March 26, 2019

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Proposed Guidance Related to the Foreign Tax Credit (REG-105600-18)

Dear Commissioner Rettig and Mr. Desmond:

The American Institute of CPAs (AICPA) appreciates the opportunity to submit the following recommendations related to the proposed regulations titled "Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act (TCJA)."

Our recommendations address the following areas:

I. Determination of Stock Basis in Connection with Section 965(b)[1]
II. Allocation and Apportionment of Research and Experimentation Expenses
III. Characterizing the Stock of a Noncontrolled 10-percent Corporation
IV. Attributing Current Year Taxes to a Controlled Foreign Corporation's Earnings and Profits Described in Section 959(c)(3)
V. Modify the Definition of an "Exempt Asset" as it Relates to Assets that Generate Foreign-Derived Intangible Income
VI. Clarify When a Withholding Tax Imposed on a Disregarded Dividend is Related to a Subpart F or Tested Income Group

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The AICPA is the world's largest member association representing the accounting profession, with more than 431,000 members in 137 countries and territories, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. Please contact Philip Pasmanik, Chair, AICPA International Taxation Technical Resource Panel, at (212) 686-7160, ext. 156 or Philip.Pasmanik@hertzherson.com; Jonathan

[1] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

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Respectfully submitted,

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Chair, AICPA Tax Executive Committee

cc: Mr. Douglas L. Poms, International Tax Counsel, Department of the Treasury
Ms. Margaret O'Connor, Acting Associate Chief Counsel (International), Internal Revenue Service
Ms. Anne Devereaux, Deputy Associate Chief Counsel (International), Internal Revenue Service
Mr. Daniel M. McCall, Deputy Associate Chief Counsel (International – Technical), Internal Revenue Service

AMERICAN INSTITUTE OF CPAS

Proposed Guidance Related to the Foreign Tax Credit (REG-105600-18)

March 26, 2019

I. Determination of Stock Basis in Connection with Section 965(b)[2]

Overview

Stock of a corporation is generally taken into account in applying the asset method for purposes of apportioning a taxpayer's interest expense. For this purpose, a taxpayer's adjusted basis in the stock of a 10-percent owned corporation is increased (or decreased) by an amount of earnings and profits attributed to such stock and accumulated in periods while the taxpayer or member of its affiliated group held the stock.

Recommendation

The American Institute of CPAs (AICPA) recommends that the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) clarify that the adjusted basis of the stock of a specified foreign corporation (SFC) to which a reduction is made pursuant to Prop. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) includes the earnings and profits of the SFC and its lower tier 10-percent owned corporations. Alternatively, the final regulations should allow for a reduction to the earnings and profits in lieu of a reduction to the stock's adjusted basis.

Analysis

Pursuant to section 965(b)(4)(B) and Treas. Reg. § 1.965-2(d)(2), the earnings and profits (E&P) of an E&P deficit foreign corporation is increased by its United States (U.S.) shareholder's pro-rata share of its specified earnings and profits deficit. Treasury and the IRS, acknowledging that this increase to earnings and profits could artificially inflate the tax book value of an SFC, allowed for a reduction to the adjusted basis of the stock in an amount equal to the increase in earnings and profits (i.e., as if the election under Treas. Reg. § 1.965-2(f)(2)(i) was made) for purposes of applying the asset method described in Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii). Under that election, the stock of an E&P deficit foreign corporation is generally reduced by the amount of its increase to earnings and profits under section 965(b)(4)(B) (i.e., the amount of the U.S. shareholder's pro-rata share of its specified earnings and profits deficit).

