NATIONAL ASSOCIATION OF Manufacturers

Chris Netram

Vice President
Tax and Domestic Economic Policy

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Internal Revenue Service
Attn: CC:PA:LPD:PR (REG-105600-18)
Room 5203
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments Related to the Foreign Tax Credit and Global Intangible Low-Taxed Income

On behalf of the National Association of Manufacturers (NAM), this letter offers comments in response to REG-105600-18, guidance related to the foreign tax credit, including guidance implementing changes made by the *Tax Cuts and Jobs Act* (TCJA).[1] 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 tax reform legislation has the intended effect of spurring economic growth and innovation.

<u>Treasury Should Adopt an Approach that Effectuates Congressional Intent</u>

The TCJA moved the United States away from its decades-old “worldwide” system for taxing international income. Under the old system, all of a U.S. company’s earnings were subject to U.S. tax, irrespective of the country in which they were 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.

In an effort to protect the U.S. tax base, the TCJA adopted an anti-base erosion provision called Global Intangible Low-Taxed Income, codified as new Section 951A.[2] Under this new section of the tax code, a U.S. taxpayer with a controlled foreign corporation (CFC) must include certain earnings in its U.S. income irrespective of whether the funds have been distributed to the ultimate U.S. taxpayer. According to the legislative history of Section 951A, the income subject to this inclusion is similar in nature to subpart F income.[3]

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[1] Pub. L. No. 115-97.
[2] References herein to “Sections” are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), and the Treasury regulations (“Treasury Regulations” or “Treas. Regs.”), including the Proposed Regulations, promulgated thereunder.
[3] Joint Committee on Taxation, General Explanation of Public Law 115-97 at 368 (December 2018).

More specifically, a U.S. shareholder of a CFC must include in its gross income the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. The shareholder's net deemed tangible income return is an amount equal to 10 percent of the aggregate of the shareholder's pro rata share of the qualified business asset investment (QBAI) of each CFC with respect to which it is a U.S. shareholder over the amount of interest expense taken into account in determining its net CFC test income for the taxable year.[4]

Once the Global Intangible Low-Taxed Income inclusion has been calculated, it is included as part of the U.S. shareholder's taxable income and taxed at the corporate tax rate of 21 percent. The TCJA does provide for a 50 percent deduction of the Global Intangible Low-Taxed Income, resulting in a minimum tax of 13.125 percent on the foreign income. However, when the provision is integrated into the existing rules for taxing international income, taxpayers with high-taxed foreign income can face an *additional* U.S. tax on income that is subject to a foreign rate of tax well in excess of 13.125 percent.

Specifically, foreign tax credits (FTCs) are affected by Section 861 (the expense allocation rules), which was unchanged by the TCJA and requires deductions to be allocated to income to which they relate. This FTC limit is based on the ratio of foreign source income to worldwide taxable income, multiplied by a taxpayer's U.S. tax liability. This limit declines as expenses are allocated to foreign income, creating the potential for high-taxed foreign income to be subject to a Section 951A inclusion. An example drafted by a former Treasury Department International Tax Counsel illustrates that a company paying tax at a rate of 25 percent in a foreign country would still face an additional U.S. tax liability under Section 951A due to expense allocation.[5]

[4] H. Rept. No. 115-466 at 641, 644 (December 15, 2017).
[5] Michael Caballero and Isaac Wood, *Restoring a 'Not GILTI' Verdict for High-Taxed Income*, Tax Notes (Oct. 8, 2018).

> For example, consider a corporate U.S. shareholder with a CFC that has $200 in income and that is subject to foreign income tax at a 25 percent rate, resulting in $50 of total foreign tax and leaving the CFC with $150 in GILTI (assuming no QBAI). The U.S. shareholder pays U.S. tax on that $150 of GILTI and $50 deemed dividend under section 78, each at an effective rate of 10.5 percent, after taking account of the section 250 deduction, resulting in a total U.S. tax liability of $21. The CFC paid $50 in foreign taxes, of which $40 is deemed paid by the U.S. shareholder and is potentially creditable after application of the 20 percent haircut in section 960(d). The U.S. shareholder's foreign-source income will be $200, representing the $150 in GILTI plus $50 from the section 78 gross-up. Given an effective rate on GILTI income of 10.5 percent, the foreign tax credit limitation will permit the taxpayer to credit $21 of the foreign taxes, which is sufficient to eliminate the U.S. tax on GILTI.
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> Now consider the result if the U.S. shareholder has $400 in interest expense, and 10 percent of that amount is allocated to the GILTI basket. The U.S. shareholder's section 904 limitation will be $160, representing the $150 in GILTI, plus $50 from the section 78 gross-up, and minus $40 in allocable expenses. Given an effective U.S. tax rate on GILTI income of 10.5 percent, there would only be sufficient limitation in the GILTI basket to credit $16.80 of foreign taxes. Thus, the CFC would pay $50 in foreign taxes, while the U.S. shareholder would pay an additional $4.20 of U.S. tax on the same income, even though the foreign tax rate of 25 percent is higher than the statutory U.S. tax rate of 21 percent and much higher than the 13.125 percent rate above which the legislative history states that there will be "no residual U.S. tax owed."

