss is treated as ordinary income/loss from the same source as the income inclusion.[144]

The statutory language for calculating foreign currency gain is broad and can be applied to previously taxed E&P attributed to the GILTI inclusion. However, because the foreign currency transaction statutes are not listed in § 951A(f)(1)(A), GILTI is not treated in the same manner as Subpart F Income for purposes of determining foreign currency gain.[145] Thus, Congress did not provide direction regarding how to apply the foreign currency gain statutes to GILTI. As a result, the procedure used to calculate foreign currency gain due to exchange rate fluctuations between the time of GILTI inclusion and the distribution of PTI is not clear.

Thus, applying the foreign currency gain laws to GILTI presents a number of issues. Because § 951A(f)(1)(A) does not apply to foreign currency transactions, the formula allocating GILTI to CFCs will not apply for purposes of determining foreign currency gain.[146] Thus, Treasury will need to establish a mechanism for determining the amount of a CFC's E&P that contributed to the USSH's GILTI inclusion. Although Treasury does not explicitly state that the GILTI to CFC Allocation Formula may be used for purposes of determining foreign currency gain under § 986(c), Treasury regulations provide that when GILTI is allocated to the CFCs using the GILTI to CFC Allocation Formula, the amount allocated can be translated from USD to the CFC's functional currency using the average exchange rate.[147] In light of this, Treasury may plan to use the GILTI to CFC Allocation Formula to allocate GILTI to each of the USSH's CFCs when determining any applicable foreign currency gain.

Once E&P attributed to the GILTI inclusion is determined for each CFC, changes in exchange rate between the deemed and actual distribution can produce a foreign currency gain or loss when the CFC's functional currency is not the USD.[148] The foreign currency gain equals the E&P at actual distribution converted to USD based on the spot rate on the date the distribution was included in income, less E&P at deemed distribution converted into USD based on the Appropriate ER

143. I.R.C. §§ 986(c)(1), 989(b); *NYSBA PTI Report*, *supra* note 44, at 15.

144. I.R.C. § 986(c)(1).

145. I.R.C. § 951A(f)(1)(A).

146. I.R.C. § 951A(f)(1)(A), (f)(2).

147. Treas. Reg. § 1.951A-5(b)(3) (2019).

148. I.R.C. § 986(c); *NYSBA PTI Report*, *supra* note 44, at 15.

for the tax year.[149] Since GILTI is not treated like Subpart F Income for purposes of determining foreign currency gain, Treasury will need to establish the appropriate method for translating E&P attributed to GILTI into USD.[150] Without additional guidance, it is likely that PTI attributed to GILTI will be translated to USD using the average exchange rate for the CFC's taxable year. The only potentially applicable "Appropriate ER" for GILTI would be the "average exchange rate for the taxable year of [the] qualified business unit," which applies to "any other qualified business unit of a taxpayer."[151] Since it is a "separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records," the CFC is a QBU of its USSH.[152] Thus, E&P attributed to GILTI should be translated to USD based on the average exchange rate for the CFC's taxable year. In fact, Treasury regulations state that the "portion of the GILTI inclusion amount of a United States shareholder allocated to a tested income CFC under section 951A(f)(2) . . . is translated into the functional currency of the tested income CFC using the average exchange rate for the CFC inclusion year of the tested income CFC."[153]

Finally, fluctuations in the exchange rate may create the anomalous result that foreign currency gain may result on the portion of GILTI that is exempt from tax by § 250. As described above, foreign currency gain equals the E&P at actual distribution converted to USD based on the spot rate on the Distribution Date, less the E&P at deemed distribution converted into USD based on Average ER for the tax year.[154] Since the foreign currency gain calculation is based on PTEP as determined by § 959, which is based on the amount included in the USSH's gross income, the deemed distribution from the GILTI inclusion would be the full amount of the gross income inclusion from GILTI, even though GILTI currently receives a 50% deduction based on § 250.[155] Similarly, the PTI distribution would be the full amount of earnings distributed from the CFC to its USSH.[156] Accordingly, foreign currency gain would be calculated based on the full amount of the

149. I.R.C. §§ 986(c)(1), 989(b).

150. I.R.C. §§ 951A(f)(1)(A), 986(c)(1), 989(b).

151. I.R.C. § 989(b)(4).

152. I.R.C. § 989(a); Treas. Reg. § 1.989(a)-1(b)(1), (b)(2)(i)(A), (e) (Example 2).

153. Treas. Reg. § 1.951A-5(b)(3) (2019). However, Treasury's rationale for applying the average exchange rate to GILTI differs from the argument set forth in this paper. Guidance Related to Section 951A (Global Intangible Low-Taxed Income), 83 Fed. Reg. 51,072, 51,074 (proposed Oct. 10, 2018).

154. I.R.C. §§ 959(a), 986(c)(1), 989(b)(1), (4).

155. I.R.C. §§ 250(a)(1)(B), 959(a), 986(c)(1).

156. I.R.C. §§ 959(a), 986(c)(1), 989(b).

GILTI inclusion and would not consider the fact that 50% of GILTI is tax exempt. Thus, half of the foreign currency gain would result from changes in exchange rates applied to exempt income. This result is anomalous.

The gain (or loss) results because the change in exchange rate creates a difference between the value of the taxable inclusion (Subpart F Income or GILTI inclusion) and the value of the tax-free distribution (PTI).[157] When a portion of the gross income inclusion is not taxed, the value of the taxable inclusion will be reduced and should not contribute to gain. This can be demonstrated by the following simple example. Assume that a USSH receives a GILTI inclusion of 100 units when the exchange rate is $0.75 to 1 unit, and a PTI distribution of 100 units when the exchange rate is $1 to 1 unit. The foreign currency gain will be 100 units ($1/1 unit) – 100 units ($0.75/1 unit) = $100 – $75 = $25. On the other hand, if the calculation accounted for the § 250 deduction of 50% of GILTI = 50% (100 units) = 50 units, then the foreign currency gain would be 50 units ($1/1 unit) – 50 units ($0.75/1 unit) = $50 – $37.50 = $12.50. If the gain was determined based only on taxable income, then the foreign currency gain would be reduced by 50%. Treasury should ensure that exempt income does not contribute to the determination of foreign currency gain.

c. FTC Remains Available for Foreign Income Taxes Paid on a Previously Taxed Income Distribution.

Prior to the TCJA, PTI was treated like a dividend for purposes of determining the § 902 deemed paid foreign income taxes attributed to the PTI.[158] The TCJA repealed § 902, expanded the baskets of income used to calculate the FTC limitation, and amended § 960, which modified the mechanics for determining the amount of deemed paid taxes (DPT) attributed to Subpart F Income, U.S. Property Investments, and GILTI.[159] Still, the FTC remains available for foreign income taxes paid or deemed paid on PTI.[160]

i. Foreign Income Taxes Imposed on PTI are Creditable.

Domestic corporations may claim a credit for "income, war profits, and excess profits taxes" imposed by foreign countries and U.S.

157. BITTKER & LOKKEN, *supra* note 18, at ¶ 74.5.
158. I.R.C. §§ 902(a), 960(a)(3) (2016).
159. I.R.C. §§ 904(d)(1), 960 (2020); TCJA of 2017, *supra* note 2, at § 14,301.
160. I.R.C. §§ 901(a) (2020), 960(b)–(c).

possessions.[161] In addition, the United States allows a credit for foreign taxes that the corporation is deemed to have paid when it receives a Subpart F inclusion from a CFC.[162] USSHs are also deemed to have paid a CFC's foreign income taxes (FIT) that are "properly attributable" to a distribution excluded from the USSH's gross income by PTI so long as the taxes are not deemed paid in the current or any previous taxable year.[163]

The FTC is limited to the amount of tax the United States would have imposed on the foreign source income.[164] However, because it was not included in gross income, PTI does not increase the FTC limit. As a consequence, the Code provides a mechanism to increase the FTC limitation by the lesser *of* the taxes paid (or deemed paid) on the PTI distribution or the value of the excess limitation account (ELA).[165] Overall this system allows a USSH to claim the FTC for foreign income taxes paid on PTI.[166]

These FTC provisions apply to Subpart F PTI resulting from GILTI inclusions (GILTI PTI). A USSH can claim a FTC based on foreign income taxes "properly attributable" to GILTI PTI so long as the taxpayer did not receive the benefit of a FTC for these taxes in a prior tax year and so long as the FIT were not attributed to a GILTI inclusion in a prior tax year.[167] However, § 951A(f)(1)(A) does not apply to § 960, so GILTI is not treated as Subpart F Income for purposes of § 960.[168] Thus, foreign taxes imposed on GILTI PTI would be eligible for the FTC but only based on their own qualification.[169]

Since excess DPT on GILTI cannot be carried forward to subsequent tax years, FIT attributed to a GILTI inclusion in a prior tax year would

161. I.R.C. § 901(a)–(b)(1).

162. I.R.C. §§ 901(a)–(b)(1), 960.

163. I.R.C. § 960(b)(1).

164. I.R.C. §§ 901(a), 904(a); BITTKER & LOKKEN, *supra* note 18, at ¶¶ 72.1, 72.6.1.

165. I.R.C. § 960(c)(1)–(2). Except for relabeling the section 960 subsection from (b) to (c), the language of this subsection was not changed by the TCJA. I.R.C. § 960(c), *see* § 960(b) (2016).

166. Similarly, domestic corporations may claim a credit for foreign taxes imposed on PTI created by Subpart F inclusions that result from a distribution to a lower tier CFC within a USSH's ownership chain. I.R.C. § 960(b)(2). E&P included in a USSH's gross income as Subpart F Income or GILTI are considered PTI, which are not taxed again as a Subpart F inclusion when distributed from one CFC to another within a USSH's ownership chain. I.R.C. § 959(b). Still, taxes attributable to this PTI are creditable so long as they were not currently or previously considered DPT by the USSH. I.R.C. §§ 959(b), 960(b)(2).

167. I.R.C. §§ 901(a), 904(c), 951A(f)(1)(A), 960(b)(1).

168. I.R.C. § 951A(f)(1)(A).

169. I.R.C. §§ 901(a), 951A(f)(1)(A), 960(b)(1).

not be creditable even if it were attributed to GILTI PTI.[170] However, to the extent the foreign income taxes were imposed on the GILTI PTI during the current tax year and the taxpayer did not receive the benefit of a FTC for these taxes in a prior tax year, § 960(b) would apply and the USSH could claim a FTC for these taxes.[171] Still, the ability to claim a FTC based on foreign income taxes "properly attributable" to PTI is restricted by the FTC limitation for each basket of income.

ii. The Increase in FTC Limitation that Applies to Foreign Income Taxes on PTI May Not Apply to GILTI PTI.

