UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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

RE: IRS REG-105495-19 - Guidance Related to the Allocation and Apportionment of Deductions and Foreign Taxes, the Definition of Financial Services Income, Foreign Tax Redeterminations under Section 905(c), the Disallowance of Certain Foreign Tax Credits under Section 965(g), and the Application of the Foreign Tax Credit Limitation to Consolidated Groups

Dear Commissioner Rettig:

USCIB[1] is pleased to provide comments on the proposed regulations regarding guidance related to the foreign tax credit and related provisions.

General Comments

USCIB believes that the government should rethink its approach to the foreign tax credit and expense allocation regulations. Foreign tax credit planning has been significantly affected by the changes made by the TCJA. Because of the combination of the reduced corporate rate and the scaling back of the foreign tax credit both for GILTI and the section 250 deduction, many more taxpayers will be in an excess foreign tax credit position on a permanent basis. Thus, shifting income, expenses or foreign taxes from one "basket" or another may have little impact on the total foreign tax credit ultimately claimed. This does not seem, however, to have influenced the decisions made in drafting the regulations. In virtually every case the decisions reflect the desire for more precision -- or at least more precision when more precision limits foreign tax credits. While each individual decision might make sense in isolation, the combined impact of those individual decisions will lead to an excessive administrative burden. The government should consider simplifying assumptions to minimize these burdens.

Having opted for substantial complexity throughout the foreign tax credit and related regulations, the government has proposed some simplifying rules that cut against taxpayers. As explained in more detail below, some of these proposals are current rules that give taxpayers options, so taxpayers are able to choose the more precise option is that better fits their facts, the

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide and works to facilitate international trade and investment.

proposed regulations would eliminate some of these options. The proposed regulations also seem to be heading to a more formulaic approach to expense allocation. While formulas can be appropriate and useful, there are factual relationships between income and expenses that should be respected in associating income and expenses.

The regulations seem to ignore the role of tax treaties in preventing double taxation. One of the principal goals of tax treaties is preventing double taxation.[2] USCIB believes that when taxpayers have a treaty protected right to relief from double taxation a statute or implementing regulation that denies a foreign tax credit in all cases would be invalid as to those taxpayers.

Countries may and do relieve double taxation unilaterally, whether by foreign tax credits or by exempting foreign source income, or more likely a combination of the two methods. Nevertheless, tax treaties have a role to play and that role cannot be ignored. Perhaps the clearest statement of the role of tax treaties in assigning taxing rights is paragraph 19 of Commentary on the OECD Model. That paragraph provides:

> For the purpose of eliminating double taxation, the Convention establishes two categories of rules. First, Article 6 to 21 determine, with regard to different classes of income, the respective rights to tax of the State of source or situs and of the State of residence, and Article 22[3] does the same with regard to capital. In the case of a number of items of income and capital, an exclusive right to tax is conferred on one of the Contracting States. The other Contracting State is thereby prevented from taxing those items and double taxation is avoided. As a rule, this exclusive right to tax is conferred on the State of residence. In the case of other items of income and capital, the right to tax is not an exclusive one. As regards two classes of income (dividends and interest), although both States are given the right to tax, the amount of the tax that may be imposed in the State of source is limited. Second, insofar as these provisions confer on the State of source or situs a full or limited right to tax, the **State of residence must allow relief so as to avoid double taxation; this is the purpose of Articles 23 A and 23 B.** The Convention leaves it to the Contracting States to choose between two methods of relief, i.e. the exemption method or the credit method.

Thus, provisions relating to the relief of double taxation must be read in light of the structure of the treaty. If the source jurisdiction has been granted the primary right to tax, the residence jurisdiction must relieve double taxation. The language in the US Model concerning limitations on the foreign tax credit:

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[2] This should be apparent from the title of the US Model and most income tax treaties: CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF __________ **FOR THE AVOIDANCE OF DOUBLE TAXATION** AND THE PREVENTION OF TAX EVASION WITH RESPECT TO TAXES ON INCOME. (Emphasis added.)

[3] The OECD Article numbers are not necessarily the same as the article numbers in the US Model or in particular US treaties, but the point is the same regardless.

> In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time **without changing the general principle hereof**), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income…[4]

Thus, the principle that is controlling is the obligation to relieve double taxation when the other jurisdiction has the primary right to tax, not the implementation of principles underlying US statutory law. So, changes as result of the TCJA and the implementing regulations that would in all cases deny foreign tax credits to taxpayers that have a treaty protected right to relief from double taxation would be invalid as to those taxpayers.

