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October 9, 2018

U.S. Department of the Treasury
1500 Pennsylvania Ave. NW
Washington, DC 20220

Internal Revenue Service
1111 Constitution Ave. NW
Washington, DC 20224

Via Online Submission

RE: Proposed Regulations under Section 965

Dear Sir or Madam:

On December 22, 2017, Public Law No. 115-97, colloquially known as the Tax Cuts & Jobs Act (the TCJA), was enacted into law. The TCJA represents the most sweeping change to the U.S. Internal Revenue Code (the Code) since the Tax Reform Act of 1986. The numerous additions and modifications to the Code require equally sweeping additions and modifications to the U.S. Treasury Regulations promulgated thereunder.

As part of these newly required regulations, on August 9, 2018, the U.S. Department of the Treasury (Treasury) and Internal Revenue Service (the Service) issued proposed regulations under section 965 (the Proposed Regulations). The Proposed Regulations provide additional detail regarding the computation and payment of liabilities arising under section 965 (the Transition Tax liability), which was amended by the TCJA as part of the movement toward a participation exemption system of international taxation under the Code. Treasury and the Service solicited comments on the Proposed Regulations from interested parties no later than October 9, 2018. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the government's request for comments.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 57 chapters in North and South America, Europe, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax

policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 individual members represent over 2,800 of the leading companies around the world.

Summary of TEI's Recommendations

TEI commends Treasury and the Service for their efforts in issuing the Proposed Regulations in such a short timeframe. The Proposed Regulations answer many key questions faced by taxpayers when determining their Transition Tax liability. Set forth immediately below is a summary of TEI's recommendations with respect to the Proposed Regulations, followed by detailed explanations of why the government should adopt our recommendations. The numbering of the summary follows the numbering of the detailed explanation.

1. Final regulations should provide that stock of a Specified Foreign Corporation (SFC) owned by another SFC is excluded from the definition of Cash Position, regardless of whether the stock so held is publicly-traded.

2. To prevent double counting of earnings and profits (E&P) and the inappropriate denial of a foreign tax credit in certain circumstances, Prop. Treas. Reg. § 1.965-1(f)(7)(B) should be rephrased as follows:

   > The term accumulated post-1986 deferred foreign income means, with respect to an SFC, the post-86 E&P of the SFC except to the extent such E&P . . . would in the case of a controlled foreign corporation, be included in income of the United States shareholder under section 956, or would, if distributed, be excluded from the gross income of a United States shareholder under section 959.

3. The rule of Prop. Treas. Reg. § 1.965-1(f)(7)(i)(C) regarding the exclusion of certain accumulated post-1986 deferred foreign income should be extended to apply to dividends paid from SFCs to a related SFC and an unrelated foreign third party.

4. Treasury and the Service should provide in final regulations that for purposes of section 965, the taxes associated with a hovering deficit are to be included in the post-1986 pool of the SFC as the hovering deficit is absorbed under section 965.

5. With respect to the basis election of Prop. Treas. Reg. § 1.965-2(f):

   a. Taxpayers should be given 180 days after the publication of final section 965 regulations to make the basis election, rather than the 90 days provided in Notice 2018-78;

  b. The final regulations should allow all shareholders who own SFC stock to determine gain resulting from the basis-shifting election on an aggregate, rather than share-by-share, basis; and

  c. To the extent gain is recognized under Prop. Treas. Reg. § 1.965-2(h)(3) because of the basis-shifting election, it should be taxed at the transition tax rate of 15.5%.

6. Final section 1.965-4 regulations should not prevent a taxpayer from changing to a permissible method of accounting from an impermissible method for purposes of calculating section 965 elements.

7. Final regulations should reflect that, for SFC to SFC dividends between measurement dates, the between measurement dates rule of Prop. Treas. Reg. § 1.965-4(f), and not the principal purpose rule of Prop. Treas. Reg. § 1.965-4(b) (as modified by the E&P reduction transactions rule), is the exclusively applicable anti-abuse rule. Treasury and the Service should also include language in final regulations that clarifies that the between measurement dates rule applies for purposes of determining the post-1986 foreign taxes. Lastly, final regulations should provide that all SFC to SFC between measurement date dividends are in the ordinary course of business for the limited application of the E&P reduction transactions rule.

8. To prevent certain mismatches between attributes of CFCs, TEI recommends that the final regulations adopt one of the alternatives detailed in section 8. below.

9. Prop. Treas. Reg. § 1.965-5(c)(1)(ii) should be excluded from the final regulations as it effectively eliminates a tax asset (a foreign tax credit) granted to taxpayers by Congress.

10. Additional guidance and examples are needed when determining the proper "applicable percentage," as defined in Prop. Treas. Reg. § 1.965-5(d)(1), in certain circumstances (such as when CFCs have different year-ends and thus different applicable percentages, either of which may apply to withholding taxes imposed on a dividend between the two CFCs. *See* section 10. below).

11. Final regulations should provide that foreign currency will be translated into U.S. dollars via the average exchange rate for a taxpayer's 2017 fiscal year, not the December 31, 2017, spot rate.

12. Taxpayers should be permitted a refund or given the ability to treat as a 2018 estimated tax payment any amounts paid in excess of the taxpayer's liabilities for 2017 regular and section 965 installment tax.

13. The Service should provide penalty protection to taxpayers who make good faith efforts to compute and pay over their Transition Tax liability.

Detailed Comments on the Proposed Regulations

1. Publicly-Traded Stock Held by a Foreign Subsidiary and the Definition of Aggregate Foreign Cash Position

Section 965 taxes unrepatriated earnings of a U.S. shareholder at a rate of 15.5 percent, up to the amount of the taxpayer's Aggregate Foreign Cash Position.[1] Any remaining earnings are taxed at a rate of 8 percent. The Cash Position of an SFC is determined under section 965(c)(3) and generally includes cash, net accounts receivable, and, among other items, "the fair market value of … [p]ersonal property which is of a type that is actively traded and for which there is an established financial market."[2] Despite numerous taxpayer comments requesting clarification of the definition of Cash Position, particularly as it relates to actively-traded personal property, the government explicitly declined to provide additional guidance in the Proposed Regulations.[3] Instead, Treasury and the Service welcomed additional comments on the definition of Cash Position.

Under Section 965(c)(3)(B)(iii)(I), an SFC's Cash Position includes the fair market value of "[p]ersonal property which is of a type that is actively traded and for which there is an established financial market." Section 965 does not define "actively traded" nor does it refer to definitions elsewhere in the Code. However, Congress's intended meaning of "actively traded" can easily be gleaned from the Conference Report:

> The cash position of an entity consists of all cash, net accounts receivables, and the fair market value of similarly liquid assets, specifically including personal property that is actively traded on an established financial market, government securities, certificates of deposit, foreign currency, and short-term obligations.[4]

Congress was concerned about asset liquidity because, if liquid, an asset could easily be converted to cash and repatriated to the United States soon after a taxpayer's section 965 liability was determined. Thus, based on the policy underlying section 965's two-tier tax rate structure, liquid assets should be subject to a higher tax rate. The House Ways and Means Committee's report, dated November 13, 2017, further expands on this policy:

> The Committee believes that many domestic companies were reluctant to reinvest foreign earnings in the United States, when doing so would subject those earnings to high rates of corporate income tax . . . . The Committee believes that the tax on accumulated foreign earnings should apply without requiring an actual

[1] As defined in Section 965(c)(3)(A) and Prop. Treas. Reg. § 1.965-1(f)(8).
[2] *See also* Prop. Treas. Reg. § 1.965-1(f)(16).
[3] *See* Preamble to the Proposed Section 965 Regulations, at 101-103.
[4] Conference Report at 609-610 (emphasis added).

