To Check or Not to Check? The TCJA's Impact on Entity Classification Decisions

By Moshe Spinowitz and Robert C. Stevenson

I. Introduction

Since the introduction of the entity classification regulations over two decades ago (the so-called "Check-the-Box Regulations"),[1] the U.S. rules governing the classification of business entities—as corporations, partnerships, or disregarded entities—have been simple and flexible, generally requiring nothing more than the filing of a two-page form with a few boxes to check (hence the common names "Check-the-Box Regulations" and "Check-the-Box Election"). Over the past two decades, the consequences of such elections have become well-understood. Such elections could be used to simplify intercompany transactions (essentially by making them "disappear" for tax purposes), to mitigate the adverse consequences of the subpart F regime, to combine (or separate) the tax attributes of various entities, and to control the characterization of various corporate transactions (*e.g.,* turning a Code Sec. 351 transaction into a reorganization under Code Sec. 368(a)(1)(D)). And with the 2006 introduction of the CFC look-through rules of Code Sec. 954(c)(6), much of the benefit of the Check-the-Box Regulations was neutered.

And then came tax reform. The enactment of the legislation commonly known as the Tax Cuts and Jobs Act (the "TCJA")[2] introduced a veritable alphabet soup of new tax regimes, in particular in the international arena. The interaction of those new tax regimes with the long-standing Check-the-Box Regulations can in turn lead to some unexpected results—presenting both traps for the unwary and opportunities for the alert. This article explores the intersection of the Check-the-Box Regulations with two of the TCJA's new regimes—the new tax on Global Intangible Low-Taxed Income ("GILTI") and the new interest limitations under Code Sec. 163(j), in particular as they apply to controlled foreign corporations ("CFCs"). As will be shown from the discussion below, in particular through a variety of examples, the Check-the-Box Regulations, through their ability to separate or combine the income and tax attributes of multiple foreign entities, can have a significant impact on the tax profile of U.S. corporations that hold foreign subsidiaries. The calculation of GILTI income under Code

MOSHE SPINOWITZ is a Partner in the Boston, MA office of Skadden, Arps, Slate, Meagher & Flom LLP. **ROBERT C. STEVENSON** is an Associate in the Washington, DC office of Skadden, Arps, Slate, Meagher & Flom LLP.

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Sec. 951A, the availability of foreign tax credits under Code Sec. 960(d), the allocation of expenses and resulting foreign tax credit limitations under Code Secs. 861 *et seq.* and 904, and the availability of interest deductions under Code Sec. 163(j) can all be altered—for better or worse, and sometimes in counterintuitive ways—through Check-the-Box Elections. Each of the sections below will demonstrate the impact that a Check-the-Box Election can have on these new features of post-TCJA tax law, thereby illustrating, at the very least, the factors that must now be considered when deciding whether to check or not to check.

II. GILTI and the Problem of Disappearing QBAI

As noted above, Code Sec. 951A, enacted as part of the TCJA, introduced a new regime for the taxation of foreign earnings pursuant to which U.S. shareholders of CFCs are required to include in income on a current basis the GILTI with respect to those CFCs.[3] GILTI for a U.S. shareholder is the excess (if any) of such shareholder's "net CFC tested income" for such taxable year over such shareholder's "net deemed tangible income return" ("DTIR") for such taxable year.[4] Net CFC tested income for this purpose is measured formulaically as including all of the "tested income" and "tested losses" of the shareholder's CFCs, other than certain specified categories of income and losses.[5] A shareholder's DTIR, in turn, is generally equal to (i) a 10% return on all of the CFCs' qualified business asset investment ("QBAI"), which is generally the CFC's basis in depreciable tangible property that is used in the production of tested income, minus (ii) the net amount of interest expense taken into account in determining the net CFC tested income above.[6]

Thus, in a simple case, assume a domestic corporation ("USP") wholly-owns a CFC ("CFC1"), and CFC1 earns $100 of gross tested income, has $20 of deductions allocable to that gross tested income, and has $100 of depreciable tangible property (Example 1a). USP's GILTI inclusion will equal $70–$100 of gross income, minus $20 of allocable deductions, minus DTIR of $10 (10% of the $100 of basis in depreciable tangible property).

The GILTI regime—unlike the subpart F regime—does, however, allow the effective netting of income (or, more precisely, tested income) against losses (or, more precisely, tested losses) across CFCs for purposes of computing a U.S. shareholder's GILTI inclusion.[7]

So, for example, assume the same facts as in Example 1a, except that CFC1 owns another CFC ("CFC2") that has $50 of tested losses (Example 1b). In that case, USP's GILTI inclusion would be reduced to $20–$100 of gross tested income minus (i) $20 of allocable deductions, (ii) $10 of DTIR, and (iii) $50 of tested losses. In that scenario, the GILTI regime effectively permits the netting of income and losses across CFCs in a manner that mirrors the combination of those items that would occur if the two entities were to be combined *via* an election to treat CFC2 as a disregarded entity.

But a slight variation in the facts reveals a critical manner in which the GILTI regime does not truly net results across CFCs. Assume now the same facts as Example 1b except that CFC2 also owns depreciable tangible property with a basis of $100 that is held for the production of tested income (Example 1c). The preamble to the proposed regulations under Code Sec. 951A (the "Proposed GILTI Regulations") states that, "[c]onsistent with the statute and the conference report … the proposed regulations clarify that a tested loss CFC does not have specified tangible property."[8] As a result of that rule, CFC2's investment in tangible property is simply irrelevant for purposes of calculating USP's GILTI inclusion. Since CFC2 is a tested loss CFC, the Proposed GILTI Regulations treat it as if it "does not have [any] specified tangible property," and USP's "intangible return" from its foreign subsidiaries is unaltered by its tangible property investment. USP's GILTI inclusion in Example 1c thus remains $20—just as in Example 1b. Isolating the tangible property in a separate CFC with a tested loss effectively made the QBAI disappear for GILTI purposes.