However, this rule does not entirely address the potential for a non-economic increase to the tax book value of an SFC. For example, assume that USP, a domestic corporation, wholly-owns SFC1, a foreign corporation. SFC1 wholly-owns SFC2, also a foreign corporation. USP's adjusted basis in its SFC1 stock is $0. SFC1 has earnings and profits of $100 attributable to its stock which was accumulated while USP held all of the stock of SFC1. SFC2 has a deficit of earnings and profits of $100, also attributable to its stock and accumulated while USP held all of

[2] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

the SFC2 stock. Prior to the passage of the TCJA, the tax book value of SFC1's stock was $0. However, post-TCJA and notwithstanding an adjustment for earnings and profits under Prop. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii), it is unclear if the tax book value of SFC1 is $100. Proposed Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) is not clear on whether any basis reduction is allowed, potentially creating the above result. Should the basis reduction only apply to USP's adjusted basis in its SFC1 stock before the adjustment for its earnings and profits, it appears that no basis reduction is allowed. Thus, allowing USP to compute its tax book value of SFC1 as if it had made the election under Treas. Reg. § 1.965-2(f)(2)(i) does not alleviate the issue that SFC1's tax book value is overstated.

To address the overstatement in book value, we suggest that the final regulations provide for one of the following options:

- clarify that the determination of the appropriate adjusted basis to which the reduction is allowed occurs after the adjustment for the attributable earnings and profits; or
- allow taxpayers to compute the adjustment for the attributable earnings and profits without taking into account the increase to an E&P deficit foreign corporation's earnings and profit under section 965(b)(4)(B) and Treas. Reg. § 1.965-2(d)(2).

II. Allocation and Apportionment of Research and Experimentation Expenses

Overview

Under the sales method of Treas. Reg. § 1.861-17(c), any research and experimentation (R&E) deductions not apportioned under the rules for legally mandated R&E expenses and exclusive apportionment are apportioned to the residual groupings and/or the statutory grouping. The apportionment is based on the sales from the relevant product categories that resulted in gross income within the same grouping. For this purpose, the sales comprising the apportionment base include sales of controlled corporations to the extent such corporations are reasonably expected to benefit from the taxpayer's R&E activities. Generally, the regulations provide that a controlled corporation is reasonably expected to benefit from a taxpayer's R&E activities if the taxpayer licenses the resulting intellectual property to such controlled corporation.

Recommendation

The AICPA recommends that for purposes of Treas. Reg. § 1.861-17 covering the allocation and apportionment of R&E expenses, the final regulations treat sales income of a Controlled Foreign Corporation (CFC) in a controlled group of corporations as gross income in the general and section 951A residual groupings, with a portion of the sales income allocated to the section 951A residual grouping included in the section 245A category.

Analysis

The current regulations appear to over-allocate income to the statutory grouping. A CFC cannot earn section 951A category income. Therefore, it appears that all sales of a CFC result in gross income within the general statutory grouping. This treatment likely results in an over-allocation

of R&E expenses to the general statutory grouping. This over-allocation occurs because most, if not all, of the sales income will generally result in gross income at the taxpayer level that is either within the section 951A category or is never included in the taxpayer's gross income because it is eligible for the section 245A dividends received deduction (DRD) upon distribution. Prior to the passage of the TCJA, sales income received as royalties from a CFC, paid out as a dividend by a CFC or treated as subpart F income of a CFC were included in the general residual grouping. However, post-TCJA, the means by which the taxpayer takes into account the gross income affects the category of such income.

To account for this change and the potential over-allocation and apportionment of R&E expense to the general statutory grouping, we recommend modifying Treas. Reg. § 1.861-17(c) to instead allocate and apportion at least a portion of the taxpayer's R&E expenses to the section 951A residual grouping and thus treat a portion of the R&E expenses as deductions described in section 904(b)(4)(B). This change should apply to the extent a CFC subsidiary of the taxpayer is benefitting from the taxpayer's R&E activities.

III. Characterizing the Stock of a Noncontrolled 10-percent Corporation

Overview

Generally, the interest expense allocation and apportionment rules require a taxpayer to categorize its stock in its foreign subsidiaries based on the type of income to which the stock gives rise. Under Prop. Reg. § 1.904(b)-3(c)(2), the stock of a noncontrolled 10-percent corporation held by a taxpayer is included in the section 245A subgroup in the relevant statutory or residual grouping. This rule follows the general principle that stock is categorized based on the type of income to which the stock gives rise. To the extent dividends from the noncontrolled 10-percent corporation give rise to dividends that are eligible for the section 245A deduction, the stock is properly assigned to the section 245A category.