> distribution of earnings, and further believes that the tax rate should take into account the liquidity of the accumulated earnings. Accordingly [Section 965] establishes a bifurcated rate, i.e., [15.5 percent] for earnings held in liquid form and [8 percent] for accumulated foreign earnings that have been reinvested in the foreign subsidiary's business.[5]

Despite clear Congressional intent, section 965 leaves open to interpretation what it means for personal property to be actively traded, potentially subjecting illiquid investments in subsidiaries' businesses to the higher tax rate of 15.5 percent. For example, suppose United States Parent (USP) owns a foreign holding company (ForHoldCo) organized in Country X. ForHoldCo in turn owns the foreign operating companies of USP. Since the 1960s, ForHoldCo has owned approximately 40% of the stock of a foreign operating company (ForOpCo) organized in Country Y. The remaining stock of ForOpCo is held by the general public.

The ForOpCo stock is listed on an established exchange in Country Y. ForOpCo routinely repurchases shares from the general public. To ensure that ForHoldCo's ownership percentage remains constant, ForOpCo will also purchase a pro rata number of shares from ForHoldCo. Aside from these repurchases, ForHoldCo does not sell its shares in ForOpCo on the Country Y exchange. ForOpCo represents a critical piece of USP's foreign operations, representing USP's go-to-market approach in Country Y. USP does not otherwise operate a business or own a company in Country Y. ForHoldCo's equity interest in ForOpCo is not equivalent to a public shareholder's investment, but instead represents a long-term, strategic investment core to the success of USP's supply chain and go-to-market strategy in Country Y.[6]

Under an expansive interpretation of "actively traded," the fair market value of ForOpCo's stock could be included in ForHoldCo's Cash Position, and thus increase the amount of USP's deferred foreign earnings subject to the higher tax rate. The stock is not a liquid asset, but instead represents USP's and ForHoldCo's long-term investment in ForOpCo's business. The potential inclusion of the stock in Cash Position would be an unintended result of section 965's actively traded requirement. Section 965 was not intended to tax illiquid assets, such as ForOpCo's stock, at the higher tax rate of 15.5 percent. To prevent such unintended results in this

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[5] *See* H. Rept. 115-409 at 375 (Nov. 13, 2017) (emphasis added).

[6] To the extent the liquidity of an asset represents the ease to which it can be converted into cash at an equivalent market value, it is unclear that a 40 percent stake in a publicly traded company can be viewed as liquid in any case regardless of the investor's strategic stake in the venture. For example, if the 40 percent owner in the example were to attempt to sell its stock in a short period of time the stock price would almost certainly rapidly decline before the entire stock block was sold, rendering the stock an improper proxy for cash. Thus, even in the unlikely event that a 40 percent stake in a publicly traded company does not represent a strategic investment of a multinational group, it still should not be viewed as cash and therefore should not be subject to the 15.5 percent Transition Tax rate applicable to the Aggregate Foreign Cash Position.

and similar situations, we suggest that Treasury provide additional guidance interpreting Cash Position and "actively traded" consistent with Congressional intent.

In the preamble to the Proposed Regulations, Treasury and the Service expressed concerns that it would not be administrable to create regulatory exclusions from the definition of Cash Position because a facts-and-circumstances test would be required to analyze the liquidity of every asset. However, a narrowly-tailored regulation may require no such analysis, but instead would provide an easily-administrable test to apply to all situations where stock held by a foreign subsidiary is publicly traded.

The Proposed Regulations should provide that the stock of an SFC, owned by another SFC, is excluded from the Cash Position definition, regardless of whether such stock is publicly-traded. This simple, straightforward approach is easily administrable and should provide results consistent with Congressional intent. Such a limit on the definition of Cash Position would provide the correct outcome from a policy perspective, as stock of an SFC is by its nature an illiquid asset.

Treasury has the legal authority to provide guidance interpreting the definition of Cash Position consistent with Congressional intent. Section 965(o) expressly authorizes the Secretary to prescribe regulations and guidance as may be "necessary or appropriate to carry out the provisions of this section." Additionally, Section 7805(a) allows the Secretary to "prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." Clearly, the policy behind the two-tiered rate structure of Section 965 was to tax cash and non-cash assets at different rates because SFCs could easily repatriate liquid assets to the United States. By clarifying that the stock of an SFC is not included in another SFC's Cash Position, the regulations would ensure results consistent with Congressional intent and general policy behind Section 965.

2. Double Counting of Section 956 E&P and Denial of a Foreign Tax Credit

The application of two rules can produce a result that is inconsistent with fundamental principles of U.S. taxation. The first rule is the definition of accumulated post-86 deferred foreign income. This means, with respect to an SFC, the post-86 earnings and profits (E&P) of the SFC except to the extent that such E&P, if distributed would, in the case of a CFC, be excluded from the gross income of a U.S. shareholder under section 959.[7] Second is the rule in section 959(a)(2), which provides that E&P of a CFC attributable to amounts which are included in the gross income of a U.S. shareholder under section 951(a) (which includes 956 amounts) shall not, when such amounts are distributed to such shareholder, be again included in the gross income of the shareholder.

Consider how these two rules result in double taxation in the following example in which a November 30 year-end CFC has a 956 loan to a U.S. shareholder during the fiscal year that

[7] Prop. Treas. Reg. § 1.965-(1)(f)(7)(B).

includes November 2, 2017: SFC1 makes a 100u loan to its U.S. shareholder that is outstanding for all four quarter ends in SFC1's year ending November 30, 2017 (fiscal 2017). As of November 30, 2017, SFC1 has 100u of post-86 E&P, all subject to section 956 (section 956 E&P), and 30u of foreign taxes in the post-86 tax pool. SFC1's E&P as of November 2, 2017, is also 100u. SFC1's section 965 inclusion year is its year ending November 30, 2018.

The section 956 E&P, if distributed in fiscal 2017, would not be excluded from gross income under section 959 because section 956(b)(1)(B) provides that the applicable earnings of a CFC considered for section 956 inclusion are reduced by distributions made during the taxable year. Therefore, in the example above, a distribution of 100u would negate the application of section 956 and would be treated as a dividend rather than a distribution of previously taxed income (PTI) (contrast the application of subpart F where the distribution during the year would be treated as a distribution of PTI). Since the E&P, if distributed, would not be excluded from the gross income of a U.S. shareholder under section 959, the 100u E&P would still be included when calculating the post-86 foreign income of SFC1 as of November 2, 2017, even though the same 100u would be fully included by U.S. shareholder with respect to SFC1's fiscal 2017 year. The amount of SFC1's E&P as of December 31, 2017, is zero, as the 100u section 956 inclusion becomes PTI as of November 30, 2017 and is therefore excluded from the post-86 E&P of SFC1 as of December 31, 2017, pursuant to the rule above. Because the "greater of" amount is the November 2, 2017 E&P amount, the E&P is double counted and therefore double taxed upon the application of section 965.

Double taxation of income is inconsistent with fundamental U.S. federal income tax principles. For example, the primary purpose of U.S. income tax treaties – and, indeed, almost all income tax treaties – is to avoid double taxation of income by source and residence countries. The foreign tax credit evidences a similar policy, permitting taxpayers to credit their foreign taxes paid against their U.S. tax liability, subject to certain limitations. Thus, double counting of income as set forth above would be at odds with the general approach of the U.S. international tax system to tax income only once.

In addition to the double taxation in the example above, the interplay of the foreign tax credit rules and the Proposed Regulations result in the denial of a credit for the foreign taxes that were paid with respect to the earnings being again taxed pursuant to section 965. In the example, as of December 1, 2018, the post-86 E&P is zero and the post-86 undistributed E&P has also been reduced to zero. Assume that the SFC1 has no earnings or taxes for fiscal year 2018. Applying the rules as currently drafted, its 965 inclusion amount would be 100u, and the post-86 taxes in the pool would be zero. Thus, not only would the U.S. shareholder have a second inclusion of the earnings, but it would be denied a foreign tax credit for taxes paid with respect to that earnings inclusion. This result would also be inconsistent with the fundamental approach of U.S. tax policy to tax income only once.

