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Abandoning §78 and the After-Tax Computation of GILTI: How Getting the Math Right Became Getting the Math Wrong

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I. INTRODUCTION

Although the international tax system was radically reshaped by the Tax Cuts and Jobs Act of 2017 (the "TCJA"),[1] the underlying (and imperfect) mechanism for taxing the income of foreign subsidiaries was not only retained but was adopted generally for all foreign income. Specifically, the TCJA expanded the subpart F approach for taxing a U.S. shareholder on a foreign subsidiary's income by requiring the shareholder to effectively include such income on a current basis as a "deemed dividend" (the "subpart F model").[2] Of course, the subpart F model is simply an accelerated

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[1] Pub. L. No. 115-97 (Dec. 22, 2017). The actual name of the TCJA, after Congress stripped "Tax Cuts and Jobs Act of 2017" from the legislation to address concerns with the so-called Byrd Rule (an explanation of which is beyond the scope of this article, and certainly this footnote), was "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

[2] The TCJA also adopted the shareholder model for the transition tax imposed under §965 for purposes of taxing a U.S. shareholder's deferred foreign earnings (by treating such income as

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version of the general approach that applied to all foreign earnings of a CFC, and to ''active'' (non-subpart F) earnings after 1962: taxing those earnings only when distributed as dividends (the ''dividend model''). In both cases, the taxation of income earned through a foreign affiliate is done by taxing the shareholder when the income is distributed, either actually or when this is deemed to occur as in the case of subpart F (and thus the dividend model and subpart F model are referred to collectively as the ''shareholder model'').

The shareholder model has a number of infirmities when contrasted with more robust forms of aggregated taxation for affiliated entities such as corporate consolidation as implemented under the §1502 regulations or pass-through treatment under subchapter K.[3] The differences between corporate consolidation for domestic subsidiaries and the shareholder model for foreign subsidiaries have been reduced over the years as the international tax rules have incorporated a number of ''second best'' approaches to move the system closer to the ''one taxpayer'' approach that is the north star of the U.S. consolidated return rules. Examples of these quasi-consolidation approaches can be found across the international tax provisions of the Code, including the foreign tax credit look-through rules of §904(d)(3) (preservation of the separate category (or foreign tax credit ''basket'') for income that is then shifted to an affiliate through intercompany payments), the qualified electing fund rules of §1293 under the passive foreign income corporations provisions (preservation of the character of income as capital or ordinary), and the chain deficit rules of §952(c)(1)(C) (limited sharing of losses among certain related controlled foreign corporations (CFCs), in this case, in the same chain of ownership). Of course, certain aspects of the shareholder model are not (accidental) bugs, but (intended) features, such as the inability to use losses incurred by a foreign affiliate to reduce the income of the U.S. shareholder or members of its consolidated group. These features were incorporated into the Global Intangible Low-Taxed Income (GILTI) regime under the TCJA by its adoption of the subpart F model.

Many aspects of the shareholder model recommend revising the rules to embrace a more consolidated approach for taxing the income of foreign subsidiaries. The shareholder model's concept of corporate earnings and its differences with taxable income was developed in the context of a domestic corporation where there are two levels of U.S. taxation, and creates discontinuities when applied to foreign corporations where the subpart F and GILTI regimes only impose a single level of U.S. taxation. For example, the subpart F regulations do not permit the exclusion from income under §103 to apply at the shareholder level because the subpart F income is effectively an advanced dividend to the U.S. shareholder and exemption from income is considered to apply only at the CFC level.[4] However, in the case of disallowed deductions, the rules of §163(j) apply to limit the interest deduction at the CFC level for purposes of computing subpart F income and GILTI. Because the deductions reduce the CFC's value, without the corresponding reduction in basis, the foregone deduction at 10.5% ultimately creates a built-in loss (or reduction in gain) that may be worth twice as much, or 21 cents for each dollar when the basis is recovered such as upon a sale of the CFC stock.[5] And while sales of CFC stock are often in the distant future, this basis

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subpart F income that was included under §951), and thus many of the issues raised herein were also presented in the operation of §965. Given the magnitude of its impact and differences in its treatment of the foreign tax credit (e.g., disallowing a ratable portion of indirect foreign tax credits under §965(g), rather than simply adjusting the foreign tax credit limitation through the allocation of the §250 deduction to foreign source income) §965 is worthy of its own, comprehensive discussion. But given its brief moment in the sun, it will only be discussed herein in the context of how the ''after-tax'' approach played out at different tax rates, as §965 provided a second example of this phenomenon.

[3] Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended, and to the Treasury regulations promulgated thereunder.

[4] Although prior regulations had permitted a U.S. shareholder to receive the benefit of the exclusion under §103 for interest income on municipal debt, the regulations were changed in the mid-1990s to provide parity with income earned through a domestic corporation. The preamble to the proposed regulations explained the change as follows:

> Section 1.954-2(b)(3) of the proposed regulations would amend the rule in the temporary regulations to provide that foreign personal holding company income includes interest income that is exempt from tax under section 103. The tax-exempt interest would not retain its character as such in the hands of the United States shareholder upon a deemed distribution under subpart F. This proposed rule closely parallels the domestic rule for tax-exempt interest. The controlled foreign corporation realizes the tax benefit associated with the receipt of interest income described in section 103 because no United States withholding tax is collected on the income when it is paid to the controlled foreign corporation. As in the domestic context, however, this tax benefit is limited to the corporate level and is not retained when the tax-exempt interest is distributed to the United States shareholders or included in their gross income under subpart F. This rule simplifies the interaction of the tax-exempt interest and alternative minimum tax provisions, and avoids the double-taxation and administrative problems associated with the current rule.

Notice of Proposed Rulemaking, Definition of Foreign Base Company Income and Foreign Personal Holding Company Income of a Controlled Foreign Corporation, 60 Fed. Reg. 46,548 (Sept. 7, 1995).

[5] This results because, among other reasons, the shareholder model is a modified form of the pass-through taxation under subchapter K, but the basis adjustments provided for under §961 do not take into account non-deductible expenses under §705(a)(2)(B).

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may also be used to support the repatriation of earnings in excess of basis, thereby providing a more immediate benefit.[6]

This article focuses on perhaps the most policy neutral aspect of the shareholder model: the ''after-tax approach'' for computing subpart F income and GILTI, and the corresponding ''gross-up'' of income under §78 for so-called indirect or deemed paid foreign tax credits. Former §902 extended the foreign tax credit to include taxes paid by a foreign subsidiary by treating such taxes as ''deemed paid'' when the earnings on which the tax was imposed were repatriated, provided that the shareholder was a corporation. The indirect credit was intended to provide parity with the direct foreign tax credit for situations where a U.S. taxpayer conducted operations abroad through a foreign subsidiary rather than directly.

The indirect credit operated with a design flaw for four decades, effectively permitting shareholders a double benefit: both a deemed paid credit and the economic equivalent of a deduction for a single tax payment. In 1962, Congress corrected the design flaw by enacting §78 to ''get the math right'' and eliminate the double benefit.[7] Section 78 required corporate shareholders claiming an indirect tax credit upon receipt of a dividend to include an amount in income equal to the taxes deemed paid with respect to such dividend under §902.

As part of the same legislation in 1962, and somewhat more famously, Congress enacted subpart F, and the deemed paid credit was expanded with the enactment of §960 to provide similar relief from double taxation when income was included under the subpart F rules. Section 78 also applied to deemed paid credits under §960 as it was necessary to also get the math right under the subpart F rules given that they also relied on the after-tax approach of the shareholder model.

Everything changed, however, with the TCJA's adoption of the subpart F model (including §78) for inclusions of GILTI under §951A. As demonstrated below, the after-tax approach (and its corrective adjustment under §78) is ''getting the math wrong'' in most cases.[8] The problem arises because a portion of the foreign income that is governed by the GILTI rules is effectively exempted from U.S. taxation — the territorial aspect of the rules that has largely been viewed as an over-advertised aspect of the TCJA's revision of the international tax system, and something that did not exist under the subpart F rules or the taxation of dividends of deferred earnings.

Under the GILTI rules, although exempt income can be created in several ways, two categories raise the distortive concerns addressed in this article.[9] The first category of exempt income is provided for di-

[6] This additional basis is particularly important in a post-TCJA world given the significant amount of non-previously taxed earnings that were created under §965(b)(4) (''§965(b) PTEP''). That provision treated deferred earnings that were offset by deficits when applying the §965 transition tax as previously taxed earnings, even though they were not subject to tax. Most §965(b) PTEP did not give rise to corresponding adjustments to the CFC stock under §961 and thus the need for basis to avoid immediate taxation upon distributions of PTEP has increased dramatically after the enactment of TCJA.

[7] Although §78 is viewed as correcting a mathematical error in the operation of the deemed paid credit, the provision was more controversial at the time of its enactment, demonstrating either the underestimated importance of international tax law or the willingness of Congress to politicize almost anything. For example, Sen. Thomas Curtis of Missouri raised the following concerns about the gross-up, along with subpart F, presaging a second U.S. defeat, in this case in the area of global trade, reminiscent of the Soviet Union's successful launch of Sputnik.

> I write in alarm over tax changes originally urged by the U.S. Treasury Department which in my considered judgment would subserve the aims of our enemies and would subvert the vitality of our economic endeavors both at home and abroad. . . .The policies implicit in the foreign tax provisions of this bill indicate a shocking unawareness of the benefit the Communist countries would derive from curtailed American overseas economic endeavors as a consequence of added U.S. tax encumbrances. If the Treasury foreign income tax proposals are enacted, Mr. Khrushchev will have some degree of success in making good on his promise of November 1957 to ''win over the United States'' in the ''field of trade.''

House Ways & Means Committee, H. Rpt. No. 1447, Revenue Act of 1962, at B39 (Mar. 16, 1962) (Separate views of the Republicans on H.R. 10650).

[8] In the case of GILTI, the subpart F model produces an inclusion in income under §951A(a) without regard to whether such amount is distributed, and then treats the amount in the same manner as subpart F income inclusions. *See, e.g.*, §959 (rules for avoiding double taxation of earnings previously taxed under subpart F (''PTEP'') when distributed to a U.S. person), §961 (basis adjustment corresponding to PTEP to expand the exemption for distributions to includes gains from stock sales), §986(c) (recognition of foreign currency gains and losses on distributions of PTEP), and §960(c) (allowing additional foreign tax credit limitation from subpart F and GILTI inclusions to be carried forward for use against additional foreign income taxes imposed on distributions of PTEP). In the case of §965, the adoption was even more direct as the statute simply converts all deferred earnings to subpart F income and includes such amounts under the pre-existing rules.

[9] In addition to the two categories discussed in the text, the GILTI rules also contain other direct exclusions from tested income, some of which create similarly exempt income, but none of which produces the issues discussed herein. Foreign oil and gas extraction income (FOGEI) is also excluded from the definition of tested income, but because this income and any related taxes are completely excluded from the rules, such amounts do not produce the same consequences as tested income that is within the definition of tested income but is not ultimately part of the income inclusion under §951A. §951A(c)(2)(A)(V). The same is true of in-

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rectly in the statute: when tested income of a CFC is offset by deemed tangible income return (DTIR, which is 10% of the qualified business asset investment (QBAI)). The second category arises indirectly from the operation of the GILTI rules: when the tested income of one CFC that is offset by tested losses from another CFC (a ''tested loss CFC'').[10] While neither category is directly exempted from taxation, both result in the reduction of a taxpayer's GILTI inclusion on a portion of the income earned by the taxpayer's CFCs, and create earnings that, when distributed, receive a 100% dividends received deduction under §245A (in most cases). Thus, such income is effectively exempted from U.S. taxation by the overall operation of the TCJA international tax system. For this reason, and to simplify the discussion herein, references to ''exempt income'' or ''exempt earnings'' will be to earnings that are excluded from taxation under the GILTI rules for either of these two reasons. However, most of the discussion below focuses on exemption arising from the presence of QBAI as it avoids the complexity introduced by the additional tax consequences of tested loss CFCs.

''Exempt income'' was also effectively created by the enactment of §965. Section 965 implemented the so-called transition tax or repatriation tax — a one-time tax on the deferred earnings of certain 10%-owned foreign corporation. The tax was imposed at a reduced rate, allowed a correspondingly reduced foreign tax credit.[11] Because §965(b) permitted taxpayers to offset deferred earnings with deficits in related CFCs, the same phenomenon occurred as is the case with tested losses, and with similar results.