This result is clearly inconsistent with Congressional intent. The legislative history of Section 951A indicates that Congress intended to limit the scope of this provision to exempt from additional U.S. taxation foreign earnings that are taxed beyond a threshold rate in the local country. As the TCJA conference committee report states, "The minimum foreign tax rate, with respect to [Global Intangible Low Tax Income], at which no U.S. residual tax is owed by a domestic corporation is 13.125 percent."[6]

In the proposed regulations, the Treasury Department generally applies the existing expense allocation rules to determine a taxpayer's Section 951A inclusion, which can result in a U.S. tax liability for foreign earnings taxed at more than a 13.125 percent rate in the local country. Manufacturers appreciate Treasury's willingness to mitigate this result by exempting certain income and assets "in the section 951A category that is offset by the deduction allowed under section 250(a)(1) for inclusions under section 951A(a) and a corresponding percentage of the stock of CFCs that generates such income.[7]" While this approach is a step in the right direction, it fails to fully reflect Congress' intent by potentially subjecting higher-taxed foreign earnings to an additional layer of U.S. tax.

In the absence of regulations that would exclude Section 951A amounts from the expense allocation rules (achieving a result that is consistent with Congressional intent), we would urge Treasury to craft regulations providing for an elective high-tax exception. Allowing this exception is consistent with the existing rules governing subpart F income. Under the tax code, taxpayers are given the option of electing a high-tax exception for subpart F income that faces an effective tax rate higher than 90 percent of the U.S. corporate tax rate or 18.9 percent.[8] As stated in the TCJA conference report, a U.S. taxpayer must include Section 951A amounts "in a manner generally similar to inclusions of subpart F income."[9] Accordingly, we believe that Treasury has the authority to provide for such an elective exception. For example, Treasury could provide a rebuttable presumption with respect to subpart F income or use the regulatory authority under Section 951(A)(f).[10]

Ideally, Treasury would give effect to the legislative intent of the provision and avoid imposing additional U.S. tax on earnings that are subject to a tax rate of at least 13.125 percent where earned. While a much better approach would be to allocate no expenses to Global Intangible Low-Taxed Income to enable the provision to work more like the minimum tax concept that Congress clearly intended, allowing for a high-tax exception would at least be similar to the subpart F high-tax exception and thereby allow taxpayers to essentially exclude high-taxed income from the Global Intangible Low-Taxed Income. Under the existing Section 954 subpart F high-tax exception, income that is taxed at a rate greater than 90 percent of the corporate rate (*i.e.*, 18.9 percent) is excluded from subpart F; Treasury should adopt a similar elective regime for Section 951A income. At the current U.S. corporate tax rate of 21 percent, a high-tax exception would allow a taxpayer to elect to exclude income that is taxed at a rate of 18.9 percent or more in the local jurisdiction from its 951A amount. Moreover, a failure to provide parallel exceptions for amounts included under Sections 954 and 951A would provide an

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[6] H. Rept. No. 115-466 at p. 626 (December 15, 2017). Also see Joint Committee on Taxation, General Explanation of Public Law 115-97 at 382 (December 2018).
[7] Preamble to REG-105600-18.
[8] Section 954(b)(4); Treas, Reg. § 1.954-1(d)
[9] H. Rept. 115-466 at 641
[10] *See* Michael Caballero and Isaac Wood, *Restoring a 'Not GILTI' Verdict for High-Taxed Income*, Tax Notes (Oct. 8, 2018).

incentive for taxpayers to restructure their operations such that income that would otherwise qualify as Global Intangible Low-Taxed Income instead be recharacterized as subpart F income.