As with all foreign income taxes, including those attributed to distributions of PTI, the FTC is limited to the amount of taxes the U.S. would impose on the foreign source income. The FTC limitation is determined by the following formula:[172]

$$FTC\ Limitation\ = U.S. Tax\ on\ Total\ Taxable\ Income * \frac{Foreign\ Source\ Taxable\ Income}{Total\ Taxable\ Income}$$

The FTC limitation, including the foreign source taxable income and total taxable income used to determine the FTC limitation, applies separately to passive income, GILTI, foreign branch income, and general income, where "general income" is a residual group that includes all income except that included in the preceding three categories.[173]

Although foreign taxes imposed on this PTI are potentially creditable,[174] the FTC limit would not normally be expanded for foreign income taxes imposed on PTI since PTI is not included in gross or taxable income.[175] Without an adjustment of the FTC limit, unrelieved double taxation would potentially occur when FIT or withholding tax is imposed on the PTI distribution. Thus, the FTC limit must be adjusted to allow a credit for any foreign taxes attributable to PTI. Section 960(c) provides this adjustment.[176]

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170. I.R.C. §§ 904(c), 960(b)(1).

171. I.R.C. §§ 901(a), 904(c), 951A(f)(1)(A), 960(b)(1).

172. I.R.C. §§ 901(a), 904(a); BITTKER & LOKKEN, *supra* note 18, at ¶¶ 72.1, 72.6.1.

173. I.R.C. § 904(d)(1), (2)(A)–(B), (J).

174. I.R.C. § 960(b). Foreign taxes attributed to PTI are creditable when not previously "deemed to have been paid by" the USSH. *Id.* Potentially creditable taxes include any withholding tax imposed on the distribution.

175. I.R.C. §§ 904(a), 959(a).

176. I.R.C. § 960(c).

Section 960(c) is implicated when a corporate USSH either (a) receives Subpart F Income or U.S. Property Investment from a CFC in a tax year (Inclusion Year) and elects to apply the FTC, or (b) does not pay or accrue FIT during the Inclusion Year.[177] In either case a gross income inclusion must reclassify Untaxed E&P as PTI during the Inclusion Year.[178] Section 960(c) will increase the FTC limit when: (a) the CFC makes a distribution of these earnings to the USSH in a subsequent tax year (Exclusion Year), and (b) foreign income taxes are paid or deemed to be paid on the PTI, the distribution is excluded from gross income as PTI by § 959(a), and the USSH claims a FTC.[179] Section 960(c) adjusts for foreign taxes imposed on PTI by increasing the FTC limitation by the lesser of the taxes paid (or deemed paid) on the PTI distribution or the value of the excess limitation account or the ELA (collectively the "Section 960(c) Adjustment").[180]

The ELA tracks the amount of FTC limitation that is unused by the parent corporation. The "opening balance" of the ELA is zero.[181] ELA is then increased by the amount of any unused FTC limitation attributed to a Subpart F inclusion and reduced by any increase in the FTC limitation made by the Section 960(c) Adjustment.[182]

However, this analysis is complicated by the fact that the FTC limit, and therefore the ELA, must be calculated based on the four baskets of income used to determine the FTC limit. Consequently, the ELA for each basket of income starts at zero.[183] For each basket, the account is increased by the excess of the FTC limit from Subpart F Income and U.S. Property Investment less any FIT or DPT from these inclusions that already received the benefit of the FTC.[184] Analogously, the ELA is reduced by the amount of Section 960(c) Adjustment, if any, for each basket of income.[185] Unfortunately, without statutory or regulatory modification, the Section 960(c) Adjustment and the ELA likely do not apply to GILTI PTI.

Although a USSH can claim a FTC based on foreign income taxes "properly attributable" to GILTI PTI so long as the taxpayer did not

177. I.R.C. § 960(c)(1)(A). When it elects to receive the benefit of the FTC during the Inclusion Year, the USSH cannot subsequently choose to receive the Section 164 deduction for foreign taxes in the year of the PTI distribution. I.R.C. § 960(c)(4).

178. I.R.C. § 960(c)(1)(B).

179. I.R.C. § 960(c)(1).

180. I.R.C. § 960(c)(1), (5).

181. I.R.C. § 960(c)(2)(A).

182. I.R.C. § 960(c)(2).

183. I.R.C. § 960(c)(2)(A).

184. I.R.C. § 960(c)(2)(B).

185. I.R.C. § 960(c)(2)(C).

receive the benefit of the FTC in a prior tax year and the taxes were not attributed to a GILTI inclusion in a prior tax year, the provisions allowing for an increase in the FTC and the excess limitation account likely do not apply to GILTI PTI.[186] As stated above, § 960 is not one of the statutes listed in § 951A(f)(1)(A), so GILTI is not treated as Subpart F Income for purposes of § 960.[187] Thus, GILTI PTI must independently satisfy the requirements for the Section 960(c) Adjustment and excess limitation account to receive these benefits.[188]

The FTC limit is increased by the lesser of the taxes paid or deemed paid on the PTI distribution or the value of the ELA.[189] Since the opening balance of the ELA is zero and the ELA may only be increased by Subpart F Income or U.S. Property Investments, GILTI inclusions will not increase the excess limitation account.[190] Accordingly, the ELA for the GILTI basket would always be zero, GILTI PTI will not receive the benefit of the Section 960(c) adjustment, and the FTC limit will not be increased to accommodate taxes attributable to GILTI PTI. Thus, taxpayers need not maintain an ELA for the GILTI basket, and any foreign taxes attributed to GILTI PLI will only be creditable to the extent of the FTC limitation otherwise available for the GILTI basket during the tax year. In light of the foregoing, Treasury has proposed to apply Section 960(c) and the excess limitation accounts to GILTI inclusions.[191]

In summary, the TCJA made significant changes to the U.S. international tax law, especially as applied to multinational corporations. The TCJA created a dividend exemption system and a new gross income inclusion for GILTI, which requires a USSH to pay tax on most of its CFCs' foreign source active business income without a

186. I.R.C. §§ 901(a), 904(c), 951A(f)(1)(A), 960(b)(1), (c)–(d).

187. I.R.C. § 951A(f)(1)(A).

188. I.R.C. §§ 951A(f)(1)(A), 960(c)(1)–(2).

189. I.R.C. § 960(c)(1).

190. I.R.C. § 960(c)(2)(A), (B)(i).

191. Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act, 83 Fed. Reg. 63,200, 63,214, 63,265 (proposed Dec. 7, 2018) [hereinafter 2018 Proposed FTC Regs]. In fact, the Final FTC Regs apply §960(c) to GILTI inclusions. Final FTC Regs, supra note 105, at 69047, 69117. Although not entitled to deference, proposed regulations can be used as guidance. BITTKER & LOKKEN, supra note 18, at ¶ 110.5.3. Since the U.S. Treasury Department may modify the proposed regulations in response to public comments, this paper generally will not analyze the rules set forth in any proposed regulation and assumes the state of the law exists without the proposed regulations. However, occasionally the proposed regulations are referenced to clarify ambiguous provisions or highlight a proposed change in the law. Accordingly, this paper generally will assume that the law regarding foreign tax credits is that which applies without proposed guidance.

realization event. In addition, the TCJA developed new income categories that reallocate Untaxed E&P to PTI. Because a CFC's distributions to its USSHs preferentially use PTI over Untaxed E&P, the § 245A deduction generally will not exempt a dividend from tax until all of the CFC's PTI has been distributed to USSHs. Thus, despite the significant changes implemented by the TCJA, the operation of the PTI System is relatively unchanged. The following section will use a hypothetical MNE to demonstrate the operation of the PTI System after the 2017 tax reform.

III. APPLICATION OF PREVIOUSLY TAXED INCOME ANALYSIS TO A HYPOTHETICAL MULTINATIONAL CORPORATION.

The complexities of previously taxed income analysis are demonstrated by the following hypothetical. U.S. corporation, US Corp, owns 100% of the stock and is the USSH of foreign corporation CFC A. US Corp's adjusted basis in CFC A is $1.5 billion. US Corp is incorporated in the United States, while CFC A is incorporated in County X. The tax rate in Country X is 10%. US Corp and CFC A both use the calendar year as their taxable year, and CFC A uses the U.S. dollar as its functional currency. The corporate structure has been stable throughout the life of all involved corporations. To avoid timing of basis adjustment issues, assume all transactions occur on the last day of US Corp's and CFC A's tax year. At the start of tax year 1 (TY1), none of the entities have accumulated E&P or PTI. None of CFC A's income is derived from passive activity or U.S. sources and CFC A's QBAI is stable at $700 million for all tax years.[192] US Corp does not have any foreign derived income except for that earned through CFC A.

For TY1, US Corp earns $900 million in U.S. source income with no associated deductions, which is general category income for purposes of the FTC limitation. CFC A: (a) earns $100 million earnings that is characterized as Subpart F Income and pays Country X $10 million in foreign income taxes on these earnings; (b) earns $500 million other foreign source income (FSI) and pays $50 million in FIT on these earnings (all of which is properly allocated to tested income used to determine GILTI); and (c) invests $50 million in U.S. Property with no associated foreign income taxes. In tax year 2 (TY2), CFC A earns $180 million in Subpart F Income after paying $20 million in foreign income

192. QBAI only includes the aggregate adjusted bases of tangible property used in a trade or business to produce tested income. I.R.C. § 951A(d). As a result, QBAI is zero when a CFC has a tested loss.

taxes to Country X.[193] In addition, CFC A makes a $500 million distribution to US Corp.

A. Corporate Income Tax and PTI Analysis for Tax Year 1.

1. US Corp's Corporate Income Tax for Tax Year 1.[194]

Gross income is broadly defined to include "all income from whatever source derived."[195] US Corp's gross income inclusion consists of $900 million U.S. source income, $90 million Subpart F Income, and $50 million U.S. Property (which is excluded from US Corp's gross income as PTI attributed to the current E&P from the $90 million Subpart F Income),[196] and $10 million § 78 gross-up, which is the deemed paid taxes associated with the Subpart F inclusion.[197] In addition, US Corp's GILTI inclusion is determined based on all of its CFCs' tested income and loss.

CFC A's tested income equals gross income ($500 million + $100 million) less the sum of ECI with a U.S. TorB ($0), gross income accounted for in Subpart F Income ($100 million), dividends from a related person ($0), foreign oil and gas extraction income ($0) and properly allocated deductions and taxes ($50 million), or $450 million.[198] Net CFC Tested Income is the aggregate pro rata share of tested income less the aggregate pro rata share of tested loss for each of US Corp's CFCs.[199] In this case, US Corp only owns stock in one CFC. So, US Corp's Net CFC TI equals 100% ($450 million) = $450 million. Net Deemed Tangible Income Return is 10% of US Corp's pro rata share of QBAI for each of its CFCs with tested income ($700 million) less interest expense included in Net CFC Tested Income when the associated interest income is not so included ($0), or 10% ($700 million) – $0 = $70 million.[200] GILTI is the Net CFC TI ($450 million) less NDTIR ($70 million) = $380 million.[201]

193. Foreign personal holding company income, and foreign base company sales and services income are reduced by "properly allocable" deductions before determining the USSH's pro rata share of Subpart F Income. I.R.C. § 954(b)(5).

