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Not GILTI 'by Reason of' the High-Tax Exclusion

by Jasper L. Cummings, Jr.

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In this article, the author criticizes as disingenuous Treasury's explanation for expanding the global intangible low-taxed income subpart F high-tax exclusion to cover all foreign high-tax income, as well as its different explanation for changing the effective date of the amendment to the section 78 "dividend" gross-up for foreign taxes. He argues that even if no one complains about the first explanation, the latter will be attacked and defeated.

I. The Gift Horse

A. Stunning Power Play

On July 20 Treasury released T.D. 9902. It finalized 2019 prop. reg. section 1.951A-2(c)(1)(iii) and (7) to apply the high-tax exclusion from global intangible low-taxed income to all foreign high-tax income, not only income that had become GILTI because the taxpayer elected to exclude it from subpart F income through a parallel election under section 954(b)(4).[1]

That expansion of the exclusion is a stunning application of the Bill Clinton reason for doing what you ought not do: "Because I could." Treasury could, because almost no one will look the gift horse in the mouth, except some professors and other purists.[2] Only highly unusual facts could produce an actual taxpayer that will be harmed by the expanded election. But as discussed later, the equally stunning advancement of the effective date of the 2017 amendment of section 78 will be attacked and stricken down by the courts.

The expanded GILTI exclusion is a small part of a larger set of administrative choices that give multinationals many ways to limit the damage of the GILTI "territorial lite" regime (such as loss blending and credit strategies). Indeed, the biggest untold story of the 2017 tax act is the muted reaction of U.S. multinationals for which a 21 percent rate will cover a multitude of sins.[3] This new regulation makes it even easier not to complain.

This article does not primarily berate Treasury for exceeding its authority, although it addresses that issue. Rather, it assesses how much damage can be done to the tax law by Treasury's convoluted explanation of its drafting creativity. Here, Treasury's explanation relied heavily on a novel interpretation of the phrase "by reason of," which appears in 524 other places in the code. Surely some taxpayer can profit from applying the reasoning of the regulation's preamble to some other use of that phrase.

[1] Like other early observers, I did not foresee this possibility. For my original analysis, see Jasper L. Cummings, Jr., "GILTI Puts Territoriality in Doubt," *Tax Notes*, Apr. 9, 2018, p. 161. *See also* Lee A. Sheppard, "GILTI High-Tax Rules and Foreign Tax Credits," *Tax Notes Int'l*, Aug. 3, 2020, p. 573.

[2] *See, e.g.*, Stephen E. Shay, "A GILTI High-Tax Exclusion Election Would Erode the U.S. Tax Base," *Tax Notes Federal*, Nov. 18, 2019, p. 1129; and letter from Michael L. Schler, "More on Tax Regulations and the Rule of Law," *Tax Notes Federal*, Aug. 3, 2020, p. 879. For lack of gift-horse dentists, see Andrew Velarde, "Themes Emerge in Comments on GILTI High-Tax Exception," *Tax Notes Int'l*, Oct. 14, 2019, p. 185 (top six comments on 2019 proposal did not include complaints about expansion, only requests for more expansion).

[3] For example, *The Wall Street Journal* wrote about the Tax Cuts and Jobs Act, as it is colloquially known, only four times total, the most recent in late 2018 when it said corporations were still digesting the regulations, were not rushing to repatriate cash, but mostly liked the 21 percent corporate rate. Theo Francis, "Lessons From the Tax Overhaul, a Year In," *The Wall Street Journal*, Dec. 2, 2018.

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Perhaps more important, if the tax collector can bend over backward this far to help taxpayers, won't taxpayers argue that Treasury has performed similar jujitsu to collect more tax, even when it hasn't?

B. The Treasury Rethink

1. First, It Says What It Says

a. Summary

Treasury originally read section 951A(c)(2)(A)(i)(III) to say what it says, and first proposed in 2018 and then finalized in 2019 a regulation saying what it says.[4] At the same time it finalized that regulation, Treasury proposed a new regulation, expanding the statutory exclusion to all foreign high-tax income, active and otherwise. Treasury finalized that regulation in 2020 with a further softening to allow retroactive elections.[5]

b. The Original Interpretation

Section 951A(c)(2)(A)(i)(III) defines one of the exclusions from gross income, yielding what will be the "tested income" that can be GILTI. Those exclusions include U.S.-source income, subpart F income, and this amount:

> any gross income excluded from the foreign base company income (as defined in section 954) and the insurance income (as defined in section 953) of such corporation by reason of section 954(b)(4).

In other words, the exclusions included a type of income — foreign base company income — whether taxed as subpart F income or not (because it was excluded as a result of the taxpayer making a section 954(b)(4) election). That pair of exclusions makes perfectly good sense; Congress wanted to exclude from GILTI a type of income (sometimes referred to as passive) that did not fit within the intended limits of GILTI because of its character (not because of the foreign tax level). In other words, the high-tax active income was likely in the "intangible" category of income that Congress wanted to tax. Congress installed other offsets in the GILTI regime to manage its application to high-taxed active income.

When Treasury originally proposed a regulation on this subject in 2018, it proposed to define the exclusion according to the statute.[6] On June 21, 2019, Treasury published final regulations adopting the proposal on this point unchanged.[7]

2. Second, Inquiring Commentators Wanted to Know

On that same day Treasury published another proposed regulation on the same subject.[8] Section IV of that proposal, describing section 951A, recounted the fact that some commentators wanted a broader exclusion and then stated: "The GILTI final regulations adopt the GILTI high-tax exclusion of the proposed [2018] regulations without change."[9]

If you stopped reading there you would think that was the end of the issue and that the commentators lost. But two pages later, under "Explanation of Provisions," the proposal recites the same comments made on the original proposal and states that now, on the same day Treasury finalized the original proposal, Treasury agrees to expand the high-tax exclusion beyond what would otherwise be subpart F income.