Carryovers and Carrybacks of Unused Foreign Taxes

TCJA created a new FTC regime by expanding the number of FTC baskets. It splits the pre-TCJA general basket into new baskets, which include a general basket and a foreign branch basket. In adopting this new regime, the TCJA did not include transition rules with respect to carryforwards of pre-TCJA FTCs. In the proposed regulations, Treasury would allow taxpayers to keep their pre-TCJA general limitation carryforwards in the post-TCJA general basket. In addition, Treasury has proposed an exception that allows taxpayers to reallocate pre-TJCA general limitation carryforwards to the newly created foreign branch basket provided that taxpayers can demonstrate a basis for such a reallocation. We appreciate Treasury's approach and encourage Treasury to adopt this approach. As manufacturers previously noted, the alternative – a mandatory reallocation of old general limitation FTCs among the new general limitation, and foreign branch baskets – would penalize manufacturers for structures adopted years prior to the enactment of the TCJA and unduly burden manufacturers by requiring a retrospective tracing of the source of income at the entity level, potentially diverting significant time and resources from core operations.[11]

Treasury Should Issue Clarifying Guidance Relating to Research and Experimentation Expenses

With respect to FTCs and the Global Intangible Low-Taxed Income, Treasury should provide guidance making clear that the allocation and apportionment of U.S.-based research and experimentation (R&E) expenses is based on the ownership stake of the intellectual property (IP) arising from the R&E. More specifically, if the IP is owned by the U.S. taxpayer, then R&E expenses should be allocated to income generated by the U.S. taxpayer. If, however, the CFC has ownership stake in the IP, then it would accordingly be appropriate to allocate the R&E expenses to the CFC. In the case of the U.S. taxpayer contracting with a CFC for support functions (e.g. manufacturing support), R&E expense should be attributed to the U.S. taxpayer because the CFC's income does not result from a return from the IP but rather from its support functions.

Separately we would recommend that Treasury issue clarifying guidance with respect to the sales method and the gross income method. When it comes to allocating and apportioning U.S.-based R&E expenses under the sales method, the sales that should be taken into account are those generated by controlled or uncontrolled parties using IP in their products that is either licensed or sold by the taxpayer. Meanwhile the gross income method should reflect the exploitation of IP such as royalty income. Finally, consistent with the proposed regulation section 1.861-8(d)(2)(ii)(C)(1), Treasury should provide clarifying guidance that the gross income method is considered exempt income.

[11] Letter from the National Association of Manufacturers to the Honorable Steven Mnuchin. Secretary of the Treasury and the Honorable David Kautter, Assistant Secretary for Tax Policy (September 11, 2018).

Treasury Should Apply a Similar Rule for a Loan from a Partnership as One for a Specified Partnership Loan

The calculation of the foreign tax credit can be distorted in the case of a specified partnership loan whereby a taxpayer makes a loan to a partnership in which it also has an interest in the partnership. The distortion arises because the same taxpayer that is receiving the interest income is also incurring the interest expense. In response to the distortion, Treasury proposes to assign the interest income to the same groups as those that the interest expense is deducted[12] Unfortunately, Treasury does not apply the same rule for a loan being made by a partnership. In the case of a partnership and the borrower being part of the same affiliated group, the interest income would be attributed to the partners, but the interest expense would be treated differently as it would be assigned to different groupings as governed by the income sourcing rules.[13] We recommend that Treasury apply a similar rule for a loan from a partnership as one for a specified partnership loan.

Administrative Burden Associated with Adjustment of Foreign Branch Income Related to Disregarded Transactions

In an effort to prevent non-economic reallocations of income to the foreign branch category, Treasury proposes an adjustment of the foreign branch income relating to disregarded transactions such as IP transfers to or from a foreign branch[14]. While recognizing Treasury's tax-avoidance concern, the regulation as proposed covers transactions before the effective date of the regulation, which would result in a significant compliance burden for taxpayers. More specifically, the effort of trying to reconstruct past disregarded transactions would not only be costly but also may lead to inaccurate results. Taxpayers would also face an administrative burden in determining possible future reallocations. When finalizing this regulation we would urge Treasury to take into consideration the burden that would be placed on taxpayers as the regulation is currently proposed.

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,

Chris Netram

Vice President

Tax & Domestic Economic Policy

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[12] Prop. Treas. Reg. §1.861-9(e)(8)(ii).

[13] Section 861.

[14] Prop. Treas. Reg. §1.904-4(f)(2)(vi)(D).