In order to prevent the anomalous results presented above, TEI recommends that Treasury and the Service rephrase Prop. Treas. Reg. § 1.965-1(f)(7)(B) as follows:

> The term accumulated post-1986 deferred foreign income means, with respect to a specified foreign corporation, the post-86 earnings and profits of the specified foreign corporation except to the extent such earnings and profits . . . would in the case of a controlled foreign corporation, be included in income of the United States shareholder under section 956, or would, if distributed, be excluded from the gross income of a United States shareholder under section 959.

3. SFC dividends to both related SFCs and unrelated non-U.S. parties

The rule of Prop. Treas. Reg. § 1.965-1(f)(7)(i)(C) should be extended to apply to dividends from SFCs to a related SFC and an unrelated foreign third party. Proposed Treas. Reg. § 1.965-1(f)(7)(i)(C) provides that the term accumulated post-1986 deferred foreign income means, with respect to an SFC, the post-1986 E&P of the SFC except to the extent such E&P, if distributed, would, in the case of a CFC that has shareholders that are not U.S. shareholders on an E&P measurement date, be excluded from the gross income of such shareholders under section 959 if such shareholders were U.S. shareholders.

Proposed Treas. Reg. § 1.965-1(g) Example 3 demonstrates the application of the above rule:

> Example 3. Determination of accumulated post-1986 deferred foreign income. (i) Facts. USP, a domestic corporation, and FP, a foreign corporation unrelated to USP, have owned 70% and 30% respectively, by vote and value, of the only class of stock of FS, a foreign corporation, from January 1, 2016, until December 31, 2017. USP and FS both have a calendar year taxable year. FS had no income until its taxable year ending December 31, 2016, in which it had 100u of income, all of which constituted subpart F income, and USP included 70u in income with respect to FS under section 951(a)(1) for such year. FS earned no income in 2017. Therefore, FS's post-1986 earnings and profits are 100u as of both E&P measurement dates.
>
> (ii) Analysis. Because USP included 70u in income with respect to FS under section 951(a)(1), 70u of such post-1986 earnings and profits would, if distributed, be excluded from the gross income of USP under section 959. Thus, FS's accumulated post-1986 deferred foreign income would be reduced by 70u pursuant to section 965(d)(2)(B) and paragraph (f)(7)(i)(B) of this section. Furthermore, under paragraph (f)(7)(i)(C) of this section, the accumulated post-1986 deferred foreign income of FS is reduced by amounts that would be excluded from the gross income of FP if FP were a United States shareholder, consistent with the principles of Revenue Ruling 82-16. Accordingly, FS's accumulated post-1986 deferred foreign income is reduced by the remaining 30u of the 100u of post-1986 earnings and profits to which USP's 70u of section 951(a)(1) income inclusions were attributable. As a result, FS's accumulated post-1986 deferred foreign income is 0u (100u minus 70u minus 30u).

Assume in the example above, USP owned 100% of FS1, a foreign corporation, and FS1 and FP, a foreign corporation unrelated to FS1 or USP, own 70% and 30% of FS2 respectively. Assume further that FS2 pays a pro rata dividend to FS1 and FP. The 70% portion increases the E&P of the payee and is regarded under section 965 and the Proposed Regulations. The E&P of FS2 is reduced to the extent of that 70% portion.[8] The 30% piece, however, did not increase the earnings of a related SFC and so is still considered to be earnings of FS2 for section 965 purposes. Because the 70% portion of the dividend is respected, the post-86 E&P of FS2 are determined without diminution of the 30% portion. Consequently, the 30% of earnings arguably remains part of the accumulated post-1986 deferred foreign income of FS2, of which 70% should be included by the U.S. shareholder under section 965.

This would seem to be an obviously inappropriate result, and TEI encourages the IRS and Treasury to extend the general rule of Prop. Treas. Reg. § 1.965-1(f)(7)(i)(C) to address this situation.

4. Foreign taxes related to hovering deficits

TEI requests the government provide guidance with respect to two significant issues regarding hovering deficits. The first is whether hovering deficits reduce post-1986 undistributed E&P (the "denominator") for purposes of applying the deemed paid foreign tax credit. The second is whether taxes associated with a hovering deficit are added to the post-1986 foreign income taxes of the relevant entity as the hovering deficit is absorbed.

The general rule of Prop. Treas. Reg. § 1.965-1(f)(29)(iii) provides that any deficit related to post-1986 E&P, including a hovering deficit of an SFC, is taken into account for purposes of determining the SFC's post-1986 E&P, including any deficit of the SFC. Because Treas. Reg. § 1.367(b)-7(d)(2)(ii) provides that a hovering deficit shall only offset E&P accumulated by the foreign surviving corporation (after the relevant 381 transaction), the general rule above effectively turns off the rule in Treas. Reg. § 1.367(b)-7(d)(2)(ii). It is not clear why the Proposed Regulations sometimes turn the rule on and sometimes turn the rule off.

The Preamble provides that, consistent with the Conference Report[9] and section 3.03(b) of Notice 2018-13, hovering deficits are taken into account for purposes of determining post-1986 E&P. That hovering deficits are taken into account for purposes of determining post-1986 E&P, however, does not mean that hovering deficits are taken into account for any other purpose. For example, hovering deficits are not taken into account for purposes of determining the post-1986 earnings (denominator) in computing the deemed paid foreign tax credit.[10] The language clarifies that hovering deficits will not apply for purposes of determining the foreign tax credit

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8 *See* Prop. Treas. Reg. § 1.965-1(f)(29)(i)(B).
9 H.R. Rep. No. 115-466, at 619 (2017)
10 *See* Preamble to the Proposed Regulations, at 31.

denominator, but does not address affirmatively or negatively whether hovering taxes are to be added to the tax pool as the hovering deficit is absorbed.

Elsewhere the Preamble states comments recommended that hovering deficit taxes should be added to the post-1986 tax pool in the inclusion year as those deficits are treated as reducing post-1986 E&P of a DFIC. Treasury and the Service determined the existing rules in Treas. Reg. § 1.367(b)-7 adequately address this issue and continue to apply. However, it is not clear whether the Preamble is referring to Treas. Reg. § 1.367(b)-7(d)(2)(iii), which provides that such taxes are added to the pool as the hovering deficit is absorbed, or Treas. Reg. § 1.367(b)-7(d)(2)(ii), which, unless overridden, provides that the hovering deficit is not absorbed unless and until the post section 381 transaction earnings accumulate.

Since the proposed regulations effectively override Treas. Reg. § 1.367(b)-7(d)(2)(ii) in whole or in part, the guidance provided in the Preamble is not sufficiently clear. TEI recommends that Treasury and the Service provide in final regulations that for purposes of section 965, the taxes associated with a hovering deficit be added to the post-1986 pool of the SFC as the hovering deficit is absorbed under section 965.

The rule of Treas. Reg. § 1.367(b)-7(d)(2)(ii) is clearly turned off for purposes of determining the post-1986 E&P. Consistent application of the Treas. Reg. § 1.367(b)-7(d) rules would warrant rendering this same application of Treas. Reg. § 1.367(b)-7(d)(2)(ii) for purposes of applying the rule in Treas. Reg. § 1.367(b)-7(d)(2)(iii). To turn the rule off for purposes of determining the post-1986 E&P and turn it back on for purposes of assessing whether a hovering deficit had effectively been absorbed seems arbitrary, inconsistent, and contrary to Congressional intent.