Specific Comments

Allocation of Stewardship Expenses

The proposed regulations would eliminate the permissible methods for purposes of apportioning stewardship expenses and instead require all stewardship expenses to be apportioned based on the relative values of stock. The effect of the methodology of the proposed regulations would be to allocate virtually all stewardship expenses to foreign source income; this is not an appropriate result. The current regulation mentions the possibility of using time spent (weighted by compensation), gross receipts, gross income, or unit sales volume assuming the stewardship activities are not substantially disproportionate to such factors.[5] USCIB believes that the current regulations may provide a more accurate result. The current regulations permit differences in the manner in which the taxpayer operates to be taken into account. In particular, different business lines may require very different levels of supervision given the relative risk – riskier businesses require more supervision. While the amount of capital at risk is clearly a factor in determining the level of risk, so too is the type of nature of the business activity, so a pro rata allocation based on the rules applicable to interest expense are inappropriate here.

The government solicited comments on the difficulty of distinguishing stewardship expenses from supportive or duplicative activities. These expenses are difficult to distinguish. The government could provide flexibility with respect to the method of allocation – allowing the taxpayer to determine the most appropriate allocation method – and require the same method for both stewardship and support functions. We oppose sourcing of support costs based on the relative values of stock for the same reasons we oppose the proposed regulations treatment of stewardship expenses, supports costs will differ depending on the nature of the business.

Allocation of Damages, Awards and Prejudgment Interest

Proposed §1.861-8(e)(5) would allocate expenses such as damages, awards, prejudgment interest, and settlement payments associated with litigation filed by investors in a corporation,

[4] US Model, Article 23, paragraph 2. (Emphasis added.)
[5] Treas. Reg. §1.861-8(e)(4)(ii).

or that arise from negligence or malfeasance of the corporation, to all income of the corporation. As such, the proposed regulation allocates these expenses based on the corporation's consolidated assets. The link between the consolidated assets of the corporation and these expenses is tenuous. Claims associated with corporate malfeasance may be very narrow or very broad in scope, and to assume the lawsuit (and corporate expenses related thereto), relate to or impact all gross income of the corporation is unconvincing. There is a closer factual link between the expenses associated with these lawsuits and the classes of gross income recognized in the jurisdiction where the litigation occurs because it this income and these assets that are most likely to be affected by the lawsuit. Thus, the expenses should be allocated to income from the jurisdiction in which the litigation is pursued.

Allocation and Apportionment of R&E Expenditures

Issues Relating to FDII

The proposed regulations exclude GILTI from the definition of "gross intangible income". Therefore, R&E expenses are not allocated and apportioned to GILTI. Congress intended that the Foreign Derived Intangible Income ("FDII") deduction would result in parity between income earned in a CFC and taxable under the GILTI provisions and income earned in the US and taxable in the hands of a US person. Parity is necessary, otherwise there would be a significant disincentive to performing R&E in the US and retaining intellectual property in the US. Because Including FDII in the definition of gross intangible income undermines that parity, the government should exclude FDII from the definition of "gross intangible income". Since FDII and GILTI apply many of the same concepts in determining the amount of both FDII and GILTI, and to bolster the argument that FDII and GILTI operate as two halves of a unified whole, consistent with the GILTI carve-out, FDII should be treated as not constituting gross intangible income.

The application of the section 904 regulations, the section 250 regulations and the section 861 regulations may result in over allocation of R&E expenses to FDII because the regulations provide that the exclusive apportionment rule only applies for purposes of section 904. Treasury analysis has found that R&E has greater value in the place of performance.[6] Therefore, extending the exclusive apportionment to the determination of FDII, or providing taxpayers an option to extend the exclusive apportionment to FDII, would be consistent with data and Treasury analysis showing that the value of R&E is greater where it is performed and there is a technology lag in "exporting" R&E.

Assigning items of income to the statutory and residual groupings

Proposed §1.861-20(d) provides rules for determining how each item of foreign gross income is assigned to a statutory or residual grouping. The rules of paragraphs (d)(1) and (d)(2) should generally reach appropriate results. These rules assign the amount of gross income determined

[6] *The Relationship between US Research and Development and Foreign Income",* US Treasury Study dated May 19, 1995.

under foreign law to the same category as the corresponding item would be assigned under U.S. law. This is the case even if the U.S. and foreign amounts fall in different taxable years.