The seemingly unanticipated results of the new TCJA model being hoisted upon the old subpart F mechanics is a bad news / good news story. The bad news, at least from the taxpayer's perspective, is that they receive too few foreign tax credits if some portion of their tested income is exempt. And the good news, again from the taxpayer's perspective, is that they also receive a deduction for the portion of foreign taxes imposed on the exempt income. Of course this benefit is achieved because the results effectively sidestep the principles of §245A(d)(2) (disallowing a deduction for foreign taxes on dividends that qualify for the §245A dividends received deduction (DRD), §265 (denying a deduction for expenses allocable to exempt income) and §275(a)(4) (year disallowing a deduction for all foreign income taxes if the taxpayers elects to claim a foreign tax credit under §901 for the taxable year). This result can also be contrasted with the operation of §78 as applied to inclusions of GILTI under §951A(a). In that case, the gross-up applies to the full amount of foreign taxes even though only 80% are creditable under §960(d), thus also disallowing a deduction for the noncreditable 20% of foreign taxes on income that is included under the GILTI rules.

Perhaps most interestingly of all, while neither consequence is ''correct,'' they offset one another and, in most cases, produce results that either have no practical impact or are slightly beneficial to taxpayers. More specifically, the net effect of these offsetting amounts is favorable in all cases for taxpayers that are in an excess limitation position[12] with respect to GILTI, with the deduction providing more benefit that the dilution of foreign tax credits. And for taxpayers in an excess credit position, although the foreign tax credit dilution outweighs the benefit of the deduction, the loss of such credits is without consequences as the credits are neither usable in the current year, nor can they be carried over to another year and thus they are simply lost forever under the GILTI rules.[13]

Although the net tax consequences are marginal in most cases, these distortions are worth highlighting for several reasons. First, and most importantly, it is one of several features of the shareholder model that suggest a different mechanism is more desirable for taxing the earnings of a foreign subsidiary. While there are various (often competing) policies to consider when deciding how to tax foreign income (such as the principles of capital export neutrality and capital import neutrality), the plumbing that implements policy decisions should be neutral and efficient or, at

come excluded under the high-taxed exception of §954(b)(4). §951A(c)(2)(A)(III). The other exclusions from tested income are different in that they do not exclude the income from U.S. taxation, but prevent income that has already been subject to U.S. tax from being included a second (or third) time under the GILTI rules. The other exceptions are for: (1) income effectively connected with a U.S. trade or business, and thus subject to direct U.S. net taxation under §882; (2) subpart F income; and (3) any dividend from a related person as the underlying earnings of that related person presumably were subject to U.S. taxation (and thus similar to the domestic dividends received deduction under §245; and the exclusion from subpart F income for dividends under §954(c)(6)). §951A(c)(2)(A)(I), §951A(c)(2)(A)(II), §951A(c)(2)(A)(IV).

[10] A tested loss CFC is a CFC that has an overall loss for GILTI purposes because the entity's gross tested income is exceeded by allocable expenses and foreign taxes allocable thereto for a given taxable year. *See* Reg. §1.951A-2(b)(2) (providing the regulatory definition of a tested loss and a tested loss CFC).

[11] See §965(c), §965(g).

[12] A taxpayer is in an ''excess limitation position'' if it has less foreign tax credits than its foreign tax credit limitation in a specific basket.

[13] A taxpayer is in an ''excess credit position'' if it has more foreign tax credits than its foreign tax credit limitation in a specific basket, with such excess carrying over to another taxable year under §904(c) (except ion the case of the GILTI basket). Section 904(c) does not provide a carryover for excess foreign tax credits in the GILTI basket.

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a minimum, not distortive — even if, as in this case, the distortive results largely offset one another.

Second, although the ''plumbing'' of the tax code is (or should be) apolitical (and generally uninteresting, though hopefully that's not the case here), its proper operation is essential for the intended policy results of Congressional actions to be appropriately realized. And as Congress begins to consider modifications to the TCJA's international tax rules, fixing the plumbing would ensure a more consistent application of the TCJA's original policies as well as any policy decisions underlying subsequent revisions to its international tax rules. Moreover, these distortions are symptomatic of the TCJA enacting extremely complex rules that were hoisted on top of a somewhat out-of-date system, and hopefully this argues for a similar rethinking of other aspects of the international tax changes made by the TCJA.

Third, the problems arising from the after-tax approach for GILTI also highlight features of the GILTI rules that produce ''interesting'' results as these effects are exacerbated by the shareholder model. For example, the GILTI rules disallow the benefits of both foreign tax credits and QBAI of a CFC with a net loss for GILTI purposes (a ''tested loss CFC''). While a full discussion of the policy concerns presented by this treatment of tested loss CFCs is beyond the scope of this article, the scope of the rule includes profitable CFCs because the determination of whether a company is a tested loss company is made on an after-tax basis, a byproduct of the GILTI's adopting the subpart F model. While these results could be ameliorated by shifting away from the shareholder model to a different approach, the best response to the treatment of tested loss CFCs would be to eliminate the problems directly by changing the applicable rules.

Finally, the story is interesting (I hope, though perhaps only to Elisabeth Owens[14]) because it results from a series policy decisions dating back to the earliest days of the foreign tax credit and how the decision to adopt the shareholder model instead of a consolidated approach became ill-fated over a century later with the enactment of the TCJA. Section 78's role in this long narrative was only a supporting one: a mathematical correction necessary to properly implement the after-tax approach. But post-TCJA, the after-tax approach with its §78 correction is no longer up to the task, and instead, history has now come full circle where the shortcomings of the indirect credit under after-tax approach could be resolved by providing a direct credit as part of a pass-through or consolidated approach.

The best starting point for this discussion is a simple example. Assume that a domestic corporation (''USP'') owns 100% of a CFC (''FC'') formed in Country X. Assume further that: (1) FC earns 100,000 of gross income for the year, (2) has no deductions, and (3) the Country X imposes a creditable income tax at a rate of 10% such that FC pays 10,000 of foreign tax on its income.[15] If the income were foreign base company income (as defined in §954), then USP would have 100,000 of subpart F income and receive a deemed paid credit of 10,000 for the taxes paid under §960(a).[16]

Similarly, if the 100,000 were tested income, then USP would include 100,000 of GILTI, receive a 50,000 deduction under §250 (thus producing an effective tax rate of 10.5%) and have an 8,000 deemed paid credit under §960(d).[17] (USP only has a foreign tax credit of 8,000 because the GILTI rules limit the foreign tax credit to 80% of the taxes paid, or 8,000 of the 10,000 foreign taxes paid.)[18] Both situations produce the appropriate result because the complicating factor, the existence of some exempt income, is not present in either case.

The problem arises when FC has tested income, and FC (or another CFC owned by USP) also has QBAI. This can be demonstrated by assuming that in addition to the facts above, FC owns depreciable personal property with an adjusted tax basis for U.S. purposes of 500,000, resulting in 50,000 of DTIR.[19] As noted above, DTIR implements the ''territorial'' as-

[14] Elisabeth Owens is the author of the Foreign Tax Credit and, with Gerald Ball, the Indirect Tax Credit, which taken together are perhaps the best treatise on a topic of international tax law ever written and worth reading even today as the fundamental principles of the foreign tax credit remain the same notwithstanding the many changes to its operative rules. She also was the first woman to receive tenure at the Harvard Law School. For a fuller description of Prof. Owens' achievements, *see* Herma Hill Kay, Gerald T. Ball, Michael J. McIntyre and Oliver Oldman, In Memoriam: Elisabeth A. Owens, 112 Harv. L. Rev. 1403 (1999).

[15] In order to simplify the analysis, this example assumes that the CFC operates with the U.S. dollar as its function currency and, more generally, all amounts used throughout this article are in U.S. dollars. The example also assumes that there are no differences between the timing and amount of tax items for U.S. and foreign income tax purposes and therefore net income is equal in both countries.

[16] As discussed below, this result is an oversimplification of the statutory mechanics as the 100,000 of subpart F income is reduced by the 10,000 of foreign taxes, producing a 90,000 inclusion under §951(a), and then income is grossed-up for the 10,000 of foreign taxes under §78, resulting in 100,000 of taxable income.

[17] This computation of GILTI also reflects the same oversimplification as discussed in note 16 regarding the reduction of tested income for foreign income taxes.

[18] §960(d).

[19] A taxpayer's GILTI inclusion under §951A is reduced by its net DTIR, which is computed as 10% of the adjusted U.S. tax basis of the taxpayer's QBAI (the combined depreciable tangible personal property held by the taxpayer's CFC that give rise to tested income), reduced by specified interest. For purposes of sim-

pect of the GILTI regime and thus effectively exempts that portion of the tested income with the result that those earnings receive a 100% dividends received deduction (DRD) under §245A when distributed to USP. Because 50,000 of DTIR is exactly one-half of FC's 100,000 of pre-tax tested income, one might expect that USP will lose one-half of the 8,000 of foreign taxes deemed paid under §960(d) (again, 80% of the 10,000 total foreign tax paid) that are available in the case without DTIR. However, under the GILTI rules, the indirect foreign tax credit under §960(d) is 3,555.56 and not 4,000. This is the bad news — this taxpayer receives 444.44 too few foreign tax credits (offset partially by the smaller gross-up amount under §78). Further, though less apparent, the taxpayer also receives the economic benefit of a deduction for the 5,000 of foreign taxes imposed on the DTIR. The remainder of this article begins with how we got here — i.e., how the combination of the after-tax approach to taxing the income of CFCs and related indirect credit under §902, §960, and §78 and the creation of exempt income within the GILTI regime, resulted in the dilution of foreign tax credits under the GILTI rules. This explanation is best begun with a historical review of the key development of the two components of the current shareholder model for taxing income of foreign subsidiaries: the enactment of the indirect foreign tax credit and the correction to its computation by the gross-up of §78. Next, the article examines how the then innocuous, but unnecessary, decision in 1962 to track the after-tax approach of the shareholder model for the deemed paid credit on subpart F inclusions ultimately would present difficulties when it was expanded to apply to GILTI, with its exempt income, as part of the TCJA.

Next, the article will quantify the detriment from lost foreign tax credits, and the benefit of effectively permitting a deduction for foreign taxes attributable to the exempt income, and show that the combined impact of these two largely offset in most cases. Moreover, given the operation of the GILTI rules, with its failure to provide for carryovers for excess foreign tax credits (as almost every other tax attribute in the Internal Revenue Code does), means that the after-tax approach only helps taxpayers (albeit only slightly) that have excess limitation, and is neutral for those in an excess credit position. The article then takes a brief detour and considers the impact this principle under §965, as it is the one example outside of the GILTI rules where this phenomenon occurs (the application of the after-tax approach to a system that also exempts a portion of the income). The article then focuses on several aspects of the post-TCJA international tax system and how they impact the after-tax approach.

plifying the discussion herein, the examples will assume that the CFCs involved have no specified interest.

The final section proposes two solutions. The first is to simply change the after-tax approach of subpart F and GILTI to a pre-tax one, an approach that computes subpart F income in tested income without regard to the reduction for foreign income taxes (i.e., revising §954(b)(5) to reducing gross income by deductions only, and not foreign income taxes). The second, bolder solution, would be to address the problem more comprehensively by abandoning the shareholder model and moving closer to a consolidated approach for taxing foreign income. As noted above, the Congress considered a consolidated approach at the time when the foreign tax credit was first enacted a century ago before the idea was abandoned and the indirect tax credit was appended to the long-lived approach of deferring the taxation of foreign income until repatriation.

II. HISTORY OF THE AFTER-TAX APPROACH TO THE DEEMED PAID CREDIT

A. The Origins of the Indirect Foreign Tax Credit — The Revenue Act of 1918

The foreign tax credit was enacted as part of the Revenue Act of 1918 (the ''1918 Act'').[20] Section 238 of the 1918 Act provided that ''in the case of a domestic corporation the total taxes imposed for the taxable year. . .shall be credited with the amount of any income, war-profits and excess-profits taxies paid during the taxable year to any foreign country, upon the income derived from sources therein, or to any possession of the United States.''[21] Thus, §238 was essentially identical to current-day §901, except that a credit was only permitted for taxes on income derived from foreign sources, a limitation which was soon removed and replaced with the foreign tax credit limitation in 1921.[22]

A credit for taxes paid by a foreign subsidiary was also included, though as part of the §240 and the rules for corporate consolidation. Section 240(c) provided that

> for the purposes of section 238 a domestic foreign corporation which owns a majority of the voting stock of a foreign corporation shall be deemed to have paid the same proportion of any income, war-

[20] Revenue Act of 1918, §222(a) (for individuals), §238(a) (for corporations).

[21] Revenue Act of 1918, §238(a).

