USCIB UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

October 5, 2018

Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20044

RE: IRS REG-104226-18 - Guidance Regarding the Transition Tax Under Section 965 and Related Provisions

Dear Commissioner Rettig:

USCIB[1] is pleased to provide comments on the proposed regulations regarding the transition tax under Section 965 (REG-104226-18).

As part of the transition to the new participation exemption regime, Congress amended section 965 to impose a one-time "transition tax" on post-1986 untaxed foreign earnings that, absent amended section 965, would permanently escape U.S. tax if repatriated under the participation exemption regime. Congress also intended to end the "lock-out effect", so that taxpayers could repatriate their foreign earnings, which would spur investment in the U.S. The rate of tax imposed under section 965 differs depending on the specified foreign corporation's cash position. Foreign tax credits may be available to offset this tax, but the foreign tax credits are reduced (the "haircut") to account for the lower rate of tax.

Section 965 raises numerous unique issues including: the definition of section 965 earnings and how those earnings interact with deficits and previously taxed income ("PTI"); how cash is defined; and how foreign taxes are determined.

General Comments

- In reaching decisions on section 965 issues the IRS and Treasury should consider the purpose of section 965 and how the new rules interact with pre-existing rules. The regulations should be drafted to achieve Congress's goal of ensuring that untaxed

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earnings do not permanently escape tax, taxpayers are able to repatriate cash without punitive consequences, and liquid assets are taxed at higher rates than illiquid assets.

- Earnings that have been previously taxed by the United States, have not escaped taxation and therefore should not be taxed again under section 965. While section 965 earnings are reduced by PTI, other aspects of the regulation will result in double counting of PTI, essentially taxing the same earnings twice. This an especially perverse result since PTI that was subject to tax under the pre-TCJA law would have been subject to U.S. tax at the higher historical rate.[2] PTI should be excluded in determining the existence and amount of an E&P deficit. PTI can be "trapped" by the operation of other rules – the IRS and Treasury should interpret rules to avoid trapping PTI.

- The proposed regulations provide rules for determining the amount of taxes deemed paid under the special circumstances of section 965. To the extent possible, the statutory language should be interpreted to avoid trapping foreign taxes. The section 902 and 960 formulas are simply mechanisms to move taxes paid at one level to another level so that dividends (and subpart F inclusions) are not subject to double taxation. Although these mechanisms do not function flawlessly, the goal should be to allow foreign taxes that have been paid by a foreign subsidiary[3] to be available as credits. In addition, taxes relating to hovering deficits taken into account for section 965 purposes should be allowed as credits to the extent that the requirements under existing regulations for hovering taxes are otherwise fulfilled.

- The proposed regulations have taken a broad view of the aggregate foreign cash position. The broad view fails to recognize when taxpayers do not have cash available to fund the repatriation tax. The IRS and Treasury should reconsider this broad view and provide additional exceptions to the definition of aggregate foreign cash position.

- The IRS and Treasury have substantial regulatory authority under section §960(o) to prescribe regulations or other guidance necessary or appropriate to carry out the provisions of section 965. USCIB believes this authority supports the changes suggested below, additional authority may be noted as appropriate.

<u>Specific Comments</u>

Treatment of PTI

In the Notice of Proposed Rule Making (RIN 1545-BO51), the Internal Revenue Service (IRS) followed the interpretation set forth in Notice 2018-13, in providing that

[2] PTI from pre-TCJA years would of course have been permitted full-foreign tax credits for foreign taxes paid on those earnings, so residual U.S. tax may or may not have been due. This was entirely appropriate under a world-wide, foreign tax credit system.

[3] Subject to the three or six-tier limit.

"previously taxed E&P is not excluded in determining the existence and amount of a specified E&P deficit…"[4]. The proposed regulations then state that the "Treasury Department and the IRS are considering other rules with respect to the definitions of post-1986 earnings and profits, accumulated post-1986 deferred foreign income, and specified E&P deficit in connection with the finalization of these proposed regulations." The proposed regulations cite section 965(o) as providing the necessary authority to consider a different interpretation.[5]

USCIB requests that the IRS and the Treasury adopt the position that, consistent with the rules for calculating deferred foreign income, the rules for calculating earnings deficits should exclude the amount of undistributed foreign earnings that have already been subject to U.S. tax. We believe adopting this position would align the regulation with the intent of Congress that the transition tax apply to a taxpayer's net, historic foreign earnings "which had not been previously taxed."[6] Further, we believe that this calculation achieves the most accurate measure of a taxpayer's earnings and profits that should be subject to the transition tax.

The preamble to the proposed regulations explains that while the specific language of section 965 makes clear that PTI is excluded from the calculation of E&P when a specified foreign corporation has net positive E&P, it is silent on whether PTI should be excluded from the calculation of a specified E&P deficit. The proposed regulations therefore propose to adopt the interpretation that Congress must have intended that silence to mean that PTI should be included. We believe this is the wrong approach and urge the IRS and Treasury to reconsider.