194. For a more detailed description of the method used to calculate the corporation tax liability for a cross-border corporation, see Davis, *supra* note 4, at Parts II–III.

195. I.R.C. § 61(a) (2020).

196. *See supra* text accompanying notes 44–47. *See also infra* Part III.A.3.a.

197. I.R.C. §§ 78, 951(a), 956, 960(a) (2020).

198. I.R.C. § 951A(c)(2)(A).

199. I.R.C. § 951A(c)(1).

200. I.R.C. § 951A(b)(2).

201. I.R.C. § 951A(b)(1).

Finally, US Corp's gross income includes GILTI's § 78 inclusion for deemed paid taxes.[202] This inclusion is determined by formula. The § 78 gross-up is the inclusion percentage multiplied by the CFCs' aggregate foreign income taxes that are "properly attributable" to tested income included in GILTI (Aggregate Tested FIT).[203] In this case, the Aggregate Tested FIT are the FIT paid by CFC A on its tested income, which is $50 million. The inclusion percentage is GILTI ($380 million) divided by US Corp's aggregate pro rata share of tested income ($450 million), or 84.4%.[204] Therefore, the § 78 inclusion for GILTI = 84.4% ($50 million) = $42.2 million.

US Corp's total gross income includes $900 million U.S. source income, $90 million Subpart F Income and its $10 million § 78 gross-up, $50 million U.S. Property (but this is excluded as PTI), $380 million GILTI and its $42.2 million § 78 gross-up. Thus, US Corp's gross income = $900 million + $90 million + $10 million + $50 million (– $50 million PTI) + $380 million + $42.2 million = $1,422.2 million. Although the § 245A deduction potentially applies to investments in U.S. Property, in this case the § 245A deduction will not apply because the investment is exempt from taxation as PTI.[205] Thus, the only available deduction is the § 250 deduction, which is 50% of GILTI (including its § 78 gross-up) plus 37% foreign derived intangible income (FDII). Since US Corp does not have any foreign derived income except for that earned through a CFC, its FDII = $0.[206] Thus, the § 250 deduction is 50% ($380 million + $42.2 million) plus 37.5% ($0) or $211.1 million, and US Corp's taxable income (TI) is the gross income ($1,422.2 million) less deductions ($211.1 million), or $1,211.1 million.[207] U.S. corporate income tax is 21% of taxable income ($1,211.1 million), which equals $254.33 million.

2. US Corp's Foreign Tax Credit for Tax Year 1.

The FTC provides a credit for foreign income taxes paid or deemed paid by US Corp.[208] US Corp's only potentially creditable taxes are deemed paid taxes for Subpart F Income and GILTI. For Subpart F Income, the deemed paid taxes are the same as its § 78 inclusion ($10

202. I.R.C. § 78.

203. I.R.C. §§ 78, 960(d).

204. I.R.C. §§ 951A(c)(1)(A), 960(d)(2).

205. *See infra* text accompanying notes 302–09.

206. The calculation of FDII excludes a U.S. corporation's foreign derived income that is earned through CFCs and branches. I.R.C. § 250(b)(3)(A)(i)(IV), (VI).

207. I.R.C. § 63(a) (2020).

208. I.R.C. § 901(a), (b)(1).

million).[209] However, deemed paid taxes for GILTI are limited to 80% of its § 78 inclusion.[210] So GILTI's DPT = 80% ($42.2 million) = $33.8 million. Moreover, the FTC is limited to the amount of tax the United States would have imposed on the domestic corporation's foreign source taxable income.[211]

The FTC limit is determined separately for passive income, GILTI, income from a foreign branch, and all other income, which is referred to as general category income.[212] For each of these categories or "baskets" of income, the FTC is limited to the lesser of the actual foreign income taxes paid or deemed paid by US Corp, or the FTC limitation, where the FTC limit is the U.S. income tax on total taxable income multiplied by the ratio of foreign source taxable income to the total taxable income.[213]

In this case, US Corp has $900 million U.S. source income, while all Subpart F Income, U.S. Property, GILTI, and § 78 inclusions are foreign source income.[214] In addition, since § 250 is the only available deduction, US Corp's gross income is also its taxable income except for GILTI and its § 78 gross-up. So taxable income from GILTI equals GILTI ($380 million) less its § 250 deduction ($190 million) = $190 million, and its taxable § 78 gross-up equals the § 78 inclusion for GILTI ($42.2 million) less its associated § 250 deduction ($21.1 million) = $21.1 million.

After separating the U.S. and foreign source taxable income, these amounts must be further categorized into the four baskets of income. The facts assume that US Corp's U.S. source income is general category income. GILTI is a § 951A inclusion and therefore included in the GILTI basket.[215] Since US Corp does not operate as a branch, nothing is allocated to the branch basket.[216] Subpart F Income is only allocated to

209. I.R.C. §§ 78, 960(a).

210. I.R.C. §§ 78, 960(d).

211. I.R.C. § 904(a); BITTKER & LOKKEN, *supra* note 18, at ¶ 72.6.1.

212. I.R.C. § 904(d)(1), (2)(A)–(B), (J).

213. I.R.C. § 904(a).

214. I.R.C. §§ 78, 904(h)(1)–(2), (4)–(6), 951A(f)(1)(A). Subpart F Income, U.S. Property, and GILTI inclusions are only treated as U.S. source income to the extent revenue is attributable to the CFC's U.S. source income. I.R.C. §§ 904(h)(1)–(2), 951A(f)(1)(A). Since the CFC does not generate U.S. source income, all of these inclusions are categorized as foreign source income. In addition, the § 78 gross-up for GILTI is treated as a dividend. I.R.C. § 78. None of the dividends from a CFC to a U.S. Shareholder are treated as U.S. source income when less than 10% of the CFC's E&P are attributed to U.S. source income. I.R.C. §§ 78, 904(h)(1), (4)–(6). In this case, none of the CFCs generate U.S. source income, so dividends (including the § 78 inclusions) are foreign source.

215. I.R.C. § 904(d)(1)(A).

216. I.R.C. § 904(d)(1)(B), (2)(J).

the passive basket when attributable to the CFC's passive income.[217] In this case, CFC A does not have passive income, so none of the Subpart F Income is placed in the passive income basket. Since it is not allocated to any other basket, Subpart F Income is placed in the general income basket.[218] Furthermore, since Subpart F Income and its gross-up are allocated to the same basket, the $10 million § 78 inclusion is also categorized as general income.[219] For purposes of this hypothetical the § 78 gross-up for GILTI will be placed in the same basket as the GILTI inclusion, which is consistent with Treasury's proposed and final regulations.[220] U.S. Property Investments are treated like dividends for purposes of determining the FTC limitation.[221] Dividends are placed in the passive basket only to the extent attributable to the CFC's passive income.[222] Since the CFC does not generate passive income, the U.S. Property inclusion is categorized as general income.[223]

The source and category of US Corp's taxable income is summarized as follows:

217. I.R.C. § 904(d)(1)(C), (2)(A)(i), (B).

218. I.R.C. § 904(d)(1)(D), (2)(A)(ii), (3)(B).

219. I.R.C. § 904(d)(3)(G).

220. On November 28, 2018, the Treasury Department released proposed regulations that provide guidance related to the FTC and that place the § 78 gross-up for GILTI in the GILTI basket. 2018 Proposed FTC Regs, *supra* note 191, at 63,248, 63,252. Although proposed regulations are not entitled to deference, to simplify the calculations, this hypothetical will assume that the § 78 gross-up is placed in the GILTI basket for purposes of determining the FTC limitation. In addition, this provision was recently finalized as Treasury Regulation §1.904-4(o). Final FTC Regs, supra note 105, at 69090-91.

221. I.R.C. § 904(d)(3)(A), (D), (G).

222. I.R.C. § 904(d)(3)(A), (D).

223. I.R.C. § 904(d)(2)(A)(ii), (3)(A), (D).

Passive Income	GILTI	Foreign Branch	General Income
None	$190M	None	$900M (U.S. Source Income)
	$21.1M (§78 Gross-Up)		$90M (Subpart F Income)
			$10M (Subpart F Income §78 Gross-Up)
			~~$50M (U.S. Property inclusion)~~ U.S. Property is Exempt as PTI
Total (Passive) = $0	Total (GILTI) = $211.1M	Total (Branch) = $0	Total (General) = $1000M
FS Passive = $0	FS GILTI = $211.1M	FS Branch = $0	FS General = $100M
U.S. Passive = $0	U.S. GILTI = $0	U.S. Branch = $0	U.S. General = $900M

Thus, the FTC limit for the GILTI and General Baskets are:

$$FTC\ Limitation\ (GILTI)$$
$$= US\ Income\ Tax\ on\ Total\ TI * \frac{Foreign\ Source\ GILTI\ TI}{Total\ TI}$$
$$= \$254.33M * \frac{\$211.1M}{\$1211.1M} = \$44.3M$$

$$FTC\ Limitation\ (General)$$
$$= US\ Income\ Tax\ on\ Total\ TI * \frac{Foreign\ Source\ General\ TI}{Total\ TI}$$
$$= \$254.33M * \frac{\$100M}{\$1211.1M} = \$21M$$

The FTC is the lesser of the sum of taxes paid or deemed paid or the FTC limitation in each basket of income. In this case, the FTC for GILTI is the lesser of the DPT ($33.8 million) or the FTC limit for the GILTI basket ($44.3 million). So, the FTC for GILTI is $33.8 million, and all of the deemed paid taxes for GILTI are creditable. The unused FTC limitation for GILTI is $44.3 million – $33.8 million = $10.5 million.

The FTC for general category income is the lesser of the DPT for Subpart F Income ($10 million) or the general category FTC limitation ($21 million). So, the FTC for general category income is $10 million, and all of the deemed paid taxes are creditable. The unused general category FTC limitation = $21 million – $10 million = $11 million.

Assuming the base erosion anti-abuse tax (BEAT) does not apply, US Corp's U.S. tax payable is the U.S. corporate income tax ($254.33 million) less FTC ($33.8 million + $10 million), or $210.53 million.

3. Earnings and Profits, PTI and Excess Limitation Account for Tax Year 1.

a. E&P and PTI for Tax Year 1.

