Dear Ladies and Gentlemen,

On behalf of the Florida Bar Tax Section, we would like to request a modification to Treas. Reg. Section 1.962-1 to clarify that a Section 250 deduction applies to an Electing Code Section 962 Shareholder. We present to you comments explaining why a Section 250 deduction is available to an electing Section 962 shareholder. Based primarily upon the plain language of Section 962(a)(1) and legislative intent, we believe that the Section 250 deduction is available to an electing Section 962 shareholder.[1] We present our positions below for your review. We also include additional comments relating to several foreign law constraints we have experienced with restructuring U.S. non-corporate ownership of CFCs into the U.S. C corporation ownership for purposes of preventing the harsh effects of the Section 951A global intangible low-taxed income ("GILTI") regime in the non-U.S. C corporation shareholder context. Finally, we address the benefits to small business that this regulatory clarification will afford.

I. Positions that Support that the Section 250 Applies to an Electing Section 962 Shareholder

a. The plain language of Section 962(a)(1) in operation with Section 11 supports that the Section 250 deduction be allowed.

i. Section 962(a)(1) provides that "the tax imposed under this chapter on amounts which are included in his gross income under section 951(a) shall (in lieu of the tax determined under sections 1 and 55) be an amount equal to the tax which would be imposed under section 11 if such amounts were received by a domestic corporation." *Emphasis Added*.

1. Section 962(a)(1) references Section 11 as opposed to a specific subsection of Section 11 (e.g., subsection (b) of Section 11 pertaining to rates). We recognize that many statutory provisions of the Internal Revenue Code reference specific subsections or paragraphs of statutes, for example, see Section 962(c) [referencing the tax rates imposed in "section 11(b)"], Section 246(a)(2)(C) [referencing "section 243(a)"] or Section 246(c)(3)(B) [referencing "paragraph (3) of section 1223"]. If Congress chose for Section 962(a)(1) to apply to the corporate tax rates imposed by Section 11(b) then it would have explicitly stated so. Instead, the statute references Section 11, requiring that a taxpayer begin with Section 11(a) which first requires the taxpayer to determine taxable income as that term is defined in Treas. Reg. § 1.11-1(b).

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[1] When applicable, the Section 250 deduction effectively reduces the federal corporate income tax rate on a GILTI inclusion from 21% to 10.5%. A Section 962 election can be made by individuals, trusts and estates that own at least 10% of CFCs directly or indirectly through partnerships, disregarded entities or S Corporations (including an S corporation shareholder that had made a Section 965(i) election to indefinitely defer transition tax liability). An electing Section 962 shareholder would otherwise be subject to an ordinary income inclusion subject to federal income tax rates of up to 37% if such shareholder did not make a Section 962 election.

2. As shown below, Section 962(a)(1) references "the tax imposed under this chapter on amounts . . ." as opposed to referencing the tax imposed under section 11 specifically. This quoted language may be broadly interpreted to mean the actual "tax liability" resulting from the tax rate imposed that would have taken into account deductions.

3. Finally, in the recent *Barry M. Smith, et ux. v. Commissioner* case,[2] the Tax Court stated the following: "Nor do we find any ambiguity in the text of section 962(a). In the case of an electing U.S. shareholder, section 962(a)(1) provides that the tax imposed on the section 951(a) inclusions "shall *** be an amount equal to the tax which would be imposed if such amounts were received by a domestic corporation." 151 T.C. No. 5.

ii. The "tax which would be imposed under section 11" is, imposed on "taxable income" as referenced in Section 11(a). Specifically, Section 11(a) provides that "A tax is hereby imposed for each taxable year on the taxable income of every corporation."

iii. Treas. Reg. § 1.11-1(b) defines "taxable income" as "gross income of the corporation minus the deductions allowed by chapter 1 of the Code." Thus, if the tax imposed under this chapter on amounts which are included in his or her gross income under Section 951(a) is equal to the tax which would be imposed under Section 11 if such amounts were received by a domestic corporation, then such tax would take into account gross income of the corporation minus allowable deductions. A Section 250 deduction is a deduction allowed by Chapter 1 of the Code. Section 962 recognizes that the tax be "equal" to the tax imposed under Section 11 if such amounts were received by a U.S. corporation.

iv. If an actual U.S. C corporation included the GILTI inclusion, it would be entitled to claim the Section 250 deduction. Such U.S. corporation's tax rate would still be determined under the rules of Section 11. A U.S. non-corporate shareholder that makes a 962 election should be treated "equal" based upon this statute.

v. As noted above, Section 962(a)(1) does not reference "tax rates" but instead tax imposed under Section 11. This should be contrasted with Section

