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Interpreting the TCJA: Standing Up (With Reservations) for Treasury

To the Editor:

The exchange between Mindy Herzfeld ("Did Treasury Weaken the TCJA?" *Tax Notes Federal*, Jan. 13, 2020, p. 205) and Patrick Driessen ("The TCJA Reg Innocents," *Tax Notes Federal*, Jan. 20, 2020, p. 425) is interesting and important. Permit me to jump in. I have some relevant experience, having been centrally involved while serving at Treasury in the development of the foreign tax credit regulations, the section 367(b) regulations, the regulations governing the interest deduction for foreign corporations, the section 892 regulations, the section 907 regulations, and a variety of other regulatory projects.

I agree with portions of what both Herzfeld and Driessen have said. Specifically, I am with Herzfeld in finding *The New York Times* article with which she leads to lack nuance and a fair evaluation of Treasury's task in interpreting the international provisions of the Tax Cuts and Jobs Act. The statute is a challenge, and it is easy to understand Treasury's impulse to shape it into a coherent and administrable set of rules. She notes — indisputably, in my view — that Treasury has diverged from the statutory language in drafting regulations it deems appropriate, but she says the results have proceeded at times in favor of, but at times contrary to, taxpayer interests. I agree. And she is surely correct in noting that there is nothing to suggest "that an administrative agency can grant less deference to comments based simply on who submits them," although it is worth noting that probably not many of Treasury's new friends with helpful suggestions about what the regulations might say have offered interpretations adverse to taxpayer interests.

But Driessen is correct in suggesting that Herzfeld's treatment of the issue of expense allocation (and apportionment) leaves a lot to be desired. First of all, as Driessen notes, conversations with leading lawmakers are not legislative history, much less cause to ignore what the statute says. I pause here to clear up, at least to my satisfaction, what expense allocation really does. It does *not* result in a U.S. tax rate in excess of 13.125 percent on foreign earnings subject to the global intangible low-taxed income rules. The effective U.S. tax rate on GILTI is and remains 10.5 percent. Allocation, however, effectively reduces gross GILTI (after the 50 percent deduction allowed by section 250) to a net figure for purposes of the foreign tax credit limitation. This lowers the limitation, creating the possibility of (more) excess foreign tax credits — in other words, raising the effective *foreign* tax rate. This does not "render the effective tax rate on . . . foreign earnings higher than expected."

The allocation and apportionment rules had been with us in their present form for more than 40 years at the time of enactment of the TCJA. They were hardly unknown or mysterious to people working in the international tax field. Moreover, the TCJA clearly provides in section 904(b)(4)(B) for the allocation and apportionment of expenses with respect to GILTI. The "rude awakening" that Herzfeld describes taxpayers as experiencing upon discovering that they might face normal allocation and apportionment of expenses and thus excess credits even at a foreign tax rate of 13.125 percent may have indeed occurred for some of them, but that must be chalked up to a failure to pay attention. Objectively, there was no surprise here.

The underlying reason for the hullabaloo about foreign taxes is that the TCJA cut the corporate rate from 35 percent to 21 percent. Taxpayers complaining about their inability to credit all their foreign taxes under normal allocation and apportionment rules plus a 50 percent deduction for GILTI are really saying that Congress did them a disservice in lowering the rate. In light of this terrible deed they want to credit foreign taxes they cannot credit under normal rules against the U.S. tax on their U.S.-source income. That seems a bit rich.

It is hard to say precisely where the line should be drawn on the question of Treasury's leeway to interpret the statute in regulations. Surely Treasury must have authority to fill in gaps

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and resolve ambiguities. On the other hand, regulatory rules that are flatly contrary to the statutory text seem less defensible. What strikes me most about the Herzfeld/Driessen debate is not the respective positions taken by the participants but rather the fact that neither Herzfeld nor Driessen raises what seem to me to be two of the largest and most important problems with Treasury interpretations of the TCJA.

First, there is asymmetry in the remedies available for Treasury regulations that stray from the statutory text. The Supreme Court has been clear that there is no standing for a member of the public to object to a regulation that errs on the side of taxpayer benefits. Such a regulation, once established by Treasury, stands uncontested. On the other hand, regulations for which Treasury goes beyond the statute to the detriment of taxpayers can and will be litigated. If Treasury is found to have gone too far, the courts will say so. Although I completely agree with Herzfeld that Treasury's creative instincts have operated in both directions in developing the TCJA regulations, the consequences are very different for favorable regulations than for unfavorable ones.

Second, once the statutory language is no longer an anchor, where does Treasury turn? It appears to have some wholly internal, and entirely unarticulated, sense of how far is too far — the base erosion and antiabuse tax cannot apply to income that is effectively connected and therefore fully subject to U.S. tax, but it must apply to income that is subject to subpart F and therefore fully subject to U.S. tax. Say what? Is this purely a matter of administrative convenience? In the case of Treasury's generosity with the high-tax election out of tested income, Herzfeld cites the "narrowness" of the proposal, but, predictably and logically, taxpayers have asked for a broadening. We do not yet have Treasury's response, but regardless of what it is, what principle is invoked to evaluate the question? Treasury may be comfortable referring to general considerations of good tax policy, but that is a pretty squishy standard and highly subjective. It is true that Treasury's interpretations emanate from its "Office of Tax Policy," but the choice of appropriate policy for the country is a legislative prerogative.

In sum, Treasury has done a heroic job in producing thousands of pages of generally at least somewhat readable regulations in a very short time. The level of professionalism is commendable, and some gap-filling has been inevitable. On the other hand, it is not Treasury's job to rewrite statutory provisions that should have been written properly by Congress. A nervousness about the role that Treasury has found itself playing here is understandable. The *Times* article was, in my view, insufficiently sensitive to the difficulties inherent in the development of these regulations, but it is also true that Congress made this mess, and it should be for Congress to clean it up.

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