Return of Capital

While proposed §1.861-20(d)(2) generally reaches correct results, USCIB disagrees with the proposed treatment of a distribution of property to the extent of section 301(c)(2) as a base difference. This is contrary to the government's longstanding position that base differences should be rare. It is also inconsistent with the most basic rule of §1861-20(d)(1) that the amount of the item is determined under foreign law. Thus, under the general rule, if the foreign country sees an income amount of 1000 and imposes tax on that amount of 250, the fact that the amount of income differs from the amount determined under US law does not change the character of the item or the allocation of the taxes. Thus, if the income were sales income and the US "saw" only 500 of sales income, the full 1000 of income and the associated 250 of taxes would be associated with the appropriate statutory grouping and not considered a base difference. The same should be true of distributions characterized as dividends under foreign law, this is particularly important when the tax associated with the dividend is a gross basis withholding tax.

The rule may also violate income tax treaty obligations. As discussed above, one of the principal purposes of any income tax treaty is the prevention of double taxation. This is, in part, accomplished by assigning a Contracting State the primary right to tax and requiring the other Contracting State, with the secondary right to tax, to relieve double taxation. The US Model Income Tax Treaty defines a dividend by reference to the law of the Contracting State in which the payor is resident.[7] That is:

> the term "dividends" means income from shares or other rights, not being debt-claims, participating in profits, as well as income that is subject to the same taxation treatment as income from shares **under the laws of the Contracting State of which the company making the distribution is a resident**. **The term does not include distributions that are treated as gain under the laws of the Contracting State of which the company making the distribution is a resident. In such case, the provisions of Article 13 (Gains) shall apply.[8]**

The definition is clear that is the Contracting State of the residence of the payor that determines the character of the distribution – distribution versus capital gain. While the treaty does not explicitly reference return of capital, that would be because return of capital is not taxed and therefore it is not necessary to determine taxing rights. Nevertheless, it would be impossible to apply this sensibly and permit allocation of payor country taxes to return of capital determined under US law. A new US law that effectively disallows a credit for a dividend determined under foreign law by assigning the foreign tax to the residual grouping would, therefore, violate US treaty obligations. While it would be possible to have a separate rule for dividends from

[7] US Model, Article 10 paragraphs 2 and 7.
[88] US Model, Article 10 paragraph 7. (Emphasis added.)

companies resident in treaty jurisdictions and other dividends, it is likely that a significant majority of dividends would be paid of out of treaty resident entities.

Partnership Distributions

USCIB also disagrees with the treatment of a distribution by a partnership under section 733 as a base difference. Distributions by a partnership to a partner represent a return of a partner's investment in the partnership. However, unlike in the case of corporate stock, a portion of the partner's outside basis in its partnership interest may be attributable to its distributive share of partnership income. To the extent that foreign tax is imposed on a distribution to a partner that reduces the partner's outside basis, the foreign tax may be attributable to the partner's share of the partnership income that gave rise to such basis. Although there are no rules under current law for identifying the particular portion of basis of a partnership interest to which a distribution to a partner is attributable, it would be unreasonable to treat all distributions by a partnership to a partner as base differences. This would lead to an inequitable outcome between investment in a partnership and investment in a corporation, the latter of which allows distributions described under section 301(c)(1) and (c)(3) to be treated as timing differences. See discussion above regarding section 301(c)(2).

Disregarded Payments Made by an Owner

The proposed rules of paragraph (d)(3) concerning disregarded payments made by an owner are especially problematic. Proposed §1.861-20(d)(3)(ii)(A) provides that "an item of foreign gross income that a taxpayer includes by reason of the receipt of a disregarded payment made to a foreign branch owner is assigned to the residual grouping." There is an exception to this rule for a disregarded payment in exchange for property. In the case of a foreign branch of a CFC owner, assignment of the foreign taxes to the residual groupings means that no foreign tax credit will be allowed for foreign taxes associated with the payment made by an owner to a disregarded entity. Thus, the proposed rule will treat taxpayers differently depending on the form of organization (corporation vs. disregarded entity). There is no policy justification for this approach. The logic of this rule must be that all payments from an owner (other than in exchange for property) are treated as contributions to capital and, thus, as base differences. This logic is flawed. A contribution to capital does not include any money or property transferred to the corporation in consideration for goods or services rendered.[9] Thus, at a minimum, the exception for property should be expanded to include services. USCIB believes that base difference treatment should be limited to those payments that are the equivalent of an actual capital contribution.