[22] This limitation on creditability of foreign taxes to those imposed on foreign-source income has appeared for a second time in proposed regulations that have been issued under §901 and would impose a jurisdictional nexus requirement for a foreign tax to be a creditable income tax for U.S. purposes. Prop. Reg. §1.901-2(c).

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profits and excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources without the United States, which the amount of any dividends (not deductible under section 234) received by such domestic corporation from such foreign corporation during the taxable year bears to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid. . . .

The provision was most likely included in the consolidation rules, as the enacted version of the provision reflected a scaled-back version of the original proposal to include foreign corporations in consolidation and provide the foreign tax credit directly.

This use of the after-tax approach had the unfortunate consequence of providing taxpayers the economic benefit of both a deduction and a credit for income taxes paid by foreign subsidiary. This result was beyond the concerns policed by §275(a)(4), which limits taxpayers from claiming a credit for some foreign taxes while deducting others in the same taxable year. In this case, taxpayers would enjoy the benefit of both for the same foreign tax, produce a net tax benefit in excess of the expense itself (a credit equal to 100% of the foreign taxes paid plus the marginal tax rate for the deduction); or at today's rates, $1.21 of benefit for each $1.00 of foreign tax paid.

The double benefit can be demonstrated with an example. Assume a CFC earns 100 of income and pays 30 of foreign tax, and thus the CFC has 70 of net earnings for the year. The CFC then pays a dividend of all 70 of earnings. Absent the §78 gross-up, the taxpayer would include 70 in income and then receive an indirect credit of 30 for the foreign taxes paid. If the U.S. rate were 50%, the pre-credit tax would be 35 (50% of 70), reduced by a 30 credit such that the taxpayer would owe 5 of residual U.S. tax. The credit would thus have provided 45 of benefit, a credit worth 100% of the tax, or 30, plus a deduction worth the taxpayer's marginal tax rate, or 15 (given the 50% tax rate). This result can be compared this to the result if the foreign subsidiary had not paid any foreign taxes. In such event, the CFC would have had 100 of net earnings to distribute, all of which would have been a taxable dividend, and no indirect credit, as no foreign taxes had been paid by the CFC. The taxpayer would have 100 of income taxed at 50% for a net tax of 50, which is 45 more than in the first case.

B. American Chicle—The Supreme Court Upholds Treasury's Second-Best Solution

The double benefit provided to income taxes paid by a foreign subsidiary did not go unnoticed and ultimately was partially resolved by the government by adjusting the computation of the indirect credit. Although the IRS did not issue regulations reflecting this double benefit, it had issued tax forms that provided for the computation of the indirect foreign tax credit as discussed above.[23] The government then reversed course and issued regulations that attempted to mitigate this double benefit by adjusting the computation of the foreign tax credit. The regulations retained the §902 fraction — the amount of the dividend over the total earnings for the year — but provided that the foreign taxes were only those taxes attributable to the after-tax earnings.[24] The change in the computation of the deemed paid credit can be demonstrated using the above example of a CFC that paid 30 of taxes on 100 on net income. If the CFC paid 70 as a dividend, the §902 fraction would be 1/1 as it had distributed all of the earnings for the year. But unlike before the regulation, only 70/100 of the taxes were attributable to the 70 of earnings that were distributed and thus the taxpayer was only entitled to an indirect tax credit of 21 (30 × 70/100) Thus, the benefit of the deduction remained, but the foreign tax credit was reduced accordingly.

Taxpayers challenged this approach, ultimately reaching the Supreme Court in the *Am. Chicle* case. The Supreme Court upheld the regulation, though perhaps more importantly, deemed the reduced credit to be sufficient to eliminate the double taxation of income given that the full net profit (the 100, in this example) was not subject to tax, only the after-tax amount.

> If, as is admitted, the purpose is to avoid double taxation, the statute, as written, accomplishes that result. The parent receives dividends. Such dividends, not its subsidiary's profits, constitute its income to be returned for taxation. The subsidiary pays tax on, or in respect of, its entire profits; but, since the parent receives distributions out of what is left after payment of the foreign tax,—that is, out of what the statute calls ''accumulated profits,'' it should receive a credit only for so much of the foreign tax paid as relates to or, as the Act says, is paid upon, or with respect to, the accumulated profits.[25]

C. Enactment of §78: Getting the Math Right

More than 40 years after indirect credit was created, Congress finally corrected the math to fully eliminate the double benefit from foreign income taxes paid by a subsidiary. As the foreign tax credit benefit was always intended, the correction eliminated

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[23] *Am. Chicle Co. v. United States*, 316 U.S. 450, 454 (1942).

[24] Former Reg. §19.131-7; *see also Am. Chicle* at 454.

[25] *Id.* at 452–453.

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the deduction benefit. Because the deduction was an implicit one — reducing the amount of earnings that could be distributed as a dividend — there was no deduction that could be disallowed. Instead, the economic equivalent was required, in this case, deeming additional income equal to the amount of taxes that were deemed paid under §902.

This adjustment to income corrected the tax results in the example to eliminate the benefit of the implicit deduction. The taxpayer was again entitled to the full 30 of deemed paid taxes upon the distribution of the 70 of earnings, but the 70 dividend would now be grossed up by the 30 of taxes such that the taxpayer included 100 in income. The 100 of income corresponds precisely to the pre-tax net income of the foreign subsidiary, thus removing the benefit of the deduction for the foreign taxes paid.

Ironically, because subpart F is not reliant upon actual distributions, and indeed is an inclusion in income even in the absence of such a distribution, there was no need to reduce the subpart F income for foreign taxes as was the case with a system tied to actual cash dividends. Section 951 could simply have required an inclusion of the CFC's pre-tax net subpart F income. But Congress enacted an approach that was consistent with dividends, potentially a show of new found confidence in the rules after the math had been corrected with the contemporaneous enactment of §78. Adopting the after-tax approach, though unnecessary, did not produce the distortive effects discussed in this article, as subpart F (unlike GILTI) did not include exempt income as part of its operation. The latent defect would only become apparent 55 years later with the enactment of the GILTI rules under the TCJA.

D. The Tax Cuts and Jobs Act of 2017 — Enactment of GILTI and §965

As discussed above, the TCJA introduced exempt income into the international tax rules in three ways: the reduction of net tested income for the return on QBAI, the associated earnings of which then qualify for the §245A DRD, (2) the offset of tested income by tested losses, again, because the earnings arising from the offset of tested income qualify for the §245A DRD, and (3) the deferred earnings offset by deficits that were deemed repatriated under §965 (similar to the earnings in (2)). The introduction of exempt income combined with the adoption of the after-tax approach for GILTI (and staying the course under the subpart F rules in the case of §965) converted to what was an unnecessary two-step in the case of subpart F to a distortive one under the GILTI rules, diluting the amount of creditable taxes and allowing for the deduction of foreign taxes on exempt income.

This result is particularly ironic given that the TCJA repealed the indirect credit on dividends. The combination of immediate taxation under GILTI for most deferred income, and the effective exemption for the remaining amount from the §245A DRD, results in income earned through a foreign subsidiary being taxed either immediately under subpart F or GILTI, or not at all because of the DRD. There is no longer a need for a deemed paid credit on dividends because the credit was already provided under §960 at the time the income was earned by the CFC, or is inappropriate since the dividend income was not subject to U.S. tax, and thus there is no threat of double taxation.

III. CONSEQUENCES OF THE AFTER-TAX APPROACH WHEN APPLIED TO GILTI

A. Dilution of Foreign Tax Credits

As noted above, the after-tax approach generally operates by including foreign income after reduction for foreign taxes, and then grossing up the income by the amount of the reduction to ultimately tax foreign income on a pre-foreign tax basis. Consider the original example discussed above, where FC's 100,000 of subpart F income resulted in 100,000 of net taxable income to USP. This description is an oversimplification of the actual operation of the rules. Although it generally did not matter pre-TCJA, the precise mechanism for reaching the 100,000 of taxable income and 10,000 of credit was as follows. FC's 100,000 of gross subpart F income is reduced by deductions (0 in this case) *and foreign taxes* of 10,000, resulting in net subpart F income of 90,000 that is included under §951(a). This approach is embodied in §954(b)(5), which provides that gross subpart F income is ''reduced, under regulations prescribed by the Secretary, so as to take into account deductions *(including taxes)* properly allocable to such income.''[26] USP then receives a 10,000 indirect tax credit under §960(a), and is required to include an additional 10,000 of income from the gross-up under §78. Thus, USP has 100,000 of taxable income and is entitled to a 10,000 foreign tax credit.

Computing the §951(a) inclusion on an after-tax basis produces the same result as if the computation had been done on a pre-tax basis without the gross-up. USP would simply have had 100,000 of subpart F income included under §951(a), and 10,000 of credit. (If the pre-tax approach were used, the amount of previously-taxed earnings and profits (PTEP) would still need to be determined on an after-tax basis as the cash used to pay the taxes cannot be distributed as it has been spent.) Reducing subpart F income by foreign taxes only to then increase it by the same amount

[26] Emphasis added.

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introduces two steps into the process when neither is needed. There is no explanation for this approach in the legislative history, and the adjustment necessary to ensure correct amount of PTEP at the CFC could have been achieved without requiring the reduction when computing taxable income.

Accordingly, a U.S. shareholder of a CFC either could include 90,000 of after-tax subpart F income and then gross that amount up to 100,000, or could simply include 100,000 of post-tax subpart F income, and not include a gross-up; in either case, the taxable result is the same. And while subpart F income did not require an after-tax approach, it also did not create distorted results to use this approach. Prior to the TCJA, the U.S. rules generally taxed all income of a CFC, whether under subpart F or when other active earnings were repatriated as dividends. The system did not include exempt earnings. GILTI (and §965) changed that. As discussed above, when the after-tax approach is applied to GILTI, and the taxpayer has some exempt income (from either DTIR or tested losses), the after-tax income dilutes the foreign tax credits. This happens technically by the computation of the inclusion percentage (which is based on this after-tax model). Returning to the original example, consider its consequences if the 100,000 of income were tested income. The results are the same as sub-

were tested income. The results are the same as sub-
part F income, except for the differences from the §250 deduction and the 80% haircut on foreign taxes under §960(d). FC has 90,000 of tested income (100,000 of income less 10,000 of foreign taxes), which is included in taxable income. Section 960(d) provides an indirect credit of 8,000 (8% of 10,000), and the §78 gross-up adds another 10,000 of income. The taxpayer also gets a 50,000 deduction under §250.

But when DTIR is introduced (for example, assume the CFC has sufficient QBAI to result in DTIR equal to 50% of pre-tax tested income), not only are the deemed paid foreign taxes reduced proportionately but another 444.44 of foreign tax credits disappear. This arises because the inclusion percentage is equal to GILTI over positive net tested income, both amounts of which are after-tax numbers.[27] Thus, USP is entitled to 80% of 4/9 (40,000 of GILTI/90,000 *of Tested Income*) of the foreign taxes paid, or 35.6%, and not 80% of 5/10 (50,000 *of pre-tax GILTI*/ 100,000 *of pre-tax Tested Income*), or 40% of the taxes, thus reducing the foreign taxes by 4.44% as follows:

$$\begin{matrix} Percentage\ of \\ Lost\ Taxes \end{matrix} = \left(80\% \times \begin{matrix} Section\ 960(d)\ Pre\text{-}tax \\ Inclusion\ Percentage \end{matrix}\right) - \left(80\% \times \begin{matrix} Section\ 960(d)\ Post\text{-}tax \\ Inclusion\ Percentage \end{matrix}\right)$$

$$\begin{matrix} Percentage\ of \\ Lost\ Taxes \end{matrix} = \left(80\% \times \frac{50{,}000}{100{,}000}\right) - \left(80\% \times \frac{40{,}000}{90{,}000}\right)$$

$$\begin{matrix} Percentage\ of \\ Lost\ Taxes \end{matrix} = 80\% \times (50\% - 44.44\%) = 80\% \times 5.55\% = 4.44\%$$

The amount of lost taxes can be generalized using the following equation, the derivation of which is provided in Appendix A.

$$Lost\ Taxes = 80\% \times DTIR \times \frac{FTR^2}{(1 - FTR)}$$

Where:

$$DTIR = Deemed\ Tangible\ Income\ Return$$
$$FTR = Foreign\ Tax\ Rate$$

[27] §960(d)(2).

