COVINGTON

BEIJING BRUSSELS DUBAI FRANKFURT JOHANNESBURG
LONDON LOS ANGELES NEW YORK SAN FRANCISCO
SEOUL SHANGHAI SILICON VALLEY WASHINGTON

Covington & Burling LLP
One CityCenter
850 Tenth Street, NW
Washington, DC 20001-4956
T +1 202 662 6000

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VIA HAND DELIVERY AND FEDERAL eRULEMAKING PORTAL

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

Re: Comments on Section 965 Proposed Regulations (Internal Revenue Service REG–104226–18) – Downward Attribution Under Section 318 in Examples 1 & 2 of Proposed Treasury Regulation Section 1.965-1(g)

To Whom It May Concern:

This letter is submitted in response to the request for comments regarding the proposed regulations under section 965 of the Internal Revenue Code that were published in the Federal Register on August 9, 2018. 83 Fed. Reg. 39,514 (Aug. 9, 2018). Specifically, this letter addresses the operation of the rules under section 318(a)(3) that attribute stock held by the owner of an entity from such person to the entity ("downward attribution") as reflected in Examples 1 and 2 of Proposed regulation section 1.965-1(g).

Proposed regulation section 1.965-1 provides guidance on the determination of when a foreign corporation is a "specified foreign corporation" or "SFC" within the meaning of section 965(e). An SFC is either a controlled foreign corporation (as defined in section 957, "CFC") or a foreign corporation with respect to which at least one United States shareholder (as defined in section 951(b), "U.S. shareholder") is a domestic corporation. Because the definition of an SFC is tied to the definitions of CFC and U.S. shareholder, it effectively incorporates the constructive ownership rules of section 958, and indirectly the rules of section 318.

The Proposed regulations include a "Special Attribution Rule" that provides relief in certain instances by turning off downward attribution from a partner to a partnership in determining whether a foreign corporation is an SFC. Proposed regulation section 1.965-1(f)(45)(ii). This rule helpfully provides relief in addressing real world situations where the operation of the constructive ownership rules present significant compliance issues, and thus we support retention of the rule when the regulations are finalized.

However, in illustrating the Special Attribution Rule, the examples reflect a general application of the section 318 downward attribution rules that is inconsistent with that statute as it effectively nullifies the statutory prohibition against so-called "sidewise attribution" under section 318(a)(5)(C), and is directly at odds with IRS and Treasury's prior application of section 318 in this precise fact pattern. The examples do this by interpreting a rule that allows for the reattribution of stock ownership — treating stock of a corporation that has been attributed to one person as being actually owned by that person for purposes of reattributing that same stock to another person — to instead allow for the subsequent attribution of *other* stock to the corporation whose stock was subject to the initial application of the attribution rules. The examples would first move ownership of a corporation through application of the attribution rules, and then attribute other stock ownership to that now moved entity — in effect, overlapping ownership attribution.

Of course reattribution of stock ownership is necessary for the constructive ownership rules to work, as without such reattribution taxpayers could easily circumvent these rules by inserting another person in the structure and thereby cut off constructive stock ownership. In contrast, overlapping ownership attribution reflects a strained reading of section 318 that would render the prohibition against sidewise attribution mute as is apparent from the examples in proposed regulation section 1.965-1(g) (which produce the precise results that the prohibition on sidewise attribution was enacted to prevent) and as illustrated further below. Not surprisingly, IRS and Treasury have not interpreted the rules to allow for such overlapping ownership attribution in the 54 years going back to the 1964 amendment discussed below, and instead have taken a contrary view in informal guidance. The misapplication of the rules in this manner would be extraordinarily consequential; such an expanded application of the section 318 rules would change the tax consequences for a wide range of transactions, including many ordinary business transactions previously executed based on the prior interpretation and application of the law.

Because overlapping ownership attribution reflects a clear departure from prior application of section 318, such a departure should not be made in regulatory examples under section 965. The departure would impact many taxpayers, and specifically taxpayers that do not own stock in an SFC. These taxpayers likely would not be aware of the change and thus would not have practical notice about the change and the associated opportunity to comment.

Therefore, we respectfully request that the Treasury Department and the IRS revise the examples as suggested in Appendix 1 when the proposed regulations are finalized. The proposed changes are intended to apply section 318 in a manner that avoids expanding the downward attribution rules of that section beyond their long-understood scope, while at the same time continuing to illustrate the application of the Special Attribution Rule.

