UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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

RE: IRS REG-105600-18 - Guidance Related to Foreign Tax Credit

Dear Commissioner Rettig:

USCIB[1] is pleased to provide comments on the proposed regulations regarding guidance related to the foreign tax credit, including guidance implementing changes made by the Tax Cuts and Jobs Acts (hereinafter "TCJA").

General Comments

USCIB believes that the draft is too complex and that the administrative burdens associated with compliance outweigh the benefits – more precise computation of foreign tax credits – that result from that complexity. The preamble to the proposed regulations acknowledges that foreign tax credit planning is significantly affected by the changes made by the TCJA. USCIB believes that this must mean, that to the extent foreign tax credits remain available many more taxpayers will be in an excess foreign tax credit position on a permanent basis. Thus, shifting income, expenses or foreign taxes from one "basket" or another may have little impact on the total foreign tax credit ultimately claimed. This does not seem, however, to have influenced the decisions made in drafting the regulations. In virtually every case the decisions reflect the desire for more precision. While each individual decision might make sense in isolation, the combined impact of those individual decisions may lead to system collapse. The government should consider simplifying assumptions wherever possible to minimize these burdens, especially when simplifying the calculation is unlikely to result in much change in the total amount of foreign tax credits claimed.

The preamble also states that the government will reexamine approaches for allocating expenses including interest, research and experimentation, stewardship, and general and administrative expenses. USCIB strongly encourages this reexamination given the systemic changes to the international tax system[2].

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide and works to facilitate international trade and investment.
[2] The government is also reexamining the CFC netting rule; this rule should be eliminated as it essentially redundant in light of all of the TCJA changes.

Given that many taxpayers may permanently be in an excess foreign tax credit position (especially in the GILTI basket), allocating and apportioning additional deductions to this income will effectively deny the benefit of these deductions. If Congress intends that these deductions be available, then it is appropriate to reconsider the expense allocation rules. This may be especially important in the context of research and experimentation given that the Congress clearly wants to create incentives to perform high-value activities in the United States. USCIB has made some initial suggestions below on how to minimize over-allocation of such expenses to foreign source income. USCIB encourages Treasury and the IRS to rethink these rules in line with the desire to promote R&E in the United States and provide taxpayers with a benefit for these high-value activities.

Although USCIB is commenting on the proposed regulations, the comment period is very compressed, especially given the number of other regulations that need to be evaluated and that these regulations interact with each other. Companies will only discover problems as they work with the regulations and apply them to their facts. If the regulations are finalized before problems can be identified, then correcting problems will be more difficult. USCIB is aware that the government would like to meet the 18-month deadline imposed by section 7805(b)(2), nevertheless there should be a mechanism to review these regulations (and other TCJA guidance) to correct for unexpected interactions that create distortive results. One option would be to issue the regulations as temporary regulations with a cross-reference notice of proposed rulemaking. This would both permit the regulations to be retroactive under 7805(b)(2) and allow additional comments to be considered as the regulations move from temporary to final.

The Treasury and the IRS should also make every effort to incorporate clerical or technical corrections into the final regulations. To the extent that there is pressure to finalize these regulations in the short-term and there are obvious glitches in the statutory language that need to be addressed, finalizing regulations that perpetuate those mistakes will complicate compliance for both taxpayers and the government going forward.

Specific Comments

<u>Allocation of expenses to section 951(A) income</u>

U.S. shareholder expenses should not be allocated to amounts includable under section 951(A)

The Treasury and the IRS should reconsider their decision to allocate expenses to amounts includable under section 951A. USCIB believes that the Congress did not intend to impose U.S. tax on GILTI income if a foreign tax of at least 13.125% is imposed on that income.[3] Allocating expenses at the U.S. shareholder level to this income, undercuts that goal. Even if this argument is rejected, the Treasury and IRS have not addressed the need to comply with U.S. income tax treaty obligations (Article 23 of the U.S. Model). Those provisions were designed under prior law and require the United States to allow the source jurisdiction the primary right to tax and relieve double taxation by granting a credit for foreign taxes paid. The requirement to allow a credit is not absolute and is subject to limitations under U.S. law, "so long as the general principle of the Article, that is, the allowance of a credit, is retained."[4] Given the partial shift to an exemption system and the overall design of section 951A, taxpayers might argue, and U.S. treaty partners might agree, that the TCJA shifts away from the general principle of granting a foreign tax credit

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[3] See, H.R. Rep. 115-466 (2017).