The rhetorical pivot point for hearing the commentators was a focus on the words of section 954(b)(4), the elective subpart F high-tax exclusion. Some clever lawyer at Treasury (or IRS Office of Chief Counsel (international)) reasoned that the high-tax foreign income that taxpayers have been electively removing from subpart F was

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[4] The 2019 regulation said that tested income is to be determined without regard to "gross income excluded from the foreign base company income (as defined in section 954) or the insurance income (as defined in section 953) of the corporation solely by reason of an election made under section 954(b)(4) and section 1.954-1(d)(5)." Reg. section 1.951A-2(c)(1)(iii) (removed in 2020).

[5] The Tax Executives Institute and others sought retroactivity for the expanded exclusion. *See* TEI comment letter on the proposed GILTI high-tax exception (Sept. 18, 2019).

[6] REG-104390-18, 83 F.R. 51072. The preamble stated: "This exclusion applies only to income that is excluded from foreign base company income and insurance income solely by reason of an election made to exclude the income under the high-tax exception of section 954(b)(4)." *Id.* at 51075.

[7] T.D. 9866, 84 F.R. 29288 (as corrected at 84 F.R. 44693). The preamble states that the final regulations do not adopt comments on the proposed high-tax exception and that they do not change the proposed version.

[8] REG-101828-19, 84 F.R. 29114 (as corrected at 84 F.R. 37807).

[9] 84 F.R. at 29118.

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never limited to subpart F income. So when section 951A referred to that income, it referred to the broader set of income, not the income actually excluded from subpart F, because it was both high-tax and subpart F income. You have to look hard at section 954(b)(4) to see what this cleverness is getting at. That provision reads:

> For purposes of subsection (a) and section 953, foreign base company income and insurance income shall not include *any item of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11*. [Emphasis added.]

The new regulation reads the cross-reference to section 954(b)(4) as if it only referred to the italicized words and as if they existed in isolation from the rest of the sentence. Of course, standard interpretation would require taking into account the context in the very same sentence; there would be no reason to exclude non-subpart F income from subpart F, so the italicized words should describe only high-tax subpart F income.[10]

But Treasury was thinking outside the box. Once it chose to put on blinders, then "by reason of section 954(b)(4)" the non-subpart F high-tax income (also) could be electively excluded from GILTI. That can be true only if the GILTI exclusion is rephrased to say "by reason of the definition of income in section 954(b)(4)."

The 2019 explanation of the new proposal recognized that the election under section 954(b)(4) has a sole reason for being: to exclude income from subpart F. But it bifurcated that section between its sole reason election and the phrase describing the income subject to the election, which Treasury says encompasses any high-tax foreign income, subpart F or not. The explanation leaned on legislative history, even though it didn't clearly say what Treasury wanted it to say, plus a practical desire not to encourage shifting high-tax active foreign income into subpart F income so that it could then be excluded from both subpart F and GILTI.

Trying to not appear to be giving away the store, Treasury made the ancillary rules in the 2019 proposed regulation rather restrictive: The controlling shareholder would make the election, which would bind all other U.S. shareholders; the election would apply to each controlled foreign corporation; the election would be continuous and not year-by-year; if revoked, the election could not be made again for 60 months; the election would apply to all CFCs in a controlling member's controlling domestic member shareholder group (the consistency requirement); the high-tax income would be determined on the basis of qualified business units, to avoid mixing high- and low-taxed income; and the proposed expanded election would be prospective only. The 2019 proposed regulation was not changed by Office of Management and Budget's Office of Information and Regulatory Affairs in this aspect, presumably because the political work had already been done in Treasury.[11]

The final 2020 regulation somewhat softened the tougher ancillary rules, including by determining high-tax income on the basis of annual income of tested units (which may be the CFC itself) instead of qualified business units; redefining the controlled CFC group; allowing year-by-year elections, as requested by the Tax Executives Institute and others;[12] and allowing taxpayers to retroactively make the election back to the beginning of the GILTI regime. Treasury also proposed in 2020 regulations tightening the section 954(b)(4) election to conform to the new GILTI election. Practitioners quibbled about the tightening of the section 954(b)(4) requirements but were wholly unconcerned with the authority overreach of the 2020 GILTI regulation.[13]

The preamble's added flourishes explaining the 2020 finalization of the regulation are reviewed next.

[10] *See* Cummings, *The Supreme Court's Federal Tax Jurisprudence* 295 (2d ed.) (reading words in context).

[11] Comparison of proposed regulations (REG-101828-19) before and after OIRA review, at 36.

[12] TEI, *supra* note 5.

[13] Velarde, "Subpart F High-Tax Exception Changes Surprise Practitioners," *Tax Notes Int'l*, July 27, 2020, p. 542.

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II. The Second Final Regulation

A. *Chevron* Deference

1. Leaning on Ambiguity

The preamble to the 2020 final regulations recognizes and discusses questions about Treasury's authority to interpret section 951A(c)(2)(A)(i)(III), which it says was ambiguous (it does not say section 954(b)(4) was ambiguous).[14] The preamble claims that the 2019 proposal also had described section 951A(c)(2)(A)(i)(III) as ambiguous, but it did not. The preamble focuses on ambiguity because *Chevron* treats a statutory ambiguity as akin to a grant of authority by Congress to write a rule.[15] Alternatively, if a court can interpret the ambiguity away, there will be no special deference to the agency rule, which is just its view of the statutory interpretation.[16] The claimed ambiguity is the meaning of "by reason of."

