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February 5, 2019

CC:PA:LPD:PR (REG-105600-18)
Office of Associate Chief Counsel (International)
Attention: Jeffrey P. Cowan, Jeffrey L. Parry, and Larry R. Pounders
Internal Revenue Service
1111 Constitution Avenue N.W.
Washington, D.C. 20224

Via the Federal eRulemaking Portal

Re: Comments on REG-105600-18, Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the TCJA

Dear Sirs:

On behalf of Tax Executives Institute Inc., I am pleased to submit the enclosed comments and recommendations concerning the newly proposed regulations (REG-105600-18) under sections 861 and 904 of the Internal Revenue Code, which were published in the *Federal Register* on December 7, 2018. We appreciate this opportunity to contribute our input and engage constructively with the Service in the tax reform implementation process.

The enclosed comments were prepared jointly under the aegis of the Institute's Tax Reform Task Force, the chair of which is Emily Whittenburg. Watson M. McLeish and Benjamin R. Shreck, Tax Counsels for the Institute, coordinated their preparation. If you have questions regarding the enclosed comments, please contact Mr. McLeish at (202) 470-3600 or wmcleish@tei.org, or Mr. Shreck at (202) 464-8353 or bshreck@tei.org.

Respectfully submitted,

James P. Silvestri
International President

TAX EXECUTIVES INSTITUTE, INC.
COMMENTS ON THE PROPOSED FOREIGN TAX CREDIT REGULATIONS

Tax Executives Institute Inc. ("TEI") welcomes this opportunity to comment on the newly proposed regulations (REG-105600-18) under sections 861 and 904 of the Internal Revenue Code (the "Code"),[1] which were published in the *Federal Register* on December 7, 2018.[2] The proposed regulations would provide guidance relating to the determination of the foreign tax credit under the Code and reflect changes made by Public Law 115-97, colloquially known as the Tax Cuts and Jobs Act (the "Act").[3]

About TEI

TEI is the preeminent association of in-house tax professionals worldwide. Our more than 7,000 members represent 2,800 of the leading companies in North and South America, Europe, and Asia. TEI represents a cross-section of the business community, and is dedicated to the development of sound tax policy, uniform and equitable enforcement of tax laws, and minimization of administration and compliance costs to the benefit of both government and taxpayers. As a professional association, TEI is committed to fostering a tax system that works—one that is administrable and with which taxpayers can comply in a cost-efficient manner.

TEI members are responsible for administering the tax affairs of their companies and must contend daily with provisions of the tax law relating to the operation of business enterprises, including the rules governing the determination of the foreign tax credit. We believe that the diversity and professional experience of our members enables TEI to bring a balanced and practical perspective to the issues raised by the proposed regulations, and we are eager to assist the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") in their important, collective efforts to implement the Act.

Discussion

I. Allocation and Apportionment of Deductions and the Calculation of Taxable Income for Purposes of Section 904(a)

Section 904 of the Code requires the calculation of taxable income from foreign sources in various categories (or "baskets") to determine the maximum allowable foreign tax credit against U.S. federal income tax otherwise imposed on such foreign-source income. To that end, the

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[1] Unless otherwise indicated, all references to "section" herein are to sections of the Internal Revenue Code of 1986, as amended.

[2] Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act, REG-105600-18, 83 Fed. Reg. 63,200 (Dec. 7, 2018).

[3] Act of Dec. 22, 2017, Pub. L. No. 115-97, 131 Stat. 2054.

source-of-income rules of sections 861 through 865 determine the sources of *gross* income for U.S. federal tax purposes, and the source rules for deductions under sections 861(b), 862(b), and 863(a) identify which deductions may be taken against foreign- versus U.S.-source gross income to determine foreign- and U.S.-source *taxable* income. The proposed regulations would amend Treasury regulations sections 1.861-8 through 1.861-13 and 1.861-17 to clarify how deductions are allocated and apportioned in general, and provide new rules to account for the specific changes made to sections 864(e) and 904 by the Act. Two of those changes are the subjects of TEI's comments below.

a. Repeal of Fair Market Value Method and Transition Relief

Section 14502 of the Act repealed the fair market value method of asset valuation for purposes of apportioning interest expense under section 864(e)(2) of the Code for taxable years beginning after December 31, 2017. Thus, taxpayers using the fair market value method must switch to the tax book or alternative tax book value method for the taxpayer's first taxable year beginning after that date.