In this instance, though, a simple Check-the-Box Election can make that QBAI reappear. If the facts remain the same as those in Example 1c, but USP elects to treat CFC2 as a disregarded subsidiary ("DRE2") of CFC1 (Example 1d), then for U.S. federal income tax purposes there is simply a single, profitable entity that has $100 of gross tested income, $70 of allocable deductions (the $20 of deductions from CFC1 and the $50 of deductible expenses of DRE2), and $20 of DTIR (10% of the $200 of total tangible property held by both CFC1 and DRE2)—yielding a GILTI inclusion of $10. Essentially, by checking the box on CFC2, USP received credit for the tangible property investment in CFC2 and thereby reduced its GILTI inclusion by $10 (or 10% of the additional tangible property investment in CFC2).

The initial—and perhaps most straightforward manner—in which the TCJA has complicated the Check-the-Box Election calculus is thus through the treatment of QBAI held by tested loss CFCs. While the GILTI

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regime in many respects purports to be an "aggregate" CFC regime (unlike the subpart F regime) that allows for the combination of attributes across CFCs, the treatment of tangible property held by tested loss CFCs creates an incentive for taxpayers in certain circumstances to achieve a more fulsome "synthetic" netting across CFCs *via* entity classification elections to mitigate the problem of "disappearing QBAI."

III. Code Sec. 960(d) and the Inclusion Percentage Haircut

A similar, but somewhat more subtle, issue arises with respect to tested loss CFCs and their impact on the foreign tax credits that can be claimed with respect to GILTI inclusions under Code Sec. 960(d). New Code Sec. 960(d), which was introduced in the TCJA as part of the general GILTI regime, provides domestic corporate shareholders of CFCs with a foreign tax credit equal to 80% (the so-called "GILTI FTC haircut") of the "tested foreign income taxes" paid by the CFC multiplied by the U.S. shareholder's "inclusion percentage."[9] Tested foreign income taxes are generally foreign income taxes paid by a CFC that are properly attributable to the CFC's tested income,[10] and a U.S. shareholder's inclusion percentage is defined as the shareholder's GILTI inclusion divided by "the aggregate amount described in section 951A(c)(1)(A) with respect to such corporation."[11] Following through the cross-references, Code Sec. 951A(c)(1)(A) refers to a U.S. shareholder's *pro rata* share of the *tested income* of each CFC with respect to which it is a U.S. shareholder. The immediately following subparagraph—951A(c)(1)(B)—in turn allows a U.S. shareholder to calculate its GILTI inclusion by taking into account its *pro rata* share of the *tested losses* of the CFCs with respect to which it is a U.S. shareholder. The cross-reference in Code Sec. 960(d) to Code Sec. 951A(c)(1)(A)—to the exclusion of Code Sec. 951A(c)(1)(B)—causes the inclusion percentage to be equal to a U.S. shareholder's GILTI inclusion divided by the tested income of its tested income CFCs without regard to the losses of its tested loss CFCs. The result of this is that while tested loss CFCs reduce a U.S. shareholder's GILTI inclusion, those losses reduce the U.S. shareholder's "inclusion percentage," thereby effectively reducing the foreign tax credits available with respect to that GILTI inclusion under Code Sec. 960(d).

As with the discussion above regarding the problem of disappearing QBAI, the inclusion percentage formula under Code Sec. 960(d), and its resulting impact on the Code Sec. 960(d) foreign tax credit formula, reveals a second way in which the GILTI regime is not a true "netting" regime. As illustrated in more detail below, the presence of a separate CFC with a tested loss results in the inclusion of fewer foreign tax credits under Code Sec. 960(d) than would be included if such loss had been incurred within another CFC with offsetting income. This disparity, in turn, requires domestic corporate shareholders of CFCs to consider entity classification elections as a means to achieve more comprehensive netting than the GILTI regime does by itself.

Continuing with the example from above in which USP wholly-owns CFC1, which in turn owns CFC2, assume now that CFC1 has $100 of net tested income (before taking into account foreign taxes) and pays $10 of foreign income tax, while CFC2 has a $20 tested loss and pays no foreign income tax; for the sake of simplicity assume neither CFC owns any QBAI (Example 2a). USP's GILTI inclusion would equal $70—CFC1's $100 of pre-tax tested income, minus $10 of CFC1's foreign tax, minus $20 of tested losses from CFC2.[12]

But we then need to determine how many of those foreign taxes are available to USP as a deemed paid foreign tax credit under Code Sec. 960(d). To do so we need to compute USP's inclusion percentage, which equals its GILTI inclusion ($70 per the above) divided by the tested income of its tested income CFCs. Since CFC2 has a tested loss, it is ignored for these purposes. Instead we only compute the tested income of CFC1, which is $90–$100 of pre-tax tested income minus $10 of foreign tax. So USP's inclusion percentage is 70/90 (approximately 78%), and its Code Sec. 960(d) credits would equal the $10 of taxes, multiplied by 70/90, and further multiplied by 80%—resulting in $6.22 of foreign tax credits. A further twist in the calculation—the Code Sec. 78 gross-up is calculated in the same manner, only *without* the 80% GILTI FTC haircut, yielding a Code Sec. 78 gross-up of $7.78 ($10 multiplied by 70/90). USP's additional U.S. taxable income is thus $77.78 (the $70 of GILTI plus the $7.78 Code Sec. 78 gross-up). And USP can claim $6.22 of foreign tax credits. Assuming no limitation on USP's Code Sec. 250 deduction with respect to its GILTI inclusion,[13] and no limitation on its use of those foreign tax credits under Code Sec. 904 (more on that below), USP's taxable income would equal $38.89 (50% of its $77.78 income inclusion), and it would owe U.S. tax of $8.17 (21% of $38.89) on a pre-credit basis, or $1.95 of U.S. tax after utilizing the foreign tax credits ($8.17 minus $6.22). In essence, while USP was allowed to use the losses of CFC2 to offset the GILTI arising from CFC1, the use of those tested losses

"cost" USP some of the foreign tax credits associated with CFC1 *via* the reduced inclusion percentage and its resulting reduction in the Code Sec. 960(d) foreign tax credit calculation.