The government may be concerned that it would be too complex to determine the allocation of taxes between an owner and a branch. Companies have stand-alone QBU tax workpapers that can be used to attribute taxes to the correct items of income – so performing this allocation would be less complex and require less additional recordkeeping than many of the other rules provided in the foreign tax regulations. USCIB has advocated for a substantially simpler foreign

[9] See §1.118-1.

tax credit regime, but if the regulations will not be simplified, then complexity should not be a one way street: permissible when it reduces the ability to claim foreign tax credits, but not permissible when it allows more accurate results that may favor taxpayers.

The proposed rule may also violate income tax treaty obligations to provide double tax relief. Assume that an owner that makes a payment for services that is taxable to the disregarded entity by the foreign jurisdiction because the entity has a permanent establishment it that jurisdiction. A treaty consistent with the US Model would grant primary taxing rights to that jurisdiction and Article 23 would require the US to relieve double taxation. Treating the taxes associated with an item of services income in a manner that will result in the denial of a foreign tax credit in all cases may violate the treaty (this would be the impact of assigning the taxes to the residual group, U.S. source income). The fact that this income could generate foreign source income within a statutory grouping if earned by a corporation makes that point even clearer. That is, it is not the type of income or the fact that the foreign jurisdiction is taxing it, but an arbitrary U.S. rule that is resulting in the denial of the credit. This rule is not consistent with the general principle that a credit be allowed.[10] The credits allowed under paragraph 2 are allowed in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, so long as the general principle of the Article, that is, the allowance of a credit, is retained. Giving the other jurisdiction the primary right to tax, requires the US to relieve double taxation. In these cases, no credit would ever be given, so despite the limitations in the US Model, the allocation of taxes proposed by §1.861-20(d) may violate the obligation to relieve double taxation.

Disregarded Payments Made from One Branch to Another Branch under a Common CFC Owner

The proposed regulations do not provide a rule for allocating taxes that are imposed on a disregarded payment made by one branch to another branch under a common CFC owner. The regulations should provide a rule that those taxes are allocated to the statutory grouping based on the income that would be earned in the recipient branch if the payment were regarded. As discussed in the previous section, assigning income to the residual grouping (US source income) would create inappropriate results because it would routinely disallow otherwise creditable foreign income taxes.

Disregarded Transfer of Appreciated Property

Post-acquisition restructuring is often performed to better align a multinational's legal structure with its commercial operations. In many cases this includes the "inbounding" of appreciated property. Proposed regulation §1.861-20(g)(11) Example 10 provides an example of a distribution of appreciated property from a disregarded entity to its US owner. This example is not limited to post-acquisition restructuring but could apply in that context. USCIB believes that the gain on the transfer of appreciated property is appropriately treated. However, at least in the case of post-acquisition restructuring, the withholding tax imposed on the distribution should not be allocated on the basis of the tax-book value of the assets. The proposed rule will

[10]Technical Explanation of the US Model, 2006, page 74.

discourage inbounding of acquired assets and will create unnecessary complexity. The government should consider adopting a transitory ownership rule, similar to the one adopted in §1.904-4(f)(2)(vi)(D)(3), any transitory ownership rule should apply to business assets used in the ordinary course of the taxpayer's trade or business.

Definition of a Financial Services Entity

Proposed § 1.904-4(e) aligns the definitions of financial services entity with certain definitions in sections 954(h), 1297(b)(2)(B), and 953. The preamble indicates one of the reasons for the change is to "promote simplification." The change to §1.904-4(e) does not promote simplification. The proposed change replaces an easily applicable objective test with a facts-and-circumstances, subjective test. Specifically, the proposed regulation replaces the objective test (a component of the regulations since the 1980s) whereby if more than 80% of a CFCs gross income relates to twenty-four specified categories (current Reg. 1.904-4(e)(2)(i)) the CFC is a financial services entity, with a subjective test that hinges on whether the CFC's income is derived directly from the "active and regular conduct of a lending or finance business." This creates ambiguity and increases uncertainty for both the taxpayers and the IRS.

Consistency between Section 904(d)(2)(C) and Section 954(h) is not achieved or necessary. Congress imposed additional qualifications to Section 954(h), like the substantial activity and local country activities tests, which do not apply to Section 904. These qualifications are inapplicable to Section 904, but without these qualifications the standard in Section 904 and Section 954(h) differ enough that the companies qualifying for each section are not consistent. Sections 904 and 954 were developed at different times and reflect different policy objectives. The current list of twenty-four categories of income in the Section 904 regulations derives primarily from the legislative history of the enacting statute, and the legislative history of subsequent modifications to Section 904. The enactment of Section 954(h) does not reflect an intent to change the financial services tests reflected in the current regulations under section 904. Treasury should not erase the historical development of the definition of financial services income in Sec. 904(d)(2)(C) only to create consistency (which will not be achieved in any event) with a different code section (Section 954(h)) that was fashioned to address different policy concerns.