As transitional relief for taxpayers required to change their methods of apportioning interest expense, proposed Treasury regulations section 1.861-9(g)(2)(i) would provide that for the first taxable year beginning after December 31, 2017, taxpayers may choose to determine asset values using an average of the end of the first quarter and the year-end values of their assets, subject to certain conditions. The preamble to the proposed regulations acknowledges that relief is warranted because "taxpayers previously using the fair market value method may not have had an independent reason to calculate the adjusted tax basis of their assets as of the beginning of their first post-2017 taxable year as required by the tax book value and alternative tax book value methods."[4]

It appears that the proposed transitional relief would merely permit an affected taxpayer to calculate the tax book value of its assets at a different time than that prescribed by the tax book or alternative tax book value method (and then only once). If Treasury and the Service believe that more is contemplated by this relief, then TEI recommends that the final regulations clarify the purpose and intent behind this provision in the proposed regulations.

A more welcome form of transitional relief for affected taxpayers would be to permit such taxpayers to average their last fair market value asset calculations with their first tax book method calculations in the first year for which such taxpayers may no longer use the fair market value method. That is, TEI recommends that an affected taxpayer be permitted to use its year-end fair market value calculation for the last taxable year the fair market value method may be used and average that against the year-end tax book method calculation in the first year for which the taxpayer is required to use the tax book method. For example, a calendar-year taxpayer would average the fair market value of its assets as of December 31, 2017, against the

[4] 83 Fed. Reg. 63,200, 63,203–04 (Dec. 7, 2018).

tax book value of its assets as of December 31, 2018, for purposes of apportioning interest expense. This would not only provide taxpayers with the administrative relief contemplated by the proposed regulations but also alleviate the associated economic burdens of forcing taxpayers off the fair market value method.

b. Allocation and Apportionment of Research and Experimental Expenditures

For purposes of the foreign tax credit limitation under section 904, in general, research and experimental ("R&E") expenditures are apportioned between groupings within product categories according to either a sales or gross income method of apportionment, at the taxpayer's election, as described in Treasury regulations section 1.861-17. Regarding the interaction of the foreign tax credit limitation, the new section 951A (or "GILTI") category, and the allocation regulations under section 861, the preamble to the proposed regulations states:

> The Treasury Department and the IRS request comments on whether other aspects of § 1.861-17 should be revised in light of the changes to section 904(d), in particular the addition of the section 951A category. For example, because the look-through rules in section 904(d)(3)(C) do not assign interest, rents, or royalties that reduce tested income to the section 951A category, royalties paid by a CFC to a United States shareholder are generally general category income even though the sales by the CFC to which the royalties relate may generate income in the section 951A category to the United States shareholder. This could result in R&E expenditures being apportioned under the sales method solely to the section 951A category, even though the royalty income is assigned to the general category. However, under the gross income method, R&E expenditures would be apportioned to both the general and section 951A category. Comments are requested on whether and how the regulations governing either or both methods should be revised to account for the addition of the section 951A category.[5]

To avoid this oddity, TEI recommends that Treasury and the Service amend the regulations governing the allocation and apportionment of R&E expenditures to account for the addition of the section 951A category to section 904(d). We further recommend that any such changes should ensure the alignment of various classes of gross income (e.g., royalties) with their related R&E expenditures to avoid the anomalous result described in the preamble. That is, if royalty income is assigned to the general category, then related R&E expenditures should also be apportioned to the general category—consistent with the overall policy of matching expenses to the separate category that includes the income on which the taxes were imposed.

Furthermore, TEI recommends that Treasury and the Service revise the regulations governing the gross income methods of apportionment to account for the addition of the section 951A

[5] 83 Fed. Reg. at 63,206.

category in cases where a corporation controlled by the taxpayer has entered into a cost-sharing arrangement, in accordance with the provisions of Treasury regulations section 1.482-7, with the taxpayer for the purpose of developing intangible property. Specifically, we recommend that Treasury regulations section 1.861-17(d) be revised to incorporate a provision similar to that in section 1.861-17(c)(3)(iv), *Effect of cost sharing arrangements*, applicable to taxpayers electing the gross income methods of apportionment.

II. Foreign Tax Credit Limitation Under Section 904

a. Foreign Branch Category Income

Section 14302 of the Act created a new separate foreign tax credit limitation basket for "foreign branch income," which is defined as the business profits of a U.S. person attributable to one or more qualified business units (as defined in section 989(a)) in one or more foreign countries.[6] The addition of this new foreign tax credit limitation category in section 904(d) was intended to prevent excess foreign tax credits generated in high-tax branch countries to be used to reduce U.S. tax owed on income generated in a low-tax country.[7] To that end, the statute provides that the amount of business profits attributable to a qualified business unit will be determined under rules established by the Secretary.[8] The proposed regulations would establish a number of such rules, including special rules regarding disregarded transactions. Those rules are the subject of TEI's comments below.