The policy behind requiring that E&P accumulate before absorbing a hovering deficit is rooted in preventing loss trafficking. This policy is not implicated in taxpayer treatment of hovering taxes pursuant to section 965. Further, the concept of post 381 transaction earnings becomes irrelevant in light of the enactment of section 965 and further provisions.

The taxes associated with hovering deficits are already effectively haircut two different times as a result of section 965 and the Proposed Regulations. They are haircut pursuant to section 965(c), and further haircut (effectively) as a result of the aforementioned rule providing that the utilization of the hovering deficit is not taken into account for purposes of the denominator.

Allowing the hovering taxes to apply to the tax pool is also consistent with Congressional intent. The Conference Report (at 619) and the Conference Agreement (at 490) both provide that foreign income taxes would not generally be deemed paid by the U.S. shareholder recognizing an incremental income inclusion (presumably because of the rule requiring post 381 transaction accumulation).

> However, the conferees expect the Secretary may issue guidance to provide that, solely for purposes of calculating the amount of foreign income taxes deemed paid by the U.S. shareholder with respect to an inclusion under section 965, a hovering deficit may be absorbed by current year earnings and profits and the foreign income taxes related to the hovering deficit may be added to the specified foreign corporation's post-1986 foreign income taxes in that separate category on a pro rata basis in the year of inclusion.[11]

While the conferees do say that the Secretary may provide such guidance, read in the overall context it seems clear that the conferees expect this end result, whether done through guidance, because of the existing application of Treas. Reg. §1.367(b)-7(d)(iii), or otherwise.

In conclusion, TEI suggests that providing that hovering taxes be added to the post-1986 tax pool of the SFC is both the better tax policy and the policy that Congress intended to accompany the enactment of section 965.

5. Comments regarding the basis adjustment election of Prop. Treas. Reg. § 1.965-2(f)(2)

TEI has two substantive concerns regarding the basis-shifting election allowed under Proposed Regulations section 1.965-2(f). Proposed Treas. Reg. § 1.965-2(f) allows an electing U.S. shareholder to increase its basis in CFC stock to the extent that such CFC's E&P was reduced by other CFC's E&P deficits pursuant to section 965(b) (the "basis-shifting election"). The basis increase is paired with a corresponding reduction in the U.S. shareholder's basis in the stock of the CFCs with an E&P deficit. TEI appreciates the change made to the election procedure in Notice 2018-78. TEI believes that the election procedure as contemplated in the Proposed Regulations had procedural deficiencies and the Notice provides clear filing guidance. The Notice provides that if the basis election was made on or before the date of the final regulations are published, the revocation should be made no later than 90 days after the publication of the final regulations in the Federal Register. TEI proposes that 180 days to file the amended return (rather than the 90 days provided in the Notice), would better provide sufficient time for taxpayers to make the necessary calculations and ancillary changes, especially for complex multi-national corporations most likely to make the election.

The election under Prop. Treas. Reg. § 1.965-2(f), while a welcome attempt at relief from issues arising from section 965(b), creates the potential for recognition of capital gains where there are no economic gains due to the share-by-share calculation required by the Proposed Regulations. In addition, we note that there are tax rate disparities that arise as a result of section 965(b) and a taxpayer's decision to make or not make the election. These issues are discussed in further detail below.

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11 Conference Report, at 490.

a. Capital gain recognition and share-by-share approach of Prop. Treas. Reg. § 1.965-2(h)(4)

The Proposed Regulations, in providing for an elective solution to the basis and PTI issues created by the E&P shifting of section 965(b), require taxpayers to recognize gain to the extent the "specified basis adjustment(s)" exceeds a U.S. shareholder's basis in such stock. We recommend that final regulations allow U.S. shareholders of CFCs to determine such gain on an aggregate, rather than share-by-share basis. The share-by-share rule in the Proposed Regulations may in many cases trigger gains on a share-by-share calculation where there is ample basis, as calculated in the aggregate, to support the deficit E&P that has been allocated to any deferred foreign income corporations. The share-by-share rule in the Proposed Regulations makes it difficult for taxpayers to avail themselves of the intended relief from the corollary impacts of section 965(b) and lacks a compelling policy justification to cause gain recognition where none exists economically, in particular for CFCs with highly concentrated ownership. The share-by-share rule also imposes undue administrative burdens, particularly with respect to large U.S. multinationals, and significantly increases audit complexity.

As noted, the basis-shifting election of Prop. Treas. Reg. § 1.965-2(f) allows an electing U.S. shareholder to increase its basis in CFC stock to the extent that such CFC's E&P was reduced by other CFC's E&P deficits pursuant to section 965(b). The basis increase is paired with a corresponding reduction in the U.S. shareholder's basis in the stock of the CFCs with an E&P deficit. Prop. Treas. Reg. § 1.965-2(h)(3) treats basis reductions in excess of a deficit CFC's pre-adjustment stock basis as gains from the sale or exchange of property. Prop. Treas. Reg. § 1.965-2(h)(4) specifies that basis is reduced on a share-by-share basis. As a result, taxpayers with non-uniform basis in stock of a CFC may recognize gain without exhausting the basis in all shares held in the relevant CFC.

As stated in the preamble to the Proposed Regulations (quoting from the TCJA's Conference Report), the purpose of the election is to create an "appropriate" increase to the basis of deferred foreign income corporations (DFIC) where there is a "corollary reduction to the basis of E&P deficit foreign corporations." This adjustment is "appropriate" because it matches basis in a CFC with the location of PTI, after the application of section 965(b). TEI agrees with the premise and policy of these matching rules and appreciates that the Proposed Regulations provide an election to cure the basis/PTI disparity created by section 965(b). However, the current version of the Proposed Regulations, by preventing taxpayers from using the total aggregate basis available in an E&P deficit foreign corporation to offset the basis reduction resulting from the election, results in non-economic gain recognition where a deficit CFC has tranches of stock with disparate bases.

The distribution rules allow basis recovery as a proxy to measure economic gains above cost. If taxpayers are not allowed to offset their aggregate basis, the elective solution to the basis disparity problem gives rise to artificial gain for taxpayers unfortunate enough to have created (or tracked) basis tranches, which will often have resulted from ordinary-course section 351 cash funding transactions over the historic life of a wholly-owned deficit CFC.

In addition to the non-economic gain created by share-by-share calculations in Prop. Treas. Reg. § 1.965-2(h)(4), tracking CFC stock basis over years of funding transactions imposes substantial burdens on taxpayers and the Service. For many taxpayers who did not sell stock or pay distributions, a parent's basis in its CFC stock was not a priority attribute calculation. Taxpayers who have never contemplated redemptions in excess of basis may not track share-by-share basis. Because foreign law often requires shares to be issued in funding transactions, regardless of whether there is a change in ownership percentage among the funder(s) of the transaction, basis "tranches" will inevitably arise in CFCs.

Moreover, reconstructing the U.S. tax consequences of past funding transactions is cumbersome. Calculation of share-by-share gain simply to make the elective relief offered by Prop. Treas. Reg. § 1.965-2(f)(2) would require data collection potentially of wire transactions and share issuance records going back years or even decades, where aggregate basis data may not be readily available. The Proposed Regulations thus offer taxpayers a difficult choice: either make the election and bear significant administrative costs to reconstruct basis tranches across many CFCs, or refrain from making the election, and face the burden of tracking PTI/basis mismatches indefinitely. Imposing a substantial burden to ameliorate a quirk of the legislative text of section 965(b) appears to nullify the offered benefit. Revenue agents examining returns on audit will face the same difficulties encountered by taxpayers in making such basis calculations.

