September 12, 2019

Internal Revenue Service
CC:PA:LPD:PR (REG-101828-19)
Room 5203, Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

Re: GILTI Regulations

Ladies and Gentlemen:

This letter provides comments on behalf of the Securities Industry and Financial Markets Association ("SIFMA")[1] regarding the regulations under section 951A that were issued on June 21, 2019.[2] The final regulations address many of the concerns that taxpayers had raised regarding the prior proposed regulations. We commend the drafters for their efforts to take account of taxpayer comments.

This letter focuses primarily on the provisions of the proposed regulations that confirm that the high-tax exclusion will be available in respect of all income that is subject to foreign tax at a rate greater than 18.9%. This determination represents an appropriate and sensible exercise of the drafters' regulatory authority, and will bring the GILTI rules into closer conformity with what we believe Congress to have intended.[3]

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1 SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

2 *See* T.D. 9866, Guidance Related to Section 951A (Global Intangible Low-Taxed Income) and Certain Guidance Related to Foreign Tax Credits, 84 FR 29,288 (final and temporary regulations). The proposed regulations were included as part of Guidance Under Section 958 (Rules for Determining Stock Ownership) and Section 951A (Global Intangible Low-Taxed Income), 84 FR 29,114.

3 Annex 1 to this letter includes examples illustrating (i) the difficulties associated with computing the effective rate of foreign tax on a QBU-by-QBU basis (Example 1); (ii) the reasons why multiyear elections would be particularly problematic for U.S. taxpayers that conduct foreign operations through branches as well as subsidiaries (Example 2); and (iii) the need for relief in cases where mismatched taxable years create distortions (Example 3). Annex 2 provides a more detailed account, based on the facts of Example 2, of the reasons why section 904(b)(4) does not provide full relief in all cases for financial services companies from the unfavorable interaction between the GILTI and interest allocation rules.

We have technical and practical concerns regarding the mechanics of the exclusion, and particularly regarding the extent to which the proposed regulations would diverge from the longstanding statutory provision on which it is based: the elective exclusion for subpart F purposes, commonly referred to as the "high-tax kickout".[4] Our recommendations regarding the high-tax exclusion are set out in paragraphs 1 through 5 of this letter. We have noted a couple of small comments regarding other issues in paragraphs 6 and 7.

1. The exclusion should be conformed to the high-tax kickout.

The GILTI exclusion is based on the high-tax kickout. However, the proposed regulations would introduce significant differences between the GILTI and subpart F rules. We believe that the differences are inappropriate and unnecessary.

2. The foreign tax rate should be determined at the level of CFCs, not QBUs.

For subpart F purposes, the foreign tax rate computation generally is made with respect to all of a CFC's income in a particular category, without assigning significance to whether the income is earned by a foreign corporation through its home office or through a separate branch. By contrast, the proposed regulations would determine eligibility for the GILTI exclusion separately with respect to each qualified business unit of a controlled foreign corporation.

This requirement is unprecedented and unnecessary. We encourage you to eliminate it, and to provide instead for computations at the level of each CFC. Requiring that income and tax computations be made separately in respect of each QBU seems particularly inappropriate in the context of the GILTI rules. Under those rules, determinations generally are made on a combined basis with respect to a U.S. shareholder's entire foreign group. In the context of a rule that aggregates the income and losses of multiple foreign corporations, it doesn't make sense to require each such corporation to make disaggregated computations of income and taxes with respect to its qualified business units.

In the context of the GILTI rules, and for purposes of the high-tax exclusion, we don't agree that the blending of income that is subject to taxation at different rates is problematic, or that it should make a difference whether the income is derived by a corporation directly or through a QBU. Income derived from the conduct of an active foreign business may be subject to foreign tax at different rates for a variety of reasons. If a CFC's active business income is subject to an effective rate of foreign tax that exceeds 18.9%, it shouldn't make a difference whether that rate reflects the averaging of amounts taxed at different rates, or whether the differences relate to the conduct of activities through QBUs.

The requirement to make effective rate computations at the level of each QBU would give rise to additional compliance burdens, and an increased potential for inappropriate results.

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[4] *See* section 951A(c)(i)(III) (the GILTI high-tax exclusion), which incorporates section 954(b)(4) (the high-tax kickout) by reference.

The resulting costs seem to us disproportionately greater than any possible benefit of such computations.

The drafters clearly understood that QBU-level computations would be complex.[5] However, they may have failed to fully appreciate the novelty of such a requirement. For many years, U.S. shareholders have been required to determine the earnings and foreign tax liability of their foreign subsidiaries using U.S. tax accounting principles. No similar generally applicable requirement applies to branches or QBUs of foreign subsidiaries. In many cases, a U.S. shareholder will not even have had occasion to consider whether a particular activity conducted by a foreign subsidiary constitutes a QBU, because it doesn't matter.[6] Partially as a result of the limited practical significance of QBU classification prior to the enactment of the TCJA, the rules for determining what constitutes a QBU, and how to measure its income, are not fully developed, and some basic questions remain unanswered.[7]

For the reasons discussed in this letter, we think it is important that the new GILTI exclusion be coordinated with the longstanding subpart F rule. In many or most cases, it will be significantly more practical to determine the effective rate of foreign tax on a CFC-by-CFC basis. Taxpayers have been required to make such computations for subpart F and foreign tax credit purposes for more than 30 years.

