February 4, 2019

Internal Revenue Service

CC:PA:LPD:PR (REG-105600-18)

Room 5203, Post Office Box 7604

Ben Franklin Station

Washington, DC 20044

Re: Proposed Foreign Tax Credit Regulations (REG-105600-18)

Ladies and Gentlemen,

This letter and the attached paper provide comments on the proposed foreign tax credit regulations. The comments were prepared by a task force of the Federal Tax Committee of the Securities Industry and Financial Markets Association ("SIFMA").[1]

The TCJA made sweeping changes to the U.S. tax treatment of foreign business income: perhaps the most significant in two or three generations. The Treasury Department and the IRS have provided very thoughtful guidance on an exigent timetable.

This letter focuses only on aspects of the proposed regulations with respect to which you have requested comments. We agree with many of the judgments reflected in the proposed regulations. An area where we are not in agreement, but as to which you have not requested

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[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).

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comments, relates to the scope of the look-through rules. If you are prepared to reconsider this question, we would be happy to make a supplemental submission concerning it.

Summary of Recommendations

Interest Expense

1. Banks and other regulated financial services companies should determine the amount of interest expense allocable to the foreign branch category using the following principles:

    a. Liabilities and interest expense should be apportioned on a bank-only basis (*i.e.*, by reference to the assets and liabilities of the bank's home office, its foreign branches, and any "bank group" subsidiaries, without regard to the position of other members of its U.S. affiliated group).

    b. The liabilities properly allocable to foreign branches should be determined by formulary apportionment.[2]

    c. The amount of interest expense attributed to those branches should be determined by looking first to the liabilities reflected on their books and records.[3]

Disregarded Transactions

2. Adjustments to take account of disregarded transactions should be made on an aggregate net basis across all of a taxpayer's foreign branches, rather than on a transaction-by-transaction or branch-by-branch basis.

    a. Under this approach, transactions between two foreign branches would not be taken into account, because they won't affect the net amount of branch category income.

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[2] The methodology described above is based on the principles of Treasury Regulations §1.882-5 (the rules that apply to taxable businesses conducted by U.S. branches of foreign banks).

[3] Thus, if a branch operates in a market where local interest rates are significantly lower than the prevailing U.S. rate, the resulting reduction in borrowing costs would be taken into account for branch basket purposes.

b. The principles for determining the tax treatment of adjustments in respect of disregarded transactions should be simplified and rationalized to produce appropriate results and to minimize the need for taxpayers to rely on tax treaties.

   i. Adjustments that are attributable to economic activity conducted by a foreign branch in a foreign country generally should constitute foreign source branch category income.[4]

   ii. The regulations should confirm that they are not intended to conflict with, or supersede, the principles for determining the allocation, character and source of items subject to a global dealing transfer pricing methodology.

c. Subject to the adoption of appropriate netting and sourcing rules, financing transactions should be taken into account to the same extent as other disregarded transactions.

Intercompany Transactions

3. The sourcing of income and expense derived or incurred by foreign branches in respect of intercompany transactions should be conformed to the treatment of disregarded branch-to-home office transactions. For this purpose, the consolidated return intercompany transaction regulations should be amended to turn off the matching rule if one of the parties to the transaction is acting through a foreign branch.

Carryovers

4. Taxpayers should not be required to reconstruct income from pre-enactment years in order to establish the amount of foreign tax credits that may be carried over into the foreign branch category. Instead, they should be allowed to use an alternative methodology under which carryovers from a particular year would be allocated to the branch category in the same proportion as taxes paid by foreign branches bears to all foreign taxes paid by the taxpayer in that year.

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[4] We believe that Treasury and the IRS have authority to prescribe such a rule, and that it would produce fair and appropriate results. The attached paper discusses an alternative approach that could be considered if you are concerned about the scope of your regulatory authority.

Accrual of Foreign Taxes

5. Taxpayers should be allowed to apportion foreign taxes in respect of periods that straddle two U.S. taxable years to the extent necessary to ensure an effective matching of income and taxes.

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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 any of the issues addressed by the comments in more detail.

Sincerely,

Payson Peabody
Managing Director & Tax Counsel
SIFMA

cc: David J. Kautter
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Comments on the Proposed Foreign Tax Credit Regulations

I. Overview

Under prior law, financial services income was included in a single foreign tax credit basket. Amounts derived from the conduct of a financial services business by a U.S. company were included in the same basket without regard to whether they were received directly, through foreign branches, or from foreign subsidiaries. The foreign tax credit pooling and carryover rules provided a further simplification by reducing the sensitivity of differences between the timing of income recognition and tax accrual for U.S. and foreign tax purposes.

Following the enactment of the TCJA, income from the same unitary financial services business is split between three foreign tax credit categories: the general, branch and GILTI baskets.[5] Moreover, the TCJA eliminated pooling, and prohibited carryovers within the GILTI basket. As a result, taxes that are not allowed as credits in a particular year may be lost forever. These changes will make it more difficult for financial services companies to make effective use of foreign tax credits.

The proliferation of baskets and the restrictions on carryovers are features of the statute. We single these provisions out for attention here *not* because we are asking for relief from them—we recognize that any relief would have to come from Congress—but because they will exacerbate the effect of gaps and imperfections in the regulations. This makes it particularly important to adapt, update and rationalize the rules for determining the allocation and source of items of income and expense.