Untaxed E&P is designated as PTI when a USSH includes Subpart F Income or U.S. Property in its gross income.[224] In this case, US Corp receives Subpart F inclusions from CFC A in the amounts of $90 million for Subpart F Income and $50 million for investments in U.S. Property. Although both reassign Untaxed E&P as PTI, these inclusions have very different characteristics. Subpart F Income is a portion of the gross income earned by the CFC, and will increase the CFC's E&P. However, this portion of the CFC's gross income is also taxed as phantom income to the USSH and therefore Subpart F Income also reclassifies Untaxed E&P as PTI. On the other hand, U.S. Property is a portion of the CFC's existing E&P that is used to fund certain investments and will decrease the CFC's E&P. However, because this investment is also taxed as phantom income of the USSH, it also designates Untaxed E&P as PTI. So, both inclusions designate E&P as PTI but one does so by increasing the CFC's E&P, while the other does so by decreasing the CFC's E&P.

For purposes of performing the PTI analysis, the Subpart F Income must be recorded before the U.S. Property inclusion. There are two reasons for this requirement. First, because current E&P is allocated to distributions before accumulated E&P, items that reclassify Untaxed E&P as PTI must be recorded before items that utilize PTI. In this case, both Subpart F Income and U.S. Property reallocate Untaxed E&P to PTI, so they must be recorded before any distributions of current E&P can occur. Second, as described in the previous paragraph, U.S. Property both develops and utilizes PTI. As a result, the Subpart F Income must be accounted for before U.S. Property can be allocated to current PTI.

The hypothetical states that none of the entities have accumulated E&P or PTI at the beginning of TY1, so CFC A's current and accumulated E&P is zero at the start of the hypothetical. CFC A's E&P increases when it receives the E&P characterized as Subpart F Income ($100 million) and FSI ($500 million) and decreases when it invests in U.S. Property ($50 million) and pays foreign income taxes on the Subpart F earnings ($10 million) and the FSI ($50 million). Thus,

224. *See* I.R.C. § 959(a).

CFC A's E&P = \$100 million + \$500 million – \$50 million – \$10 million – \$50 million = \$490 million at the end of TY1.

Since no actual distribution of earnings occurs when US Corp receives the Subpart F Income or U.S. Property, neither US Corp's nor CFC A's E&P will change as a result of these inclusions. However, when the Subpart F Income is included in US Corp's gross income, which occurs on the last day of the CFC's tax year, CFC A's Untaxed E&P will be decreased by the amount of this distribution (\$90 million), and its Subpart F PTI will increase by the same amount. Then \$50 million of this current year Subpart F PTI will be allocated to US Corp's U.S. Property inclusion, and this \$50 million will be excluded from US Corp's gross income as PTI.

After enactment of the TCJA, GILTI inclusions also convert Untaxed E&P to PTI. Section 951A states "any global intangible low-taxed income *included in gross income . . . shall be treated in the same manner as* an amount included under section 951(a)(1)(A) [Subpart F Income] for purposes of applying sections . . . 959, [and] 961."[225] Thus, the GILTI inclusion, which is the amount of GILTI included in gross income, is treated as if it were Subpart F Income. To do so, GILTI must be allocated to each of USSH's CFC utilizing the following formula:

$$GILTI\ from\ CFC\ A = US\ SH's\ GILTI * \frac{US\ SH's\ PRS\ of\ CFC\ A's\ Tested\ Income}{US\ SH's\ Aggregate\ PRS\ of\ All\ CFCs'\ Tested\ Income}$$

except that the GILTI allocation is zero when a CFC has no tested income.[226] In this case, US Corp owns 100% of a single CFC, so all of the GILTI (\$380 million) is allocated to CFC A. This amount must be "treated in the same manner as" Subpart F Income.[227] Thus, CFC A's Untaxed E&P accounts are reduced by \$380 million, and its Subpart F PTI account is increased by the same amount.

In summary, during TY1 CFC A's untaxed E&P account is increased by the corporation's \$600 million in foreign source income, and is decreased by (a) \$50 million when CFC A purchases U.S. Property; (b) \$10 million and \$50 million when CFC A pays foreign income taxes; and (c) \$90 million and \$380 million when Subpart F Income and GILTI are included in USSH's gross income. In addition, the Subpart F PTI account is increased by \$90 million and \$380 million for USSH's Subpart F Income and GILTI inclusions, and decreased by the \$50

225. I.R.C. § 951A(f)(1)(A) (emphasis added).

226. I.R.C. § 959(f)(2).

227. I.R.C. § 951A(f)(1)(A).

million for USSH's U.S. Property Investment. Finally, CFC A's U.S. Property PTI account is increased by $50 million for USSH's U.S. Property inclusion. Thus, at the end of TY1, CFC A has $490 million total E&P of which $50 million is U.S. Property PTI, $420 million is Subpart F PTI (with $40 million attributed to Subpart F Income and $380 million attributed to GILTI), and $20 million is Untaxed E&P.

Since its only earnings were the U.S. source income, US Corp's E&P is stable at $900 million during TY1. Because phantom income inclusions cannot be distributed to shareholders, Subpart F Income, U.S. Property Investments, GILTI, and the § 78 gross-ups do not increase US Corp's E&P. US Corp's and CFC A's E&P and PTI accounts for TY1 are summarized in the table set forth in Attachment A.

b. Adjusted Basis of CFC A Stock During Tax Year 1.

Furthermore, to prevent gain recognition on PTI before it is recovered by an actual distribution, § 961 requires that a USSH's basis in CFC stock is increased by the amount of any Subpart F inclusions actually included in gross income, and then decreased by any amount received that was excluded from gross income by PTI.[228] During TY1, US Corp recognized gross income inclusions in the amounts of $90 million for Subpart F Income and $380 million for GILTI. As a result, US Corp's adjusted basis in CFC A stock must be increased by $380 million plus $90 million, or $470 million. In addition, since the $50 million U.S. Property Investment creates a Subpart F inclusion and a Subpart F PTI distribution in the same year, the US Corp's basis in CFC A's stock must be increased and decreased by the $50 million. Thus, US Corp's basis in CFC A's stock is increased by the amount of the Subpart F Income ($90 million), GILTI ($380 million), and U.S. Property Investment ($50 million) and decreased by the PTI distribution ($50 million) used to reallocate Subpart F PTI to U.S. Property PTI since this amount is excluded from US Corp's gross income by PTI. Thus, US Corp's adjusted basis in CFC A is $1500 million + $90 million + $380 million + $50 million – $50 million = $1970 million. US Corp's adjusted basis account for TY1 is summarized in the table set forth in Attachment A.

c. Excess Limitation Account for Tax Year 1.

In this case, both the GILTI and general category income have unused FTC limits in the amounts of $10.5 million and $11 million respectively. Unless Treasury finalizes its proposed regulations to apply Section 960(c) and the excess limitation accounts to GILTI inclusions,

228. I.R.C. § 961(a)–(b).

the unused FTC limitation for GILTI will be lost.[229] On the other hand, the unused general category FTC limitation may be carried forward for use in a future tax year.

The ELA tracks the unused FTC limitation attributed to Subpart F Income or U.S. Property. The general category ELA will be increased by the portion of the unused general category FTC limitation that is attributable to Subpart F Income or U.S. Property. The opening balance of the ELA for each basket of income is zero.[230] The account for the general basket is increased by the excess of the increase in FTC limit from the Subpart F Income and U.S. Property investment *less* previously credited FIT or DPT from these inclusions.[231] In this case, the only foreign source income in the general category basket is Subpart F Income so 100% of the FTC limitation ($21 million) and 100% of the FTC ($10 million) is from Subpart F Income and U.S. Property Investments. Therefore, the ELA equals the starting balance ($0) plus FTC limit from Subpart F Income ($21 million) less the FTC used by Subpart F Income ($10 million), or $11 million. Thus, US Corp's General Basket ELA at the end of TY1 is $11 million. US Corp's E&P, income, adjusted basis and ELA accounts, as well as CFC A's E&P and PTI accounts for TY1 are summarized in the table set forth in Attachment A.

B. Corporate Income Tax and PTI Analysis for Tax Year 2.

1. Corporate Income Tax, FTC and Excess Limitation Account for Tax Year 2.

In tax year 2 (TY2), CFC A earns $200 million foreign source income, which is characterized as Subpart F Income, and pays $20 million foreign income taxes to Country X on this income. In addition, CFC A makes a $500 million distribution to US Corp. In this case, no GILTI inclusion exists since the only income earned by a CFC is Subpart F Income, which is excluded from tested income. The Subpart F Income from CFC A is included in US Corp's gross income and will reclassify Untaxed E&P to PTI. However, the $500 million distributions will only be included in US Corp's gross income to the extent that it is not a distribution of PTI.[232]

For purposes of determining the order of PTI utilized, distributions are attributed to PTI using the Last In, First Out Approach. Using this

229. *See supra* text accompanying note 191.
230. I.R.C. § 960(c)(2)(A).
231. I.R.C. § 960(c)(2)(B).
232. I.R.C. § 959(a).

method, distributions are attributed first to U.S. Property PTI, second to Subpart F PTI, and third to Untaxed E&P, using current E&P before accumulated E&P in each category and using the "most recently accumulated" E&P first.[233] Accordingly, the first $230 million of the $500 million distribution from CFC A utilizes PTI in the following order: (1) $50 million U.S. Property PTI from TY1, and (2) $180 million Subpart F PTI from TY2 (current E&P). This utilizes all US Property PTI, which was accumulated in TY1, and all current year Subpart F PTI.

At this point, CFC has $440 million E&P remaining, of which $420 million is Subpart F PTI ($40 million is attributed to Subpart F Income and $380 million is attributed to GILTI) and $20 million is Untaxed E&P from TY1. Since Subpart F PTI is distributed preferentially over Untaxed E&P, the remaining $270 million in distributions will be attributed to Subpart F PTI. Since GILTI and Subpart F Income are both included in US Corp's gross income on the last day of the same tax year, the PTEP are accumulated at the same time. Thus, the distributions are allocated to the Subpart F Income PTI and GILTI PTI on a pro rata basis.[234] Of the $270 million distribution, the amount allocated to GILTI PTI = $270 million ($380 million/$420 million) = $244.3 million, and the amount allocated to Subpart F Income PTI = $270 million ($40 million/$420 million) = $25.7 million. Thus, of the remaining $270 million of the $500 million distribution from CFC A, $25.7 million will be attributed to Subpart F Income PTI and $244.3 million will be attributed to GILTI PTI.

Since all of the $500 million from CFC A is allocated to PTI, none of these distributions are included in US Corp's gross income. Therefore, US Corp's gross income is the aggregate of Subpart F Income ($180 million) and its § 78 gross-up ($20 million), which totals $200 million. Since there are no deductions, US Corp's taxable income is gross income ($200 million) less deductions ($0), or $200 million. US Corp's domestic tax is 21% of $200 million = $42 million.