It may be helpful to note that neither of the possible methodologies inherently favors taxpayers. Some taxpayers in fact may prefer to determine whether income is high-taxed on a QBU-by-QBU basis.[8] We would have no objection if the Service wishes to *permit* taxpayers to use this methodology if they wish to do so. But a rule that *requires* all taxpayers to determine the rate of foreign tax on a QBU-by-QBU basis seems to us unnecessary and inappropriate.

The drafters may have believed that CFC-level computations could produce inappropriate results in some cases. They may have intended the requirement that the effective rate of foreign tax be determined on a QBU-by-QBU basis as an anti-stuffing rule, to prevent taxpayers from

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[5] The topics with respect to which the drafters asked for comments provide a daunting, but by no means comprehensive, roadmap of the questions that taxpayers and tax administrators will need to address, including how to apply the rule in the context of fact patterns involving multiple QBUs in the same country, group relief and similar systems, and cases where the foreign tax base does not correspond to the QBU's books.

[6] The question whether an activity conducted by a foreign corporation outside the United States constitutes a QBU for U.S. tax purposes can be relevant for purposes of section 987 (methodology for reconciling accounts kept in more than one functional currency) and section 954 (transactions effected through a foreign branch can give rise to foreign base company sales and services income; exceptions for income derived in the conduct of an active business in some cases require separate QBU-level determinations).

[7] Example 1 illustrates the practical difficulties that could arise if effective rate computations are required to be made at the QBU level. The example involves a holding company structure in which a CFC owns multiple subsidiaries in the same foreign country, and those subsidiaries have elected to be disregarded as entities separate from the holding company. Our concerns about QBU-level computations are not limited to this fact pattern.

[8] For example, a U.S. shareholder may prefer to make a QBU-level election if a CFC's home-country income is taxed at a 19% rate and income derived by a clearly separate foreign QBU is taxed at a 13.125% rate.

seeking to maximize the benefit of the GILTI high-tax exclusion by combining unrelated businesses within a single corporation. We don't know how often this will represent a real-world opportunity.[9] We question whether it should be seen as a problem. But if this is the concern, it would be strongly preferable to deal with this limited fact pattern by prescribing a targeted anti-abuse rule, instead of by imposing burdensome new requirements on all taxpayers.

3. The GILTI high-tax election should be made annually on a company-by-company basis.

In addition to the issues discussed above, the proposed regulations would deviate very significantly from the longstanding subpart F rules in two important respects:

- Annual elections.
  - Subpart F. Taxpayers may elect to claim the benefit of the high-tax kickout on an annual basis.
  - GILTI. An election to claim the benefit of the exclusion, once made, must remain in effect for five years.
- Company-by-company elections.
  - Subpart F. Taxpayers may invoke the high-tax kickout selectively in respect of some foreign subsidiaries and not others.
  - GILTI. The election must be made on an all-or-nothing basis: if a taxpayer wishes to claim the benefit of the high-tax exclusion in respect of any foreign income, it must do so in respect of all foreign income.

Note, in this regard, that when Congress modified the high-tax kickout in 1986, its clear intention was to make the application of the provision elective, objective, and readily available.[10] The differences highlighted above would make the GILTI exclusion less readily available, and

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[9] There are a variety of practical constraints, including the difficulty of predicting the average rate of foreign tax on multiple streams of operating income derived from disparate businesses.

[10] The description of the change provides that: "Congress intended, by making the operation of this rule more certain, to ensure that it could be used more easily than the subjective test of prior law could be. This is important because it lends flexibility to Congress' general broadening of the categories of income that are subject in the first instance to current tax under subpart F. Congress' judgement was that because movable income could often be as easily earned through a U.S. corporation as a foreign corporation, a U.S. taxpayer's use of a foreign corporation to earn that income may be motivated primarily by tax considerations. If, however, in a particular case no U.S. tax advantage is gained by routing income through a foreign corporation, then the basic premise of subpart F taxation is not met, and there is little reason to impose current tax under subpart F. **Thus, since the scope of transactions subject to subpart F is broadened under the Act and may sweep in a greater number of non-tax motivated transactions, Congress expected that the flexibility provided by a readily applicable exception for such transactions would become a substantially more important element of the subpart F system."** [emphasis added]. *See* Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, p. 983.

more difficult to apply, than the high-tax kickout. There is no indication in the TCJA or the legislative history that Congress intended for there to be any such differences.

We recommend that the GILTI regulations be conformed to the subpart F rules, so that taxpayers are permitted to choose whether to invoke the exclusion annually on a CFC-by-CFC basis.

The ability to make elections in respect of some subsidiaries and not others would enable taxpayers to reduce exposure to the unfavorable interaction between the GILTI and interest allocation rules (as discussed in Annex 2) to the maximum extent possible without triggering incremental U.S. taxes on GILTI.[11]

The tax policy considerations supporting the approach taken by the subpart F rules seem to us even stronger in the context of the GILTI rules. The preamble to the proposed regulations notes that, if an appropriately inclusive high-tax exclusion is not provided, taxpayers will have incentives to reconfigure their business processes to replace GILTI with subpart F income. The proposed regulations are intended to reduce the use of formal and economically inefficient self-help strategies by eliminating the need for them. This is a powerful and persuasive rationale for the drafters' decision regarding the scope of the exclusion.