If the government does adopt a new definition of financial services, it should provide a transition rule for qualified deficits generated in earlier years. That is, taxpayers should be able to use an existing qualified deficit to offset income of the same type in future years.

At the very least, given taxpayers have relied on Reg. 1.904-4(e) for more than 30 years, the government should make the effective date of any changes on or after the date the final regulations are published in the Federal Register.

Notification of Foreign Tax Redetermination

USCIB appreciates the difficulties involved in applying 905(c) to redetermine foreign tax credits. However, with the increased complexity of international taxes and subsequent changes in foreign tax laws, the frequency of redeterminations of foreign tax is likely to increase. This creates a significant burden for both taxpayers and tax authorities. Amending federal returns will result in the need to amend associated state tax returns. For example, some large multinational taxpayers are required to file hundreds of state and local tax returns each time an amended federal tax return is filed. A foreign tax redetermination that affects multiple tax years could result in the need to file thousands of state and local tax returns. The sheer magnitude of amended return filings would put an undue burden not only on taxpayers but also on state and municipal revenue agencies. The penalties for failure to comply may also be significant.

USCIB believes that the government should consider all possible avenues for minimizing this burden. In particular, the government should consider the suggestions listed below.

- The scope of §1.905-4(b)(4) should be expanded to permit more taxpayers within the jurisdiction of the Large Business and International Division to provide notice of a foreign tax redetermination on audit. This should include allowing taxpayers to provide notice of an upward adjustment, as well as offsetting adjustments between different jurisdictions.
- The government should also consider allowing prospective adjustments to current year foreign taxes, especially if the amount of the adjustment is below a de minimis threshold. The government could permit taxpayers to include a "section 905(c) notification schedule" with its current year returns and adjust the current year taxes claimed based on taking into account the adjustments from prior years. While current year adjustments might not reach precisely the same result as redetermining the prior year taxes, this should not be objectionable. The prior law rules that permitted forward adjustments to the pools of taxes and earnings would have had different results than redetermining the foreign taxes for the prior years and yet those adjustments were permitted, as long as the taxes pool did not go negative.

<u>Foreign Tax Redeterminations of Foreign Corporations that Relate to Taxable Years of the Foreign Corporation Beginning Before January 1, 2018</u>

The pooling rules of section 905(c) were repealed by TCJA. The pools of earnings and profits and taxes should have been eliminated by the inclusion required under section 965. Thus, foreign tax redeterminations relating to pre-TCJA years of a foreign corporation must be accounted for in some other way – there cannot be a forward adjustment to the pools.

The proposed regulations would require an adjustment in the taxable year of the foreign corporation to which the foreign taxes relate (§1.905-5(a)(1)). Thus, a refund of foreign taxes relating to say 2010 would require adjustments to be made with respect to the 2010 return and presumably would have ripple effects on the pools of earnings and taxes for subsequent years, which would all need to be adjusted. This is so, even though under prior rules, the forward adjustments to the pools would avoid the ripple effects. While there is no longer a pool that can

be adjusted perhaps the effect could be mimicked by adjusting only the final pre-2018 year, so long as the taxes did not go negative in that final year. If such a rule were adopted, then only the amounts relating to the final year would need to be adjusted.

Determination of Foreign Taxes Deemed Paid under Section 960

USCIB believes that the language of proposed § 1.960-1(d)(3)(ii)(A) should be clarified. The last sentence currently reads, "Foreign gross income attributable to a base difference, ***or resulting from the receipt of a disregarded payment made to a foreign branch,*** is assigned to the residual income grouping under Sec. 1.861-20(d)(2)(ii)(B)…" USCIB thinks, based on language in the preamble and the cross reference, the language highlighted in bold is intended to apply payments from the branch owner to the branch, but the language is not so limited. USCIB requests that the sentence be amended to read as follows: "Foreign gross income attributable to a base difference, or resulting from the receipt of a disregarded payment ***made by a foreign branch owner to a foreign branch,*** is assigned to the residual income grouping under Sec. 1.861-20(d)(2)(ii)(B)…"[11]

Sincerely,

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

[11] As discussed above, USCIB believes the proposed §1.861-20 regulation is overbroad and should be limited to capital contributions. We believe that would be accomplished by the amendment suggested above along with a change to the proposed §1.861-20 regulation.