For the same reasons discussed above, the $180 million Subpart F Income and its $20 million § 78 gross-up are foreign source taxable income allocated to the general basket.[235] The source and category of US Corp's taxable income for TY2 are summarized as follows:

233. *See supra* text accompanying notes 44–47. I.R.C. §§ 959(c), 316(a). I.R.S. PTI Notice, *supra* note 45, at 278.

234. IRS PTI Notice, *supra* note 45, at 278, 279–80; *NYSBA PTI Report*, *supra* note 44, at 58.

235. *See supra* text accompanying notes 214, 218–19. I.R.C. §§ 78, 904(d)(1), (2)(A)(ii), (d)(3)(A)–(B), (D), (G), (h)(1), (2), (4)–(6).

Passive Income	GILTI	Foreign Branch	General Income
None	None	None	\$180M (Subpart F Income)
			\$20M (Subpart F Income §78 Gross-Up)
Total (Passive) = \$0	Total (GILTI) = \$0	Total (Branch) = \$0	Total (General) = \$200M
FS Passive = \$0	FS GILTI = \$0	FS Branch = \$0	FS General = \$200M
U.S. Passive = \$0	U.S. GILTI = \$0	U.S. Branch = \$0	U.S. General = \$0M

The FTC limit for the General Basket is:

$$FTC\ Limitation\ (General) = US\ Income\ Tax\ on\ Total\ TI * \frac{Foreign\ Source\ General\ TI}{Total\ TI} = \$42M * \frac{\$200M}{\$200M} = \$42M$$

The FTC for general category income is the lesser of the DPT for Subpart F Income (\$20 million) or the general category FTC limitation (\$42 million). So, the FTC = \$20 million, and all of the deemed paid taxes are creditable. The unused FTC limitation = \$42 million – \$20 million = \$22 million. Since this excess limitation is solely attributable to Subpart F Income, which is general category income, the General Category ELA is increased by the amount of the unused FTC limit. Thus, the General Category ELA = Existing ELA Amount (\$11 million) + Unused FTC Limit (\$22 million) = \$33 million. Again, assuming BEAT does not apply, US Corp's U.S. tax payable is \$42 million – \$20 million = \$22 million.

2. Earnings and Profits and PTI for Tax Year 2.

Again, the inclusions and distributions must be accounted for in US Corp and CFC A's E&P and PTI accounts. At the start of TY2, CFC A's Total E&P is \$490 million, which is categorized as \$50 million of US Property PTI, \$420 million Subpart F PTI (\$40 million is attributed to PTI from Subpart F Income and \$380 million is attributed to GILTI PTI) and \$20 million Untaxed E&P. When CFC A receives

$200 million in FSI characterized as Subpart F Income, CFC A's Total E&P and Untaxed E&P each increase by $200 million, to $690 million and $220 million respectively. Then the $20 million FIT paid to Country X decreases the Total E&P to $670 million and the Untaxed E&P to $200 million. However, US Corp's Subpart F inclusion would then shift $180 million from the Untaxed E&P to the Subpart F PTI, after which the Untaxed E&P = $200 million – $180 million = $20 million and the Subpart F PTI = $420 million + $180 million = $600 million.

When it distributes $500 million in earnings insulated from tax by PTI to US Corp, which is an actual distribution of earnings, CFC A's PTI and E&P accounts will decrease by $500 million and US Corp's E&P will increase by the same amount. The $500 million PTI distributions will reduce CFC A's PTI and E&P accounts as described above in the previous section, leaving (a) no U.S. Property PTI; (b) $150 million Subpart F PTI, of which $14.3 million is attributed to Subpart F Income PTI and $135.7 million is attributed to GILTI PTI from TY1; and (c) $20 million Untaxed E&P.[236] After these distributions, CFC A's Total E&P = $670 million – $500 million = $170 million.

US Corp's E&P is $900 million at the start of TY2. US Corp includes the $180 million Subpart F Income and $20 million § 78 gross-up from CFC A in its gross income. However, these inclusions are phantom income, which are not actual distributions of earnings, so US Corp's and CFC A's E&P will not change. In contrast, although the PTI distributions are excluded from gross income, the full amount is available to be distributed to shareholders as dividends and thus are included in US Corp's E&P. Accordingly, the $500 million distribution from CFC A will increase US Corp's E&P from $900 million to $1400 million.

In addition, US Corp's basis in CFC A's stock must be adjusted for Subpart F inclusions and subsequent distributions of PTI. To prevent gain recognition before PTI is recovered by an actual distribution, US Corp's basis in CFC A's stock is increased by the amount of the Subpart F inclusion ($180 million).[237] Therefore, US Corp's basis in CFC A's stock is $1970 million + $180 million = $2150 million. However, because US Corp recovered the PTI by an actual distribution, US Corp's adjusted basis in CFC A stock is reduced by the amount of distributions excluded from gross income by PTI.[238] Thus, US Corp's adjusted basis in CFC A's stock is the old basis ($2150 million) less PTI

236. *See supra* text accompanying Part III.B.1.
237. I.R.C. § 961(a).
238. I.R.C. § 961(b)(1).

used to exclude distributions from US Corp's gross income ($500 million), or $1650 million. In summary, US Corp's basis in CFC A's stock from the TY2 transactions is $1970 million + $180 million – $500 million = $1650 million.

Thus, at the end of TY2, CFC A's total E&P is $170 million, which is categorized as $150 million Subpart F PTI (of which $14.3 million is attributed to PTI from Subpart F Income and $135.7 million is attributed to GILTI PTI) and $20 million Untaxed E&P. In addition, US Corp's Total E&P is $1400 million and its adjusted basis in CFC A's stock is $1650 million. The E&P, PTI, and adjusted basis accounts for TY2 are summarized in the tables set forth in Attachment A.

C. Hypothetical MNE Demonstrates that the Operation of the PTI System is Generally Unchanged By the TCJA.

The TCJA made significant changes to the U.S. international tax law. However, the operation of the PTI System is relatively unchanged. Yet it is the continuation of the preexisting policy in conjunction with significantly more PTI created by the TCJA that has the power to overturn the U.S. exemption tax system. Since the 245A DRD can only be utilized with distributions of Untaxed E&P, the deduction was not available for distributions of previously taxed E&P. Thus, after the TCJA, the PTI System has the potential to preempt the § 245A deduction. This effect and the policy behind the PTI System will be examined in further detail in the following section, including the current existence of two mechanisms, PTI and the 245A DRD, to protect earnings from repeat taxation by the United States.

IV. TAX POLICY SUPPORTING PTI REMAINS VALID, BUT TWO MECHANISMS POTENTIALLY PREVENT DOUBLE TAXATION OF EARNINGS.

Although both potentially protect a CFC's earnings from double taxation, the § 245A deduction and the PTI System have very different mechanisms of action. As a result, the advantages and disadvantages of these provisions differ. This part will demonstrate the ongoing relevance of the tax policy supporting, as well as the continued need for, the PTI System. Although more complex than exempting dividends from tax, the PTI System singlehandedly prevents a second tax on previously taxed earnings and, in fact, operates to substantially limit the § 245A deduction and the exemption system.

A. Tax Policy Supporting the PTI System Remains Relevant and Justifies Its Continued Use.

The PTI regime is fundamental to Subpart F. Subpart F and the PTI System were enacted during a time when MNEs could avoid paying U.S. income tax by holding profits at the level of the CFC in lieu of paying dividends to the USSH. Subpart F requires that USSHs pay taxes currently on their CFCs' earnings without receiving an actual distribution from these subsidiaries.[239] The PTI regime ensures that the USSH is not taxed a second time when these previously taxed earnings are actually distributed.[240]

As a matter of tax policy, the United States designed the PTI System to recover the PTI by excluding actual distributions from the USSH's gross income at the "earliest possible point."[241] Treasury expressed the policy rationale for PTI as follows:

> Section 959 was enacted so that PTI is excluded from gross income and, thus, not taxed again when distributed by the foreign corporation. Moreover, section 959 effects the relevant gross income exclusion at the earliest possible point. Thus, the "allocation of distribution" rules of section 959(c) ensure that distributions from the foreign corporation are to be paid first out of earnings and profits attributable to amounts that have been previously included in income by the United States shareholders. Accordingly, as a result of its section 951(a)(1) inclusion, a United States shareholder is made whole by receiving, without further U.S. tax, PTI attributable to its stock in a foreign corporation before it receives any taxable distributions from the foreign corporation. Section 961, which adjusts basis in the stock in a foreign corporation for PTI attributable to such stock, also ensures that PTI is not taxed twice if the stock in the foreign corporation is sold before the PTI is distributed.[242]

Thus, PTI served two policy goals prior to the enactment of the TCJA. First, PTI prevented double taxation of a CFC's earnings when the USSH actually received a distribution of the CFC's earnings. Second, the allocation of distribution requirements ensured that the USSH was "made whole" at the earliest possible moment by classifying earnings transferred from a CFC to its USSH first as tax exempt distributions of

239. I.R.C. §§ 951(a), 951A.
240. I.R.C. § 959(a).
241. 2006 Proposed PTI Regs, *supra* note 8, at 51,155.
242. *Id.*

PTI and then as taxable distributions of E&P.[243] These policy rationales for PTI are challenged by the enactment of § 245A.

The TCJA fundamentally changed the U.S. system of international taxation. The TCJA added the 245A DRD, which exempts from taxation the foreign source portion of a dividend from a CFC to its USSH.[244] In addition, the TCJA added the GILTI regime, which currently taxes, at a preferential rate, all of the CFC's income except for that already taxed by or exempt from tax by the U.S. and an estimate of the return on tangible assets.[245] Together the GILTI regime and § 245A deduction potentially argue against the need for PTI.

GILTI broadens the types of CFC income subject to current taxation and eliminates the benefit of deferral for these earnings. When these earnings are actually distributed to the USSH, § 245A potentially exempts the distribution from taxation without the use of the PTI System. As a result, the PTI System appears unnecessary. Without the PTI system in place, none of the dividends from a CFC to its USSH would be taxable so long as the dividend qualified for the § 245A deduction. In addition, arguably the ordering rules are not needed to recover PTI at the earliest possible time. Even without the PTI system, distributions that qualify for the § 245A deduction would not be taxed regardless of the order of the distribution. Thus, § 245A appears to eliminate the policy rationale for the PTI regime.

However, the tax policy for PTI remains necessary after the TCJA and may be even more critical than before. As stated above, the TCJA implements a number of other provisions that categorize E&P as Subpart F PTI, including GILTI, Transition Tax Income, and Hybrid Dividends paid to a lower tier CFC.[246] For each of these items, the USSH pays tax on a CFC's earnings without receiving an actual distribution. As a result, these earnings are potentially taxed again when distributed to the USSH unless a mechanism, such as PTI, is used to track the items and ensure that they are not taxed a second time.

