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March 9, 2018

VIA ELECTRONIC MAIL

The Honorable David Kautter
Assistant Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable William Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Request for Guidance in Applying Controlled Foreign Corporation Rules following P.L. 115-97

Dear Assistant Secretary Kautter and Acting Chief Counsel Paul:

This letter is submitted in response to Notice 2018-13, Section 7, in which Treasury requested comments regarding the repeal of Internal Revenue Code section 958(b)(4)[1] as part of the Tax Cuts and Jobs Act of 2017, Public Law 115-97 (the "2017 Act").

We respectfully request that the Treasury Department and the IRS issue guidance announcing their intention to issue regulations, consistent with the purpose and historical application of the controlled foreign corporation rules (the "CFC Rules"), as well as Congress' stated intent in repealing section 958(b)(4), confirming that:

> A foreign corporation shall not be treated as a controlled foreign corporation with respect to a "U.S. shareholder" if the foreign corporation is only treated as a controlled foreign corporation as a result of constructive attribution under section 318(a)(3) of stock owned by a person who is not a United States person to a United States person that is not a related person (within the meaning of section 954(d)(3)) to such U.S. shareholder.

Prior to its repeal, section 958(b)(4) prevented the "downward attribution" of stock ownership from a foreign person to a related U.S. person for, *inter alia*, determining the status

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[1] All references to section or sections are to the Internal Revenue Code of 1986, as amended and currently in effect, except where otherwise noted.

of a corporation as a CFC.[2] Congress repealed section 958(b)(4) with the specific intent "to render ineffective certain transactions that are used []as a means of avoiding the subpart F provisions,"[3] including so-called "de-control" transactions.

Congress did not intend for the repeal of section 958(b)(4) to override the bedrock principle of the CFC Rules that a U.S. taxpayer should not be taxed on subpart F income from an entity it does not control either individually or collectively with other U.S. taxpayers. To the contrary, the Conference Report to the 2017 Act explicitly stated that the repeal "is *not intended* to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is not a related person. . . ."[4]

Congress' targeted intent in repealing section 958(b)(4) was further reinforced by the colloquy between Senators Perdue and Hatch on the Senate floor, during which Senator Hatch confirmed that the above statement reflected the intent of the Senate Finance Committee and the conferees. *See* 163 Cong. Rec. S8, 110 (daily ed. Dec. 19, 2017) (colloquy between Sens. David Perdue and Orrin Hatch). Senator Hatch advised fellow Senators that a statutory amendment was not required to reflect such intent and that "[t]he Treasury Department and the Internal Revenue Service should interpret the stock attribution rules consistent with this explanation."[5]

Thus, we respectfully request that Treasury and the IRS issue guidance interpreting the CFC Rules, in particular the repeal of section 958(b)(4) and the stock attribution rules under section 318(a)(3), consistently with clearly expressed Congressional intent. Such guidance will mitigate the risk that the CFC Rules could be applied in an overbroad manner, inconsistent with clearly expressed Congressional intent.

The requested guidance is fully consistent with the text and purpose of the CFC Rules, as set forth below. Treasury has authority to issue guidance necessary for the proper and intended

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[2] *See* 2017 Act, § 14213. In general, under the CFC rules, certain income of a foreign corporation that is owned by five or fewer United States persons, each holding a 10 percent or greater interest in the corporation (a "U.S. Shareholder"), is included in the income of each U.S. Shareholder regardless of whether the income is distributed to the U.S. Shareholder.

[3] *See,* Conference Report to Accompany H.R. 1, Rpt. 115-466, December 15, 2017 (the "Conference Report"), at p. 508.

[4] *See,* Conference Report, at p. 507. *See also* Committee Print, *Reconciliation Recommendations Pursuant to H. Con. Res. 71,* S. Prt. 115-20, (December 2017) at p. 382-383, as reprinted on the website of the Senate Budget Committee, available at *http://www.budget.senate.gov/taxreform.*

[5] "The conference report language for the bill does not change or modify the intended scope of the statement [Sen. Perdue] cites. The Treasury Department and the Internal Revenue Service should interpret the stock attribution rules consistent with this explanation, as released by the Senate Budget Committee. I would also note that the reason his amendment No. 1666 was not adopted is because it was not needed to reflect the intent of the Senate Finance Committee or the conferees for the Tax Cuts and Jobs Act." 163 Cong. Rec. S8, 110 (daily ed. Dec. 19, 2017) (colloquy between Sens. David Perdue and Orrin Hatch).

application of the CFC Rules, and to prevent results manifestly incompatible with the intended operation of these rules.

History of the CFC Rules

Congress implemented the CFC regime in 1962, to address certain U.S. tax deferral and avoidance opportunities then-available to U.S. taxpayers. The initial proposals of the CFC Rules would have applied to (1) newly formed foreign corporations in which 10 percent or more of the stock is owned by a U.S. person and (2) existing foreign corporations in which more than 50 percent of the stock is owned by 10 or fewer U.S. persons.[6] Policymakers and commentators criticized these initial proposals, because U.S. persons would have been required to include earnings of foreign corporations in income, even though such U.S. persons could not, either alone or together with other U.S. persons, compel the foreign corporation to distribute the associated earnings. Policymakers argued that taxing a person on income which the person did not actually receive or have the authority to demand was unfair and potentially unconstitutional.[7]

In response to such criticism, the CFC Rules enacted in 1962 only applied to foreign corporations in which more than 50 percent of the stock was owned by five or fewer U.S. persons, each owning 10 percent or more of the stock – i.e., a controlling block.[8] This ownership threshold – that a foreign corporation must be controlled has remained essentially unchanged since 1962. Similarly, the passive foreign investment companies ("PFIC") regime, subsequently enacted in 1986, also does not require non-controlling U.S. Shareholders to pay tax on foreign earnings until realized.[9]

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[6] *See* Detailed Explanation of the President's Recommendations Contained in His Message on Taxation, Submitted by Secretary of the Treasury Dillon in connection with the Hearings before the Committee on Ways and Means, House of Representatives, May 3, 1961, *reprinted in* Hearings before the Committee on Ways and Means on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress, April 20, 1961, 87th Cong., 1st Sess. (Vol. 1) at 253, 261 (1961).