These administrative burdens are not justified by policy considerations. Share-by-share basis recovery makes sense in the context of an actual sale or distribution because taxpayers are permitted to minimize gains by identifying the specific shares exchanged in a sale transaction, so permitting aggregate basis recovery in section 301 distributions could be an unjustifiable and taxpayer-favorable asymmetry. This policy justification bears much less weight for substantial interests in CFC ownership because those interests are highly illiquid and are unlikely to be sold to third parties. For these reasons, the final regulations should allow all shareholders who own SFC stock to determine gain resulting from the basis-shifting election on an aggregate basis.

b. Gain recognition rate disparity of the basis-shifting election

Finally, the basis-shifting election raises an equitable concern in that if section 965(b) had not been enacted, earnings of a DFIC equal to offsetting deficits of an E&P deficit foreign corporation would have been taxed at the transition tax rate of 15.5%. Instead, taxpayers electing relief under the basis-shifting election could subject any E&P deficit mismatch to a 2017 corporate tax rate of 35%. Even taxpayers who do not choose to make the election and instead maintain DFICs with a mismatch between basis and PTI would be subject to the new 21% corporate tax rate on future distributions.

The disparity in rates as a result of the basis-shifting election in various situations relative to the 15.5% transition rate seems difficult to justify. TEI recommends that to the extent gain is recognized under Prop. Treas. Reg. § 1.965-2(h)(3) that it be taxed at the transition tax rate of 15.5%.

6. Change in accounting method

The anti-abuse rules previewed in Notice 2018-26 and adopted in Prop. Treas. Reg. § 1.965-4(c) disregard a change in accounting method that would "change the amount of any section 965 element" even if the change is from an impermissible to a permissible accounting method. The preamble noted that taxpayer comments critical of this rule were rejected because section 965 was intended to take a "snapshot" as of November 2, 2017, and cites the Conference Report's expectation that the Secretary would prescribe anti-abuse rules to combat "tax strategies designed . . . to reduce the amount of inclusion" under section 965.[12] The preamble goes on to explain that taxpayers are free to change to permissible methods, but any such change would be disregarded solely for purposes of section 965.[13]

TEI views this as an insufficient basis to prevent taxpayers from moving from impermissible to permissible methods in calculating E&P for purposes of section 965. TEI members bring the perspective of multi-national taxpayers that must choose how to focus limited resources when complying with tax reporting obligations. Many taxpayers not planning to repatriate overseas earnings and without significant subpart F or other inclusions, particularly those representing under ASC 740 indefinite reinvestment offshore, did not focus these limited resources on a deep analysis of accounting methods for calculating foreign E&P, which at the time had minimal to no impact on U.S. taxation or GAAP financial statements. After passage of section 965, taxpayers that have now reallocated limited resources to ensure proper E&P calculations are discovering potentially impermissible methods that under normal circumstances would be uncontroversial method changes. There is little reason to believe that a change from an impermissible to permissible accounting method is evidence of an abusive "tax strategy" that the legislative history had in mind. Accordingly, we believe that the final regulations under section 1.965-4 should not prevent a change to a permissible method from an impermissible method for calculating section 965 elements.

7. Conflict between Anti-Abuse Rule and Other Rules in Prop. Treas. Reg. § 1.965-4(b) and (f)

Proposed Treas. Reg. § 1.965-4 provides rules that disregard certain transactions for purposes of applying section 965 to a U.S. shareholder. Paragraph (b) provides rules that disregard transactions undertaken with a principal purpose of changing the amount of a section 965 element of a U.S. shareholder (the "principal purpose rule"). Paragraph (f) provides rules that disregard certain transactions occurring between measurement dates (the "between measurement dates rule"). The E&P reduction transaction portion of the principal purpose rule (the "E&P reduction transactions rule"), as currently written, is broad and could be interpreted to apply to transactions beyond those to which it was intended. In fact, when applying the E&P reduction transactions rule to dividends between measurement dates, a literal interpretation of

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12 *See* Preamble to the Proposed Section 965 Regulations, at 61-62.

13 *Id*; Conference Report at 619-620.

the E&P reduction transactions rule could render the between measurement dates rule superfluous and unnecessary.

Proposed Treas. Reg. § 1.965-4(f) contains the between measurement dates rule. The rule provides that a specified payment made by an SFC (payor SFC) to another SFC (payee SFC) is disregarded for purposes of determining the post-1986 earnings and profits of each of the payor SFC and the payee SFC as of the measurement date on December 31, 2017.

Proposed Treas. Reg. § 1.965-4(f) is silent on whether the payment is also disregarded for purposes of determining the post-1986 foreign taxes of the payor and payee as of December 31, 2017. Since foreign taxes typically accompany the movement of earnings and profits with respect to a dividend from one SFC to another, the consistent approach would be to also disregard the payment for purposes of determining the post-86 tax pools of the payor and payee as of December 31, 2017 (as well as for purposes of determining the post-86 tax pools as of the last day of the payor and payee's inclusion years if that date is not December 31, 2017). TEI recommends that the IRS and Treasury include language that clarifies that Prop. Treas. Reg. § 1.965-4(f) also applies for purposes of determining the post-1986 foreign taxes.[14]

The between measurement dates rule applies to a payment in between measurement dates to a related SFC that would reduce the post-86 earnings and profits of the payor SFC as of December 31, 2017, where the payor and the payee do not have the same tentative E&P measurement date. Among other things, this rule alleviates double counting of dividends between measurement dates that would be included in the SFC of the payor as of November 2, 2017, and also in the E&P of the payee as of December 31, 2017. The rule is not elective.

Proposed Treas. Reg. § 1.965-4(b)(iv) addresses the application of E&P reduction transactions to the principal purpose rule of 1.965-4(b). This comment analyzes the interplay of the principal purpose rule, specific application of the E&P reduction transactions rule, and the between measurement dates rule with a specific focus on the application of those rules to between measurement dates dividends.

Pursuant to the principal purpose rule, a transaction is disregarded for purposes of determining the amounts of all section 965 elements of a U.S. shareholder if each of the following conditions ("three prongs" or "criteria") is satisfied with respect to any section 965 element of the U.S. shareholder –

i) The transaction occurs after November 2, 2017;

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[14] If left unchanged, a dividend transaction described in both the principal purpose rule and the between measurements dates rule would disregard the impact of the transaction upon the amount of foreign income taxes of the SFCs deemed paid by the US shareholder under the principal purpose test (*see* Prop. Treas. Reg §§ 1.965-4(b)(1) and (d)(3)) yet regard the impact upon the foreign income taxes for purposes of the between measurement dates test.

ii) The transaction is undertaken with a principal purpose of changing the amount of a section 965 element of the United States shareholder; and

iii) The transaction would, without regard to this rule, change the amount of the section 965 element of the United States shareholder.

In the case of a between measurement dates SFC to SFC dividend (sometimes referred to as "dividend"), the first of the three prongs of the principal purpose test is by definition always satisfied.

In the case of a between measurement dates dividend, the third prong is almost always satisfied. Although it may be possible to construct a scenario where none of the three section 965 elements is "changed", it seems that in substantially all cases this third criteria will be satisfied. Consequently, the application of the principal purpose rule to a between measurement dates dividend comes down to whether the principal purpose criteria is also met.

The E&P reduction transactions rule provides that for purposes of the principal purpose general rule, an E&P reduction transaction is presumed to be undertaken with a principal purpose of changing the amount of a section 965 element of a U.S. shareholder. Consequently, if a between measurement dates dividend constitutes an E&P reduction transaction then it will be presumed to meet the second prong in which case all three criteria will be satisfied and the dividend will be disregarded without any need to apply the between measurement dates rule specifically intended to address the regard or disregard of such dividends.