As a consequence, the tax policy supporting PTI remains valid after the TCJA. Because Subpart F still requires that USSHs pay tax on their CFC's income without a distribution, a mechanism must exist to prevent a second tax when these earnings are actually distributed. But since enactment of the TCJA, two potential mechanisms—PTI and

243. *Id.*

244. I.R.C. § 245A(a)–(c).

245. I.R.C. § 951A.

246. I.R.C. §§ 245(e)(2), 951A(f)(1)(A), 959(a), (c), (e), 964(e), 965(a), (b)(4)(A), 1248(a), (d)(1); *NYSBA PTI Report*, *supra* note 44, at 5–6.

§ 245A—prevent this double taxation, and both mechanisms coexist and potentially apply simultaneously.

B. Both the § 245A Deduction and the PTI System Prevent a Second Taxation of Earnings Upon Repatriation.

The § 245A deduction and § 959 PTI each prevent repeat taxation of a CFC's earnings. But since enactment of the TCJA, both mechanisms coexist to potentially prevent this double taxation. However, the mechanism used by each to obtain the exemption differs. The following sections will compare the exemptions provided by §§ 245A and 959 and consider whether either provision could be used alone to prevent double taxation.

1. Advantages and Disadvantages of the § 245A Deduction.

Dividends are included in gross income.[247] However, when a dividend satisfies the requirements of § 245A, the foreign source portion is excluded from taxable income by a 100% deduction.[248] In general, a distribution must satisfy certain requirements to receive the benefit of the § 245A deduction, and this can be challenging. However, when the conditions for the deduction are satisfied, the exemption is complete and § 245A makes a final determination regarding the taxation of the applicable earnings.

The 245A DRD fully exempts the foreign source portion of dividends from taxation.[249] As a result, foreign taxes paid on distributions are ignored and, normally, no additional issues must be resolved after the exemption occurs.[250] When the § 245A deduction applies, the application is straightforward and the exemption is complete. However, not all distributions from a CFC to its USSH will receive the benefit of this deduction.

Although the TCJA was publicized as the United States' move to a territorial tax system, the dividend exemption is severely limited. The § 245A deduction only applies to the foreign source portion of dividends distributed to a corporate USSH from its STFC (which includes CFCs) when the USSH owned the CFC's stock for at least 365 days of the 731-

247. I.R.C. § 61(a)(7).

248. I.R.C. § 245A(a).

249. *Id.*

250. *Id.* Neither the FTC nor a deduction for foreign income taxes are available for dividends that receive the benefit of the § 245A deduction. I.R.C. § 245A(d). In addition, all deductions, including taxes, allocated to the exempt dividend or the stock producing the dividend, are excluded for purposes of determining the available FTC limitation. I.R.C. § 904(b)(4).

day period starting on the day that is 365 days prior to the ex-dividend date.[251] In addition, this deduction does not apply to individuals or non-corporate USSHs, Hybrid Dividends, or PTI distributions.[252] When distributions do not satisfy the conditions for the § 245A deduction, another method of relieving double taxation would be required.[253]

2. Advantages and Disadvantages of the PTI System.

In contrast with the § 245A deduction, PTI distributions are relatively easy to exempt from gross income. However, addressing tax issues during the Interim Period is complex. Furthermore, GILTI may be difficult to integrate with PTI because GILTI is determined based on Tested Income, which is not comparable to the concept of E&P that determines PTI.

a. The Amount of PTI is Relatively Easy to Calculate, But Determining the Order of Distributions and Resolving Tax Issues During the Interim Period Complicates the PTI System.

The amount of PTI created is relatively easy to establish because the exclusion is based solely on gross income. PTI is calculated at the CFC level based on the amount included in the USSH's gross income.[254] The CFC's deductions are considered when determining the Subpart F or GILTI inclusion, and the USSH's deductions are irrelevant.[255] Accordingly, PTI distributions are completely excluded from gross income without additional conditions.[256]

Since § 951A(f)(1)(A) requires GILTI to be treated like Subpart F Income for purposes of applying § 959, GILTI PTI should be the E&P included in gross income by § 951A. The fact that GILTI receives 50% deduction from § 250, which exempts 50% of GILTI's gross income from tax, does not affect the amount of PTI from GILTI. All of GILTI (even the exempt part) is PTI.

Calculating the amount of PTI is moderately straightforward since it is based solely on amounts included in gross income. Nevertheless, the PTI System is far from simple. As extensively discussed above, determining the order of PTI utilized and accounting for events that occur during the Interim Period that affect the USSH's tax liability

251. I.R.C. §§ 245(a); 246(c)(1), (5) (2020).

252. I.R.C. §§ 245A(a), (e), 959(d); *NYSBA PTI Report*, *supra* note 44, at 10 n.25, 17–18.

253. *NYSBA PTI Report*, *supra* note 44, at 16–18.

254. I.R.C. § 959(a).

255. I.R.C. §§ 951A(c)(2)(A)(ii), 954(b)(5).

256. I.R.C. § 959(a).

(basis adjustments, foreign currency gains, and FTC for foreign taxes paid on PTI) significantly complicates the PTI System.[257] In addition, integrating GILTI with the PTI System may be challenging since GILTI is calculated based on tested income and PTI is determined based on E&P.

b. GILTI is Determined by Tested Income, which is Not Comparable to the E&P-Based PTI.

Historically PTI protected the earnings and profits attributed to Subpart F Income from repeat taxation when distributed to the USSH.[258] The Subpart F inclusion follows the design of a deemed dividend[259] and therefore inclusions of Subpart F Income are limited to the CFC's current E&P and will not reduce a CFC's earnings below zero.[260] In contrast, GILTI has been characterized as a minimum tax on a CFC's earnings.[261]

GILTI is a new concept that was introduced by the 2017 tax reform. With the exception of an estimate for the return on tangible assets, the GILTI regime currently taxes, at a preferential rate, all of the CFC's income except for certain income that is already taxed by or exempt from tax by the U.S. corporate income tax system.[262] Because GILTI is modeled as a minimum tax, as opposed to a deemed dividend, GILTI creates new concepts that were not previously part of and are not necessarily consistent with Subpart F and the PTI System. Specifically, GILTI is determined based on tested income rather than E&P and is not restricted by the CFC's E&P.[263]

Despite these differences, the TCJA requires that GILTI is treated "in the same manner as" Subpart F Income for purposes of determining PTI and the § 961 basis adjustments.[264] This raises the issue of whether

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257. *See supra* Parts II.B.2 (discussing the order of E&P allocated among the various categories of PTI) and II.B.3 (discussing the tax issues that occur during the Interim Period).

258. I.R.C. § 959(a).

259. BITTKER & LOKKEN, *supra* note 18, at ¶ 69.10.

260. IRS PTI Notice, *supra* note 45, at 278; BITTKER & LOKKEN, *supra* note 18, at ¶ 69.10.

261. Lee A. Sheppard, *Learning to Love GILTI*, 162 TAX NOTES 259 (Jan. 21, 2019), [hereinafter *Learning to Love GILTI*].

262. I.R.C. § 951A(a)–(d).

263. I.R.C. §§ 951A(b)–(c), 959(a); IRS PTI Notice, *supra* note 45, at 278; *Learning to Love GILTI*, *supra* note 261, at 259–60; Marie Sapirie, *When Worlds Collide: GILTI and Subpart F*, 162 TAX NOTES 264 (Jan. 21, 2019). Similarly, the § 965 inclusions are not limited to a CFC's E&P. However, the effects of § 965 are beyond the scope of this article. IRS PTI Notice, *supra* note 45, at 278.

264. I.R.C. § 951A(f)(1)(A).

E&P and tested income are comparable terms that can be integrated when determining PTI. For the reasons described below, Tested Income is likely not comparable to E&P, but E&P may no longer be a critical limitation.

Earnings and profits "represents the economic earnings and losses of a corporation that may be distributed to shareholders in the form of a dividend."[265] E&P is an accounting concept and is not synonymous with taxable income.[266] Generally, E&P is broader than taxable income and is calculated by making adjustments to taxable income.[267] Ordinarily, there are four categories of adjustments that must be made to taxable income when calculating E&P (collectively the "Adjustments to Determine E&P").

First, nondeductible expenses or losses are deducted from taxable income when determining E&P.[268] Nondeductible expenses, such as dividends to shareholders, nondeductible taxes, and charitable contributions in excess of the annual limits, are not accounted for when determining taxable income but do reduce the corporation's reserves and ability to pay dividends to shareholders.[269] Therefore, nondeductible expenses reduce E&P.[270]

Second, deductions that reduce taxable income but do not affect the corporation's ability to pay dividends are added to taxable income when determining E&P.[271] For example, the § 245A dividend received deduction removes the foreign source portion of a dividend payment from the shareholder's taxable income to prevent double taxation but does not affect the shareholder's earnings. Because the deduction does not affect the ability to pay dividends, it must be added back to E&P.[272] Therefore, deductions that do not affect the corporation's ability to pay dividends must increase E&P.[273]

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265. Cory Perry and David Weiner, *Foreign Corporation Earnings and Profit: Common Misconceptions and Pitfalls*, 47(2) TAX ADVISOR 95 (February 2016), *available at* https://www.thetaxadviser.com/issues/2016/feb/foreign-corporation-earnings-and-profits.html.

266. MERTENS LAW OF FED. INCOME TAX'N, § 38C:1 (Thomson Reuters Tax & Accounting, April 2019).

267. MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:1.

268. *Id.*

269. MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:13, 24–26, 32.

270. *Id.*

271. MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:1, 38.

272. MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:39.

273. MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:1, 38.

Third, income excluded from gross income is added to E&P.[274] For example, tax exempt interest is not included in gross income. However, since the income is available to be distributed to shareholders, tax exempt interest is added to E&P.[275] Therefore, earnings excluded from gross income must increase E&P.[276]

Fourth, timing adjustments must be made to accurately demonstrate the corporation's ability to pay dividends when provisions allow artificial deferral of income or acceleration of expenses.[277] For example, corporations can calculate taxable income using the installment sales method. However, E&P must be calculated as if all principal payments were received in the year of the sale.[278] Therefore, E&P must be adjusted for provisions that modify the timing of income and expenses.[279]

For purposes of Subpart F, a foreign corporation's E&P is "determined according to rules substantially similar to those applicable to domestic corporations."[280] Accordingly, when Subpart F income or GILTI is distributed, no reduction in the CFC's E&P would occur since there is no actual distribution and the earnings remain in the CFC's accounts. However, when PTI is utilized by an actual distribution of income, the CFC's E&P would be reduced by the amount of the distribution since earnings are transferred to the USSH.[281] On the other hand, the USSH's E&P would be increased by amounts received from a CFC even when the earnings are excluded from gross income as PTI, while no adjustments would be made for Subpart F or GILTI inclusions because no actual transfer of income occurs.