Under prior law (and particularly in the context of a 35% federal income tax rate), the system was fault-tolerant. The regulations produced rough justice. As a result, taxpayers and tax

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[5] The preamble says that Treasury and the IRS are considering modifications to the test for determining financial services entity status. The test serves a very useful purpose, because it eliminates the need to consider whether particular items of income are active or passive in cases where the recipient is a member of a group that is predominantly engaged in the conduct of an active financial business. This outcome is strongly in the interest of tax administrators as well as taxpayers.

administrators may not have assigned priority to addressing problems with the regulations. Under the new system (and in the context of a 21% rate), rough justice is no longer good enough.

We believe that Treasury and the IRS recognize the need for a major overhaul of the rules for determining the allocation and source of items of income and expense. Treasury and the IRS have acknowledged the problems with the current rules a number of times over the years.[6] But a reminder nevertheless may be helpful:

- This is not an area where there are immutable baseline principles that must be respected.
- Treasury and the IRS have authority to tailor the allocation and sourcing rules to make them compatible with the new statute.[7]
- The provisions of the existing regulations are not set in stone, they reflect judgments made, in some cases more than 30 years ago, in the context of a system that has changed dramatically since then.

II. Attribution of Items to Branches

A. Overview

The proposed regulations assign significance to a foreign branch's books and records for purposes of allocating income but not expenses. As the preamble acknowledges, if the final regulations don't provide a rule for branch expenses to correspond to the proposed rule for branch income, then the provisions of Treasury Regulations §§1.861-8 through 1.861-17 will determine the allocation of expenses to the foreign branch category.

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[6] *See*, for example, Notice 2001-59, 2001-2 CB 315 (requesting comments regarding modifications to the interest allocation rules to deal with integrated transactions); Notice of Proposed Rulemaking, Fed. Reg. Vol. 63, No. 44, p. 11177 (1998) (preamble to proposed global dealing regulations, recognizing "the need for multi-location sourcing of income earned in a global dealing operation," and the inadequacy of the rule under which income is attributed to locations on an all or nothing basis; T.D. 9465 (2009) (prescribing an interest allocation methodology specially designed for U.S. branches of foreign banks).

[7] *See, e.g.*, section 864(e)(7).

The disparity between the treatment of assets and liabilities creates a potential for distortions. The same business, regulatory and accounting considerations that determine whether assets and income are appropriately reflected on a foreign branch's books and records also apply to liabilities and expenses. If books and records determine the allocation of income, and the expenses associated with that income are determined using a formulaic methodology, then there inevitably will be mismatches between income determined for financial, regulatory and foreign tax purposes, and income for U.S. tax purposes.

The drafters requested comments regarding whether:

- The generally applicable expense allocation rules should be revised and updated, including in particular with respect to interest, research and experimentation, stewardship, and general and administrative expenses; and
- Targeted rules should be provided for:
    - Allocating deductions between the general and the foreign branch categories;
    - Financial institutions whose branches are affected by regulatory capital requirements ("regulated branches"); and
    - True branches.[8]

We would say "yes" to all of the above. This paper focuses on regulated branches because they provide the clearest example of the need for targeted rules, and are an important part of our global

8 Taxpayers normally think of a true branch as a taxable business activity that is conducted in a foreign country, is treated as a branch of a U.S. corporation both for U.S. and foreign tax purposes, and doesn't involve a separate legal entity. The preamble uses a more complex definition that, among other things, contemplates that a true branch will not be taxable as a resident of the country where it is located "with respect to amounts that are deemed to be made to or from the home office of the branch under the foreign jurisdiction's rules for attributing profits to the branch." We haven't been able to identify circumstances in which the expanded definition makes a difference.

businesses. We would also support efforts to update the generally applicable rules, and to provide a targeted rule for foreign branches.[9]

B. Interest Expense

The current interest allocation regulations rely on assumptions that may operate correctly in ordinary circumstances, but do not deal effectively with special cases, and can produce results that deviate significantly from economic reality. Under prior law, the consequences of those systemic imperfections were mitigated by a single basket/multi-year pooling system, and by the relatively high U.S. tax rate. The imperfections could have more severe consequences under the new system, where income from the conduct of a single unitary business must be split between three foreign tax credit baskets, credits must be calculated on an annual basis, and some credits may not be carried over.

Under the current system, interest expense incurred by any member of a consolidated group for any purpose generally is considered to have been incurred to fund all of the assets held by the group on a pro rata basis. The current interest allocation regime is premised on the following assumptions:

- Money is fungible. Accordingly, borrowing costs generally are treated as having been incurred to fund all of the assets of a corporate enterprise, rather than being attributed to particular locations, assets or activities.[10]

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[9] Regulatory considerations can influence or determine the funding structure of a foreign branch; its sources and uses of funds; and the nature of the activities that it conducts. Moreover, because financial services companies are highly leveraged, a small variation between a branch's *actual* funding costs, from a financial and regulatory perspective, and its *deemed* funding costs, determined using a formulaic allocation mechanism, can give rise to significant distortions. U.S. financial services companies conduct activities through foreign branches primarily in countries where significant customers, or significant financial markets, are located, and that have an appropriate regulatory climate. Countries with these characteristics tend to be high-tax jurisdictions. A high foreign tax rate reduces the margin for error, and increases the risk that an uneconomic allocation of expenses will give rise to inappropriate costs or benefits.

[10] An exception applies to a narrowly-defined class of integrated financial transactions. The exception is not available to financial services companies. As indicated above, the Treasury and the IRS have authority to prescribe interest allocation rules to address fact patterns in which formulaic allocation would be inappropriate. *See* section 864(e)(7).