Recommendation

The AICPA recommends that Treasury and the IRS modify step 1 of Prop. Reg. § 1.861-13 to categorize the stock of a noncontrolled 10-percent owned foreign corporation held by a CFC in the specified foreign source income grouping to the extent its distributions are eligible for the section 245A DRD applied at the CFC level.

Analysis

The interest expense allocation and apportionment rules diverge from the general principle described in the overview above when categorizing CFC stock that holds a noncontrolled 10-percent corporation. If a taxpayer, instead of holding stock of a noncontrolled 10-percent corporation directly, contributes its interest in that 10-percent corporation to a wholly-owned CFC, under Prop. Reg. § 1.861-13(a)(1), the stock of the noncontrolled 10-percent corporation held by the CFC is assigned to the gross subpart F income grouping. This result is due to the likelihood that the noncontrolled 10-percent corporation's assets generate income that if distributed to the CFC, is classified as gross subpart F income. Thus, if the CFC only holds stock of a noncontrolled

10-percent corporation, its stock is assigned to the gross subpart F income grouping and is ineligible for assignment to the relevant section 245A subgroup. This treatment occurs even though the dividends paid by the noncontrolled 10-percent corporation to the CFC should not result in a subpart F inclusion since the CFC is likely entitled to the section 245A deduction for purposes of determining its net subpart F income under Treas. Reg. § 1.952-2. Although the only income generated from the CFC stock is likely dividend income eligible for section 245A, the stock is categorized in the general statutory grouping and in a non-245A subgroup.

Accordingly, we recommend modifying step 1 of Prop. Reg. § 1.861-13 to categorize the stock of a noncontrolled 10-percent owned foreign corporation in the specified foreign source income grouping to the extent its distributions are eligible for the section 245A DRD applied at the CFC level.

IV. Attributing Current Year Taxes to a Controlled Foreign Corporation's Earnings and Profits Described in Section 959(c)(3)

Overview

Proposed Reg. § 1.960-2(c)(5) reduces a domestic corporation's proportionate share of tested foreign income taxes to zero if either the domestic corporation's inclusion under section 951A(c)(1)(A) (the numerator) or the tested income group's tested income (the denominator) is zero or less. As a result, the earnings and profits of a CFC with positive tested income is not moved to a previously taxed earnings and profits (PTEP) group and is instead allocated to the residual group.

Recommendation

The AICPA recommends that Treasury and the IRS allow a proportionate carryforward of the foreign taxes allocable to a CFC's earnings and profits that are not treated as PTEP due to the application of Prop. Reg. § 1.960-2(c)(5). We also recommend that those earnings and profits are subject to U.S. tax in a subsequent year as a dividend and not eligible for the section 245A deduction.

Analysis

Under Prop. Reg. § 1.960-2(c)(5), a CFC's earnings and profits subject to foreign tax is not treated as PTEP under certain circumstances related to the application of the Qualified Business Asset Investment (QBAI) test or the use of an offsetting tested loss from another commonly owned CFC. However, if these earnings and profits are paid out by the CFC as a dividend in a subsequent year and not eligible for the section 245A deduction, they are subject to double taxation. This issue is illustrated by the following two examples.

Example 1

USP owns 100% of the stock of CFC1. Both USP and CFC1 use a calendar year as their taxable year. In year 1, CFC1 has $100 of net tested income and $1,200 of QBAI. CFC1 paid or accrued $25 of foreign tax. USP's Global Intangible Low-Taxed Income (GILTI) inclusion in year 1 is $0 because the tested income of CFC1 is equal to or less than 10% of the QBAI. Thus, USP's deemed paid tax under Prop. Reg. § 1.960-2(c)(5) is $0 and none of the tested income is moved to the PTEP group.

