Multinational Financial Groups After the U.S. Tax Reform: Selected Inbound and Outbound Issues

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I. Introduction and Overview

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The Tax Cuts and Jobs Act ("TCJA") resulted in the most sweeping changes to the Internal Revenue Code (the "Code") in decades and will result in countless articles and commentary to address the many changes to taxpayers of all types.[1] Indeed, the international tax changes alone will be the subject of many of those writings, as the framework under which the United States taxes U.S. and non-U.S. businesses on U.S. and non-U.S. income has shifted considerably. This article focuses on several of those changes and their particular, though perhaps not isolated, impact on one category of taxpayers—a *multinational* affiliated group of companies that includes a bank and/or a registered securities dealer (each such company, a "Financial Institution" and such group, a "Financial Group").[2] Both U.S. parented and non-U.S. parented Financial Groups will be discussed in this article. Certain provisions apply primarily to U.S. parented Financial Groups (or to a U.S. parented subgroup of a non-U.S. parented Financial Group), while other enacted changes affect both U.S. and non-U.S. parented Financial Groups. The international tax changes impact many types of taxpayers, and their application generally can have similar results as those for Financial Groups. However, the somewhat unique footprint of Financial Groups' global operations, the fact that the commodity they deal with is money itself, and, not least, the extensive non-tax regulatory rules by which they must operate combine so that the international changes discussed below may be expected to impact Financial Groups in manners unlike any other industry, and sometimes, disproportionately unfavorably.

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The key legislative changes on which this article focuses are:

A. The reduced corporate tax rate of 21%.
B. The limitation on the ability of most businesses to deduct interest expense under a revamped Code Sec. 163(j), and the manner in which it is expected to affect Financial Institutions as taxpayers and as providers of financing to customers.
C. The new, partial, territorial tax regime by which overseas profits of U.S. multinationals are taxed.[3] This topic generally falls into three subtopics, notably:
   1. the new dividends received deduction for U.S. corporate shareholders on distributions from certain foreign corporations, as provided under Code Sec. 245A;
   2. the TCJA's retention of most of the infrastructure of Subpart F, which has been in the Code since the Kennedy Administration; and
   3. the new minimum tax on foreign earnings imposed under Code Sec. 951A ("global intangible low-taxed income" or "GILTI" regime).

With increased pressure on managing foreign taxes and an incentive for Financial Groups present in the United States to minimize payments from the United States to foreign affiliates, it is also reasonable to anticipate increased tax controversy activity in other countries.

D. The surprise retention of Code Sec. 956 as applicable to corporate shareholders of controlled foreign corporations ("CFCs"), despite the fact that the House and Senate versions of the tax bill had both included its repeal,[4] and its impact on Financial Groups under the new international tax rules, both as taxpayers and as providers of financing for clients.
E. The new base erosion and anti-abuse tax ("BEAT"), which applies in a manner to essentially reduce or deny the availability of a deduction for payments made by U.S. persons to their foreign affiliates and reduce or eliminate the benefit of certain tax credits, and its unique application to Financial Groups, in the context of both U.S. parented and foreign parented groups.
F. Continuing, and to a degree, enhanced, disparity in tax treatment between foreign branches and CFCs, and the emerging potential effect that the changes in A–E above may have on whether a Financial Group opts to conduct its activities through a branch (including a disregarded entity)[5] or a subsidiary, whether it be of a U.S. corporation in a non-U.S. jurisdiction or of a non-U.S. corporation in the United States.

The article approaches the discussion of all these changes in a conceptual way, except in the discussion of the BEAT, where the focus shifts to transaction analysis and numeric examples. This difference in approach is warranted because unlike in the application of GILTI and its interplay with other tax provisions, which are primarily qualitative, the BEAT is heavily dependent on the analysis of particular transactions and computational outcomes, which are more readily demonstrated through examples.

II. Summary of Key Legislative Changes[6]

A. Reduction in the Corporate Tax Rate

The corporate tax rate has been permanently reduced to 21%, which places the United States slightly below the worldwide average corporate statutory rate of approximately 23%.[7]

B. New Limitations on Deductibility of Interest Expense

Through the years, the Code has applied numerous limits to the deductibility of interest expense, which have often targeted: (1) instruments which are equity flavored and (2) instruments issued by U.S. affiliates to related foreign persons (or issued to unrelated persons but guaranteed by related foreign persons). Prior to its amendment by the TCJA, Code Sec. 163(j) (the "earnings stripping" limitations) limited the amount of interest deductions that could be taken by certain corporations, if the interest was paid or accrued to, or guaranteed by, certain related persons. The TCJA replaced prior Code Sec. 163(j) in its entirety with a general cap on net business interest expense equal to 30% of net business income (*i.e.,* "adjusted taxable income" or "ATI"), regardless of who the lender or guarantor is.[8] Under new Code Sec. 163(j), there is no longer any international or related party prerequisite to the application of the interest expense limitation, which applies to businesses regardless of whether the interest crosses borders or whether the loan involves a related party.

Net business interest expense is the excess of business interest expense over business interest income.[9] Business

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interest is any interest paid or accrued on indebtedness properly allocable to a trade or business, and business interest income is interest income properly allocable to a trade or business, excluding investment interest and investment income within the meaning of Code Sec. 163(d).[10] Code Sec. 163(j) does not define interest specifically, and therefore amounts treated as interest (which would include amounts treated as "original issue discount") under general U.S. federal income tax principles should be treated as interest for Code Sec. 163(j) purposes.[11]

ATI means a taxpayer's taxable income, computed without regard to (i) items of income, gain, deduction or loss not properly allocable to a trade or business, (ii) business interest or business interest expense, (iii) net operating loss deductions, (iv) deductions under Code Sec. 199A (relating to "qualified business income") and (v) for taxable years beginning before January 1, 2022, deductions allowable for depreciation, amortization or depletion.[12] Additional adjustments to ATI may be made by future regulations.[13] ATI includes earnings regardless of whether they are earned in the United States or abroad, as long as such earnings are included in the borrower's taxable income. To that end, Subpart F income and GILTI would increase ATI, but receipt of any dividends exempt under the new participation exemption would not increase ATI.

A group filing a consolidated return appears to be treated as a single taxpayer for purposes of computing the 30% cap limitation.[14] Special rules govern the application of this limitation to partnerships and S corporations.[15] Any disallowed business interest can be carried over indefinitely and treated as additional interest paid in a subsequent taxable year.[16]

C. Taxation of U.S. Parented Groups' Overseas Earnings: Partial Territorial Regime

1. In General

The TCJA's changes to the taxation of overseas profits of U.S.-based multinationals are notable for what they do and, equally as important, for what they do not do.

The stated purposes of the TCJA's international changes to the Code are to "replace the existing, outdated worldwide tax system," to "end the perverse incentive to keep foreign profits offshore," to "prevent companies from shifting profits to tax havens" and to "level the playing field between US headquartered parent companies and foreign headquartered parent companies."[17] The baseline for achieving these purposes is the enactment of the long-contemplated, but only partial, territorial system, which the TCJA achieved by introducing a limited exemption for overseas profits of U.S.-based multinational groups. Subject to the important exceptions discussed below, the partial territorial system eliminates the U.S. repatriation tax on foreign earnings by allowing corporate U.S. Shareholders[18] a 100% dividends received deduction, or "participation exemption" for the foreign-source portion of dividends from foreign subsidiaries.[19] By eliminating the U.S. tax on a repatriation of profits from foreign subsidiaries, the TCJA removes the lockout effect on those earnings.[20] The participation exemption applies, however, to only a relatively narrow slice of overseas earnings of U.S.-based multinationals, as the framework to tax those overseas profits when earned or invested in U.S. property has been maintained, and in fact expanded, through three general mechanisms. Under any of these three mechanisms, a U.S. Shareholder may be subject to tax on the foreign earnings of a CFC.[21] First, a U.S. Shareholder may be subject to current U.S. tax under the general Subpart F rules, which for the most part remain in place and in the same form taxpayers have dealt with for decades.[22] For example, foreign base company sales and services income rules remain unchanged. Second, a U.S. Shareholder may be subject to tax, at a reduced effective rate for corporate shareholders, under the GILTI regime which applies a new minimum tax as described in detail below.[23] Finally, by a last minute surprise retention of Code Sec. 956 in Congress' joint conference agreement on the TCJA, the foreign earnings of a CFC remain subject to U.S. tax if invested in U.S. property, including *via* credit support for debt of a U.S. affiliate.[24]

2. Minimum Tax on Global Intangible Low-Taxed Income

For the first time in history, the United States imposes a minimum tax on U.S. Shareholders with respect to foreign earnings of CFCs, and generally regardless of the composition of those earnings. Historically, the string of anti-deferral rules in the Code have focused on either passive type income or certain base company (*i.e.,* perceived as easily mobile) income. Under new Code Sec. 951A, each U.S. Shareholder effectively pays a U.S. minimum tax on its share of all of its CFCs' GILTI tested income (as defined below).[25] A foreign tax credit mechanism under the GILTI rules suggests that GILTI may have been designed to subject this type of foreign income to U.S. tax only to the extent the income is subject to foreign tax at a rate less than 13.125%.[26] Given, however, the manner in which GILTI interacts with other provisions in the Code,[27] including various expense allocations and apportionments, earnings of a CFC may well be subject

to a foreign tax rate higher than 13.125% yet still result in an incremental U.S. tax at the U.S. Shareholder level.[28]

GILTI is calculated as the excess (if any) of a U.S. Shareholder's "net CFC tested income" over its "net deemed tangible income return" as described more fully below.

a. Net CFC Tested Income. The "net CFC tested income" is the netted aggregate of the U.S. Shareholder's *pro rata* share of each applicable CFC's "tested income" (or loss).[29] Each CFC determines its tested income (or loss) by netting its gross income against the deductions allocable to such income, but excluding for this purpose any (i) income that is effectively connected with a U.S. trade or business, (ii) subpart F income of such CFC, (iii) income which is not subpart F income by reason of the high-tax exception of Code Sec. 954(b)(4), (iv) dividends received from a related person and (v) certain foreign oil and gas extraction income.[30]

b. Net Deemed Tangible Income Return. The "net deemed tangible income return" is equal to 10% of the aggregate of the U.S. Shareholder's *pro rata* share of each applicable CFC's qualified business asset investment ("QBAI"), but reduced by the net interest expense taken into account in determining the U.S. Shareholder's net CFC tested income.[31] A CFC's QBAI is the aggregate adjusted basis of depreciable tangible property used in a trade or business to generate the CFC's GILTI tested income.[32] This has the effect of excluding from GILTI an assumed return on tangible assets at a stated 10% rate on their adjusted tax basis.

c. GILTI Inclusion Amount. A U.S. Shareholder's GILTI inclusion amount is equal to the excess (if any) of a U.S. Shareholder's "net CFC tested income" over its "net deemed tangible income return," or the following formula:

$$\text{GILTI} = \text{Net CFC Tested Income} - \text{Net Deemed Tangible Income Return}$$

Importantly, a U.S. Shareholder's GILTI inclusion amount is calculated by aggregating tested income (or loss) and QBAI over all the CFCs with respect to such U.S. Shareholder. This is in contrast to Subpart F, which generally applies, and inclusions under which are determined, on a CFC-by-CFC basis.[33]

d. GILTI Deduction. Once the GILTI inclusion amount is determined as provided above, U.S. Shareholders that are domestic corporations are allowed a deduction of 50% of the GILTI inclusion.[34] At the 21% corporate tax rate, this results in an effective tax rate of 10.5% on GILTI. Rather than enact a separate tax rate on GILTI, which would create a number of complexities with using NOLs and FTCs, Congress instead enacted the 50% deduction.

e. Foreign Tax Credits. A U.S. Shareholder that is a domestic corporation is deemed to have paid foreign taxes equal to 80% of the aggregate "tested foreign income taxes" paid by CFCs attributable to the GILTI inclusion amount, multiplied by the "inclusion percentage" ("GILTI FTCs").[35] The inclusion percentage is the ratio of such U.S. Shareholder's GILTI inclusion amount over the aggregate amount of tested income included in the calculation of such U.S. Shareholder's net CFC tested income. The "tested foreign income taxes" means the foreign income taxes paid or accrued by a CFC which are attributable to the tested income of such CFC taken into account in determining a corporate U.S. Shareholder's inclusion under Code Sec. 951A.[36] GILTI inclusions are treated as a separate basket for foreign tax credits purposes under Code Sec. 904 and GILTI FTCs are not entitled to carryover or carryback.[37] The gross-up under Code Sec. 78 consists of the full amount of foreign income taxes deemed paid under Code Sec. 960(d).[38]

f. GILTI and Subpart F. GILTI relies on many preexisting mechanisms of the Subpart F regime of current income inclusions, previously taxed income amounts ("PTI"), basis adjustments and other rules.[39] However, because GILTI is separately includible under Code Sec. 951A(a) (and because Subpart F income is specifically carved out from the determination of a CFC's GILTI tested income), it is not included in Subpart F income for purposes of Code Sec. 951.[40] A GILTI inclusion at the U.S. Shareholder level gives rise to many of the same Subpart F consequences as, for example, an inclusion of foreign base company sales or services income, with some important differences to achieve certain policy objectives, for example, with respect to the foreign tax credits. For purposes of several key Code sections, including Code Sec. 959 on PTI, and Code Sec. 961 on basis adjustments, a GILTI inclusion is treated in the same manner as a subpart F inclusion under Code Sec. 951(a).[41]

Also note that Subpart F generally applies, and inclusions are determined, on a CFC-by-CFC basis. Subpart F income is determined by reference to the specific tax accounting items of the particular CFC, including the CFC's transactions with related persons.[42] In contrast, GILTI applies by aggregating with respect to all CFCs of a U.S. Shareholder the tested income (and loss), QBAI, and foreign taxes.[43] The aggregation approach for GILTI means that high QBAI in one CFC that has tested income can mitigate a U.S. Shareholder's overall GILTI by offsetting the tested income of another CFC. Similarly, foreign taxes of one CFC on its tested income may be available to credit against tested income of another CFC.

D. Additional Considerations Concerning Subpart F

1. Expanded U.S. Shareholder Definition and Ownership Attribution Rule

As discussed above, the TCJA retained the infrastructure of Subpart F largely unchanged, except for the repeal of the foreign oil related income category. In addition, the TCJA broadens the application of Subpart F by (1) expanding the definition of U.S. Shareholder and (2) expanding the attribution of ownership of stock held by foreign persons in applying the constructive ownership rules under Code Sec. 958.[44] These two changes will generally mean more persons will be treated as U.S. Shareholders and more foreign corporations will be treated as CFCs.