The same rationale applies with equal or greater force to the questions regarding the mechanics of the exclusion that are discussed in this section. An election could have unfavorable consequences for financial services businesses in some cases.[12] It is impossible to predict whether an election will produce net benefits, or net costs, over a multi-year period. The requirement that the election be irrevocable for five years, as contemplated by the proposed regulations, will defeat the purpose described in the preamble by discouraging companies from taking advantage of the exclusion.

Finally, the use of the same statutory framework to delineate two very different exclusions could give rise to significant complexity. In the event that there are any remaining

[11] For example, assume that a taxpayer has three foreign operating subsidiaries, each of which has pretax income of 1,000. Sub_1 and Sub_2 are subject to foreign tax at a 20% rate; Sub_3 is taxed at an 8% rate. Depending on the relationship between the interest allocation detriment and the incremental GILTI cost, it could be in the taxpayer's interest to make a high-tax election with respect to both Sub_1 and Sub_2, and incur residual U.S. tax on GILTI derived from Sub_3. Alternatively, it may be preferable to make a high-tax election only in respect of Sub_1, so that the average rate of foreign tax on income derived from Sub_2 and Sub_3 is greater than 13.125%. We don't see a good reason to prevent taxpayers from making this judgment on a case-by-case basis in the context of their particular circumstances. It would be inappropriate to require taxpayers to claim the benefit of the high-tax exclusion with respect to both subsidiaries or neither of them.

[12] *See* the discussion in Annex 2 and Example 2.

differences between the high-tax kickout and the GILTI exclusion, the regulations should provide clear guidance concerning how the rules will interact with each other.[13]

4. Relief should be provided in cases where mismatched taxable years produce distortions.

Under prior law, the amount of foreign tax allocable to a particular item of income (including for purposes of the high-tax kickout) was determined by reference to multiyear pools of earnings and foreign taxes. This methodology tended to reduce the significance of differences between U.S. and foreign tax accounting principles. Multiyear pooling of course is no longer available following the enactment of the TCJA. Taxpayers now are required to compute foreign taxes allocable to items of income by reference to the amount of foreign taxes payable in respect of a particular year.

Year-by-year effective rate computations will increase the practical significance of disparities between the U.S. and foreign rules governing the timing of accrual of items of income, expense and foreign tax. As shown in Example 3, the effective rate of foreign tax determined by reference to the results of a single year can deviate significantly from the stated rate of foreign tax even in a case where the U.S. and foreign systems are substantially similar.[14]

We recommend that the regulations provide relief in the limited circumstances described below. Taxpayers should be allowed to claim the benefit of the high-tax exclusion if they can establish to the satisfaction of the Secretary that income derived in a particular year will be subject to foreign tax at a rate greater than 18.9%, even if the tax would not be considered to have accrued in that year for U.S. tax purposes.[15] This circumstance could arise, for example, if a CFC is required to use an April 30 taxable year for foreign purposes and a calendar year for U.S. purposes. Making the exclusion available in cases where disparities between U.S. and foreign rules otherwise would produce distortions is not inconsistent with the Congressional determination that foreign tax credits should be determined on a year-by-year basis. The GILTI

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13 For example, if a taxpayer claims the benefit of the high-tax kickout in respect of a single foreign subsidiary, would it be deemed to have made a GILTI election in respect of all of its foreign subsidiaries? Would a taxpayer be permitted to claim the benefit of the high-tax kickout annually, and with respect to some subsidiaries and not others, if it has made a GILTI election in respect of income that would not otherwise have been subject to taxation under subpart F?

14 Congress made a policy judgment to eliminate pooling. It is not permissible or desirable to revisit that judgment. Congress presumably believed that pooling would not be compatible with the new system for taxing foreign income, and that the benefits of the new system outweighed the potentially serious disadvantages associated with year-by-year computations. The creation of a multiyear pooling system in 1986 was motivated in part by Congress's desire to eliminate planning opportunities available to taxpayers under the prior year-by-year system. At the very least, year-by-year computations will make it more difficult to effectively forecast and provide for taxes, and will increase the level of uncertainty.

15 Alternatively, taxpayers could be allowed to accrue foreign taxes on a mark-to-market basis, as if the foreign taxable year had ended concurrently with the U.S. taxable year.

high-tax exclusion is not a foreign tax credit rule: foreign tax credits are not allowable in respect of income that qualifies for the benefit of the exclusion.

5. The exclusion should be available retroactively to the date of enactment.

The proposed regulations provide that the high-tax exclusion will be available only in respect of periods after the regulations are published in final form. The considerations supporting the decision to make the exclusion generally available apply with equal force to income earned before and after regulations are issued in final form. Taxpayers should be permitted to claim the benefit of the exclusion in respect of all periods beginning on the date the GILTI rules entered into force.