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Applying the formula to the Example confirms the result.

$$Lost\ Taxes = 80\% \times 50{,}000 \times \frac{(10\%)^2}{(1-10\%)} = 80\% \times 50{,}000 \times \frac{0.01}{0.9} = 444.44$$

Of course, the more useful analysis is to generalize the equation to show the percentage of taxes lost, as opposed the absolute amount of taxes. This generalized approach can be computed using the following equation, the derivation of which is provided in Appendix B. The formula demonstrates that percentage of lost taxes depends on the facts of a specific case, or more precisely, on two specific facts: the exemption percentage (i.e., the percentage of DTIR relative to pre-tax taxable income or DTIR%) and the foreign tax rate.

$$\begin{matrix} Percentage\ of \\ Lost\ Taxes \end{matrix} = 80\% \times DTIR\% \times \frac{FTR}{(1-FTR)}$$

This generalized equation can then be used to compute the percentage of lost foreign taxes across the full range of values for the percentage of DTIR and foreign tax rates as shown below in Table I.

Table I: Computation of Diluted Foreign Tax Credits (Percentage of Tested Income)

	DTIR Percentage										
Foreign Tax Rate	0.00%	10.00%	20.00%	30.00%	40.00%	50.00%	60.00%	70.00%	80.00%	90.00%	100.00%
0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
5.00%	0.00%	0.42%	0.84%	1.26%	1.68%	2.11%	2.53%	2.95%	3.37%	3.79%	0.00%
10.00%	0.00%	0.89%	1.78%	2.67%	3.56%	4.44%	5.33%	6.22%	7.11%	8.00%	0.00%
13.125%	0.00%	1.21%	2.42%	3.63%	4.83%	6.04%	7.25%	8.46%	9.67%	8.00%	0.00%
15.00%	0.00%	1.41%	2.82%	4.24%	5.65%	7.06%	8.47%	9.88%	11.29%	8.00%	0.00%
20.00%	0.00%	2.00%	4.00%	6.00%	8.00%	10.00%	12.00%	14.00%	16.00%	8.00%	0.00%
25.00%	0.00%	2.67%	5.33%	8.00%	10.67%	13.33%	16.00%	18.67%	16.00%	8.00%	0.00%
30.00%	0.00%	3.43%	6.86%	10.29%	13.71%	17.14%	20.57%	24.00%	16.00%	8.00%	0.00%
35.00%	0.00%	4.31%	8.62%	12.92%	17.23%	21.54%	25.85%	24.00%	16.00%	8.00%	0.00%
40.00%	0.00%	5.33%	10.67%	16.00%	21.33%	26.67%	32.00%	24.00%	16.00%	8.00%	0.00%
45.00%	0.00%	6.55%	13.09%	19.64%	26.18%	32.73%	32.00%	24.00%	16.00%	8.00%	0.00%
50.00%	0.00%	8.00%	16.00%	24.00%	32.00%	40.00%	32.00%	24.00%	16.00%	8.00%	0.00%
55.00%	0.00%	9.78%	19.56%	29.33%	39.11%	40.00%	32.00%	24.00%	16.00%	8.00%	0.00%
60.00%	0.00%	12.00%	24.00%	36.00%	48.00%	40.00%	32.00%	24.00%	16.00%	8.00%	0.00%
65.00%	0.00%	14.86%	29.71%	44.57%	48.00%	40.00%	32.00%	24.00%	16.00%	8.00%	0.00%
70.00%	0.00%	18.67%	37.33%	56.00%	48.00%	40.00%	32.00%	24.00%	16.00%	8.00%	0.00%
75.00%	0.00%	24.00%	48.00%	56.00%	48.00%	40.00%	32.00%	24.00%	16.00%	8.00%	0.00%
80.00%	0.00%	32.00%	64.00%	56.00%	48.00%	40.00%	32.00%	24.00%	16.00%	8.00%	0.00%
85.00%	0.00%	45.33%	64.00%	56.00%	48.00%	40.00%	32.00%	24.00%	16.00%	8.00%	0.00%
90.00%	0.00%	72.00%	64.00%	56.00%	48.00%	40.00%	32.00%	24.00%	16.00%	8.00%	0.00%
95.00%	0.00%	72.00%	64.00%	56.00%	48.00%	40.00%	32.00%	24.00%	16.00%	8.00%	0.00%

Several aspects of the table are worth noting. First, the shaded region that starts at the bottom of the chart and increases as the DTIR percentage rises, highlights cases where the foreign tax rate plus the DTIR percentage equals or exceeds 100% and therefore no portion of the CFC's taxes are deemed paid under §960(d). Thus, the percentage dilution of taxes shown above does to include the full amount of taxes lost in such case and instead only shows the extent of lost taxes attributable to the after-tax approach, and thus the portion lost from the 20% haircut under §960(d) is not included, nor is the reduction for the portion of taxes properly attributable to the DTIR. Consider a taxpayer with a foreign tax rate of 50% that has 50%

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DTIR. In that case, the DTIR will reduce the 80% of foreign taxes by 50%, leaving 40% of taxes remaining. This 40 percent portion of the foreign taxes is then lost because the after-tax approach computes tested income or loss by taking into account not just deductions but foreign taxes, thus resulting in a tested loss CFC and eliminating all taxes. To allow these cases to be comparable with other cases reflected in the chart, the amount shown is limited to the 40%.

A second item to note about Table I is that the amounts therein are percentages of the foreign taxes lost, and thus as the foreign tax rate increases, the absolute amount of foreign taxes lost also increases proportionally. Consider the effect on a taxpayer with 20 percent DTIR. At a 10% foreign tax rate, the taxpayer has lost 1.78% of the foreign taxes paid, and at a 20% foreign tax rate, the taxpayer has lost 4.00% of foreign taxes. Even though the tax rate is doubled, the amount of taxes lost for every 100,000 of pre-tax tested income (the amount from the example) is 177.78 (100,000 *of net income* × 10% *foreign tax rate* × 1.78% *lost taxes*) and 800.00 (100,000 *of net income* × 20% *foreign tax rate* × 4.00% *lost taxes*). Converting the table to absolute amounts yields the numbers in Table II, below, using 100,000 of income.

Table II: Amount of Lost Foreign Taxes per 100,000 of Tested Income

		DTIR Percentage										
		0.00%	10.00%	20.00%	30.00%	40.00%	50.00%	60.00%	70.00%	80.00%	90.00%	100.00%
Foreign Tax Rate	0.00%	-	-	-	-	-	-	-	-	-	-	-
	5.00%	-	21.05	42.11	63.16	84.21	105.26	126.32	147.37	168.42	189.47	0.00
	10.00%	-	88.89	177.78	266.67	355.56	444.44	533.33	622.22	711.11	800.00	0.00
	13.125%	-	158.63	317.27	475.90	634.53	793.17	951.80	1,110.43	1,269.06	1,050.00	0.00
	15.00%	-	211.76	423.53	635.29	847.06	1,058.82	1,270.59	1,482.35	1,694.12	1,200.00	0.00
	20.00%	-	400.00	800.00	1,200.00	1,600.00	2,000.00	2,400.00	2,800.00	3,200.00	1,600.00	0.00
	25.00%	-	666.67	1,333.33	2,000.00	2,666.67	3,333.33	4,000.00	4,666.67	4,000.00	2,000.00	0.00
	30.00%	-	1,028.57	2,057.14	3,085.71	4,114.29	5,142.86	6,171.43	7,200.00	4,800.00	2,400.00	0.00
	35.00%	-	1,507.69	3,015.38	4,523.08	6,030.77	7,538.46	9,046.15	8,400.00	5,600.00	2,800.00	0.00
	40.00%	-	2,133.33	4,266.67	6,400.00	8,533.33	10666.67	12800.00	9,600.00	6,400.00	3,200.00	0.00
	45.00%	-	2,945.45	5,890.91	8,836.36	11781.82	14727.27	14400.00	10800.00	7,200.00	3,600.00	0.00
	50.00%	-	4,000.00	8,000.00	12000.00	16000.00	20000.00	16000.00	12000.00	8,000.00	4,000.00	0.00
	55.00%	-	5,377.78	10755.56	16133.33	21511.11	22000.00	17600.00	13200.00	8,800.00	4,400.00	0.00
	60.00%	-	7,200.00	14400.00	21600.00	28800.00	24000.00	19200.00	14400.00	9,600.00	4,800.00	0.00
	65.00%	-	9,657.14	19314.29	28971.43	31200.00	26000.00	20800.00	15600.00	10400.00	5,200.00	0.00
	70.00%	-	13066.67	26133.33	39200.00	33600.00	28000.00	22400.00	16800.00	11200.00	5,600.00	0.00
	75.00%	-	18000.00	36000.00	42000.00	36000.00	30000.00	24000.00	18000.00	12000.00	6,000.00	0.00
	80.00%	-	25600.00	51200.00	44800.00	38400.00	32000.00	25600.00	19200.00	12800.00	6,400.00	0.00
	85.00%	-	38533.33	54400.00	47600.00	40800.00	34000.00	27200.00	20400.00	13600.00	6,800.00	0.00
	90.00%	-	64800.00	57600.00	50400.00	43200.00	36000.00	28800.00	21600.00	14400.00	7,200.00	0.00
	95.00%	-	68400.00	60800.00	53200.00	45600.00	38000.00	30400.00	22800.00	15200.00	7,600.00	0.00

The silver lining, albeit a small one, from the lost foreign tax credits under the after-tax approach is the corresponding reduction in taxable income from the smaller §78 gross-up—in other words, less creditable taxes under §960(d) means less grossed-up income under §78. As discussed in the next section, this is essentially permitting a deduction for the lost taxes as is true of any foreign income tax that effectively reduce GILTI income and are not grossed-up at the U.S. shareholder level. This is a small effect that partially offsets the detriment from the lost credits, the benefit of which like any other deduction depends on the U.S. tax rate. In the case of GILTI, and in light of the reduced tax rate that is effected under §250, each dollar of lost credits results in a savings of 10.5 cents (assuming that the §250 deduction is not limited by the taxpayer's taxable income).[28] This benefit is for the full amount of taxes even though the creditable taxes are reduced by 20% under §960(d) as §78 applies without regard to this haircut. This benefit can be expressed using the following formula:

[28] The tax rate on GILTI income is effectively 10.5%, and not the full corporate tax rate of 21%, because a taxpayer receives a deduction under §250 for 50% of its GILTI inclusion, including the gross-up amount for taxes deemed paid under §960(d). §250(a)(1)(B). The §250 deduction, which also applies to foreign derived intangible income (FDII), is limited to the extent of taxable income. In cases where taxable income is less than the sum of GILTI and FDII for the taxable year, the effective tax rate on both types of income is increased.

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$$\begin{matrix}Benefit\ of\\ Reduced\ Gross\text{-}Up\end{matrix} = \frac{Lost\ Taxes}{80\%} \times 10.5\%$$

Computing this benefit for our example, the taxpayer lost 444.44 of foreign taxes from the after-tax approach. The benefit from the reduced gross-up is the 10.5% of the full amount of lost taxes without regard to the 80% haircut under §960(d) (or 555.55), for a net benefit of 58.33 as computed below.

$$\begin{matrix}Benefit\ of\\ Reduced\ Gross\text{-}Up\end{matrix} = \frac{444.44}{80\%} \times 10.5\% = 58.33$$

B. Deduction for Foreign Taxes Attributable to Exempt Income

The second distortion resulting from the after-tax approach is to provide the equivalent of a deduction for the foreign taxes allocable to exempt income. This result is at odds with several other features of the TCJA. First, §245A(d) not only disallows a credit for foreign taxes related to the earnings that qualify for the DRD but also disallows a deduction for such amounts. Second, §78 was specifically revised during the TCJA's legislative process to increase the gross-up to the full amount of creditable taxes without regard to the 80% haircut under §960(d). This adjustment operates in the same way as §78 more generally, increasing income to eliminate the implicit deduction that arises from taxes imposed directly on a CFC. Thus, by increasing the gross-up in this manner, the implicit deduction for the 20% of taxes that are not deemed paid is reversed.

The deductibility of foreign income taxes related to exempt income also is contrary to long-standing principles of the foreign tax credit system. While not directly contrary to the purposes of §78, which was focused on the U.S. tax deduction and the credit arise from the same foreign tax, it is at cross purposes with §275(a)(4), which requires a taxpayer to claim either a credit or a deduction with respect to all of their foreign income taxes for a given taxable year.[29] While it seems clear that nothing in §275 technically upsets this result, the policy of the provision has been undone by the TCJA in this set of circumstances.