Previously, a U.S. person was a U.S. Shareholder with respect to a CFC if such person held at least 10% of the voting power of all classes of stock of the CFC. Under the TCJA, ownership of at least 10% of either voting power *or* value will cause a U.S. person to be treated as a U.S. Shareholder.[45] In determining the amount of stock that is owned by a U.S. person for various purposes of the CFC rules, such as whether a U.S. person is a U.S. Shareholder and whether a foreign corporation is a CFC, stock that is held indirectly or constructively is treated as owned by such U.S. person. Prior to the TCJA, under Code Sec. 958(b)(4), stock of a foreign person was not attributed "downward" to a U.S. entity from its foreign owner; thus the stock of a foreign sister company owned by a common foreign parent was not attributed to a U.S. brother company owned by such common foreign parent.[46] The elimination of Code Sec. 958(b)(4) under the TCJA creates such attribution, potentially causing foreign subsidiaries of a foreign group to be treated as CFCs if such foreign group includes a U.S. subsidiary.[47] Subpart F and GILTI inclusions remain limited to direct and indirect U.S. shareholders.[48]

2. Active Financing Exception

As noted, the fundamentals of Subpart F remain largely intact, including the definitions of foreign personal holding company income under Code Sec. 954(c). The TCJA also retained the active financing exception ("AFE") under Code Sec. 954(h) (the AFE). Under Code Sec. 954(h)(1), the term "foreign personal holding company income" for purposes of Code Sec. 954(c)(1) does not include "qualified banking or financing income" of an "eligible controlled foreign corporation."[49] The term "eligible controlled foreign corporation" is defined as any CFC which is predominantly engaged in the active conduct of a banking, financing, or similar business and conducts substantial activities with respect to such business. The term "qualified banking or financing income" is defined as any income of an eligible CFC which (i) is derived in the active conduct of a banking, financing or similar business by (I) such eligible CFC or (II) a qualified business unit of such eligible CFC, (ii) is derived from one or more transactions (I) with customers located in a country other than the United States and (II) substantially all of the activities in connection with which are conducted directly by the corporation or unit in its home country, and (iii) is treated as earned by such corporation or unit in its home country for purposes of such country's tax laws.[50]

3. Surprise Retention of Code Sec. 956

Under Code Sec. 956, earnings of a CFC that are not PTI are generally includible in the income of the CFC's U.S. Shareholders when invested in certain "United States property." For purposes of Code Sec. 956, subject to various exceptions, U.S. property includes tangible property located in the United States, stock of a domestic corporation, obligations of a U.S. person and certain intellectual property acquired or developed by the CFC for use in the United States.[51] As particularly relevant to Financial Groups, Code Sec. 956 contains several exceptions for deposits with U.S. banks and for posted cash and securities collateral and debt of a U.S. person under repurchase agreements ("repos") or reverse repos, in both cases as posted or incurred on commercial terms in the ordinary course of business of a dealer in securities or commodities.[52] A CFC is treated as acquiring an obligation of a U.S. person if such CFC is a pledger or guarantor of such obligation (or in certain circumstances, if at least two-thirds of the total combined voting power of all classes of voting stock of such CFC is pledged in support of such obligation).[53] Although both the House and Senate versions of the TCJA included provisions to repeal the application of Code Sec. 956 for corporate U.S. Shareholders, the final version of the TCJA retained Code Sec. 956 in its entirety. The retention of Code Sec. 956 for corporate U.S. Shareholders was surprising, given that actual distributions of untaxed foreign earnings are exempt from taxation under new Code Sec. 245A. The practical impact of retention of Code Sec. 956 remains to be seen.

E. The Base Erosion Anti-Abuse Tax

1. In General

In contrast to GILTI, which captures income derived by subsidiaries of U.S. parented groups, the BEAT was enacted to address transactions between U.S. and non-U.S.

related parties which produce tax deductions reducing the U.S. tax base.[54] The application of the BEAT is mechanical in nature and does not depend on whether a transaction is carried out in the ordinary course of business and also does not depend on whether the transactions otherwise meet the arm's-length standard under the application of transfer pricing rules.

2. Operation of the BEAT

a. Applicable Taxpayer. The BEAT is a tax, imposed on a corporation that has combined gross receipts of over $500 million (an "applicable taxpayer").[55] It is currently unclear whether the BEAT applies at the level of a group filing a consolidated return or on a separate entity basis, although good arguments support (and the industry appears to intend to follow in the absence of guidance) the consolidated return application.[56] The BEAT generally applies only to taxpayers whose "base erosion percentage" (calculated as described below) for the taxable year is at least 3%. Members of a Financial Group are subject to more restrictive rules, with the threshold base erosion percentage equal to 2% and the applicable BEAT rate increased by one percentage point compared to non-Financial Group taxpayers.[57]

b. Computation of the BEAT. The BEAT generally is computed as the excess (if any) of the 10% (5% for 2018 and 12.5% for years after 2025) of the taxpayer's "modified taxable income" ("MTI") over that taxpayer's regular tax liability, after reduction for certain tax credits (as discussed below).[58] For members of a Financial Group, the relevant tax rates are 11% (6% for 2018 and 13.5% for years after 2025).[59] Because the BEAT is computed as an excess over the regular tax liability after such liability is reduced for certain tax credits, such credits are effectively not creditable under the BEAT regime.[60]

MTI is the taxpayer's regular taxable income plus all "base erosion tax benefits" and the base erosion percentage of any NOL deduction for the taxable year (which includes NOLs that were generated before the enactment of the BEAT).[61] A base erosion tax benefit is a tax deduction (including depreciation or amortization) allowable or attributable to a "base erosion payment." A base erosion payment generally is a deductible payment or accrual to a foreign related party and specifically includes the purchase of depreciable property.[62]

c. Foreign Related Party. Foreign related parties include a 25% owner of the taxpayer (by vote or value) and persons related to either the taxpayer or such 25% owner directly, indirectly, or by attribution.[63]

d. Exclusions from Base Erosion Payment. Absent a transaction involving a surrogate foreign corporation under Code Sec. 7874, a base erosion payment does not include any reduction in gross receipts, such as a cost of goods sold payment.[64] In addition, base erosion payments do not include services that can qualify for the services cost method under Code Sec. 482 (without regard to the business judgment rule)[65] and which are provided at cost without a markup.[66] Very importantly for Financial Groups, certain derivative payments are also excluded. Specifically, any payment made pursuant to a derivative which the taxpayer marks to market under Code Sec. 475 and for which it complies with reporting requirements is not a base erosion payment.[67] Payments of interest, royalty or service fees that are made pursuant to a derivative, as well as any non-derivative component of the derivative, cannot benefit from this exception.[68] For this purpose, "derivative" is generally defined as a financial contract (*e.g.,* option or swap), the value or payment on which is determined by reference to any stock, debt or actively traded commodity, or any currency, rate, price, amount, index, formula or algorithm.[69] In addition, a payment is not treated as a base erosion payment to the extent it is subject to U.S. withholding tax.[70] The list of the allowed reference underliers does not include partnerships.[71]

e. The Base Erosion Percentage Computation. The base erosion percentage is computed generally as the ratio of the aggregate amount of base erosion tax benefits of the taxpayer for the taxable year over the aggregate amount of all income tax deductions allowable to the taxpayer for the taxable year. Deductions for qualified derivative payments to related parties which would be base erosion payments but for the Code Sec. 59A(h) exception are not included either in the numerator or in the denominator of the base erosion percentage.[72]

The BEAT has a cliff effect as a result of which meeting the base erosion percentage may produce a significant tax liability even if the amount of payments to related parties is not a significant portion of the overall deductions, because of the interplay between the foreign tax credits and NOLs.

In particular, the BEAT itself is not directly reduced by any tax credits. The amount of the BEAT equals the MTI multiplied by the applicable rate, less the taxpayer's regular tax liability. The taxpayer may have tax credits (such as foreign tax credits or general business tax credits) that reduce its regular tax liability and that generally do not depend on the taxpayer's taxable income or deductions. In computing the BEAT, the taxpayer's regular tax liability is reduced by certain tax credits. Because there is no corresponding tax credit reduction to 10% of MTI, any tax credits that reduce the regular tax liability increase the BEAT. Table 1 illustrates the simple principle by which this mechanism operates:

TABLE 1.

	Without Credits		With Credits	
MTI	$	1,000	$	1,000
MTI × 10%	$	100	$	100
Regular tax liability	$	110	$	110
"Disallowed credits"			$	(20)
Adjusted regular tax liability	$	110	$	90
BEAT: (MTI × 10% – Adjusted regular tax liability)		**0**	**$**	**10**

When computing the BEAT for years before 2026, the regular tax liability is reduced (and thus, the BEAT amount effectively increased) by credits other than (A) research and development ("R&D") and (B) 80% of the lesser of (i) the sum of the low income housing tax credit ("LIHTC"), the production tax credit ("PTC") and the investment tax credit ("ITC") (together the "general business credits" or "GBCs") or (ii) the BEAT (as computed without regard to such credits). After 2025, the regular tax liability is reduced by all credits, with the effect that no credits at all can be utilized in computing the BEAT.[73] Thus, in some cases, the difference between the regular tax liability and the BEAT may be attributable entirely to the effective disallowance of certain tax credits under the BEAT regime, rather than to the increase in the MTI due to adding back base erosion tax benefits.[74]

F. Continuing Disparity in Treatment of Branches and CFCs

Under the new partial-territorial system, foreign branch income of a U.S. taxpayer continues to be taxed largely the same as under the pre-TCJA law, subject to the lower corporate tax rate, with limited exceptions.[75] Under prior law, all foreign earnings whether earned through a branch (including a disregarded entity) or through a CFC generally faced taxation at the full corporate rate, either immediately, or with respect to non-Subpart F earnings of a foreign subsidiary, on a deferred basis when repatriated. Under the TCJA, foreign earnings of a branch remain fully taxable in the United States, with the benefit of the foreign tax credits allowed, although a separate limitation basket has been created for non-passive branch FTCs.[76] Contrast this result with the non-Subpart F earnings of a CFC, which are either (i) entitled to a potential full exemption if such earnings fall below the 10% return on the tax basis of tangible assets and therefore do not generate any GILTI or (ii) subject to tax as GILTI, including aggregate treatment at the level of a U.S. Shareholder, and subject to restrictive limitations on FTC usage (*e.g.*, only 20% of foreign income taxes disallowed as either credit or deduction, loss of FTCs for any foreign tax paid by a CFC generating a tested loss, and no FTC carryovers).

III. Financial Groups Business and Structure Overview[77]

A. In General

This Part III provides an overview of Financial Groups' business, structure and regulatory concerns, because these characteristics significantly influence how the TCJA's key legislative provisions affect Financial Groups. As discussed in Part IV, below, the combination of these features may raise unique issues in applying the discussed TCJA's provisions to Financial Groups.

B. Financial Services Business and Global Footprint

A large Financial Group generally consists of Financial Institutions that may each engage in a number of lines of business and conduct various activities. These activities may include, among other things, deposit taking and consumer and commercial lending; underwriting, dealing, and making a market in securities; providing financial, investment, or economic advisory services; acting as a placement agent in the private placement of securities; engaging in merchant banking activities; acting as principal in foreign exchange and in derivative contracts based on financial and non-financial assets; and making, acquiring, or trading loans or other extensions of credit, all of which activities are subject to regulation or supervision. The countries in which a Financial Group does business and the locations of its assets are dictated primarily by the identity of its clients, by those clients' needs and by regulatory considerations, rather than by tax planning.

The success of a large Financial Group greatly depends on its ability to seamlessly deliver various services and products to clients globally. Financial products and services may need to be sourced from many jurisdictions, depending on the client's needs. In addition, a Financial Group must be physically present (through offices or affiliates) in multiple time zones to trade globally on a 24-hour basis. Except in very limited situations, the relevant activities are conducted through the Financial Group's affiliated member Financial Institutions, rather than third parties which would typically charge a market premium to offset their own risks. Each of these activities in one or more

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particular jurisdictions may be conducted by a different affiliate that has the necessary regulatory permissions and licenses to engage in such business and must operate in compliance with such regulatory requirements in the relevant jurisdictions.

C. Financial Groups' Use of Capital, Technology and Services

Financial Groups generate profits by mixing human capital with financial capital, investment in technology and other intangibles. Financial capital is central in all aspects, because Financial Groups are capital intensive and are highly leveraged. Interest expense and the cost of carry for securities positions are a key component of profitability. "Fixed assets" in a conventional sense, such as machinery or equipment, are typically very limited. Instead, money, various securities and financial contracts serve the same purpose for a Financial Group as factory equipment, machinery and widget inventory for a widget maker. As with conventional fixed assets, a Financial Group's money and money equivalents generally cannot be easily relocated to another jurisdiction due to the extensive regulatory capital requirements placed on the financial industry by each jurisdiction in which a Financial Group operates. Therefore, since a Financial Group's capital investment bears not just credit risk but also market and operational risks, most Financial Groups' business models require that capital be compensated at a level greater than a routine return.

Financial Groups make non-financial investments mainly in communications and trading technology (systems and trading platforms) to support trading and hedging activities on a "real time" basis, track flows, comply with regulatory and other reporting requirements, monitor various "red flags," identify and manage conflicts, and provide customers with various types of information. These systems are usually deployed globally and may be licensed to affiliates, but computer software and data may be developed and maintained in various locations.

Finally, a key factor in conducting a Financial Group's activities is performance of services by the Financial Group's employees. To meet customer demands and to identify and effectively manage correlated financial risks in multiple countries, core functions such as intermediation (capital supply, market making and underwriting, securities lending and margin lending, and providing liquidity) and risk management (systematic hedging of risks) must be carried out in a globally integrated network of affiliated Financial Institutions (that each must comply with its own regulatory and legal requirements in relevant jurisdictions) rather than through uncoordinated local enterprises. Each of these core activities may require contributions from many individuals employed by various entities within a Financial Group, located in different countries, providing appropriate inputs to the common coordinated activity, and compensated to reflect such distinctive inputs. Gains and losses from all these activities and from assumed and hedged risks must be accurately reflected in the financial results of the relevant business units and appropriate affiliates both for regulatory and for U.S. and non-U.S. tax reasons.

Distinctions between core and non-core activities conducted by Financial Groups may be blurry and difficult to define. For example, dealer activities are considered core activities while credit analysis and accounting may be treated as back office functions. Marketing, sales, pricing, brokering, risk management, and general management may be somewhere in the middle. It is often not permissible from a regulatory perspective and impractical operationally to segregate such activities and have them be purchased by the customers directly and separately. However, each of these activities frequently is required to be compensated on an intercompany basis, and how it is compensated bears on the pricing of intergroup transactions, including cross-border transactions.[78]

D. Regulatory Oversight and Its Impact on Organizational Structure[79]

The financial industry is subject to extensive regulation in most countries and is widely considered the most regulated industry in the world. For example, one or more regulators routinely dictate where a Financial Institution can have clients, how it is required to conduct dealings with such clients, how much capital it is required to have and in what form it must do business in a particular locale.[80]

As a result of the combination of the business location and input factors, the regulatory framework, and other considerations, common organizational structures have evolved for (i) U.S. parented Financial Groups and (ii) non-U.S. parented Financial Groups that do business in the United States. Figure 1 demonstrates a U.S. parented Financial Group structure and Figure 2 demonstrates a non-U.S. parented Financial Group structure.