6. Basis adjustment rule.

In our comment letter concerning the prior proposed regulations, we expressed concern about a basis adjustment rule that was intended to prevent taxpayers from deriving duplicative benefits from a single economic loss. We noted that the rule could require a taxpayer to make a basis adjustment even if there was no potential for duplicative benefits, and recommended that the rule be modified to avoid this outcome. The final regulations do not include the proposed basis adjustment rule. The preamble indicates that the Service is considering how to craft a workable and fair rule. We respectfully request that the Service take account of the concerns that we had raised about the proposed rule.

7. Compliance and reporting issues.

The final regulations are effective retroactively to the date on which the GILTI rules entered into force. The regulations make a number of important changes, including with respect to the application of the GILTI rules to interests held through U.S. partnerships. Some of the changes could not reasonably have been anticipated. Some taxpayers have been required to make complex computations, to prepare and deliver information returns, or to file tax returns, based on determinations made in good faith before the final regulations became available.

In the absence of guidance, there could be significant diversity of practice regarding how to deal with such cases. Some taxpayers may conclude that they are required in all cases to rerun the numbers, and to provide amended information returns, without regard to whether the required changes are material; others may wish to take account of materiality and costs; others may prefer to make true-up adjustments on future filings instead of preparing amended returns.

Notice 2019-46 provides helpful guidance concerning some cases in which actions were required to be taken prior to the issuance of the final regulations. As similar fact patterns are identified, the Service should endeavor to foster uniformity without imposing unreasonable burdens on affected taxpayers.

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We appreciate the opportunity to comment on the GILTI regulations. Please do not hesitate to contact me at (202) 615-4732 or jwall@sifma.org if you have questions or would like to discuss our comments in more detail.

Respectfully submitted,

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Annex 1: Examples

Example 1.

A. Overview.

As illustrated by the fact pattern described below, a substantial foreign subsidiary of a U.S. company may have dozens of activities or interests that could be classified as QBUs for U.S. tax purposes. In many cases, however, a U.S. shareholder will not have had occasion to consider which of them are in fact QBUs, because their classification does not have any U.S. tax consequences. Similarly, a U.S. shareholder may never have needed to compute the income and foreign tax liability that would be attributed to a QBU on a separate-company basis, because such a computation isn't required or relevant for U.S. tax purposes.

For a company in this position, a requirement that computations be made on a QBU-by-QBU basis would be entirely novel: it would not be building on an existing reporting and compliance infrastructure, because there isn't one.

B. Facts.

Country A is a major regional financial center. Parent conducts a diversified financial services business in that country through direct and indirect subsidiaries. The subsidiaries are wholly owned; all of them are organized and based in Country A.[1]

Parent's Country A group consists of more than two dozen separately organized legal entities. Only one of those entities ("Topco") is a corporation for U.S. purposes; the others have elected to be disregarded as entities separate from Topco for U.S. tax purposes. Most of them are treated as separate taxable entities for Country A tax purposes; some are disregarded (or treated as tax-transparent) for Country A as well as for U.S. tax purposes.

Topco owns an intermediate holding company ("Holdco"), a group finance company ("Finco"), and a company through which it participates in a joint venture ("JVco").

Holdco owns three substantial operating companies ("Bank", "Dealer" and "Leaseco"). The businesses conducted by those companies are required to be held separately for Country A regulatory reasons.

Each of the operating companies owns half a dozen subsidiaries. Some of the subsidiaries were organized for Country A regulatory or accounting purposes (for example, to ring-fence assets that are not subject to regulatory capital requirements if held separately, or to facilitate a securitization transaction or a limited-recourse borrowing). Some were organized for Country A

