NATIONAL ASSOCIATION OF
Manufacturers

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Internal Revenue Service
Attn: CC:PA:LPD:PR (REG-104226-18)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Section 965 Regulations

On behalf of the National Association of Manufacturers (NAM), this letter offers comments in response to REG-104226-18, proposed regulations implementing revisions to Section 965 of the Internal Revenue Code. The NAM is the largest industrial association in the United States representing manufacturers in every sector and in all 50 states. We appreciate this opportunity to help ensure that the implementation of the recently-enacted tax reform legislation[1] (informally known as the Tax Cuts and Jobs Act or "TCJA") has the intended effect of spurring economic growth and innovation.

The Purpose of Section 965

The TCJA moved the United States away from its decades-old "worldwide" system for taxing international income. Under the old system, all earnings of a U.S. company were subject to U.S. tax, irrespective of the country in which it was earned. While a deferral regime sometimes delayed the imposition of tax until earnings were brought back to the United States, our high federal income tax rates served as a disincentive to repatriation. This resulted in what has been referred to as the "lockout" effect. The TCJA addressed this issue by reducing statutory tax rates and adopting a dividend exemption system, which allows businesses to repatriate foreign earnings without an additional layer of U.S. tax.

As part of the transition to this new system, the TCJA imposed a one-time "transition tax" on previously unrepatriated foreign earnings. The rate at which the tax is imposed depends on the form in which the foreign earnings are held. Corporate taxpayers are subject to a tax rate of 8 percent for earnings invested in fixed assets and a rate of 15.5 percent for earnings held in cash.

The amount subject to tax is determined by reference to two measurement dates. Specifically, a taxpayer's Section 965 inclusion is the greater of (i) the foreign corporation's accumulated earnings and profits ("E&P") as of November 2, 2017 or (ii) the foreign corporation's accumulated E&P as of December 31, 2017.[2] If a U.S. person is a shareholder in a corporation with accumulated E&P and also a shareholder in a corporation with a deficit in E&P, the

[1] Pub. L. No. 115-97.
[2] 26 U.S.C. Sec. 965(a).

allocable portion of the deficit can be used to reduce E&P that would otherwise be subject to the transition tax.[3]

Once a taxpayer determines their amount of transition tax liability, they may elect to pay the amount in installments over eight years.[4] Recent guidance from the IRS states that taxpayers who elect to pay their Section 965 liability in installments, and who overpay their total federal income taxes for a particular year, are not be eligible for a refund. In a legal memorandum explaining its decision, the IRS argued that the right to a refund cannot exist until the entire 965 liability is paid in full.[5]

<u>Defining "Cash"</u>

In providing a bifurcated rate structure, Congress intended to tax "earnings held in liquid form" at a higher rate than earnings "that have been reinvested".[6] Section 965 defines the items that are counted as "cash" subject to a higher rate of tax as cash, net accounts receivable and the fair market value of certain assets, including: actively traded personal property for which there is an established financial market and short term obligations.[7] The statute defines "net accounts receivable" as the amount of receivables less accounts payable, and leaves the definition of payables largely undefined.[8]

In interpreting "accounts payable", the proposed regulations exclude payables to employees in the ordinary course of business, payables arising from the purchase of depreciable property and payables from the licensing of intellectual property. Excluding these items provides an inaccurate picture of a taxpayer's net foreign cash. These items represent obligations that have already been incurred and prohibiting taxpayers from using these items to reduce their cash position subjects more foreign earnings to Section 965's higher rate of tax on liquid assets. It is illogical to treat a taxpayer as having "cash" for purposes of Section 965 despite the fact that funds are already committed, with simply the act of payment waiting to occur.

The proposed regulations' approach to short-term obligations is similarly problematic, in that they do not allow taxpayers to net their short-term payables and receivables. Rather, the gross amount of short-term receivables is counted as "cash." To accurately determine a foreign corporation's liquid assets that are subject to the higher rate of tax under Section 965, Treasury should allow netting of obligations and receivables.

In addition, we note that the proposed regulations affirmatively rejected liquidity testing for assets treated as cash. The assumption that a facts-and-circumstances standard would be needed in all instances (and the difficulty of administering such a standard) was cited as the reason for the rejection. However, as the preamble notes, taxpayers requested that Treasury exclude items that are clearly illiquid: cash or stock that must be held to meet foreign capital requirements, the ownership of a market-moving amount of publicly-traded stock (i.e., at least 10 percent of a company's stock), and obligations that have already resulted in a U.S. tax liability (i.e., loans that meet the requirements of Section 956). We urge Treasury to reconsider

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[3] 26 U.S.C. Sec. 965(b).
[4] 26 U.S.C. Sec. 965(h).
[5] IRS Chief Counsel Memorandum (Aug. 2, 2018).
[6] H. Rept. 115-409, at 375.
[7] Section 965(c)(3).
[8] Section 965(c) defines payables by reference to Section 461, which provides rules for determining the timing of deductions.

its position. The tax code and associated regulations are rife with provisions that require the Treasury and IRS to perform an analysis of the facts and circumstances of a particular item.[9] The IRS and Treasury have decades of experience in administering these provisions; an inquiry into whether an asset is liquid is well within their capabilities. As noted above, the preamble to the proposed regulations highlighted several bright-line cases for which a facts-and-circumstances analysis would not be required. At a minimum, these items should be excluded from the definition of "cash."