- Interest expense should be allocated by reference to the assets of an affiliated group (and in some cases an expanded affiliated group) rather than by reference to the assets of a particular borrower.[11]

The presumption that money is fungible breaks down when applied to global financial services businesses. A financial services business can incur widely varying funding costs in different countries as a result of disparate regulatory capital requirements and other factors. Business and regulatory considerations make it strongly desirable to fund local assets with local liabilities.[12] As a result, a significant proportion of a financial services group's funding costs are determined at the level of individual businesses, and not by reference to the corporation or affiliated group as a whole. Local market interest rate and currency-related effects can increase the disparity between a foreign branch's actual funding costs and the costs that would be allocated to it under the current regulations.

The amount of interest expense that a U.S. bank's foreign branches are considered to bear, from a financial, regulatory and foreign tax perspective, can differ significantly from the amount determined under a formulary apportionment method based on the assets of the entire consolidated group. Reasons for the differences can include:

- A distinguishing characteristic of banks (and bank branches) is that they are permitted to accept deposits. Deposits can represent a very low cost source of funding. This is attributable to their perceived safety, which is attributable in part to the enforced separation of banking activities from other businesses.

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11 This rule was originally targeted at an abuse that involved situating all of a U.S. group's indebtedness at the level of an intermediate holding company that did not hold any foreign assets. For the reasons illustrated in Example 1, this would not have been practical for banks: their capitalization and funding structure is determined by financial and regulatory considerations.

12 Banks have powerful financial and regulatory incentives to match-fund local assets with local liabilities. Nevertheless, as indicated in note 10, they are excluded from the benefit of the very limited matching rule provided under the current regulations. *See* Treasury Regulations §1.861-10T(c)(2)(vi).

- Local market conditions, typically due to relatively low interest rates on foreign currency deposits (*e.g.*, Yen), can make it possible for a foreign branch to raise funds at a rate lower than the rates available for comparable borrowings by the U.S. home office;

- Variations in the mix of activities conducted by different business units can affect their funding costs, and the amount of leverage that they can support;[13] and

- A foreign branch may be treated for foreign regulatory and tax purposes as if it had more capital (and less indebtedness, and less interest expense) than would be implied by a formulaic allocation of the bank's liabilities.

Treasury and the IRS requested comments concerning whether the principles of Treasury Regulations §1.882-5 would be relevant in considering similar issues in the context of the foreign branch basket.[14] We believe that those principles would represent a useful starting point. Our recommendations include the following structural features adopted from the §1.882-5 regulations:

1. Regulated financial services companies should allocate liabilities and expenses on a *separate-company* (rather than consolidated) basis;[15]

2. The liabilities properly allocable to foreign branches should be determined by formulary apportionment;

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13 Different businesses can support different amounts of leverage, and can borrow at different rates. For example, if a bank conducts a mezzanine financing business in New York home office and a matched-book repo business in London, then the London branch may be more highly leveraged, but may have a lower interest-to-asset ratio, than the home office.

14 The specific provisions of those regulations (as contrasted with their general principles) were designed for the particular factual context of the taxable U.S. activities of foreign banks.

15 The provisions of Treasury Regulations §1.861-11T(d)(4), permitting taxpayers to allocate expenses separately to financial and non-financial groups, might appear to address the concerns addressed in the text, but in practice they never have. First, the line of demarcation between financial and non-financial groups will not necessarily correspond to the distinction between bank and non-bank groups discussed above and in Example 1. Moreover, the regulations require that expenses incurred at the bank holding company level (which will include high-cost funding incurred to finance non-bank operations) must be taken into account in allocating expenses to the bank group, and thus to foreign branches.

3. The amount of interest expense attributed to those branches should be determined by looking first to the terms of deposits and other debt obligations that are reflected on their books and records.[16]

The §1.882-5 regulations are also notable as one of several examples (the proposed global dealing regulations are another) of cases in which Treasury and the IRS, in considering the appropriate treatment of multinational financial services businesses, rejected a "one size fits all" approach, and developed allocation and sourcing rules targeted specifically to the characteristics of those businesses.[17]

III. R&E, Stewardship, and G&A Expenses

Treasury and the IRS requested comments regarding the need for changes to Treasury Regulations §1.861-17 to take account of the creation of the GILTI category and other features of the new law. A significant problem with the existing regulations, from the perspective of financial services companies, is that they do not reflect contemporary business practice. The regulations require that expenses be classified by reference to a list of categories that hasn't been updated in many years. Moreover, the regulations provide for the use of a cost-sharing methodology, developed originally in the context of former Section 936, that financial services companies don't use. The ability to allocate costs should not depend on the use of any particular methodology.

For many global financial services businesses, the flow of value runs in both directions: research and experimentation conducted outside the United States will produce benefits for U.S. businesses, as well as the other way around. If a financial services business uses an appropriately robust transfer pricing mechanism to allocate costs incurred in various locations among the

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[16] Thus, if a branch operates in a market where local interest rates are significantly lower than the prevailing U.S. rate, the resulting reduction in borrowing costs would be taken into account for branch basket purposes.

[17] For the avoidance of doubt, our recommendations are not intended to affect the amount of interest expense that is subject to allocation, or the consequences of allocating interest expense to a particular foreign tax credit category. Instead, our recommendations are intended to provide a more accurate mechanism for determining the amount of interest expense incurred by foreign branches, and to reduce the potential for disparities between the allocation of interest expense for financial, regulatory and foreign tax purposes, and the allocation of the same expense for U.S. tax purposes.

beneficiaries of those costs (the U.S. home office, and foreign branches and subsidiaries), then that allocation should be respected.

IV. Transactions Involving Foreign Branches

A. Overview

The drafters of the proposed regulations appropriately recognized that disregarded transactions would need to be taken into account in determining the amount of income in the branch basket. However, we believe that the proposed treatment of those transactions is overbroad, under-inclusive and needlessly complex.