In summary, E&P is an accounting concept that is determined by making adjustments to taxable income to reflect the earnings actually available for shareholder distributions. PTI is the portion of the E&P that has already been taxed as a Subpart F or GILTI inclusion, and is determined by the amount of the USSH's gross income inclusion attributed to Subpart F Income and GILTI respectively.[282] Because it is

274. MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:1, 41.

275. MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:42.

276. MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:1, 41–42.

277. MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:1, 45.

278. I.R.C. § 312(n)(5) (2020); MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:54.

279. MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:1, 45.

280. I.R.C. § 964(a); MERTENS LAW OF FED. INCOME TAX'N, *supra* note 266, at § 38C:61–62.

281. I.R.C. § 959(d).

282. I.R.C. § 959(a).

calculated based on tested income, GILTI may not be comparable with the E&P-based PTI.

As demonstrated above, tested income is a defined term that serves as a starting point for determining GILTI.[283] Tested income is the CFC's gross income less "properly allocated" deductions (including taxes), excluding ECI with a USTB; Subpart F inclusions (after adding back income excluded by the § 954(b)(4) high-tax exception); dividends from related persons; and foreign oil and gas extraction income (FOGEI).[284] Since taxable income equals gross income less deductions,[285] the gross income less properly allocable deductions and taxes portion of the GILTI formula represents the CFC's taxable income. The exclusions used to calculate tested income further remove the result from the CFC's E&P, since ECI, Subpart F inclusions, dividends from a related party and FOGEI are all potentially available for distribution to shareholders and therefore should be added to E&P. However, these items are, by definition, not included in GILTI and therefore should not be included in the E&P attributed to GILTI. Thus, Tested Income represents the CFC's taxable income that contributes to GILTI.

E&P is determined by making the Adjustments to Determine E&P to the CFC's taxable income. However, in the formula for tested income, none of the Adjustments to Determine E&P are made to the CFC's taxable income. As a result, Tested Income reflects the tax concept of "taxable income" and not the accounting concept of "earnings and profits." Furthermore, the GILTI calculation excludes NDTIR from the Tested Income, which is an estimate of the return on tangible assets. NDTIR is a non-economic deduction that does not affect the CFC's ability to pay dividends, and therefore should be added back when determining E&P.

Since Tested Income does not allow for the Adjustments to Determine E&P, Tested Income and E&P are not comparable terms. In addition, since GILTI is calculated by removing NDTIR from Tested Income, the GILTI inclusion is not a good estimate of the E&P attributed to GILTI. Although Tested Income and GILTI are likely not comparable to E&P, it is not clear that E&P is a critical factor in determining PTI after the TCJA.

As stated above, historically PTI protected E&P attributed to Subpart F Income from double taxation when earnings were distributed

283. *See supra* Part II.B.2.

284. I.R.C. § 951A(c)(2)(A). Properly allocable deductions are determined using "rules similar to the rules of section 954(b)(5)." I.R.C. § 951A(c)(2)(A)(ii).

285. I.R.C. § 63(a).

to the USSH.[286] Subpart F Income was characterized as a deemed dividend and therefore was limited to the CFC's current E&P.[287] Because of this limitation, Subpart F Income could not reduce a CFC's earnings below zero. The rationale for limiting Subpart F inclusions may be stated as follows:

> Subpart F income may not exceed the CFC's earnings and profits for the taxable year. The purpose of subpart F to deny deferral of U.S. taxation never requires that U.S. shareholders of a CFC be taxed on amounts exceeding the dividends they would have received if all income had been distributed currently, and earnings and profits are the measure of dividend income.[288]

Thus, prior to the enactment of the TCJA, E&P was critical because it defined income that was distributable to taxpayers as a taxable dividend.

After the TCJA, however, income is taxable as GILTI as a minimum tax on income, regardless of whether the income could be distributed as a dividend. Thus, GILTI is determined based on tested income and is not restricted to the CFC's E&P.[289] As a result, a GILTI inclusion is taxable even when it exceeds the CFC's current and accumulated E&P for a tax year and creates an E&P deficit.[290] This suggests that the United States is no longer taxing Subpart F inclusions based on a deemed dividend model, or, at least, is not taxing GILTI based on a deemed dividend model. If so, the dissimilar nature of E&P and tested income is no longer a critical factor in determining the gross income inclusion and therefore no longer a critical factor in determining the amount of PTI.

3. Although the 245A DRD is More Simple to Administer, the PTI System Could be Used as the Lone Mechanism to Prevent Double Taxation.

As described above, the § 245A deduction is a simpler method of preventing multiple taxation of a Subpart F Income and GILTI inclusions, but it does not apply in all cases. When the 245A DRD is not applicable, such as in the case of Hybrid Dividends, PTI distributions, non-corporate USSHs and shareholders that do not satisfy the requisite

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286. I.R.C. § 959(a).

287. IRS PTI Notice, *supra* note 45, at 278.

288. BITTKER & LOKKEN, *supra* note 22, at ¶ 69.10 (footnote omitted).

289. I.R.C. § 951A(b)–(c); IRS PTI Notice, *supra* note 45, at 278; *Learning to Love GILTI*, *supra* note 261, at 259–60; Sapirie, *supra* note 263, at 264.

290. IRS PTI Notice, *supra* note 45, at 278–79, 281.

holding period, a second mechanism of preventing double taxation would need to be utilized. The required use of two systems to prevent taxation on PTEP would counteract the simplicity of the 245A DRD.

The PTI System, on the other hand, is far more complicated. But this mechanism is well established and has been in place since the implementation of Subpart F in 1962. In addition, the PTI System is already integrated with the 245A DRD and would require no further modification to satisfy the policy goals of preventing multiple taxation of Subpart F and GILTI. Furthermore, the PTI System substantially limits, and receives priority over, the § 245A deduction. For corporations with a substantial amount of PTEP, the PTI System may singlehandedly prevent a second tax on previously tax earnings. In these situations, the tax consequences of a CFC's distributions would be exclusively determined by the PTI System.

V. THE PTI SYSTEM SUBSTANTIALLY LIMITS AND MAY OVERRIDE THE § 245A DEDUCTION AND THE U.S.'S EXEMPTION TAX SYSTEM.

Although the TCJA effected a dividend exemption system and terminated the benefit of deferral by implementing a minimum tax on GILTI, the mechanics and ordering rules of the PTI System were not changed. These rules prioritize distributing PTI over Untaxed E&P.[291] In addition, the § 245A deduction only applies to dividends. [292] Since PTI distributions reduce E&P but are not treated as dividends for any other purpose,[293] PTI is not considered a dividend for purposes of the § 245A deduction and § 245A will not exempt distributions of PTI from taxation.[294] Thus, only distributions of E&P in excess of PTI are dividends that qualify for the § 245A deduction.

The inability to use the § 245A deduction is further exacerbated by the new income categories created by the TCJA that redesignate Untaxed E&P as PTI. Prior to the TCJA, only the Subpart F Income, U.S. Property Investments, and the §§ 1248 and 964(e) gain reallocated Untaxed E&P as PTI.[295] The TCJA established new categories of income, including Transition Tax Income, Hybrid Dividends, and

291. *See supra* Part II.B.3. I.R.C. §§ 959(c), 316(a); IRS PTI Notice, *supra* note 45, at 5, 278.

292. I.R.C. § 245A(a).

293. I.R.C. § 959(d). *See supra* Part II.A.

294. I.R.C. § 959(d); N.Y. ST. B. ASS'N TAX SEC., REP. NO. 1404, *Report on Section 245A*, at 7 (Oct. 25, 2018) [hereinafter *NYSBA Section 245A Report*], *available at* http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2018/1404_Report.html.

295. *See supra* Part II.A.

GILTI, which also reallocated earnings to PTI and created new subcategories of Subpart F PTI.[296] This significantly increases the amount of PTI held by CFCs,[297] which further elevates the amount of PTI that must be distributed before the § 245A deduction may be utilized. This effect is exacerbated by GILTI, which is not limited by E&P.[298] As a result, for MNEs that have a significant amount of GILTI and therefore a significant amount of Subpart F PTI (or at least more PTI than they are willing to distribute to its USSHs), the § 245A deduction may not be available for any distribution.

After the enactment of the TCJA, theoretically some types of earnings can still be exempt from tax by § 245A. "[C]ertain items of income earned by CFCs should be excluded from the GILTI, either because they should be exempt from U.S. tax—as they are generally not the type of income that is the source of base erosion concerns—or are already taxed currently by the United States."[299] Thus, Subpart F Income (including that excluded by § 954(b)(4) high-tax exception), ECI with a USTB, the return on QBAI, income from immobile assets (such as FOGEI), and Tested Income offset by Tested Loss, among a few other types of income (collectively Non-PTI Earnings), would not be included in gross income by GILTI.[300] As a result, these items would not reallocate Untaxed E&P to Subpart F PTI. Since Non-PTI Earnings are not previously taxed, they would not qualify for the § 959 exclusion and could receive the benefit of the § 245A deduction.

However, the order of allocation rules still require that Untaxed E&P is only distributed after PTEP.[301] When a CFC's PTI exceeds its distributions, none would be Untaxed E&P and the USSH would not be able to utilize the 245A DRD. In this case, the Non-PTI Earnings will be held in the Untaxed E&P account until the CFC's distributions exhaust its PTI. So Non-PTI Earnings may only be excluded by the 245A DRD

296. *See supra* Part II.B.2.

297. *Learning to Love GILTI*, *supra* note 261, at 260.

298. IRS PTI Notice, *supra* note 45, at 278; *Learning to Love GILTI*, *supra* note 261, at 259; Sapirie, *supra* note 263, at 264.

299. Limitation on Deduction for Dividends Received from Certain Foreign Corporations and Amounts Eligible for Section 954 Look-Through Exception, 84 Fed. Reg. 28,398, 28,399 (June 18, 2019) (alteration in original) [hereinafter Final Temporary 245A Regs].

300. Final Temporary 245A Regs, *supra* note 299, at 28,399; Mindy Herzfeld, Twitter (May 10, 2019) (posting slide from "Foreign Activities of US Taxpayers: Repatriation of Foreign Earnings" at the 2019 May Tax Meeting of the American Bar Association Section of Taxation in Washington, D.C., May 9–11, 2019), https://twitter.com/InternationlTax/status/1126862611755220997.