<u>The Operation of Downward Attribution in the Examples</u>

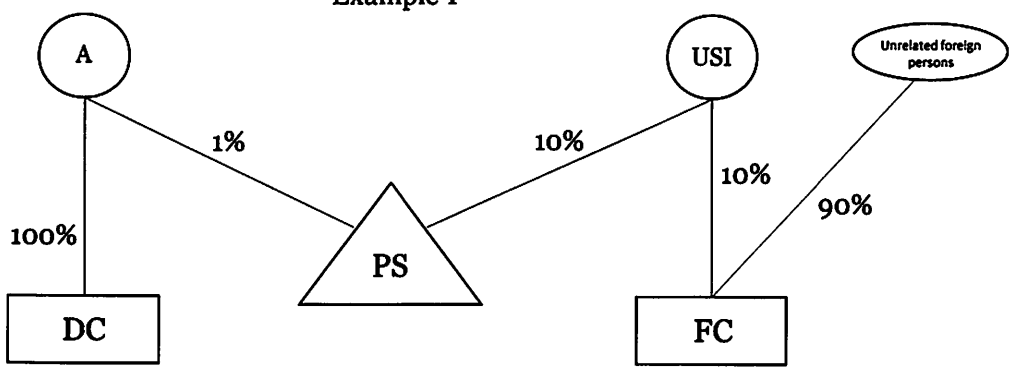
The Special Attribution Rule turns off the downward attribution of stock from a partner to a partnership if such partner owns less than a 5 percent interest in the partnership:

> Special attribution rule. Solely for purposes of determining whether a foreign corporation is a specified foreign corporation within the meaning of section 965(e)(1)(B) and paragraph

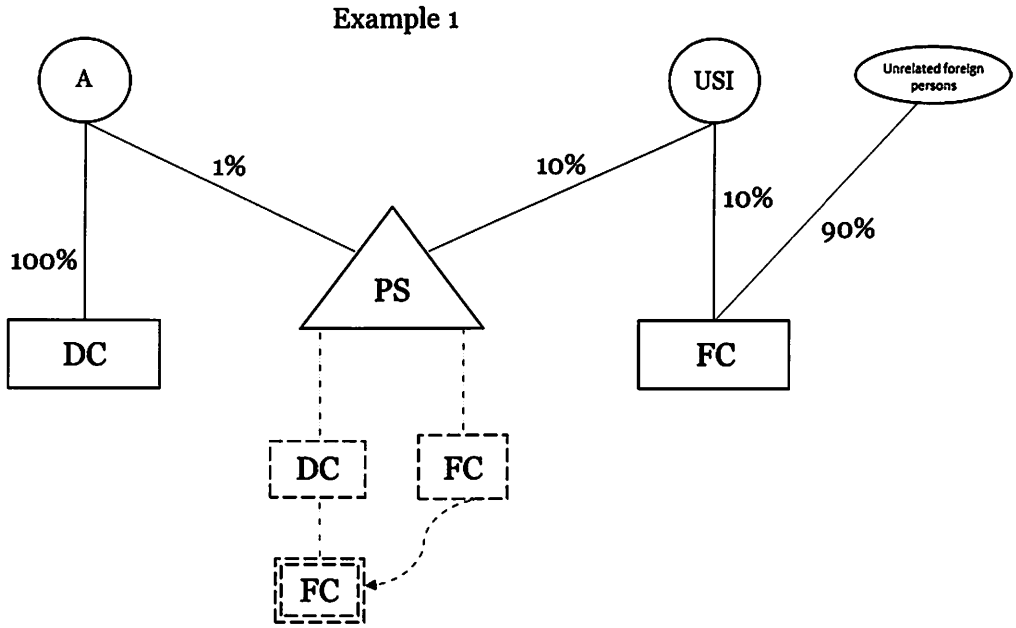
> (f)(45)(i)(B) of this section, stock owned, directly or indirectly, by or for a partner (tested partner) will not be considered as being owned by a partnership under sections 958(b) and 318(a)(3)(A) and §1.958-2(d)(1)(i) if the tested partner owns less than five percent of the interests in the partnership's capital and profits. For purposes of the preceding sentence, an interest in the partnership owned by another partner will be considered as being owned by the tested partner under the principles of sections 958(b) and 318, as modified by this paragraph (f)(45)(ii), as if the interest in the partnership were stock.