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[2] In *Smith*, the Tax Court held that dividends paid to taxpayers from their controlled foreign corporations (CFCs), one located in Cyprus (a treaty jurisdiction) and the other located in Hong Kong (a non-treaty jurisdiction), were not qualified dividend income. Consequently, the dividends did not qualify for a reduced rate of tax under Section 1(h). The taxpayer argued that distributions from the Hong Kong CFC qualify as qualified dividend income, because such distributions should be considered made by a "notional" domestic corporation. The Tax Court concluded that while Section 962 allows the taxpayer to treat the Section 951(a) inclusion amount as received by a domestic corporation for the limited purpose of computing the amount of tax owed on the Section 951(a) inclusion, Section 962 did not create a hypothetical corporation for any other purpose. For example, Section 962 would not enable the shareholder to claim that the earnings were distributed by a domestic corporation as opposed to a CFC located in a non-treaty jurisdiction.

962(c), which references "tax table in section 11(b)." Had Congress chosen individuals to be taxed specifically at corporate tax rates, but in the context of a domestic corporation earning Subpart F income, it would have stated so.

vi. Canons of Statutory Construction & Chevron Deference: Traditionally, courts are tasked with interpreting statutes as passed by Congress. Courts do this by constructing the statute in the most likely correct fashion, if there are two reasonable interpretations of a statute and one is correct with a probability of 51% and the other 49%, courts will apply the first interpretation. See, e.g., Antonin Scalia, Judicial Deference to Administrative Interpretations of Law. Generally, where Congress has granted an agency with authority to promulgate regulations carrying the force of law, the courts' interpretative role shifts and the interpretations of the statute found in those regulations will receive a high level of deference from the courts. See, U.S. v. Mead Corp., 533 U.S. 218 (2001). That deference will be determined based on a two-prong test ("Chevron Deference"). See, Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 1227 (1984). Moreover, the Supreme Court has ruled that Treasury Regulations are subject to the same Chevron Deference. See, Mayo Foundation v. U.S., 562 U.S. 44 (2011). The first prong asks whether "Congress has directly spoken to the precise question at issue," i.e. whether the statute is sufficiently clear to invalidate any contrary agency regulation; however, if the statute is ambiguous, or, rather, not clear, the courts ask in the second prong whether the regulation is a permissible interpretation, in which case the regulation is valid. Generally, where courts find that the statute is ambiguous, the courts take a broad view of what is a permissible interpretation and uphold the overwhelming majority of regulations. Thus, where regulations are struck down, tends to be because the statute is held to be sufficiently clear in the first prong. The standard for whether a statute is clear is not the same standard which the courts use to interpret a statute in the absence of a regulation, i.e. 51% may not be enough to determine a statue is clear.

vii. We believe it is clear that Congress has stated in Section 962 that the individual with respect to its Subpart F/GILTI income shall compute its tax liability in the same manner as under Section 11. Further, in the Joint Committee Report accompanying the bill containing the language which would become the statute, Congress unequivocally stated that the individual who makes the election under Section 962 shall be subject to the same tax liability with respect to its Subpart F as the C corporation which is similarly situated. Over 55 years ago, the Treasury promulgated regulation 1.962-1(b)(1) which states that for purposes of determining its "taxable income" under Section 11, the Section 962 electing individual shall use the Subpart F amount as its taxable income, ostensibly without means for taking into account deductions, specifically the Section 250 deduction. The effect of the regulation is two-fold: (1) it disallows the deduction against the Subpart

F/GILTI of the individual shareholder to which the shareholder is generally entitled in the absence of an election under Section 962 (e.g. home mortgage interest, personal capital loss, etc); (2) it disallows the deduction against the Subpart F/GILTI of the individual for which the shareholder is entitled because of the election under Section 962—those deductions afforded to corporate shareholders of CFCs (e.g. Section 250). If a court would find that Section 962 is clear (which we believe it is) then, the Treasury regulation may stand only if it is not contrary to the statute. Prior to the creation of Section 250 on December 22, 2017, the mechanics of the Treasury Regulation were such that the computation of an electing Section 962 shareholder's tax liability for its Subpart F/GILTI was insulated from the shareholder's deductions in its individual capacity and there were no corporate deductions afforded through the application of Section 11 because none existed (until Section 250). Thus, prior to the creation of Section 250, the regulations were consistent with the language put forth by Congress in the statute and the legislative history; the tax liability of a Section 962 electing shareholder and a corporate shareholder would be the same with respect to the Subpart F whether the tax was imposed on a net or gross basis; however, with the introduction of Section 250, there is now a corporate deduction that if not allowed to a Section 962 electing shareholder would not result in the same tax liability, contrary to the statute and the legislative history. The only thing supporting such a reading is the Treasury Regulation. For that reason, since Section 962 should be clear, and because the Treasury Regulation is contrary to that clear interpretation of the statute in its application, it must be invalidated.