[4] U.S. Model Technical Explanation, 2006, page 74. Although, the U.S. Model has been updated, the model technical explanation has not been.

and towards an exemption system. A change to an exemption system does not eliminate the requirement to relieve double taxation, it would simply change the mechanism and could be interpreted to require U.S. expense allocation rules to be applied consistent with the shift to exempting income. In that case, the CFC stock should be treated as entirely an exempt asset. While not all CFCs will be resident in treaty jurisdictions, substantial majorities would be and having a different rule for allocating expenses at the U.S. shareholder/consolidated group level would likely be extremely difficult from an administrative perspective.

R&E Expenses and GILTI Basket

If the Treasury and IRS continue the treatment of CFC stock set forth in the proposed regulations, then other changes or clarifications should be made to minimize the negative impact of the expense allocation rules.

For purposes of Section 904(d)(1)(A), guidance should be issued confirming that allocation and apportionment of U.S.-level "R&E" expenses to the GILTI basket is not required. This is particularly the case where the controlled foreign corporations ("CFC") has not licensed or otherwise acquired intangible property from the taxpayer engaged in R&E (or an affiliate of the taxpayer).[5] In instances where the ownership of the IP resulting from the R&E is in the United States R&E expenses should only be allocated to classes of income that are directly created or earned by the activities of the U.S. IP owner. Put another way, in these contexts, R&E expenses should not be allocated to the class of income constituting deemed dividends from CFCs.

R&E Expenses and Sales Method/Gross Income Method

For purposes of section 904, guidance should be issued to clarify that the sales method of allocating and apportioning U.S.-level "R&E" expense takes into account only sales by controlled or uncontrolled parties of products involving intangible property that was licensed or sold by the taxpayer to such parties. Similarly, for purposes of section 904, guidance should be issued to provide that the gross income method of allocating and apportioning U.S.-level "R&E" expense takes into account only gross income from the exploitation of intangible property, for example (1) royalty income, or (2) income from sales of a product by a taxpayer that owns or licenses intangible property embedded in the product. The changes to the international tax rules, in particular the changes to the foreign tax credit system, have put additional pressure on the appropriate allocation of R&E expense.

R&E Expenses and Gross Income Method

For purposes of section 904, guidance should be issued to clarify that the gross income used for allocating and apportioning U.S.-level "R&E" under the gross income method does not include gross income that is treated as exempt income based on the section 250 deduction. This is consistent with the rule in proposed regulation 1.861–8(d)(2)(ii)(C)(1). An explicit reference to this rule should be provided in Treas. Reg. 1.861-17(d), or an explicit reference to Treas. Reg. 1.861-17(d) should be provided in regulation 1.861–8(d)(2)(ii)(C)(1).

[5] See, Treas, Reg. §1.861-17(c)(3).

Section 1.861-9(c)(5) Allocation and Apportionment of Interest Expense Interaction with Section 163(j)

The proposed regulations under section 163(j) would apply the 163(j) at the CFC level. (USCIB disagrees with this decision and will comment separately on that issue in our comments on section 163(j).) The proposed rule under §1.861-9(c)(5) provides that interest is allocated and apportioned as though it were incurred in the taxable year in which it is deducted. This rule may not work at the CFC level because even though the expense is not currently deductible, it may be necessary to allocate the expense for purposes of determining earnings and profits. Although the look-through rules are no longer the general rule, there are cases when look-through would apply under the proposed regulations (and USCIB recommends expanding the look-through rules below). The disallowance of the deduction does not defer the recognition of the income in the hands of the U.S. shareholder (which argues against applying section 163(j) at the CFC level). If look-through applies to a payment of interest, then the interest expense would need to be allocated during the year the interest expense is incurred (even if not allowed as a deduction) to determine the character of the interest income. In that case would interest expense be allocated inconsistently in a later year when the deduction is allowed or would the earlier allocation for earnings and profits purposes be tracked?