The examples in the proposed regulations demonstrate the application of the Special Attribution Rule, one which turns off downward attribution and another which does not. The following chart illustrates the facts of Example 1.

Example 1



The issue is whether FC, a foreign corporation, is an SFC. Example 1 concludes that, absent the Special Attribution Rule providing that A's 100 percent interest in DC is not attributed down to PS, FC would be an SFC under the constructive ownership rules of section 318(a) (as incorporated by section 958(b)). The reasoning of the example is that, under the downward attribution rule of 318(a)(3)(A), PS would be treated as owning 100 percent of the stock of DC and 10 percent of the stock of FC. Thereafter, under section 318(a)(5)(A) and (a)(3)(C), DC would be treated as owning the stock of FC treated as owned by PS. This result causes DC to be a U.S. shareholder with respect to FC, which thus causes FC to be an SFC. The constructive attribution in Example 1 is depicted immediately below.



Example 2 has a similar fact pattern, except that A is a corporation wholly-owned by B, and B directly owns 4 percent of the interest in PS. This results in A constructively owning 5 percent of PS, and thus the Special Attribution Rule does not apply to prevent FC's classification as an SFC.

Both examples apply the attribution rules to allow overlapping ownership attribution – DC is first moved to PS and thereafter FC shares are attributed to it – and thus both examples involve prohibited sidewise attribution. Shares of FC are attributed sidewise across PS to cause DC to be treated as the owner of the FC shares in a manner that violates section 318(a)(5)(C), as explained immediately below.

The Examples' Interpretation of Downward Attribution Contravenes Section 318

When operative, section 318 treats a person as owning stock held by another person by attributing such ownership by the second person to the first. Relevant here, section 318(a)(2), when operative, treats shareholders, partners, or grantors/beneficiaries as owning the stock owned by their corporation, partnership or trust (so called "upward attribution"). And section 318(a)(3), when operative, treats a corporation, partnership or trust as owning the shares actually owned by its shareholders, partners, or grantors/beneficiaries (so called "downward attribution"). For purposes of this letter, we assume the application of the upward and downward attribution rules is self-explanatory, and indeed have no qualms with the application of these rules in the examples in the proposed regulations.

Section 318(a)(5) contains operative rules, two of which are relevant here. Section 318(a)(5)(A) provides that stock owned constructively by reason of the downward or upward attribution rules "shall, for purposes of applying paragraphs (1), (2), (3), and (4), be considered as actually owned by such person." And section 318(a)(5)(C) provides that "[s]tock constructively owned by a partnership, estate, trust, or corporation by reason of the application

of paragraph (3) shall not be considered as owned by it for purposes of applying paragraph (2) in order to make another the constructive owner of such stock." As explained below, the operation of these two rules allows for reattribution of stock but does not allow for overlapping ownership attribution.

Section 318 was amended in 1964 to limit sidewise attribution. In other words, stock constructively owned by an entity by attribution from one owner through downward attribution is not reattributed upward to another owner. Or, in common vernacular, there is no sidewise attribution of stock from one owner to another through common ownership in an entity.[1]

Section 318(a)(5)(C) is the result of a Congressional decision that such sidewise attribution should not apply because it "has the effect of attributing one person's stockholding to another even though there is neither an economic nor family connection between the two" shareholders. H.R. Rep. No. 1514, 88th Cong., 2d Sess., 1964-2 C.B. 705. As the legislative history to that section explains:

> Your committee concluded, since there is no basis either in family relationship or in common economic interest for the application of these two attribution rules at the same time, that sidewise attribution should be eliminated from the constructive ownership rules of present law. This is in accord with numerous recommendations of technical advisory groups which have concerned themselves with this problem.

Id. at 706. Section 318(a)(5)(C) was added to the Code specifically to prevent sidewise attribution, including in the case of two partners in a partnership.

Accordingly, whatever "actual ownership" of stock means under section 318(a)(5)(A), it cannot be interpreted to allow for the type of sidewise attribution precluded by section 318(a)(5)(C). But there is a very natural reading of section 318(a)(5)(A) that would allow for the necessary reattribution of stock, but not the prohibited sidewise attribution – that is stock constructively owned "shall, for purposes of applying paragraphs (1), (2), (3), and (4) *[to the stock constructively owned]*, be considered as actually owned by such person." In effect, stock attributed to one person may be reattributed from that person to another. Such a rule stands in stark contrast to a rule that would first move an entity within the organization chart for the purpose of subsequently attributing other stock to it.