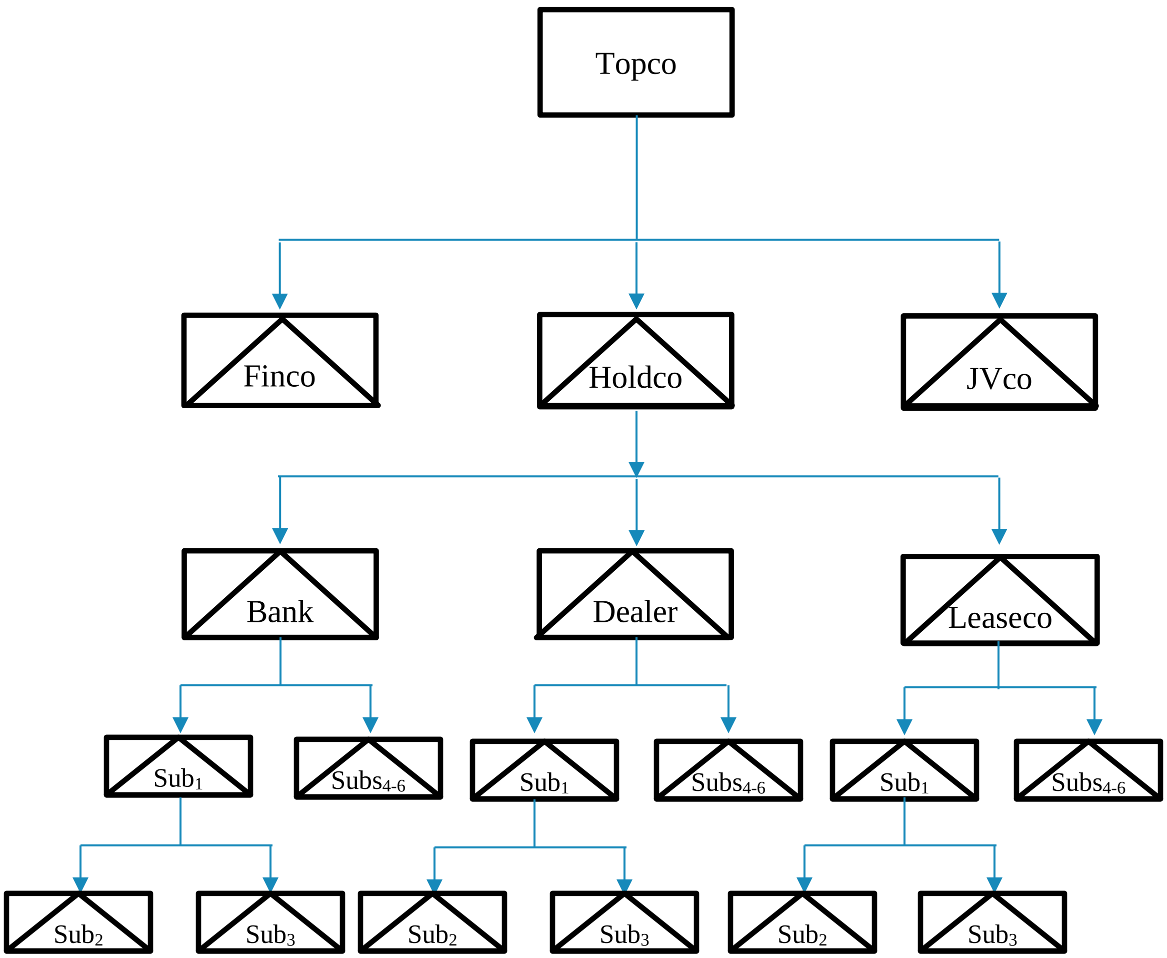
1 A real-life fact pattern could easily be more complex than the structure described in the example. For ease of illustration, the example assumes that none of the members of Parent's Country A group conducts activities or owns interests that constitute a QBU outside Country A: none of them has a true foreign branch, a deemed foreign branch, or an interest in a foreign entity whose activities give rise to a QBU.

tax planning purposes (for example, to facilitate the efficient use of loss carryovers or other favorable tax attributes). Some may have been created or left in place for business reasons (for example, to preserve benefits, or limit risks, associated with an acquired business).

Parent's Country A group determines its tax liability on a consolidated basis. The group is consistently profitable, but not all of its members are profitable on a stand-alone basis.

The operating companies enter into transactions directly with unrelated customers, and have substantial third-party assets and liabilities. Most of the other companies enter into transactions only with each other, and transact with the outside world, when necessary, through a regulated affiliate such as Bank or Dealer. Most of the transactions entered into between the subsidiaries are respected in accordance with their form for Country A tax purposes; some are not.

Each of the companies shown in the organization chart below is potentially a QBU, and most of them probably are QBUs, under current law. But more facts would be required in order to determine whether all of them are QBUs, and in some cases the answer may be uncertain. The check-the-box elections have the intended and actual effect of causing Topco's subsidiaries to be disregarded for U.S. tax purposes. Their separate existence will have U.S. tax consequences only in a limited range of circumstances. As a result, it is entirely possible that Topco's U.S. shareholder will never have had occasion to consider whether a particular company is a QBU, or what its income and tax liability would be on a stand-alone basis.


Topco
Finco
Holdco
JVco
Bank
Dealer
Leaseco
Sub1
Subs4-6
Sub1
Subs4-6
Sub1
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Sub2
Sub3
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Sub2
Sub3

Example 2

A. Overview.

This example demonstrates that a U.S. company that conducts a significant proportion of its worldwide business through foreign branches can incur costs instead of benefits as a result of an election to apply the GILTI high-tax exclusion. The outcome in a particular year will depend on global economic conditions and other factors that are not within the taxpayer's power to predict or control. For taxpayers in this position, an election that is required to cover a multiyear period would represent a leap into the unknown. This could make companies reluctant or unwilling to make such an election. The effect would be to create unfair disparities between taxpayers, and possibly also to defeat the purpose of the proposed regulations by not providing an effective alternative to artificial strategies based on subpart F.

B. Facts.

1. Assets and liabilities.

Bank is engaged in the conduct of active financial businesses in the United States and around the world. For interest allocation and foreign tax credit purposes, Bank is considered to have $100 billion of assets. The assets fall into three categories:

- Home office assets that give rise to U.S. source income, representing 40% of the total.

- Foreign branch assets that give rise to foreign source branch category income, representing 40% of the total. The income is subject to foreign tax at a rate that equals or exceeds the U.S. corporate income tax rate.

- Stock in foreign subsidiaries that give rise to GILTI (unless Bank elects to apply the high-tax exclusion), representing 20% of the total. The subsidiaries' income is subject to foreign tax at a rate that equals or exceeds the U.S. corporate income tax rate, and qualifies for the high-tax exclusion. None of the income is distributed currently.