Consider, instead, what happens if USP elects to treat CFC2 as a disregarded entity. Assume all the same facts as Example 2a, except that CFC2 now becomes DRE2—a disregarded subsidiary of CFC1 (Example 2b). USP has the same $70 GILTI inclusion—$100 of CFC1's pre-tax tested income, minus $10 of CFC1's foreign taxes, and minus $20 of DRE2's losses. But now the denominator of USP's inclusion percentage fraction is also equal to the same $70 since those expenses of DRE2 net against the income of CFC1 within a single tested income CFC, rather than arising in a separate tested loss CFC as above. USP can thus claim $8 of foreign tax credits with respect to CFC1, and its taxable income inclusion arising from GILTI plus its Code Sec. 78 gross-up equals $80. Assuming the same Code Sec. 250 deduction and foreign tax credit utilization profile as above, USP would have net taxable income of $40 (50% of the $80 income inclusion), U.S. tax of $8.40 on a pre-credit basis (21% of $40), and only $0.40 ($8.40 minus $8) of U.S. tax on an after-credit basis, as compared to $1.95 of U.S. tax without the election. Essentially, by checking the box on CFC2, USP was able to fully utilize *both* the losses of CFC2 and the foreign tax credits of CFC1. As with the problem of "disappearing QBAI," the entity classification election allowed for a more efficient netting of tax items across CFCs than would otherwise be available "naturally" under the GILTI regime.

In particular with respect to the impact of the inclusion percentage on the Code Sec. 960(d) calculation, given the annual nature of both tested losses and Code Sec. 960(d) foreign tax credits—neither can be carried forward—the loss of credits due to tested loss CFCs can be particularly harsh. For example, in Example 2a, absent the Check-the-Box Election, USP was able to fully utilize the tested loss of CFC2 at the price of losing foreign tax credits from CFC1. But what if in the subsequent year CFC2 earns positive taxable income? For local country purposes, CFC2 may be able to carry forward its prior-year operating loss and thereby reduce its local country tax burden. But the tested income of CFC2 would be fully includible under the GILTI regime in that second year. And the adverse impact of the Code Sec. 960(d)(2) inclusion percentage formula from the prior year would not be reversed. In essence, across the two years, USP would have included all of the income of both CFCs under the GILTI regime without any true benefit from an economic loss, and yet USP would have permanently lost a portion of the foreign tax credits associated with the CFC1 income. If instead, CFC2 is treated as a disregarded entity throughout that period, USP can fully utilize all of the attributes of the two entities without suffering any loss of foreign tax credits.

IV. 904 Limitations—Inclusion Percentage and the GILTI Basket Limitation

At this stage a reader might be wondering—why the ponderous question in the article's title? Isn't the answer obvious? If the absence of a Check-the-Box Election results in a potential increase in GILTI through the loss of QBAI and reduced foreign tax credits through the Code Sec. 960(d) inclusion percentage calculation, then why not *always* check the box? The beginning of the answer lies in the even more complex foreign tax credit limitation rules of Code Sec. 904, and the expense allocation rules that feed into the Code Sec. 904 limitation calculation.

While a complete review of the foreign tax credit limitation and expense allocation rules under Code Secs. 904 and 861, *et seq.*—including the 312 pages of proposed new rules that were released in late 2018[14]—is beyond the scope of this article, a brief overview is necessary for the following discussion.

Under Code Sec. 901, a U.S. taxpayer can claim a credit in respect of certain foreign taxes paid with respect to its income. However, to prevent the foreign tax credit from effectively allowing taxpayers to reduce U.S. tax on U.S. source income, Code Sec. 904 limits the available foreign tax credits to those that bear the same proportion to total taxes as the taxpayer's foreign source income bears to its total taxable income.[15] In essence, Code Sec. 904 generally limits the available foreign tax credits to those that equal the U.S. tax rate multiplied by the taxpayer's foreign source income. Code Sec. 904(d), in turn, applies that same limitation to each separate category (so-called "basket") of foreign source income identified in that subsection. Critically for purposes of this article, the TCJA created a new separate foreign tax credit limitation for income includible under Code Sec. 951A—*i.e.*, GILTI inclusions (the so-called "GILTI basket").[16] Thus, to determine the portion of the Code Sec. 960(d) credits that a taxpayer can actually use, it must calculate its Code Sec. 904 foreign tax credit limitation in the GILTI basket.