It is a fairly big deal for the explanation of a final tax regulation to rely on the statute being ambiguous. Treasury preambles rarely say that, which is too bad (for Treasury) because if it is true that the statute is ambiguous, that facilitates greater judicial deference to the regulation. Treasury previously did not admit that a code section was ambiguous, to avoid the notice and comment process of the Administrative Procedure Act. But for several years Treasury has been issuing all regulations with notice and comment, as now required by the Trump administration, for the purpose of claiming *Chevron* deference.[17]

One of the other few examples of an admitted ambiguity is the meaning of the services cost method in the base erosion and antiabuse tax: The regulation adopting a pro-taxpayer interpretation says the statute is ambiguous.[18]

It is useful to step through precisely what the 2020 preamble tries to say [with commentary]:

- Tested income excludes gross income excluded from subpart F income "by reason of" section 954(b)(4).
- [Logically, the only way section 954(b)(4) can exclude gross income from subpart F income is through an election applied to what otherwise would be subpart F income.]
- But the preamble reasons that the high-tax non-subpart F income was excluded from subpart F by the election even if it did not need to be excluded because it was not subpart F income in the first place.
- According to the preamble, that makes the elective exclusion an independent, but not "but for," reason the active high-tax income was not subpart F income.
- [The only way this makes sense is to interpret "by reason of" to mean that the election would have excluded the active income from subpart F if it had been passive, but that's not the fault of the election, which excluded all income known to man from subpart F.]

The preamble believes this reasoning process depends on the possibility that sometimes the term "by reason of" refers to one of the reasons that need not be a "but for" reason. The fundamental problems with that argument are that (1) the section 954(b)(4) election was not any sort of cause of the exclusion of active high-tax income from subpart F; and (2) even if "by reason of" means "might have caused," it does not mean that here.

2. An Odd *Chevron* Cite

The preamble first cites *EPA*[19] for a statement of the *Chevron* doctrine, to try to give the

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[14] Preamble to T.D. 9902, at Section VII.

[15] *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

[16] *See* Cummings, *Federal Tax Jurisprudence*, *supra* note 10, at 358. The best example of application of this process to a tax regulation is *Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44 (2011). *See also* Cummings, "The Meaning of Regulatory Authority Grants," *Tax Notes Federal*, Dec. 23, 2019, p. 1919.

[17] *See* Cummings, "*Chevron*, the APA, and Tax Regulations," *Tax Notes*, Mar. 25, 2019, p. 1463.

[18] T.D. 9885. *See* Cummings, "The APA, *Chevron*, and the BEAT," *Tax Notes*, Apr. 8, 2019, p. 225. *See also* T.D. 9901 (identifying an ambiguity in the foreign-derived deduction-eligible income statute); and T.D. 9889 (stating that parts of the Opportunity Zone statute are ambiguous).

[19] *Michigan v. EPA*, 135 S. Ct. 2699 (2015), *rev'g White Stallion Energy Center LLC v. EPA*, 748 F.3d 1222 (D.C. Cir. 2014).

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regulation a *Chevron* deference footing.[20] It is not obvious why, out of the many Supreme Court opinions following *Chevron*, the preamble picked the *EPA* opinion to misapply. The *EPA* holding is noteworthy mostly for its political dynamics. It addressed the same group of environmental regulations addressed by the original *Chevron* decision, which reversed the opinion of Judge Ruth Bader Ginsburg, then on the court of appeals, and upheld the Reagan administration regulation that was liked by the industry. In contrast, the *EPA* decision struck down an Obama administration regulation by using additional embroidery that has grown up around the *Chevron* analysis; Justice Antonin Scalia wrote the *EPA* opinion and Ginsburg dissented.

The preamble likes the statement in *EPA* that the court must accept the agency's reasonable interpretation of an ambiguous statute, even though the *EPA* opinion did not use the verb "must." The majority found that the EPA flunked the *Chevron* test because it failed to make a cost-benefit analysis. That is not the pure *Chevron* doctrine, but rather reflects other Supreme Court holdings that have grown into a huge focus on the thought process of the agency and how it explained itself and responded to comments.[21] As Justice Elena Kagan's dissent in *EPA* points out, the agency did consider cost many times, just not at a specific early stage on which the majority focused. That reflects another of the many ways that the Republican-appointed majority on the Court is undercutting *Chevron* deference while continuing to cite it as a "yes, but" concept.[22] *Chevron* is being slowly killed by kindness, even at the expense of a Trump rule, when the Court applied it to strike down the improperly explained elimination of Deferred Action for Childhood Arrivals (DACA).[23]

[20] *Chevron*, 467 U.S. 837. *See* Cummings, "What Is Anti-Deference Really About?" *Tax Notes Federal*, Sept. 23, 2019, p. 2075; and Cummings, "*Chevron*, the APA, and Tax Regulations," *supra* note 17.

[21] For a summary list of these steps, see Cummings, "The Supreme Court's 2019 Term in Tax," *Tax Notes Federal*, Sept. 21, 2020, p. 2175.

[22] *See* Cummings, "What Is Anti-Deference?" *supra* note 20.

[23] *Department of Homeland Security v. Regents of the University of California*, 140 S. Ct. 1891 (2020) (an explanation generated after the announcement of DACA's rescission was too late).

B. 'By Reason of'

While the 2019 proposal focused on the words of section 954(b)(4), the 2020 preamble focuses on the phrase "by reason of" in section 951A(c)(2)(A)(i)(III), which is said to be ambiguous. Immediately after the *Chevron* cite, the preamble states:

> Specifically, the regulation interprets the words "by reason of" in that provision as denoting independently sufficient causation. The assertion by some commenters to the contrary that the words "by reason of" unambiguously require "but for" causation is not supported by the case law. Terms such as "by reason of" have been equated with other causal terms, such as "because of" or "as a result of," and have been interpreted flexibly based on the underlying context and purposes of the applicable provision. Several recent decisions have interpreted such terms as encompassing independently sufficient causation based on dicta in the Supreme Court's recent opinion in *Burrage v. United States*, 134 S. Ct. 881, 890 (2014). *See, e.g.*, *United States v. Ewing*, 749 Fed. Appx. 317, 327-28 (6th Cir. 2018); *United States v. Seals*, 915 F. 3d 1203, 1206-07 (8th Cir. 2019); *United States v. Feldman*, 936 F. 3d 1288, 1317-18 (11th Cir. 2019).

"Is not supported by the case law" is incorrect.

Before diving into the weeds, let's understand how this issue has mostly arisen. Business interests are highly invested in the project of limiting the ability of disgruntled employees to collect damages from employers for various kinds of discrimination "based on" or "because of" some suspect category such as race, age, or disability. A similar issue comes up in criminal cases when criminality hinges on a particular drug being a cause of death or harm, and some might like to convict if the drug only contributed to the death.