301. *See supra* Part II.B.3.

after all PTEP has been distributed. A MNE with high amounts of GILTI and other Subpart F PTI may never distribute sufficient earnings to exhaust its PTEP and thereby qualify for the 245A DRD.[302]

Treasury's treatment of PTI in the Final 956 Regs supports the proposal that the PTI System overrides the § 245A deduction and therefore the U.S. exemption tax system. These regulations allow a USSH to reduce its U.S. Property Investment by the amount of the § 245A deduction (Hypothetical 245A DRD) that would have been allowed if the inclusion had been a distribution from its CFC (hypothetical distribution).[303] The U.S. Property Investment is the amount of the Subpart F inclusion for investments in U.S. Property without considering application of the Final 956 Regs (aggregate tentative § 956 amount) less the Hypothetical 245A DRD.[304] Thus, the Final 956 Regs potentially exempts the U.S. Property Investment from taxation. However, the regulations also include an ordering rule that parallels the requirements of § 959(f)(1) and treats the hypothetical distribution as attributable first to Subpart F PTI and then to any Untaxed E&P.[305] As a result, even though it is treated like a distribution and potentially qualifies for the 245A DRD, U.S. Property Investments are excluded from gross income to the extent that the CFC has Subpart F PTI. Treasury demonstrates this point by an example.[306]

In the example, USP is a corporate USSH that owns 100% of CFC FC, which owns 100% of domestic corporation USS. The parties satisfy all of the holding period and other requirements necessary for the 245A DRD. FC has 100x undistributed E&P, all of which is Subpart F PTI. USP's "aggregate tentative § 956 amount" is 100x. USP's § 956 amount is its aggregate tentative § 956 amount less the 245A DRD that USP would be allowed if USP received the aggregate tentative § 956 amount as a dividend from FC. However, the 245A DRD is still not available. USP cannot claim the § 245A deduction for the "hypothetical distribution by reason of section 959(a) and (d)," which collectively state that a distribution of PTI is not considered a dividend for any purpose except to reduce E&P.[307] As a result, USP's 245A DRD for the

302. This may be true even if Treasury finalizes the Proposed GILTI High Tax Election and allows MNEs to exclude all high-taxed income from GILTI. Proposed GILTI Regs, *supra* note 82; *GILTI Regs Make Room for High-Tax Exclusion*, *supra* note 82.

303. Treas. Reg. § 1.956-1(a)(2)(i).

304. *Id.*

305. Treas. Reg. § 1.956-1(a)(2)(ii)(C), (a)(3)(ii); Amount Determined Under Section 956 for Corporate United States Shareholders, 84 Fed. Reg. 23,716, 23,716, 23,718 (May 23, 2019).

306. Treas. Reg. § 1.956-1(a)(3)(ii).

307. I.R.C. § 959(a), (d); Treas. Reg. § 1.956-1(a)(3)(ii)(B).

hypothetical distribution is zero, and its § 956 amount is the full 100x.[308] Although the § 956 amount is 100x, USP's gross income is still zero. Because the § 956 amount (100x) does not exceed the CFC's Subpart F PTI (100x), the U.S. Property Investment utilizes Subpart F PTI and therefore is excluded from gross income by § 959(a).[309] Instead, 100x of Subpart F PTI is recharacterized as U.S. Property PTI.[310]

This example demonstrates a number of important points. First, the § 245A deduction does not apply to distributions of PTI because PTI is not considered a dividend for purposes of § 245A. Second, a hypothetical distribution that could be categorized as either a dividend that would qualify for the 245A DRD or a distribution of PTI will be characterized as PTI based on the order of allocation rules. Third, when a hypothetical distribution does not exceed the amount of Subpart F PTI held by the CFC, the distribution will be characterized as PTI, which will be excluded from gross income by § 959.

Although this analysis applies to U.S Property Investments, which are treated like hypothetical distributions, one would expect a similar analysis to apply to actual distributions from a CFC to its corporate USSH. Treasury drafted the Final 956 Regs to ensure that the current taxation of investments in U.S. Property were taxed in the same manner as actual dividends paid to USSHs.[311] The regulations state: "[t]he final regulations, like the proposed regulations, exclude corporations that are [USSHs] . . . from the application of section 956 to maintain symmetry between the taxation of actual repatriations and the taxation of effective repatriations."[312] Accordingly, Treasury will likely apply similar treatment to actual distributions to USSHs.

Thus, the priority of allocating earnings to distributions established under the pre-TCJA law now operates to give priority to PTI distributions, and this preference prevents the use of the § 245A deduction until all PTI is utilized to exempt distributions from a CFC to its USSH. The inability to use the 245A DRD will be especially problematic for MNEs with a significant amount of PTI or for those that do not make distributions in excess of the amount of their PTEP. Given the large amounts of PTI that is potentially created annually by GILTI and that was created by the one-time § 965 transition tax, the PTI

308. Treas. Reg. § 1.956-1(a)(3)(ii)(B).

309. *Id.*

310. *Id.*

311. Amount Determined Under Section 956 for Corporate United States Shareholders, 84 Fed. Reg. 23,716, 23,716 (May 23, 2019).

312. *Id.*

System may effectively nullify the § 245A deduction and therefore the U.S. exemption tax system.

VI. CONCLUSION.

The TCJA increased the complexity of the United States international tax laws by adding a dividend exemption system through the § 245A deduction and a minimum tax system through the enactment of GILTI. In many ways, the PTI system slipped under the complexity radar because there were minimal changes to §§ 959 and 961. The only complication seemed to be § 951A(f)(1)(A), which required GILTI to be treated like Subpart F Income for purposes of applying §§ 959 and 961. Still it seemed simple enough to apply the well-established PTI System to a new Subpart F inclusion. Yet together GILTI and the PTI System are a powerful combination, which dominate the United States international tax system and may obliterate the U.S. exemption system.

Because the mechanics of the PTI System are largely unchanged, PTI continues to be distributed preferentially over Untaxed E&P.[313] Furthermore, because of the large amount of PTI created by the one-time Transition Tax and potentially created annually by GILTI, a lot more PTI exists after the TCJA than before. Since PTI distributions are not considered dividends and § 245A only applies to dividends,[314] the ordering rules have the effect of only allowing the 245A DRD to be utilized after all PTEP have been allocated. For MNEs with significant amounts of GILTI and other PTI, this effect potentially eliminates the availability of the § 245A deduction and, therefore, the exemption system established by the TCJA.

This analysis is supported by Treasury's comments in the preamble to the Final Temporary 245A Regs. The preamble states:

> Thus, both the interaction of the definitions of subpart F income and tested income with the ordering rules for distributions of PTEP and the overall structure of the international provisions of the [Tax Cuts and Jobs] Act contemplate that only residual earnings remaining after the potential application of sections 951(a), 951A, and 965 generally are eligible for the section 245A deduction. That is, section 245A(a) applies only to certain "dividends" received from foreign corporations. Therefore, sections 951(a), 951A, and 965 generally have priority over section 245A because, when they apply to a foreign corporation's earnings, distributions of those earnings do

313. I.R.C. § 959(c), (f).
314. I.R.C. §§ 245(a), 959(d).

> not qualify as dividends under section 959(d), and, therefore, section 245A does not apply . . . . A central feature of this regime is that income derived by CFCs is eligible for the section 245A deduction only if the earnings being distributed have not been first subject to the subpart F or GILTI regimes.[315]

The preamble confirms that the § 959 ordering rules distribute PTI before Untaxed E&P, that § 245A does not apply to distributions of PTI, and that only distributions of Untaxed E&P are eligible for the 245A DRD.[316] Thus, Subpart F Income, GILTI and Transition Tax Income receive priority over § 245A because PTI is not eligible for the § 245A deduction. So instead of a move toward a territorial tax system, the TCJA may be characterized as a move toward a pure residence-based, worldwide tax system without deferral.

Was this Congress' intent from the beginning? Will future legislation move the United States further toward a pure worldwide tax system? In the preamble to the Final Temporary 245A Regs, Treasury states, "The CFC's U.S. shareholders are subject to current U.S. tax on [GILTI] . . . *potentially* at a reduced rate through a deduction under section 250 at the corporate U.S. shareholder level."[317] The word "potentially" suggests that the preferential tax rate on GILTI may not be a permanent feature of the comprehensive framework for taxing a CFC's foreign earnings. If Congress repeals the § 250 deduction, the United States would tax all of CFCs' income (including income from active business operations and intangible property) at the full ordinary tax rate. The result would be another step closer to a pure, residence-based worldwide tax system.

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315. Final Temporary 245A Regs, *supra* note 299, at 28,399.

316. *Id.*

317. *Id.* (emphasis added).

ATTACHMENT A: ADJUSTED BASIS AND E&P ACCOUNTS FOR US CORP AND E&P ACCOUNTS FOR CFC A

US Corp							CFC A				
	Phantom Income	PTI (Exempt)	Included in GI	Total E&P[318]	Adj. Basis CFC A Stock	ELA (General)		959(c)(1) PTI	959(c)(2) PTI	Untaxed E&P	Total E&P
Start TY1	$0	$0	$0	$0	$1500M	$0	Start TY1	$0	$0	$0	$0
Other E&P			$900M	$900M		N/A	Other E&P			$500M $100M	$600M
Subpart F Income	$90M		$90M	$900M	$90M	N/A	Subpart F Income		$90M	($90M)	$600M
U.S. Property	$50M	$50M		$900M	$50M ($50M)	N/A	U.S. Property (Purchase)			($50M)	$550M
GILTI	$380M		$380M	$900M	$380M	N/A	U.S. Property Inclusion	$50M	($50M)		$550M
Subpart F §78 Gross-Up	$10M		$10M	$900M		N/A	GILTI		$380M	($380M)	$550M
GILTI §78 Gross-Up	$42.2M		$42.2M	$900M		N/A	FIT			($10M) ($50M)	$490M
End TY1	$572.2M	$50M	$1422.2M	$900M	$1970M	$11M	End TY1	$50M	$420M $40M is SubF Inc TY1 $380M is GILTI TY1	$20M	$490M

318. In this hypothetical, the only deduction available is the § 250 deduction, which does not affect E&P. Since there are no economic deductions, Gross Income equals Taxable Income. Therefore, Total E&P can be estimated as Gross Income Inclusion *plus* Tax Exempt Income *less* Phantom Income.

Start TY2	$572.2M	$50M	$1422.2M	$900M	$1970M	$11M	Start TY2	$50M	$420M $40M is SubFInc TY1 $380M is GILTI TY1	$20M	$490M
Other E&P				$900M		N/A	Other E&P			$200M	$690M
Subpart F Income	$180M		$180M	$900M	$180M	N/A	FIT			($20M)	$670M
Subpart F §78 Gross-Up	$20M		$20M	$900M		N/A	Subpart F Income		$180M	($180M)	$670M
Distribution from CFC A		$500M		$1400M	($500M)	N/A	Distribution to US Corp	1st($50M) USPropPTI TY1	2nd($180M) Current Subpart F Income PTI 3rd($25.7M) TY1 Subpart F Income PTI 3rd($244.3M) TY1 GILTI PTI		$170M
Unused FTC Limit						$22M					
End TY2	$772.2M	$550M	$1622.2M	$1400M	$1650M	$33M	End TY2	$0	$150M $14.3M is SubFInc TY1 $135.7M is GILTI TY1	$20M	$170M