Treasury and the IRS asked for comments regarding how adjustments relating to disregarded transactions could be limited or simplified to reduce burdens while still providing for an accurate categorization of gross income, consistent with the statutory purpose. In particular, you asked whether disregarded payments should be netted, and whether the rules should be narrowed to cover a more limited set of transactions.

We believe that the proposed regulations provide an appropriate conceptual framework: they provide for adjustments to branch category income that are determined *by reference to* disregarded transactions, but do not provide for those transactions to be regarded. We think it is strongly desirable to take disregarded transactions into account in making adjustments to branch category income, but not to treat those transactions as if they had been entered into between separately-incorporated subsidiaries.

However, we have significant concerns regarding the proposed rules for determining the source of adjustments in respect of disregarded transactions. As discussed below, we encourage Treasury and the IRS to adopt a rule under which adjustments in respect of disregarded transactions will increase foreign source branch category income.[18]

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[18] By the same token, a net downward adjustment to the amounts attributed to foreign branches would result in a reduction in foreign source branch category income.

B. Netting

We believe that netting is important for fairness reasons, and not merely because making computations on a net basis will reduce compliance burdens. Adjustments to branch category income in respect of disregarded transactions should be made on an aggregate net basis across all of a taxpayer's foreign branches, rather than on a transaction-by-transaction or branch-by-branch basis.

Under a netting approach, transactions between two foreign branches would not be taken into account, because they would not affect the aggregate amount of foreign branch category income. We think that this is the right result. A requirement to take account of branch-to-branch transactions, as contemplated by the proposed regulations, would give rise to administrative burdens that seem to us disproportionate to any possible tax policy benefit. If policymakers have concerns about particular transactions, they can be addressed by targeted rules.

C. Sourcing of Adjustments in respect of Disregarded Transactions

The principles for determining the source of branch income should be simplified and rationalized to produce appropriate results, and to minimize the need for taxpayers to rely on tax treaties.[19]

In considering the appropriate treatment of adjustments to take account of disregarded transactions between a U.S. home office and its foreign branches, it is important to remember that positive adjustments—adjustments that increase the amount of net income allocated to foreign branches—generally will be attributable to economic activity that is reflected on the books and records of a foreign branch, and is attributable to functions performed by employees of the branch in a foreign country. Foreign tax authorities appropriately will consider the resulting income to have been earned by the branch, and to be subject to foreign tax.

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[19] In this regard, only a very small proportion of U.S. tax treaties currently include a resourcing provision. Countries that haven't entered into a treaty that includes such a provision include major financial centers in which U.S. banks conduct significant operations. Hong Kong hasn't entered into a tax treaty with the United States, and is unlikely to do so in the foreseeable future.

It would be fair and appropriate for the U.S. tax authorities to adopt the same characterization. Thus, adjustments to take account of disregarded transactions would be applied to increase (or reduce) foreign source branch basket income for U.S. tax purposes. We believe that Treasury and the IRS have authority to prescribe regulations to this effect.[20]

If you have concerns regarding the scope of your authority, or believe that adjustments should not be attributed to foreign source branch income in every case, then we encourage you to consider the alternative approach described in section E below.

D. Coordination with Global Dealing

The proposed foreign tax credit regulations don't address the treatment of taxpayers that are engaged in the conduct of a global dealing business. Many financial services businesses have adopted transfer pricing methodologies that are based on the proposed global dealing regulations.[21] Those proposed regulations prescribe a methodology for taking account of disregarded transactions entered into in the context of a global dealing business.

The proposed global dealing regulations deal with adjustments for disregarded transactions in a manner that may not be entirely consistent with the treatment of such adjustments under the proposed foreign tax credit regulations. To the extent there are differences, the global dealing approach seems to us more practical, and more likely to produce an appropriate result, from the perspective of tax administrators as well as taxpayers.

In order to avoid any possible uncertainty regarding their interaction with the global dealing rules, the new foreign tax credit regulations should confirm that they are not intended to conflict

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[20] Treasury and the IRS requested comments regarding whether foreign taxes should be attributed to the same foreign tax credit category as income that is resourced pursuant to a tax treaty if the taxes are paid to a country other than the treaty country. We believe that it is strongly desirable for taxes to follow income, without regard to the country that imposes the tax.

[21] Taxpayers are permitted to rely on the proposed regulations. *See* T.D. 9456 (2009). The proposed regulations should be adopted in final form.

with, or supersede, existing methodologies that taxpayers are permitted to use to determine the allocation, character and source of items derived in the conduct of a global dealing business.

The most significant difference between the global dealing methodology and the approach contemplated by the proposed foreign tax credit regulations is that the proposed global dealing regulations *first* determine the allocation of income between business units in different locations, and *then* determine the source of that income. By contrast, the proposed foreign tax credit regulations would reverse these two steps, and effectively would treat the source of an item of income or expense as a static attribute that is not affected by the location to which the item is attributed. This can make a big difference when the item being attributed is subject to a residence-based sourcing rule.

E. Alternative Approach

If you believe that you do not have sufficient regulatory authority to adopt a general rule that adjustments to take account of disregarded transactions would always be applied to increase (or reduce) foreign source branch category income, we would respectfully request that you should consider the alternative described below.

Under the global dealing rules, upward adjustments to branch income generally would be attributed to foreign sources, *unless* the source of the third-party income derived by the home office to which the adjustment relates is determined by reference to factors other than the residence of the recipient or the place where functions are performed (*e.g.,* the situs of the payor or the place of title passage). Adjustments in respect of compensation for services by a foreign branch, or that relate to home-office income that is subject to a residence-based sourcing rule, generally would be treated as foreign source income under this approach.