Potential for Double Taxation

A key goal of tax reform was moving the U.S. toward a territorial tax system to address the lockout effect. To achieve this goal, Section 965 immediately imposes a U.S. tax on untaxed foreign income, effectively capturing all earnings that would have been subject to tax under the old system. However, the proposed regulations' approach may subject some of these earnings to double taxation.

Specifically, when foreign funds are distributed from a "specified foreign corporation"[10] to a U.S. shareholder between the two measurement dates (November 2, 2017 and December 31, 2017), the proposed regulations provide that the same funds are as a distribution and also subject to tax under Section 965.

A simple example illustrates the potential for double taxation. Assume USP, a domestic corporation, owns all the stock of CFC1, a foreign corporation. CFC1's tax year ends on November 30th. As of November 1, 2017, CFC1 had $80 of foreign earnings that had not been subject to U.S. tax. On November 3, 2017 CFC1 paid an $80 dividend to USP. Because of this dividend, CFC1 had no earnings left as of November 30th. The November 3rd distribution is taxed by the U.S. as a dividend. For purposes of Sec 965, CFC1's accumulated E&P as of November 2nd is $80 and is $0 as of Dec 31, making its Sec 965(a) inclusion amount $80 (the greater of the earnings available on the two measurement dates). Without any other adjustments for double counting, the $80 of earnings will be taxed twice – once when it was distributed to the USP, and once under Section 965.

The proposed regulations' approach would subject earnings that have already been taxed by the U.S. to an additional layer of tax. This represents a dramatic expansion of the U.S. tax net. Prior to enactment of the TCJA, foreign earnings were subject to tax in the United States only once – when distributed to a U.S. shareholder (assuming an anti-deferral rule did not accelerate the timing of the inclusion).[11]

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[9] *See, e.g.*, Treas. Reg. sec. 1.701-2(b) (even though the transaction may fall within the literal words of a particular statutory or regulatory provision, *the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K* . . . "); Treas. Reg. sec. 1.355-2(b) ("Section 355 applies to a transaction only if it is carried out for one or more corporate business purposes.").

[10] The proposed regulations define this term as (i) any controlled foreign corporation and (regardless of whether there is a domestic corporate shareholder) and (ii) any foreign corporation with respect to which one or more domestic corporations is a United States shareholder.

[11] Under prior law, an optional second level of tax could apply if the U.S. corporation receiving the foreign dividend distributed those funds. However, the tax law does not compel the distribution of dividends. Contrast this result with the approach outlined in the proposed regulations, where the same funds could be taxed three times: immediately under Section 965, when distributed to the U.S. corporation between the measurement dates, and again if distributed to shareholders.

Clearly this result is inconsistent with decades of tax policy norms and the purpose of the transition tax. Previously untaxed foreign earnings should only be subject to U.S. taxation once, as a means to put all taxpayers on equal footing as we transition to a territorial tax system.

Overstating the amount of income subject to Section 965

As noted above, Section 965 allows U.S. shareholders to net accumulated E&P in one corporation against an E&P deficit in another corporation. The statutory language specifically excludes previously taxed income ("PTI") from the calculation of E&P when a corporation does, in fact, have net positive E&P, which the proposed regulations refer to as a "deferred foreign income corporation" ("DFIC"). However, the statute is silent regarding the treatment of PTI when a corporation has an E&P deficit.

The NAM urges Treasury to adopt a position that disregards PTI in determining whether a corporate has an E&P deficit. Such an approach would provide a consistent set of rules for DFICs and E&P deficit corporations. Moreover, the legislative history indicates that excluding PTI would be consistent with Congressional intent. In describing the purpose of Section 965, the House Committee on Ways and Means report on the TCJA states that a shareholder "must include in income its pro rata share of the accumulated post-1986 deferred foreign income *which was not previously taxed*."[12]

In addition, excluding PTI from the deficit calculation would help ensure that the same income is not taxed twice. Recall that PTI is, by definition, income that has already been taxed by the United States. Consider the following simple example: USP owns CFC1 and CFC2. CFC1 has $100 of E&P. CFC2 has $60 of PTI and an E&P deficit of $60. In the aggregate, there is only $40 of E&P that has not already been subject to U.S. tax. If PTI is included in the deficit calculation, USP will have $100 subject to tax under Section 965. While the section allows taxpayers to offset income and deficits, CFC2's PTI would offset its deficit, and the full amount of CFC1's E&P would be subject to tax. However, if PTI is excluded from the deficit calculation, USP would have $40 subject to tax, because the deficit in CFC2 could be used to offset the E&P in CFC1 – capturing the full amount of untaxed earnings in the group.