As indicated above, the examples in the proposed regulations adopt an interpretation of section 318 that requires overlapping ownership attribution; they first move the entity at issue, DC, and then attribute ownership of the FC stock to DC. This interpretation overrides the prohibition against sidewise attribution, which would otherwise prevent A and DC from owning FC stock by reason of their ownership of PS. Moreover, such an interpretation would override most (if not all) applications of section 318(a)(5)(C), and effectively read that section out of the Code. The reason is simple: If overlapping ownership attribution is allowed, any prohibited

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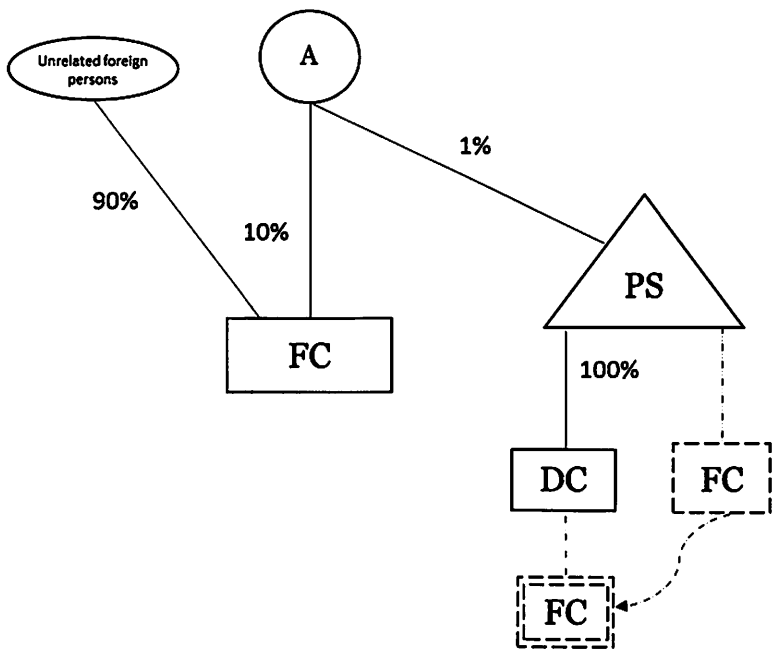
[1] Sidewise attribution is also referred to as "downwards-and-upwards" attribution.

sidewise attribution may be avoided by first moving the entity at issue, and then attributing shares to it in a manner that technically does not involve section 318(a)(2) upward attribution.

A correct application of section 318(a)(5)(A) and (a)(3)(C) can be illustrated with a slightly altered example from the proposed regulations; that is, if PS itself actually owns 100 percent of the stock of the domestic corporation, DC, prior to the application of the attribution rules. In that case, as illustrated below, the stock of FC is properly attributed to PS and then reattributed to DC, causing FC to be an SFC. This application of the rules is proper, as it prevents the insertion of an entity (here PS) from artificially cutting off the application of the constructive ownership rules. *See also* Meyer Fedida & Daniel Hanna, "Applying the Repatriation Tax to Individuals," Letter to the Editor, Tax Notes, at 1407-08 (Mar. 5, 2018) (supplying another example using a wholly-owned U.S. subsidiary of a private investment fund).

Proposed Example to Replace Example in Proposed Regulations – See Appendix



The Examples Are Inconsistent with Previous IRS Policy

The examples also diverge from the IRS's previous interpretation of section 318. In Private Letter Ruling 200637022 (Sept. 15, 2006), the IRS concluded that section 318 did not cause a stock sale to become a section 304 transaction. In that ruling, brother-sister corporations, Buyer 1 and Buyer 2, planned to purchase various target foreign subsidiaries from Seller, another corporation. Seller's and Buyers' respective shareholders, who were otherwise

unrelated, were also both partners in the same partnership. The issue was whether the shareholders' common interests in the partnership resulted under section 318(a) in Seller's constructive ownership of Buyers — i.e., whether some manifestation of sidewise attribution would result in common ownership — thus transforming an otherwise straightforward stock sale into a section 304 transaction.