There is no policy reason for including PTI in the calculation of a specified E&P deficit. Indeed, including PTI in the calculation will cause a taxpayer to have its E&P that is subject to the transition tax "over-measured" and cause the transition tax to be imposed on more than 100% of the taxpayer's E&P. There is nothing in the legislative history that suggested that Congress intended to include PTI in the calculation of a specified E&P deficit. In fact, there is evidence in the legislative history that Congress intended to exclude income that had been previously taxed from the transition tax, as noted above. At most, the statute's silence on the issue should be interpreted as a simple failure of Congress to provide guidance one way or the other. In that case, the broad grant of regulatory authority in section 965(o) gives the IRS and Treasury the ability to implement the policy in a way that is clearly aligned with Congressional intent and achieves the most reasonable measurement of a taxpayer's E&P for purposes of calculating the transition tax.

[4] Preamble page 33.
[5] Preamble page 34.
[6] See Ways and Means Committee Report p. 375.

For these reasons, we respectfully request that in the final regulations the IRS and Treasury adopt an approach that would exclude PTI from determining the existence and amount of a specified E&P deficit.

Treatment of distributions to US shareholders between the November 2 measurement date and December 1, 2017

The preamble to the proposed regulations[7] provides that rules preventing double counting of post-1986 earnings and profits should not be extended to distributions by specified corporations to a US shareholder. This position is justified by the statement that the statement that double counting concerns relate to transactions between specified foreign corporations and not to transactions between a US shareholder and a specified corporation. Further, the preamble notes that a distribution to a US shareholder may permit the taxpayer to take into foreign tax credits that would be disallowed under the "haircut".

While the above statements may be technically true – the same earnings will not be included in the post-1986 earnings of two different specified foreign corporations – the point of the anti-double counting rule is to avoid two inclusions of the same earnings at the US shareholder level. Thus, a distribution to a US shareholder between November 2 and December 1, 2017, has a similar effect to a distribution between two specified foreign corporations.

The following example is instructive on this point. Facts: USP, a domestic corporation, owns all the stock of CFC1, a foreign corporation. USP has a 12/31 year-end and CFC1 has a 11/30 year-end. As of January 1, 2017, CFC1 had $80 of section 959(c)(3) (post-1986 undistributed earnings) with post-1986 taxes of $20. CFC1 had no earnings and paid no taxes in 2017. On November 3, 2017 CFC1 paid a $80 dividend to USP. Because of this dividend, CFC1 had no section 959(c)(3) earnings or section 902 taxes remaining in its earnings and taxes pools as of its year end on 11/30. CFC1 did not have any earnings or pay any taxes in December 2017, and it is anticipated that CFC1 will not have any earnings or pay taxes in its tax year ending 11/30/2018 (its inclusion year). Analysis: CFC1's distribution to the US on Nov 3 is fully taxed in its pre-inclusion year, with $100 of income to be taxed in the US at 35% ($80 dividend plus $20 Sec 78 gross-up) with $20 of taxes credits available to offset this gain (subject to FTC limitations). Assuming this is USP's only income, USP would owe $15 of residual US tax. For purposes of section 965, CFC1's accumulated post-86 deferred foreign income as of November 2nd is $80 and is $0 as of December 31st, making its Sec 965(a) inclusion amount $80 (the greater of the amounts determined on the two measurement dates). Without any other adjustments for double counting, USP will be subject to tax on this $80 of earnings twice--once when it was distributed to the US, and once under section 965. Further, because all CFC1's tax credits were deemed paid with respect to its November 3rd dividend, there will have no

[7] Preamble pages 63 and 64.

foreign taxes left in its taxes pool at the end of the year.[8] This means that not only are the same $80 of earnings taxed twice, but when those earnings are taxed under section 965 this inclusion comes with no tax credits. If the $80 is subject to tax at the 15.5% rate, then the US tax imposed on this second inclusion would be $12.40. Thus, US tax of $27.40 would be imposed on what is really $80.00 of earnings after foreign taxes for a 34.25% US effective rate. If one considers not only the US taxes, but also the foreign taxes and consider the grossed-up dividend, then the overall effective rate is 47.40% (100 of earnings including the gross-up and 20 of foreign taxes plus 27.40 of US taxes).

Depending on the source of the underlying earnings, this approach may violate US income tax treaties. Article 23 of the US Model provides for the elimination of double taxation by means of foreign tax credit, including for dividends paid from a corporation resident in the other country. Thus, is CFC1 is resident in a treaty country, then imposing US tax at an effective rate of 34.25% effectively denies USP relief from double taxation guaranteed under an income tax treaty.

To address this, Treasury should follow the policy of section 965, the foreign tax credit regime, and tax treaties to either (1) exclude any 2017 inclusion of pre-965 earnings from the measurement of post-86 deferred foreign income of each DFIC or (2) allow tax credits available for use for the taxable dividend to also apply in when included under section 965 (using the example above, the $20 of taxes would also be available to reduce the US tax on the section 965 inclusion). The first option is probably easier to implement given the statutory scheme.