We would encourage you to consider applying this methodology to all transactions between a branch and its home office, without regard to whether those transactions otherwise would be considered part of a global dealing business. This would significantly reduce the number of cases in which economic activity that is conducted by a foreign branch, and is subject to foreign tax, would

be deemed to constitute U.S. source income. This in turn would reduce the need to rely on tax treaties.

F. Application to Loans and Deposits

Subject to the adoption of appropriate netting and sourcing rules, we believe that the scope of the proposed regulations be expanded rather than being narrowed. The coverage of disregarded transactions should be expanded to take account of loans and deposits between foreign branches and their U.S. home office. This is particularly important for banks and other regulated financial services businesses.

G. Intercompany Transactions Involving Foreign Branches

The consolidated return regulations do not take account of cases in which one of the parties to an intercompany transaction is acting through a foreign branch. The current rules governing such transactions present essentially the same problems as the proposed rules governing disregarded transactions between a foreign branch and its U.S. home office.[22]

The sourcing of income and expense on intercompany transactions in which one of the parties is acting through a foreign branch should be conformed to the treatment of disregarded branch-to-home office transactions.

V. Carryovers

The proposed regulations appropriately provide that pre-enactment foreign tax credit and overall domestic loss carryovers may be carried over into the new foreign branch category. The drafters requested comments regarding further measures to simplify this rule.[23]

As the drafters recognized, the principal source of complexity is likely to be the need to reconstruct pre-enactment income to determine how that income should be apportioned between

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[22] Under the consolidated return regulations, the tax attributes of a transaction between two members of a consolidated group generally are matched and offset. *See* Treasury Regulations §1.1502-13.

[23] The preamble acknowledges that taxpayers may face difficulties in reconstructing the allocation of unused foreign taxes. Treasury and the IRS requested comments regarding whether a simplified rule should be provided.

the general and foreign branch categories. Some taxpayers will find it extremely burdensome to make such a redetermination.

An equally reliable, and much simpler, alternative will be available in many cases. A bank normally would be able to determine the proportion of its foreign taxes in a particular year that were incurred by foreign branches. For example, if a bank paid total foreign taxes of $100 million in 2015, and $35 million of that amount was paid by foreign branches, then 35% of any amounts available for carryover from 2015 (including ODLs as well as FTCs) should be allocated to the foreign branch category.

VI. Accrual of Foreign Tax

The proposed regulations would codify the traditional rule that foreign taxes accrue only at a foreign taxable year-end, and may not be apportioned between U.S. taxable years.

The continued application of this rule has the potential to produce significant unfairness as a result of three changes introduced by the TCJA:

- The replacement of foreign tax credit pooling with a year-by-year method;
- The creation of two new foreign tax credit baskets; and
- The rule that GILTI foreign tax credits may not be carried forward or back.

Taxpayers should be allowed to apportion foreign taxes in respect of periods that straddle two U.S. taxable years to the extent necessary to ensure an effective matching of income and taxes.

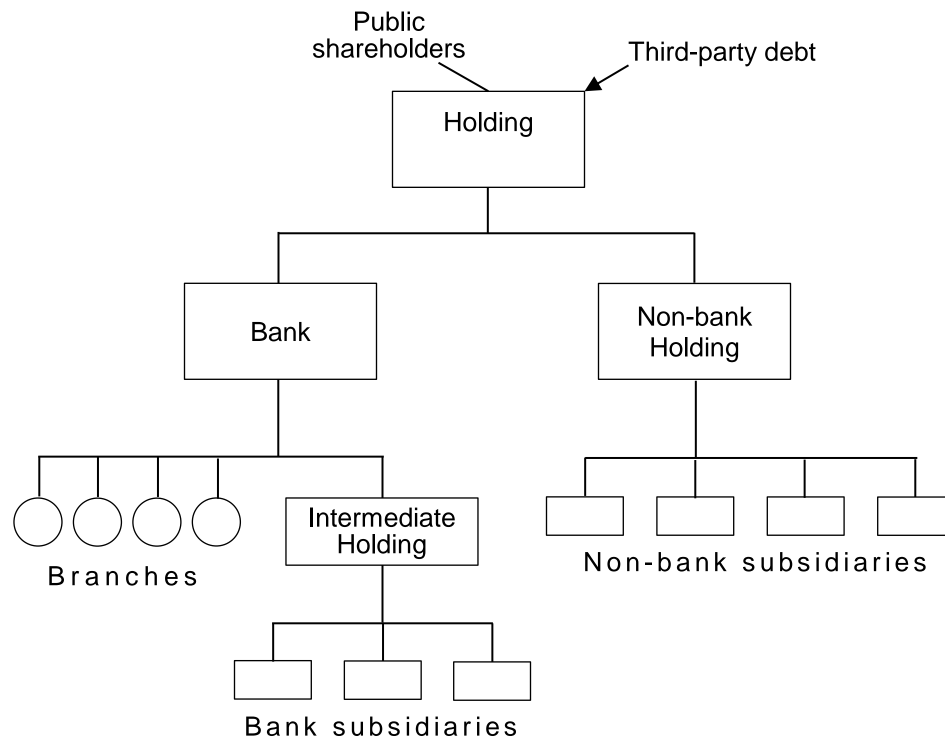
VII. PTEP

The proposed PTEP rules seem to us disproportionately complex. We encourage the drafters to consider whether the complex tracking obligations that the rules would create are really necessary.