That in turn requires calculating the net foreign source income in the GILTI basket, which requires computing both the GILTI inclusion *and* the expenses that are

allocable to such income. Regulations under Code Sec. 861 set forth the rules for allocating expenses to foreign source income and the baskets therein. Those regulations include both existing, long-standing expense allocation regulations, as well as new recently-proposed regulations that were released as part of the broader set of proposed foreign tax credit regulations issued in late 2018. The following discussion assumes some familiarity with those rules. But to briefly summarize a few key features of the expense allocation rules, as relevant here:

- Interest expense must be allocated solely on an asset basis method, and not under the fair market value method[17];
- When allocating interest expense, stock basis in a CFC must be characterized based on either the underlying gross income generated by a CFC and its subsidiaries or the assets of the CFC and its subsidiaries[18];
- On that basis, CFC stock basis is categorized into a variety of categories and subgroups, among which are the Code Sec. 951A category to reflect earnings includible under GILTI, and a Code Sec. 245A subgroup to reflect earnings that are not subject to taxation under either the GILTI or subpart F regimes[19];
- To the extent CFC stock is characterized as a GILTI basket asset, the Code Sec. 250 deduction (where available) causes 50% of that stock basis to be treated as an exempt asset that is effectively disregarded for purposes of interest expense allocation,[20] and last but not least;
- When determining the portion of CFC stock that is placed in the Code Sec. 951A category, the portion so treated is based, in part, on the U.S. shareholder's inclusion percentage.[21]

Which brings us back to the question of whether or not to make an entity classification election, and the impact that has on the U.S. taxation of a corporate shareholder that owns foreign subsidiaries that have both tested income and tested losses. But now, rather than taking into consideration only the impact that loss CFCs have on the Code Sec. 960(d) credits, we also consider the impact they have on expense allocation in light of the use of the inclusion percentage in the interest expense allocation regulations and the features of the inclusion percentage formula discussed above—*i.e.,* computing GILTI in the numerator but ignoring tested loss CFCs in the denominator. As will be shown through the below examples, unlike above where combining tested income and tested loss CFCs through Check-the-Box Elections led to a clear benefit, once expense allocation is considered, the analysis becomes considerably more complex. And unlike the examples above that show a clear benefit to checking the box, the examples below will show how a Check-the-Box Election can actually be detrimental.

Assume yet again that USP owns CFC1, which owns CFC2. USP has domestic assets with a basis of $500 that generate U.S. source income and USP has basis of $1,000 in its CFC1 stock. USP earns $100 of U.S. source net income before taking into account GILTI and has $20 of net interest expense. CFC1 earns $100 of non-passive, non-subpart F, foreign source tested income on a pre-tax basis and pays $20 of foreign tax. CFC2 incurs $20 of tested losses (Example 3a).

Per the discussion above, USP's GILTI inclusion equals $60–$100 of pre-tax tested income, minus $20 of foreign taxes, minus $20 of tested losses. But the tested losses of CFC2 reduce USP's inclusion percentage to 75% – $60 of GILTI divided by $80 of tested income *without regard* to the tested losses of CFC2. USP can claim credits under Code Sec. 960(d) equal to 80% (the "standard" GILTI FTC haircut) of 75% (the "inclusion percentage haircut") of the $20 of CFC1's foreign taxes—or $12. USP's Code Sec. 78 gross-up is $15 (75% of $20). USP thus has a total income inclusion of $75 – $60 of GILTI plus a $15 Code Sec. 78 gross-up, and can claim a $37.50 deduction under Code Sec. 250. Thus, before taking into account expense allocation, USP has $37.50 of GILTI basket foreign source income and a foreign tax credit limitation of $7.875 (21% of $37.50), and USP would not owe any further marginal U.S. tax as a result of the GILTI inclusion (because the $7.875 foreign tax credit limitation is precisely equal to the U.S. tax on that net income inclusion).

But USP is required to allocate a portion of its interest expense to that GILTI basket foreign source income. Determining how much it must allocate requires characterizing the stock of CFC1 for expense allocation purposes, which again relies on our old friend, the inclusion percentage. Much as USP's Code Sec. 960(d) credits were haircut by USP's 75% inclusion percentage, so too the portion of the CFC1 stock that is characterized as a GILTI basket asset is cut back by the same percentage.[22] Thus, only $750 of the $1,000 of CFC1 stock basis is tentatively characterized as a GILTI asset; the remaining $250 is assigned to the Code Sec. 245A subgroup. Since the Code Sec. 250 deduction is fully available to USP, the portion of the CFC1 stock that would have been characterized as a GILTI asset is then cut in half,[23] with the other half (50% of $750, or $375) characterized as an exempt asset that is effectively ignored for interest expense allocation purposes. As a result USP is treated as having three categories of assets totaling $1,125 for interest expense allocation purposes: (i) U.S. source assets of

$500, (ii) a Code Sec. 245A subgroup asset of $250, and (iii) a GILTI basket asset of $375 (50% of $750).

USP's $20 of interest expense then gets allocated in the same proportions, with 33.3% ($375/$1125) or $6.67 allocated to the GILTI basket and 22.2% ($250/$1125) or $4.44 allocated to Code Sec. 245A "income." USP's GILTI basket income for foreign tax credit limitation purposes is thus not the $37.50 that was actually included in income (net of the Code Sec. 250 deduction), but is instead the lesser amount of $30.83 ($37.50 minus the $6.67 of allocated interest expense).

But that is not the end of the analysis. Because some of USP's interest expense is allocated to Code Sec. 245A group income, new Code Sec. 904(b)(4) must be taken into account—and what the "inclusion percentage haircut" giveth, Code Sec. 904(b)(4) taketh away. Specifically, Code Sec. 904(b)(4) provides that when calculating a taxpayer's foreign tax credit limitation, both the foreign source income *and the* "entire taxable income" of the taxpayer must be calculated without regard to deductions properly allocable to income that is not includible under Code Secs. 951 or 951A. Thus deductions that are allocable to dividends that would be exempt under Code Sec. 245A are disregarded for purposes of computing "entire taxable income" and must effectively be added back to worldwide income—not for purposes of actually calculating taxable income but purely for purposes of measuring the foreign tax credit limitation. Since the foreign tax credit limitation in a particular basket equals the total tax of the taxpayer multiplied by the taxpayer's foreign source income in that basket and divided by the taxpayer's entire taxable income, adding those expenses back to entire taxable income increases the denominator of the Code Sec. 904 fraction and thereby reduces the foreign tax credit limitation.