The deduction for taxes on exempt income can be demonstrated by returning to the original example with 100,000 of pre-tax tested income and 10,000 of foreign taxes. Because 50% of this income is exempt as a result of the 50,000 of DTIR, 5,000 of the 10,000 of foreign taxes is attributable to this exempt amount. These taxes are never deemed paid under §960(d), and therefore the §78 gross-up never applies. But since the DTIR reduces the inclusion under GILTI, the taxpayer receives the economic equivalent for these foreign income taxes. The deduction for these taxes provides a benefit equal to the amount of foreign taxes attributable to the DTIR multiplied by the U.S. tax rate on GILTI as follows:

$$\begin{matrix}Benefit\ from\ Deduction\\ for\ \text{"}Exempt\text{"}\ Taxes\end{matrix} = \begin{matrix}Foreign\ Taxes\\ on\ DTIR\end{matrix} \times U.S.Tax\ Rate$$

Where taxes on DTIR equal the amount of DTIR multiplied by the foreign tax rate

$$\begin{matrix}Benefit\ from\ Deduction\\ for\ \text{"}Exempt\text{"}\ Taxes\end{matrix} = \left(DTIR \times \begin{matrix}Foreign\\ Tax\ Rate\end{matrix}\right) \times U.S.Tax\ Rate$$

Applying this formula in our example, the value of the deduction for these taxes is equal to 525 (assuming that the §250 deduction is not limited by taxable income), computed as follows:

$$\begin{matrix}Benefit\ from\ Deduction\\ for\ \text{"}Exempt\text{"}\ Taxes\end{matrix} = 50{,}000 \times 10\% \times 10.5\% = 525.00$$

C. Combined Cost/Benefit of the After-Tax Approach

The overall impact of the after-tax approach requires combining the offsetting costs and benefits from the dilution of taxes and the deduction for foreign taxes on exempt income. In our example, the value of this deduction (525.00) is greater than the value of the lost foreign credits (444.44), even before taking into account the added benefit from the inapplicability of §78 to the lost taxes (58.33). Thus, the net cost/benefit in the case of our example can be computed as follows:

$$Net\ Cost/Benefit = -444.44 + 58.33 + 525.00 = 138.89$$

The deduction for lost taxes is so significant that, for all taxpayers in an excess limitation position, the after-tax approach produces a small net benefit. This can be demonstrated by computing the net cost/benefit to a taxpayer from these three effects across the range of foreign tax rates and percentages of exempt income. This can be done by using the following formula:

[29] §275(a)(4).

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$$Net\ Cost/Benefit = -\frac{Amount\ of}{Lost\ Taxes} + \frac{Benefit\ of}{Reduced\ Gross\text{-}Up} + \frac{Benefit\ from\ Deduction}{for\ "Exempt"\ Taxes}$$

Appendix D demonstrates how this can be generalized by converting the equation to determine the amount of tax benefit as a percentage of pre-tax taxable income, and then using the current tax rate for GILTI of 10.5%. The cost/benefit of the after-tax approach can be computed as follows:

$$\frac{Net\ Cost/Benefit}{Taxable\ Income\ (pre-tax)\ or\ TI_p} = (DTIR\% \times FTR) \times \left[-(69.5\%) \times \frac{FTR}{(1-FTR)} + 10.5\%\right]$$

This benefit can also be shown more explicitly through a step-by-step computation of the U.S. tax liability in the example by more explicitly applying the GILTI rules in Table III below.

Table III: Computation of U.S. Tax on GILTI

Pre-Tax v. Post-Tax Comparison	Formula*	Pre-Tax	Post-Tax	Difference
Computation of GILTI				
Aggregate Net Tested Income (pre-foreign tax)	(1)	100,000.00	100,000.00	-
Foreign Tax Rate	(2)	10%	10%	-
Foreign Taxes	(3) = (1) * (2)	10,000.00	10,000.00	-
Tested Income	(4) = (1) - (3)	100,000.00	90,000.00	(10,000.00)
Computation of DTIR				
DTIR Percentage	(5)	50%	50%	-
Net DTIR	(6) = (1) * (5)	50,000.00	50,000.00	-
GILTI Inclusion	(7) = (4) - (6)	50,000.00	40,000.00	(10,000.00)
GILTI FTC Computation				
Creditable Taxes (none if a tested loss CFC)	(8) = (3)	10,000.00	10,000.00	-
Computation of Inclusion Percentage				
GILTI Inclusion	(9) = (7)	50,000.00	40,000.00	(10,000.00)
Aggregate Positive Tested Income	(10) = (4)	100,000.00	90,000.00	(10,000.00)
Inclusion Percentage	(11) = (9) / (10)	50.00%	44.44%	-5.556%
Section 960(d) Deemed Paid Taxes (80%)	(12) = 80% * (3) * (11)	4,000.00	3,555.56	(444.44)
Section 78 Gross-Up	(13) = (12) / 80%	-	4,444.44	4,444.44
Total GILTI + Gross-Up	(14) = (9) + (13)	50,000.00	44,444.44	(5,555.56)
Section 250 Deduction	(15) = 50% * (14)	25,000.00	22,222.22	(2,777.78)
Net Taxable Income from GILTI	(16) = (14) - (15)	25,000.00	22,222.22	(2,777.78)
US Taxable Income	(17) = (16)	25,000.00	22,222.22	(2,777.78)
Pre-Credit US Tax Liability (at 21% US tax rate)	(18) = 21% * (17)	5,250.00	4,666.67	(583.33)
Foreign Tax Credits				-
Creditable Taxes (GILTI)	(19) = (12)	4,000.00	3,555.56	(444.44)
FTC Limitation (assumes no expenses -or- 904(b)(4) adj.)	(20) = (18) * [(16) / (17)]	5,250.00	4,666.67	(583.33)
Net Creditable Taxes (GILTI)	(21) = min of [(19), (20)]	4,000.00	3,555.56	(444.44)
Lost Taxes from Section 904 FTC Limitation	(22) = (19) - (21)	-	-	-
Net US Tax	(23) = (18) - (21)	1,250.00	1,111.11	(138.89)

The three separate effects of the after-tax approach are the reason for the difference in the computations. The 444.44 of lost foreign tax credits is reflected in the difference (the far-right column) in "Section 960(d) Deemed Paid Taxes (80%)." The combined effect of the reduced §78 gross-up and the deduction for the foreign taxes on exempt income is reflected in the 583.33 (the sum of 58.33 and 525.00) of difference "Pre-Credit US Tax Liability." The combination of all effects is the 138.89 difference in "Net US Tax."

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Table IV below repeats the exercise in Table III, above, except that it shows the combined benefit (positive percentage) or cost (negative percentages) for taxpayers at various percentages of DTIR and different foreign tax rates, shown as a percentage of pre-tax net tested income.

Table IV: Computation of Overall Tax Consequences

		DTIR Percentage										
		0.00%	10.00%	20.00%	30.00%	40.00%	50.00%	60.00%	70.00%	80.00%	90.00%	100.00%
Foreign Tax Rate	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
	5.00%	0.00%	0.03%	0.07%	0.10%	0.14%	0.17%	0.21%	0.24%	0.27%	0.31%	0.53%
	10.00%	0.00%	0.03%	0.06%	0.08%	0.11%	0.14%	0.17%	0.19%	0.22%	0.25%	1.05%
	13.125%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.33%	1.38%
	15.00%	0.00%	-0.03%	-0.05%	-0.08%	-0.11%	-0.13%	-0.16%	-0.19%	-0.21%	0.37%	1.58%
	20.00%	0.00%	-0.14%	-0.27%	-0.41%	-0.55%	-0.69%	-0.83%	-0.96%	-1.10%	0.50%	2.10%
	25.00%	0.00%	-0.32%	-0.63%	-0.95%	-1.27%	-1.58%	-1.90%	-2.22%	-1.38%	0.62%	2.63%
	30.00%	0.00%	-0.58%	-1.16%	-1.74%	-2.31%	-2.89%	-3.47%	-4.05%	-1.65%	0.75%	3.15%
	35.00%	0.00%	-0.94%	-1.88%	-2.83%	-3.77%	-4.71%	-5.65%	-4.73%	-1.93%	0.87%	3.68%
	40.00%	0.00%	-1.43%	-2.87%	-4.30%	-5.73%	-7.17%	-8.60%	-5.40%	-2.20%	1.00%	4.20%
	45.00%	0.00%	-2.09%	-4.17%	-6.26%	-8.35%	-10.43%	-9.68%	-6.08%	-2.48%	1.13%	4.73%
	50.00%	0.00%	-2.95%	-5.90%	-8.85%	-11.80%	-14.75%	-10.75%	-6.75%	-2.75%	1.25%	5.25%
	55.00%	0.00%	-4.09%	-8.19%	-12.28%	-16.38%	-16.23%	-11.83%	-7.43%	-3.03%	1.38%	5.77%
	60.00%	0.00%	-5.63%	-11.25%	-16.88%	-22.50%	-17.70%	-12.90%	-8.10%	-3.30%	1.50%	6.30%
	65.00%	0.00%	-7.71%	-15.41%	-23.12%	-24.38%	-19.18%	-13.98%	-8.78%	-3.58%	1.63%	6.82%
	70.00%	0.00%	-10.62%	-21.23%	-31.85%	-26.25%	-20.65%	-15.05%	-9.45%	-3.85%	1.75%	7.35%
	75.00%	0.00%	-14.85%	-29.70%	-34.13%	-28.13%	-22.13%	-16.13%	-10.13%	-4.13%	1.88%	7.87%
	80.00%	0.00%	-21.40%	-42.80%	-36.40%	-30.00%	-23.60%	-17.20%	-10.80%	-4.40%	2.00%	8.40%
	85.00%	0.00%	-32.58%	-45.48%	-38.68%	-31.88%	-25.08%	-18.28%	-11.48%	-4.68%	2.12%	8.92%
	90.00%	0.00%	-55.35%	-48.15%	-40.95%	-33.75%	-26.55%	-19.35%	-12.15%	-4.95%	2.25%	9.45%
	95.00%	0.00%	-58.43%	-50.83%	-43.23%	-35.63%	-28.03%	-20.43%	-12.83%	-5.23%	2.37%	9.97%

As Table IV shows, the after-tax approach provides a benefit in all cases where the taxpayer is in an excess limitation position, though that benefit is very small. Further, the modest benefit for taxpayers slowly diminishes as the tax rates approaches 13.125%, which is the point where foreign taxes should eliminate all residual U.S. tax liability on GILTI.[30] For taxpayers with an effective foreign tax rate greater than 13.125%, the results seem increasingly grim until two additional considerations are factored into the analysis. First, the effective foreign tax rates are higher, and thus uncommon, though because this is an annual computation, high effective tax rates, including rates in excess of 100%, are possible due to differences in the U.S. and foreign income tax systems. Second, and most importantly, these taxpayers are in an excess credit position in the GILTI basket, and thus the negative consequences for taxpayers in this range is irrelevant because there is no carryover of excess credits. Thus, there is no residual U.S. tax liability, and the excess credits that are lost would have been eliminated in any event in light of the foreign tax credit carryover not applying to the GILTI basket.[31] Of course, as there is no residual tax on their GILTI, the benefit of the deduction for foreign income taxes on the exempt income also provide no additional direct tax benefit as well.

Although there is no direct detriment to excess credit taxpayers because there is no carryover under the current GILTI regime, if the carryover were permitted as part of future legislation modifying the GILTI rules (as there is no compelling policy reason to have disallowed one), then this loss of foreign

[30] In most cases the residual U.S. tax on foreign income is eliminated completely when the foreign effective tax rate on income is equal to the U.S. rate. Because §960(d) limits the amount of creditable foreign taxes to 80% of the total amount paid, the break-even point for GILTI is a foreign effective tax rate of 13.125% (80% × 13.125% = 10.5%).

The larger benefit found on the right-hand portion of the table arises because these are the more extreme cases where the foreign taxes ultimately exceed the remaining pre-tax net income and thus produce a tested loss company. In those cases, as noted above the combination of DTIR and foreign taxes result in no GILTI inclusion.

[31] §904(c).

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credit taxpayers would have significant negative consequences for these taxpayers. Of course, if a taxpayer is systemically is in an excess credit position year after year, then the carryover may have no value. But even this also may depend on future legislation as there have been a number of proposals to increase the tax rate on GILTI — and that was before the onset of the global pandemic and the related legislative relief made the revenue concerns in United States.[32] An increase in the U.S. tax rate on GILTI income would shift more taxpayers into an excess limitation position with respect to GILTI, which if coupled with a restoration of the carryover for these foreign taxes, would mean that many taxpayers would be adversely affected in a material way by the after-tax approach if these changes were enacted.