As may be seen in Figure 1, U.S. parented Financial Groups have traditionally conducted broker-dealer

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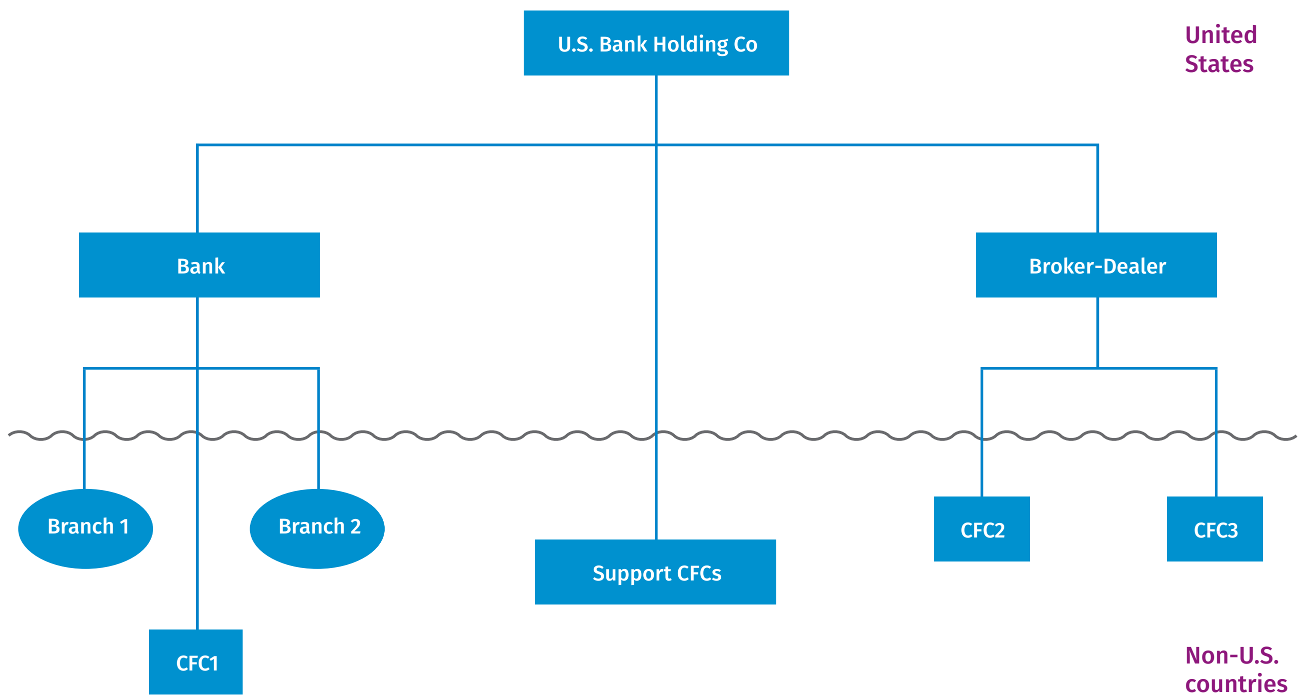
FIGURE 1.



activities through affiliates, including those organized in non-home countries, while conducting commercial banking activities more commonly through branches. Branches generally benefit from the enhanced credit rating and large diversified pool of capital and assets, ability to deploy capital, lower cost of funding, worldwide capital base, and ability to engage in transactions without operational restrictions.[81] The local regulatory environment sometimes necessitates forming a separate entity to conduct operations in a particular jurisdiction in order to avoid overlapping regulatory and oversight requirements and to address other legal considerations.

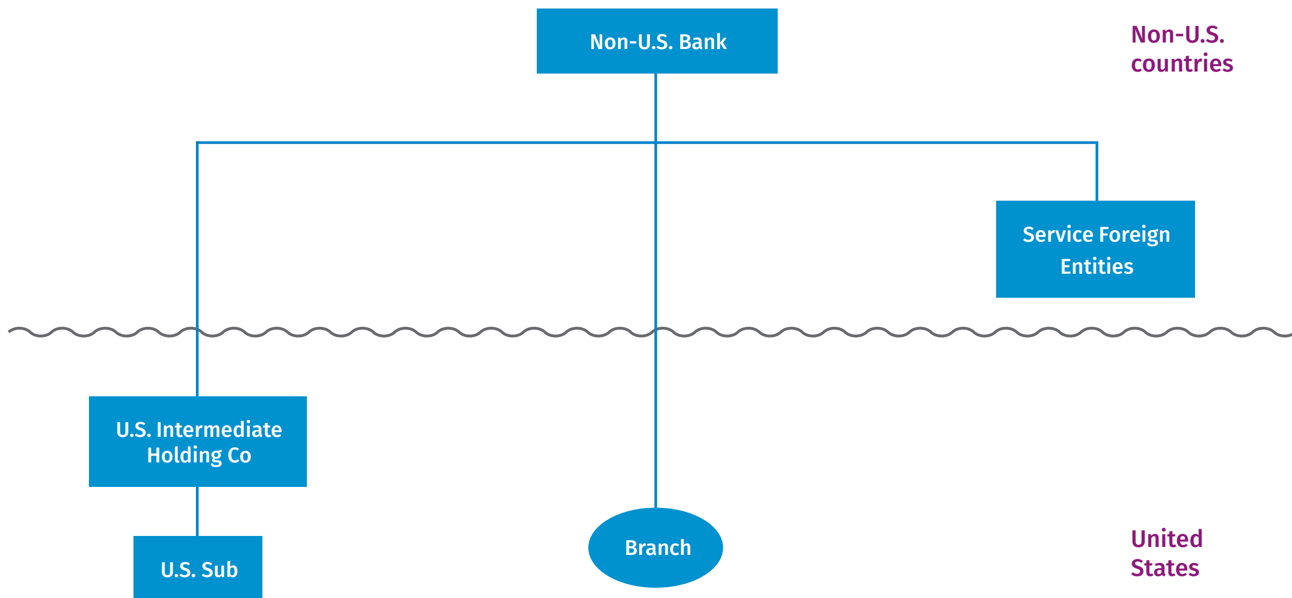
Figure 2 illustrates a common structure for a non-U.S. parented Financial Group doing business in the United States. Such groups are subject to special U.S. regulatory requirements. The U.S. Federal Reserve imposes special total loss absorption capacity ("TLAC") requirements on foreign banks.[82] Under these TLAC rules, a foreign bank must create a U.S. intermediate holding company, which must issue, in addition to equity capital, a prescribed amount of subordinated debt to its foreign parent company. By its terms, such TLAC debt can be canceled or converted into additional equity to prevent the need to put the intermediate holding company into receivership if the foreign parent fails.

E. Intercompany Transactions

Financial Groups that conduct global activities must share and transfer risks in a way that appropriately reflects each entity's economic contribution and also complies with the regulatory requirements regarding the types of activities each entity may engage in, what risks it may assume, and the capital it must carry. The compensation associated with customer trades or products must be distributed accordingly. Sometimes such sharing within the Financial Group is accomplished through intercompany cross-border transactions between affiliates, which must be carried out in compliance with the regulatory and capital requirements imposed on each of the affiliates. Sometimes, the profits are transfer priced among various entities participating in servicing a global client and are allocated based on various factors rather than on a transaction-by-transaction basis.

The organizational structure of Financial Groups and the manner in which they conduct global business may result in the provisions of the TCJA impacting them in a disproportionate way. In addition, such taxpayers may be limited in their ability to restructure their organization or operations so as to mitigate any detrimental effects of the new tax rules. Part IV, below, discusses certain issues that may be particularly relevant to Financial Groups.

FIGURE 2.



IV. Application of Select TCJA Provisions to Financial Groups

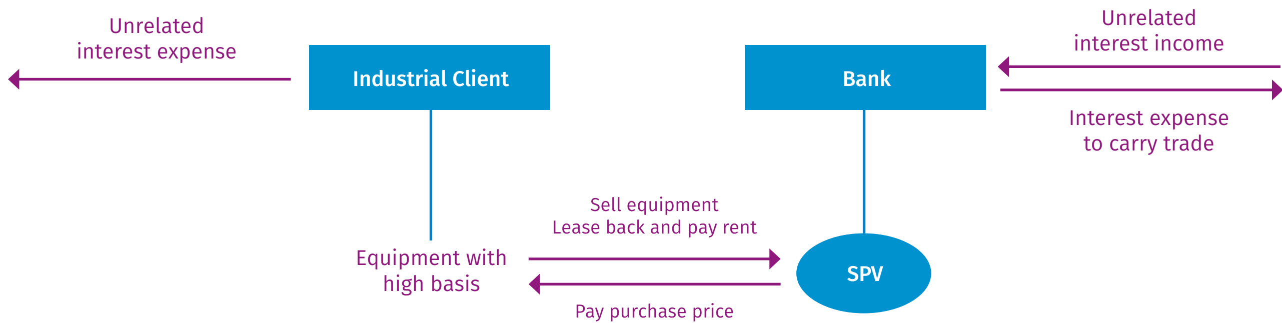
A. Impact of the Corporate Rate Reduction and Interest Expense Limitation

U.S. parented Financial Groups with primarily U.S. operations and little cross-border activity largely stand to benefit from the changes made by the TCJA. First, the reduction in the top corporate rate will provide a sizeable benefit by reducing such companies' U.S. federal income tax liability. Second, the limitation on the deductibility of net business interest deduction under Code Sec. 163(j) will be unlikely to have significant detrimental effect on a Financial Group that is engaged in commercial lending activities and earns most of its revenue as interest income. Because the limitation is imposed on *net* business interest expense—meaning that business interest expense is fully deductible against income that is characterized as interest for tax purposes—a Financial Institution such as a commercial bank is unlikely to have net business interest expense. By contrast, Financial Institutions that earn most of their business income in the form of fees (origination, brokerage, *etc.*), trading gains, dividends, derivatives payments and marks, and substitute payments, while maintaining high leverage (either through direct borrowing or by entering into repos), may be more vulnerable to the net interest expense deduction limitation because such non-interest income does not offset interest expense for purposes of Code Sec. 163(j). Because Code Sec. 163(j) is expected to apply at the consolidated return level, if a Financial Group has a Financial Institution with significant traditional banking activities, such Financial Group may be minimally impacted by the Code Sec. 163(j) limitation. However, it would be prudent for Financial Groups to review deconsolidated entities, which may be subject to the 30% cap, because they cannot benefit from the business interest income earned at the consolidated return level.

With respect to the impact of the TCJA on a Financial Group's business, rather than as a taxpayer, the net business interest expense limitation may provide the Financial Group with opportunities. Financial Groups with significant interest income may be uniquely positioned to utilize their excess interest income posture by offering alternative financing structures, such as sale leasebacks, to taxpayers that face the 30% net business interest cap. Figure 3 demonstrates an example of a tax benefit that can be created by a sale leaseback of equipment where a bank acts as a lessor.

Consider a client that finances equipment through a conventional loan secured by a pledge of the equipment and interest payments. In that case, the client would continue to deduct depreciation under the applicable schedules and could potentially be subject to interest

FIGURE 3.



expense disallowance under Code Sec. 163(j) if its ATI is insufficient. Alternatively, as shown in Figure 3, the client could sell the equipment to a Financial Institution's special purpose vehicle (treated as a disregarded entity for tax purposes) and lease the equipment back in exchange for rental payments. The tax cost to the selling client would equal 21% of the difference between the fair market value of the equipment and its tax basis. The acquisition of the equipment by the Financial Institution may qualify for the 100% bonus depreciation deduction under Code Sec. 168(k), allowing it to immediately realize tax savings of 21% of the entire purchase price of the equipment.[83] The rental payments would not be subject to the Code Sec. 163(j) limitations, because they are not characterized as interest for U.S. tax purposes, provided that the transaction would be characterized as a sale and lease back under the existing guidance.[84] The Financial Institution on the other hand may retain its ability to fully deduct any interest payments incurred on amounts borrowed to finance the equipment purchase despite the 30% cap, as it would generally have excess interest income unrelated to this transaction providing sufficient cushion for the deduction.

U.S. parented Financial Institutions that conduct predominantly U.S. activities and do not engage in significant cross-border business with foreign affiliates may now have a competitive advantage over both U.S. parented and non-U.S. parented Financial Groups with respect to transactions that generate certain U.S. tax credits. As discussed in Part IV.C below, the value to a Financial Group of various GBCs may be significantly affected by whether the Financial Group is potentially subject to the BEAT. A Financial Group may not be able to take full advantage of the tax benefit of the LIHTC, PTC, and ITC and might anticipate losing any of these benefits altogether after 2025. It remains to be seen whether the effects of the BEAT will change the landscape of the deals that generate GBCs.

B. Subpart F, GILTI, and Branches—U.S. Parented Financial Groups

Figure 1 in Part III illustrates a simplified organizational structure of a U.S. parented Financial Group. Because of such structure, the mix of assets and how such entities conduct business, U.S. parented Financial Groups face a combination of issues arising from the interplay between the branch regime, the continued application of Subpart F regime, and the new GILTI regime.

For U.S. parented Financial Groups with CFCs, the TCJA is as important for what it enacted as for what it did not enact. For the last several years, as various tax reform proposals played out in Washington, it was reasonable to believe that with all the discussion of U.S. competitiveness, the lockout effect on overseas earnings, and the overall notion of a territorial regime, Subpart F would be scaled back and remain in place only for the narrow category of passive personal holding company income which has been the target of offshore anti-deferral rules for decades. Instead, but for a narrow repeal of the Subpart F category of certain oil-related income, U.S.-based multinational corporations must continue navigating the Subpart F rules, but now must do so in tandem with understanding how they interact with the new GILTI regime. The following is a discussion of the issues particularly relevant to Financial Groups.

Under Code Sec. 954(c), foreign personal holding company income generally includes interest and dividends; net gains from sales or exchanges of property that give rise to the preceding types of income; net gains from commodities transactions; net gains from foreign currency transactions; income that is equivalent to interest (including income from commitments or similar amounts); and net income from notional principal contracts.[85] The "inventory" of Financial Groups is money and financial contracts. As such, the income of Financial Groups (hereafter "Financial Contracts

Income") will, by definition, be of a type that would generally constitute Subpart F income. Therefore, absent an exception, Financial Contracts Income would generally be included in the income of a U.S. Shareholder under Code Sec. 951(a). Any Financial Contracts Income included in Subpart F would be excluded from GILTI under the general exception from GILTI tested income for Subpart F income.[86]

Importantly, however, certain Financial Contracts Income of a CFC can be excluded from Subpart F income (and thus not entitled to the general exception from GILTI tested income) under two notable exceptions, the Active Financing Exception and the exception for income subjected to sufficiently high foreign taxes under Code Sec. 954(b)(4) (the "High-Tax Exception").[87] The Active Financing Exception, or AFE, is described in Part II.D.2 above and is well known to Financial Institutions. The High-Tax Exception provides that foreign base company income does not include any item of income received by a CFC if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90% of the maximum rate of tax specified in Code Sec. 11.[88] With the TCJA reducing the domestic corporate tax rate to 21%, the High-Tax Exception is now available when the effective rate of foreign tax is greater than 18.9% (as opposed to 31.5% under prior law).[89] Because Financial Contracts Income is often subject to higher effective rates of tax in foreign countries than other types of income, the High-Tax Exception may be more frequently available to CFCs of Financial Groups. The interaction of the AFE and the High Tax Exception creates a matrix of alternative treatments for Financial Contracts Income.