Therefore, the plaintiffs typically argue that they should win even if some other cause could have justified the firing, because but for their race, they would not have been fired for the other sufficient reason. That is actually not a low

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threshold, because the plaintiffs have the burden of proving actual causation in the face of other plausible causes. In the criminal cases, prosecutors typically argue that they don't have to prove that a particular drug was the actual cause of death, if it contributed to the death. So the meaning of causative language in statutes gets aired mostly in those charged contexts.

The meaning of the phrase the preamble uses — "independently sufficient causation" — is not clear. Evidently, the preamble intends it to mean that the section 954(b)(4) election could cause the exclusion of non-subpart F high-tax income even if it is not a "but for" cause. That is somewhat analogous to the position of the prosecutors in the drug death cases.

In contrast, in *Bostock*,[24] one of the employment discrimination cases decided in June, the Supreme Court (citing *Gross*,[25] on which *Burrage*[26] relied, as discussed below) held that "because of" means that but for the protected category, the employee would not have been fired, no matter that he could have been fired for other reasons.[27] The *Bostock* opinion made the important but easy to miss point that an event can have multiple "but for" causes. So an employer can be liable for firing an employee in a suspect category for being tardy if tardy employees who are not in that category are not fired. That meaning is exactly contrary to "independently sufficient causation," which has no "but for" element.

Note that the term "independently sufficient causation" is inherently inappropriate in this context because it implies some sort of causation, which is the whole point of this dispute. The phrase sort of assumes the conclusion by use of the word "causation." The point of this article is that the section 954(b)(4) election did not cause the exclusion of non-subpart F income from subpart F in any way, shape, or form. The preamble assumes that it did.

"Independently sufficient causation" has never appeared in any opinion of the Supreme Court. It appears in only one federal court opinion (one of the criminal drug cases), stating: "Because there is sufficient evidence that carfentanil use was a but-for cause of L.K.W.'s death, we need not address independently sufficient causation."[28] That opinion refers to the *Burrage* opinion. Note that *Burrage* is part of the case law that supports the "but for" interpretation, of which the preamble implied there was little to none.

Burrage found that a death "results from" use of a particular drug, stating that the standard meaning of that term is "but for," meaning that death would not have occurred without it. The Court recognized that in some cases in which there were multiple causes of death, an "independently sufficient cause" might suffice in other contexts, but here "but for" causation was proved. The *Burrage* opinion stated that use of such alternate meaning was rare.[29]

The regulation's preamble does not refer to the rarity of the alternate meaning on which it relies but admits that the *Burrage* citation is only dicta. It bootstraps the "rare" dicta by citing three appellate decisions that are not directly on point.[30]

Burrage cites several examples of the "rare" cases of multiple causation rules, but the first, *Nassar*,[31] referred only to the possibility. *Nassar* was an employment discrimination case that interpreted "because of" to mean "but for" causation. The plaintiff wanted to apply a lesser standard that another part of the statute applied to a different type of wrong: "a motivating factor for any employment practice, even though other factors also motivated the practice." But because Congress did not write that standard into the section at issue, it did not apply.

[24] *Bostock v. Clayton County*, 140 S. Ct. 1731 (2020).

[25] *Gross v. FBL Financial Services*, 557 U.S. 167 (2009).

[26] *Burrage v. United States*, 571 U.S. 204 (2014).

[27] *Bostock*, 140 S. Ct. at 1737 and 1744 ("An employer who fires an individual for being homosexual or transgender fires that person for traits or actions it would not have questioned in members of a different sex. . . . The defendant easily could have pointed to some other, nonprotected trait and insisted it was the more important factor in the adverse employment outcome."). Discussed in Schler letter, *supra* note 2.

[28] *United States v. Hamm*, 952 F.3d 728, n.3 (6th Cir. 2020).

[29] *Burrage*, 571 U.S. at 214.

[30] *United States v. Ewing*, 749 F. App'x 317 (6th Cir. 2018), applied *Burrage*'s conclusion that the drug had to be the "but for" cause of the death for criminal liability. *United States v. Seals*, 915 F. 3d 1203 (8th Cir. 2019), had more discussion of the possibility that the drug was not a "but for" cause but said that was for the jury. *United States v. Feldman*, 936 F. 3d 1288 (11th Cir. 2019), was similar. None of these decisions deal with or prove the meaning of "by reason of," and they confirm its general meaning as "but for," contrary to the preamble's false assertion.

[31] *University of Texas Southwestern Medical Center v. Nassar*, 570 U.S. 338 (2013).

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Therefore, the only actual examples of a multiple causation standard cited in *Burrage* were some state court decisions, which the *Burrage* Court found unpersuasive. It contrasted the Model Penal Code, which uses "but for" causation. And the principal tort treatise says, "Except in the classes of cases indicated" (an apparent reference to the situation in which each of two causes is independently effective) "no case has been found where the defendant's act could be called a substantial factor when the event would have occurred without it."[32]

C. Back to Applying Law to Facts

Even applying the preamble's attempt at logic, it does not make sense. The election under section 954(b)(4) would not be independently effective to exclude the non-subpart F high-tax income from subpart F, because you can't exclude something that was never included.

The preamble seems to be arguing that when the subsection says "by reason of section 954(b)(4)," it does not mean "but for" an election under that section; rather, it refers to another independently sufficient meaning of section 954(b)(4)'s identification of high-tax income, which the preamble says obviously is not limited to subpart F income.

The preamble tries to state a second argument and stumbles:

> In addition, commenters have suggested that, based on the statutory structure of sections 954(b)(4) and 951A(c)(2)(A)(i)(III), the provisions can only apply to income that would otherwise qualify as FBCI [foreign base company income] or insurance income. The Treasury Department and the IRS disagree with this assertion because it would require that income both qualify as FBCI or insurance income and be excluded from such categories of income for purposes of the same provision.

