November 15, 2018

Internal Revenue Service
CC:PA:LPD:PR (REG-104390-18)
Room 5203, Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Proposed Regulations under Section 951A

Ladies and Gentlemen:

This letter provides comments on behalf of the Securities Industry and Financial Markets Association ("SIFMA")[1] regarding the proposed GILTI regulations.

Our recommendations are set out below. The attached paper describes the rationale for the recommendations, provides examples illustrating the need for them, and sets out suggested language to implement them.

We recommend that:

1. A basis adjustment rule that is designed to prevent taxpayers from applying a single economic loss to derive tax benefits twice should not apply when its effect would be to prevent taxpayers from using the loss even once.

2. With respect to the exception for qualified interest expense,

    a. A double-counting issue affecting related-party loans should be corrected; and

    b. Interest expense should be treated as qualified interest only if and to the extent that the taxpayer establishes to the satisfaction of the Secretary that the expense falls into this category.

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

We acknowledge the extraordinary burdens that have been placed on the Internal Revenue Service and the Treasury Department as a result of the need to prescribe timely guidance concerning the changes enacted as part of the Tax Cuts and Jobs Act ("TCJA") (P.L. 115-97). We commend the drafters for their efforts, and for the progress that they have made.

The changes made by the TCJA are extensive and interrelated. Some of the issues that are most important to us have not yet been addressed in proposed regulations. It is possible that forthcoming guidance will interact with the GILTI rules in ways that affect the recommendations set out in this letter. We will submit supplemental comments if this proves to be the case.

We very much appreciate the opportunity to comment on the proposed regulations. Please let me know if you have questions, or would like to discuss our comments in more detail.

Sincerely,

Payson R Peabody

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COMMENTS ON PROPOSED GILTI REGULATIONS

A. RECOMMENDATIONS.

1. A basis adjustment rule that is designed to prevent taxpayers from applying a single economic loss to produce duplicative benefits should not apply when its effect would be to prevent taxpayers from using the loss even once.

2. With respect to the exception for qualified interest expense,

   a. A double-counting issue affecting related-party loans should be corrected; and

   b. Interest expense should be treated as qualified interest only if and to the extent that the taxpayer establishes to the satisfaction of the Secretary that the expense falls into this category.

B. DISCUSSION.

1. Basis adjustment for tested losses.

The proposed regulations provide for basis adjustments that are intended to prevent taxpayers from deriving duplicative benefits in respect of a single tested loss. As drafted, however, the mechanism could result in the disallowance of *any* relief for very real economic losses sustained by the taxpayer. The potential for this unfair result can be minimized, without jeopardizing the drafters' policy objective, by applying the basis adjustment rule only in cases where the prior use of a tested loss actually has produced tax savings. The suggested language in section D.1 would allow taxpayers to elect not to make use of tested losses to reduce tested income.[2] This represents one possible means of preventing duplicative benefits without unfairness.

2. Qualified interest.

Congress was concerned that taxpayers would seek to minimize GILTI inclusions, and to maximize the amount of foreign earnings eligible for exemption under section 245A, by artificially increasing the amount of their CFCs' investments in tangible property.[3] The statute addresses this concern by providing an interest offset rule under which the deemed return on

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2 The consolidated return regulations provide a similar rule for a similar purpose. Under Treasury regulations §1502-31(e), a loss carryover will not result in a negative stock basis adjustment if the taxpayer makes an irrevocable election to treat the carryover as having expired immediately before a group structure change.

3 This concern is manifested not only by the interest offset rule discussed in this section, but also by the grant of regulatory authority to prevent the use of temporary investments in tangible property to reduce GILTI inclusions. See section 951A(d)(4) and Proposed regulations §1.951A-3(h).

tangible property held by a CFC generally must be reduced by interest expense incurred by the CFC.[4]

The proposed regulations provide an exception for qualified interest expense.[5] We have two concerns about the exception:

a. Double-counting of related-party loans.

The proposed regulations appear to require taxpayers to make two unfavorable adjustments in respect of a single income-generating asset. This double-counting problem should be corrected.