Examples

Background

1. Separation of banking and non-banking activities. Significant limitations apply to the activities that can be conducted by regulated banks, and the manner in which those activities can be conducted. A global financial services group that conducts diverse business activities typically will be organized as follows:



As illustrated above, the top-tier holding company generally is required to hold the bank and non-bank chains separately. This will be the case even if the activities conducted by the non-bank chain are subject to significant regulatory supervision (*e.g.*, dealing in securities or derivatives). The holding company may provide funding to each chain (typically including longer-dated or subordinated debt), but often provides funding predominantly to the

non-bank chain.[24] Banking businesses are expected to be self-sustaining, and to raise funds to support their own activities.

Banks are subject to regulatory capital requirements. Stringent limitations apply to the ability to provide cross-chain funding. In effect, the bank chain is ring-fenced from the businesses conducted by the non-bank chain, and vice versa.

2. Foreign branches. Banks conduct significant activities through foreign branches. Banks make use of branch networks for business and regulatory reasons.[25] Each foreign branch operates in a local market. Branches can have disparate characteristics. A branch may be subject to foreign regulatory and tax rules that reduce the amount of interest expense that it is considered to incur, as compared to the amounts attributed to them under a formulaic allocation method. Regulators in some countries allow branches doing business in that country to be entirely debt-financed. The U.K. tax authorities apply rules under which branches of foreign banks are deemed to have tiered liabilities that replicate the capital structure of stand-alone banks.

   Some branches operate in markets that provide access to lower-cost funding than is available to the bank's home office; other branches don't have special access to such funding. There can be significant differences in the capitalization and funding costs of particular foreign branches.

3. Deposit funding. Banks are permitted to accept deposits. Deposits can represent a very low-cost source of funding. This is attributable to the perceived safety of bank deposits, which is attributable in part to the enforced separation of banking from non-banking businesses.[26]

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24 *See* the discussion of this issue in note 15, above.
25 Some foreign branches of U.S. banks predate the Internal Revenue Code.
26 Deposit insurance provided by the FDIC and similar foreign regulators also serves to attract retail deposits.

Example 1: Allocation of Interest Expense on a Separate-Company Basis.

Bank has 1,000 of assets and 900 of liabilities. It incurs interest expense of 10, for an interest-to-asset ratio of 1%. Bank's sister companies in the non-bank chain have the same amount of assets and liabilities, and incur interest expense of 20, for an interest-to-asset ratio of 2%.

As discussed above, banking and non-banking activities are required to be conducted separately. Funds borrowed by Bank normally may not be used to support activities conducted by entities in the non-bank chain. Funds borrowed by entities in the non-bank chain normally may not be used to support activities conducted by Bank.

However, under Treasury Regulations §1.861-14, the interest expense allocable to Bank's foreign assets is required to be determined on a consolidated basis, taking account not only of interest expense incurred by Bank and its foreign branches, but also of interest expense incurred by members of the non-bank chain. As a result, Bank would be considered to have incurred 15 of interest expense (1,000 bank assets/2,000 total assets x 30 of total interest expense).

The resulting overstatement of the interest expense borne by Bank, and by its foreign branches, may not have given rise to significant incremental tax costs when all financial services income was included in a single foreign tax credit basket, and the U.S. corporate income tax rate was 35%. Such an overstatement is more likely to give rise to immediate costs in a system where foreign tax credits must be computed separately with respect to the general, branch and GILTI baskets, and the U.S. rate is 21%.

Example 2: Terms of Branch Liabilities.

Bank conducts business through a New York home office and a Tokyo branch. Each office raises funds, and makes loans, solely in its local market. Each office has assets of 500 and liabilities of 450, and earns a spread of 25 basis points over its funding costs.

The New York home office incurs interest expense of 5 (for an interest-to-asset ratio of 1%), and receives interest income of 6.25 (for a return on assets of 1.25%). The Tokyo branch

incurs interest expense of 1 (for an interest-to-asset ratio of 0.2%), and receives interest income of 2.25 (for a return on assets of 0.45%).

If the principles of Treasury Regulations §1.861-9T are applied without modification, then the Tokyo branch would be deemed to have interest expense of 3 (500 branch assets/1,000 total assets x interest expense of 6). The branch would have taxable income of 1.25 for Japanese tax purposes (income of 2.25 minus expense of 1), and a loss of 0.75 for U.S. tax purposes (income of 2.25 minus expense of 3).

Example 3: Benefits of Netting.

Bank conducts business through branches in two foreign countries. The branch in country A is able to attract local deposits in amounts that significantly exceed local lending opportunities. When that branch has funds that exceed its near-term business needs, it will deposit them with Bank's home office in New York. The branch in country B conducts an active lending business, but doesn't have a significant local deposit base. (This could be the case, for example, because regulatory, depositor protection or tax considerations in that country favor locally-incorporated banks.) The branch typically needs to fund its activities with borrowings from the home office.

In 2020, the country A branch receives 100 of interest income on its deposits with the home office, and the country B branch incurs 80 of interest expense on its borrowings from the home office. On a combined basis (and before netting), Bank's foreign branches have 100 of disregarded interest income and 80 of disregarded interest expense. On a net basis, the foreign branches have an upward adjustment of 20 (100-80), and the home office has a downward adjustment of the same amount.

Making adjustments to branch category income on a net basis will reduce the sensitivity to imperfections in the sourcing rules. The use of gross amounts increases the potential for traps for the unwary, and possibly also for windfall benefits. In the case illustrated by this example, we believe that the net adjustment should constitute foreign source income, but the amount of the adjustment in any event will be no more and no less than 20. By contrast, if adjustments are required to be made on a gross basis, the range of outcomes could be much wider. The total amount of items of income

and expense that would need to be allocated is 180. The risk of serious distortions would increase in proportion to the size of the difference between the gross and net amounts.