1. Financial Contracts Income That Does Not Qualify for the Active Financing Exception

Typically, Financial Contracts Income derived by a CFC of a Financial Institution will qualify for the AFE. But in the limited circumstances in which it does not so qualify, whether such income constitutes Subpart F income will typically hinge on application of the High-Tax Exception. As discussed below, income which is excluded from Subpart F income solely by reason of the High-Tax Exception does not constitute GILTI tested income and any foreign taxes incurred with respect to such income may end up being ineligible for the FTC, because income that is eligible for the participation exemption under Code Sec. 245A does not get taxed in the United States upon distribution. Financial Contracts Income not eligible for either the AFE or the High-Tax Exception would generally be treated as Subpart F income and be subject to the regular FTC rules applicable to Subpart F income.[90]

a. Financial Contracts Income Eligible for the High-Tax Exception.

i. General. Financial Contracts Income earned by a CFC that does not qualify for the AFE is nevertheless excluded from Subpart F income if the High-Tax Exception applies. Such Financial Contracts Income that would otherwise be Subpart F income but satisfies the High-Tax Exception will also not constitute GILTI, because GILTI tested income does not include any gross income excluded from foreign base company income by reason of the High-Tax Exception.[91] Accordingly, such Financial Contracts Income will not be includible as either Subpart F income or GILTI.[92]

If the earnings attributable to this income are distributed or recognized as dividend equivalent gain under Code Sec. 1248, they generally will qualify for the participation exemption under Code Sec. 245A. If, however, the earnings are treated as invested in U.S. property within the meaning of Code Sec. 956, the U.S. Shareholder generally will have a Code Sec. 956 inclusion of those earnings, taxable at 21% but with available FTCs for corporate U.S. Shareholders, due (as discussed above) to the unexpected retention of Code Sec. 956 as applicable to corporate U.S. Shareholders.

ii. Foreign Tax Credits. If such earnings are distributed through a dividend for which a deduction is allowed under Code Sec. 245A, no FTC is allowed.[93] However, if the earnings are treated as invested in U.S. property within the meaning of Code Sec. 956, a corporate U.S. Shareholder generally will be entitled to a credit for foreign taxes deemed paid by the CFC under Code Sec. 960. Such FTCs will be general limitation for purposes of the separate application of FTC baskets if they are either treated as "financial services income" under 904(d)(2)(C)[94] or are subject to at least a 21% tax rate.[95] If neither, the FTCs generally will be passive category for FTC purposes.

b. Financial Contracts Income Not Eligible for the High-Tax Exception.

i. General. Financial Contracts Income earned by a CFC that does not qualify for either the AFE or the High-Tax Exception would generally be includible as Subpart F income.[96] If included in Subpart F, such income would not constitute GILTI due to the Subpart F exception from GILTI tested income.[97]

ii. Foreign Tax Credits. A corporate U.S. Shareholder is entitled to a credit for foreign taxes deemed paid with respect to Financial Contracts Income included under Subpart F.[98] This income would be general category income if treated as "financial services income" under 904(d)(2)(C), and if not, would likely be passive income for FTC limitation purposes.[99]

2. Financial Contracts Income That Qualifies for the Active Financing Exception

More typically, Financial Contracts Income derived by a CFC of a Financial Group will qualify for the AFE. In that case, such income is excluded from foreign personal holding company income and will not constitute Subpart F income. The question then becomes whether such income constitutes GILTI tested income.

a. Financial Contracts Income Not Eligible for the High-Tax Exception.

i. General. Financial Contracts Income that qualifies for the AFE but not the High-Tax Exception would likely constitute GILTI tested income as it would not qualify for the exception from tested income under Code Sec. 951A(c)(2)(A)(i)(III).[100]

ii. Foreign Tax Credits. As discussed in Part II.C.2 above, for foreign tax credit purposes, a corporate U.S. Shareholder is deemed to have paid 80% of the foreign income taxes allocable to GILTI tested income. Any creditable foreign taxes with respect to GILTI tested income generally are treated as being in a separate FTC basket under Code Sec. 904(d), and such amounts may not be carried back or forward under the general carryover rules of Code Sec. 904(c).

Financial Contracts Income that qualifies for the AFE would, however, also likely meet the definition of financial services income for purposes of Code Sec. 904(d)(2)(C).[101] This raises a separate question of whether such income should remain in the GILTI category under Code Sec. 904(d)(1)(A) or, alternatively, should be placed in the general limitation category by reason of Code Sec. 904(d)(2)(C). Code Sec. 904(d)(2)(C) financial services income is treated as general category income for foreign tax credit purposes. The TCJA did not change this provision. Further guidance is needed to address the apparent conflict between these two provisions on how to categorize GILTI tested income which would also meet the definition of financial services income.[102]

b. Financial Contracts Income Eligible for the High-Tax Exception.

i. General. Financial Contracts Income that qualifies for the AFE is not included in foreign personal holding company income and is therefore excluded from Subpart F.[103] If such income also qualifies for the High-Tax Exception, a question arises as to whether it is included in GILTI tested income. Given that there is an exception from GILTI tested income for income which qualifies for the High-Tax Exception, an initial reaction might be that such income is not GILTI tested income.

Code Sec. 951A(c)(2)(A)(i)(III) provides that tested income for GILTI purposes does not include "any gross income excluded from the *foreign base company income* (as defined in Section 954) … of such corporation by reason of [the High-Tax Exception]."[104] Code Sec. 954 defines "foreign base company income" as the sum of *foreign personal holding company income*, foreign base company sales income, and foreign base company services income.[105] However, income that qualifies for the AFE is not treated as foreign personal holding company income in the first place and therefore not included when calculating foreign base company income. In that case, the High-Tax Exception is not applicable since there is no foreign base company income to exclude.[106] In other words, one never gets to the High-Tax Exception under Code Sec. 954 because such income is already outside the scope of foreign personal holding company income due to the AFE.

It would appear therefore that such income would be treated as GILTI tested income, as it would neither be Subpart F income nor excluded from Subpart F income by reason of the High-Tax Exception.[107] From a policy perspective, it may not make sense to sweep income into GILTI which is both active and subjected to sufficiently high foreign taxes.[108] At the same time, there are many categories of income outside of the financial services area that may be high taxed yet still fall within the sweep of GILTI tested income. For example, active business or manufacturing income which is not foreign base company sales or services income does not need the High-Tax Exception to remove it from foreign base company income, but such income would be considered GILTI tested income.

ii. Foreign Tax Credits. Assuming such income is GILTI tested income, it would be subject to the rules, and issues, discussed in Part IV.B.2.a above. If on the other hand such income is not treated as GILTI, and is distributed through a dividend for which a deduction is allowed under Code Sec. 245A, no foreign tax credit is allowed. However, if the earnings are treated as invested in U.S. property within the meaning of Code Sec. 956, a U.S. Shareholder will be entitled to a credit for any foreign taxes deemed paid under Code Sec. 960.

Assuming such income is excluded from GILTI by reason of the High-Tax Exception, if such income is included in U.S. Shareholder's income pursuant to Code Sec. 956, such income should also qualify for the general category income basket under the high-taxed exception in Code Sec. 904(d)(2)(B) assuming the requirements of such Section are met.[109]

The application of the GILTI and Subpart F rules with respect to Financial Contracts Income as described in this Part IV.B. is summarized in the flowchart in Figure 4.

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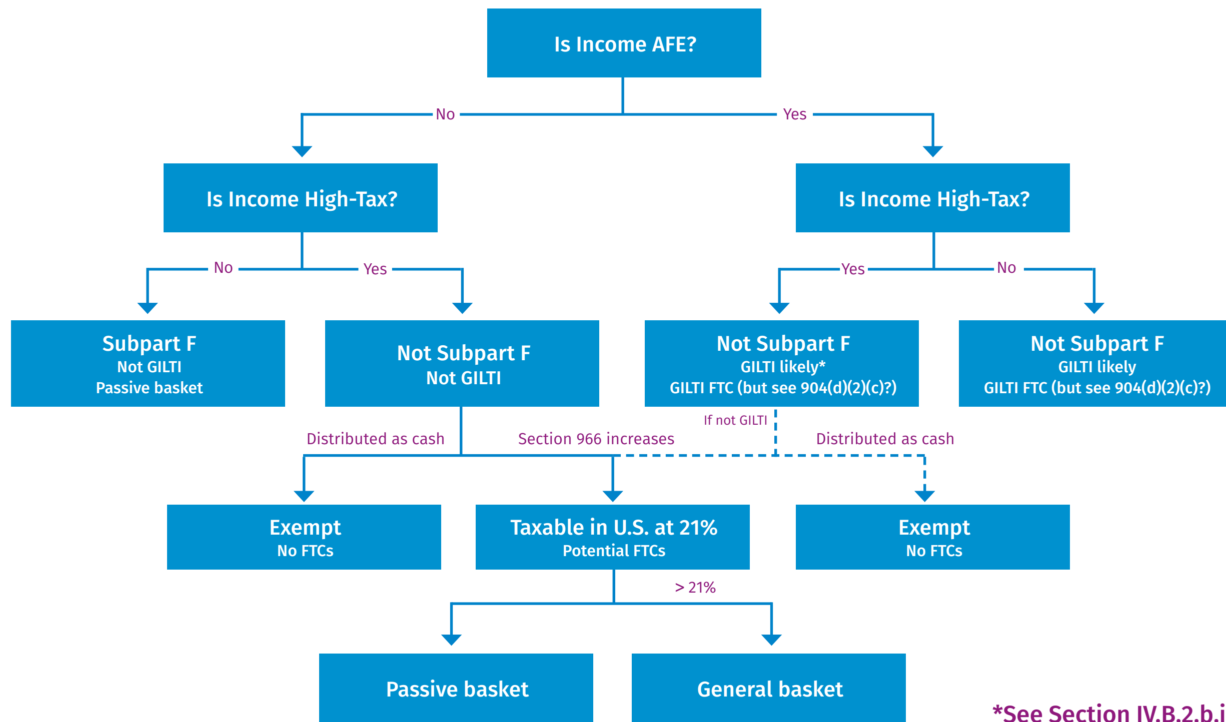
FIGURE 4.



3. Branch Income

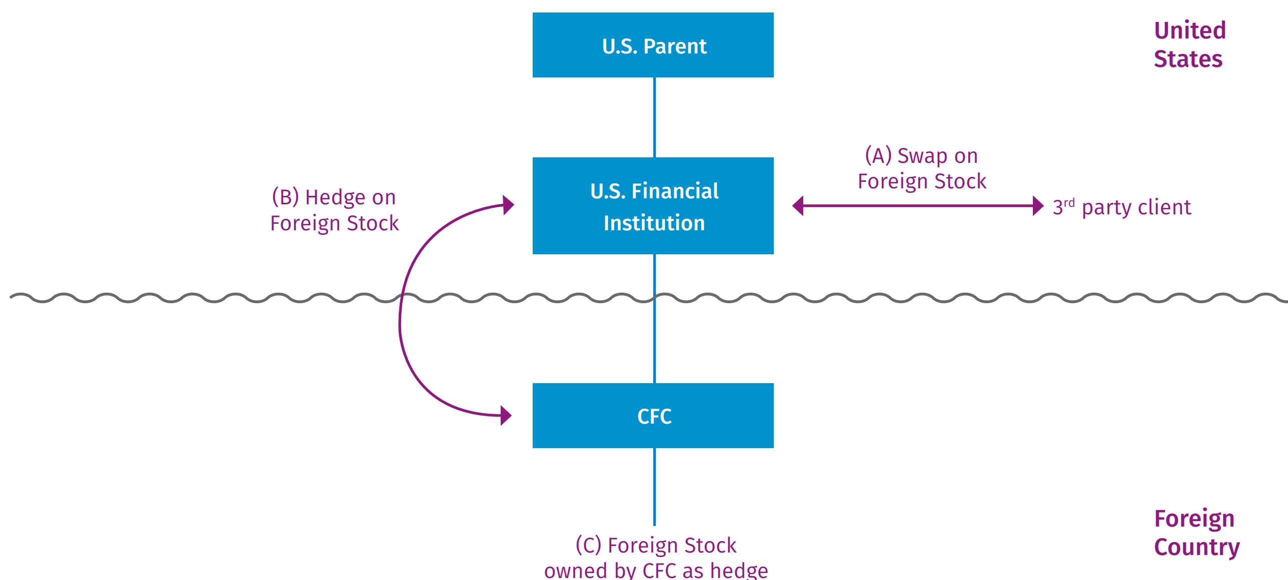
As discussed above, a U.S. parented Financial Group may generate a significant portion of its overseas earnings through branches of U.S. corporations which are Financial Institutions. The TCJA did not change U.S. taxation of foreign earnings of branches of U.S. companies, which continue to be fully taxed at the applicable U.S. corporate tax rate.[110] The TCJA did, however, create a separate foreign tax credit basket applicable solely to non-passive foreign branch earnings, which means that foreign taxes imposed on such earnings cannot reduce U.S. tax imposed on any other income (*e.g.,* income earned in the United States or deemed distributed to the United States through the application of Code Sec. 956), including general category income.[111] Because the foreign tax credit rules applicable to branch income generally are more favorable than those applicable to GILTI,[112] there may now be more circumstances than under prior law in which earning income through a branch is more preferable than earning income through a CFC, despite the lower tax rate applicable to GILTI.

In particular, in a foreign jurisdiction with the effective rate of tax at or above the U.S. tax rate of 21%, operating through a branch may be preferable to operating through a CFC. Neither branch income nor GILTI should generally produce significant incremental U.S. tax liability due to the availability of the FTCs[113] but the ability to use FTC carryovers and carrybacks under the branch regime may provide benefits not available under the GILTI regime. By contrast, there may be situations where conducting activities through a CFC would still be preferable to a branch. If the local jurisdiction imposes no or very low tax, GILTI inclusions would benefit from the Code Sec. 250 GILTI deduction, which would reduce the U.S. tax rate to 10.5%, while any income earned through a branch would be subject to the full 21% tax rate. Ultimately, the most beneficial location of foreign income may depend on the mix of relative high- and low-taxed income in the CFCs and in the branches.[114]

C. BEAT

As discussed above in Part III, the interconnected global nature of a Financial Group makes cross-border payments between affiliates a business necessity and creates multiple situations that could result in a "base erosion payment" under the BEAT. Five examples below illustrate commonplace intercompany transactions and analyze their

FIGURE 5.



possible treatment under the BEAT. The sixth example illustrates the numeric operation of the BEAT through scenarios. The first three transactional examples apply with equal force to U.S. parented Financial Groups or to U.S. Financial Institutions that are a part of non-U.S. parented Financial Groups. The last two transactional examples are specific to non-U.S. parented Financial Groups. Whether certain of such payments that appear to be treated as base erosion payments should be so treated for policy reasons may not be clear.