Bank incurs interest expense in an amount equal to 0.9% of its total assets, or $900 million. Before taking account of the special rules applicable to assets that give rise to income described in sections 245A and 250, the expense would be allocated between the three categories of assets in proportion to their tax book value (*i.e.*, on a 40/40/20 basis).[2]

[2] For purposes of simplicity, this example does not address the important issues that we have been discussing with you regarding the appropriate methodology for determining the amount of interest expense that is allocable to branch category assets.

On these facts, interest expense that is allocated to the GILTI category will not give rise to any U.S. tax savings, because the expense will crowd out foreign tax credits that otherwise would have been allowable. Interest expense that is allocated to the foreign branch category similarly will produce U.S. tax savings only to the extent it does not exceed the amount that the branches are entitled to deduct for foreign tax purposes. It is strongly in the interest of taxpayers, and of the U.S. tax system, to ensure that the amount of interest expense that is allocable to these categories is determined fairly, using a methodology that does not overstate the actual cost of funding assets held through foreign branches and subsidiaries.

If Bank doesn't take advantage of the high-tax exclusion, then its stock in foreign subsidiaries will be assigned to the section 951A category, and 50% of that stock will be considered a tax-exempt asset. As a result, its interest expense of $900 million will be allocated as follows:

- $100 million to the GILTI category ($900 million interest expense x 10/90 [$20 billion section 951A category assets minus $10 billion exempt assets/$100 billion total assets minus $10 billion exempt assets]);

- $400 million to the foreign branch category ($900 million interest expense x 40/90 [$40 billion branch category assets /$100 billion total assets minus $10 billion exempt assets]); and

- The remaining $400 million to domestic source income.

If Bank elects to claim the benefit of the high-tax exclusion, then its stock in foreign subsidiaries will be assigned to the section 245A category. As a result, the foreign tax credit limitation applicable to income in the foreign branch category will be determined in a two-step process, as follows:

- First, $360 million of interest expense will be allocated to the foreign branch category ($900 million interest expense x 40/100 [$40 billion branch category assets /$100 billion total assets]); and

- Second, for purposes of determining the foreign tax credit limitation applicable to branch category income, $180 million (interest expense allocable to section 245A category income [$900 million x 20/100]) will be added back to the denominator of the foreign tax credit limitation fraction.

2. <u>Income and foreign tax credits: Year 1</u>.

Bank has $750 million of domestic source income, $750 million of branch category income, and $375 million of tested income that would be GILTI if Bank doesn't elect to claim the benefit of the high-tax exclusion. Bank's foreign source income is subject to foreign tax at a 21% rate.

- No election. Bank will incur U.S. tax costs of $73.5 million, determined as follows:
  - Income before expenses=$1.875 billion ($750 million domestic source income, $750 million branch category income and $375 million of GILTI).
  - Taxable income=$787.5 million (total income of $1.875 billion minus expenses of $1.0875 billion [$900 million interest expense plus $187.5 million section 250 deduction]).
  - U.S. tax liability before credits=$165.375 million (21% of taxable income of $787.5 million).
  - Foreign tax credits=$91.875 million, consisting of the sum of its branch category credits and GILTI credits.
    - Branch category limitation=$73.5 million ($165.375 million tax before credits x $350 million branch category taxable income [$750 million income minus $400 million interest expense]/$787.5 million worldwide taxable income).[3]
    - GILTI limitation=$18.375 million ($165.375 million tax before credits x $87.5 million GILTI taxable income ($375 million income minus $187.5 million section 250 deduction and $100 million interest expense)/$787.5 million worldwide taxable income.
  - Tax payable=$73.5 million ($165.375 million tax before credits minus $91.875 million credits).
- Election. Bank will realize savings of **$10.5 million** as compared to the no-election case, determined as follows:
  - Income before expenses=$1.875 billion ($750 million U.S. source income, $750 million branch category income and $375 million of section 245A category income).

[3] If the $400 million of interest expense that is allocable to branch category income for U.S. tax purposes corresponds to the amount of interest expense that Bank's foreign branches are entitled to deduct for foreign tax purposes—this is a big 'if'—then the allocation of interest expense against branch category income will not give rise to incremental costs, and Bank's branch category income will be fully sheltered by foreign tax credits.

- Taxable income=$600 million (total income of $1.875 billion minus expenses of $1.275 billion [$900 million interest expense plus $375 million section 245A deduction]).

- U.S. tax liability before credits=$126 million (21% of taxable income of $600 million).

- Foreign tax credits= $63 million (branch category limitation=$126 million tax before credits x $390 million [branch category taxable income]/$780 million [worldwide taxable income plus $180 million added to denominator pursuant to section 904(b)(4)]).

- Tax payable=$63 million ($126 million liability before credits minus $63 million credits). This represents $10.5 million less than in the no-election case.[4]

3. Income and foreign tax credits: Year 2.

Economic conditions deteriorate in the U.S. market, and Bank's domestic source income is reduced to $400 million. The downturn doesn't affect Bank's foreign operations, which derive the same income as in year 1.

- No election. Bank will not have any U.S. tax liability after credits, determined as follows:
  - Income before expenses=$1.525 billion ($400 million U.S. source income, $750 million branch category income and $375 million GILTI).
  - Taxable income=$437.5 million (total income of $1.525 billion minus expenses of $1.0875 billion [$900 million interest expense plus $187.5 million section 250 deduction]).
  - U.S. tax liability before credits=$91.875 million of (21% of taxable income of $437.5 million).
  - Foreign tax credits=$91.875 million, consisting of the sum of its branch category credits and GILTI credits.
    - Branch category limitation=$73.5 million (21% of branch category taxable income of $350 million [$750 million income minus $400 million interest expense]).