The amount of a CFC's qualified interest expense is determined in a two-step process:

- First, a CFC must apportion its interest expense between specified 'qualified' assets (financial instruments that give rise to income that constitutes active financing income described in section 954(h)) and all other assets.[6] The proposed regulations provide that related-party loans don't count as good assets for purposes of this computation.

- Second, interest expense allocable to qualified assets (as determined in the first step) is *reduced* by interest income on related-party loans that qualifies for the same-country or look-thru exceptions under sections 954(c)(3) or (6). Since interest expense allocable to related-party loans has already been subtracted in the first step, the second-step adjustment necessarily relates to interest expense that is allocable to some other asset.

b. Establishing the amount of qualified interest.

We recommend that the existence and amount of qualified interest be determined using as "establish to the satisfaction of the Secretary" standard. Taxpayers that expect to derive meaningful benefits from the exception of course would make the computations required to

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[4] Section 951A(b)(1)(B).
[5] Proposed Treasury regulations §1.951A-4(c)(1)(iii). The purpose of this exception is not completely clear. Under the proposed regulations, "specified interest expense" (*i.e.*, the amount that must be applied to reduce the deemed return on tangible property) is determined on a net basis. Specified interest expense is the amount, if any, by which "tested interest expense" exceeds "tested interest income". Tested interest income and expense are defined not to include qualified interest income and expense. Thus, what may have been intended as a narrowly-drafted but favorable exception for active financial businesses in practice appears to be more restrictive than the rule that applies to all other taxpayers. The preamble doesn't discuss the rationale for providing two distinct netting rules. The preamble's discussion of the treatment of interest expense also does not appear to be fully consistent with the text of the proposed regulations.
[6] Banks and other financial services companies typically rely on the subpart F exceptions for income derived by active securities and derivatives dealers (sections 954(c)(1)(A) and (c)(2)(C)) as well as on the active financing exception (section 954(h)). The proposed regulations' failure to refer to the dealer exception—which we assume represents an oversight—should be corrected.

establish their entitlement to it. Taxpayers that are not in this position should be permitted to make the simplifying assumption that none of their interest expense constitutes qualified interest.

This would eliminate the need to make burdensome computations in order to identify what in the best case is likely to be an insignificant sliver of tax-advantaged expense. It is easy to imagine circumstances in which the cost of making those computations would exceed the benefit, if any, of the resulting relief.

In particular, many financial services companies won't benefit from the qualified interest exception, because their business model doesn't require them to hold significant tangible property, and they are highly leveraged. As shown in Example 4, the combined effect of these characteristics will be to reduce or eliminate the benefit of the exception: a very small percentage of an extremely large number [interest expense that is *not* allocable to qualified assets] easily could exceed a larger percentage of a much smaller number [the deemed return on tangible property].

C. EXAMPLES.

In the following examples, a U.S. financial services company ("Parent") conducts business outside the United States through substantial foreign operating subsidiaries.[7] The subsidiaries are regulated banks and broker-dealers. Their assets consist predominantly of financial instruments—loans, securities and derivatives—held in the conduct of an active financial business.

The subsidiaries own $200 billion of financial assets, and only $250 million of tangible property. The subsidiaries are highly leveraged: they are funded with $180 billion of debt and $20 billion of equity. The subsidiaries' assets produce an average return of 4%; their debt has an average cost of 3.5%. Thus, assuming for convenience that the subsidiaries do not have any other expenses, they will have net income, before foreign taxes, of $1.7 billion (4% of $200 billion minus 3.5% of $180 billion). None of that income is subpart F income.

Examples 1 and 2 involve cases in which the basis adjustment rule could prevent Parent from deriving any benefit from real economic losses sustained on the disposition of its interest in a loss-making foreign subsidiary. In Example 1, this is because Parent's profitable foreign operations are high-taxed, and the subsidiary's losses don't produce any U.S. tax savings. Example 2 illustrates a fact pattern in which the basis adjustment rule can trigger duplicative adjustments in respect of the same loss. Example 3 involves the double-counting of expenses attributable to related-party loans. Example 4 illustrates the implications of the relationship between interest expense and tangible property.