On the facts above, USP's actual worldwide taxable income was $137.50, consisting of $100 of domestic income plus $37.50 of GILTI (including the Code Sec. 78 gross-up and after taking into account the Code Sec. 250 deduction). But as noted above, $4.44 of the $20 of interest expense was allocated to the Code Sec. 245A income group. So for purposes of computing USP's foreign tax credit limitation, USP's entire taxable income equals $141.94 ($137.50 + $4.44). USP's GILTI basket foreign tax credit limitation is thus reduced to $6.27, calculated by taking USP's pre-credit tax liability of $28.88 (21% of 137.50) and multiplying it by $30.83 (USP's GILTI basket income after the $6.67 of interest expense allocation) and dividing it by $141.94 (USP's total taxable income *plus* the $4.44 of interest expense allocated to the Code Sec. 245A income group). In the end, USP must include $37.50 of income pursuant to the GILTI regime, but can only use $6.27 of foreign tax credits to offset the U.S. tax, resulting in residual U.S. tax on the income of $1.60 (21% of $37.50, minus $6.27).

In essence, in this example, the reduced inclusion percentage had the effect of characterizing a portion of USP's stock basis in CFC1 as something other than a GILTI asset, which in turn reduced the expense allocation to the GILTI basket. That, of course, provided a benefit. But the benefit was reduced somewhat by the allocation of interest expense to the Code Sec. 245A subgroup, which under the "addback" of Code Sec. 904(b)(4) effectively diluted the GILTI basket income and correspondingly reduced the foreign tax credit limitation in that basket.

What if USP instead elects to treat CFC2 as a disregarded entity—a path that seemed clearly advisable in the sections above when considering the calculation of QBAI and Code Sec. 960(d) credits? In this case, such a decision would actually lead to a worse result. And again it turns on the inclusion percentage formula.

If USP elects to treat CFC2 as a disregarded entity ("DRE2") and all other facts remain the same (Example 3b), then USP's inclusion percentage rises from 75% to 100% since USP would have a GILTI inclusion of $60 (same as above) and CFC1 (the only CFC left) would have tested income of $60 ($100 of pre-tax tested income, minus $20 of taxes, minus the $20 of DRE2's losses). With a 100% inclusion percentage, USP would have a Code Sec. 78 gross-up of $20 (all of CFC1's foreign taxes) and 960(d) credits of $16 (80% of the $20 of credits). USP would thus have a $40 income inclusion net of the Code Sec. 250 deduction, and before taking into account expense allocation would have a foreign tax credit limitation in the GILTI basket of $8.40 (21% of $40), and would not owe any residual tax on the GILTI inclusion.

But as with Example 3a, USP must allocate a portion of its $20 of interest expense to the GILTI basket. Since CFC1 generates exclusively non-passive tested income, and since USP's inclusion percentage is 100%, all of the $1,000 of USP's stock basis in CFC1 is characterized as a "GILTI asset." Due to the availability of the Code Sec. 250 deduction, half of that CFC1 stock basis is treated as an exempt asset, leaving USP with two assets: (i) $500 of domestic assets and (ii) a GILTI basket asset of $500. USP must thus allocate half of its $20 of interest expense to its GILTI basket income, reducing the GILTI basket income from $40 to $30. That in turn reduces USP's foreign tax credit limitation in the GILTI basket to $6.30 (21% of $30).[24] So while USP owes additional tax (pre-credit) on

its GILTI inclusion of $8.40 (21% of $40), it can only use credits of $6.30, resulting in $2.10 of residual U.S. tax as a result of the GILTI regime (as compared to the $1.60 of residual U.S. tax in Example 3a).

Example 3b, in which the economic earnings and foreign taxes paid were identical to those in Example 3a, actually yielded *increased* U.S. tax *vis-à-vis* Example 3a as a result of the election to treat CFC2 as a disregarded entity. The assumption that such an election was favorable due to the increased Code Sec. 960(d) credits that resulted from an increased inclusion percentage was proven wrong as a result of the increased GILTI-basket expense allocation that resulted from the same increased inclusion percentage. An increased inclusion percentage can thus be a blessing or a curse—offering its holder increased foreign tax credits on the one hand but a potentially decreased foreign tax credit limitation on the other.

V. Code Sec. 163(j)—Partnerships vs. Consolidated Entities

Thus far, the discussion has focused on the impact of Check-the-Box Elections on the income and foreign tax credits that arise under the new GILTI regime. In this next section we shift our focus to the impact of such elections on the interest expense limitations under new Code Sec. 163(j) that apply to CFCs (at least under proposed regulations).

(a) Code Sec. 163(j)—A *Very* Brief Overview

New Code Sec. 163(j)—adopted as part of the TCJA—imposes significant new and far-reaching limitations on the deductibility of interest expense. As a general matter, the provision limits the deductible net business interest expense of a person to 30% of the adjusted taxable income of the taxpayer for a given taxable year, with any disallowed business interest expense generally permitted as a carryforward to future taxable years.[25] Adjusted taxable income, which is intended as a proxy for EBITDA, is generally equal to taxable income without regard to business interest income and expense, deductions for net operating losses, and until 2022, deductions in respect of depreciation, amortization, and depletion.[26] Starting in 2022, that last adjustment falls away, with adjusted taxable income becoming a proxy for EBIT (rather than EBITDA), and the Code Sec. 163(j) limitation thereby becoming that much tighter.