Reduction of section 959(c)(3) pools below zero

The reduction of section 959(c)(3) pools below zero as the result of a section 965 inclusion presents potential pitfalls for taxpayers. First, section 965 PTI may be trapped to the extent it reduces section 959(c)(3) earnings below zero because it is unclear whether a CFC can distribute PTI when it has aggregate positive earnings and profits – if not the distribution is a return of capital or treated as the sale or exchange of that stock. There is also a risk that if the CFC has subpart F income going forward, the current foreign taxes will not be able to be deemed paid because of the net negative accumulated section 959(c)(3) earnings. It is, therefore, especially important to avoid trapping taxes. This issue will be present in any DFIC with an 11/2 measurement date, as by definition its section 965 inclusion is larger than its earnings as of 12/31.

Treasury should clarify that section 959(c)(3) earnings cannot be reduced below zero as a result of a section 965 inclusion. At a minimum, Treasury should clarify under section

[8] Because the purpose of the section 902 and section 960 formulas is to move a pro rata portion of taxes up the chain to a US shareholder so that foreign taxes and foreign earnings are both included on the US shareholder's return. The foreign taxes pool is appropriately reduced by the amount of foreign taxes previously deemed paid. However, in this case the same earnings support two different inclusions (the dividend and the 956 inclusion),

960(a) that the existence of a prior deficit in section 959(c)(3) earnings does not preclude the recognition of current year foreign tax credits attributable to current year subpart F income. This is especially important given that under pre-TCJA law, foreign taxes might be trapped by a negative earnings pool; it was, however, possible for a CFC to accumulate positive earnings in the pool and thus eventually access those taxes.[9] Under the new law, this is no longer possible. The TCJA reverts to annual layers for future years, so if a deficit traps taxes in a year, they will be permanently lost. Under the prior interpretation of how deficits were allocated to annual layers[10] deficits were rolled back to prior years. If the deficit exceeded a particular year's earnings and profits, then taxes would have been trapped. In revising the foreign tax credit rules in light of the TCJA the IRS and Treasury should consider other options to avoid trapping taxes, especially since countries post-financial crisis have limited the ability to carry-back losses.

Payments from one DFIC to another DFIC between measurement dates

Proposed regulation section 1.965-4(f) provides rules for disregarding certain payments between related DFIC's when such payments occur between measurement dates. By disregarding the transaction, the earnings remain with the payor. This approach of disregarding the transaction may create negative section 959(c)(3) earnings for the payor, which may result in trapped PTI or limit the amount of taxes available as tax credits if that entity has a subpart F inclusion post inclusion year. (See above.) This approach is inconsistent with the ordering rules codified in section 965(d)(3). That section provides that dividends between specified foreign corporations reduce the post-86 E&P for purposes prior to determining the section 965 inclusion amount for that entity as opposed to disregarding that dividend and keeping those earnings with the payor.

The following example is instructive on this point. Facts: CFC2, a 12/31 year-end DFIC with $100 of accumulated earnings and profits as of 11/2/2017 and no other earnings after this date, pays a dividend of $100 on 11/3/2017 to its parent, CFC1, another 12/31 year-end DFIC with $100 of accumulated earnings and profits immediately prior to receipt of the distribution and has no other earnings for the year. CFC2 has $100 of post-86 earnings and profits using the tentative measurement date of November 2nd

[9] The preamble to the final section 902 regulations (TD 8708, RIN-154-AL98) set forth the arguments for denying foreign taxes in the case of a nimble dividend: "The rule is retained in the final regulations for two reasons. First, the legislative history of the Tax Reform Act of 1986 (Public Law 99-514) clearly indicates that Congress was aware of the issue and agreed with the position stated in the regulation. See S. Rep. No. 313, 99th Cong., 2d Sess. 321 (1986). Second, because no taxes can be deemed paid under the computational rules of section 902 when post-1986 undistributed earnings are zero or less than zero, no taxes are removed from the post-1986 foreign income taxes pool. Thus, all of the foreign corporation's taxes remain in its post-1986 foreign income taxes pool and are available to be credited if the corporation pays another dividend in a later year in which the post-1986 undistributed earnings pool is positive." Both of these justifications are no longer valid.

[10] Rev. Rul. 74-550, 1974 – 2 C.B. 209.

and CFC1 has $200 post-86 earnings and profits using the tentative measurement date of December 31st. Without an anti-double counting rule this outcome would result in the double counting of $100 for section 965 purposes.

Analysis: If the $100 payment is disregarded per the double counting rules in proposed regulation section 1.965-4(f), then CFC2, the payor, would have $100 of post-86 earnings and profits on the November 2nd measurement date (unchanged from the prior example), and CFC1 would have $100 of post-86 earnings and profits as of the December 31st measurement date. From a US shareholder perspective, this approach removes the double counting of the $100 payment, but on a CFC level it results in the mismatch of section 959(c)(2) and (c)(3) earnings. CFC2 has $100 of 965 inclusion, but it has $0 of Sec 959(c)(3) earnings at the end of the year, meaning that after adjustments from section 965 it would end the year with negative ($100) of section 959(c)(3) earnings. CFC1, on the other hand, has $100 of section 965 inclusion, but has $200 of Sec 959(c)(3) earnings at the end of the year before the application of section 965, meaning that it would end the year with positive $100 of section 959(c)(3) earnings. While an excess of section 959(c)(3) earnings may not be disadvantageous due to the application of Sec 245A, the negative section 959(c)(3) earnings at CFC2 may cause significant adverse impacts to taxpayers.