Those benighted commentators are stating the interpretation that Treasury adopted in its originally finalized regulations. Every rule that excludes some part of a group from the group has the effect of that part being both in and out of the group, before and after the exclusion. For another example, discharge of indebtedness income is in gross income until section 108 excludes it, so it would be subject to the same complaint.

Third, the preamble states:

> Moreover, neither section 954(b)(4) nor 951A(c)(2)(A)(i)(III) contains any limitation on the category of income to which the provisions can apply, instead referring broadly to "any item of income" and "any gross income," respectively.

This third point is, of course, the primary ground of the proposed regulation. For *Chevron* purposes, the Supreme Court would hold Treasury to its originally proposed reason and ignore the first and second explanations stated above.[33] And Treasury would lose, with or without all the explanations.

D. The 2019 Explanation

1. Legislative History

The 2019 proposal explanation stated:

> Section 954(b)(4) is not explicitly restricted in its application to an item of income that first qualifies as FBCI or insurance income; rather, the provision applies to "any item of income received by a controlled foreign corporation." *Therefore, any item of gross income, including an item that would otherwise be gross tested income, could be excluded from FBCI or insurance income "by reason of" section 954(b)(4) if the provision is one of the reasons for such exclusion, even if the exception under section 954(b)(4) is not the sole reason*. Any item thus excluded from FBCI or insurance income by reason of section 954(b)(4) would then also be excluded from gross tested income under the GILTI high tax exclusion, as modified in these proposed regulations.
>
> *The legislative history evidences an intent to exclude high-taxed income from gross tested*

[32] *Prosser and Keeton on Torts*, section 41, p. 268 (5th ed.).

[33] *See Regents of the University of California*, 140 S. Ct. 1891, discussed in Cummings, "2019 Term in Tax," *supra* note 21.

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> *income.* See Senate Explanation at 371 ("The Committee believes that certain items of income earned by CFCs should be excluded from the GILTI, either because they should be exempt from U.S. tax — as they are generally not the type of income that is the source of base erosion concerns — or are already taxed currently by the United States. Items of income excluded from GILTI because they are exempt from U.S. tax under the bill include foreign oil and gas extraction income (which is generally immobile) and income subject to high levels of foreign tax."). The proposed regulations, which permit taxpayers to electively exclude a CFC's high-taxed income from gross tested income, are consistent, therefore, with this legislative history. [Emphasis added.]

The first italicized part is the primary Treasury argument rehearsed above. In effect, it says that if a rule excludes green bicycles from the class of automobiles, that rule is one of the reasons the green bicycles are not in the car class. Of course, the real reason the green bicycles are not in the car class is that bicycles are not cars, and the exclusion has nothing to do with it.

The second paragraph quotes legislative history that is itself ambiguous. The preamble relies on that ambiguous history to clarify an unambiguous section that the preamble claims is ambiguous. The Senate explanation (not an actual Senate report with a number and date and document number) posits two types of income that should be exempt from GILTI: (1) income that is not the type to which GILTI should apply; and (2) income that has already been taxed in the United States. Then it appears to say that the exempted items in group 1 are exempted because they are highly taxed. Of course, that is an accurate description: The high-tax subpart F income can be exempted by election because it is highly taxed. The Senate explanation did nothing more than quote section 954(b)(4).

2. Take It or Leave It

Treasury has a love-hate relationship with legislative history in writing guidance under the 2017 tax act. It rejected a much clearer direction of Congress to allow a CFC to use the section 245A dividends received deduction.[34] It disagreed with the legislative history because:

> Permitting the deduction in such a case would undermine the application of the rule that reduces the amount of the dividend eligible for the section 954(c)(6) exception (discussed in Part III. A of this Explanation of Provisions).

Similarly, not applying the high-tax exclusion to active income would undermine what Treasury viewed as the overall intent of Congress to not tax high-tax foreign income. Good to know that Treasury sees the big picture and will enforce it consistently, whether for or against the legislative history. Of course, in both cases the big picture Treasury saw was not the picture painted by the law as it actually had been written.

E. Other Preamble Statements

Section D of the preamble is economic analysis, which, as a result of congressional mandates, has grown over the years to equal or exceed the length of the substantive analysis. It generally goes over the same ground with supposed economic comments. The analysis says the expanded exclusion may cause some taxpayers to make more offshore investments in high-tax jurisdictions (contrary to the purpose of the GILTI regime). The preamble estimates that 4,000 business entities and 1,500 partners are the number of taxpayers that could potentially be affected by guidance governing the election into the high-tax exception. That's enough to catch a regulation writer's attention.

F. Helpers' Suggestions, Republican Ideology

Well-connected law firms, accounting firms, and tax lobbying shops routinely visit Treasury to educate Secretary Steven Mnuchin or his subordinates on the needs of corporate America.[35] Usually we do not know about those visits. The visitors typically are sufficiently knowledgeable to not leave a paper trail behind, which is the only

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[34] *See* Cummings, "The Foreign Dividends Received Deduction," *Tax Notes*, Mar. 12, 2018, p. 1487; and T.D. 9865 (disagreeing with legislative history).

[35] *See also* Sheppard, *supra* note 1 (explaining that the intense lobbying on this exclusion prompted a Senate investigation).

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avenue to disclosure, unless they want to be seen as rubbing shoulders with Treasury officials. Either for that reason or by accident, or because it liked clarity, Covington & Burling supplied slides to Treasury, which Treasury was obliged to release to Tax Analysts. Those slides contained Covington's pitch for expanding the GILTI exclusion.[36] The pitch reached all the way back to 1986. It cited 1986 legislative history stating that taxpayers needed flexibility regarding subpart F because the Tax Reform Act of 1986 expanded its reach; similarly, the 2017 act expanded the reach of — something like subpart F, called GILTI.

Covington also successfully argued for a year-by-year election, by making the most straightforward argument: Sometimes the interactions with foreign tax credits, qualified business asset investment, and the interest deduction limitation make the high-tax election costly to taxpayers. Well, yes, that would be true. The same could be said of consolidated return elections, but we don't let groups flip in and out of consolidation every year. If that argument works, it is an all-purpose tax lobbying argument: Don't adopt this rule because it sometimes will cause some taxpayers to pay more tax. The real issue should have been: Why is this case different?