(b) Code Sec. 163(j) and CFCs

While the statutory text of Code Sec. 163(j) does not give any express indication of whether or how new Code Sec. 163(j) applies to CFCs, proposed regulations issued under Code Sec. 163(j) (the "Proposed 163(j) Regulations") generally apply the Code Sec. 163(j) limitation to CFCs "in the same manner as those provisions apply to determine the deductibility of a domestic C corporation's business interest expense."[27] As an initial matter then—and subject to a significant caveat discussed immediately below—a CFC computing its taxable income for any purpose—in particular for purposes of computing subpart F income and tested income under Code Sec. 951A—would only be able to claim a deduction in respect of net business interest expense to the extent of 30% of the CFC's adjusted taxable income.[28]

The Proposed 163(j) Regulations acknowledge, however, that CFC-to-CFC lending within a corporate group can lead to inappropriate results where Code Sec. 163(j) is applied on an entity-by-entity basis. Accordingly, they provide an election (the so-called "group election") that limits the net business interest expense that is subject to limitation under Code Sec. 163(j) to the overall CFC group's net external business interest expense.[29] The regulations provide a formula for both calculating that net business interest expense, as well as for allocating it to individual CFCs within the group for purposes of applying any resulting Code Sec. 163(j) limitation at the individual CFC level.[30] The group election is available to two or more CFCs that are at least 80% owned by value by a single U.S. shareholder (or multiple U.S. shareholders that are members of a single consolidated group) or in some cases by two or more related U.S. shareholders.[31]

In addition to the "netting" of CFC-to-CFC interest income and expense that is achieved through a CFC group election, the group election also allows the sharing of the excess Code Sec. 163(j) capacity among CFCs within the group—but only to a limited extent. Under the Proposed 163(j) Regulations, an upper-tier CFC that is a member of the CFC group may take into account its proportionate share of the lower-tier CFCs' excess taxable income ("ETI"), which is essentially the adjusted taxable income of the lower-tier CFC that is in excess of the amount of adjusted taxable income the CFC would have needed to permit it to deduct its net business interest expense.[32] Put differently, the formula for CFC ETI can be stated as CFC ETI = ATI – (Net Business Interest Expense/0.3).

Thus, for example, as above, assume USP (a domestic corporation) wholly-owns CFC1 (an upper-tier CFC),

which in turn owns 100% of CFC2 (a lower-tier CFC). CFC2 has $150 of ATI and $30 of net business interest expense and CFC1 has $50 of ATI and $30 of net business interest expense (Example 4a). CFC2 would have $50 of ETI, since only $100 of ATI is necessary to permit a deduction in respect of CFC2's $30 of net business interest expense (150 – 30/0.3 = 50). CFC1, as the sole owner of CFC2, can add the ETI from CFC2 to CFC1's own ATI for purposes of measuring its Code Sec. 163(j) limitation. Thus adding CFC1's $50 of ATI to the $50 of ETI from CFC2, CFC1's Code Sec. 163(j) limitation would be $30, and it would be permitted to deduct all $30 of its net business interest expense. In essence, the two CFCs together had $200 of ATI and $60 (or 30% of $200) of net business interest expense, and the result of the CFC group election is that the CFCs can fully deduct that interest expense on a current basis.

Importantly, the sharing of ETI among CFCs under the Proposed 163(j) Regulations operates through a tiering-up of excess ATI, starting with the lowest-tier CFCs in the group, and up through any intermediate CFCs until you reach the top-tier CFC.[33] But ETI can only move up—not down or sideways. The Proposed 163(j) Regulations effectively adopt a partnership model in which the tax items of the partnership pass through to the partners, but not *vice versa*. Thus, ETI of lower-tier CFCs can increase the Code Sec. 163(j) capacity of upper-tier CFCs, but ETI cannot be shared by an upper-tier CFC with a lower-tier CFC, nor can a CFC share ETI with a brother-sister CFC.

Returning to the above example, assume the same facts as Example 4a except that the ATI numbers are reversed such that CFC1 has $150 of ATI and CFC2 has only $50, and each has $30 of net business interest expense (Example 4b). In that case, CFC2 has a Code Sec. 163(j) limitation of $15 (30% of $50); the remaining $15 of CFC2's interest expense would be disallowed currently, with the result that CFC2's taxable income as measured for U.S. tax purposes would be $35 (rather than its $20 of actual net income). CFC1—which has $150 of ATI and $30 of business interest expense—has a Code Sec. 163(j) limitation of $45 and can thus fully deduct all of its $30 of interest expense. And in fact, CFC1 has ETI of $50 ($150 – $30/0.3). But under the Proposed 163(j) Regulations that ETI cannot be shared "downward" with CFC2. As a result, on a combined basis CFC1 and CFC2 have ATI of $200, but they can only deduct $45 of interest expense, resulting in net taxable income as measured for U.S. tax purpose of $155 (as compared to net taxable income as measured for U.S. tax purposes of $140 in the prior example above).

Which brings us to the Check-the-Box Election conundrum. Is it advisable to check the box on CFC2 and elect to treat it as a disregarded entity of CFC1 or not? In Example 4a above, a Check-the-Box Election has no impact. If CFC2 is treated as a disregarded entity, then for U.S. tax purposes there would be a single CFC with $200 of ATI, a Code Sec. 163(j) limitation of $60, and $60 of net business interest expense, all of which would be currently deductible. And as noted above, absent such an election, the tiering-up of ETI yields the same result, with all $60 of net business interest expense deductible in the current year. In either event, on a current basis the ATI of the two entities is effectively shared in a manner that permits the full deduction of all of the net business interest expense of the CFCs on a current basis. In essence, the CFC group election achieves the same result through the tiering-up of ETI as a Check-the-Box Election would.