Example 1. U.S. Parent, intercompany derivative (*see* Figure 5). A U.S. customer wants exposure to Foreign Stock, which can only be held by institutional investors licensed in Foreign Country. U.S. Financial Institution enters into a derivative contract on Foreign Stock with the customer and also enters into another derivative contract with CFC, which is a licensed investor in Foreign Country. U.S. Financial Institution makes payments under the derivative to CFC. Because U.S. Financial Institution generally would qualify as a dealer in securities under Code Sec. 475, it would be required to mark to market its derivative with CFC. In that case, under Code Sec. 59A the payments made by U.S. Financial Institution under the intercompany derivative would not be considered base erosion payments and would be excluded from both the numerator and denominator of the base erosion percentage. Gross payments and mark-to-market losses that U.S. Financial Institution would recognize on the derivative with the customer would constitute deductions which would arguably be included in the denominator of the base erosion percentage.[115]

Example 2. U.S. Parent, repo (*see* Figure 6). CFC needs to obtain U.S. Treasuries to fill an order from a local customer, and therefore U.S. Financial Institution enters into a repurchase agreement ("repo") with CFC (selling U.S. Treasuries to CFC with the obligation to buy U.S. Treasuries back at a pre-determined price). Depending on the facts, the repo may be treated as either a collateralized loan of money by CFC to U.S. Financial Institution, on which U.S. Financial Institution will pay interest, or a securities loan, with CFC paying a borrow fee and U.S. Financial Institution paying an interest charge.[116] It is currently unclear whether a repo in this case qualifies as a derivative under Code Sec. 59A(h), the payments under which would be exempt from the BEAT. If the repo is treated as a collateralized loan, and the payments are treated as interest, then such payments could be considered base erosion payments subject to the BEAT. If the repo is characterized as a securities loan, there is a good argument that it is treated as a derivative, and assuming that all other requirements for exclusion are met, should benefit from the derivatives exclusion.[117] However, the interest charge paid on cash collateral in any event appears to be treated as a base erosion payment pursuant to the carve-out

FIGURE 6.

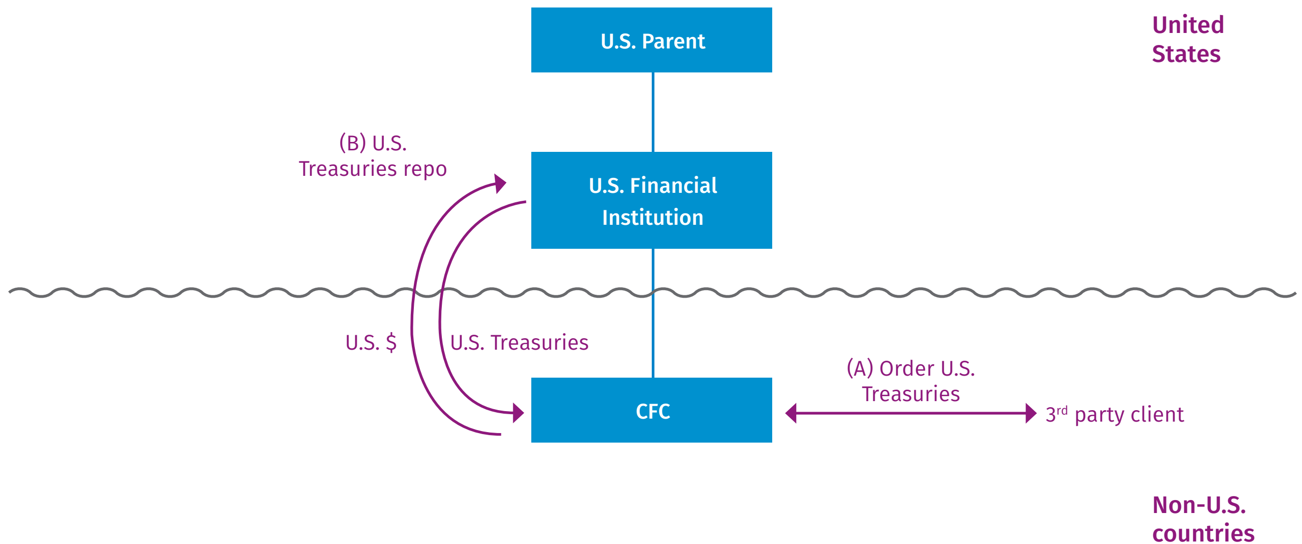
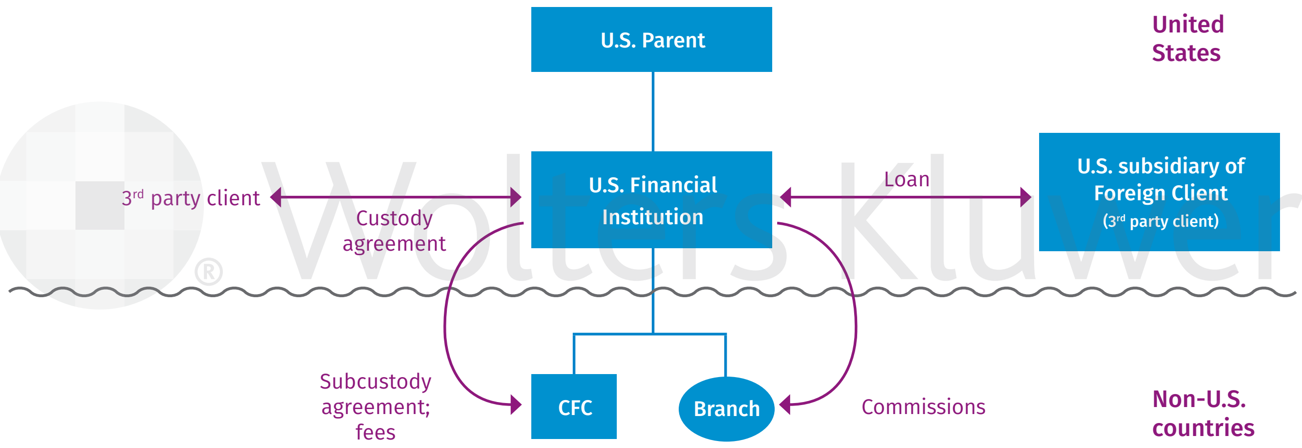


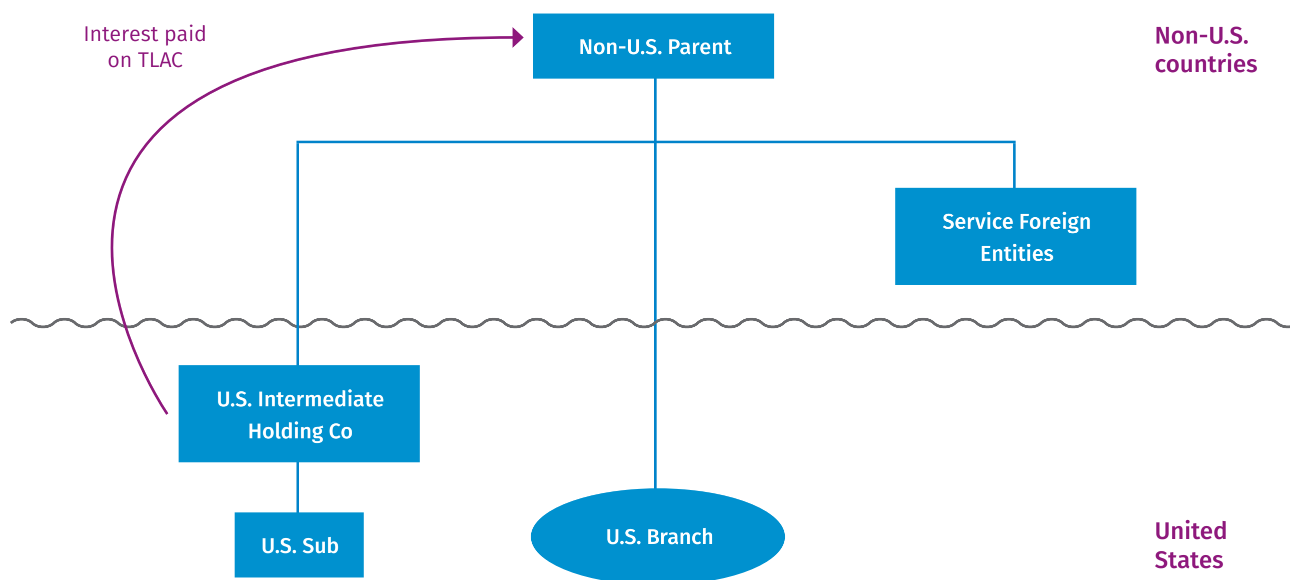
FIGURE 7.



from the derivative treatment in Code Sec. 59A(h)(3), stating that payments of interest, royalty or service payments cannot benefit from the derivative contract exception.

Example 3. U.S. Parent, service fees versus revenue shares; disregarded payments (*see* Figure 7). U.S. Financial Institution custodies securities for an institutional client based in the United States. The institutional client invests in a variety of foreign securities, which must be custodied abroad. CFC provides custody services for certain securities in Foreign Country, where such foreign securities are listed. CFC provides its custody services to U.S. Financial Institution, as the global custodian, rather than directly to the client. U.S. Financial Institution compensates CFC for its services by paying a custody fee that is required to have a markup component to comply with the applicable transfer pricing rules in Foreign Country, where CFC is resident. U.S. Financial Institution also lends money to a U.S. subsidiary of Foreign Client, a customer that is a foreign corporation. The relationship banker for Foreign Client is employed by Branch in the country of the Foreign Client's incorporation. U.S. Financial Institution compensates Branch for the banker's services to comply with

FIGURE 8.



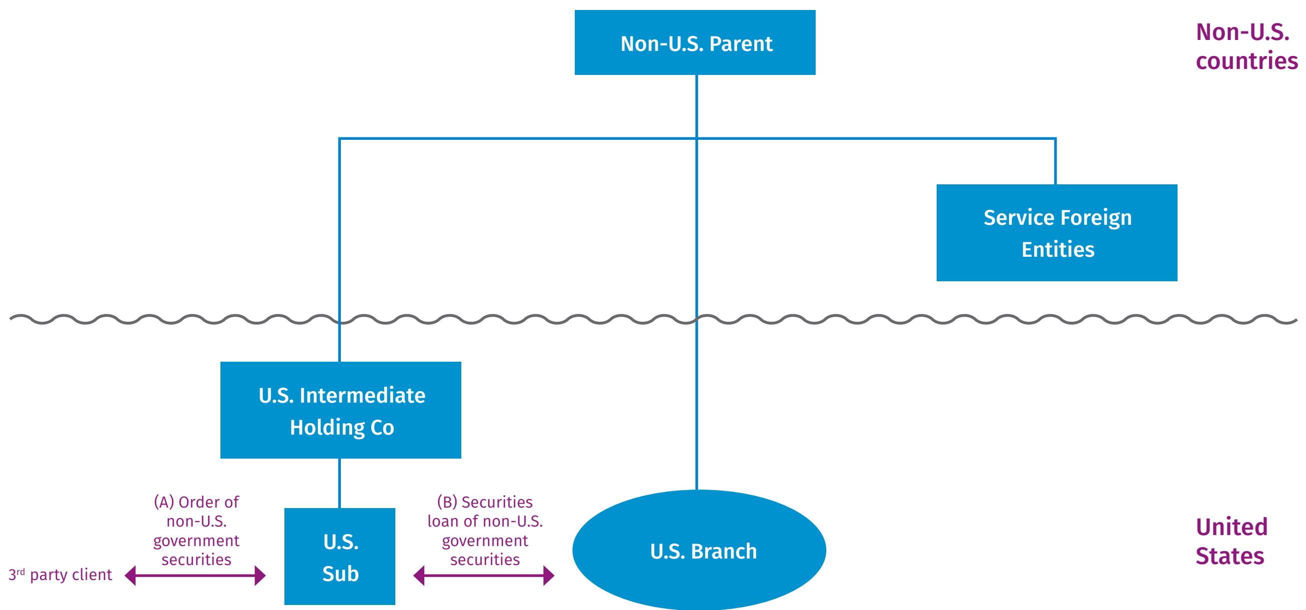
the appropriate transfer pricing rules. If the custody fee is characterized as compensation for services, it likely would be considered a base erosion payment because services with markup components appear to be disqualified from the BEAT services exception.[118] However, if the custody fee is structured as a reduction in gross receipts because it is a revenue share (where U.S. Financial Institution is treated as receiving a portion of the fee on behalf of CFC), such payment could fall outside of the BEAT regime because it is not a deductible payment.[119] By contrast, regardless of the characterization of the compensation paid by U.S. Financial Institution to Branch for assistance with lending to U.S. subsidiary of Foreign Client, the payment would be disregarded for purposes of the BEAT, because it would be treated as non-existent for U.S. tax purposes and would not be deductible.

Example 4. Non-U.S. Parent, TLAC (*see* Figure 8). For regulatory capital purposes, U.S. Intermediate Holding Co is required to issue a subordinated note to Non-U.S. Parent. The note pays interest. The interest payment appears to be treated as a base erosion payment under the BEAT regardless of the fact that it is required under the regulatory framework.

Example 5. Non-U.S. Parent, ECI payment (*see* Figure 9). U.S. Sub of non-U.S. parented Financial Group needs to obtain foreign government securities to fill U.S. customer orders and therefore enters into a securities lending agreement with the U.S. branch of Non-U.S. Parent whereby U.S. Sub borrows securities with the promise to return securities at a later date. U.S. Sub is required to pay a borrow fee to U.S. Branch. As discussed in Example 2, although it is uncertain, there is a good argument that a securities loan in this case could qualify as a derivative, the payment under which would be exempt from the BEAT. In this case, the borrow fee received by U.S. Branch would be treated as income effectively connected with the U.S. trade or business and therefore subject to the U.S. taxation on a net basis. Therefore, the payment would not decrease the Financial Group's U.S. tax base. In view of that, it may be argued that treating such payments as subject to the BEAT would be contrary to the intent of the statute. However, another view is that the BEAT also has replaced the alternative minimum tax, and therefore its operation should not necessarily be conditioned on the reduction in the taxable income due to base erosion.[120] Under that view, a payment that constitutes effectively connected income to the recipient may still be properly treated as a base erosion payment with respect to the payor.

Example 6. Effect of tax credits on BEAT. As discussed above, Financial Groups have several types of payments that raise concerns from the perspective of the BEAT and could cause a group to meet the

FIGURE 9.



base erosion percentage and therefore become an applicable taxpayer. However, what also may create or significantly increase the BEAT liability is the effective disallowance of foreign tax credits and a portion of the GBCs (until 2025, after which all GBCs would be disallowed). While for non-U.S. parented Financial Groups the BEAT liability may be created primarily due to sufficiently high amounts of related party tax deductions, for U.S. parented Financial Groups, the BEAT liability could result due to the Financial Institution's significant amounts of foreign income subject to foreign tax creditable for purposes of the regular U.S. tax liability.

The effect of the disallowance of the foreign tax credits for BEAT purposes is especially concerning due to the fact that most U.S. parented Financial Groups with extensive non-U.S. operations likely would be subject to U.S. tax on most of their offshore earnings as either branch income, GILTI or Subpart F income. Under GILTI in particular, a potential significant reduction in the amount of the FTCs that the U.S. Financial Group could benefit from if it becomes subject to the BEAT produces a counterintuitive result. GILTI appears to have been enacted with the stated intent to function as a type of minimum worldwide tax on certain income implemented through the mechanism of reduced FTCs. The BEAT unexpectedly acts as a second level of minimum U.S. tax on *any* income. It is unclear whether this result was also intended by the lawmakers, because the interplay between GILTI and BEAT was not discussed by the legislative history.