A second interesting feature of these results is that the net cost/benefit equals zero when the foreign tax rate is 13.125%, or the point at which foreign tax should eliminate any residual U.S. tax liability because 80% of such amount equals the U.S. effective tax rate on GILTI of 10.5% (and why 13.125% is included in the tables above). This is demonstrated based on the formula for computing the net cost/benefit.

$$\frac{Net\ Cost/Benefit}{TI_p} = (DTIR\% \times FTR) \times \left[-(69.5\%) \times \frac{FTR}{(1-FTR)} + 10.5\%\right]$$

If any of the three factors in the formula equals zero, the equation will equal zero. The first is where the DTIR percentage (DTIR%) equals zero, in which case there is no exempt income and thus no net cost/benefit. As the after-tax approach is only problematic in cases where there is exempt income; if there is no DTIR, the system works appropriately. It is for this reason that these distortions do not arise under subpart F, as there is no exempt income under its rules.

The second case in which this formula equals zero is where the foreign tax rate is zero. If there are no foreign taxes, then the cost from diluting those taxes, or the benefit of deducting a portion of those taxes, also will be zero. The final case is where the foreign rate is 13.125%, or the point at which the foreign tax liability eliminates the U.S. residual tax. If this foreign tax rate is substituted into the third factor, the amount also equals zero, as shown in Appendix D.

Finally, one additional consideration not reflected in the chart is the impact on these computation from the allocation of certain expenses incurred by the members of the U.S. group. The article does not attempt to quantify this effect across the range of possible cases because the effect of expense allocation depends on the amount of certain expenses allocated to GILTI for purposes of the foreign tax credit limitation (e.g., interest expense and research and experimentation), which is a function of the total amount of these expenses incurred by the U.S. members of the group and the proportional size of the foreign opera-tions, and thus not a function of the taxpayer's amount of GILTI, DTIR, the relevant foreign tax rate, or the operation of the GILTI rules more generally. More-over, computing GILTI on a pre-tax basis would have several smaller effects on the foreign tax credit limi-tation. The change would shift the ratio of PTEP and §959(c)(3) earnings, with the corresponding impact on the amount expenses allocated to GILTI (and ad-justed under §864(e)(3), if applicable in the current year). This shift would also affect the amount of ad-justment to the denominator of the §904 fraction as a result of the application of §904(b)(4), an adjustment that also would depend on the relative amounts of U.S.-source income, GILTI and other categories of foreign-source income. Thus, there is no way to generalize the impact of such amounts based solely on the GILTI operations. However, these expenses reduce the amount of foreign tax credits that may be claimed to the extent they are allocated to foreign-source income, whether GILTI or other foreign source income. Thus, the distortions discussed above have no impact at a lower foreign effective tax rate, because expense allocation has the effect of moving a taxpayer into an excess credit position at a foreign effective tax rate that is below 13.125%.

D. Tested Loss CFCs

The after-tax approach has a number of implications in the case of tested loss CFCs. A tested loss CFC is a CFC that has a net loss for GILTI purposes, or more specifically, a CFC with gross tested income that is less than the allocable expenses and foreign

[32] A number of bills have been introduced proposing various changes to the GILTI rules, including increasing the tax rate on GILTI by eliminating the §250 deduction. *See, e.g.*, S. 780, §2(b) (introduced by Sen. Whitehouse on March 13, 2019). The increase in the U.S. tax rate from 10.5% to 21% would result in a significant number of taxpayers shifting from an excess credit to an excess limitation position. *Id.* at §2(a). Of course, this legislation would also eliminate the creation of exempt income from DTIR, eliminating one category of cases that produce the distortions discussed herein, but the results would remain where exempt income is created by the offset of tested income by tested losses.

taxes.[33] Tested loss CFCs have a number of direct consequences under the GILTI rules. First, foreign taxes attributable to gross tested income incurred by a tested loss CFC are not creditable.[34] This disallowance of foreign taxes is not explained in the legislative history but presumably was done to provide parity with the pre-TCJA rules that do not allow for deemed paid credits unless there was positive earnings in the CFC.[35] Second, QBAI attributable to a tested loss CFC's tangible depreciable property is also forfeited.[36] Third, because the net loss of a tested loss CFC also offsets net tested income of other CFCs, the tested loss also reduces the foreign tax credits that are deemed paid under §960(d). The last consequence is implemented by the inclusion percentage and also suffers from an equally questionable policy footing.

The after-tax approach in the case of a tested loss CFC have several significant effects. First, it increases the frequency and magnitude of the negative consequences of tested loss CFCs. The determination of whether a CFC is ''profitable'' for GILTI purposes, and thus constitutes a tested income CFC or a tested loss CFC, is done on an after-tax basis. Therefore, foreign tax credits can take an otherwise profitable company and convert it to a tested loss CFC subject to all of the consequences above. For example, a CFC that has 100 of tested income before taxes, but pays taxes of 150, becomes a tested loss CFC. While this fact pattern may seem unusual given that it would represent a 150% effective tax rate, it results not from high foreign tax rates (which do not exist) but rather from differences in the U.S. and foreign tax systems — for example, the foreign jurisdiction including more taxable income than the CFC's U.S. taxable income due to differences in the tax accounting rules under each system. Thus, while the tax rate is artificially high in one year, it presumably results in the rate being artificially low in another year, as these difference generally offset across multiple years.[37] Given that it is not clear why tested loss companies produce the negative consequences discussed above, there is no policy reason for treating a company as ''unprofitable'' for this purpose simply because of timing or similar differences in the operation of the U.S. and foreign tax systems. These results are exacerbated by the annual approach of the GILTI rules, causing loss of credit for taxes shifted to one year if it creates a tested loss CFC, with no mitigation in the other year when there is U.S. taxable income, and thus subjecting the taxpayer to GILTI tax with less than all of the foreign tax credits related to such income.

Second, tested loss CFCs increase the frequency and magnitude of the distortive effects discussed herein that created by the intersection of the after-tax approach of GILTI with exempt income. Because tested losses offset tested income, these losses effectively create ''exempt income'' in the system much like the presence of QBAI. Because foreign taxes decrease tested income and increase tested loss, the after-tax approach increases both the frequency of tested losses and their magnitude, thereby increasing the amount of exempt income in the system. Greater exempt income in the system increases the absolute magnitude of the loss of foreign taxes and the deduction for taxes attributable to DTIR.

Finally, as noted above, any foreign taxes paid by the tested loss CFC are lost forever. While the detriment from the lost credits of the tested income CFC

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[33] *See* Reg. §1.951A-2(b)(2) (providing the regulatory definition of a tested loss and a tested loss CFC).

[34] Although not clear from the statute, the legislative history provides that no foreign income taxes incurred by a tested loss corporation are creditable. Conf. Rept. 115–466, at 643, n. 1538 (Dec. 15, 2017) (''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).'') The regulations under §960 adopt this approach. Reg. §1.960-2(c)(3).

[35] The policy for perpetuating this approach under the GILTI rules is difficult to support. The result under pre-TCJA law was largely driven by the deemed paid foreign tax credit being tied to a dividend, and thus requiring earnings and profits in the distributing corporation. Dissatisfaction with the result in individual years under pre-1987 law (so-called ''annual layers'') is in part what motivated the adoption of the pooling approach in the Tax Reform Act of 1986. The only vestige of this approach remaining after the 1986 Act was in the case of nimble dividends, which was not a policy-driven result but rather was a product of the imperfect intersection of the multi-year pooling approach of then newly enacted §902(c) and the historic approach in subchapter C permitting dividend treatment from companies that have current-year earnings despite an accumulated deficit from prior taxable years. Moreover, this approach does not provide parity with pre-TCJA law; the absence of a deemed paid credit for nimble dividends was exclusively an issue of timing, as the taxes were not disallowed but rather remained in the foreign tax pool and would be creditable when the company later had sufficient earnings to pay a dividend other than a nimble one. Further, the availability of carryovers under §904(c) allowed the foreign taxes and a nimble dividend to be matched across different taxable years. Under the GILTI rules, this loss of credit is permanent even before considering the absence of carryovers in the GILTI basket.

[36] As with the loss of foreign tax credits, the loss of QBAI is not clear from the statutory text, which suggests to the contrary, but the legislative history and changes to the text of the legislation as it moved from the House to the Senate supported this result and the implementing regulations adopt this approach. Reg. §1.951A-1(c)(3)(ii).

[37] There are cases involving significant base differences that do not reverse out between years, for example when a §338 election is made in connection with the acquisition of a foreign corporation. This reduction in U.S. taxable income following the basis step-up from the §338 election is a permanent difference in the tax base of both jurisdictions. However, in this and many similar cases, §901(m) would apply to the acquisition and thus disallow taxes with a practical result that closes the difference between the U.S. and foreign effective tax rates.

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is approximately offset by the benefit of the increased deductions for the taxes attributable to DTIR, this parity does not take into account the loss value of any foreign tax credits of tested loss CFCs. Because the amount of credits lost in a tested loss CFC is not tied directly to any part of the GILTI computation for U.S. tax purposes, its effect cannot be generalized as was the case for the other distortions discussed above. But any additional detriment arising from the loss of foreign tax credits that otherwise would have been available may well eliminate the small net benefit noted above, such that the distortions discussed above produce a net tax burden on taxpayers that are in an excess limitation position in the GILTI basket.

E. The TCJA's Transition Tax of §965

The same distortive results under GILTI also took place under the transition tax that was enacted as part of the TCJA. Section 965 used the subpart F rules for purposes of imposing a one-time transition tax on the existing deferred earnings of U.S. multinational companies. Specifically, §965 required all 10% shareholders of foreign corporations to include their ratable share of deferred foreign earnings in income and pay tax on such amounts at reduced rates. The income tax rate on such deferred earnings ranged from 8% to 15.5% depending on the percentage of such earnings that were deemed to be held in cash and not operating assets (as defined in the statute).

Section 965 introduced a wrinkle into the operation of the subpart F rules. As part of an effort to tax deferred earnings under §965, Congress permitted taxpayers to use any deficits to offset the deferred earnings. Such offset is similar to the reduction of tested income by tested losses, and thus §965 introduced exempt income into the subpart F system, in this case in the form of deferred earnings that were not required to be included because they were offset by deficits in other affiliates. This exempt income, combined with the after-tax approach of subpart F, resulted in the same distortions present under the GILTI rules. Table V, below, replicates the computation of the net impact of these distortions, but for deferred earnings that were included under §965 in 2017, and assuming a tax rate on such earnings of 15.5%.[38]

[38] The same analysis can be done for 2018, which is the year in which significant amounts of deferred earnings were included given the prevalence of CFCs that had made an election under §898(c) to have their U.S. taxable year end on November 30 (so-called ''11/30 CFCs''). The reduction in the corporate tax rate from 35% to 21% was in effect, which was adjusted for by the statute providing a different percentage deduction for 2018 to ensure that the tax rate on deferred earnings ranged from 8% to 15.5% as was the case for inclusions under §965 in 2017. §965(c). The foreign tax credits deemed paid on the 2018 inclusion were also adjusted, though in this case to ensure that the credit had equivalent value in both taxable years. §965(g)(2).

Table V: Computation of Overall Tax Consequences Under §965

	DTIR Percentage										
Foreign Tax Rate	0.00%	10.00%	20.00%	30.00%	40.00%	50.00%	60.00%	70.00%	80.00%	90.00%	100.00%
0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
5.00%	0.00%	0.07%	0.14%	0.21%	0.28%	0.35%	0.42%	0.49%	0.56%	0.63%	0.78%
10.00%	0.00%	0.12%	0.25%	0.37%	0.49%	0.62%	0.74%	0.86%	0.98%	1.11%	1.55%
13.125%	0.00%	0.15%	0.29%	0.44%	0.59%	0.73%	0.88%	1.02%	1.17%	1.45%	2.03%
15.00%	0.00%	0.16%	0.31%	0.47%	0.63%	0.78%	0.94%	1.09%	1.25%	1.66%	2.33%
20.00%	0.00%	0.17%	0.33%	0.50%	0.66%	0.83%	1.00%	1.16%	1.33%	2.21%	3.10%
25.00%	0.00%	0.15%	0.30%	0.44%	0.59%	0.74%	0.89%	1.03%	1.66%	2.77%	3.88%
30.00%	0.00%	0.09%	0.19%	0.28%	0.38%	0.47%	0.57%	0.66%	1.99%	3.32%	4.65%
35.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.77%	2.32%	3.87%	5.43%
40.00%	0.00%	-0.15%	-0.30%	-0.44%	-0.59%	-0.74%	-0.89%	0.88%	2.66%	4.43%	6.20%
45.00%	0.00%	-0.36%	-0.73%	-1.09%	-1.45%	-1.81%	-1.00%	1.00%	2.99%	4.98%	6.98%
50.00%	0.00%	-0.66%	-1.33%	-1.99%	-2.66%	-3.32%	-1.11%	1.11%	3.32%	5.54%	7.75%
55.00%	0.00%	-1.08%	-2.17%	-3.25%	-4.33%	-3.66%	-1.22%	1.22%	3.65%	6.09%	8.53%
60.00%	0.00%	-1.66%	-3.32%	-4.98%	-6.65%	-3.99%	-1.33%	1.33%	3.98%	6.64%	9.30%
65.00%	0.00%	-2.47%	-4.94%	-7.41%	-7.20%	-4.32%	-1.44%	1.44%	4.32%	7.20%	10.08%
70.00%	0.00%	-3.62%	-7.24%	-10.85%	-7.75%	-4.65%	-1.55%	1.55%	4.65%	7.75%	10.85%
75.00%	0.00%	-5.32%	-10.63%	-11.63%	-8.31%	-4.99%	-1.66%	1.66%	4.98%	8.30%	11.63%
80.00%	0.00%	-7.97%	-15.95%	-12.41%	-8.86%	-5.32%	-1.77%	1.77%	5.31%	8.86%	12.40%
85.00%	0.00%	-12.55%	-16.95%	-13.18%	-9.42%	-5.65%	-1.89%	1.88%	5.64%	9.41%	13.18%
90.00%	0.00%	-21.93%	-17.94%	-13.96%	-9.97%	-5.98%	-2.00%	1.99%	5.98%	9.96%	13.95%
95.00%	0.00%	-23.15%	-18.94%	-14.73%	-10.52%	-6.32%	-2.11%	2.10%	6.31%	10.52%	14.73%

As above, Table VI walks through the computations for §965 in one specified case.