In Example 4b, however, the Check-the-Box Election will indeed change the results: If CFC2 elects to be treated as a disregarded entity, we get back to the result in Example 4a: the single entity (as viewed for U.S. purposes) would have $200 of ATI, $60 of deductible net business interest expense, and $140 of taxable income as measured for U.S. tax purposes. If instead, no such election is made, $15 of interest expense is disallowed at the CFC2 level, resulting in combined ATI of $200, deductible interest expense of $45 ($60 of total interest expense minus the $15 disallowance), and net taxable income as measured for U.S. tax purposes of $155. Assuming, for example, that all of the income earned by CFC1 and CFC2 is tested income for purposes of measuring USP's GILTI inclusion under Code Sec. 951A, USP would have an additional $15 GILTI inclusion absent the Check-the-Box Election. A simple Check-the-Box Election could thus save USP $15 in 951A inclusions, or $7.50 in taxable income after taking into account the Code Sec. 250 deduction.

But that is not the end of the analysis. The CFC group election does not only permit tiering-up of ETI within the CFC group; it allows the CFC group's ETI to tier-up to the U.S. shareholder as well, subject to a formulaic limitation that is designed to prevent the U.S. shareholder from having increased ATI in respect of CFC earnings that are *not* includible under subpart F or GILTI.[34]

As an initial matter, the Proposed 163(j) Regulations generally exclude from the ATI of a U.S. shareholder the taxable income of that U.S. shareholder that arises due to a subpart F or GILTI inclusion.[35] The rationale offered in the regulations for the approach is to prevent the "double counting" of ATI—first at the CFC level for purposes of

computing subpart F income or GILTI and then again (net of the deductible interest expense) at the U.S. shareholder level. For example, if a domestic corporation wholly-owns a CFC and the CFC has $100 of ATI (all of which is either subpart F income or GILTI) and $30 of interest expense, the CFC would be able to fully deduct the interest expense under Code Sec. 163(j) and the U.S. shareholder would have a $70 inclusion under Code Sec. 951 or 951A. If that $70 counted as ATI at the U.S. shareholder level, the U.S. shareholder would be able to deduct an additional $21 of interest expense (30% of $70; or perhaps only $10.50 if the income was GILTI income eligible for the Code Sec. 250 deduction). Economically, the $100 of earnings would be offset by more than $30 of interest expenses, due to what the proposed regulations identify as inappropriate double counting.

Even though the Proposed 163(j) Regulations disallow subpart F and GILTI inclusions from being included in ATI, they then allow a U.S. shareholder to include in ATI the portion of a top-tier CFC's ETI that is attributable (determined under a fixed formula) to the GILTI or subpart F income of the CFCs in such top-tier CFC's CFC group.[36] Thus, if in the above example a CFC group election were in place,[37] since CFC1 had $100 of ATI but only $15 of interest expense, and all of CFC1's ATI was tested income for GILTI purposes, CFC1 would have $50 of ETI (100 – 15/0.3) that would increase USP's ATI by $50 (capped by the GILTI inclusion attributable to that CFC group net of the applicable Code Sec. 250 deduction).[38]

Returning to Example 4b from above—is it beneficial to check the box or not? If CFC2 elects to be a disregarded entity, there is a single entity with ATI of $200 and deductible interest expense of $60. The CFC would have net tested income (assuming all the gross income is gross tested income) of $140; no ETI would tier-up to USP, and USP would have a GILTI inclusion of $140, a Code Sec. 250 deduction of $70 (assuming no other limitations on the Code Sec. 250 deduction) and would owe additional tax of $14.7 (140 × 0.5 × 0.21) without any additional capacity to claim interest deductions.

Without a Check-the-Box Election, there would be $200 of total ATI between the two CFCs, only $45 of deductible interest expense, and a resulting $155 GILTI inclusion, yielding additional tax of $15.75 ($155 × 0.5 × 0.21). But $50 of ETI would also tier-up from CFC1 to USP. USP would be able to deduct additional interest expense of $15 (30% of $50) that would reduce USP's taxable income to $62.5 ($155 × 0.5 – $15) resulting in a net tax liability of $13.125—less than under the Check-the-Box scenario (assuming USP in fact has excess interest expense that it can use to absorb that additional Code Sec. 163(j) capacity; otherwise it would carry forward). In other words, the absence of the Check-the-Box Election allowed the ETI to tier-up to USP where it was able to reduce fully taxable income, whereas a Check-the-Box Election effectively would have "pushed down" the ETI to income that was only taxable at a reduced rate under the GILTI regime.

The analysis gets even more complicated once we add the possibility of foreign tax credits or U.S. losses into the mix. Assume, for example, that under the facts of Example 4b, USP has excess foreign tax credits in the GILTI basket that it can use to mitigate the U.S. tax on the marginal GILTI income that arises by virtue of the Code Sec. 163(j) limitation at the CFC2 level. In that case, the extra $15 of GILTI that arises by virtue of that interest expense disallowance may be partially or fully offset by foreign tax credits that can be claimed under Code Sec. 960(d). If USP has other U.S. taxable income, though, the additional $50 of ATI can permit the deduction of an additional $15 of interest expense in the U.S. yielding reduced tax of $3.15 (21% of $15), which is even more favorable than the result described above where no such excess credits were assumed. In contrast, with a Check-the-Box Election there would be no ETI tiering-up to USP, the excess foreign tax credits would go unused, and USP would have a lower Code Sec. 163(j) limitation.

In contrast assume USP has domestic losses before taking into account the GILTI inclusion. In that case, the additional GILTI income from the absence of a Check-the-Box Election may simply absorb more of that domestic loss without in fact yielding additional Code Sec. 163(j) limitation since the limitation is effectively reduced by the domestic loss. The reduced GILTI inclusion that would then result from a Check-the-Box Election under Example 4b would reduce the net taxable income of USP and reduce its consumption of domestic net operating losses.