Consider the following situation illustrated in Table 2, which shows the application of the BEAT to a Financial Group. Table 2 demonstrates how different types of items may influence the amount of the BEAT owed. The base case (Scenario 1) shows a Financial Group taxpayer at the 2% threshold (and thus subject to BEAT) but with $0 of BEAT liability. When the percentage of deductible intercompany "base erosion payments" is greatly increased to 38% (Scenario 2), the BEAT liability becomes significant. Note, however, that the taxpayer would have the same significant amount of BEAT liability without any increase to intercompany payments if either it instead generated additional GILTI (Scenario 3) or there was simply an increase in the proportion of its overall income earned through a foreign branch versus U.S. domestic income (Scenario 4), because in each case the additional FTCs associated with the additional foreign income are effectively not fully creditable.[121] This computation demonstrates that the BEAT does not function solely as an anti-base erosion tax, but also could be fairly described as, similar to GILTI, a minimum U.S. tax on global earnings.

TABLE 2.

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
	Base	Increase in Related expense	Increase in GILTI	Increase in foreign branch income
U.S. gross revenue	$ 1,000	$ 1,000	$ 1,000	$ 1,000
Total U.S. tax deductions	$ (500)	$ (500)	$ (500)	$ (500)
Related party tax deductions (included in total)	$ (10)	**$ (190)**	$ (10)	$ (10)
Net foreign branch income (before taxes) (Incl in total)*	$ 100	$ 100	$ 100	**$ 200**
GILTI	$ 350	$ 350	**$ 700**	$ 350
GILTI deduction	$ (175)	$ (175)	$ (350)	$ (175)
Regular U.S. Tax Calculation				
Net taxable income	$ 675	$ 675	$ 850	$ 675
21% tax	$ 142	$ 142	$ 179	$ 142
Foreign tax paid on branch income at 20%	$ 20	$ 20	$ 20	$ 40
[Branch basket FTC limitation at 21%]	$ 21	$ 21	$ 21	$ 42
Branch FTC (100% of branch tax paid, up to limit)	$ (20)	$ (20)	$ (20)	$ (40)
Foreign tax paid on GILTI at 20%	$ 70	$ 70	$ 140	$ 70
GILTI basket FTC limitation at 21%	$ 37	$ 37	$ 74	$ 37
GILTI FTC (80% of GILTI tax paid, up to limit)	$ (37)	$ (37)	$ (74)	$ (37)
Net regular U.S. tax liability	**$ 85**	**$ 85**	**$ 85**	**$ 65**
BEAT Calculation				
base erosion percentage	2%	38%	2%	2%
base erosion tax benefits (add back)	$ 10	$ 190	$ 10	$ 10
Modified Taxable Income	$ 685	$ 865	$ 860	$ 685
11% tax (BEAT minimum amount)	$ 75	$ 95	$ 95	$ 75
BEAT liability	**$ 0**	**$ 10**	**$ 10**	**$ 10**
Total U.S. tax paid	$ 85	$ 95	$ 95	$ 75
Foreign tax paid	$ 90	$ 90	$ 160	$ 110
Total tax burden	$ 175	$ 185	$ 255	$ 185
Effective Tax Rate	20.5882%	27.4296%	29.9529%	27.4593%

* The net foreign branch income is included in the aggregate of U.S. gross revenue and Total U.S. tax deductions.

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As the computation above shows, under the BEAT, a U.S. parented Financial Group that is already subject to the BEAT does not receive any benefit from additional FTCs. Likewise, the benefit of any GBCs is reduced by 20% until 2025 and eliminated after 2025.[122] Accordingly, there is heightened potential for taxpayers that (i) have a high share of earnings coming from non-U.S. sources (including GILTI) that generate foreign tax credits, (ii) that generate a lot of GBCs (as many Financial Institutions do) or (iii) that have NOLs, in each case, to have a significant BEAT liability, even if they do not have a large amount of related party payments.

D. Code Sec. 956

The retention of Code Sec. 956 has an impact on Financial Institutions as both taxpayers and as lenders. Traditionally, U.S. parented Financial Groups have been subject to Code Sec. 956 to the same extent as any other U.S. parented multinational group, with the exception that U.S. Shareholders can maintain deposits in U.S. affiliate banking institutions, and Code Sec. 956(c)(2)(I) and (J) permit U.S. Shareholders to engage in ordinary course of business repo and securities lending transactions with their CFCs that are treated as broker-dealers.

U.S. borrowers have generally resisted having their non-U.S. subsidiaries guarantee their indebtedness, in order to avoid triggering U.S. federal income taxes due to income inclusions under Code Sec. 956. In addition, U.S. borrowers have generally only allowed a pledge of the equity of a non-U.S. subsidiary that is held directly by the U.S. borrower or one of its U.S. affiliates (and often only if the U.S. affiliate is not owned directly or indirectly by a non-U.S. subsidiary), and such pledge is typically limited to less than two-thirds of the equity of the non-U.S. subsidiary.[123] However, for a group with substantial non-U.S. subsidiaries, a U.S. borrower may obtain better financing terms such as lower interest rates if non-U.S. subsidiaries and their equity are available to support the credit of such U.S. borrower. Occasionally, lenders will refuse to lend without the support of non-U.S. subsidiaries. Therefore, it may be to the benefit of both Financial Groups, as lenders, and U.S. borrowers to make non-U.S. subsidiaries available to support U.S. borrowings.

Although the TCJA retained Code Sec. 956 without modification, the changes made under the TCJA indirectly affect the scope of Code Sec. 956. For example, triggering income inclusions under Code Sec. 956 could be very tax-inefficient because the result is more than merely a timing difference. Prior to the TCJA, distributions made by a CFC would be potentially taxable as dividend income, to the extent of such CFC's current or accumulated earnings and profits.[124] Amounts distributed by a CFC that represent PTI under either Subpart F or Code Sec. 956 are not taxed again when actually distributed by the CFC.[125] Therefore, an inclusion under Code Sec. 956 could previously be viewed as an acceleration of income that would have been eventually taxed when the CFC makes an actual distribution (or the stock of such CFC is sold). However, under the TCJA, because actual distributions by a CFC are potentially exempt if received by a corporate U.S. Shareholder eligible for the participation exemption, inclusions under Code Sec. 956 could result in U.S. taxation of earnings that would never otherwise be imposed. Therefore, for certain taxpayers, avoiding Code Sec. 956 is now even more important than prior to the TCJA.

On the other hand, the TCJA creates more opportunities to limit the actual scope of Code Sec. 956 than under prior law.[126] For example, the one-time mandatory inclusion of previously untaxed earnings and profits under Code Sec. 965[127] could create a large amount of PTI, allowing for tax-free inclusions under Code Sec. 956 to the extent of such PTI. Also, the participation exemption under Code Sec. 245A potentially allows a CFC to make actual distributions free of U.S. net income taxation while reducing earnings and profits.[128] If earnings and profits are eliminated, Code Sec. 956 would not result in taxable income to a CFC's U.S. Shareholders.

Furthermore, if a CFC has little income that is not already subject to inclusion by a U.S. Shareholder as Subpart F or GILTI (*e.g.,* the CFC has little or no tangible assets), Code Sec. 956 should have little impact on such CFC, assuming the GILTI regime applies prior to Code Sec. 956, which appears to be the case.[129] In such case, a CFC that has little income not already subject to Subpart F or GILTI may guarantee, and may allow all of its shares to be pledged in support of, a U.S. borrower without a substantial tax arising as a result of Code Sec. 956. For many borrowers, this might be the most common result. However, because GILTI is computed on an aggregated worldwide basis, while Code Sec. 956 applies on a CFC-by-CFC basis, Code Sec. 956 exposure may emerge unless earnings and profits of CFCs that provide credit support are carefully monitored. Specifically, because GILTI tested income of some CFCs may be reduced by tested losses of other CFCs, with the resulting GILTI being subsequently allocated solely to CFCs with tested income, a particular CFC could end up with earnings and profits treated as untaxed for PTI purposes. If such a CFC has previously provided a guarantee or pledged all of its shares in support of a U.S. affiliate, such untaxed earnings and profits could give rise to a Code Sec. 956 inclusion.[130]

Because of this interplay between the GILTI and Subpart F regimes, it is possible that a U.S. parented Financial Group's CFCs would have little untaxed earnings and profits. If all of the group's CFC earnings have been taxed currently and treated as PTI, even though Code Sec. 956 technically remains a part of the U.S. tax law there may be more flexibility to enter into intercompany borrowings between various affiliates without the necessity to restrict such borrowings to deposit taking or the exceptions of Code Secs. 956(c)(2)(I) and (J). Caution, however, is warranted to ensure that the allocation of the worldwide GILTI for purposes of determining each CFC's PTI does not cause pockets of untaxed earnings and profits that may become subject to Code Sec. 956 inclusion.

V. Conclusion

As discussed in this article, the changes in U.S. federal income taxation made by the TCJA will have a significant impact on Financial Groups due to their interconnectedness and global footprint. The reduction in corporate tax rate is likely to provide a significant benefit, and the new Code Sec. 163(j) and increased flexibility to deal with the retained Code Sec. 956 may allow some business opportunities to the Financial Groups as providers

of financing products. However, the combination of the new provisions enacted by the TCJA, such as GILTI and BEAT, together with the modification of the FTC regime, may create unique tax costs and challenges for Financial Groups. Importantly, the tax rules have increased in the level of complexity, which would likely result in a substantial increase in the costs of tax planning and compliance.

Because of the significant regulatory restrictions on the manner in which Financial Groups operate, their ability to restructure their operations may be limited, at least in the shorter term. In the longer term, assuming that the new rules discussed in this article are retained in their current form after the expected technical corrections, and their interpretation is not significantly shifted by the expected Treasury and IRS guidance, Financial Groups may consider maximizing income in high tax jurisdictions earned through branches or disregarded entities due to the more flexible FTC rules applicable to such income and maximizing GILTI inclusions from low tax countries due to the availability of the GILTI deduction. Further, checking the box to disregard for U.S. tax purposes foreign affiliates that receive substantial payments from the U.S. related parties may mitigate exposure to the BEAT.

With increased pressure on managing foreign taxes and an incentive for Financial Groups present in the United States to minimize payments from the United States to foreign affiliates, it is also reasonable to anticipate increased tax controversy activity in other countries. Furthermore, other jurisdictions may respond legislatively to some of the provisions in the TCJA, which may affect Financial Groups present in those jurisdictions.

Many uncertainties exist under each provision discussed above, and more importantly, in how these new provisions interact with each other and with the pre-existing provisions. Government guidance that takes into account unique features of Financial Groups would be important to minimize any unintended consequences and facilitate smooth implementation of the new rules by the financial industry.

ENDNOTES

[*] The authors wish to thank Valentin L. Riazanov for his comments and assistance on this article.

[1] The Tax Cuts and Jobs Act (P.L. 115-97) (Dec. 22, 2017).

[2] For purposes of this article, a Financial Institution generally is a bank (as defined in Code Sec. 581) or registered securities dealer under Code Sec. 15(a) of the Securities Exchange Act of 1934. *See also* Code Sec. 59A(b)(3)(B). This article does not address insurance companies or any other taxpayers that are subject to special tax rules. Finally, issues specific to smaller banks with exclusively U.S. operations, community banks or closely held banks organized as S Corporations also are outside of the scope of this article. Further, the discussion in this article is limited to the effect on corporations and corporate shareholders, and therefore, unless stated otherwise, any reference to shareholders or taxpayers is intended to refer to corporations.

Unless otherwise indicated, all section numbers refer to Code sections in effect after the passage of the TCJA.

[3] The TCJA also enacted a one-time mandatory transition tax on all previously untaxed earnings of certain foreign corporations. *See* Code Sec. 965. This provision raises many pressing issues, and the IRS has already issued initial guidance on the application of Code Sec. 965. *See* Rev. Proc. 2018-17, 2018-9 IRB 384, Feb. 13, 2018, Notice 2018-7, 2018-4 IRB, Dec. 29, 2017, and Notice 2018-13, 2018-6 IRB 341, Jan. 19, 2018. Discussion of Code Sec. 965 is beyond the scope of this article.

[4] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, H.R. 1, (H.R.) 115th Cong. (Nov. 2, 2017); H.R. 1 (Senate) 115th Congress (Dec. 2, 2017).

[5] All terms used in this article are being used within their tax meaning and are not intended to create any inference about any regulatory treatment of entities, transactions or activities.

[6] This Part II is intended to provide a high level summary of the key enacted changes and, by necessity, omits discussion of multiple issues that could be important in any particular context.

[7] *See Corporate Income Tax Rates Around the World, 2017*, Tax Foundation (Sept. 2017). This comparison ignores any impact of state and local or similar taxes.

[8] *See* Code Sec. 163(j). The limitation does not apply to certain businesses (*e.g.,* business with average annual gross receipts of less than $25 million, certain electing real property businesses, farming businesses, and other designated businesses). *See* Code Secs. 163(j)(3) and (7)(A). The amount of the deduction allowable is increased for "floor financing interest," relating to certain motor vehicle financings.

[9] *See* Code Sec. 163(j)(1).

[10] *See* Code Secs. 163(j)(5) and (6).

[11] *See* H.R. 1, 115th Congress (2017–2018) at 228 (referred to herein as the Conference Report) ("Any amount treated as interest for purposes of the Internal Revenue Code is interest for purposes of the provision."). For example, in the absence of specific IRS guidance, any interest incurred on a debt instrument integrated with a hedge under Reg. §1.1275-6 or 1.988-5 is expected to be treated as interest for purposes of Code Sec. 163(j). *See* Reg. §§1.1275-6(f) (stating that an integrated transaction generally is treated as a single transaction) and 1.988-5(a)(9) (same). *But see* Reg. §1.1275-6(f)(12) (permitting the IRS to specify that the integrated transactions be treated as separate transactions for specific purposes).

[12] *See* Code Sec. 163(j)(8).

[13] *See* Code Sec. 163(j)(8)(B).

[14] By its terms, Code Sec. 163(j) appears to apply to a "taxpayer" and does not provide any rules to apply the limitation at the level of a consolidated group. The Conference Report specifically states that the limitation applies on a group-wide basis for a group filing a consolidated return. *See* Conference Report at 228 ("The limitation applies at the taxpayer level. In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level."). Several government officials have publicly stated that the Treasury and IRS are thinking about how to apply the interest expense cap rules at the consolidated return level. *See, e.g.*, *Business Interest Deductions Parameters Explained*, Tax Notes (Jan. 26, 2018) (citing statement of Brenda Zent, special adviser, Treasury Office of International Tax); *ABA Section of Taxation Meeting: Consolidated Groups Struggle with Tax Law's Vague Rules,* Tax Notes (Feb. 19, 2018) (citing statement of Brett York, associate international tax counsel, Treasury Office of Tax Legislative Counsel).

[15] For partnership debt, the general 30% cap would apply at the partnership level. Any net business interest expense of the partnership in excess of the cap is not currently deductible by a partner but may be carried forward and deducted in a succeeding year, but only to the extent the partner is allocated "excess taxable income" above the 30% cap in a later year from the same partnership that generated the disallowed interest deduction (and the partner satisfies other limitations on deductibility of interest at the partner level). The excess taxable

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income above the 30% cap is also allocated to the partner, and increases the partner's ATI available to offset interest unrelated to the partnership, to the extent such partner does not use it to deduct carried over disallowed interest from the same partnership's prior years. The TCJA also allows a partner to increase basis in its partnership interest upon a disposition for the excess business interest previously incurred that has not yet been utilized. *See generally* Code Sec. 163(j)(4).