An E&P reduction transaction includes a transaction between an SFC and another SFC of a U.S. shareholder if the transaction would reduce either the accumulated post-1986 deferred foreign income or the post-1986 undistributed earnings of the specified corporation or another SFC of any U.S. shareholder of such SFC. Based on this definition, every SFC to SFC dividend should qualify as an E&P reduction transaction. Therefore, a between measurement dates SFC to SFC dividend will be presumed to be disregarded under the principal purpose rule.

The presumption, where applicable, of disregarding the dividend transaction may be rebutted only if facts and circumstances clearly establish that the transaction was not undertaken with a principal purpose of changing the amount of a section 965 element of a U.S. shareholder. A taxpayer that takes the position that the presumption is rebutted must attach a statement to its return for its taxable year in which or with which the relevant taxable year of the relevant SFC ends disclosing that it has rebutted the presumption.

The taxpayer burden of proving a negative with respect to every between measurement dates dividend is an extremely onerous task so lacking in guidelines as to almost certainly set taxpayers up for failure. What are the facts and circumstances that clearly establish that the transaction was not undertaken with a principal purpose of changing the amount of a section 965 element of a U.S. shareholder? How are auditors and taxpayers to know what they must demonstrate, and what documentation or evidence would taxpayers need to produce?

The E&P reduction transactions rule goes on to say that the presumption that would otherwise apply to a between measurement dates SFC to SFC dividend does not apply to an E&P reduction transaction that occurs in the ordinary course of business. However, it does not appear that any definition or parameters are provided as to what constitutes a transaction that occurs in the ordinary course of business. TEI recommends that the final regulations clarify that all SFC to SFC between measurement date dividends are in the ordinary course of business for the limited application of the E&P reduction transactions rule. Dividends typically follow an ordinary approval and execution process, and providing that they are considered to be in the ordinary course of business would mitigate both the enormous administrative burden on both taxpayers and auditors, and the almost unachievable burden of proof on taxpayers. Furthermore, the between measurement dates rule is directly intended to address whether to regard or disregard such dividends and should be the solely applicable rule in such instances.

The E&P reduction transactions rule goes on to provide that if the presumption does not apply because the transaction occurs in the ordinary course of business, whether the transaction was undertaken with a principal purpose of changing the amount of a section 965 element of a U.S. shareholder must be determined under all the facts and circumstances. This language, though not as forcefully worded as the "rebut the presumption" language, in essence still requires that taxpayer to prove a negative and satisfy the Service that the facts and circumstances demonstrate that the transaction was not undertaken with a principal purpose of changing a section 965 element.

The existence of the between measurement dates rule suggests that Treasury and the Service did not intend to nullify that rule through the principal purpose and E&P reduction transactions rules. The between measurement dates rule as drafted seems to capture all "ordinary" dividends, is clear and administrable, and is driven by reasoned policy. It is hard to contemplate any SFC to SFC dividend between measurement dates that would be governed by the between measurement dates rule given the sweeping application of the principal purpose and E&P reduction transaction rules as currently written.

TEI suggests that the final regulations be modified in a manner to reflect that, for SFC to SFC dividends between measurement dates, the between measurement dates rule, and not the principal purpose rule as modified by the E&P reduction transactions rule, be the exclusively applicable rule.

One possible way to accomplish this is to provide in the principal purpose and/or E&P measurement dates rules that if a transaction is described in both the between measurements dates and E&P reduction transactions rule, that the between measurement dates rule will govern and the E&P reduction transactions rule will not apply.

8. Treatment of certain transactions between SFCs under Prop. Treas. Reg. § 1.965-4(f)

Section 965(a) provides:

> [i]n the case of the last taxable year of a deferred foreign income corporation which begins before January 1, 2018, the subpart F income of such foreign corporation (as otherwise determined for such taxable year under section 952) shall be increased by the greater of (1) the accumulated post-1986 deferred foreign income of such corporation determined as of November 2, 2017, or (2) the accumulated post-1986 deferred foreign income of such corporation determined as of December 31, 2017.

Prop. Treas. Reg. § 1.965-4 provides rules that disregard certain transactions for purposes of applying section 965 to a U.S. shareholder. Paragraph (f) of this section provides rules that disregard certain transactions occurring between E&P measurement dates, *i.e.*, November 2 and December 31, 2017. The regulations state, "[a] specified payment made by a specified foreign corporation (payor specified foreign corporation) to another specified foreign corporation (payee specified foreign corporation) is disregarded for purposes of determining the post-1986 earnings and profits of each of the payor specified foreign corporation and the payee specified foreign corporation as of the E&P measurement date on December 31, 2017."[15]

The regulations provide the following example illustrating the application of the rules in paragraph (f):

> Example 1. Deductible payment between wholly owned specified foreign corporations is a specified payment. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP, CFC1, and CFC2 have calendar year taxable years. On November 2, 2017, each of CFC1 and CFC2 has post-1986 earnings and profits of 100u. Neither CFC1 nor CFC2 has post-1986 earnings and profits that are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1 or that, if distributed, would be excluded from the gross income of a United States shareholder under section 959 or from the gross income of another shareholder if such shareholder were a United States shareholder; therefore, no adjustment is made under section 965(d)(2) or §1.965-1(f)(7) and each of CFC1's and CFC2's accumulated post-1986 deferred foreign income is equal to such corporation's post-1986 earnings and profits. On November 3, 2017, CFC2 makes a deductible payment of 10u to CFC1. The payment does not constitute subpart F income. CFC1 and CFC2 have no other items of income or deduction.

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15 Prop. Treas. Reg. §1.965-4(f)(1).

> <u>(ii) Analysis</u>. (A) Determination of tentative E&P measurement date. Without regard to paragraph (f)(1) of this section, as of the E&P measurement date on December 31, 2017, CFC1 has post-1986 earnings and profits of 110u (100u plus 10u income from the payment from CFC2), and CFC2 has post-1986 earnings and profits of 90u (100u minus 10u deduction from the payment to CFC1). Therefore, the tentative E&P measurement date of CFC1 is December 31, 2017 (110u), and the tentative E&P measurement date of CFC2 is November 2, 2017 (100u).
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> (B) Application of the requirements for a specified payment. The payment from CFC2 to CFC1 is a specified payment because (A) CFC1 and CFC2 are related specified foreign corporations; (B) CFC1 and CFC2 do not have the same tentative measurement date; (C) the payment occurs after November 2, 2017, and on or before December 31, 2017; and (D) the payment would, without regard to the application of the rule in paragraph (f)(1) of this section, reduce the post-1986 earnings and profits of CFC2 as of the E&P measurement date on December 31, 2017. Under paragraph (f)(1) of this section, the payment is disregarded and CFC1 and CFC2 each have post-1986 earnings and profits of 100u as of December 31, 2017. Accordingly, the section 965(a) earnings amount of each of CFC1 and CFC2 is 100u.

If Prop. Treas. Reg. § 1.965-4(f)(1) is adopted as proposed, the scenario outlined in the above regulatory example will have anomalous results. First, for purposes of section 902(a) and Prop. Treas. Reg. § 1.965-6(c)(1)(ii) (regarding the amount of a foreign corporation's post-1986 undistributed earnings), CFC1 will have post-1986 undistributed earnings as of December 31, 2017, of 110u and a section 965(a) earnings amount of 100u. CFC2 will have post-1986 undistributed earnings as of December 31, 2017, of 90u and a section 965(a) earnings amount of 100u. Accordingly, each CFC will recognize subpart F income of 100u, which, after the inclusion year, will lead to CFC1 having a previously taxed E&P balance of 100u and a post-86 undistributed earnings balance of 10u, and CFC2 having a previously taxed E&P balance of 100u and either a deficit in post-86 undistributed earnings of (10u) or post-86 undistributed earnings of zero (the current guidance is ambiguous as to the intended outcome).