While the CFC group election was designed to recognize the "fungibility of money" within a closely-held CFC group, the precise mechanism used for calculating the Code Sec. 163(j) limitation for members of the group—essentially a "partnership model" in which income tiers-up but not down or sideways—yields some potentially unexpected results that make the decision of whether to check or not check lower-tier CFCs complex. As illustrated above, there may be scenarios where the absence of a "tiering-down" of ETI hurts you, such that the synthetic sharing of ATI that can be accomplished through a Check-the-Box Election is favorable. In other scenarios, the absence of tiering-down among CFCs, and the corresponding tiering-up of the ETI to the U.S.

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shareholder, may be beneficial such that a Check-the-Box Election on lower-tier CFCs is undesirable. In yet other circumstances, you may be indifferent. And of course, the calculus can change over time depending on the income and foreign tax credit profile of the relevant CFCs and the U.S. parent company, yielding a complex modeling and projections exercise that requires significant caution when deciding whether to check an entity or not.

VI. Conclusion

If the above discussion teaches us anything, it is that the question of "to check or not to check" has become a difficult and highly context-dependent one. Those with significant QBAI held by tested loss CFCs will generally be strongly incentivized to use Check-the-Box Election to combine those tested loss CFCs with tested income CFCs so as to avoid the problem of disappearing QBAI. But if that is not a significant consideration, foreign tax credits may well become the driving factor—and on that front the trade-off is one between more Code Sec. 960(d) credits on the one hand and reduced expense allocation on the other. As a result, one would generally expect that taxpayers that have excess limitation in their GILTI foreign tax credit basket would want to avoid losing Code Sec. 960(d) credits as a result of the inclusion percentage haircut that results from tested loss CFCs. On the other hand, those with excess credits in the GILTI basket—perhaps a more common occurrence given lower U.S. tax rates and the impact of expense allocation—may well find that sacrificing Code Sec. 960(d) credits is a worthwhile price to pay for the reduced expense allocation that comes with a reduced inclusion percentage.

Similarly, the application of Code Sec. 163(j) at the CFC level, as modified by the CFC group election under the Proposed Code Sec. 163(j) Regulations, complicates the Check-the-Box Election decision, as the question as to whether it is better to have ETI tier-up under the regulations or "tier-down" *via* a Check-the-Box Election is a highly fact-dependent one. Ultimately, the overlay of the TCJA's new international tax rule on the decades-old entity classification regime forces taxpayers to reevaluate—both today and on an ongoing basis—their entity classification decisions. It is safe to say that while the Check-the-Box Regulations may be two decades old, the TCJA has given them a new lease on life.

ENDNOTES

1 T.D. 8697, 61 FR 66,584 (Dec. 18, 1996).
2 The TCJA is actually entitled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97.
3 Code Sec. 951A(a).
4 Code Sec. 951A(b)(1).
5 Code Sec. 951A(c).
6 Code Sec. 951A(b)(2). The precise rules for measuring the various components of GILTI—gross tested income, allocable deduction, DTIR, QBAI, and interest expense—are beyond the scope of this article.
7 Code Sec. 951A(c)(1).
8 Guidance Related to Code Sec. 951A (Global Intangible Low-Taxed Income), REG-104390-18, 83 FR 51,072 (Oct. 10, 2018), Preamble at 8. *See also* Proposed Reg. §1.951A-3(b) ("A tested loss CFC has no qualified business asset investment.").
9 Code Sec. 960(d)(1).
10 Code Sec. 960(d)(3).
11 Code Sec. 960(d)(2).
12 As an aside, it is worth noting that while the GILTI inclusion is based upon a measure of taxable income—as opposed to earnings and profits as under the subpart F regime—foreign taxes are effectively deducted from that measure of taxable income, with the addback of those taxes accomplished through the mechanism of the Code Sec. 78 gross-up. *See* Code Secs. 78 and 951A(c)(2)(A)(ii).
13 Code Sec. 250(a)(1)(B) provides domestic corporation with a 50% deduction in respect of their GILTI inclusion and associated Code Sec. 78 gross-up, subject to certain limitations.
14 Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act, REG-105600-18, 83 FR 63,200 (Dec. 7, 2018).
15 Code Sec. 904(a).
16 Code Sec. 904(d)(1)(A).
17 Code Sec. 864(e)(2).
18 Reg. §1.861-13(a)(1).
19 Proposed Reg. §1.861-13(a).
20 Proposed Reg. §1.861-8(d)(2)(ii)(C)(2)(ii).
21 Proposed Reg. §1.861-13(a)(2).
22 Proposed Reg. §1.861-13(a)(2).
23 Proposed Reg. §1.861-8(d)(2)(ii)(C)(2)(ii).
24 Since in this example there are no expenses allocated to 245A income, Code Sec. 904(b)(4) is not relevant.
25 Code Sec. 163(j)(1), (2).
26 Code Sec. 163(j)(8).
27 Limitation on Deduction for Business Interest Expense, REG-106089-18, 83 FR 67490 (Dec. 28, 2018), Preamble at 92.
28 Proposed Reg. §1.163(j)-7(b)(2).
29 Proposed Reg. §1.163(j)-7(b)(3).
30 Proposed Reg. §1.163(j)-7(b)(3), (f)(1).
31 Proposed Reg. §1.163(j)-7(f)(6).
32 Proposed Reg. §1.163(j)-7(c)(3).
33 *Id.*
34 Proposed Reg. §1.163(j)-7(d)(2).
35 Proposed Reg. §1.163(j)-7(d)(1).
36 Proposed Reg. §1.163(j)-7(d)(2).
37 One apparent quirk of the CFC group election is that it appears to require that the group have two or more CFCs. It is not clear what the purpose of that rule is or why an election would not be available where the U.S. corporation owns only a single CFC. But for purposes of these examples, we can assume that there is another CFC that is a member of the group thus permitting an election.
38 Proposed Reg. §1.163(j)-7(d)(2)(i), (iii).

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