Example 2

USP owns 100% of the stock of both CFC1 and CFC2. USP, CFC1 and CFC2 all use a calendar year as their taxable year. In year 1, CFC1 has $100 of net tested income and $0 of QBAI. CFC2 has a net tested loss of $100. USP's GILTI inclusion in year 1 is $0 because the group net tested income is $0. Thus, USP's proportionate share of tested foreign income is $0 and there is no deemed paid tax or PTEP group increase.

In both examples, a distribution from CFC1 to USP in a subsequent year would result in a dividend subject to tax with no corresponding foreign tax credit. In addition, a deduction under section 245A is not available for this dividend. As a result, with no deemed paid taxes in a prior year and no available carryover, the earnings and profits from CFC1 is subject to double tax.

We recommend that the final regulations provide a carryforward credit for a proportionate share of foreign taxes allocable to a CFC's earnings and profits subject to U.S. taxation in subsequent years that are not included in taxable income when earned as a result of Prop. Reg. § 1.960-2(c)(5).

V. Modify the Definition of an "Exempt Asset" as it Relates to Assets that Generate Foreign-Derived Intangible Income

Overview

Under section 864(e)(3), a tax-exempt asset is not taken into account for purposes of allocating and apportioning a taxpayer's expenses. Proposed Reg. § 1.861-8(d)(2)(ii)(C)(2)(i) defines a tax-exempt asset to include "the portion of a domestic corporation's assets that produce gross income included in foreign-derived intangible income…"

Recommendation

The AICPA recommends that Treasury and the IRS modify the definition for tax-exempt assets to include assets that produce foreign-derived deduction eligible income rather than assets that produce foreign-derived intangible income.

Analysis

Foreign-derived intangible income is calculated based on a ratio, and it is unclear which assets produce the gross income included in foreign-derived intangible income. This ambiguity will not exist if the proposed regulations are modified to define a tax-exempt asset to include the portion of a domestic corporation's assets that produce *foreign-derived deduction eligible income*. As part of this modification, Treasury and the IRS should consider whether to reduce the amount of assets treated as tax-exempt assets by the ratio of foreign-derived deduction eligible income to the deduction eligible income.

VI. Clarify When a Withholding Tax Imposed on a Disregarded Dividend is Related to a Subpart F or Tested Income Group

Overview

Under Prop. Reg. § 1.960-1(d)(3)(ii)(B)(2), a withholding tax imposed on a disregarded payment made to a CFC owner is considered a timing difference. Therefore, the proposed regulations state that it is never related to a PTEP group but may relate to a subpart F income group or a tested income group.

Recommendation

The AICPA recommends that Treasury and the IRS clarify the application of the timing difference rules to withholding taxes imposed on disregarded dividends to a CFC owner and provide specific examples illustrating their proper application.

Analysis

It is unclear from the proposed regulations under what circumstances a withholding tax imposed on a disregarded distribution to a CFC owner is related to a subpart F or tested income group. For example, assume a disregarded entity (DRE) pays a dividend to its CFC owner and the DRE's country of residence imposes a withholding tax on the dividend. There are several possible methods the taxpayer could use to assign the withholding tax to the proper income group. For example, a taxpayer could look to the type of income the DRE generated in the past. If only tested income is generated, the withholding tax is assigned to the tested income group. However, such a rule would place a heavy burden on the taxpayer, requiring them to separately track the types of income all of its DREs have earned in the past. Alternatively, one could assign the withholding tax to the same income group as the type of income the DRE earns in the current year, regardless of whether the distribution is made out of the DRE's current or historic earnings. Finally, the taxpayer could assign the withholding tax to an income group based on the CFC's own current year income, ignoring the type of income actually earned by the DRE. We recommend that Treasury and the IRS clarify the application of the timing difference rules to withholding taxes imposed on disregarded dividends to a CFC owner and provide examples illustrating their proper application.