Some unknown but likely Treasury or White House official wrote in blue ink at the top of that page: "This applies where pay high foreign tax (usually a 'deadweight' cost)." That is a highly suggestive comment. First, it implies that the writer did not know much about the details of GILTI in 2019 (that is, it is someone outside Treasury's Office of Tax Policy). Second, it refers to a high foreign tax, using a term that has academic economic roots[37] but is primarily weaponized by Republican think tanks. The penman could even have been Mnuchin, who is said to be a micromanager.[38]

Deadweight loss conveys the idea that *any* tax that takes money from taxpayer A to pay something (think welfare) to B has a deadweight cost, being a marginal maldistribution of goods and services in the economy, hence reduced GDP, hence all the boats do not get raised by the rising tide, etc.[39] So while the kibitzing Treasury or White House official may not have known much about GILTI, he or she instinctively went to the deadweight tax costs argument (which can be applied to all taxes other than a poll tax).

But not all helpers were arguing for expansion of the high-tax exclusion. Before the 2018 proposal, the New York State Bar Association Tax Section sent Treasury a 123-page report on GILTI guidance.[40] It did not imagine, much less recommend, such an expansion.

G. Proposed Subpart F Regulations

REG-127732-19, proposed July 20, would amend the section 954 regulations. The proposed regulations provide for a single election under section 954(b)(4) for purposes of both subpart F income and tested income for GILTI (the high-tax exception). Rather than conform the GILTI election to the subpart F regulation, the proposal would do the reverse.

This maneuver is intended to bootstrap the argument for the exclusion expansion. The proposed regulations assume that the section 954(b)(4) election should apply to all of the foreign corporation's high-tax foreign income regardless of its nature, making it effective for both subpart F and GILTI high-tax exclusion purposes. So the preamble to the proposed regulations states that the new GILTI election will be withdrawn when these regulations are final.

[36] Covington, "GILTI High Tax Exclusion: Comments on the Proposed Regulations" (Aug. 28, 2019).

[37] *See* Richard S. Grossman, *Wrong* 13-14 (2013); and Harvey Rosen, *Public Finance* 305-308 (3d ed.).

[38] Sheelah Kolhatkar, "Dollar for Dollar," *The New Yorker*, July 20, 2020.

[39] For example, this typical statement appears in *Reason*, a Cato Institute publication: "Government programs often fail to generate value because the taxes to support them create 'deadweight losses' or economic damage. Taxes are compulsory, and so they induce people to avoid them by changing their working, investing, and consumption activities. That reduces overall output and incomes. . . . The size of the damage depends on the type of tax, but for the income tax, empirical studies show that the deadweight loss of raising taxes by a dollar is roughly 50 cents." Chris Edwards, "Coercion Is Bad Economics," *Reason*, July 27, 2015.

[40] NYSBA Tax Section, "Report on the GILTI Provisions of the Code" (May 4, 2018).

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III. Unintended Consequences

A. Did IRS Really Want to Do This?

The code uses "by reason of" terminology hundreds of times. The preamble pushed from the rarity category into the "maybe often or mostly" category the interpretation that "by reason of" means "contributing factor [not even that here] but not 'but for' cause." Normally you would hope that someone is in charge here, who might have thought about the unexpected consequences for the tax system of turning a rare interpretation of that common phrase into the normal interpretation.

That someone might be the IRS deputy chief counsel (technical). It might be the tax legislative counsel or someone in his office.[41] Better yet, it might be a subordinate with experience in the ranks and credibility, who would speak up. But some higher-up made this call, and there are no career advantages at the IRS in bucking the call, even for non-career employees.

As a general matter, the preamble's theory could turn any "by reason of" into "one among other contributing factors." Section 22(e)(3) refers to a person who is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment. It turns out that this same standard appears in many other tax rules.[42] Although the IRS requires that the impairment be the "but for" cause, can such persons cite the preamble for the argument that maybe impairment was one of several causes or even contributing factors? Sometimes the code says "solely by reason of."[43] Will the IRS or taxpayers argue that when "solely" is not used, it does not mean "solely"?

How about this one: Section 461(j)(4) limits deductions for excess farm losses, but the limit does not apply to deductions by reason of fire, storm, or other casualty. Does that mean the limit does not apply if the casualty was a contributing cause?

The preamble's theory could have different consequences in contexts closer to that of sections 951A and 954(b)(4) when one section refers to a situation in another section. Section 2(b) excludes a child from a category if the child "is not a dependent of such individual by reason of section 152(b)(2) or 152(b)(3)." Those other sections describe persons who file joint returns or are foreign. Does that mean that foreign adult persons are not in the category because they are foreign, rather than because they are not children?

I don't know if such speculative interpretations are truly problematic, but do we really want to find out? The preamble's theory is just too counterintuitive to fit the normal usage of connective phrases.

B. Other Connectors in the Code

"By reason of" connectors are not the only connectors in the code. Some are official connectors that are the whole point of the substantive rule, such as section 355(e): Was the change of ownership "part of a plan" with the spin? Even though that is the loosest possible connector language, the IRS has in practice allowed taxpayers to escape connection if they can say they would have done it anyway, which is another way of saying the stock sale was not the "but for" cause of the spin.[44]

And then there is "attributable to," which also appears more than 300 times in the code, including in section 165(i) on disaster losses.[45] The IRS recently staked out an original-cause meaning for "attributable to" in another context.[46] That conclusion was correct in context and right down the middle of the fairway. The conclusion in the preamble is not but is equally as subject to reuse.

IV. Other Supreme Court Authorities

The Supreme Court frequently determines the meaning of words in statutes indicating a linkage or causation. Most recently, in its 2019 term the Supreme Court issued a major ruling on "but for"

[41] *See* Monte A. Jackel, "The Politics of Drafting Regulations," *Tax Notes Federal*, Jan. 20, 2020, p. 411 (discussing control that the Office of Tax Policy is supposed to have over regulation writing, and contrasting that with actual conduct).

