March 19, 2019

LG "Chip" Harter
Deputy Assistant Secretary (International Tax Affairs)
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Jason Yen
Attorney Advisor
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Harvey Mogenson
Department of the Treasury
Tax Specialist
1500 Pennsylvania Ave., NW
Washington, DC 2022

Doug Poms
International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue., NW
Washington, DC 20220

Lindsay Kitzinger
Attorney Advisor
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Re: Follow-up on February 27 meeting regarding the proposed FTC regulations

Dear Ladies and Gentlemen,

Thank you for taking the time to meet with members of the SIFMA foreign tax credit working group.[1]I am writing to follow up on the topics discussed at our meeting, and in the comments that we submitted on February 4th. In particular, this letter discusses what we think should be your key priorities in developing guidance concerning foreign branches. We hope that you will find our recommendations helpful.

[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).

As we discussed, the existing rules for determining the allocation and source of items of income and expense, within and outside the branch context, have been developed sporadically over a period of more than 30 years, in the context of a system that no longer exists. Some of the rules are uncoordinated and inconsistent; others have not been updated to take account of developments since they were first issued. Even before taking account of the TCJA, it was past time for a major overhaul of the existing regulatory infrastructure, particularly as it affects regulated financial services businesses. With the entry into force of the TCJA, there is an urgent need to update the rules, and to adapt them to the requirements of the new system.

We encourage you to assign priority to this project. We would be happy to help in any way that you would find constructive. We recognize that it may not be possible to complete it by the time the first set of final regulations is due to be issued at midyear.

In the meantime (and until you are in a position to undertake such a major overhaul), it is critically important to provide workable interim solutions. This is particularly important for financial services companies, because:

- Many of us conduct a significant proportion of our worldwide operations through foreign branches, often in high-tax locations;
- The nature of our business model (high leverage; thin margins; enormous notional amounts) exacerbates the cost of uncertain or uneconomic tax rules; and
- The structure of our businesses is driven largely by regulatory and rating agency considerations: it can be difficult or impossible for us to exercise self-help.

This letter is not intended to obviate or supersede our February 4th comments. Those comments discuss a wider range of issues, and would provide more comprehensive relief, than the narrow recommendations set out below. We believe, however, that adopting the recommendations now, as part of the first installment of final regulations, would reduce the potential for unfairness, and would buy time for the Treasury Department and the IRS to consider the broader issues.

1. **Branch interest expense**. Taxpayers should be permitted to take account of the terms of their branches' borrowings in determining the amount of interest expense that is allocable to the foreign branch category. This is particularly important in cases where

foreign currency-related factors significantly affect a branch's funding costs and investment returns.

We continue to believe that the best approach would be a rule based on the principles of Treasury regulations §1.882-5, with adjustments to take account of the different factual context. Among other important features, those regulations provide for adjustments to reflect differences in interest rates by currency. We appreciate that it may not be possible to develop such a rule between now and June. However, at least in cases where foreign currency effects otherwise would produce distortions, taxpayers should be permitted to take account of branch-level borrowing costs now.

One possible approach would be to allow taxpayers to allocate interest expense to the foreign branch category using any reasonable method (or any reasonable method based on the branch's books and records) until definitive guidance is provided, and to confirm specifically that taxpayers will be permitted to take account of differences in interest rates by currency.

2. **Disregarded transactions**. Adjustments in respect of disregarded transactions between a taxpayer's home office and its foreign branches should be made on an aggregate net basis.

As discussed at our meeting, this recommendation effectively is a stopgap. A netting rule would not address the serious concerns described below. However, netting would significantly reduce the potential for distortions in cases where very sizable gross amounts offset each other in whole or in part. A netting rule should be adopted now, as part of the first set of final regulations, even if it proves to be impossible to address the larger issues on the same timetable.

The treatment of disregarded transactions is tremendously important to our industry. Our February 4th comments discuss the principles that should be applied in determining the amount and source of adjustments in respect of disregarded and intercompany transactions.

The legislative history doesn't provide much detail regarding why Congress determined that foreign tax credits in respect of branch category income should be calculated separately from other foreign income. No matter what Congress intended, there can be no potential for abuse if branch income determined for U.S. tax purposes doesn't exceed branch income for foreign tax purposes.

We aren't suggesting that branch income for U.S. tax purposes must always correspond with branch income for foreign tax purposes. However, in evaluating alternative approaches to dealing with disregarded transactions, it is important to remember that parity between U.S. and foreign tax computations generally would further the purpose of the foreign branch category; significant disparities between those computations would give rise to capricious and unreasonable costs. The Treasury Department and the IRS should disfavor features that necessarily and inevitably would give rise to such disparities. We were heartened to learn that you generally agree with this proposition.