[16] *See* Code Sec. 163(j)(2).

[17] Unified Framework for Fixing Our Broken Tax Code, Press Release (Sept. 27, 2017), at 9.

[18] A "U.S. Shareholder" is any "United States shareholder" within the meaning of Code Sec. 951(b). *See infra* Part II.D.1 for a discussion of how the definition of U.S. Shareholder has been expanded by the TCJA.

[19] *See* Code Sec. 245A. The participation exemption applies to dividends received from *any* foreign corporation (*i.e.,* not just CFCs) with respect to which the taxpayer is a corporate U.S. Shareholder. Code Sec. 245A(b)(1).

[20] Earnings accumulated prior to the TCJA are subject to a one-time transition tax to 10% U.S. shareholders *via* a mandatory inclusion of such income at reduced rates. To achieve this result, the deferred foreign income is fully included in the income of the 10% U.S. shareholder and then eligible for a special partial participation exemption. *See* Code Sec. 965(c).

[21] A CFC is a "controlled foreign corporation" as defined in Code Sec. 957. *See infra* Part II.D.1 for a discussion of how the definition of controlled foreign corporation has been expanded by the TCJA.

[22] Generally speaking, Subpart F requires U.S. Shareholders to include certain classes of income earned by their CFCs. *See* Code Secs. 951 and 954. The inclusions are subject to several exceptions, such as the "active financing exception" discussed *infra* Part II.D.2. The amount of a Subpart F inclusion is limited by the CFC's non-previously taxed earnings and profits. *See* Code Secs. 952(c) and 959(a). The U.S. Shareholder's basis is increased by the amount of the inclusion. *See* Code Sec. 961. Upon an actual distribution on the CFC stock, amounts treated as previously included under Subpart F are not again included in a U.S. Shareholder's income. *See* Code Sec. 959(d).

[23] *See infra* Part II.C.2.

[24] Conference Report at 472 (stating in a single sentence, with respect to the repeal of Code Sec. 956 for corporate U.S. Shareholders, that "[t]he conference agreement does not follow the House bill or the Senate amendment").

[25] The use of the word "intangible" in the definition and infrastructure of Code Sec. 951A is in a sense a misnomer, as the income inclusion is generally determined by measuring the CFC's gross income (subject to limited exclusions), and is only reduced by a deemed return on the adjusted tax basis of tangible assets, based on certain assumptions.

[26] Conference Report at 498 and n. 1526. The 13.125% rate results from applying the 50% GILTI deduction and 80% GILTI FTC to the highest corporate rate of 21%.

[27] *See* discussion *infra* Part IV.C example 6 (referring to the interplay between GILTI and BEAT).

[28] For example, in determining the amounts of foreign source income, a U.S. Shareholder must apportion the amount of its own interest expense to its income under the principles of Temporary Reg. §1.861-9T. The practical effect of this rule could be that a portion of the U.S. Shareholder's interest expense deductions would reduce the amount of GILTI treated as foreign source against which a credit may be claimed. The impact on banks, which are often highly leveraged, may be significant. The effect of the interest expense apportionment was not discussed in the Conference Report.

[29] Code Sec. 951A(c)(1).

[30] *See* Code Sec. 951A(c)(2)(A). For GILTI purposes, the terms "tested income" and "tested loss" refer to the gross income of a CFC included in the GILTI computation, net of the deductions properly allocable to such gross income.

[31] Code Sec. 951A(b)(2).

[32] *See* Code Sec. 951A(d). The calculation takes into account only the assets that are used in the production of GILTI tested income. Assets of a CFC with a GILTI tested loss are not counted. *See* Code Sec. 951A(d)(2)(A); *see also* Conference Report at 517, n. 1536 ("Specified tangible property does not include property used in the production of tested loss, so that a CFC that has a tested loss in a taxable year does not have QBAI for the taxable year.").

[33] Certain rules apply in the case of a chain deficit, which may allow a Subpart F deficit in one CFC to offset Subpart F income in another. *See* Code Sec. 952(c)(1)(C).

[34] *See* Code Sec. 250(a)(1)(B). The deduction is 37.5% for years beginning after December 31, 2025. Code Sec. 250(a)(3).

[35] *See* Code Sec. 960(d)(1).

[36] *See* Code Sec. 951A(d)(3). The requirement that such foreign income taxes be attributable to the tested income of such CFC taken into account for purposes of Code Sec. 951A excludes any foreign income taxes attributable to income excluded under Code Sec. 951A(c)(2)(A)(i) (*e.g.,* income effectively connected with a U.S. trade or business, income included under Subpart F, and income which is not Subpart F income by reason of the high-tax exception of Code Sec. 954(b)(4)). Foreign taxes that are attributable to GILTI tested loss are not counted. *See* Conference Report, at 518, n. 1538 ("Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).").

[37] *See* Code Secs. 904(c) and (d)(1).

[38] *See* Code Sec. 78, which specifies that the gross-up with respect to Code Sec. 960(d) is computed without regard to the phrase "80 percent of" in subsection (d)(1). The result of this rule is that 20% of the foreign income taxes properly attributable to GILTI become disallowed as a deduction or credit. While it is not entirely clear whether the gross-up for foreign taxes deemed paid with respect to GILTI would be placed in the same GILTI basket for the FTC limitation purposes, it appears to be a logical result. For a further discussion of the Code Sec. 78 gross-up for GILTI, *see* E. Stevens & H. Rosenbloom, *GILTI Pleasures*, TAX NOTES INT'L 615 (Feb. 12, 2018).

[39] *See* Code Secs. 951A(a), (e) and (f).

[40] A U.S. Shareholder's *pro rata* shares with respect to GILTI tested income are determined under similar principles to the determination of its *pro rata* shares of Subpart F income under Code Sec. 951(a)(2). Code Sec. 951A(e)(1). However, unlike a Subpart F inclusion, a GILTI inclusion is not limited to the amount of a CFC's current earnings and profits. Code Sec. 951A(f)(1)(A) lists the sections for which purposes GILTI is treated as Subpart F but does not include Code Sec. 952(c) (the Subpart F earnings and profits limitation).

[41] *See* Code Sec. 951A(f)(1)(A) (cross-referencing Code Secs. 959 (PTI), 961 (basis adjustment), 962 (election by an individual to be subject to tax at corporate rates), 1248(b)(1) and (d)(1) (dividend treatment upon sale of CFC stock), 904(h)(1) (certain FTC sourcing rules), 535(b)(10) (deduction of inclusions in determining CFC accumulated taxable income), 851(b) (RIC dividends out of Subpart F PTI), 993(a)(1)(E) (qualified export receipts), 996(f)(1) (DISC income), 168(h)(2)(B) (exceptions to tax-exempt use property for ACRS), 6501(e)(1)(C) (statute of limitations on constructive dividends), and 6654(d)(2)(D) and 6655(e)(4) (installments of, and failure to pay, estimated income tax). Similar rules for other Code sections are to be provided under regulations as necessary. Code Sec. 951A(f)(1)(B).

[42] *See* Code Sec. 954(d) (foreign base company sales income); Code Sec. 954(e) (foreign base company services income); Code Sec. 954(c)(3) (certain income received from related persons within the same country); Code Sec. 954(c)(6) (look-through to underlying income of related CFCs); *see also* Code Sec. 952(c)(1)(C) (chain deficit rule).

[43] To avoid double counting of losses, a CFC's Subpart F earnings and profits limitation is increased by its tested loss. Surprisingly, this rule applies regardless of whether or not the tested loss actually reduced tested income in the calculation of a U.S. Shareholder's GILTI inclusion. *See* Code Sec. 951A(c)(2)(B)(ii).

Additionally, once GILTI is determined on an aggregate basis, it is then re-allocated under Code Sec. 951A(f) on a CFC-by-CFC basis for certain purposes, including allocation of GILTI PTI. *See* Code Sec. 951A(f)(1). An important consequence of this reallocation is that, perhaps unexpectedly, Code Sec. 956 remains a potential issue with respect to a CFC which is expected to have only GILTI tested income (or Subpart F income), even if it has no tangible asset basis. This issue is discussed in more detail in Part IV.D, below.

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[44] In addition, the TCJA removed the requirement that a foreign corporation qualify as a CFC for an uninterrupted 30-day period during a calendar year in order for the U.S. Shareholder to have a Subpart F inclusion. *See* Code Sec. 951(a)(1).

[45] Code Sec. 951(b). This change is effective for taxable years of foreign corporations beginning after December 31, 2017.

[46] The elimination of prior Code Sec. 958(b)(4) applies, for a foreign corporation, starting with the last taxable year beginning before January 1, 2018, and for U.S. Shareholders, any year in which such taxable year of a foreign corporation ends.

[47] Downward attribution is not applied to cause a foreign parent of a U.S. corporation to be treated as a CFC solely as a result of the repeal of Code Sec. 958(b)(4). *See* Rev. Rul. 74-605, 1974-2 CB 97.

[48] *See* Code Secs. 951(a)(2) and 951A(e)(1).

[49] Code Sec. 954(h)(1). Code Sec. 954(c)(2)(C) also provides an exception from "foreign personal holding company income" for certain amounts derived by a regular dealer in financial contracts in an ordinary course of trade or business. This provision has become largely subsumed by the AFE, but structurally would overlap with the TCJA provisions in the same conceptual way as the Active Financing Exception, as discussed below.

[50] Code Sec. 954(h)(3)(A).

[51] *See* Code Sec. 956(c).

[52] *See* Code Secs. 956(c)(2)(I) and (J).

[53] *See* Code Sec. 956(d); Reg. §1.956-2(c)(2).

[54] *See* Unified Framework for Fixing Our Broken Tax Code, Press Release (Sept. 27, 2017), at 9 ("to prevent companies from shifting profits to tax havens"); Conference Report at 524 (titling the description of the BEAT section: "Prevention of Base Erosion").

[55] *See* Code Sec. 59A(e). RICs, REITs and S corporations are not subject to the BEAT.

[56] The definition of an "applicable taxpayer" is unclear and would benefit from significant IRS guidance. *See, e.g.*, *infra* note 63.

[57] *See* Code Secs. 59A(b)(3) and (e)(1)(C).

[58] *See* Code Secs. 59A(b)(1) and (2).

[59] Code Sec. 59A(b)(3).

[60] *See* Code Sec. 59A(a) (imposing the BEAT in addition to any other U.S. federal income tax) and Code Sec. 26(b)(2)(B) (excluding the BEAT from the list of taxes against which a credit can be taken).

[61] *See* Code Sec. 59A(c)(1).

[62] *See* Code Sec. 59A(d). Base erosion payments also include certain reinsurance payments and payments to certain inverted entities.

[63] The attribution rules under Code Sec. 318 generally apply, but with the threshold for proportional attribution from a corporation reduced from 50% to 10%, and with the attribution to entities not applied so as to consider a U.S. person as owning stock which is owned by a person who is not a U.S. person. *See* Code Sec. 59A(g). Code Sec. 59A(e)(3) provides that "all entities treated as a single employer under Section 52 are treated as one person" for purposes of the BEAT and that "in applying Section 1563 for purposes of Section 52, the exception for foreign corporations under Section 1563(b)(2)(C) shall be disregarded." Read literally, this rule would result in only a very limited set of non-U.S. affiliates being treated as related foreign parties (essentially those that are treated as indirectly or constructively related by larger than 25% but smaller than 50% ownership). Such a result does not appear to be reasonable in view of the legislative history of the statute.

[64] *See* Code Sec. 59A(c)(2)(A)(iv). A reduction in gross receipts resulting from a payment made to certain surrogate foreign corporations (under Code Sec. 7874) will be treated as a base erosion payment. *See* Code Sec. 59A(d)(4).

[65] The services cost method ("SCM") is a specified transfer pricing method under which "covered services" can be charged out at cost. Such services essentially include non-core and incidental services, as well as low-margin services. A service cannot constitute a covered service unless the taxpayer reasonably concludes in its business judgment that the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group.

[66] *See* Conference Report at 532; *see also* Code Sec. 59A(d)(5).

[67] *See generally* Code Sec. 59A(h). Code Sec. 59A(h)(2)(B) also includes a reporting requirement that could be an additional requirement for qualified derivative treatment once the Treasury promulgates regulations under Code Sec. 59A. This provision in itself raises a multitude of questions (some of which are addressed in Part IV.C, further below) and the resolution of which by the Treasury and the IRS may have a profound impact on whether a particular Financial Group is subject to the BEAT.

[68] *See* Code Sec. 59A(h)(3).

[69] *See* Code Sec. 59A(h)(4).

[70] *See* Code Sec. 59A(c)(2)(B). If the rate of withholding is reduced under an applicable treaty, only such portion of the payment is excepted as is proportionate to the actual rate of withholding divided by the statutory withholding rate of 30%.

[71] However, certain partnerships could potentially fall under other categories within the definition of qualified derivative.

[72] *See* Code Sec. 59A(c)(4). The denominator also does not include deductions under Code Sec. 172 (NOLs), Code Sec. 245A (participation exemption) and Code Sec. 250 (GILTI and FDII rate adjustments).

[73] *See* Code Secs. 59A(b)(1)(B) and (2). *See also* Code Sec. 26(b)(2)(B).

[74] For an illustration of the effect of GILTI foreign tax credits on the BEAT liability, *see infra* Part IV.C example 6.

[75] Such exceptions include the provision for recapture of foreign branch losses on branch incorporation and a separate limitation basket for non-passive foreign branch FTCs. *See* Code Secs. 91 and 904(d)(1).

[76] *See* Code Secs. 904(d)(1)(B) and (2)(J).

[77] *See generally The Taxation of Global Trading of Financial Instruments* (OECD Comm. on Fiscal Affairs, 1998); OECD, *The New Financial Landscape—Forces Shaping the Revolution in Banking, Risk Management and Capital Markets* (1995); Bank for International Settlements, *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2001* (2002).

[78] *See, e.g.*, Reg. §1.482-9(b)(5) (specifying that certain services are not eligible for the SCM, if they contribute significantly to fundamental risks of business success or failure).

[79] The purpose of this subsection is to provide a very simplified, lay person's overview of the extraordinarily complex financial industry regulatory system, solely to give a flavor of the extremely constrained environment in which each Financial Institution, and therefore a Financial Group, must structure its operations. Any tax structuring or planning must necessarily accommodate the regulatory requirements.

[80] *See generally The Conditions for Establishment of Subsidiaries and Branches in the Provision of Banking Services by Non-Resident Institutions* (OECD Financial Affairs Division, Directorate for Financial and Enterprise Affairs, January 2017).

For example, in the United States, national banks must be members of the Federal Reserve System, and the Federal Reserve serves as a federal regulator for bank holding companies. Banks are regulated by the Office of the Comptroller of the Currency. Broker-dealers are regulated at the federal and state level in the United States. The U.S. Securities and Exchange Commission is the primary regulator of U.S. broker-dealers in the United States and all U.S. broker-dealers must also become members of the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory organization with broad supervisory oversight over the activities of its members. The regulation of U.K. banks in the United Kingdom, for example, is undertaken by three main regulators, the Bank of England, the Prudential Regulation Authority, and the Financial Conduct Authority ("FCA"). The FCA is the primary regulator of U.K. broker-dealers. Banks and broker-dealers located in other jurisdictions are additionally subject to local regulations and oversight.