The ruling holds that section 304 did not apply. While not stated, implicit in the analysis is that section 318 does not allow for overlapping ownership attribution, as the application of such attribution principles in the ruling would have resulted in common ownership, and would have resulted in the application of section 304 to the transaction.[2] That is, application of overlapping ownership attribution would have allowed (1) the attribution of the stock of Seller and Buyers to the partnership, and (2) then the reattribution of the stock of the Buyers to the now moved Seller entity.

Potential Consequences of the Examples' Interpretation of Section 318

The letter ruling illustrates how the examples' interpretation of section 318(a) has implications well beyond section 965, in that case, the possible application of section 304 to an acquisition between wholly unrelated companies. (Of course, whether section 304 treatment would be better or worse for one or more of the taxpayers involved will depend on the circumstances, but in all events this conclusion and the resulting tax consequences would be unexpected.) Indeed, the misapplication of section 318 in this manner would be extraordinarily consequential as it would alter the expected tax consequences of myriad ordinary business transactions. This results because, while the Special Attribution Rule is limited to section 965, the interpretation of section 318 reflected in the examples is not. Nothing in the section 965 proposed regulations purports to revise the operation of section 318, and thus, the examples can only be interpreted as arising from a general application of that rule. Thus, if the overlapping ownership attribution in the examples is correct, it applies in every instance that section 318 applies.

More than 40 Code sections cite section 318, including individual, corporate, employee benefits, international, and information-reporting provisions. There are approximately an additional 30 Treasury regulations that cite section 318 where the underlying statute does not. The interpretation of section 318(a) as reflected in the examples would apply to all of these. For purposes of illustration only, we describe a tiny subset of these below.

Section 338 allows a corporation purchasing the stock of an unrelated corporation to elect to treat the acquisition as a taxable asset acquisition. Under the interpretation of section 318 in the examples, the availability of section 338 would be sharply curtailed; any time that two unrelated corporations sold the stock of a lower-tiered target, a section 338 election would not be available if their shareholders owned any interests in the same joint venture or partnership. Building on the facts of Example 1, if FC wholly-owned a subsidiary that DC planned to

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[2] Commentators have discussed the ruling's conclusion precluding sideways attribution and reasons supporting the conclusion that the ruling reached the correct result. *See, e.g.*, Jasper L. Cummings, Jr., *The Deep Structure of Attribution*, 113 Tax Notes 507 (Oct. 30, 2006); Robert Willens, *Sideways Attribution* (Nov. 14, 2006), Doc 2006-21881, 2006 TNT 219-54.

purchase, DC would not be able to make a section 338 election because the stock in the subsidiary would be acquired from a corporation, FC, whose stock DC constructively owns.

For an even more timely example, the Base Erosion and Anti-Abuse Tax ("BEAT") applies to certain deductible payments made by an applicable taxpayer to a foreign related party. A related party includes any 25 percent owner of the taxpayer, taking section 318 into account. Section 59A(g)(1), (3). If, for example, DC and FC were 100 percent owned by A and USI, respectively, and DC made deductible payments to FC, such payments would give rise to a BEAT liability under the interpretation reflected in the examples.

The Special Attribution Rule Is a Relief Provision

We note in conclusion that the Special Attribution Rule is a provision that grants relief to certain partners in a partnership in light of the administrative hardship in complying with the downward attribution rule, given that no minimum interest is required for section 318(a)(3)(C) to apply to partnerships. Explanation of Provisions, Section II.B.1, 83 Fed. Reg. at 39,520 (citing Notice 2018-26, § 3.01, which originally described the provision) ("[I]t may be difficult to determine if a foreign corporation is a specified foreign corporation under certain circumstances.").

Unfortunately, although the examples are meant to illustrate a generally taxpayer-favorable relief provision, the interpretation of section 318 reflected therein would have the opposite effect and vastly expand the application of numerous unrelated Code provisions, and ironically, in a manner that would impose the same or similar administrative burdens the Special Attribution Rule was intended to reduce. A similar regulatory provision turning off certain partner-partnership attribution with respect to section 336(e) elections grants meaningful relief without creating the broad-reaching consequences that the examples as currently drafted would generate. *See* Treas. Reg. § 1.336-1(b)(12) ("[N]either section 318(a)(2)(A) nor section 318(a)(3)(A) apply to attribute stock ownership from a partnership to a partner, or from a partner to a partnership, if such partner owns, directly or indirectly, interests representing less than five percent of the value of the partnership."). The proposed changes to the examples are designed to achieve this same goal.