i. Attribution of Gross Income to Which Disregarded Payments Are Allocable

Under the proposed regulations, certain transactions that are disregarded for U.S. federal income tax purposes would affect the amount of a taxpayer's gross income that is foreign branch income within the meaning of section 904(d)(2)(J). Those transactions include transactions between a foreign branch and its foreign branch owner, as well as between or among foreign branches, involving payments that would be deductible or capitalized if the payment were regarded for federal income tax purposes. The proposed regulations would require the gross income attributable to a foreign branch that is not passive category income to be "adjusted" to reflect such disregarded transactions.[9] This adjustment would reallocate the U.S. person's gross income between the foreign branch category and the general category to reflect the disregarded transactions; it would *not* change the total amount, character, or source of the U.S. person's gross income.[10]

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[6] I.R.C. § 904(d)(1)(B), (2)(J).

[7] S. Comm. on the Budget, 115th Cong., *Reconciliation Recommendations Pursuant to H. Con. Res. 71*, S. Prt. 115-20, at 393 (Comm. Print 2017).

[8] I.R.C. § 904(d)(2)(J).

[9] *See* Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(A), 83 Fed. Reg. 63,200, 63,245 (Dec. 7, 2018).

[10] *Id.*

It is unclear under the proposed regulations whether a payment from a foreign branch to its foreign branch owner (a disregarded payment) would be treated differently than a payment from a foreign branch to a member of its foreign branch owner's affiliated group (a regarded payment). TEI recommends that Treasury and the Service clarify in the final regulations that regarded and disregarded branch payments are treated in the same manner for purposes of determining the amount of a consolidated taxpayer's gross income that is foreign branch category income.

ii. Certain Transfers of Intangible Property

For purposes of applying the adjustment described in the penultimate paragraph, and to "prevent non-economic reallocations of the amount of gross income attributable to the foreign branch category in connection with certain transactions," the proposed regulations include another special rule.[11] Pursuant to proposed Treasury regulations section 1.904-4(f)(2)(vi)(D),

> 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 . . . 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.[12]

In determining the amount of gross income attributable to a foreign branch that must be adjusted by reason of this special rule, the proposed regulations further provide that "the principles of sections 367(d) and 482 apply."[13] Thus, for example, if a foreign branch owner transfers intangible property described in section 367(d)(4), the principles of section 367(d) would apply 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.[14]

TEI appreciates Treasury and the Service's efforts to promulgate sophisticated guidance that would implement the statutory command of section 904(d)(1)(B) in a theoretically accurate manner. At the same time however, it is inescapable that the proposed guidance would impose an undue compliance burden on taxpayers, add undue complexity to the federal tax laws, and be extremely difficult, if not impossible, for taxpayers—and in many cases, the Service—to administer. The administrative burden of requiring taxpayers to reallocate gross income to reflect disregarded transfers of intangible property would be unreasonably high, particularly with respect to transactions completed *prior* to the effective date of the proposed regulations. Many taxpayers are unlikely to have access to the necessary information with

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[11] 83 Fed. Reg. at 63,210.

[12] Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(D), 83 Fed. Reg. at 63,245.

[13] *Id.*

[14] *Id.*

respect to such transactions, which were properly disregarded for federal income tax purposes at the time they were undertaken.

TEI respectfully recommends that Treasury and the Service withdraw and thoroughly reconsider the special rule in proposed Treasury regulations section 1.904-4(f)(2)(vi)(D) in consultation with affected taxpayers from across industry lines. At a minimum, however, TEI would urge Treasury and the Service to clarify in the final regulations that this special rule applies only to actual transfers of property (e.g., not to any transactions that are deemed to occur under Treasury regulations section 301.7701-3(g) as a result of a change in classification election).

b. Separate Limitation Losses

Generally, a separate limitation loss ("SLL") is created when a foreign loss in one separate category of income offsets foreign-source income in another separate category. The SLL is recaptured when the separate category that previously generated a loss instead results in income in a subsequent taxable year. SLLs generally do not create adverse foreign tax credit implications to the extent that they are recaptured within the 10-year foreign tax credit carryover period—that is, in general, the carryover period for such SLLs sufficiently ameliorates the temporary suspension in the first year. GILTI SLLs are an exception, however, because foreign taxes properly attributed to the section 951A category cannot be carried over to a future taxable year.

There is no indication that this disparate treatment of GILTI SLLs was intended by the Act. Accordingly, TEI recommends that either (i) SLLs should not be permitted to arise with respect to the section 951A category or (ii) foreign taxes properly attributable to section 951A category income should "hover" until the SLL with respect to the section 951A category is recaptured. Absent relief, an affected taxpayer would permanently lose the benefit of the foreign tax credit to the extent that a SLL is created with respect to the section 951A category.