While the statutory language does not address the treatment of PTI in deficit corporations, silence on the issue should be interpreted as a simple failure of Congress to provide guidance one way or the other. In that case, the broad grant of regulatory authority in Section 965(o) gives Treasury and the IRS the ability to implement the policy in a way that is clearly aligned with Congressional intent and achieves the most reasonable measurement of a taxpayer's E&P for purposes of calculating the transition tax.

As a corresponding matter, we note that the manner in which the proposed regulations net E&P deficits among DFICs may act as a disincentive to repatriation. The aggregate deficit is allocated among DFICs in proportion to each DFIC's contribution to the aggregate deferred foreign income. This allocation is treated as PTI; however, there is no corresponding increase in the basis of the DFIC stock, as would typically occur under the rules of Section 961(a). Consequently, when the DFIC later distributes this zero-basis PTI to its U.S. shareholder, the corresponding basis decrease required by Section 961(b)(1) would trigger a capital gain under Section 961(b)(2). As a result, taxpayers would be incentivized to leave cash offshore rather than repatriating it and triggering a U.S. tax liability. This result is contrary to Congress's stated

[12] H. Rept. 115-409 at 375 (emphasis added).

purpose for enacting Section 965 and the territorial system. We urge Treasury to re-examine the approach taken in the proposed regulations.

Consolidated Return Issues

The proposed regulations do not treat members of a consolidated group as a single entity for purposes of computing the taxpayer's aggregate foreign cash position.

This is directly contrary to IRS guidance issued immediately after the enactment of the TCJA. In Notice 2018-07, the IRS stated that "the Treasury Department and the IRS intend to issue regulations providing that, solely with respect to the calculation of the amount included in gross income by a consolidated group . . . by reason of section 965(a), all of the members of a consolidated group . . . will be treated as a single United States shareholder."[13] Taking a position that is in direct contravention to earlier guidance creates a significant administrative burden for taxpayers who relied on the IRS's earlier pronouncement.

Accordingly, the NAM urges Treasury to revise its final rules consistent with the intent expressed in Notice 2018-07.

The Treatment of Overpayments

As noted above, recent IRS guidance provides that overpayments of corporate income tax (including excess payments of estimated tax) will not be refunded to taxpayers but will be applied to the taxpayer's Section 965 tax liability until that liability is completely extinguished. This policy has the effect of negating the legislative intent of spreading the cash impact of Section 965 evidenced by the installment payment provision of the law. This policy should be reversed. A taxpayer should be allowed a refund of any overpayment of estimated tax that remains after applying the payment to the taxpayer's income tax liability for its non-Section 965 income plus its current installment payment of transition tax liability. Continuing the policy of denying refunds would frustrate the intent of the Congress when it allowed payment of the transition tax liability in installments.

Foreign Tax Credit Issues

Section 965 prohibits a taxpayer from fully using foreign tax credits ("FTCs") generated from the deemed inclusion of previously unrepatriated foreign earnings to reduce the transition tax liability.[14] However, as drafted, the proposed regulations appear to extend the scope of this provision to disallow FTCs when earnings taxed under Section 965 are distributed in the future.

Specifically, when an E&P deficit in one corporation is applied to reduce a DFIC's E&P, the amount of the deficit is treated as PTI. Under the foreign tax credit rules a distribution of PTI brings with it associated foreign tax credits. The deficit allocated to the DFIC's E&P reduces the amount of the deemed distribution to the United States under Section 965, presumably leaving the FTCs associated with the PTI in the DFIC available for future use.

[13] Notice 2018-07.
[14] H. Rept. 115-409 at 615 ("A portion of foreign income tax that is deemed paid or accrued with respect to the [Section 965 amount] is not creditable or deductible against the Federal income tax attributable to the inclusion.").

Yet the proposed regulations adopt an approach that appears to eliminate these FTCs. Such an approach increases the cost of repatriating funds that have already been subject to U.S. tax, which is contrary to the intent of adopting a territorial tax system. As a result, the NAM urges Treasury to clarify that companies do not lose credits for foreign taxes imposed on distributions of earnings that have already been subject to the transition tax.

In addition, we urge the IRS to address an unintended negative effect of prior guidance on accounting method changes. Section 8.02(5) of Revenue Procedure 2015-13 provides that the IRS can change a foreign corporation's method of accounting if the foreign corporation's U.S. shareholders include FTCs in an amount that exceeds 150 percent of the average amount of foreign taxes deemed paid by the U.S. shareholders during the prior three taxable years. This provision was intended to prevent taxpayers from adopting methods of accounting that inappropriately increase FTCs. However, the one-time inclusion of foreign income and associated taxes pursuant to Section 965 may cause a shareholder to exceed the 150 percent threshold – by merely complying with the law. We urge the IRS and Treasury to clarify that taxpayers may continue to rely on their methods of accounting.

Thank you for the opportunity to comment. If you have questions or would like to discuss this matter further, please contact me at 202-637-3077.

Sincerely,

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cc: The Honorable David Kautter, U.S. Department of Treasury