Conclusion

Consistent with the discussion above, we respectfully request that the modifications to Examples 1 and 2 of Proposed regulation section 1.965-1(g) described in the Appendix be adopted. These modifications are intended to illustrate the Special Attribution Rule within the current section 318 framework in a way that is not contrary to the statutory prohibition on sidewise attribution. Importantly, no change concerning the Special Attribution Rule is being suggested as the relief provided by this rule is important and necessary to ensure that taxpayers can comply with the provisions of section 965, and this comment relates only to the examples.

We appreciate your consideration of our request, and please let us know if a discussion of the issue would be helpful.

Respectfully submitted,

Michael J. Caballero

Michael J. Caballero

Karalyn Kornetsky for Lee Kelley

Lee Kelley

cc: Lafayette G. Harter III
Douglas Poms
Brenda Zent
Krishna Vallabhaneni
U.S. Department of the Treasury

Robert Wellen
Marjorie Rollinson
Dan McCall
John Merrick
Jeffery Mitchell
Leni C. Perkins
Internal Revenue Service

Appendix 1

Example (1). Definition of specified foreign corporation.

(i) Facts. A, an individual, owns ~~100~~10% of the stock of a ~~domestic~~foreign corporation, ~~DC~~FC, and 1% of the interests in a partnership, PS. ~~A United States citizen, USI,~~ PS owns ~~10~~100% of the ~~interests in PS and 10% by vote and value of the~~ stock of a ~~foreign~~domestic corporation, ~~FC.~~DC. The remaining 90% by vote and value of the stock of FC is owned by ~~non-United States~~foreign persons that are unrelated to A, ~~USI,~~ DC, and PS.

(ii) Analysis.

(A) Absent the application of sections 958(b), 318(a)(3)(A), and 318(a)(3)(C), and §1.958-2(d)(1)(i) and (iii), FC would not be a specified foreign corporation, because FC is not a controlled foreign corporation and there would be no domestic corporation that is a United States shareholder of FC. However, under sections 958(b) and 318(a)(3)(A) and §1.958-2(d)(1)(i), absent the special attribution rule in paragraph (f)(45)(ii) of this section, PS would be treated as owning ~~100% of the stock of DC and~~ 10% of the stock of FC. As a result, under sections 958(b), 318(a)(5)(A), and 318(a)(3)(C), and §1.958-2(f)(1)(i) and (d)(1)(iii), DC would be treated as owning the stock of FC treated as owned by PS, and thus DC would be a United States shareholder with respect to FC, causing FC to be a specified foreign corporation within the meaning of section 965(e)(1)(B) and paragraph (f)(45)(i)(B) of this section. The results would be the same whether A or PS or both are domestic or foreign persons.

(B) Under the special attribution rule in paragraph (f)(45)(ii) of this section, solely for purposes of determining whether a foreign corporation is a specified foreign corporation within the meaning of section 965(e)(1)(B) and paragraph (f)(45)(i)(B) of this section, the stock of ~~DC~~FC owned by A is not considered as being owned by PS under sections 958(b) and 318(a)(3)(A) and §1.958-2(d)(1)(i), because A owns less than 5% of the interests in PS's capital and profits. Accordingly, FC is not a specified foreign corporation within the meaning of section 965(e)(1)(B) and paragraph (f)(45)(i)(B) of this section.

Example (2). Definition of specified foreign corporation.

(i) Facts. The facts are the same as in paragraph (i) of Example 1 of this paragraph (g), except that A is a foreign corporation wholly owned by B, and B directly owns 4% of the interests in PS.

(ii) Analysis. Applying the principles of sections 958(b) and 318, as modified by paragraph (f)(45)(ii) of this section, as if the interest in PS were stock, A is treated as owning the interests in PS owned by B (in addition to the 1% interest in PS that A owns directly), and thus A is not

treated as owning less than 5% of the interests in PS's capital and profits. Accordingly, the special attribution rule in paragraph (f)(45)(ii) of this section does not apply, and PS is treated as owning A's stock of ~~DC~~FC for purposes of determining whether FC is a specified foreign corporation within the meaning of section 965(e)(1)(B) and paragraph (f)(45)(i)(B) of this section. Accordingly, under the analysis described in paragraph (ii)(A) of Example 1 of this paragraph (g), FC is a specified foreign corporation within the meaning of section 965(e)(1)(B) and paragraph (f)(45)(i)(B) of this section.