DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES

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William M. Paul, Esq.
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington DC 20224

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

Re: REG–104226–18 Relating to the Proposed Regulations under Section 965

Dear Mr. Paul:

Prior to 2018, the US taxed the income of US taxpayers regardless of where it was earned. This worldwide tax system included two key exceptions designed to ease the burden on taxpayers with overseas income -- taxpayers were allowed a credit for any foreign taxes they paid and the tax on Controlled Foreign Corporations (CFCs) was deferred until the income was repatriated back to the US parent company.

The deferral exception was particularly popular. The Institute of Taxation and Economic Policy estimated that back in 2016, just 30 US companies were holding on to a cumulative $2.6 trillion of untaxed foreign earnings.

Tax reform shifted the taxation of foreign income to a modified territorial system. The key to the new system was a Dividends Received Deduction (DRD) applied to the dividends paid by CFCs. As with the worldwide tax, the new territorial system was not pure but rather included some significant exceptions, notably a new minimum tax (GILTI) and a base erosion and anti-abuse tax (BEAT).

For reasons not made clear, S corporations were excluded from the new territorial system and otherwise disadvantaged on their foreign-sourced income -- they were explicitly excluded from the new DRD, they were subject to the new GILTI tax but ineligible for the 50-percent deduction under Section 250, and all their foreign-sourced income was ineligible for the new 20-percent deduction under Section 199A. As the law firm McDermott, Will & Emery observed:

> *In short, C corporation US shareholders are entitled to reduce their GILTI by 50 percent, are subject to a US federal corporate tax rate of only 21 percent, and are entitled to claim a credit for up to 80 percent of the foreign taxes paid or accrued by the CFC on the GILTI. As a result, the GILTI rules generally impose a US corporate minimum tax of 10.5 percent (50% x 21%) and to the*

extent foreign tax credits are available to reduce the US corporate tax, may result in no additional US federal income tax being due.

In the case of non-C corporation US shareholders, however, the effective rate imposed on GILTI is much higher. The reason for this is that non-C corporation shareholders are not entitled to deduct 50 percent of their GILTI, are subject to a US federal income tax rate of up to 37 percent and cannot generally claim a credit for the foreign taxes paid or accrued by the CFC on GILTI.

In transitioning to the new territorial system, Congress made clear that a first step would be for US taxpayers to clear the books and pay US tax on any deferred foreign profits. This deemed repatriation tax under Section 965 was seen as a "toll charge" for companies moving to the new DRD. As described by PWC:

The [2017 tax reform reconciliation act] (the Act) -- the largest overhaul of the US tax code in 31 years -- uses the mechanics under subpart F to impose a one-time 'toll charge' on the undistributed, non-previously taxed post-1986 foreign E&P of certain US-owned foreign corporations ***as part of the transition to a new territorial regime****. The toll charge is reduced by a deduction computed in a manner that ensures a 15.5-percent effective tax rate on 'cash' and an 8-percent effective tax rate to the extent the inclusion exceeds the cash position. (Emphasis added)*

To ease the burden of the toll charge, Section 965(h) gave all US shareholders of a CFC, including individuals and C corporations, an election to pay the tax in installments over eight years.

S corporations were excluded from the DRD and the new territorial system, however, so the concept of a toll charge made little sense when applied to them. Instead, Section 965(i) gave S corporation shareholders the ability to defer *indefinitely* payment of their Section 965 taxes until a "triggering event" takes place.

In other words, Congress established two very distinct systems of taxing foreign business income -- a quasi-territorial regime for CFCs owned by a C corporation parent and a separate, more onerous worldwide system for S corporations. Since S corporations were excluded from the new territorial regime, they were allowed to indefinitely defer payment of the "toll charge" until a triggering event takes place.

Two policies outlined by Treasury in the proposed rules and accompanying notices violate this general approach and would effectively apply the "toll charge" tax on S corporations in the absence of a triggering event. The S Corporation Association requests that Treasury address these two instances and preserve Congressional intent with regard to applying the Section 965 tax to S corporations.

Overpayments

The proposed rules do not address the issue of overpayments made by taxpayers with Section 965 liabilities. The S Corporation Association requests that the final rules on Section 965 address this issue and reverse the position taken by the IRS to date. This is a significant issue for all taxpayers with Section 965 liabilities, but it is of particularly importance for S corporation shareholders.

On August 2nd, the Internal Revenue Service's Office of Chief Counsel released a [memorandum] reaffirming its position that for taxpayers making an election under Section 965(h), any overpayments would not be refunded to the taxpayer but would be applied against future installment payments of their Section 965 liabilities instead. As the memorandum states:

> *The Service will apply any excess amount to the next successive annual installment due in 2019, and to the extent such excess exceeds the amount of that installment due, then to the next such successive annual installment until the excess amount has been fully applied. Section 6403 does not permit the Service to refund any excess installment payment to the taxpayer prior to there being an overpayment of the entire liability as provided in section 6402. Because there is no overpayment under section 6402 until the entire 2017 tax liability is paid, including all of the installments of the deferred payment, the Service's offset refund bypass procedures will not apply.*

While the memorandum focuses on elections made under Section 965(h), the policy it articulates appears to apply to elections made under Section 965(i) as well. As the Counsel argues:

> *Section 965(h) does not permit the United States shareholders to defer recognizing these amounts as income and therefore defer the tax liability;* ***it only permits a deferral of the payment of that liability if the shareholder elects to do so.*** *Accordingly, an overpayment under section 6402(a) does not exist with respect to a 2017 income tax liability unless and until the entire liability is fully paid, including any amount of that liability that is subject to an election to pay that income tax liability in installments under section 965(h). Absent an overpayment of the entire tax liability for the 2017 tax period, the Service cannot issue a credit or refund under section 6402(a) with respect to the 2017 tax period. (Emphasis added)*