[4] The net savings represent the difference between (i) the $21 million benefit of avoiding the unfavorable interaction between interest expense and foreign tax credits on GILTI category income; and (ii) the $10.5 million cost of applying section 904(b)(4) to a taxpayer that has high-taxed branch category income.

    - GILTI limitation=$18.375 million (21% of GILTI taxable income of $87.5 million [$375 million income minus $187.5 million section 250 deduction and $100 million interest expense]).

  - Tax payable=0 ($91.875 liability before credits minus $91.875 million credits).

- Election. Even though Bank's foreign source income is subject to foreign tax at a 21% rate, that income will not be fully sheltered by foreign tax credits. Bank will incur incremental U.S. tax costs of **$21.98 million**, determined as follows:

  - Income before expenses=$1.525 billion ($400 million U.S. source income, $750 million branch category income and $375 million section 245A category income).

  - Taxable income=$250 million (total income of $1.525 billion minus expenses of $1.275 billion [$900 million interest expense plus $375 million section 245A deduction]).

  - U.S. tax liability before credits=$52.5 million (21% of taxable income of $250 million).

  - Foreign tax credits. Under section 904(b)(4), Bank's entitlement to foreign tax credits on branch category income will be capped at $30.52 million (foreign tax credit limitation=$52.5 million tax before credits x $250 million [the lesser of branch category and worldwide taxable income]/$430 million [worldwide taxable income plus $180 million]).

  - Tax payable. Bank will be liable for $21.98 million of U.S. tax ($52.5 million [21% of taxable income of $250 million before credits] minus $30.52 million foreign tax credits on branch category income).

Example 3

A. Overview.

This example shows the distortions than can result from the combined effect of the longstanding rule that foreign income taxes accrue on the last day of the foreign taxable year, and the requirement to compute the effective rate of foreign tax on a year-by-year basis.

B. Facts.

Sub is engaged in the conduct of an active financial services business in Country B, where its income is subject to tax at a 30% rate. The tax systems in Country B and the United States are essentially similar: there are no significant differences in the rules for determining the timing and amount of income and deductions. Sub is required to compute its taxable income for Country B purposes on the basis of a taxable year ending April 30; it uses a calendar year for U.S. tax purposes.

Sub is consistently profitable, but its income and tax liability can vary significantly from year to year.[5] Even though all of Sub's income is subject to foreign tax at a 30% rate, most of its income will *not* qualify for the GILTI high-tax exclusion, as shown below.

Y/E Apr 30	**Income**	**Foreign tax**	**Y/E Dec 31**	**Income**	**Foreign tax**	**High-taxed?**
2020	120	(36)	2020	440	(36)	No
2021	600	(180)	2021	360	(180)	Yes
2022	240	(72)	2022	120	(72)	Yes
2023	60	(18)	2023	420	(18)	No
2023 [May-December]	400	—[6]	—	—	—	—

[5] For convenience, the example assumes that Sub's income varies from year to year, but not within a single foreign taxable year. Thus, Sub is assumed to earn the same amount of income in each month of its foreign taxable year (*i.e.*, 10 in each of the twelve months ending April 30, 2020, 50 in each of the twelve months ending April 30, 2021, 20 in each of the twelve months ending April 30, 2022, 5 in each of the twelve months ending April 30, 2023 and 50 in each of the twelve months ending April 30, 2024).

[6] No foreign tax is payable during 2023 on income earned after April 30 of that year.

Annex 2: Disparate treatment of businesses conducted through foreign branches

This section uses the facts of Example 2 to illustrate the unfavorable interaction between the GILTI and interest allocation rules, and the reasons why the proposed regulations will not always provide full relief (and in some cases will not provide any relief) for financial services companies. Although these points reinforce the importance to our industry of the changes suggested in the body of our comment letter (and particularly the need to be able to make a high-tax election annually), they are not otherwise directly relevant to the proposed regulations. For this reason, we are discussing them in a separate annex.

1. Year 1.

In this year, Bank's GILTI foreign tax credit limitation will be $18.375 million. This amount is significantly lower than (i) the amount of foreign taxes actually paid by Bank's foreign subsidiaries (21% of $375 million, or $78.75 million); and (ii) the amount of foreign taxes that Bank is deemed to have paid after taking account of the 20% haircut on foreign tax credits for GILTI purposes (80% of $78.75 million, or $63 million). Bank therefore will have $44.625 million of unusable excess credits in the GILTI category.

If interest expense had not been allocated to GILTI category income, Bank would not have incurred any incremental U.S. tax costs, because it would have been entitled to an additional $21 million of foreign tax credits. Bank will not derive any net benefit from the interest expense, because the resulting deduction will crowd out foreign tax credits that otherwise would have been available to shelter GILTI from U.S. tax.[7] This represents a significant incremental cost for financial services companies and other businesses that rely on a leveraged business model.