Section 1.861-9(e)(8)(ii) Specified Partnership Loan Transactions

Proposed regulations §1.861-9(e)(8)(ii) provides that to the extent a lender in a specified loan transaction takes into account both interest expense and interest income with respect to the same loan, the interest income is assigned to the same statutory and residual groupings as those groupings from which the interest expense is determined. A similar rule for a loan going in the opposite direction should be adopted. For a loan from a partnership to a borrower, the interest income and expense of the borrower should be sourced and categorized in the same manner. If not, for example, a loan from a partnership to a borrower, where the partners are in the same consolidated group, would result in U.S. source interest income to the partners in the partnership, but would result in disparate treatment to the borrower with it having its interest expense allocated and apportioned to various groupings determined under the rules of section 861 as applied to the consolidated group.

Transition Rules

Proposed §1.904-2(j)(1)(ii) clarifies that pre-2018 foreign taxes carried forward to a taxable year beginning after December 31, 2017 will generally be carried to the same separate category in the post-2017 year. Proposed §1.904-2(j)(1)(iii) provides an exception to this rule that permits taxpayers to allocate unused general category taxes to the foreign branch basket. USCIB supports the default placement of pre-2018 foreign taxes in the same post-2017 category as the pre-2018 separate category from which they are carried. USCIB also supports the exception provided in proposed §1.904-2(j)(1)(iii) and the suggested use of simplifying assumptions to achieve proper matching of income and taxes.

The exception in proposed §1.904-2(j)(1)(iii) only applies to direct foreign tax credits that would have been claimed under section 901 and not to indirect foreign tax credits claimed under section 902. The proposed regulations do not provide a mechanism for determining whether any excess credits are direct or indirect. USCIB recommends that indirect credits be used first.

High Tax Exception

The current 904 regulations move high-taxed passive income from the passive basket to the general basket. Proposed regulations §1.904-4(c)(1) would move the income from the passive basket to either the general basket, the foreign branch basket or the GILTI basket[6]. Possibly moving the taxes to the GILTI basket seems incorrect. Subpart F income is excluded from the GILTI basket; while this income is not subpart F because it is earned by a domestic person applying the direct foreign tax credit, the definition is based on the definition of foreign personal holding company income which is excluded from the GILTI calculation if the income were earned at the CFC level. Thus, this income could not be GILTI income if earned by a CFC and should not be kicked into the GILTI basket. Furthermore, it is not at all clear how one would characterize income as GILTI basket income since GILTI is a mechanical calculation that has no real relationship to the type of income that is earned. The income earned at the U.S. shareholder level could not be tested income and, therefore, should not be able to end up in the GILTI basket.

Foreign Branch Category Income

Under proposed regulations §1.904-4(f)(2) the foreign branch category is determined on an aggregate basis, not for each foreign branch. USCIB supports this decision. The starting point for the category is the separate books and records for the branch. Adjustments are made to the books and records which (among other things) cannot include income arising from activities in the US, which generally does not include income arising from stock or from the disposition of a partnership interest, and which is adjusted with respect to certain disregarded payments.

The operation of the disregarded payment rule is extremely unclear. Although, the payments are not to be "regarded" but somehow disregarded payments would cause income to shift baskets and 482 would apply to determine the amount of the shift. This will introduce novel and complex calculations to the computation of the foreign branch basket.

The proposed regulations solicit comments on whether these rules should be applied to "true" branches. USCIB recommends against applying these rules to "true" branches. Taking these payments into account would be inconsistent with the application of the AOA as applied to determining branch income under income tax treaties, while the treaties do not apply in all cases, the Treasury and IRS should avoid rules that would be inconsistent with income tax treaties and, therefore, require two sets of rules.

Proposed regulations §1.904-4(f)(2)(iv)(A) excludes gain from the disposition of an interest in a partnership or disregarded entity from the foreign branch category. This exclusion does not apply and gain may be included in foreign branch income if the gain is reflected on the books and records of a foreign branch and the interest is held in the ordinary course of the branch's trade or business. (Prop. Reg. §1.904-4(f)(2)(iv)(B).) This exception is ambiguous and should be clarified. The ambiguity arises from the following language:

> An interest is considered to be held in the ordinary course of the foreign branch's active trade or business if the foreign branch engages in the same or a related trade or business as the partnership or other pass-through entity (other than through a less than 10 percent interest) or disregarded entity.