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Table VI: Section 965 Sample Case

ASSUMPTIONS			
Foreign Tax Rate	(1)	10.00%	
Cash Percentage of Deferred Earnings	(2)	100.00%	
US Tax Rate on Sec. 965 Earnings	(3)	15.500%	
US Tax Rate (generally)	(4)	35.00%	
Positive CFC Earnings			
Pre-tax Earnings	(5)	100,000.00	
Foreign Taxes	(6) = (5) * (1)	20,000.00	
Net Earnings	(7) = (5) - (6)	80,000.00	
DFIC			
Pre-tax Earnings	(8)	(50,000.00)	
Foreign Taxes	(9)	-	Foreign taxes would
Net Earnings (Deficit)	(10) = (8) - (9)	(50,000.00)	also be lost

Pre-Tax v. Post-Tax Comparison	Formula	Pre-Tax	Post-Tax	Difference
Total Section 965 Inclusion	(11) = (5) - (8) or (7) - (8)	50,000.00	30,000.00	(20,000.00)
Foreign Tax Credits				
Total Foreign Taxes on Inclusion	(12) = (6) * (11) / (5) or (7)	10,000.00	7,500.00	(2,500.00)
Section 965 Applicable Percentage	(13)	55.700%	55.700%	-
Disallowed Credits	(14) = (12) * (13)	5,570.00	4,177.50	(1,392.50)
Creditable Credits	(15) = (12) - (14)	4,430.00	3,322.50	(1,107.50)
Section 78 Gross-up	(16) = 0 or (15)	-	3,322.50	3,322.50
Taxable Income				-
Section 965 Inclusion	(17) = (11)	50,000.00	30,000.00	(20,000.00)
Section 965 Deduction	(18) = (17) * (3)	27,857.14	16,714.29	(11,142.86)
Net income (before the gross-up)	(19) = (17) - (18)	22,142.86	13,285.71	(8,857.14)
Section 78 Gross-up	(20) = (16)	-	3,322.50	3,322.50
Total Taxable Income	(21) = (19) + (20)	22,142.86	16,608.21	(5,534.64)
US Tax Rate	(22) = (4)	35.00%	35.00%	-
Pre-Credit US Tax Liability	(23) = (21) * (22)	7,750.00	5,812.88	(1,937.13)
Creditable FTCs	(24) = min (15,23)	4,430.00	3,322.50	(1,107.50)
Net US Tax Liability	(25) = (23) - (24)	3,320.00	2,490.38	(829.63)
Section 904(c) Carryover	(26) = (15) - (25)	-	-	-
Net difference				(829.63)

One difference between §965 and the GILTI rules is the impact on excess credit taxpayers. As demonstrated above, under GILTI, these distortions would have a significant cost to excess credit taxpayers if the taxes lost from the after-tax approach could be carried over and used in another taxable year. The deferred earnings included under the transition tax were generally allocable to the general basket and thus any excess credits could have been carried over to another taxable year under §904(c). Thus, a taxpayer that had excess credits on its repatriated earnings, would be negatively affected by the after-tax approach as the impact of the lost foreign tax credits would be greater than the benefit of the deduction for taxes on earnings that were offset by deficits, and the excess credits would have been usable in another year. As a practical matter, this did not affect most taxpayers, as deferred earnings generally were low-taxed.

F. Expense Allocation and Apportionment

One additional factor that is not addressed in the examples above is the impact of allocating expenses of the U.S. members of an affiliated group to the foreign-source income. Expense allocation has taken center stage following the enactment of the TCJA, as the lower tax rates on corporate income — especially

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in the case of GILTI — dramatically reduced the foreign tax credit capacity of all taxpayers, many of which have shifted from an excess limitation position to an excess credit one in the GILTI basket. The general consequence of expense allocation is to reduce a taxpayer's foreign tax credit limitation under §904, and thus the primary impact of expense allocation is to shift taxpayers from an excess limitation to an excess credit position at a lower effective rate of foreign taxation. Although the expense is allocable to foreign-source income for U.S. tax purposes, the allocable expenses of the U.S. owners of CFCs are not deductible in the CFC's home jurisdiction, and thus the effective tax rate is higher in the foreign jurisdiction. When the consequences of the after-tax approach above are considered, this shift means that the small benefit from the after-tax approach phases out sooner at a lower foreign effective tax rate than 13.125%. Of course, once a taxpayer is in an excess credit position, the after-tax approach is neutral (at least until there is some other change to the rules like a restoration of the §904(c) carryover).

The magnitude of the excess credit position on an after-tax and pre-tax basis is different, and this level of allowable expenses at which the taxpayer shifts from an excess limit to an excess credit position will be different for different taxpayers. In general, this results in the after-tax position being closer to the ''excess credit'' line, and thus the impact of expense allocation affects a taxpayer under this approach more quickly. The benefit is therefore eliminated more quickly for the range of situations where the after-tax approach places a taxpayer in an excess credit position while the pre-tax approach would not.

G. BEAT Taxpayers

In addition to the complexity of GILTI, the TCJA also introduced taxpayers to the Base Erosion Anti-Abuse Tax (BEAT) under §59A. The BEAT imposes a 10% tax rate on an expanded base of income that is generally determined by disallowing deductions for any payments to related foreign persons or for depreciation on property acquired from such persons. BEAT liability is computed by ignoring the value of tax credits (other than the research and experimentation credit under §41, and even that preferential treatment sunsets for taxable years after 2025). Thus, for a BEAT taxpayer, foreign tax credits are effectively disallowed. Happily for BEAT taxpayers this means that the primary detriment of the after-tax approach — the loss of foreign tax credits — is not relevant, but the primary benefit, a deduction for taxes on the taxpayers exempt income is. Unfortunately, happiness under the BEAT is limited at best. Because the effective tax rate on GILTI income is only 5% (10%, reduced to 5% as a result of the §250 deduction), the benefit from the deduction on foreign taxes on exempt income is correspondingly reduced.

While this means that the after-tax approach ameliorates the impact of BEAT at the margin, at least as it operates today, corrections to the operation of BEAT might remove this benefit, or possibly impose an overall cost. For example, the BEAT's disallowance of foreign tax credit is incongruous with the purposes of the BEAT and thus is one of the more compelling changes that should be considered if it is revised to improve its operation. If the benefit of foreign tax credits were restored, it would appropriately limit the focus of the BEAT to inbound taxpayers where the risk of base erosion is of greater concern, and not for outbound taxpayers, many of which find themselves confronting the possible application of the BEAT primarily because of the foreign tax credit disallowance. If implemented, along with permitting a carryover for GILTI taxes, the negative impact from the after-tax approach would begin to impose an overall detriment at effective foreign tax rates greater than 6.25%, and thus affect most U.S. multinational companies.

H. Why It Matters

Given that the distortive consequences of the after-tax approach as applied to GILTI largely offset, and in all cases are (slightly) taxpayer favorable, there is a question of why does this matter, and is it worth correcting? As discussed below, these questions depend on whether corrective legislation simply addressed the distortions, or if Congress were more ambitious, fixing these distortions as part of a broader effort to shift the international tax rules closer to pure consolidation and address a number of other shortcomings that persist under TCJA. But before turning to specific solutions, this section discusses the reasons why correcting the distortive effects that arise from adopting the after-tax approach under the GILTI rules should be addressed, whether in isolation or as part of other changes to the international tax system.

First, correcting the distortive effects of the after-tax approach is simply the right thing to do. There is no reason to dilute foreign tax credits, or to permit a deduction for foreign taxes attributable to exempt income. Just as in 1962, when §78 was adopted, the statute should be revised to get the math right.

Second, the distortions under the after-tax approach exacerbate the largely indefensible treatment of tested loss CFC rules under the GILTI rules. And while taxpayers can often avoid these consequences through self-help, by combining profitable and unprofitable CFCs, there is no reason to compel them to do so. At a minimum, the consequences of tested loss status should not apply to companies that are actually profitable, and thus creditable taxes should not be a consideration in whether a company has made money. In-

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deed, to paraphrase Ms. Austen, one would have thought that a CFC paying income tax is rather a confirmation that it has been profitable.[39] This position is most compelling as a CFC can become a tested loss company because of foreign taxes (i.e., a CFC that would not have been a tested loss CFC but for the reduction in tested income for foreign income taxes) only if: (1) the foreign tax rate exceeds 100% assuming that the foreign tax rules determine taxable income in a similar fashion, or (2) the foreign tax rules do not correspond to their U.S. counterparts. Since the first option does not exist in practice (and is hard to imagine even as a theoretical matter), the creation of tested loss CFCs from the deduction of foreign income taxes must be attributable to differences between the U.S. and the foreign tax systems. And there is no policy reason for imposing the numerous pains of tested loss CFCs status on a company that appears unprofitable in a given taxable year only because of differences between the U.S. and foreign tax system.

Third, the modest impact of these distortions under current law may not be the case if the GILTI rules were modified in a number of respects. And given that correcting the distortions discussed herein would require a statutory change, any such correction is likely part of a broader set of changes to the GILTI rules. For example, modifications to the GILTI rules might well include permitting the carryover of excess foreign tax credits in the GILTI basket. If such a change were made, the neutrality that applies to an excess credit taxpayer (because the diluted foreign taxes have no value) would no longer apply, and the distortive effects would injure taxpayers in all cases where the taxpayer was in an excess credit position in the GILTI basket unless they were perpetually excess credit. Further, while many taxpayers may be in an excess credit position year after year given the current rate, if the rate were increased many may well move into an excess limitation position.

IV. FIXING THE MATH POST-TCJA

A. Adopt a Pre-Tax Approach for GILTI (and Subpart F)

The distortions of the after-tax approach can be eliminated by switching to a pre-tax approach for the GILTI rules. Instead of reducing tested income for foreign income taxes, tested income could be determined by only taking into account allocable deductions. Doing so would eliminate the need to apply the §78 gross-up. And while the distortive effects on the after-tax approach are not present under subpart F, there is no reason for adopting a consistent computation across both sets of rules.

If the pre-tax approach were adopted for subpart F and GILTI, the system would still require an after-tax approach to track earnings and profits, including principally previously taxed earnings and profits (PTEP). Regardless of whether the income is subpart F, GILTI or exempt, the earnings and profits of a corporation, and therefore the dividend-paying potential of the company, should be determined on an after-tax basis, because the after-tax income is all that can be distributed. Taxes paid to a foreign country, like any other expense, reduce the assets of the company, as the cost has been incurred even though it may entitle the U.S. shareholder of a foreign corporation to a foreign tax credit. Similarly, the collateral rules that apply to PTEP work appropriately only if the amount of earnings is reduced for foreign income taxes, for example, the recognition of foreign currency gains and losses under §986(c).