2. Year 2.

It would be strongly inadvisable for Bank to invoke the GILTI high-tax exclusion in year 2: such an election would give rise to incremental U.S. tax costs of $21.98 million. It may be instructive to consider why Bank would not derive any benefits, and instead would incur such significant costs, if it made a high-tax election in year 2.

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[7] A deductible interest payment normally would give rise to U.S. tax savings equal to 21% of the amount of the payment, so long as the taxpayer has sufficient profits to make effective use of the deduction. However, interest expense that is required to be allocated against high-taxed GILTI will not produce any net benefits, because the interest deduction will crowd out foreign tax credits with a value equal to the expected benefit of the deduction. Those credits otherwise would have been available to shelter income from U.S. tax. This is no longer "just" a timing issue. Under the TCJA, excess credits in the GILTI category may not be carried over from year to year. As a result, foreign tax credits that are crowded out by interest deductions are lost forever.

As illustrated by the no-election cases in Example 2, interest expense that is allocated against high-taxed GILTI category income generally will not produce any net U.S. tax benefits. The drafters of the proposed regulations appear to have recognized that the allocation of interest expense against high-taxed GILTI category income could have unintended and inappropriate consequences. The remedy that the drafters adopted—making the GILTI high-tax exclusion available more broadly—should reduce the potential for those consequences in many cases. However, that remedy will not always be fully effective for U.S. companies that conduct activities in high-tax jurisdictions through branches as well as subsidiaries. In some cases, the cure will be worse than the disease.

If Bank elects to invoke the GILTI high-tax exclusion, then stock in its foreign subsidiaries will be considered a section 245A category asset. Section 904(b)(4) prescribes a special rule for expenses allocable to such assets (in this case, $180 million of interest expense). That provision will have disproportionately unfavorable consequences for businesses that conduct activities through high-taxed foreign branches, such as financial services companies.

In year 1, when Bank derives the same return on assets within and outside the United States, a high-tax election will provide partial relief for interest expense allocable to section 245A category assets. In year 2, when the return on Bank's U.S. assets is depressed relative to the return on its foreign assets, an election will not provide any such relief, and instead will trigger significant additional costs.[8]

Section 904(b)(4) is not by its terms an interest allocation rule. That section functions solely as a mechanism for determining the foreign tax credit limitation applicable to particular categories of foreign source income. However, in some cases, that section will produce results that are essentially similar to the results produced by an interest allocation rule such as section 864(e)(3) and the GILTI regulations.[9] This will be the case where, as in year 1, the taxpayer derives the same return (expressed as a percentage of tax book value) on its domestic and foreign assets.[10]

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8 Under the methodology prescribed by section 904(b)(4), the $180 million of interest expense that is allocable to section 245A category assets (*i.e.*, stock in Bank's foreign subsidiaries) will produce U.S. tax benefits if and to the extent of the proportion of Bank's worldwide taxable income that is attributable to U.S. source taxable income. In year 1, U.S. source taxable income represents 50% of Bank's worldwide taxable income, and Bank therefore derived a partial benefit from that interest expense. In year 2, none of Bank's worldwide taxable income is attributable to U.S. source taxable income, and Bank derives no benefit from that interest expense.

9 Under those rules, assets that give rise to tax-exempt income are not taken into account for interest allocation purposes, and interest expense that would have been allocated to those assets is apportioned among the taxpayer's non-exempt assets.

10 The branch category foreign tax credit limitation in year 1 would not be affected if, instead of grossing up the denominator of the foreign tax credit limitation fraction by the interest expense allocable to section 245A category assets as contemplated by section 904(b)(4), all of Bank's interest expense had been apportioned among its non-exempt assets in proportion to their tax book value as contemplated by section 864(e)(3) (limitation=$63 million, or $126 million tax before credits x $300 million [$750 million income minus $450 million interest expense]/$600 million [worldwide taxable income]).

In other cases, section 904(b)(4) will produce materially less favorable results. In year 2, Bank will incur additional U.S. tax costs as a result of the combined effect of the fact that (i) the return on the taxpayer's domestic assets is depressed relative to its return on branch category assets (and, as a result, the implicit allocation of interest expense to branch category assets is overstated); and (ii) branch category taxable income exceeds worldwide taxable income.[11]

By contrast, section 904(b)(4) will have no practical consequences for a U.S. corporation that conducts all of its foreign operations through subsidiaries. A taxpayer in this position could incur significantly lower U.S. tax costs over time.[12]

[11] The problems associated with a high-tax election in year 2 would be alleviated if Bank were allowed to use an interest allocation rule of the kind prescribed by section 864(e)(3) and the GILTI regulations instead of the methodology prescribed by section 904(b)(4). Moreover, under prior law, if a taxpayer's entitlement to foreign tax credits in a particular year was reduced because its foreign source income in a particular category was greater than its worldwide income, the reduction would have corresponded to an overall domestic loss or a separate limitation loss, and would have been recoverable in future years. Under the TCJA, this will no longer be the case if the reduction is attributable to section 904(b)(4).

[12] If all of a taxpayer's foreign operations are conducted through foreign subsidiaries, and the taxpayer qualifies for and claims the benefit of the GILTI high-tax exclusion, then there will be no credits to disallow, and section 904(b)(4) will have no consequences.