Sections 965(h) and (i) are constructed similarly. In both sections, the statue refers to the net tax liability owed by a taxpayer under Section 965:

- 965(h)(1): In the case of a United States shareholder of a deferred foreign income corporation, such United States shareholder **may elect to pay the net tax liability** under this section in 8 installments of the following amounts….
- 965(i)(1): In the case of any S corporation which is a United States shareholder of a deferred foreign income corporation, each shareholder of such S corporation **may elect to defer payment of such shareholder's net tax liability** under this section with respect to such S corporation until the shareholder's taxable year which includes the triggering event with respect to such liability.

It therefore appears that the same overpayment analysis applying to Section 965(h) liabilities would apply to Section 965(i) liabilities.[1] This result is of particular concern to S corporation shareholders. For a taxpayer with Section 965(h) liabilities, the IRS' position would accelerate tax payments that would otherwise be spread over eight years. For S corporation shareholders making a Section 965(i) election,

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[1] This result is not *entirely* clear. Section 965-7(c)(3) of the proposed rules describes triggering events that spring the 965(i) liability to life. The last sentence of Section 965-7(c)(3)(i) states that "the shareholder's section 965(i) net tax liability with respect to the S corporation will be assessed as an addition to tax for the shareholder's taxable year that includes the triggering event." This language seems to imply that the IRS is treating the 965(i) liability as part of the triggering year liability rather than as a liability of 2017 with a deferred payment date. The S Corporation Association believes this approach is more in line with Congressional intent and that it would be more appropriate way to view Section 965(h) payments as well.

this position would force them to make tax payments that would otherwise be deferred *indefinitely*. It presents S corporation shareholders with a much bigger penalty for making overpayments and completely undermines the purpose of Section 965(i).

It is also contrary to the plain reading of the law. The IRS has argued that the statute requires this policy. The IRS memorandum noted that the Section 965 guidance was based on Section 6402 and Section 6403. Section 6403 provides:

> *In the case of a tax payable in installments, if the taxpayer has paid as an installment of the tax more than the amount determined to be the correct amount of such installment, the overpayment shall be credited against the unpaid installments, if any. If the amount already paid, whether or not on the basis of installments, exceeds the amount determined to be the correct amount of the tax, the overpayment shall be credited or refunded as provided in section 6402.*

But Section 6403 applies to the overpayment of a specific installment of a tax payable in installments only. It does not address how the overpayment of tax liabilities not subject to payment in installments should be treated. Taxpayers who overpaid their 2017 taxes overpaid their 2017 net income tax liability, not the first installment of the Section 965 tax.

Meanwhile, Section 6402(a) states that the Secretary "may" apply overpayments on one tax to another existing liability – it does not *mandate* it. Section 6402 provides the Secretary with the discretion to comply with the clear intent of Congress to defer the payment of the future Section 965 installments.

Congress gave taxpayers the election to defer their tax liabilities under Section 965. The guidance issued by the IRS and the subsequent memorandum from the Chief Counsel's Office would overturn this policy. It is contrary to congressional intent and it is contrary to a plain reading of the law. The S Corporation Association respectfully requests that the IRS revise its guidance and restore the full deferral of Section 965 tax liabilities, as intended by Congress.

Triggering Events and Elections

As noted above, Section 965(i) gave S corporation shareholders the ability to defer *indefinitely* payment of their Section 965 taxes until a "triggering event" takes place. These triggering events include:

> (i) The US parent ceases to be an S corporation;
>
> (ii) There is a liquidation or sale of substantially all the assets of the parent S corporation, a cessation of business by the parent S corporation, the parent S corporation ceases to exist, or any similar circumstance.
>
> (iii) The shareholder of the parent S corporation transfers of any share of stock in the S corporation (including by reason of death, or otherwise).

Consistent with the legislative history of Section 965, these triggering events appear designed to ensure that an S corporation that does not benefit from the new territorial regime is not subject to the "toll charge" tax. They also appear designed to ensure the payment of the tax once the S corporation is no longer in business or where the taxpayer is no longer an owner of the business. This desire is reinforced by the fact that taxpayers making the Section 965(i) election are, together with the S corporation, joint and severally liable for the deferred tax.

The proposed rules, however, would expand the scope of the triggering events under Section 965(i) to include “exchanges or other dispositions.” The S Corporation Association is concerned that this expansion of possible triggering events will result in the acceleration of Section 965 payments in cases where the S corporation is still an active business and where there is no deterioration of the ability of the S corporation and its electing shareholders to pay the tax.

For example, an S corporation that enters into a joint venture with another party could transfer significant assets into the new partnership, thus tripping the “exchange” language of the proposed rules and accelerating the payment of Section 965 tax liabilities. But an exchange is not the same as a sale and, as demonstrated in the joint venture example, the S corporation would still be in business and still the ultimate owner of those assets. Nothing has changed relative to Section 965.

That outcome was not envisioned by the underlying statute and is clearly not consistent with congressional intent. As such, the S Corporation Association respectfully requests that the proposed rules be amended to delete references to “exchanges or other dispositions.”

The S Corporation Association thanks you for the opportunity to comment on the proposed rules. We welcome the opportunity to meet with Treasury or the Commissioner to discuss these comments in detail or to answer any questions you might have.

Sincerely,

Brian Reardon
President
S Corporation Association