The proposed regulations include two features that would create disparities between U.S. and foreign computations without advancing any policy objective. As currently drafted, they (i) would not take account of interest on loans and deposits between a U.S. home office and its foreign branches; and (ii) would prescribe a methodology for determining the source of adjustments to take account of disregarded transactions that, although facially neutral, in practice could result in branches being considered to derive significant amounts from U.S. sources.

These features could give rise to serious distortions.

- The failure to take account of a very substantial class of transactions would result in disparities between the amount of branch income that is subject to foreign tax and the amount used to determine the branch category foreign tax credit limitation for U.S. purposes. In the financial services industry, these disparities easily could be measured in the hundreds of millions of dollars.
- A mechanical rule that would result in foreign branches being considered to derive significant U.S. source income inevitably would result in the disallowance of foreign tax credits. We believe that, if the income attributed to a foreign branch fairly reflects the economic contribution made by the branch, and appropriately is subject to foreign tax, then it presumptively should not be treated as U.S. source income.

We recognize, of course, that if a foreign branch actually receives income from U.S. sources (for example, interest on a U.S. Treasury security), then it will be entitled to relief only to the extent it qualifies for the benefit of a treaty resourcing rule. But that's not this case. We're dealing here with adjustments in respect of disregarded transactions. There aren't any rules for determining the source of those adjustments.[2] In the absence of authority that restricts your ability to consider what the

2 As discussed in our February 4th comments, the proposed global dealing regulations would determine the source of such adjustments *after* income has been attributed to a foreign branch, and *as if* the income had been received directly by the branch.

answer ought to be, we believe that the Treasury Department and the IRS have considerable latitude to do justice.

We encourage the Treasury Department and the IRS to develop a comprehensive fix that addresses the concerns described above. For the reasons discussed at the beginning of this section, a netting rule can and should be implemented independently. The first set of final regulations should provide for netting, even if the Treasury Department and the IRS have not yet had the opportunity to consider our more detailed recommendations.

3. **Global dealing**. The final regulations should confirm that they do not override transfer pricing methodologies that taxpayers are permitted or required to apply under current law (for example, under the proposed global dealing regulations, an advance pricing agreement, or a competent authority agreement).

As discussed at our meeting and in our comments, financial services companies have relied on the proposed global dealing regulations for more than 20 years. The approach taken by those regulations is more consistent with OECD principles, and more likely to produce a fair and appropriate result, than the approach contemplated by the proposed foreign tax credit regulations. We encourage the Treasury Department and the IRS to embrace and expand on global dealing principles. But, at the very least, they should confirm that the foreign tax credit regulations do not override existing rules that taxpayers have relied on for many years.

Under the proposed global dealing regulations, a participant in a global dealing business is considered to earn income directly, including in cases where it receives its share in the form of a remittance of amounts attributable to third-party transactions effected by other participants.[3] Accordingly, while the reconciliation of accounts in a global dealing business necessarily involves true-up payments between participants, those payments would not be deductible if the participants were separate corporations.[4] For the same reason, they should not constitute disregarded payments for purposes of Proposed regulations §1.904-4(f)(3)(ii). The source and basket classification of

---

This methodology would not address all of our concerns, but it would be strongly preferable to the approach contemplated by the proposed foreign tax credit regulations.

3 *See* Proposed regulations §1.863-3(h)(2) (source determined as if participant had received its share of income directly).

4 If the payments are made in respect of amounts that otherwise would have been included in the payor's gross income, they would be treated as an allocation of, or adjustment to, gross income.

amounts derived in a global dealing business therefore should continue to be determined under the global dealing regulations, and should not be affected by the treatment of disregarded payments for purposes of the proposed foreign tax credit regulations. As indicated above, the final regulations should confirm this point. In addition, we encourage you to consider extending global dealing principles to other fact patterns.

* * * * *

Please let me know if you have questions regarding the topics discussed in this letter, or if we can be of further assistance. You should feel free to make contact directly with the chair of our working group, Ben Lopata (212) 552-1040 or with our outside advisers, Jim Duncan (212) 225-2140 and Jeff Levey (202) 467-8413.

Sincerely,

Payson Peabody
Managing Director & Tax Counsel
SIFMA

cc: David J. Kautter
Assistant Secretary for Tax Policy
Department of the Treasury

Internal Revenue Service
CC:PA:LPD:PR (REG-105600-18)
Room 5203, Post Office Box 7604
Ben Franklin Station
Washington, DC 20044