[7] The examples use simplified facts for ease of illustration. The complications illustrated by the examples can be magnified in the context of real-world fact patterns.

1. Example 1: Tested losses not usable because tested income is high-taxed.

Parent pays $1 billion to acquire an unrelated foreign bank ("Target") in a region where it has not previously conducted activities. The acquisition is a catastrophic failure. Target incurs losses of $100 million annually for five years. Parent decides to cut its losses, and sells Target for $500 million. Parent has lost 50% of its original investment, or $500 million.

During that period, Parent's other foreign subsidiaries continue to earn substantial profits. The subsidiaries are located in major financial centers, where their income is subject to foreign tax at an average rate of 25%. They don't derive any foreign tax benefit in respect of Target's losses, and continue to pay foreign tax on their own income, without any offset for Target's losses, at the 25% rate (for total foreign tax payments of $425 million).

Prior to its acquisition of Target, Parent had GILTI of $1.7 billion. It had no residual U.S. tax liability after foreign tax credits, and excess credits in the GILTI category of $161.5 million.

The application of Target's tested losses to reduce GILTI from $1.7 billion to $1.6 billion will not affect Parent's federal income tax liability.[8] Parent's GILTI will continue to be fully sheltered by foreign tax credits, and it will have an even deeper pool of unusable excess credits.[9]

Parent should not be required to reduce its basis in Target's shares to take account of losses incurred by Target that it will never be able to use.

2. Example 2: Duplicative basis adjustments produce distortions.

Parent owns $Bank_1$ and $Bank_2$. Parent has a basis of $500 million in the stock of each subsidiary.

In year 1, $Bank_1$ makes $100 million, and $Bank_2$ loses $90 million. Parent has a $10 million GILTI inclusion ($100 million $Bank_1$ tested income minus $90 million $Bank_2$ tested loss), and a $90 million used tested loss amount in respect of $Bank_2$.

In year 2, Parent sells $Bank_2$ for $410 million. Parent will not recognize a loss, because its basis in the stock of $Bank_2$ will be reduced, immediately prior to the sale, by the $90 million used tested loss amount.

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[8] Target's losses could have indirect consequences for Parent's U.S. tax liability (for example, if expenses incurred by Parent in respect of shares in loss-making subsidiaries are not allocable to the GILTI category).

[9] Parent will continue to incur foreign tax costs of $425 million. If its GILTI is reduced to $1.6 billion ($1.7 billion from other foreign subsidiaries minus $100 million Target loss), then it will be able to use $168 million of foreign tax credits (taxable income of $800 million after section 250 deduction x 21% tax rate), and will have $172 million of excess credits ($340 million creditable foreign taxes foreign tax after $20% haircut minus $168 million credits).

In year 3, $Bank_1$ pays a $100 million dividend to Parent. The distribution will not be subject to U.S. tax under section 245A ($90 million) and section 959 ($10 million).

In year 4, Parent sells $Bank_1$ for $410 million. (The sales price reflects a downturn in market conditions, and is not attributable to any losses incurred by $Bank_1$.) Under section 961(d), solely for purposes of determining whether Parent has sustained a loss on the sale, Parent must reduce its basis in the stock of $Bank_1$ by the $90 million distribution that it received in year 3. Parent will not recognize a loss on the sale of its shares of $Bank_1$, because its adjusted basis in those shares will be equal to the $410 million sales proceeds.

On a cumulative basis, Parent has suffered an economic loss of $80 million.[10] After taking account of the $10 million that Parent has included in income, it should be entitled to a $90 million loss deduction.

3. <u>Example 3: Double-counting of related-party loans</u>.

A foreign subsidiary ("<u>Bank</u>") has $10 billion of assets, consisting of $8 billion of loans to unrelated parties and $2 billion of loans to other members of Parent's foreign group. Interest on the related-party loans qualifies for the active financing exception under section 954(h), and for the look-thru exception under section 954(c)(6). As in the other examples, Bank has a 9:1 debt:equity ratio ($9 billion of debt supported by $1 billion of equity), a 4% return on assets, and a 3.5% cost of funds.

