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Section 265 and the U.S. Non-Territorial Territorial System

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The U.S. Treasury Department's Greenbook for the 2022 fiscal year[1] generally included international tax proposals that were well foreshadowed by the Biden campaign in 2020 and by the Biden administration earlier in 2021. That being said, there were a few surprises, one of them involving a tax code provision that international tax specialists generally don't spend much time thinking about: Section 265.[2] That provision generally disallows deductions for certain expenses that are considered as being incurred to generate tax-exempt income (e.g., paying interest on debt incurred to purchase state or municipal bonds that generate tax-exempt interest under §103).

The Greenbook would expand §265 to deny deductions for expenses that would be treated as allocable to income that is wholly or partially deductible under §245A (the ever-shrinking[3] U.S. territorial-style dividends-received deduction) or §250 (the U.S. non-territorial-style global intangible low-taxed income, or "GILTI," rules, which tax U.S. parent companies on most of their foreign subsidiary income under §951A, subject to a partial deduction under §250).

SECTION 265 PRESENT LAW

Under §265(a)(1), certain otherwise-allowable deductions are disallowed if they are allocable to income that is "wholly exempt from the taxes imposed by this subtitle." Under Reg. §1.265-1(b), exempt income is income "[w]holly excluded from gross income under any provision of subtitle A" or "[w]holly exempt from the taxes imposed by subtitle A under the provisions of any other law." Non-exempt income, on the other hand, is "any income which is required to be included in gross income."[4]

GREENBOOK PROPOSAL

The Greenbook expresses a concern that, "[t]o the extent deductions are claimed for expenses allocable to income eligible for a deduction under section 245A or section 250, on the basis that section 265 does not apply because that income is not "wholly exempt" from U.S. tax, the United States is providing a tax subsidy for foreign investment."[5] Accordingly, the Greenbook would "expand the application of section 265 to disallow deductions allocable to a class of foreign gross income that is exempt from tax or taxed at a preferential rate through a deduction (e.g., a global minimum tax inclusion with respect to which a section 250 deduction is allowed or dividends eligible for a section 245A deduction)."[6] The Greenbook provides little further detail on the kinds of expenses that might be covered (presumably interest, but anything else?), allocation methods (presumably §861 principles), or other necessary mechanics (presumably the

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[1] U.S. Treasury Department, *General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals*, May 28, 2021, *available at* https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf (the "Greenbook").

[2] All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[3] The proposed elimination of the exempt net deemed tangible income return on qualified business asset investment ("QBAI") would considerably narrow the already-narrow application of §245A.

[4] Reg. §1.265-1(b).

[5] Greenbook, at 6.

[6] *Id.*, at 8.

disallowance of a deduction for expenses allocable to GILTI would be proportional to the §250 deduction and not to the gross §951A inclusion itself). The Greenbook also would repeal §904(b)(4), presumably because the §265 proposal would render it moot.[7]

THAT FOOTNOTE

The Greenbook includes a curious footnote warning the reader that ''this proposal is not intended to create any inferences regarding current law, including whether section 265 currently applies to this income.''[8] This no-inference footnote can only be read as creating an inference that the authors believed that present-law §265 might already apply to deny deductions for expenses allocable to income deductible under §245A or §250. Such an interpretation of present law would be alarming if there were any legal basis for it, as the tax community certainly has not been operating under any such interpretation. Happily, there is no basis for any such interpretation of §265, because that provision applies only where the income amounts are ''wholly exempt'' from income tax. Section 245A and §250 are *deductions* against amounts included in gross income, as opposed to exemptions from gross income. Moreover, §250, even if treated as an exemption equivalent, only partially (not wholly) offsets the relevant income item. Section 904(b)(4), itself, which the Greenbook would repeal, serves as further confirmation that Congress believed there was such a thing as an allowable deduction properly allocable or apportioned to income subject to §245A and §250 deductions.