[42] Reg. section 1.72-17(f).

[43] Section 243(b)(3)(B)(ii).

[44] *E.g.*, Rev. Rul. 2005-65, 2005-2 C.B. 684.

[45] *See* Cummings, "IRS Principles, Casualty and Disaster Losses," *Tax Notes Federal*, July 27, 2020, p. 603.

[46] ILM 202023006. The legal memorandum appears to adopt the views of Cummings, "Releasing Credits, Refunds, and NOLs," *Tax Notes*, May 8, 2017, p. 837.

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causation in *Comcast*.[47] It held that a section 1981 civil rights tort action requires proof that but for racial animus, the defendant would have contracted with the plaintiff. As part of its analysis, the opinion stated: "'by reason of' race — terms we have often held indicate a but-for causation." In the prior term, the Court in *Husted* interpreted the failure-to-vote clause of the National Voter Registration Act to refer to a removal from voter rolls solely because of nonvoting and so upheld Ohio's purging method, which was not based solely on failure to vote.[48]

Both the *Comcast* and *Husted* opinions cited *Gross* as controlling, a 5-4 opinion written by Justice Clarence Thomas.[49] *Gross* interpreted a statute "which makes it unlawful for an employer to take adverse action against an employee 'because of such individual's age.'" It equated the words "because of," "by reason of," and "on account of." Therefore, an Age Discrimination in Employment Act plaintiff had to prove that but for his age he would not have been demoted. The opinion discussed how a statute might allow a mixed-motives age discrimination claim. But it immediately cited the clear meaning of "because of" as "but for" to preclude that possibility on the facts.

Because the dissenters were the ones looking for the more nuanced meaning, it is useful to review their argument. Primarily, they argued that when Justice Anthony M. Kennedy (in the majority in *Gross*) made the argument in a similar 1989 case, *Price Waterhouse*,[50] he was dissenting. In *Price Waterhouse*, the Court interpreted "because of" to mean a motivating factor, akin to Treasury's view in the preamble. As noted by the *Gross* dissent, the *Price Waterhouse* majority "readily rejected the dissent's [that is, Kennedy's] contrary assertion and said, "To construe the words 'because of' as colloquial shorthand for 'but-for causation' . . . is to misunderstand them."[51] But not so now.

The 2018 *Husted* dissent cited plenty of other interpretive factors, including congressional action, to show that the meaning of "because of" should not be "but for" in that case. Nevertheless, the takeaway from this group of Supreme Court decisions on point is that "because of" will mean "but for" unless some majority of justices really wants it not to. And the current Supreme Court majority really likes the "but for" meaning.

V. Other Treasury Indiscretions

A. Special No More

Suggesting that tax regulations have exceeded Treasury's power has become a cottage industry.[52] Although the Supreme Court has been striking down tax regulations for a century,[53] the cheerleader of the recent trend is professor Kristin E. Hickman, a prolific academic writer who recently served as adviser to OIRA's newly minted tax regulation review process. She seems to have been motivated by concern that tax regulations had gotten an unwarranted pass from scrutiny because tax was special. Indeed, her signature academic article attacked so-called tax exceptionalism.[54] Many others picked up the chant without really analyzing the issue. It has never been clear that tax got any pass.[55]

But just like mask wearing became more standard when mass market retailers like Walmart required it, attacking each and every Treasury regulation, plus lesser guidance,[56] has become standard for the same reason: Money talks. And so it paid for Altera, or at least its lawyers, to engage in a long battle against transfer

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[47] *Comcast Corp. v. National Association of African American-Owned Media*, 140 S. Ct. 1009 (2020).

[48] *Husted v. A. Philip Randolph Institute*, 138 S. Ct. 1833 (2018).

[49] *Gross*, 557 U.S. 167.

[50] *Price Waterhouse v. Hopkins*, 490 U.S. 228 (1989).

[51] *Gross*, 557 U.S. at 183 (Stevens, J., dissenting (quoting *Price Waterhouse*, 490 U.S. at 240)).

[52] *See* Benjamin M. Willis, "TCJA International Regulations: Uncertain Validity," *Tax Notes Int'l*, July 20, 2020, p. 303; Kristin E. Hickman, "Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance With Administrative Procedure Act Rulemaking Requirements," 82 *Notre Dame L. Rev*. 1727 (2007); Cummings, "Challenging Treasury's International Regulations," *Tax Notes*, Oct. 9, 2017, p. 247; and Cummings, "*Chevron*, the APA, and Tax Regulations," *supra* note 17.

[53] *Lynch v. Tilden Produce Co*., 265 U.S. 315 (1924).

[54] Hickman, "The Need for *Mead*: Rejecting Tax Exceptionalism in Judicial Deference," 90 *Minn. L. Rev*. 1537 (2006).

[55] *See generally* Cummings, *Federal Tax Jurisprudence*, *supra* note 10.

[56] William Hoffman, "Stimulus Payment Delays Spurring Challenges to IRS Guidance," *Tax Notes Federal*, Aug. 3, 2020, p. 789.

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pricing regulations.[57] Similarly, there will be court battles over 2017 tax act regulations,[58] although Treasury has made the pickings rather sparse on purpose — the calls are mostly pro-taxpayer.[59] But one anti-taxpayer regulation stands out: The bold choice to advance the effective date of the limitation on the use of the section 245A deduction for purposes of the section 78 gross-up, previously treated as a dividend.[60]

B. The Gross-Up Dividend

1. Un-Deemed Too Late

The 2017 act did a lot of things that needed to work together, and some of them didn't. That happened in the 1954 code, and amendments continued into 1958 to straighten things out. Technical corrections to the 2017 act have not and will not be adopted because of the political stalemate. So Treasury chose to be creative, not only for taxpayers, as in the GILTI high-tax exclusion, but also against taxpayers. The 2017 act's centerpiece was the one-time tax on accumulated foreign earnings, incurred in the inclusion year of the CFC beginning in 2017 and in the shareholder's year in which that year ended.

