Taxpayers Nervously Await GILTI Expense Allocation Regs

by Alexander Lewis

Practitioners and commentators hope Treasury will bypass expense allocation rules as they pertain to global intangible low-taxed income, but a Treasury official's comments suggest that the department may take a different approach.

"In my mind, how to apply pre-tax-reform expense allocation and apportionment principles in the GILTI context is the single most important and unanswered question post tax reform," Caroline H. Ngo, a partner at McDermott Will & Emery, told *Tax Notes* August 7.

The way Treasury responds to that question when it issues regulations later this year will affect taxpayers that have hundreds of millions of dollars on the line — primarily in the form of interest. Treasury has broad authority under section 864(e) to issue regulations and could, as numerous taxpayers have requested, sidestep the expense allocation rules that existed before the Tax Cuts and Jobs Act (P.L. 115-97) and that now apply to the new section 951A GILTI inclusion.

Based on some Treasury officials' comments, however, the department does not seem likely to take such a taxpayer-friendly approach. Treasury has remained fairly tight-lipped about what it will do regarding expense allocation. However, some officials have made forward-looking comments that offer some insight into potential approaches to the regs.

Speaking June 4 at the 2018 OECD International Tax Conference in Washington, Lafayette G. "Chip" Harter III, Treasury deputy assistant secretary for international tax affairs, discussed the tension between having a separate foreign tax credit basket for GILTI and using the provision as an antiabuse backstop to territoriality.

"The solution has to be some combination of interest expense allocation rules [and] look-through rules," Harter said, adding that the result should be "reasonable, yet pragmatic." He said, "It will not be a thing of conceptual beauty, but we also have to walk a very fine line between avoiding making tax reform a marginal detriment to using the U.S. as a home office jurisdiction on

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one hand versus opening up the opportunity for cross-crediting of foreign tax credits on the other."

An Overview of the Allocation Issue

With the passage of the TCJA, U.S. taxpayers are subject to current tax on their share of their controlled foreign corporations' GILTI. This new category of income, contained in section 951A, generally consists of the aggregate of a U.S. shareholder's CFC income, reduced by 10 percent of the CFCs' qualified business asset investment, U.S. effectively connected income, and subpart F income.

Under section 250(a)(1)(B), corporate shareholders of CFCs generating GILTI are entitled to a 50 percent deduction on their gross GILTI inclusion, which reduces the effective tax rate from 21 percent to 10.5 percent. Section 960(d) provides shareholders that have a GILTI inclusion with an FTC for 80 percent of the related local taxes. Section 904 now requires that GILTI be placed in a separate FTC limitation category (the GILTI basket). However, unlike other section 904 baskets, excess GILTI FTCs cannot be carried forward or back, so the impact of limiting GILTI FTCs is significantly more severe than limiting non-GILTI FTCs.

Treasury has stated that it intends to issue regulations clarifying that the section 78 gross-up, which mustbe included in gross income when calculating the grossed-up GILTI,is properly includable in the GILTI basket, as opposed to the general basket, as some taxpayers had feared.

Under the basic GILTI regime, as long as a U.S. shareholder's foreign structure's average effective tax rate is 13.125 percent or more, there should generally be sufficient FTCs associated with the GILTI to fully offset any additional tax. However, when expense allocations are added to the equation, the final tax rate is not so tidy.

To understand the issue, it is important to note the FTC limitation calculation. Generally, the section 904 limitation is net separate-category (in this case, GILTI) foreign-source income over worldwide taxable income, multiplied by the tax on worldwide income.

Under sections 861(b), 862(b), and 863(a), taxable income in a section 904 basket is based on gross income in the category, less expenses "properly apportioned or allocated" to that gross income under the related regulations. Current section 861 regulations require the division of U.S. shareholder expenses between U.S.-source and foreign-source amounts. Foreign-source expenses are then further divided among the applicable section 904 baskets.

Companies, Associations Call for Relief

As several commentators have noted in recent letters to Treasury, when U.S. shareholder expenses are treated as foreign-source expenses allocated to the GILTI basket, the GILTI rate first increases to 13.125 percent, and then every additional dollar of expense allocation results in additional U.S. tax on the GILTI inclusion. This is because the allocation of expenses reduces the net income in the numerator of the FTC limitation formula. Thus, when U.S. shareholder expenses are allocated to the GILTI basket, no matter how far the foreign tax rate goes above 13.125 percent, additional U.S. tax will be payable on the GILTI inclusion.

Several companies and lobbying associations, including MasterCard International Inc., Illinois Tool Works Inc., the Retail Industry Leaders Association, and the Semiconductor Industry Association, have submitted comments to Treasury requesting a reduced allocation of expenses or the complete elimination of expense allocation to the GILTI basket.