Under the proposed regulations, qualified interest expense is determined first, by identifying the proportion of a CFC's interest expense that is allocable to 'good' assets (*i.e.*, financial instruments that give rise to income excluded from FPHC income under section 954(h)), and then by subtracting related-party interest income from the amount so determined.[11]

On the facts of this example, two adjustments would be made in respect of the same related-party loans. First, $63 million of interest expense ($200 million /$1 billion total assets x $315 million interest expense) would be allocable to the related-party loans, and the remaining $252 million to qualified assets. Second, $80 million of interest income on the related-party loans would be subtracted from the $252 million, leaving only $172 million of qualified interest expense.

The related-party loans have been taken into account twice: a $63 million reduction is made in the first step, and an $80 million adjustment in the second step. The second adjustment necessarily relates to interest expense that is *not* attributable to the related-party loans.

[10] Original basis of $1 billion minus $820 million sales proceeds plus $100 million distribution.
[11] *See* Proposed regulations §1.951A-4(b)(1)(iii).

4. Example 4: Qualified interest

Virtually all of the interest expense incurred by Parent's foreign subsidiaries is likely to be allocable to qualified assets. However, as illustrated below, 'virtually all' may not be sufficient to make the qualified interest exception meaningfully available to financial services companies.

On the most favorable possible facts, slightly more than one-tenth of 1% of the subsidiaries' interest expense (about $8 million, of the $6.3 billion total) would be allocable to nonqualified assets.[12] On this optimistic assumption, Parent's net deemed tangible income return would be about $17 million ($25 million [10% of $250 million tangible assets] minus $8 million interest expense allocable to nonqualified assets), representing 1% of total CFC earnings.

In most cases, however, Parent's foreign subsidiaries will have some additional nonqualified assets.[13] Moreover, Parent may find it difficult to establish that every last one of its subsidiaries' assets constitute qualified assets. A very small increase in the percentage of nonqualified assets could eliminate any benefit associated with the qualified interest exception. For example, if only 99.5% (instead of 99.9%) of the subsidiaries' assets are good assets, then nonqualified interest expense would be $31.5 million (0.5% of $6.3 billion). This would wipe out Parent's net deemed tangible income return.

As a result of the disproportion between interest expense and tangible assets, even a very slight uptick in the percentage of nonqualified assets could be sufficient to eliminate the practical significance of the qualified interest exception. Taxpayers confronted with this fact pattern would not undertake the burdensome computations required to establish the existence and amount of qualified interest expense, and should not be required to do so.

D. SUGGESTED CHANGES.

1. Tested loss.

Amend Proposed regulations §1.951A-1(c)(2) to read as follows:

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[12] Interest expense allocable to nonqualified assets = $7.865 million [$6.3 billion interest expense x $250 million tangible property divided by $200.25 billion total assets]. This best-case computation assumes that (i) the subsidiaries' only nonqualified assets are the desks, chairs, and computer terminals represented by their $250 million of tangible property; (ii) none of the subsidiaries owns debt or equity interests in a related foreign party; and (iii) the qualified interest exception will be extended to include dealer property.

[13] In addition to their tangible property, and before taking account of related-party loans, the subsidiaries are likely to own some nonqualified assets that attract interest expense. For example, the subsidiaries could have basis in intangible assets (*e.g.*, software purchased from third-party developers; capitalized software development costs; acquired goodwill), or could own assets that clearly relate to an active financial services business, but don't give rise to income described in sections 954(c)(2)(C) or 954(h) (*e.g.*, interests in a joint venture formed to develop a new trading platform).

Definition of net CFC tested income. The term net CFC tested income means, with respect to a United States shareholder and a U.S. shareholder inclusion year, the excess (if any) of—

(i) The aggregate of the shareholder's pro rata share of the tested income of each tested income CFC (as defined in §1.951A-2(b)(1)) for the year, over

(ii) The aggregate of the shareholder's pro rata share of the tested loss of each tested loss CFC (as defined in §1.951A-2(b)(2)) for the year**, unless the shareholder shall have elected, with respect to one or more tested loss CFCs, not to take account of that CFC's tested loss for that year.**

Amend Proposed regulations §1.951A-6(e)(2) to add a new subsection (C), so that the provision reads as follows:

Net used tested loss amount—(i) In general. The term net used tested loss amount means, with respect to a domestic corporation and a controlled foreign corporation, the excess (if any) of—

(A) The aggregate of the domestic corporation's used tested loss amount with respect to the controlled foreign corporation for each U.S. shareholder inclusion year, over

(B) The aggregate of the domestic corporation's offset tested income amount with respect to the controlled foreign corporation for each U.S. shareholder inclusion year.