SECTION 265 IN PREVIOUS INTERNATIONAL TAX REFORM DISCUSSIONS

But that still leaves the question of whether this proposed expansion of §265 makes sense, and how burdensome the proposal may be for various kinds of taxpayers. The concept of expanding deduction allowance under §265 in connection with adopting a territorial dividend exemption system is not a new one. Earlier U.S. international tax reform discussions either included similar proposals or specifically explained why they included no such proposals. For example, the staff of the Joint Committee on Taxation in a 2005 report recommended adopting a territorial dividend exemption system, including rules allocating interest and other expenses to the exempt dividend income.[9] Other proposals would have provided less than 100% dividend exemption, as a proxy (albeit a very rough one) for allocating expenses and denying deductions.[10]

However, even after the reforms of the 2017 tax act[11] the international tax system is far from anything that could accurately be described as ''territorial.'' In light of the inclusion of most foreign subsidiary income on a current basis under GILTI, the participation deduction of §245A is already far more the exception than the general rule. The 2005 Joint Committee territorial dividend exemption proposal, which included a deduction allocation and disallowance rule as noted above, also did *not* recommend expanding subpart F or adopting any new inclusion regime along the lines of what would become GILTI in connection with adopting a territorial dividend exemption regime.[12] Instead, the expense allocation and disallowance rule was intended in part to mitigate any offshoring incentive that otherwise might be created by adopting a territorial dividend exemption system without any accompanying broadening of subpart F or adoption of a new inclusion regime.[13]

WHAT ROLE FOR §265 IN A TCJA (OR TCJA 2.0) INTERNATIONAL TAX FRAMEWORK?

Present-law TCJA includes a very broad and significantly burdensome income inclusion regime for foreign subsidiary income, in the form of GILTI. In addition, if the Biden administration's various GILTI proposals are adopted (effective rate to 21%, elimination of exempt return on QBAI, country-by-country determination of GILTI and foreign tax credits, all while retaining the 20% haircut on credits under §960(d)), the GILTI regime would be even broader and would impose something close to full-rate U.S. tax on foreign subsidiary income on a current basis. Such a system would be awfully far from territorial and indeed would be reasonably close to the simple repeal of the pre-TCJA deferral regime long sought by commentators and policy makers concerned about po-

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[7] *Id.* Section 904(b)(4) provides that certain taxpayers' taxable income for foreign tax credit limitation purposes is determined without taking into account deductions properly allocable or apportioned to amounts deducted under §245A or §250. Because the Greenbook proposal would expand §265 to deny deductions for these amounts in the first place, §904(b)(4) would no longer serve a purpose.

[8] Greenbook, at 8, n. 1.

[9] *See* Jt. Comm. on Tax'n, *Options to Improve Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005), at 186-97 (the ''JCT 2005 Report''). The author of this commentary was part of the Joint Committee staff team that prepared the JCT 2005 Report.

[10] *See, e.g.,* House Ways and Means Committee International Tax Discussion Draft, Oct. 26, 2011 (proposing a 95% exemption, rather than 100%, for this reason).

[11] Tax Cuts and Jobs Act, Pub. L. No. 115-97 (Dec. 22, 2017) (''TCJA'').

[12] *See* JCT 2005 Report, at 194.

[13] *See* JCT 2005 Report, at 195 (''[T]he disallowance of deductions for expenses allocable to exempt income should serve as a brake on any incentive to move investments and activities offshore, as the exemption achieved by such a shift may come at a cost of greater deduction disallowance.'').

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tential tax incentives for moving business activities and income abroad. Both present law and the Biden administration's proposed version of GILTI are fundamentally different from the territorial dividend exemption system considered in the JCT 2005 Report, in that foreign subsidiary income is subject to current-basis U.S. tax at levels sufficient to address concerns about tax arbitrage from borrowing to create tax exempt income, or about tax incentives to move activities and income abroad.

The inclusion of the §265 expansion proposal in the Greenbook thus seems like overkill and in keeping with the "kitchen sink" nature of the administration's international tax proposals to date. At some point this rather large collection of various tax-increasing GILTI changes will need to be winnowed down by Congress, to approach something that businesses can work with, and something that can be defended on competitive grounds as being broadly in line with the regimes of other major multinational residence countries (through the OECD Pillar Two work and otherwise). Given the already-broad current taxation of foreign subsidiary income under GILTI, and the current proposals to increase the GILTI tax burden quite substantially (thereby reducing the revenue available to be raised via §265 expansion), the proposed §265 expansion would seem to be a good candidate for Congressional winnowing in the service of both international competitiveness and administrative simplicity.

In the meantime, however, taxpayers should take this proposed §265 expansion into account in their already-complex modeling of how the Biden administration's tax legislative proposals might affect their businesses.

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