Second, because CFC1 is deemed to have distributed only 91% of its accumulated E&P, only 91% of its accumulated taxes would be treated as deemed foreign taxes associated with the total amount required to be included in income by reason of section 965(a).

As evidenced by Example 1, the rules in Prop. Treas. Reg. § 1.965-4(f)(1) create two significant mismatches. First, the rules create a mismatch between each of the CFC's post-1986 undistributed earnings as of December 31, 2017, and their section 965(a) earnings amounts. Second, the rules create a mismatch between the aggregate amount of E&P deemed distributed from each CFC and the aggregate amount of deemed foreign taxes associated with such distributions. While 100% of the combined post-1986 earnings and profits of CFC1 and CFC2 are included in the gross income of the U.S. shareholder (200u), only 95% of the combined taxes of

CFC1 and CFC2 will be considered for purposes of calculating the foreign tax credit available to the U.S. shareholder (91% of CFC1 and 100% of CFC2).

Prop. Treas. Reg. § 1.965-1(b)(1) does state that "neither the section 965(a) earnings amount nor the section 965(a) inclusion amount is subject to the rules or limitations in section 952 or limited by the accumulated earnings and profits of the deferred foreign income corporation on the date of the inclusion." However, the underlying issue is not that the 965(a) inclusion amount exceeds the accumulated E&P of CFC1 and CFC2. In fact, the combined section 965(a) inclusion amount of 200u in this example is equal to the combined E&P of 200u of CFC1 and CFC2 as of December 31, 2017. Rather, the issue is that the application of Prop. Treas. Reg. § 1.965-4(f)(1) artificially shifts the section 965(a) inclusion from one CFC to another while ignoring the ability of each CFC to pay a dividend, which is reflected by their respective E&P pools.

TEI submits that this portion of the Proposed Regulations exceed their intended effect, as outlined in Notice 2018-07. This portion of the Regulations was to address the possibility of double-counting or double non-counting in the computation of post-1986 E&P arising from amounts paid or incurred (including certain dividends) between related SFCs of a U.S. shareholder that occur between measurement dates and that would otherwise reduce the post-1986 E&P as of December 31, 2017, of the SFC that paid or incurred such amounts. The intended result of the adjustment outlined in Notice 2018-07 would have been that CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 200u. Since the combined earnings of CFC1 and CFC2 are treated as subpart F income through a section 965(a) inclusion, it is sound policy to allow the associated combined taxes to be credited. There are several alternatives to achieve such an equitable result.

One alternative would be to reword Prop. Treas. Reg. § 1.965-4(f)(1) as follows (additional language in bold):

> A specified payment made by a specified foreign corporation (payor specified foreign corporation) to another specified foreign corporation (payee specified foreign corporation) is disregarded for purposes of determining the post-1986 earnings and profits of each the payor specified foreign corporation and the payee specified foreign corporation as of the E&P measurement date on December 31, 2017**, and is disregarded for purposes of determining the post-1986 undistributed earnings for purposes of section 902 and Proposed Treas. Reg. §1.965-6(c)(ii) as of the date of the Subpart F inclusion (typically December 31, 2017 with respect to calendar year CFCs and November 30 with respect to fiscal year CFCs).**

A second alternative would be to provide in a new Prop. Treas. Reg. § 1.965-6(c)(3) that for purposes of section 902 and Prop. Treas. Reg. § 1.965-6, the post-1986 undistributed earnings of the SFC shall be considered to be the lesser of (i) the post-1986 undistributed earnings as of December 31, 2017, or (ii) the section 965 inclusion with respect to that SFC.

A third alternative would be to provide generally that if a specified payment is to be disregarded for purposes of Prop. Treas. Reg. § 1.965-4(f), it should also be disregarded for all section 965 purposes, including Prop. Treas. Reg. §1.965-6.

This portion of the Proposed Regulations is contrary to the intent of section 965 to allow taxpayers to transition to a participation exemption system of taxation. The TEI proposed alternatives should prevent the artificial creation of deficits in some CFCs while other CFCs have remaining amounts of undistributed post-1986 E&P (which would result in additional compliance complexities in subsequent years) in addition to carrying out the policy underlying the allowance of a foreign tax credit in an equitable way.

These recommendations should also help address the mismatch where the aggregate section 965(a) earnings amount is equal to the aggregate amount of post-1986 E&P of the two CFCs, but the aggregate amount of foreign taxes deemed paid with respect to the section 965(a) inclusion amount is less than the aggregate amount of taxes accumulated by both CFCs as of December 31, 2017. For the foregoing reasons we recommend that Treasury and the Service implement one of the alternatives described above in the final section 965 regulations.

9. Deficit offsets and foreign tax credits

a. Discussion of section 965

Section 965 imposes a transition tax on the previously untaxed E&P of DFICs by causing a one-time increase in the subpart F income of such subsidiaries in the last taxable year of such subsidiaries beginning before 2018 (the inclusion year). Under section 965(b)(1), the previously untaxed earnings amount which would otherwise be taken into account under section 951(a)(1) by a U.S. shareholder with respect to a DFIC is reduced by the U.S. shareholder's aggregate foreign E&P deficit allocated to such DFIC under section 965(b)(2) (such reduced amount hereinafter referred to as the "section 965(a) inclusion amount" of a U.S. shareholder with respect to a DFIC).

Under section 965(b)(4)(A), an amount of earnings equal to the portion of the aggregate foreign E&P deficit allocated to a DFIC under section 965(b) is treated as an amount which was included in income of a U.S. shareholder of the DFIC under section 951(a) for purposes of applying section 959 in any taxable year beginning with the inclusion year. Thus, the portion of earnings of a DFIC which are offset by a portion of the aggregate foreign E&P deficit of the DFIC's U.S. shareholder ("deficit offset earnings") are treated as PTI under section 959 (such PTI hereinafter referred to as "section 965(b) PTI").

b. Pre-TCJA foreign tax credit provisions

The foreign tax credit provisions in existence before enactment of the TCJA are effective for taxable years of foreign corporations beginning before 2018 and taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. Under such

provisions, section 901 provides that a taxpayer may claim as a credit against U.S. tax on foreign earnings the amount of foreign taxes directly paid or accrued to a foreign country, or deemed paid by such taxpayer under sections 902 and 960. Under section 902 of the pre-TCJA provisions, when a domestic corporate shareholder receives a dividend from a CFC, the U.S. shareholder is deemed to pay the same proportion of such foreign subsidiary's (i.e., the CFC's) post-1986 foreign income taxes (hereinafter "foreign tax pools") as the amount of the dividend received bears to the post-1986 undistributed earnings of the foreign corporation.

Under section 960(a)(1), a subpart F inclusion of a CFC is treated as a dividend for purposes of applying section 902 to treat the U.S. shareholder of such CFC as having paid a portion of the CFC's foreign tax pools as a result of the deemed dividend. Finally, under section 960(a)(3), a distribution of PTI is treated as a dividend for purposes of taking into account under section 902 any income taxes paid to any foreign country on or with respect to the PTI earnings being distributed, to the extent related foreign taxes have not been previously deemed paid under section 960(a)(1).

c. Interaction of Pre-TCJA foreign tax credit provisions and section 965

As a result of its section 951(a) inclusion required by section 965, a U.S. corporate shareholder of a DFIC is deemed to pay an amount of the DFIC's foreign tax pools under sections 902 and 960(a)(1) in the same proportion as the section 951(a) inclusion bears to the post-1986 undistributed earnings of the DFIC. Such foreign taxes deemed paid by the U.S. shareholder under section 960(a)(1) are credited to the U.S. shareholder under section 901, as reduced by the percentage specified in section 965(g).