Treasury should revise the double counting rules so that a payment which results in double counting reduces the payor's section 965 inclusion amount without any adjustment to the payee's section 965 amount. This would solve the mismatch of section 959(c)(2) and (c)(3) earnings and avoid the trapped PTI/nimble dividend issues moving forward. Using the example above, if CFC2 was able to reduce its 965 amount by the $100 double counted earnings, it would have a section 965 amount of $0, which would match its year end Sec 959(c)(3) pool of $0 because of its $100 dividend. CFC1 would have a section 965 amount of $200 (its $100 of earnings plus the $100 dividend), which would match it year section 959(c)(3) pool of $200. Thus, the total inclusion under 965 would be correct -- $200 – and the inclusion and the earnings would both be in the same entity – CFC1. This approach would avoid double counting and align the pools on a CFC by CFC basis.

There may, nevertheless, be a mismatch between where the inclusion occurs and where the PTI is located in the structure. There are no simple answers to how this should be handled, however, the answer that may make the most sense would be to ensure that PTI follows the earnings and not the inclusion. This would be difficult to administer and might be done electively.

Reduced foreign tax credit for withholding tax attributable to a distribution of section 965 PTI

Proposed regulation section 1.965-5(b) provides that neither a deduction nor a credit is allowed for the applicable percentage of any foreign income taxes paid or accrued with respect to any amount for which a section 965(c) deduction is allowed for a section 958(a) US shareholder inclusion year. This includes the applicable percentage of any withholding tax imposed on a distribution of section 965(a) or (b) previously taxed earnings and profits.

The rule as proposed is difficult for taxpayers to apply. Under this rule, taxpayers are required to separately track not only all their section 965 PTI, but this PTI must be separated into two categories: PTI originating from liquid assets which are subject to the 0.557 applicable ratio and PTI originating from non-liquid assets which are subject to the 0.771 applicable ratio. As the regulations are silent on further application of these rules, taxpayers are left to determine how to apportion, track, and order these different tranches of earnings, which is particularly burdensome for taxpayers with multi-tier structures or who are acquisitive in nature.

It is very unclear how PTI relating to section 965(b) would be tracked. USCIB suggests that an ordering rule would be helpful and that section 965(a) PTI be prioritized before section 965(b) PTI.

Foreign taxes and inability to access those taxes

The proposed regulations do not address what happens to foreign taxes that are not deemed paid with respect to a section 965 inclusion because the denominator in the section 902 fraction is zero or less than zero. Previously, when the denominator of the section 902 fraction was zero (or less than zero) and there was a nimble dividend, the tax credits, which represent actual foreign income taxes paid, would not have been permanently trapped. Instead the foreign taxes remained in the taxes pool and would become available if the post-1986 undistributed earnings pool became positive and a dividend or subpart F inclusion was paid out of those positive earnings. As pointed out above, the annual layers of earnings and taxes will result in more trapped taxes. The IRS and Treasury should seek to limit this distortion and permit US shareholders to access these taxes. One possible method of allowing taxpayers to access taxes would be to allocate the taxes pro rata to other DFICs.

Foreign taxes relating to hovering deficits

The preamble to the proposed regulations at page 72 states that "Comments also recommended that, to the extent that a hovering deficit is treated as reducing the post-1986 earnings and profits of a DFIC, those taxes should be added to the DFIC's post-1986 foreign income taxes in the inclusion year with respect to the DFIC. The Treasury Department and the IRS have determined that the existing rules adequately address this issue and decline to adopt this comment. The proposed regulations do not provide special rules for foreign income taxes that are related to hovering deficits; as a result, the rules in §1.367(b)-7 continue to apply with respect to such foreign income taxes."

The IRS and Treasury should clarify that while the deficit offset rules of Reg. §1.367(b)-7(d)(2)(ii) have been suspended for section 965 purposes with respect to hovering **deficits**, the rule in existing Reg. §1.367(b)-7(d)(2)(iii) in respect of hovering **taxes** continues to apply. For section 965 purposes, Congress suspended the usual restrictions for use of hovering deficits, allowing them to be offset against positive E&P regardless of whether the deficit and E&P are in the same limitation category, regardless of whether distributed before year end or accumulated, without regard to whether earned out with post-section 381 event profits, and without regard to the "first day of the next year" requirement. However, Congress did not intend to suspend the normal rule of Reg. §1.367(b)-7(d)(2)(iii) for hovering **taxes**. The regulations should therefore clarify that in order to release foreign taxes along with the hovering deficit, the requirements of Reg. §1.367(b)-7(d)(2)(iii) need to be met, i.e. that the foreign taxes be in the same separate limitation category as the hovering deficit, and that the taxes become available on a pro rata basis to the extent the hovering deficit was absorbed by post-section 381 event earnings. As contained in the existing regulation for foreign taxes, pro rata means in the same proportion as the portion of the hovering deficit that offsets post-transaction earnings in the separate category.