[6] This simplifies the rule of the proposed regulations but covers the separate categories that would be relevant in the majority of cases. Since the issue relates to whether the income (and taxes) ought to be general, foreign branch or GILTI, this simplification does not distort the consideration of the correct rule.

USCIB believes that the parenthetical is misplaced. That is, the foreign branch's ownership interest in the partnership that must satisfy the 10% ownership requirement and the parenthetical should be moved, so the final regulation should read as follows:

> An interest is considered to be held in the ordinary course of the foreign branch's active trade or business if the foreign branch engages (other than through a less than 10 percent interest) in the same or a related trade or business as the partnership or other pass-through entity or disregarded entity.

Proposed regulations §1.904-4(f)(2)(iv)(A) should be amended to provide that income from the disposition of a foreign branch should be included in the foreign branch basket. Under the proposed regulations, operating income from foreign branches is allocated to the foreign branch basket, and income from the disposition of foreign branch assets is generally allocated to the foreign branch basket. The disparate treatment of income attributable to a foreign branch's disposition of its assets compared to the treatment of the disposition of the entire foreign branch produces inappropriate results. For example, a foreign branch that incurs significant R&D expenses in the foreign branch income basket by developing valuable intellectual property should not generate general category income when the foreign branch is sold. Gross income attributable to a foreign branch should be allocated to the foreign branch income basket regardless of whether that income arises with respect to the operation of the foreign branch or from the disposition of the foreign branch.[7]

Proposed Treas. Reg. §1.904-4(f)(2)(vi)(D) requires income arising from intangible property that has been transferred to or from a foreign branch to be attributed back to the foreign branch or foreign branch owner. We believe this rule should be clarified to exclude the transitory ownership by a branch of IP developed by a controlled foreign corporation and repatriated to the US.

Many companies repatriated IP (and associated income) to the US to reduce foreign taxes and address BEPS concerns by aligning IP profits with DEMPE functions. While these companies considered it worthwhile for the income to be taxed at the higher FDII rate rather than the GILTI rate to reduce foreign taxes and address BEPS concerns, they did not expect the income to be assigned to (and taxed in) the foreign branch income basket. This expectation is consistent with the tax treatment afforded by the residence foreign country of the branch, which respects the IP transfer and no longer taxes the profits generated by the IP

The stated purpose of the proposed regulation is to guard against "non-economic reallocations of gross income attributable to the foreign branch category." There is no non-economic reallocation of gross income attributable to the foreign branch category in this situation. The CFC simply repatriated IP to the US, which was a goal of Congress in enacting the FDII deduction and aligns with BEPS concerns. The form of the transaction should not produce a different result.

[7] That approach is consistent with the general exclusion of income attributable to stock of a corporation from the foreign branch income basket both while the stock is held and at disposition. *See* Prop. Treas. Reg. § 1.904-4(f)(2)(iii).

We suggest the following clarification to Proposed Treas. Reg. §1.904-4(f)(2)(vi)(D) to exclude transfers of IP from a CFC to a US corporation where the IP is transitorily owned by a branch:

> (D) *Certain transfers of intangible property.* For purposes of applying this paragraph (f)(2)(vi), the amount of gross income attributable to a foreign branch (and the amount of gross income attributable to its foreign branch owner) that is not passive category income must be adjusted under the principles of paragraph (f)(2)(vi)(B) of this section to reflect all transactions that are disregarded for Federal income tax purposes in which property described in section 367(d)(4) is transferred to or from a foreign branch, whether or not a disregarded payment is made in connection with the transfer. ***Transitory ownership by a foreign branch that neither enhances nor exploits the section 367(d)(4) property will not be considered a transfer for purposes of this paragraph (f)(2)(vi)(D).*** In determining the amount of gross income that is attributable to a foreign branch that must be adjusted by reason of this paragraph (f)(2)(vi)(D), the principles of sections 367(d) and 482 apply. For example, if a foreign branch owner transfers property described in section 367(d)(4), the principles of section 367(d) are applied by treating the foreign branch as a separate corporation to which the property is transferred in exchange for stock of the corporation in a transaction described in section 351.