B. Bolder Thoughts: "To Form a More Perfect Union"[40]

A bolder approach to addressing the distortions to GILTI caused by the after-tax approach is to use the opportunity to not only correct the math, but to adopt an approach for taxing the income of a foreign subsidiary that more closely approaches a pure consolidated approach. The tax rules should operate to minimize tax differences that arise for whether a taxpayer elects to operate as a single legal entity or through multiple affiliates. The consolidated return rules achieve this goal for affiliated domestic corporations, but foreign corporations have never been included in the consolidated group (with the narrow exception for certain contiguous country corporations).[41]

Foreign operations conducted through a branch (or a disregarded entity) provide full consolidation, as the income earned and foreign taxes paid by the branch

[39] Jane Austen, *Pride and Prejudice*, Vol. III, Chap XIV (paraphrasing Elizabeth Bennet's response to Lady Catherine de Bourgh regarding whether Mr. Darcy had made her an offer of marriage, that "[Lady Catherine's] coming to Longbourn, to see me and my family. . .will be rather a confirmation of it.").

[40] U.S. Constitution, preamble. The full text of the Preamble to the U.S. Constitution is as follows:

> We the People of the United States, in Order to form a more perfect Union, establish Justice, ensure domestic Tranquility, provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity, do ordain and establish this Constitution for the United States of America.

[41] Section 1504(e) permits a taxpayer to treat certain foreign corporations as domestic corporations for U.S. federal income tax purposes when "a domestic corporation own[s] or control[s], directly or indirectly, 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property."

are directly included on the U.S. tax return of the owner. As such, the after-tax approach of the shareholder model is not a concern in those cases. And in as much as former §902 was created to provide so-called branch-sub parity, the indirect foreign tax credit did not deliver truly equivalent results. This is in part because the tax disparities between operating through a branch or a foreign subsidiary transcend the credit; the most obvious example of this is the ability of losses in a branch to offset U.S. income, while losses in a CFC are trapped offshore (at least until the CFC is sold). But a more full consolidation of foreign subsidiary would alleviate this and many of these disparities. This consolidation could be achieved either by patterning an approach after the regulations under §1502 (though excluding the returns to any minority owners) or by treating CFCs as flow through entities. This consolidation also would not prevent the favorable treatment that is otherwise available to GILTI. This is perhaps most clearly demonstrated by the availability of the §250 deduction to foreign derived intangible income (FDII), thus demonstrating that it is possible to provide a favorable tax rate to a specified category of income even when it is earned by a U.S. taxpayer.

The one significant limitation to a more consolidated approach is the treatment of foreign currency. The difficulties presented by branch operations that are conducted in a foreign currency are reflected by the significant challenges faced in promulgating regulations under §987, which still have yet to be completed 34 years after the Tax Reform Act of 1986. For this reason alone, it may well be more desirable to address these foreign currency issues by relying on the structural advantages that exist when accounting for these operations as separate corporations.

V. CONCLUSION

The practical considerations that favored the after-tax approach at the genesis of the U.S. foreign tax credit system were not present in 1962 when §960 expanded the deemed paid credit to subpart F inclusions. The adoption of this approach, however, provided consistency with the existing rules under §902, and was otherwise harmless. But when the taxation of dividends from foreign subsidiaries was effectively eliminated by the TCJA, and the indirect credit consolidated into §960, consistency with dividends lost all value (if it ever had any). Because the TCJA introduced exempt income into the international tax rules, the latent defect of the after-tax approach created unintended distortions. These distortions should be corrected, at a minimum, by modifying the GILTI rules to adopt a pre-tax approach. (And much like subpart F tagged along with dividends in 1962, subpart F should also be aligned with a pre-tax approach for GILTI to provide consistency.) Ideally though, these distortions would be addressed as part of a broader revision of GILTI to shift it closer to a pure consolidation approach.

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Appendix A

Computation of the Foreign Taxes Lost from the After-Tax Approach

Variables:

IP_p = *Inclusion Percentage (pre-tax)*

IP_a = *Inclusion Percentage (after-tax)*

G_p = *GILTI (pre-tax)*

G_a = *GILTI (after-tax)*

TI_p = *Tested Income (pre-tax)*

TI_a = *Tested Income (after-tax)*

DTIR = Deemed Tangible Income Return (DTIR)

ATFIT = Aggregate Tested foreign Income Rates

FTR = Foreign Tax Rate

Limitation on the function:

- Assumes that there are no tested losses, including where the after-tax approach produces and overall loss and thus a tested loss CFC, where the DTIR percentage and the foreign tax rate exceeds 100%, as in such cases all foreign tax credits are disallowed.

$$(1) \quad Lost\ Taxes = \frac{Section\ 960(d)\ Taxes\ with\ a}{pre\text{-}tax\ Inclusion\ Percentage} - \frac{Section\ 960(d)\ Taxes\ with\ a}{post\text{-}tax\ Inclusion\ Percentage}$$

$$(2) \quad Lost\ Taxes = \left(80\% \times IP_p \times ATFIT\right) - (80\% \times IP_a \times ATFIT)$$

$$(3) \quad Lost\ Taxes = (80\% \times ATFIT)\left[IP_p - IP_a\right]$$

$$(4) \quad Lost\ Taxes = (80\% \times ATFIT)\left[\frac{G_p}{TI_p} - \frac{G_a}{TI_a}\right]$$

Substituting given that $\boldsymbol{G_p = TI_p - DTIR}$ ***and*** $\boldsymbol{G_a = TI_a - DTIR}$

$$(5) \quad Lost\ Taxes = (80\% \times ATFIT)\left[\frac{TI_p - DTIR}{TI_p} - \frac{TI_a - DTIR}{TI_a}\right]$$

Substituting given that $\boldsymbol{TI_a = TI_p - \left(TI_p \times \mathrm{FTR}\right)}$ ***or*** $\boldsymbol{TI_p(1 - \mathrm{FTR})}$

$$(6) \quad Lost\ Taxes = (80\% \times ATFIT)\left[\frac{TI_p - DTIR}{TI_p} - \frac{TI_p(1-FTR) - DTIR}{TI_p(1-FTR)}\right]$$

$$(7) \quad Lost\ Taxes = (80\% \times ATFIT)\left[\left(\frac{TI_p - DTIR}{TI_p} \times \frac{TI_p(1-FTR)}{TI_p(1-FTR)}\right) - \left(\frac{TI_p(1-FTR) - DTIR}{TI_p(1-FTR)} \times \frac{TI_p}{TI_p}\right)\right]$$

$$(8) \quad Lost\ Taxes = (80\% \times ATFIT)\left[\frac{TI_p^{\,2}(1-FTR) - \left(DTIR \times TI_p\right)(1-FTR) - TI_p^{\,2}(1-FTR) + \left(DTIR \times \mathrm{TI}_p\right)}{TI_p^{\,2}(1-FTR)}\right]$$

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$$(9) \quad Lost\ Taxes = (80\% \times ATFIT)\left[\frac{-(DTIR \times TI_p)(1-FTR)+(DTIR \times TI_p)}{TI_p{}^2(1-FTR)}\right]$$

Reversing the order in the numerator:

$$(10) \quad Lost\ Taxes = (80\% \times ATFIT)\left[\frac{(DTIR \times TI_p)-(DTIR \times TI_p)(1-FTR)}{TI_p{}^2(1-FTR)}\right]$$

$$(11) \quad Lost\ Taxes = (80\% \times ATFIT)\left[\frac{DTIR-DTIR(1-FTR)}{TI_p(1-FTR)}\right]$$

$$(12) \quad Lost\ Taxes = (80\% \times ATFIT)\left[\frac{DTIR-DTIR+(DTIR \times FTR)}{TI_p(1-FTR)}\right]$$

$$(13) \quad Lost\ Taxes = (80\% \times ATFIT)\left[\frac{DTIR \times FTR}{TI_p(1-FTR)}\right]$$

Substituting given that $\boldsymbol{ATFIT = TI_p \times FTR}$:

$$(14) \quad Lost\ Taxes = 80\% \times \left(TI_p \times FTR\right)\left[\frac{DTIR \times FTR}{TI_p(1-FTR)}\right]$$

$$(15) \quad Lost\ Taxes = 80\% \times FTR \times \left[\frac{DTIR \times FTR}{(1-FTR)}\right]$$

$$(16) \quad Lost\ Taxes = 80\% \times DTIR \times \frac{FTR^2}{(1-FTR)}$$

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Appendix B

Computation of the Percentage of Taxes Lost from the After-Tax Approach

Starting with Step 13 from Appendix A, the formula can be solved for the percentage of lost taxes as follows:

$$(1) \quad Lost\ Taxes = (80\% \times ATFIT) \times \left[\frac{DTIR \times FTR}{TI_p(1-FTR)}\right]$$

Solving for the percentage of lost taxes by dividing the lost taxes by the Aggregate Tested Foreign Income Taxes:

$$(2) \quad \frac{Lost\ Taxes}{ATFIT} = 80\% \times \left[\frac{DTIR \times FTR}{TI_p(1-FTR)}\right]$$

Then substituting the Percentage of DTIR, which is the amount of DTIR divided by Pre-tax Tested Income or $DTIR\% = \frac{DTIR}{TI_p}$***:***

$$(4) \quad \begin{matrix} Percentage\ of \\ Lost\ Taxes \end{matrix} = 80\% \times DTIR\% \times \left[\frac{FTR}{(1-FTR)}\right]$$

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Appendix C

Computation of the Net Tax Cost/Benefit from the After-Tax Approach

Additional variables:

USTR = US Tax Rate

DTIR% = Percentage of pre-tax tested income that is offset by DTIR

$$(1)\qquad Net\ Cost/Benefit = -\begin{matrix}Amount\ of\\ Lost\ Taxes\end{matrix} + \begin{matrix}Value\ of Deduction\ from\\ Reduced\ Gross\text{-}up\end{matrix} + \begin{matrix}Value\ of\ Deduction\\ for\ DTIR\ Taxes\end{matrix}$$

$$(2)\qquad \begin{matrix}Net\ Cost/\\ Benefit\end{matrix} = -\left[\left[80\% \times \frac{(Pre\text{-}Tax\ Tested\ Income - DTIR)}{Pre\text{-}Tax\ Tested\ Income} \times FTCs\right] - Sec.\ 960(d)\ FTCs\right] + \left[USTR \times \begin{matrix}Section\ 78\\ Gross\text{-}up\end{matrix}\right] + [USYSTR \times (FTR \times DTIR)]$$

Inserting the formula from above for lost taxes $\left(\boldsymbol{Lost\ Taxes = 80\% \times DTIR \times \frac{FTR^2}{(1-FTR)}}\right)$ and the value of the deduction from the reduced gross-up.

$$(3)\qquad \begin{matrix}Net\ Cost/\\ Benefit\end{matrix} = -\left[80\% \times \frac{DTIR \times FTR^2}{(1-FTR)}\right] + \left[USTR \times \frac{DTIR \times FTR^2}{(1-FTR)}\right] + [USTR \times (FTR \times DTIR)]$$

$$(4)\qquad \begin{matrix}Net\ Cost/\\ Benefit\end{matrix} = -\left[(80\% - USTR) \times \frac{DTIR \times FTR^2}{(1-FTR)}\right] + [USTR \times (FTR \times DTIR)]$$

Factoring out DTIR and Foreign Tax Rate.

$$(5)\qquad \begin{matrix}Net\ Cost/\\ Benefit\end{matrix} = (DTIR \times FTR) \times \left[-(80\% - USTR) \times \frac{FTR}{(1-FTR)} + USTR\right]$$

Substituting $\boldsymbol{DTIR\% \times TI_p}$ for DTIR because the amount of DTIR is equal to the amount of Pre-tax Tested Income multiplied by the percentage of such income that is offset by DTIR.

$$(6)\qquad Net\ Cost/Benefit = \left(\left(DTIR\% \times TI_p\right) \times FTR\right) \times \left[-(80\% - USTR) \times \frac{FTR}{(1-FTR)} + USTR\right]$$

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Appendix D

Confirming the Overall Tax Benefit/Cost from the After-Tax Approach Equalizes When the Foreign Rate is 13.125%

Starting with the formula for the net cost/benefit from Appendix D, line (9):

$$(1) \qquad \frac{Net\ Cost/Benefit}{TI_p} = (DTIR\% \times FTR) \times \left[-(69.5\%) \times \frac{FTR}{(1-FTR)} + 10.5\%\right]$$

If a foreign tax rate of 13.125% rate is substituted into the third factor, the amount equals zero as shown below.

$$(2) \qquad Third\ Factor = \left[-(69.5\%) \times \frac{FTR}{(1-FTR)} + 10.5\%\right]$$

$$(3) \qquad Third\ Factor = \left[-(69.5\%) \times \frac{13.125\%}{(1-13.125\%)} + 10.5\%\right]$$

$$(4) \qquad Third\ Factor = [-10.5\% + 10.5\%\ ] = 0$$

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