Because a portion of the section 951(a) income inclusion of a U.S. shareholder of a DFIC is reduced under section 965(b), a portion of the DFIC's foreign tax pools are not deemed paid by the U.S. shareholder upon its section 951(a) inclusion. Such taxes remain in the foreign tax pools of the DFIC at the time of the section 965(a) inclusion. These taxes should be deemed paid by a U.S. shareholder under section 960(a)(3) and thus credited under section 901 when the section 965(b) PTI of the DFIC is distributed to the U.S. shareholder.

d. The Proposed Regulations are inconsistent with the statutory scheme

The Proposed Regulations are inconsistent with the rules described above. Specifically, Prop. Treas. Reg. § 1.965-5(c)(1)(ii) states that foreign income taxes deemed paid by a domestic corporation under section 960(a)(3) with respect to a distribution of section 965 PTI include only the foreign income taxes paid or accrued by an upper-tier foreign corporation with respect to a distribution of section 965 PTI from a lower-tier foreign corporation. The same provision indicates that no credit is allowed under section 960(a)(3) or any other section for foreign income taxes that would have been deemed paid under section 960(a)(1) with respect to the portion of a section 965(a) earnings amount reduced pursuant to section 965(b).

The Preamble clarifies this provision by explaining the government's view that because deficit offset earnings are included in a U.S. shareholder's income under section 951(a), foreign income taxes that are not actually deemed paid but would have been deemed paid with respect to section 965(b) PTI under section 960(a)(1), had such amounts actually been included in income, are treated as having been deemed paid for purposes of the foreign tax credit calculation. The result is that no credit is allowed under section 960(a)(3) or any other provision of the Code for such taxes.

This is inconsistent with the explicit limitations provided under section 965(b)(4) with respect to treatment of deficit offset earnings because section 965(b)(4)(A) limits such treatment to the application of section 959. Therefore, it is inappropriate to use section 965(b) to effectively extinguish the taxes that remain in the tax pool after the application of section 965.

The government's conclusion also frustrates one of the main purposes of section 965 – to encourage repatriation of foreign earnings to the United States. Congress designed the transition tax to provide an additional incentive for repatriation of foreign earnings after enactment of the participation exemption. Namely, to receive credit for the foreign taxes associated with deficit offset earnings, a taxpayer would have to actually repatriate such earnings. Under the government's interpretation, there is no positive incentive for companies to repatriate section 965(b) PTI.

If this provision remains in the final regulations, it would create a significant financial burden for taxpayers, particularly those with higher foreign effective tax rates. Thus, we recommend that Prop. Treas. Reg. § 1.965-5(c)(1)(ii) be excluded from the final regulations as it effectively results in an unauthorized elimination of a tax asset granted to taxpayers by Congress.

10. <u>Guidance to address withholding percentage haircut for a distribution between SFCs with different inclusion years</u>

A credit is not allowed for the applicable percentage of any foreign income taxes treated as paid or accrued with respect to an amount for which a section 965(c) deduction is allowed for an inclusion year. This includes both the deemed paid taxes on the 965 inclusion itself (section 960(a)) as well as withholding taxes on distributions.[16]

When a United States shareholder has SFCs with different taxable years, there will be different applicable percentages to utilize for purposes of determining the future creditability of taxes. For example, assume that CFC1 is a November 30 "fiscal year filer" with a 50% applicable percentage. Assume further that CFC2, wholly owned by CFC1, is a calendar year filer with a 70% applicable percentage. If CFC2 makes a dividend to CFC1 and a $10 withholding tax applies, are the creditable taxes $3 because CFC2 has a 70% applicable percentage, or are the creditable taxes $5 because CFC1 has a 50% applicable percentage? What rules apply when CFC1 further distributes to USP, whether or not an additional withholding tax applies? TEI recommends that

[16] *See* Proposed Treas. Reg. § 1.965-5(c).

additional guidance and examples that address such fact patterns be provided in final regulations.

11. Foreign exchange rate for section 965 calculations

TEI recommends the final 965 regulations provide that foreign currency will be translated into U.S. dollars via the average exchange rate for taxpayer's 2017 fiscal year, not the December 31, 2017, spot rate. The proposed regulations take the opposite approach, which is contrary to the statutory design of section 965. This is because section 965(a) makes clear that accumulated post-1986 deferred foreign income is treated as subpart F income. Under section 989(b)(3), the appropriate rate for translating subpart F income is the average rate for the year. It follows that section 965 amounts should likewise be translated into U.S. dollars using the average exchange rate for 2017.

Moreover, use of a spot rate for section 965 and an average rate for subpart F inclusions creates additional complexity and calculation layers for taxpayers and neither the preamble nor Notice 2018-13 provide a rationale for the incongruity that justifies this additional complexity. TEI believes Treasury and the Service should err on the side of consistency with the statutory text of section 965(a), particularly where doing so results in simplification and deviation has no compelling policy justification. Section 965 amounts should therefore be translated into U.S. dollars in the same manner as other subpart F income using an annual average rate.

12. Estimated Tax Payments

Treasury and the Service have taken the position in informal guidance[17] that taxpayers may not receive a refund or credit against their 2018 estimated income tax "unless and until the amount of payments exceeds the entire 2017 income tax liability, including all amounts to be paid in installments under section 965(h) in subsequent years." This position contradicts the clear Congressional purpose of the section 965(h) election permitting taxpayers to pay their section 965 transition tax liability in installments.

Section 965 is a one-time tax intended to transition the U.S. international tax regime from a worldwide tax system to a participation exemption system. The section 965(h) election represents Congress's acknowledgement that, because section 965 potentially taxes several decades of undistributed E&P of U.S. based multinationals' foreign subsidiaries, taxpayers may not have the necessary cash to pay such a potentially large tax liability in a single year. Treasury and the Service's position reverses this taxpayer favorable element of section 965 by penalizing taxpayers who have overpaid their regular (i.e., non-section 965) estimated taxes in a particular year. It appears at odds with the Service's mission of ensuring voluntary compliance with the Code to penalize taxpayers who take conservative positions with respect to their estimated tax

[17] Specifically, in Frequently Asked Question #14 regarding the section 965 transition tax, *available at* https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns.

liability, most often with a motive to avoid any subsequent imposition of interest and penalties by the Service.

For these reasons, TEI recommends Treasury and the Service reverse the position taken in the Frequently Asked Questions and permit taxpayers a refund or the ability to treat as a 2018 estimated tax payment any amounts paid in excess of the taxpayer's 2017 liabilities for regular and section 965 installment tax.

13. Penalty protection

Finally, TEI recommends the Service provide penalty protection to taxpayers who make good faith efforts to comply with computing and paying over the amount of their section 965 liability. The compressed timeframe in which taxpayers must compute their transition tax liability, including a potential multi-decade SFC E&P and foreign taxes paid analysis, augurs toward leniency and practicality from the Service when imposing penalties. This is similar to the situation faced by withholding agents and financial institutions under the Foreign Account Tax Compliance Act rules, where the Service provided in Notice 2014-33 a two-year "transition period" whereby such entities who "made good faith efforts to comply with the requirements of the chapter 4 regulations" would be given relief from the Service's enforcement activities. Similar relief should be deemed appropriate here and is requested with respect to a taxpayers section 965 liability.

Conclusion

TEI appreciates the opportunity to comment on the Proposed Regulations. TEI's comments were prepared with the guidance of Mark Pollard and under the aegis of the Institute's U.S. International Tax Committee, whose chair is Sarah Winters. Should you have any questions regarding TEI's comments, feel free to contact Mr. Pollard at 920.721.4325 or mark.pollard@kcc.com, Ms. Winters at 312.424.8116. or sarah.winters@cushwake.com, or Benjamin R. Shreck of the Institute's legal staff at 202.464.8353 or bshreck@tei.org.

Respectfully submitted,
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