This rule could also be clarified by an example:

Proposed Treas. Reg. §1.904-4(f)(2)(i) Example (4) Certain transfers of intangible property:

(A) Facts. P, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch within the meaning of paragraph (f)(3)(iii) of this section. FDE's develops and exploits property described in section 367(d)(4), which it transfers to P for exploitation by P. Under Proposed Treas. Reg. §1.904-4(f)(2)(vi)(D), income of FDE must be increased and income of P must be decreased annually to reflect the income earned by A from the transferred intangible property.

(B) Facts. P, a domestic corporation, owns CFC1, a regarded foreign entity. CFC1 develops and exploits property described in section 367(d)(4). In order to repatriate the intangible property to the US, P makes an election to treat CFC1 as a disregarded entity. The next day CFC1, which has become an FDE, distributes the IP to P. Since the ownership of the IP by FDE is transitory and the IP was neither enhanced nor exploited by FDE, no gross income is adjusted under Proposed Treas. Reg. §1.904-4(f)(2)(vi)(D) because of the transfer.

<u>Look-through Rules Section 1.904-</u>

The proposed look-through rules are a fundamental rethinking of the existing rules. Under the prior rules, income earned by a CFC and paid to a US shareholder as dividends, interest, rents or royalties was characterized when earned and that character was preserved as the income moved from one related taxpayer to another, whether the income moved by a sub F inclusion, dividend payment, interest or royalty payment. Under the new rules, if the income is assigned to the passive category under the look-through rules, then the income remains passive. Otherwise, the income is categorized under the principles of 1.904-4 (non-look-through characterization of income). Thus, for example a royalty that offsets GILTI or general basket income at the CFC level might be foreign branch income at the US shareholder level.

USCIB believes that taxpayers should be able to elect to apply the look-through rules to include expenses that reduce amounts included under section 951A. There is no GILTI basket at the CFC level, so the look-through would need to be applied to expenses allocable against tested income and an appropriate proportion of those expenses should be treated as in the GILTI basket at the US shareholder level.

It is also not clear whether income could flip into the GILTI basket at the shareholder level. This seems as though it ought to be impossible since the GILTI calculation is a mechanical calculation and nothing under section 904 should change that outcome. If this is impossible, the regulations should clearly state that. Also, it is not clear how GILTI could be passive basket since regular subpart F trumps GILTI, so if the income is foreign personal holding company income, it should not be GILTI. That result should be clearly stated in the final regulations.

Allocation of Taxes under Section 1.904-6

Taxes are generally allocated based on how the foreign jurisdiction taxes the income. There are special rules for base and timing differences. A base difference is a difference in what constitutes income for US and foreign law purposes, so if the US does not tax an item of income that the foreign law taxes (gifts or insurance proceeds), then that income is a base difference and under prior law any foreign taxes imposed as a result of a base difference would be in the general basket. The justification for this rule was that the general basket was the residual basket and therefore any taxes attributable to a base difference should be allocable to the residual or general basket. The proposed regulations seem to be trying to preserve the rule allocating foreign taxes that are the result of a base difference to the general basket. This might not be the correct answer if the US person earning the income only operates through foreign branches. In that case the residual basket ought to be foreign branch basket. The regulations ought to recognize that, in certain circumstances, the foreign branch basket may be the residual basket.

Foreign taxes deemed paid under section 960

Proposed regulations §1.960-1(d)(2)(ii)(B) creates multiple general limitation subpart F income groups for purposes of section 960(a). The proposed regulations provide that no foreign taxes attributable to a subpart F income group are deemed paid by the U.S. shareholder unless there is positive net subpart F income in that subpart F income group. This can result in stranded foreign taxes due to timing differences even when there is a general limitation subpart F inclusion, thereby resulting in double taxation of general limitation subpart F income over time.

Guidance should be issued to provide that all items of general limitation subpart F income should be considered one item for purpose of determining whether foreign income taxes are “properly attributable” to subpart F income under section 960(a).