Year in which earnings and profits increase per section 965(b)(4)(B) occurs

Proposed regulation section 1.965-6(c)(3) provides that the section 965(b)(4)(B) increase to an earnings and profits deficit foreign corporation's earnings happens on the first day after what would be that corporation's inclusion year if it were a DFIC raises several significant issues and questions that Treasury needs to address.

First, this provision in the proposed regulations contradicts the language in the code. Section 965(b)(4)(B) states that with respect to any taxable year beginning with the taxable year described in section 965(a) (i.e., the inclusion year), the E&P deficit foreign corporation's E&P is increased by its allocated losses. The code makes it clear that this increase happens in the inclusion year, not in the year after the inclusion year.

Second, having this increase happen in the year after the inclusion year presents a number of complicated issues/questions related to its interaction with other tax provisions. For instance, are these earnings in a post inclusion year treated as GILTI? How should they be treated when determining the deemed paid foreign tax credit attributable to a subpart F inclusion?

Third, is it intended that the section 965(b)(4)(B) increase to a deficit corporation's earnings and profits give rise to an increase in the basis in the stock of the deficit foreign corporation for purposes of apportioning expenses on the basis of the tax book value of assets pursuant to regulation section 1.861-12(c)(2)(i)(A)(1)? This appears inappropriate from a policy standpoint.

Finally, this rule will cause confusion and complications when completing Forms 5471 for the inclusion year. Because the losses of an E&P deficit foreign corporation allocated to a DFIC will reduce that DFIC's Section 959(c)(3) earnings per Prop Reg 1.965-2(d)(1), the losses of an E&P deficit foreign corporation will be double reported on the inclusion year Forms 5471 schedules I & J--once in the E&P deficit foreign corporation's own 5471 Schedules I & J and the second in time in the section 959(c)(3) adjustments to the DFICs to which these losses were allocated. This will result in imprecise and confusing reporting.

Treasury lacks the regulatory authority to override the language of Sec 965(b)(4)(B) to change the year of the section 965(b)(4)(B) earnings and profits increase. Treasury should conform the final regulations to the rule of section 965(b)(4)(B) to provide that these adjustments happen in the last taxable year which begins before January 1, 2018.

Proposed basis election

USCIB is very pleased to see Notice 2018-78 extending the time to make the proposed basis election. To consider this election, taxpayers must analyze the basis in all applicable property to understand any potential taxable gain, which may require in depth reviews of multiple entities. Taxpayers must also consider that if they do not make this election, they must carefully track their PTI basis going forward to determine if and when they trigger any taxable gain from PTI distributions.

As previously taxed income has historically referred to earnings which can be distributed without any additional U.S. tax, the final regulations should state that section 961 applies to section 965(b) PTI; that is the basis adjustment is automatic, unless the taxpayer opts out. This approach would avoid the administrative difficulty of taxpayers trying to analyze the implications of this election in a short time and, if no election is made, tracking of multiple tranches of PTI. It is also necessary to ensure that basis adjustments are made below the first-tier CFC in order to avoid double counting of the same gain.

Special Attribution Rule – de minimis rule

The proposed regulations include a “Special Attribution Rule” that provides relief in certain instances by turning off downward attribution from a partner to a partnership in determining whether a foreign corporation is a SFC.

While we appreciate Treasury's acknowledgement of the administrative difficulty of the repeal of Sec 958(b)(4) as applied to section 965, limiting the *de minimis* amount to less than 5% still presents significant compliance difficulty. Generally, other partners of a partnership are not willing to share detailed information about their holdings, regardless of the taxpayer shareholder's percentage interest.

Treasury should consider increasing the *de minimis* amount to 50% or less, as partners with less than a controlling interest are unlikely to have any access to information from an unrelated partner.

Special Attribution Rule -- examples

However, in illustrating the Special Attribution Rule, the proposed regulations have examples (see proposed regulations section 1.965-1(g) Examples 1 and 2) that reflect a general application of the §318 downward attribution rules that is inconsistent with §318. The examples effectively nullify the statutory prohibition against so-called "sidewise attribution" under §318(a)(5)(C) and are directly at odds with the IRS and Treasury's prior application of §318 in a similar fact pattern.

Modify Examples 1 and 2 of proposed regulations section 1.965-1(g) when the proposed regulations are finalized, so that the final regulations apply §318 in a manner that avoids expanding the downward attribution rules of that section beyond their long-understood scope, while at the same time continuing to illustrate the application of the Special Attribution Rule.