Each of the comment letters argues that allocating expenses to GILTI is contrary to the legislative history of the provision. Several note that the conference report (H.R. Rep. No. 115-466) includes illustrations of the GILTI mechanics and explanations that do not reference expense allocation, and notably, would not reach the correct tax rates if expense allocation were included.

For example, the conference report states: "Therefore, as foreign tax rates on GILTI range between 0 percent and 13.125 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5 percent and 13.125 percent. At foreign tax rates greater than or equal to 13.125 percent, there is no residual U.S. tax owed on GILTI, so that the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate."

The comment letters also reference footnote 1526, which says: "If the foreign tax rate on GILTI

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is 13.125 percent, and domestic corporations are allowed a credit equal to 80 percent of foreign taxes paid, then the post-credit foreign tax rate on GILTI equals 10.5 percent (= 13.125 percent x 80 percent), which equals the effective GILTI rate of 10.5 percent. Therefore, no U.S. residual tax is owed."

However, it is plausible that Congress used those examples without including expense allocations simply as illustrations, as opposed to stating a definitive rule. As the New York State Bar Association noted in its report on GILTI, "The allocation of deductions to foreign income is integral to the structure of the FTC rules, and it should take more than this ambiguous statement in the legislative history to override that basic structure."

Taxpayers Hope for Treasury Compromise

Given that the topic is a current client issue, most practitioners who spoke with *Tax Notes* were fairly conservative in their predictions for what Treasury will do.

"I think Treasury should issue regulations that are consistent with the legislative history of GILTI," Ngo said. "I think in terms of what Treasury will do, I think Treasury is going to issue expense allocation apportionment rules in the GILTI context that are more favorable than current law. The question is, what?"

Ngo noted that Harter was likely referencing expanding the look-through rules under section 904(d)(3) to GILTI so that additional income could be allocated to the GILTI basket, which would benefit taxpayers. "If you put the royalties in the GILTI basket, that is generally helpful for most taxpayers because a lot of taxpayers are running into a problem of not having enough GILTI basket income and thus, they're running into an FTC limitation with respect to GILTI," she said.

"It's really important for IRS and Treasury to address this issue. A lot of taxpayers are dealing with this, and the hope is that Treasury and IRS do something reasonable in addressing the expense allocation issue and take into account the purpose of the statute and what it was trying to achieve," said Joseph Calianno of BDO USA LLP.

Practitioners generally doubt that Treasury will eliminate expense allocation altogether and are advising clients to be prepared.

"Absent guidance from Treasury saying there isn't, I think it is generally assumed, as it stands right now, that there is some type of allocation of expenses," Calianno said.

Kenneth Brewer, a senior adviser with Alvarez & Marsal Taxand LLC, told *Tax Notes* that clients that have high-taxed CFCs might want to consider whether it is feasible to rearrange their transactions so that they produce foreign base company income that would qualify for the high-tax exception from subpart F. That would remove the income from coverage by the GILTI rules.

Brewer said he believes that if Treasury does maintain pre-reform expense allocation rules, he hopes it applies them sparingly. "I believe Treasury has a great deal of leeway in designing GILTI regulations, and in particular the expense allocation regulations as applied to GILTI. When they do that, it seems to me that they ought to do it in a way that causes GILTI taxes to apply, to the extent possible, only in those situations where they were intended to apply — to low-taxed income and to income attributable to intangibles, or maybe even just intangibles that have been moved offshore," he said.

Brewer also said it might be possible for Treasury to provide taxpayers with the relief requested in letters like the one written by Timothy Berger, MasterCard's executive vice president of global tax, and to include some fairly simple antiabuse provisions.

"It seems to me that the big expense allocations that tend to cause problems are interest expense, [research and development], and to a lesser extent, stewardship expense. And so my thinking is that maybe there could be a general rule that says that there's no expense allocations to GILTI, but antiabuse exceptions might apply in the case of interest and possibly R&D," Brewer said. "In the case of interest, if the CFC in question isn't leveraged consistent with the worldwide capital structure, then maybe an allocation of interest could be required to the extent necessary to allow the CFC's income to bear a proportionate share of the group's worldwide interest."

Under Brewer's envisioned rules, a similar approach would apply to R&D expenses. If a CFC is not deemed to be bearing its appropriate share, if any, of worldwide R&D costs, either directly or

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through transfer pricing of products, services, and so forth, then there could be some residual allocation of R&D, Brewer said.

Another practitioner who asked to remain anonymous told *Tax Notes* that he believes Treasury will take an approach similar to the recommendations outlined in the NYSBA's GILTI report: Chiefly, that while the expense allocations will continue to apply to the GILTI basket under section 904, the existing section 861 framework may not be applied wholesale. ■

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