Section 1.960-1(b)(4) provides that additional payments of foreign taxes relate back to earlier years. This will raise 905(c) issues requiring redeterminations of foreign tax credits. Under the pooling rules of prior law, adjustments generally were added to the pool of foreign taxes and redeterminations were not required. In the absence of multi-year taxes pools, the administrative burden of requiring redeterminations of foreign taxes may be significant. The Treasury and the IRS should consider mechanisms that would permit forward looking adjustments, at least in cases for which the adjustments are not significant, and possibly on an elective basis.

Proposed regulation §1.960-1(d)(3)(ii)(B)(2) provides that a withholding tax on a disregarded payment from a disregarded entity to its CFC owner is treated as a timing difference and can never be related to PTEP even if all of the CFC's earnings are PTEP. This may effectively deny FTCs for such payments because there would be no earnings and profits to which the taxes could attach and in the absence of pooling, if there are no current year earnings and profits the taxes would be permanently trapped. This seems to function like a penalty on a disregarded entity. The adoption of the check-the-box regulations and their long-term acceptance should mitigate against such an onerous penalty. Further, this penalty seems to apply to all PTEP, not just post-2017 PTEP. One of the goals of the new hybrid rules is to discourage the use of hybrid instruments and entities. However, given the longstanding nature of these arrangements, unwinding may take some time. The Treasury and the IRS should not apply this rule before taxable years beginning after December 31, 2020.

Overlap with PFIC Qualified Electing Fund Rules

Section 1293(f) provides that for purposes of section 960, a 10-percent corporate shareholder of a qualified electing fund treated as having an inclusion under section 951(a). This is clearly intended to permit such a shareholder to claim a deemed paid credit under section 960. To eliminate any question about this result the regulations under section 960 should reference section 1293(f)

Notice 2019-1, Section 3.02 Ordering Rule for Distributions of Section 965 Previously Taxed Earnings & Profits (PTEP)

The Notice generally provides that the distributions come out of the various PTEP groupings on a last-in / first-out basis, consistent with rules for distributions more generally. An exception to this rule is provided for section 965 PTEP – distributions are treated first as coming out of 965 PTEP, and then on a LIFO basis from the other groupings. It is not clear why the Notice provided this exception, but USCIB believes that any regulations issued under section 959 should provide that taxpayers may elect to treat distributions from previously taxed earnings and profits (PTEP) as sourced from the various groups of PTEP based on a last in, first out (LIFO) approach, consistent the longstanding approach of section 959(c) and section 316. Because the Notice departs from the longstanding rule and some taxpayers may now rely on it and the policy reason behind this departure is unclear, taxpayers should have the option of either following the Notice or following the longstanding rule. A LIFO approach does not impose additional administrative burdens on taxpayers – once a taxpayer has determined its section 965 PTEP, the additional burden of maintaining that information is trivial.

Notice 2019-1, Section 5(4) Other guidance that should be issued under sections 959 and 961

When the E&P of a first-tier CFC (or a lower-tier CFC) is included in the taxable income of a U.S. shareholder as subpart F income including under section 965, section 961(a) provides for a corresponding increase in the tax basis of the stock of the relevant first-tier CFC in the hands of the U.S. shareholder. Similarly, when the E&P of a lower-tier CFC is included in the taxable income of a U.S. shareholder as subpart F income, section 961(c) provides for a corresponding increase in the tax basis of the stock of the relevant lower-tier CFC (as well as to the stock of any intermediate CFCs other than the first-tier CFC). However, the tax basis generated as a result of the application of section 961(c) could be interpreted as applying "only for purposes of determining the amount included under section 951 in the gross income of such United States shareholder."

In the event of an internal restructuring that results in a lower-tier CFC becoming a first-tier CFC, it is not clear whether tax basis in the stock of the CFC that was previously generated under section 961(c) is treated as any other tax basis under the Code (e.g., tax basis under section 1011 or section 961(a)).

To prevent double taxation, regulatory guidance should be issued that clarifies that tax basis in the stock of a lower-tier CFC that was generated under section 961(c) (including as a result of the deemed repatriation under section 965) should be treated as tax basis for all purposes under the Code if the lower-tier CFC becomes a first-tier CFC.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)