(C) If a domestic corporation has elected not to take account of particular tested losses for purposes of determining its net CFC tested income, then those tested losses shall not be taken into account in determining the net used tested loss amount.

Conforming changes should be made to the consolidated return basis adjustment rules in order to ensure that, if a basis adjustment is not required under Treasury regulations §1.951A-6, then an adjustment will not be required under Treasury regulations §1.1502-51.

2. Omission of dealer exception; double-counting of related-party loans.

Amend Proposed regulations §1.951A-4(b)(1)(iii) to read as follows:

Qualified interest expense. The term qualified interest expense means, with respect to a qualified CFC, the interest expense paid or accrued by the qualified CFC taken into account in determining the tested income or tested loss of the qualified CFC for the CFC inclusion year, multiplied by the fraction (not to exceed one) described in paragraph (b)(1)(iii)(A) of this section, and then reduced (but not to less than zero) by the amount described in paragraph (b)(1)(iii)(B) of this section.

(A) The numerator of the fraction described in this paragraph (b)(1)(iii)(A) is the average of the aggregate adjusted bases as of the close of each quarter of obligations or financial instruments held by the qualified CFC that give rise to income excluded from foreign personal holding company income (as defined in section 954(c)(1)) by reason of section 954**(c)(1)A), (c)(2)(C),**[14] (h) or (i), and the denominator is the average of the aggregate adjusted bases as of the close of each quarter of all assets held by the qualified CFC. For purposes of this paragraph (b)(1)(iii)(A), the basis of the stock of another qualified CFC held by a qualified CFC is treated as basis of an obligation or financial instrument giving rise to income excluded from foreign personal holding company income by reason of section 954(h) or (i) in an amount equal to the basis of the stock multiplied by the fraction described in this paragraph (b)(1)(iii)(A) determined with respect to the assets of such other qualified CFC.

(B) **If the numerator of the fraction described in this paragraph (b)(1)(iii)(A) includes loans that give rise to** interest income of the qualified CFC for the CFC inclusion year that is excluded from foreign personal holding company income (as defined in section 954(c)(1)) by reason of section 954(c)(3) or (6)**, then the amount described in this paragraph (b)(1)(iii)(B) is the interest income on such loans**.[15]

3. Qualified interest: taxpayer to establish amount.

Amend Proposed regulations §1.951A-4(b)(1)(iii) to read as follows:

In general. The term tested interest expense means interest expense paid or accrued by a controlled foreign corporation taken into account in determining the tested income or tested loss of the controlled foreign corporation for the CFC inclusion year under §1.951A-2(c), reduced by the amount, if any, that **the taxpayer establishes to the satisfaction of the Secretary** constitutes qualified interest expense of the controlled foreign corporation.

[14] The added cross-references would remedy the apparent oversight discussed in note 5, above.

[15] We are uncertain why the proposed regulations treat related-party loans as nonqualified assets. The purpose of the suggested change is to ensure that duplicative adjustments are not made in respect of a single related-party loan. This objective could be accomplished in several different ways. In addition to the approach used in the text (modifying paragraph (B) so that it only applies to related-party loans that have been taken into account in subparagraph (A)), double-counting could be avoided by including related-party loans in the numerator of the fraction described in paragraph (A), or by deleting paragraph (B). Prior to the suggested change, subparagraph (B) read as follows: "The amount described in this paragraph (b)(1)(iii)(B) is the amount of interest income of the qualified CFC for the CFC inclusion year that is excluded from foreign personal holding company income (as defined in section 954(c)(1)) by reason of section 954(c)(3) or (6)."