Example 4: Source of Income.

Example 4A: Services.

This example illustrates a range of fact patterns in which the London branch performs essentially similar services for the New York home office and receives an arm's length fee. The fee income is fully subject to U.K. tax. If the London branch had performed the same services for an unrelated party, the resulting income unquestionably would have been foreign source income. In the following alternatives, the services relate to:

- An M&A advisory assignment undertaken by the home office and consist of due diligence with respect to a U.K. target company.

- A derivatives business conducted by the home office that is not subject to a global dealing methodology. (The services consist of customer management functions.) Income from the derivatives business is subject to a residence-based sourcing rule, and normally would constitute U.S. source income in the hands of the home office.

- A loan that the home office is making to a U.S. public company. (The services consist of due diligence with respect to the borrower's U.K. subsidiaries.) Interest on the loan will be U.S. source income. The home office does not receive a separately-stated fee in connection with the origination of the loan.

In each of these cases, an upward adjustment of 100 will be made to branch income, and a downward adjustment will be made to home office income, to take account of the disregarded transaction.

Questions:

1. Should the source and basket classification of the upward adjustment to branch income depend on the activities performed by the London branch, the nature of the income derived by the home office, or some other factor?

2. Should the source and basket classification of the downward adjustment to home office income be determined by reference to the source of the upward adjustment to branch income, the nature of the income derived by the home office, or some other factor? If a matching rule applies, it would appear that the taxpayer always loses.

Under the methodology prescribed by the proposed regulations, it would appear that:

- The London branch's share of the M&A fee (as reflected in the payment received from the home office) would be treated as foreign source branch category income, and the upward adjustment would be treated as foreign source branch category income. There would be no downward adjustment to U.S. source income. The fee received by the home office would be sourced where the services are performed.

- The London branch's compensation for customer management services in connection with the derivatives business would be U.S. source income, because the corresponding home office expense relates to a business that produces U.S. source income.

- The London branch's compensation for due diligence services performed in connection with the loan would constitute U.S. source income, because the corresponding home office expense relates to a loan that gives rise to U.S. source interest income.

For purposes of comparison, if the arrangements described above were subject to a global dealing methodology, then we believe that the upward adjustment would constitute foreign source branch basket income in all three cases.

Example 4B: Hedging.

The London branch conducts a derivatives business. As part of that business, the branch manages interest rate and foreign exchange risk for the home office and for other members of Bank's U.S. group. The home office enters into a forward transaction with the London branch to hedge foreign exchange risk on a transaction between the home office and an unrelated party. The London branch hedges its exposure in the London market.

The London branch expects to derive net income of 10 for U.K. tax purposes from the forward transaction and the hedge. That income will be subject to U.K. tax. It is impossible to predict which side of the trade will be profitable. The home office expects to be flat.

When the transactions are closed out, assume alternatively that the London branch has:

- 110 of income on the hedge and 100 of loss on the forward;
- 5 of income on the hedge and 5 of income on the forward; or
- 110 of income on the forward and 100 of loss on the hedge;

In each of these cases, the London branch will have the same amount of net income from a financial and U.K. tax perspective (10). If adjustments in respect of disregarded transactions are made on a gross basis, then the consequences of the adjustments could vary by up to 200, from between +100 to -100.

Questions:

1. Should the amount of foreign source branch basket income be the same in each of these cases?
2. If not, why not?
3. Would a global dealing methodology produce a more sensible result in this case?

Example 4C: Financing.

The London branch can raise money at a 1% rate. It has access to funding in excess of its immediate needs, so it accepts deposits on which it pays interest at 1%, and deposits the proceeds with the home office, which pays interest on those deposits at a 2% rate. The home office uses the funds received from the London branch to make a loan to an unrelated U.S. customer at a 3% rate.

All loans and deposits are made on arm's length terms. The 1% return derived by the London branch represents appropriate compensation for its access to funding on favorable terms, and the 1% return derived by the home office represents appropriate compensation for its ability to make effective use of the funding.[27]

The London branch receives 200 from the home office, and pays 100 to unrelated depositors, for a net return of 100. Its net income is subject to U.K. tax. The home office receives 300 from the unrelated customer, and pays 200 to the London branch, for a net return of 100.

The transaction between the London branch and its home office should give rise to an adjustment of 200: an increase in the amount considered to be derived by the branch, and a corresponding reduction in the amount considered to be derived by the home office.

Questions:

1. How should the source and basket classification of the adjustment be determined? The branch is deriving an arm's length return. The return is attributable to functions that it performs in London, and is appropriately subject to U.K. tax.

2. Should the treatment of the upward adjustment to branch income determine the treatment of the downward adjustment to home office income, or should the source and basket

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27 For ease of illustration, this example assumes that the functions performed in London and New York are equivalent in value, and deserve to be compensated equally. In many cases, however, the services provided by the London branch to its depositors, and its resulting access to extremely low-cost funding, will be the principal contributor to the profitability of the transaction.

classification of the adjustments be determined separately? If a matching rule applies, then it appears that the bank will always lose.

3. Would it make a difference if, instead of using the deposited funds to make a loan to a U.S. corporation, the home office had made a loan on the same terms to a Mexican corporation?

Example 5: Interaction with Global Dealing Methodology.

Bank uses a global dealing transfer pricing methodology to determine the appropriate allocation of revenues or profits from swaps business between different business units. The methodology is respected by the tax authorities of the relevant countries; it may be the subject of an APA. The methodology takes account of disregarded transactions. The third-party revenues or profits recorded on the books of the branches and subsidiaries participating in the business will not necessarily correspond to the amounts attributed to those participants under Bank's global dealing methodology.