Short-term Note Payables

The proposed regulations do not permit short-term notes payable (i.e. short-term debt, generally less than 1 year, that does not arise from a purchase of a good or service) to offset short-term notes receivable, which count as cash. Due to the short-term nature of these transactions, the inability to net the short-term note payables against the receivables distorts the true cash position of a company. For an example, a specified foreign corporation ("SFC") may borrow funds from its U.S. shareholder for operational needs, and the borrowing is booked as short term intercompany ("IC") note payable ("NP"). The same SFC could also lend funds (previously taxed in the U.S.) to its U.S. shareholder or a member of the same U.S. federal consolidated group, for its needs, which is booked as IC note receivables ("NR"). Under accounting principles, the two accounts are netted to properly reflect the SFC's real cash picture. However, under the section 965 proposed regulations, the NR would be treated as short term obligations, includable as cash for the SFC, while the NP is left out and not allowed to offset or net against the SFC's NR. This disallowance results in a distortive overstatement of the SFC's cash balances and is against the Congressional intent of measuring the real foreign liquidity of the U.S. companies. Moreover, the NP owed to the U.S. is provided by US funds, which is not foreign cash the Congress intend to tax at a higher rate.

General accounting rules permit the netting of account receivables and account payables; this rule permits for a more accurate picture of a company's financials. Due to the similar nature of short-term notes, comparable rules should also be applied. Specifically, the regulations should allow a SFC to net its short term intercompany notes payable against its short term intercompany notes receivable with its U.S. shareholder or a member of the same U.S. federal consolidated group of its U.S. shareholder.

Netting of third party payables and receivables between related SFCs

Unlike related party payables and receivables, the proposed regulations do not permit netting of third party payables and receivables between related SFCs. Section 965(o) provides a broad authority to the Treasury to prescribe any regulations or other guidance as may be necessary or appropriate to carry out the provisions of section 965. This authority is broad enough to cover the netting of both intercompany receivables and payables and third-party receivables and payables. In the preamble to the proposed regulations (page 110), the Treasury expressed its intention to reduce double counting and produce more equitable tax outcomes such that similarly situated taxpayers would not have different tax liabilities. In the fact pattern involving a single U.S. shareholder owning a single SFC, section 965(c)(3)(C) provides for the netting of the SFC's accounts payable and accounts receivable. Intercompany receivables and payables, and third- party receivables and payables, owed by SFCs with different U.S. shareholders in the same consolidated group is essentially the same economic structure if the group is viewed as a whole. Thus, the lack of regulations or other guidance to allow netting of third party receivables and payables among SFCs with different U.S. shareholders in the same consolidated group would result in an inequitable tax outcome whereby similarly situated taxpayers are taxed differently. Treasury should permit netting of third party receivables and payables of related SFCs.

Overpayment of the Transition Tax

In building cash tax estimates for payment of the transition tax, businesses include anticipated federal tax overpayments to determine the net impact to free cash flow for each respective year. Taxpayers who elected to pay their deferred foreign income tax liability over eight years would have included 8% of the anticipated total transition tax in their respective net cash tax forecasts for 2018, which properly applied statutory language included in section 965(h) and demonstrated congressional intent throughout the tax reform legislative process. However, the IRS guidance in FAQ 13 and 14 published April 13, 2018, indicates any overpayment by a taxpayer to the IRS will be applied *in full* against the taxpayer’s *total* (eight-year) transition tax liability. This would mean instead of applying the 2017 overpayment as a refund or credit against their 2018 tax liability, such taxpayers would be forced to have paid a large portion – or all – of their transition tax in the first year, effectively forfeiting the taxpayer’s election to pay the tax over eight years as planned.

The guidance provided by the IRS directly conflicts with congressional intent to permit taxpayers, who elect, to pay their deferred foreign income tax liability over eight installments. This guidance would not only put companies who overpaid their taxes at a competitive disadvantage, it also creates volatility in the ability to meet anticipated financial commitments. The IRS should issue guidance aligned with congressional intent, as outlined in the conference report, that allows taxpayers, who elect, to be able to pay their transition tax over eight years under IRC Sec. 965(h).

Section 965 - Net tax liability

Pursuant to section 965(h)(6) the term “net tax liability” is defined as the excess (if any) of such taxpayer’s net income tax for the taxable year in which an amount is included in the gross income of such United States shareholder under section 951(a)(1) over such taxpayer’s net income tax for such taxable year determined without regard to this section and without regard to any <u>income or deduction</u> properly attributable to a dividend received by such United States shareholder from any deferred foreign income corporation.

However, proposed regulation 1.965-7(g)(10)(i)(B)(2) defines total net tax liability under section 965 as the excess (if any) of the person's net income tax for the taxable year in which the person includes a section 965(a) inclusion in income over the person's net income tax for the taxable year determined without regard to section 965, and without regard to any <u>income, deduction, or credit</u> properly attributable to a dividend received…..from a deferred foreign income corporation.