[7] *See, e.g.*, Memorandum of the Joint Committee dated May 4, 1961, *reprinted in* Hearings before the Committee on Ways and Means on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress, April 20, 1961, 87th Cong., 1st Sess. (Vol. 1) at 311, 311-12 (1961) (stating that the Administration's proposal "raises certain basic questions as to whether or not [a U.S. shareholder] has income within the meaning of the 16th amendment when he has received nothing and does not have the right and power to demand any payment," and noting in particular the obvious inappropriateness of applying the proposal to "a U.S. corporation engaged in merchandising [that] acquired and held 25 percent of the stock of a Belgian corporation operating a department store in Belgium").

[8] *See* Draft of Statutory Language, with Accompanying Explanation, of Amendments Proposed by the Secretary of the Treasury on May 10, 1962, to Sections 13, 15, 16, and 20 of H.R. 10650, 87th Cong., 2d Sess., at 3 (Comm. Print 1962) (Among the proposed amendments was to count only 10-percent U.S. shareholders in determining whether more than 50 percent of the stock of a foreign corporation is held by U.S. persons, and accordingly whether the corporation is a CFC. The explanation stated that the changes "remove objections that the coverage of foreign corporations was too broad, reaching situations where ownership was widely scattered and no U.S. group was in effective control."); *see also* Revenue Act of 1962, P.L. 87-834, § 12(a) (1962).

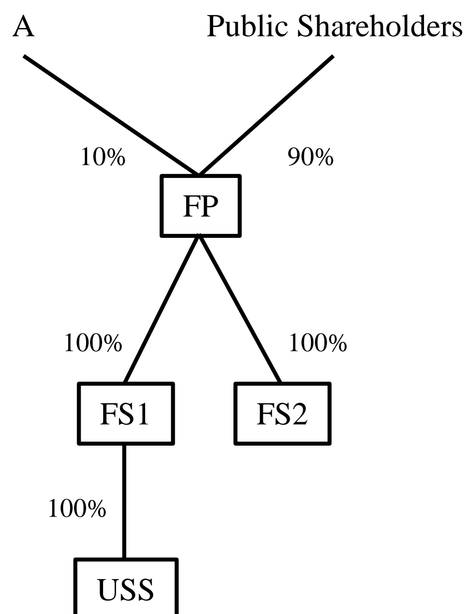
[9] The PFIC rules do, however, permit U.S. taxpayers to elect to pay tax on undistributed foreign earnings in a current year, if doing so would be more favorable to such taxpayer. *See* sections 1295 and 1296.

The CFC regime has operated for over 55 years, during which time there have been countless revisions and modifications to the operation of the rules. Yet, the principle that a U.S. Shareholder should not be taxed on earnings of a foreign corporation it neither controls (either individually or as part of a small group) or is related to (as part of an affiliated group) remains unchanged. There is no evidence, in the 2017 Act or related legislative history, that Congress sought to disregard this bedrock principle of the CFC regime in repealing section 958(b)(4). To the contrary, as noted above, Congress explicitly confirmed that it did not intend to effect such a dramatic change, but rather to prevent a targeted abuse.

Authority to Issue Requested Guidance

Treasury has the authority to issue the requested guidance under section 7805(a), which directs the Secretary to "prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." The guidance is necessary, following the repeal of section 958(b)(4), to establish Treasury's intent to apply the CFC Rules consistent with their history as well as purpose and clearly expressed Congressional intent, rather than in an overbroad manner that would create inappropriate and unintended results.

The following is an example of such an inappropriate and unintended result, which the proposal guidance, as requested, would address. A U.S. Shareholder, A, owns 10 percent of a foreign corporation, FP. The other stock of FP is publicly traded and thus widely held by unrelated investors. FP operates worldwide through two foreign affiliates, FS1 and FS2, and in the United States through a domestic corporation, USS. FP holds 100 percent of the stock of FS1 and FS2 directly, and FS1 holds 100 percent of the stock of USS.



The requested guidance would provide that FS2 is not a CFC with respect to A, because A is not related to USS, and therefore A will not be taxed on its *pro rata* share of certain types of FS2's income under the CFC Rules. In contrast, to the extent USS directly or indirectly owns any stock of another foreign affiliate (but 50 percent or less), it will be taxed on its *pro rata* share of certain types of income earned by that foreign affiliate because it is related, consistent with the intent of the 2017 Act, regardless of whether USS holds a controlling interest in the foreign affiliate.

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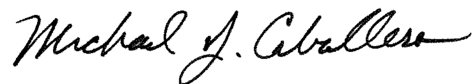
We appreciate your consideration of our request and would be happy to answer any questions that you may have.

Respectfully submitted,



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