The business produces taxable income of 900. Under Bank's transfer pricing methodology, the income is divided equally between its New York home office and its London and Tokyo branches. Bank reports and pays tax on 300 of income for U.K. and Japanese tax purposes. It treats the income attributed to the London and Tokyo branches as foreign source income for U.S. tax purposes.

In 2019, New York derives 600 of third-party income, and London and Tokyo derive 150 each. New York makes payments of 150 each to London and Tokyo in respect of transactions that are disregarded for U.S. tax purposes.

In 2020, London derives 600 of third-party income, and New York and Tokyo derive 150 each. London makes payments of 150 each to New York and Tokyo in respect of transactions that are disregarded for U.S. tax purposes.

Under Bank's transfer pricing methodology, these disparities in third-party revenues do not affect the amount or source of the income that is attributed to New York, London and Tokyo.

- ➢ The regulations should confirm that the new rules dealing with disregarded transactions won't affect this outcome.

Example 6: Intercompany Transactions.

Holding owns Bank and a non-bank chain that includes a number of domestic and foreign subsidiaries. Bank's London branch is the group's principal dealer in derivatives and foreign currencies. When Holding wishes to hedge foreign currency or interest rate risk, it enters into an intercompany transaction with Bank's London branch, and the branch hedges the resulting exposure in the market. The London branch's net income from the transaction (the spread between its return on the intercompany transaction and the cost of the third-party hedge) is subject to U.K. corporation tax at the generally applicable rate.

The London branch enters into a forward transaction with Holding that it hedges in the market. The transaction isn't disregarded for U.S. tax purposes, but in the absence of relief it will be subject to the consolidated return intercompany matching rule. As in Example 4B, the branch expects to derive a net profit of 10 for U.K. tax purposes from the forward transaction and the hedge, and will be subject to U.K. tax on that amount. It is impossible to predict which side of the trade will be profitable.

Holding is entering into the forward transaction to hedge an accounting exposure that doesn't correspond to any current taxable income or loss. Income or loss derived by the London branch from a comparable third-party transaction would be attributed to foreign sources. Income or loss derived by Holding from a comparable third-party transaction would be attributed to U.S. sources.

When the transactions are closed out, assume alternatively that the London branch has:

- 110 of income on the market hedge and 100 of loss on the related-party forward;
- 5 of income on the market hedge and 5 of income on the related-party forward; or
- 110 of income on the related-party forward and 100 of loss on the market hedge;

In each case, the London branch will have income of 10 from a financial and U.K. tax perspective. The amount of the upward adjustment to branch income in respect of the related-party transaction could be as much as 100, or as little as 5; alternatively, there could be a downward adjustment of 100.

Questions:

If there is an upward adjustment to the London branch's income and a corresponding downward adjustment to Holding's income, should the overall consequences be:

1. An increase in foreign source branch basket income and a reduction in domestic source income?
2. An increase in foreign source branch basket income, but only to the extent branch's net profits are attributable to the market hedge, and not otherwise?
3. An increase in branch income that does not create foreign tax credit capacity, because the increase is attributable to the transaction with Holding, and the source of the income derived by branch income is determined by reference to the source of the corresponding loss incurred by Holding?
4. An increase in foreign tax costs without a corresponding increase in foreign tax credit capacity in every case, because the tax attributes of the loss recognized by one party will always match and offset the attributes of the income derived by the other party?

<u>Example 7: Application of the All-Events Test when Taxable Years are Not Coterminous.</u>

The proposed regulations would reaffirm the rule under which liability for a foreign net income tax does not accrue until the end of a foreign taxable year. That rule made sense in the context of a system in which taxpayers had significant flexibility in determining the timing of inclusion of foreign earnings in income, and could carry excess credits forward and back without restriction.

As illustrated below, the continued application of this longstanding rule could give rise to significant unfairness under the new system, in which credits that are not used in a particular year may be lost forever.

Parent owns Sub, a controlled foreign corporation that is organized and engaged in an active business in Country X. Sub's income is subject to corporate income tax in country X at a 25% rate. Under the country X tax system, corporate taxpayers are required to use a taxable year ending March 31. Parent is not be permitted to determine Sub's income on that basis for U.S. tax purposes; instead, it reports on a calendar year basis. Sub's earnings can vary significantly from year to year. One of Sub's businesses generates stable and predictable earnings of 10 a month, for annual income of 120 and country X tax liability of 30. Another business is much more volatile. In December of 2020, Sub derives an extraordinary gain of 1,200 (for example, from the sale of a business) from that business. The business does not generate any other income or loss during the period covered by the example. The gain increases Sub's country X tax liability by 300 in the taxable year ending March 31, 2021. All of the income that Parent derives from Sub is GILTI.

Parent's liability for U.S. tax will be much greater than it would have been if Sub had been permitted to use the same taxable year for U.S. and country X tax purposes. From a U.S. tax perspective, Sub will be considered to have derived income, and to have paid country X tax (before taking account of the 20% foreign tax credit haircut for GILTI purposes) in the amounts shown below:

Calendar 2019: 120 income, 30 foreign tax

Calendar 2020: 1320 income, 30 foreign tax

Calendar 2021: 120 income, 330 foreign tax

- In a case like this one, taxpayers should be able to apportion foreign taxes on a closing of the books or pro rata basis. It wouldn't make sense to require all taxpayers to apportion foreign taxes: in many cases, it won't make a difference, and would just be more work. But it is

important to permit apportionment in cases where the longstanding accrual rule would produce significant distortions.