[81] *See* U.S. Treasury Dep't and Bd. of Governors of the Fed. Reserve Sys., *Subsidiary Requirement Study* (Dec. 1992).

[82] Federal Reserve TLAC Rule, 12 CFR 252 (2017).

[83] The TCJA amended Code Sec. 168(k) to provide for 100% bonus depreciation on certain qualified property, including previously used property, until 2023. *See* Code Secs. 168(k)(1)(A) and (6)(A).

[84] Whether a lease constitutes a "true lease" or a financing is addressed by a number of IRS rulings and extensive case law. *See, e.g.*, Rev. Rul. 55-540, 1955-2 CB 39; Rev. Proc. 75-21, 1975-1 CB 715; Rev. Proc. 2001-28, 2001-19 IRB

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1156; and Rev. Proc. 2001-29, 2001-19 IRB 1160. Courts apply a benefits and burdens test and/or an economic substance test in determining whether to respect a lease. The economic substance is modified by Code Sec. 7701(o).

[85] Code Sec. 954(c)(1)(A)-(E). Under Code Sec. 954(a), "foreign base company income" for Subpart F income includes the sum of foreign personal holding company income, foreign base company sales income and foreign base company services income.

[86] Code Sec. 951A(c)(2)(A)(i)(II).

[87] Subpart F income consists primarily of foreign base company income and insurance income. *See* Code Sec. 952(a). The exception from foreign base company income for regular dealer income in Code Sec. 954(c)(2)(C), discussed in *supra* note 49, has been largely subsumed by the AFE and therefore is not discussed in detail in this article. However, the structure of the interaction between Code Sec. 954(c)(2)(C) and GILTI would be similar to that discussed in this Part with respect to the AFE.

[88] Code Sec. 954(b)(4).

[89] The calculation of the tax rate for purposes of the High-Tax Exception is based on the allocation of deductions and other U.S. concepts, such that the statutory rate under foreign law is not solely determinative.

[90] *See* Code Sec. 960 (allowing a corporate U.S. Shareholder a foreign tax credit against its Subpart F inclusion for the applicable foreign taxes paid by a CFC).

[91] Code Sec. 951A(c)(2)(A)(i)(III). Note, however, that a taxpayer can elect not to apply the High-Tax Exception.

[92] Query, however, whether a taxpayer might in certain circumstance prefer not to make the High-Tax Exception election to exclude the amount from Subpart F, thereby enabling potential utilization of the FTCs associated with such high-tax income.

[93] Code Sec. 245A(d)(1).

[94] The foreign tax credit limitation is applied separately to (non-passive) GILTI (non-passive) foreign branch income, passive category income, and general category income. Code Sec. 904(d)(1). Passive category income is defined to include any income "which is of a kind which would be foreign personal holding company income (as defined in Section 954(c))." Code Sec. 904(d)(2)(B)(i). However, Financial Contracts Income which does not satisfy the AFE will nevertheless be general category income under Code Sec. 904(d)(2)(C) if it is "financial services income" earned by a "financial services entity" or a member of a "financial services group." Generally speaking, a domestic or foreign entity will be a financial services entity if at least 80% of its gross income is derived in the active conduct of a banking, insurance, financing, or similar business. A corporate group will be a financial services group if it would be an affiliated group under Code Sec. 1504(a) without regard to the exception for foreign corporations, and if it passes the 80% rule above on a group-wide basis, counting (for purposes of this rule) only income of U.S. corporations and CFCs owned at least 80% by such U.S. corporations. *See* Reg. §1.904-4(e)(1) and (3). "Financial services income" includes not only income derived in the active conduct of a banking, financing, or similar business but also any passive category income (without regard to the "high-taxed income" kickout), in each case if earned by a financial services entity or financial services group. *See* Code Sec. 904(d)(2)(D). Thus, despite potentially being either passive in character or earned by a CFC that is not itself predominantly engaged in an active financing business, Financial Services Income that does not satisfy the AFE may often be general category income. For a good illustration of how this rule works for an "affiliated" group of U.S. and non-U.S. corporations, *see* Reg. §1.904-4(e)(3)(iv) example 2.

[95] "High-taxed income" (*i.e.,* income with respect to which the foreign income taxes paid or accrued, plus the foreign income taxes deemed paid or accrued under Code Sec. 902 or 960, in each case by the U.S. person, exceeds the highest rate of tax specified in Code Sec. 1 or 11, whichever applies) is generally excluded from passive category income. *See* Code Secs. 904(d)(2)(B)(iii)(II) and (F). The highest rate in Code Sec. 11 is now 21%. Code Sec. 11(b).

[96] Other exceptions from Subpart F could also apply, such as income described in Code Sec. 954(c)(2) (discussed in *supra* notes 49 and 87), (c)(3) or (c)(6). However, the focus of this discussion is on the Active Financing Exception and the High-Tax Exception.

[97] Code Sec. 951A(c)(2)(A)(i)(II) (excluding from the definition of "tested income" any "gross income taken into account in determining the Subpart F income of such corporation").

[98] Code Sec. 960(a).

[99] *See supra* note 94 for a discussion of the FTC baskets and the treatment of certain financial services income as general category income. Financial Contracts Income that is not financial services income and that satisfies neither the AFE nor the High-Tax Exception is likely to be passive category income, unless the income is not treated as "foreign personal holding company income" because of an exception under Code Sec. 954 or another exception in Code Sec. 904(d). Such income is unlikely to meet the "high-taxed" exception from passive category income under 904(d)(2)(B)(iii)(II).

[100] There are other exceptions from GILTI tested income presumed not applicable here. *See* Code Sec. 951A(c)(2)(A)(i).

[101] To meet the AFE, income must be (among other requirements) 1) earned by a CFC that is "predominantly engaged in the active conduct of a banking, financing, or similar business" and 2) "derived in the active conduct of a banking, financing or similar business." *See* discussion, *supra*, part II.D.2. Such income is likely to be "financial services income" under Code Secs. 954(d)(2)(D)(i)(I) and (ii)(I).

[102] In enacting GILTI, Congress evidenced an intent to treat GILTI inclusions as a separate basket for foreign tax credit purposes (and not as general category income). Similarly, Code Sec. 904(d)(2)(A)(ii), as amended by the TCJA, provides that general category income means income other than GILTI, foreign branch income, and passive category income. On the other hand, if Code Sec. 904(d)(2)(C) does not apply to GILTI inclusions, it is unclear what income it may practically cover. While interaction of these Sections is uncertain and further guidance may be helpful, treating GILTI inclusions of Financial Contracts Income as general category income for FTC limitation purposes may be counterintuitive and difficult to reconcile with the legislative history.

[103] Code Secs. 954(a) and 954(h).

[104] Code Sec. 951A(c)(2)(A)(i)(III) (emphasis added).

[105] Code Sec. 954(a).

[106] *See* Code Sec. 954(h) (providing that *foreign personal holding company income* shall not include income that qualifies for the AFE). This issue is further complicated because in order for the High-Tax Exception to apply, the controlling U.S. Shareholders of the CFC must affirmatively make an election with their tax returns to exclude such high-tax income from Subpart F. Reg. §1.954-1(d)(1)(i) and (5).

[107] A similar situation could arise for income subject to a tax at a rate of 18.9% or more, but excluded from foreign personal holding by reason of Code Sec. 954(c)(2) (rents and royalties derived in active finance business, certain export financing, and certain dealer exceptions), 954(c)(3) (same country rule) or 954(c)(6) (related CFC look-thru rule).

[108] If, on the other hand, such income is not GILTI and the earnings attributable to the income are distributed, they can qualify for the participation exemption under Code Sec. 245A. If, however, the earnings are treated as invested in U.S. property within the meaning of Code Sec. 956, the U.S. Shareholder will be taxed at 21% on those earnings.

[109] *See* discussion *supra* note 95.

[110] Changes to Code Secs. 367, 482 and 936(h) regarding the valuation of intangibles may make incorporation of a foreign branch more challenging.

[111] *See* Code Secs. 904(d)(1)(B) and (2)(J). Passive foreign branch earnings generally remain subject to the passive category income FTC basket. However, as discussed in *supra* note 94, passive income earned by a Financial Institution or member of a Financial Group may qualify as financial services income under Code Sec. 904(d)(2)(C) and Reg. §1.904-4(e), and if so will be general category income. Whether such passive income should be foreign branch category, or should be general category *via* the financial services exception, is uncertain. There is little guidance on this issue.

[112] *See* discussion, *supra* Part II.F.

[113] This general rule may not hold true for either GILTI or branch income once interest and

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other expenses are allocated under Code Sec. 861. *See supra* note 28 and accompanying text, discussing the effect of interest expense apportionment on the GILTI FTC limitation. Foreign branch income also has its own FTC basket, so is subject to a similar effect.

[114] Operating a loss activity through branches may remain preferable under the new tax regime, even though there is now a requirement to recapture foreign branch losses on subsequent incorporation of the branch. *See* Code Sec. 91. In addition, the TCJA made it harder to operate through a hybrid entity by disallowing deductions paid to related parties that are hybrid entities (*i.e.,* entities respected for tax purposes in a foreign jurisdiction while being treated as tax transparent for U.S. tax purposes.) *See* Code Sec. 267A.

[115] Traditionally, payments and deductions under derivative contracts have been accounted for on a net basis. Because derivatives can be seen as consisting of two or more largely offsetting payments, accounting for net payments was easier operationally and generally yielded the same result for all regulatory, accounting, and tax purposes. However, technically, Reg. §1.446-3 generally is interpreted as requiring payments on notional principal contracts to be accounted for on a gross basis as income and deductions. Accordingly, because Code Sec. 59A(c)(4) defines the base erosion percentage denominator by reference to "deductions," it appears to require that the denominator be computed by including gross deductions, rather than netting them against payments of income or gains under the same contracts.

[116] As a practical matter, most often repos are treated as collateralized loans. Under Code Sec. 956(c)(2)(J), such loans generally are exempt from the Code Sec. 956 deemed dividend rule as long as they are undertaken in an ordinary course of business of a dealer.

[117] A securities loan appears to meet the definition of a derivative under Code Sec. 59A(h)(4)(A) as "any contract ... the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following: (i) Any share of stock in a corporation. (ii) Any evidence of indebtedness. ..."

[118] It is uncertain how services that are compensated for on a cost-based method are treated under the BEAT. The statute seems to require that only those payments for services that do not contain a markup component are exempt. *See* Code Sec. 59A(d)(5)(B). Based on a colloquy between Sen. Rob Portman, R-Ohio, and Finance Committee Chair Orrin G. Hatch, R-Utah, on December 1, 2017, there is an argument that as long as the Financial Institution separately accounts for the markup and the cost, the cost may be exempt from the BEAT, provided that the services otherwise are eligible for the cost-based method.

[119] Reductions to gross income are generally excluded from the BEAT regime because they are neither included in taxable income nor are they deductible payments. *See generally* 59A(c) and (d); *see also* Conference Report at 528 ("Base erosion payments do not include payments for cost of goods sold (which is not a deduction but rather a reduction to income).").

[120] At least one Treasury official has publically articulated this view. *See News Analysis: Proposed Regs Coming on TCJA International Rules*, Tax Notes (Feb. 19, 2018) (statement of Lafayette G. Harter III, Treasury deputy assistant secretary for international tax affairs).

[121] The mechanics of the BEAT also reduce the benefit that any company would realize from the utilization of its NOL carryover to the extent of the base erosion percentage of the NOL. *See* Code Sec. 59A(c)(1)(B). While it is not clear, it is reasonable to conclude that the base erosion percentage of the NOL carryover refers to the current year base erosion percentage, because it is difficult to believe that the statute would require a lookback to the year in which the NOL was generated.

[122] One may argue that the tax attributes whose tax benefit is eliminated or significantly reduced under the regular tax system due to the fact that the company is subject to the BEAT ought not to be considered as utilized for purposes of the regular tax. This argument may have some merit if the BEAT is viewed as an "alternative" minimum tax. However, if the BEAT is viewed as a separate add-on tax, the argument for the preservation of "unused" tax attributes is uncertain, since there is no basis in the statute or legislative history that would permit this reading. *See* Code Secs. 59A(a) and 26(b)(2)(B). Another argument may be made that effective disallowance of foreign tax credits may be contrary to the bilateral tax treaties or to the trading agreements that the United States currently is a party to.

[123] Reg. §1.956-2(c)(2).

[124] Although from a financial statements perspective, many taxpayers have benefited from the assertion that certain offshore earnings would be permanently reinvested outside the United States and therefore would never incur incremental U.S. federal income tax, which permitted certain corporations not to accrue such tax as the income was earned. *See* Accounting Principles Board, APB 23, codified as Financial Accounting Standards Board ASC 740-10-25-3.

[125] *See* Code Sec. 959(a).

[126] Even if a U.S. borrower did not want to provide guarantees or pledges that can trigger Code Sec. 956, Code Sec. 245A might be helpful in improving the credit support for a U.S. borrowing. Generally, a U.S. borrower is not required to make a distribution from a CFC to make a payment under its loan because prior to the TCJA, such distributions could be subject to U.S. federal income taxes as a dividend. However, under the TCJA, a U.S. borrower eligible for the participation exemption could covenant to cause its non-U.S. subsidiaries to distribute available cash to repay its loan without U.S. tax.

[127] Code Sec. 965 treats a CFC's previously untaxed earnings and profits, determined as of November 2, 2017, or December 31, 2017, as Subpart F income. Because such amounts are taxed as Subpart F income, a distribution or deemed distribution of such earnings and profits is not taxed again under Code Sec. 959. Under the ordering rule of Code Sec. 959(c), distributions and deemed distributions are treated as first made from previously taxed earnings and profits.

[128] Other considerations may make it difficult to eliminate earnings and profits through actual distributions, such as whether (1) the CFC has liquidity to make such distributions, (2) the current year earnings and profits of the CFC can be estimated with accuracy, (3) there are local law restrictions on actual distributions and (4) there are non-U.S. taxes imposed on actual distributions by the CFC.

[129] Although clarifying language would be welcome, GILTI ought to apply before Code Sec. 956. Unlike 956 inclusions, which are limited to earnings and profits that are not PTI, GILTI inclusions are limited *via* enumerated exclusions from a CFC's gross income. Subpart F income (among other items) is excluded from gross income when calculating the GILTI liability, but Code Sec. 956 inclusions are not. If Code Sec. 956 were applied prior to GILTI, the same item of income could be effectively taxed twice, because GILTI is not limited by PTI. No indication was given by the drafters of TCJA that such a result was intended. If instead, GILTI were applied prior to Code Sec. 956, as appears to be the rule, then only income not taxed under either Subpart F or GILTI would be subject to Code Sec. 956, as a result of the application of Code Secs. 951A(f), 951(a)(1)(A) and (B), and 959(a)(2).

[130] Similar result could occur due to QBAI reducing the amount of GILTI at the U.S. Shareholder level, rather than on a CFC-by-CFC basis.

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