The 2017 act also created a foreign dividends received deduction in section 245A for dividends received after 2017 — any time after 2017. Someone on the Hill thought about the fact that the dividends received deduction probably should not apply to the section 78 gross-up into income of the FTCs applied by the shareholder for the section 965 inclusion year, which section 78 treated a dividend. So the 2017 act said that the section 78 gross-up would not be a dividend for purposes of section 245A effective "for tax years of foreign corporations beginning after 12/31/2017."

It's not hard, in hindsight, to see where this is going. Lots of corporations that are U.S. shareholders of CFCs had fiscal inclusion years that bridged New Year's 2017. They applied FTCs to that section 965 inclusion. They thought they had received a deemed dividend on account of the gross-up of the credits into income. And many claimed (and all should amend their returns to claim) the section 245A deduction for what was in fact still treated as a dividend when received at the end of the CFC's fiscal year that began in 2017.

Naturally, the IRS didn't like that. It got Treasury to amend reg. section 1.78-1 to advance the effective date.[61] The amended regulation now provides a special applicability date to apply the deletion of the dividend treatment of the gross-up to years beginning in 2017.

2. 'By Reason of Any Alteration of Law'

The preamble's explanation of its authority for changing the effective date Congress wrote into the statute is in the same league as the high-tax exclusion, but it works the other way (anti-taxpayer). The preamble states:

> Section 7805(a) provides that the Treasury Department and the IRS shall prescribe all needful rules and regulations for the enforcement of title 26, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue. The enactment of the Act and the addition of section 245A necessitated regulations to ensure that section 78 continues to serve its intended purpose. The purpose of the section 78 dividend is to ensure that a U.S. shareholder cannot effectively both deduct and credit the foreign taxes paid by a foreign subsidiary that are deemed paid by the U.S. shareholder. See Elizabeth A. Owens & Gerald T. Ball, The Indirect Credit section 2.2B1a n.54 (1975); Stanley Surrey, "Current Issues in the Taxation of

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[57] *Altera Corp. v. Commissioner*, 145 T.C. 91, 117 (2015), *rev'd*, 926 F.3d 1061 (9th Cir. 2018), *petition for hearing en banc denied*, 941 F.3d 1200 (9th Cir. 2019), *petition for cert. filed*, Sup. Ct. Dkt. No. 19-1009 (Feb. 13, 2020), *and denied* on June 22, 2020.

[58] *E.g.*, *Silver v. United States*, No. 20-cv-01544 (D.D.C. 2020) (whether GILTI regs (REG-104390-18 and T.D. 9866) comply with the Regulatory Flexibility Act and Paperwork Reduction Act); *Silver v. IRS*, No. 19-cv-00247 (D.D.C. 2019) (whether section 965 transition tax regulations comply with the Regulatory Flexibility Act and Paperwork Reduction Act); and *New Jersey v. Mnuchin*, No. 19-cv-06642 (S.D.N.Y. 2020) (whether IRS regulations on charitable contribution workarounds to the federal cap on the state and local tax deduction are arbitrary and capricious).

[59] For another example, see Cummings, "The APA, *Chevron*, and the BEAT," *supra* note 18, discussing stretches in the BEAT regulations, mostly pro-taxpayer.

[60] Reg. section 1.78-1(c).

[61] T.D. 9866. T.D. 9909 (released August 21) adopting the final section 245A regulations also relied on the section 7805(a) new law provision as well as a broad reading of "necessary or appropriate" to support questioned authority.

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Corporate Foreign Investment," 56 Columbia Law Rev. 815, 828 (June 1956) (describing the "mathematical quirk" that necessitated enactment of section 78). Allowing a dividends-received deduction for a section 78 dividend would undermine the purpose of the section 78 dividend because taxpayers would effectively be allowed both a credit and deduction for the same foreign tax. For this reason, section 78 (as revised by the Act) provides that a section 78 dividend is not eligible for a dividends-received deduction under section 245A.

First, the preamble makes the startling interpretation of section 7805(a) that any time Congress makes any "alteration of law," Treasury can fix glitches made "necessary." Silly are those who thought the sentence meant that when Congress writes a new code section, Treasury can write interpretive regulations and even legislative regulations made necessary by a gap in the statute. There was no gap in section 78, and no way to "interpret" the accelerated effective date.

Second, the preamble reaches back to secondary sources, mainly the Stanley Surrey article, which predated subpart F and section 78 (added in 1962). All Surrey did was explain how it was unfair to let taxpayers pay U.S. tax with FTCs on an after-tax basis, so the credits should be included in gross income, which they were in 1962. Note that the 1962 change claws back only a fraction of the credit. If the tax system got along without the gross-up for half a century, it is hard to see how a grossed-up credit and a deduction amounts to double deduction. And in any event, even if it were a double deduction (which it is not), that fact is not authority to write the regulation.[62] The argued authority is in the "alteration of law" clause, which is bogus.

VI. Conclusion

Claiming that Treasury exceeded its regulatory authority is nothing new, particularly in tax litigation. And academic pushback dates to at least 1945, when the *Clifford* regulations were thought to be off the reservation.[63] But the two recent examples discussed earlier are both starker power grabs and substantially more disingenuous.

So what? What does it matter that Treasury took a couple of fliers on regulations, either knowing it would not get caught or was willing to take the chance? It matters for the same reason that having a president who routinely lies matters. It raises the question whether the office will ever get back to normal or if this a reset for the foreseeable future. Can we now trust the Office of Tax Policy to do what a senior partner routinely must do when the associates come in with off-the-wall analyses — just say no? ■

[62] For discussion of meaning of double deductions, see Cummings, "Double Deductions: *Duquesne* and *Thrifty Oil*," *Tax Notes*, Dec. 16, 2013, p. 1219.

[63] Edmund W. Pavenstedt, "The Treasury Legislates: The Distortion of the *Clifford* Rule," 2 *Tax L. Rev*. 7 (1946).

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