The proposed regulations change the definition of net tax liability to include credits which is not the language used in the statute. It is clear from the legislative history that credits were not intended to be included in the definition. The House version of the section 965(h)(6) included a reference to “credit”; the Senate version did not; and the Conference agreement adopted the Senate’s amendment. The final regulations should, therefore, conform to the statutory language as reflected in the Senate amendment and Conference agreement and exclude “credits” from the definition of total net tax liability in section 1.965-7(g)(10)(i)(B)(2).

Treatment of a Consolidated Group as a Single U.S. Shareholder; Netting of Intercompany Receivables between Related SFCs

If the aggregate foreign cash position is calculated for each separate U.S. shareholder that is a member of a consolidated group, any trade receivables, short-term notes receivables, and other intercompany obligations that are cash equivalents between SFCs with different U.S. shareholders would be included in their respective foreign cash position calculation. Consequently, the consolidated group would end up in double counting of foreign cash (or triple or more, as the case may be).

Section 3.01(b) of Notice 2018-7 made it clear that for purposes of determining the cash position of an SFC, the Treasury intended to issue regulations providing that with respect to a U.S. shareholder, any receivable or payable of an SFC from or to a related (within the meaning of section 954(d)(3)) SFC will be disregarded to the extent of the common ownership of such SFCs by the U.S. shareholder.   Section 3.04 of Notice 2018-7 further provided that the Treasury Department intended to issue regulations providing that solely with respect to the calculation of the section 965 inclusion amount by a consolidated group, all members of that group that are U.S. shareholders of one or more SFCs would be treated as a single U.S. shareholder. The combination of these two provisions of the notice made it clear that intercompany receivables and payables could be netted, regardless of whether the receivables and payables are owed by SFCs with different U.S. shareholders that are members of a consolidated group.

Although the proposed regulations reach the same result, they are far less clear on this point. The key provision is Reg. § 1.965-3(b)(1), which disregards certain obligations between related SFCs, and the second sentence of this provision provides that a SFC is treated as a related SFC with respect to another SFC if they are "related persons" within the meaning of section 954(d)(3). Section 954(d)(3) refers to section 958, which includes both the direct and indirect ownership rule under section 958(a) and the constructive ownership rule under section 958(b). As a result, SFCs owned by different U.S. shareholders within the same group are "related persons" for purposes of Reg. 1.965-3(b)(1). The first sentence of Reg. § 1.965-3(b)(1), though, focuses on a SFC with respect to which "the section 958(a) U.S. shareholder owning section 958(a) stock." Section 958(a) shareholder is a U.S. shareholder that owns section 958(a) stock of a SFC, and section 958(a) stock is stock of a corporation owned directly or indirectly (but not constructively) by a U.S. shareholder within the meaning of section 958(a). Example (4) of Reg. § 1.965-3(b)(3) addresses only the fact pattern of a single U.S. shareholder owning both SFCs. However, the "related person" rule provided in the second sentence of Reg. § 1.965-3(b)(1) is necessary to conclude that the same netting rule applies to SFCs owned by different U.S. shareholders within the same consolidated group.

Consistent with the clear rules of Notice 2018-07, with respect to a U.S. shareholder, any receivable or payable of an SFC from or to a related (within the meaning of section 954(d)(3)) SFC should be disregarded to the extent of the common ownership of such SFCs by the U.S. shareholder and all members of a consolidated group that are U.S. shareholders should be treated as a single U.S. shareholder for purposes of determining the aggregate foreign cash position of the consolidated group.

Section 960(o) grants the Secretary authority to prescribe regulations or other guidance necessary or appropriate to carry out the provisions of section 965 and section 1502 grants the Secretary authority to prescribe regulations necessary in order to clearly reflect the tax liability of a consolidated group.

Distribution Taxes Imposed on Disregarded Distributions

Taxes imposed on a distribution from a foreign corporation, which is disregarded for U.S. tax purposes, may not be creditable under section 960(a)(3) under proposed regulations section 1.965-5(c)(1)(ii). The proposed regulations provide that foreign income taxes deemed paid under §960(a)(3) with respect to a distribution of section 965(a) PTI or section 965(b) PTI should be limited to only the foreign income taxes paid or accrued by an "upper-tier foreign corporation" with respect to a distribution of section 965(a) PTI or section 965(b) PTI from a "lower-tier foreign corporation".

Although a distribution from a disregarded entity is not a "distribution" to an "upper-tier foreign corporation" for U.S. tax purposes, it is nonetheless a distribution under foreign law and taxes may be imposed on that distribution under local tax law.

Therefore, the question is whether section 960(a)(3) and the proposed regulations apply to the U.S. tax classification of these entities or their foreign legal classification. It is clear, and the Treasury reiterates this point in the preamble to the proposed regulations, that a disregarded entity's taxes are those of the owner. Thus, when a disregarded entity distributes to its foreign corporate owner and a local distribution tax applies, the local distribution tax attaches to the owner's PTI (as a foreign income tax imposed on a subsequent distribution) so that it could be credited back in the U.S. under section 960(a)(3) when the owner makes a distribution to its U.S. shareholder. There is nothing in the statute that would preclude this interpretation.

In general, taxes are attributable to the income base on which the taxes are imposed. Treas. Reg. §1.904-6(a); Treas. Reg. §1.861-8(e)(6). Under the proposed regulations, it is not clear what happens to these distribution taxes, even though the previously cited regulations would attach the distribution taxes to the PTI to which it properly relates.

Foreign income taxes deemed paid under section 960(a)(3) with respect to a distribution of section 965(a) PTI or section 965(b) PTI should include foreign income taxes paid or accrued with respect to any distribution of section965(a) PTI or section 965(b) PTI by an entity (including taxes attributable to distributions from a lower-tier corporation to an upper-tier corporation and from a disregarded foreign entity to its owner).

Section 961 Basis Related to Deficit Allocation

A taxpayer may, by making an election, increase its basis in the DFICs to the extent of the section 965(b) PTI. However, an offsetting reduction in basis is required to the E&P deficit foreign corporations. In the case where a DFIC is in a different U.S. shareholder chain than an E&P deficit foreign corporation, this effectively results in a basis shifting. If they are both under a single common U.S. shareholder, then effectively there is no basis adjustment. The interaction of these rules would result in recapturing the section 965(b) deficit allocation at the ordinary income tax rate in effect at the time of the section 965(b) PTI distribution, while at the same time providing minimal benefit from the deficit in the section 965 inclusion calculation because of the reduced rates and reduced foreign tax credit limitation imposed under the statute and the proposed regulations. Imposing a higher tax on the recapture of the deficit would be inconsistent with the purposes of the section 965(b) deficit allocation rules and with Congressional intent for encouraging the repatriation of foreign earnings.

With respect to §965(b) PTI, increase the basis of the DFIC to the extent of §965(b) PTI, or in the alternative, provide that the basis reduction rule under §961(b)(1) does not apply with respect to a distribution of §965(b) PTI.

The Conference Report[11] recognizes that "basis adjustments (increases or decreases) *may be necessary* with respect to both the stock of the deferred foreign income corporation and the E&P deficit foreign corporation and authorizes the Secretary to provide for such basis adjustments or other adjustments, as may be appropriate. For example, with respect to the stock of the deferred foreign income corporation, the Secretary may determine that a basis increase is appropriate in the taxable year of the section 951A inclusion or, alternatively, the Secretary may exercise its authority to modify the application of section 961(b)(1) with respect to such stock" (*emphasis added*).

Publicly Traded SFC Stock

The definition of foreign cash position should exclude publicly traded SFC stock. Publicly traded SFC stock held in the ordinary course of business frequently is not sufficiently liquid to be treated as a cash equivalent. For example, consider a situation in which an SFC has a significant shareholding (e.g., greater than 10%) in a publicly traded entity, such that a disposition of such stock would cause a reduction in the value of the block of stock. Furthermore, such publicly traded subsidiaries are often key parts of an SFC's supply chain and vital to the taxpayer's overall operations.

The Conference Report expected liquidity to be considered and section 965(c)(3)(B)(iii)(V) states that the cash position of an SFC shall include the fair market value of "any asset which the Secretary identifies as being economically equivalent to any asset described in this subparagraph." As the preamble to the proposed regulations notes, the Treasury asserts that liquidity principles would not be administrable and would require a facts and circumstances analysis for every asset. This overstates the problems with using liquidity as a standard, particularly as a narrow exception to a more general rule. The IRS and Treasury could, and should, provide a specified exception to shares of publicly traded SFCs that are held for a reasonable period of time, which should be administrable.

Specified Payments Made between E&P Measurement Dates

Although the rule to disregard specified payments made between earnings and profits measurement dates is seemingly a taxpayer friendly rule, the rule is in the anti-abuse

[11] H.R. Rep. No. 115-466, at 620 (2017) (Conf. Rep.).

section of the proposed regulations. Consequently, it is intended to be an anti-abuse rule to prevent taxpayers from moving earnings and profits out of SFCs having an earnings and profits measurement date of 12/31/2017 to a related SFC with an 11/2/2017 earnings and profits measurement date. In some cases, such a movement of earnings and profits could result in the non-counting of earnings and profits to the extent that the movement of the payor SFC's earnings and profits in respect of the 12/31/2017 measurement date does not cause the recipient SFC to have more earnings and profits as of 12/31/2017 than it had as of 11/2/2017. See Example 6 of proposed regulations section 1.965-4(f)(4). On the other hand, if the anti-abuse rule results in the creation of double-counted earnings and profits, it should not apply.

The IRS and Treasury should provide an exception for payments made in the ordinary course of a trade or business and revise the definition of "specified payment" to reflect a requirement that the payment or accrual in question gives rise to a double-counting of earnings and profits.

Such an exception would be consistent with the legislative history. The Conference Report[12] provides that "the Secretary may identify instances in which it is appropriate to grant relief from potential double-counting of earnings and profits, which may occur due to . . . the timing of intragroup distributions."

Sincerely,

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United States Council for International Business (USCIB)

[12] H.R. Rep. No. 115-466, at 489 (2017) (Conf. Rep.).

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