b. The Legislative History mandates that a non-U.S. corporate shareholder be placed in the same position as if he or she was a domestic corporation, which in turn owned a CFC.

    i. The legislative history to Section 962 provides that "[t]he purpose of this provision is to avoid what might otherwise be a hardship in taxing a U.S. individual at **high bracket rates** with respect to earnings in a foreign corporation which he does not receive. This provision gives such individuals assurance that **their tax burdens, with respect to these undistributed foreign earnings, will be no heavier than they would have been had they invested in an American corporation doing business abroad**." S. Rept. No. 1881, 1962-3 C.B. 784 1962 [emphasis added]. The legislative history supports that a Section 962 electing shareholder should be treated no differently than if the electing shareholder invested in an actual U.S. C corporation that in turn owned the CFC. The reference to "undistributed foreign earnings," clarifies that it was intended to mean that an electing individual be treated as a domestic corporation that owns a CFC. It does not stand for the fact that the individual should be treated as a corporation acting through a foreign branch. Thus, because an individually owned U.S. C corporation would be entitled to the Section 250 deduction, the Section 962 electing shareholder should receive the same treatment.

ii. The Section 962 election provides the additional benefit that an individual is afforded the benefit of indirect tax credits pursuant to Section 960; however, Section 962 was not designed solely to provide U.S. individual shareholders with the ability to claim indirect tax credits pursuant Section 960. The legislative history makes clear that Section 962 was designed to provide individuals with both indirect foreign tax credits and to allow the individual to be taxed at the lower C corporation rates than the higher individual tax rates. In 1962, the highest U.S. federal tax rate applicable to U.S. individuals was 91% and the highest U.S. federal tax rate applicable to U.S. C corporations was 52%. Thus, similar to today, individuals were inclined to make the Section 962 election to be taxed at lower corporate rates than to be subject to the higher individual U.S. federal tax rate.

iii. In *Barry M. Smith, et ux.*, the Tax Court clarified that "[i]n drafting section 962 Congress adopted the counterfactual hypothesis that the section 951(a) inclusions were received by a domestic corporation, rather than by the individual U.S. shareholder, for the sole and limited purpose of enabling that person to elect beneficial tax treatment under section 962(a)." In relevant part, the Tax Court held that a later distribution by the CFC of previously taxed E&P would not be treated as a dividend from a hypothetical U.S. corporation such that the distribution would be treated as a qualified dividend under Section 1(h)(11); however, the ability for the Section 962 electing individual to take a Section 250 deduction is in agreement with the decision in *Smith* that the individual should be treated as a domestic corporation in computing its tax liability for the "sole and limited purpose of determining the beneficial tax treatment under 962(a)" [i.e., determining a Section 951A(a) GILTI inclusion].

c. Treas. Reg. § 1.962-1(b)(1)(i) should be modified to allow the electing individual the Section 250 deduction. It should not disallow electing Section 962 shareholders from claiming the Section 250 deduction because of the unambiguous plain language of Section 962 and corresponding legislative history.

i. Since the time of enacting Section 962 until the time of the enactment of the Tax Cuts & Jobs Act, there has been no corporate deduction available specifically tied to foreign sourced anti-deferral income, such as Subpart F. We believe the regulation cited in Treas. Reg. § 1.962-1(b)(1)(i) is aimed at protecting the Section 962 electing shareholder's income inclusion from the shareholder's deductions it has in its individual capacity (e.g., deduction for qualified residence interest). This was necessary, because if the shareholder were required to use its deductions to which it is entitled in its capacity as an individual to reduce the income inclusion under GILTI or Subpart F, the effect of an election under Section 962 would be nullified; however, because the purpose of Section 962 is to put individuals on par with corporations with respect to inclusions under Subpart F and now GILTI, by making the tax imposed equal to the amount that would be imposed under Section 11, the deduction under Section 250 is necessary. Additionally,

making the allowance of the deduction more explicit would not offend the original purpose of the disallowance of the shareholder's deductions it would otherwise be entitled to in its capacity as an individual, because the deduction under Section 250 would not otherwise apply to reduce the shareholder's higher-taxed, non-GILTI. Although this regulation's language historically served to simplify the mechanics of the computation in the case of a Section 962 election while remaining consistent with the language of Section 962, with the introduction of Section 250, this is no longer the case and this regulation should be revised to confirm that the Section 250 Deduction is available to a taxpayer who has made an election under Section 962 to be treated as a domestic corporation.

ii. Treas. Reg. § 1.962-1(b)(1)(i) appears to rule out the possibility of a deduction, because it narrowly interprets "taxable income" to essentially mean "gross income," thereby excluding deductions. Treas. Reg. § 1.962-1(b)(1)(i) states:

> Determination of taxable income. The term 'taxable income' as used in section 11 shall mean the sum of— (a) All amounts required to be included in his gross income under section 951(a) for such taxable year; plus (b) All amounts which would be required to be included in his gross income under section 78 for such taxable year with respect to the amounts referred to in (a) of this subdivision if such shareholder were a domestic corporation.
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> For purposes of this section, such sum shall not be reduced by any deduction of the United States shareholder even if such shareholder's deductions exceed his gross income.

iii. The flush language of Treas. Reg. § 1.962-1(b)(1)(i) clearly prohibits deductions of the U.S. shareholder (i.e., the electing Section 962 shareholder), but not the domestic corporation in which it is treated for purposes of including GILTI income. For example, the electing Section 962 shareholder could not utilize personal itemized deductions, schedule C deductions or losses or otherwise personal but deductible items to reduce the tax calculated because of the Section 962 election; however, the Section 250 deduction is a corporate level deduction, not an electing Section 962 shareholder level deduction.

iv. Treas. Reg. Section 1.962-1(a) applied to dividend income and subpart F income that was, for the most part, taxed on a gross income basis. The GILTI under Section 951A, that is contained in Subpart F of the Code is a net income tax. It is based upon the net income of the CFC. After net income for a given CFC is determined, one of the applicable deductions is Section 250 which effectively reduces the tax rate for GILTI from a top corporate tax rate of 21% to 10.5% (with an allowance for 80% of the CFCs

indirect foreign taxes with respect to such income). As such, Treas. Reg. Section 1.962-1(b)(1)(i) should be updated to tax on a net income basis.

v. Finally, in relation to this regulation, we note that Section 962(a)(1) provides "Under regulations prescribed by the Secretary . . ." essentially giving deference to Treasury to implement regulations that would carry the provisions of Section 962; however, please note the Canons of Statutory Construction and Chevron deference above.

vi. The Treasury Regulations under 1.962-1 should be revised to confirm that the Section 250 Deduction is available to a taxpayer who has made an election under Section 962 to be treated as a domestic corporation. This would be similar to the deduction that was made available under the Proposed Section 965 regulations. According to the preamble of the Proposed Section 965 regulations, "subject to future guidance, 'taxable income' as used in section 11 is not reduced by any other amounts, including any other deductions." We suspect that this reference to "future guidance" meant that future guidance would allow a deduction for a Section 250 deduction that would be available when an individual made a 962 election.

II. Similar to When Section 962 Came into Law, there are Various Foreign Law Constraints on Restructuring U.S. Non-Corporate Ownership of CFCs into the U.S. C Corporation Ownership for Purposes of Preventing the Harsh Effects of GILTI.

a. Many foreign jurisdictions impose transfer taxes on either a direct or an indirect transfer of shares in a company resident in the foreign jurisdiction. The transfer tax is generally imposed upon the fair market value of the shares of the foreign company. Not only may the tax generally be expensive, but the cost of obtaining an appraisal to value the shares of the transferred corporation can be costly.

b. Some foreign jurisdictions have exchange control rules that prevent a person from being able to transfer shares of a foreign corporation resident in the foreign jurisdiction to a newly formed or existing U.S. corporation. At times, the person may be required to approach the governing body to approve the transfer. This process can be expensive, and in some cases their request will not be granted for various reasons.

III. The Code Section 250 Deduction Applying to Electing Section 962 Shareholders is a Benefit to Family Owned Companies, Small Businesses, and Entrepreneurs.

The Section 962 election is one generally made by individuals. Thus, it inherently applies to small business and entrepreneurs. In today's global world, small businesses operate internationally. The TCJA was intended to benefit family owned & small businesses and entrepreneurs.

A significant amount of small businesses were organized in a manner whereby the direct shareholder of the foreign corporation is an individual. In fact, the Section 1(h)(11) qualified dividend regime provided a benefit to individuals who owned foreign corporations directly. Such structures are common. As mentioned in the previous section, there are significant foreign law

constraints imposed on individuals from being able to restructure the ownership of his or her CFC shareholding.

In her recent Tax Notes International Article, author Mindy Herzfeld summarized the issue as follows:

> Section 962 — an old but infrequently used provision — is designed to mitigate some of that disparity. In general, it allows an individual U.S. shareholder of a CFC to elect to be placed in approximately the same position for subpart F inclusions as if the CFC stock were held through a domestic corporation. Congress clearly contemplated that a section 962 election could be available for a section 951A inclusion, as noted in the cross-reference in section 951A(f)(1)(A), but regulations under section 962 provide that the includable amount can't be reduced by any deduction of the U.S. shareholder. An important question for many individual shareholders is therefore whether taxpayers that make a section 962 election can claim the section 250 deduction — a corporate-level deduction.
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> From a policy perspective, the rationale for allowing the section 250 deduction seems obvious. Unlike other deductions that involve outlays of expenses that reduce the calculation of taxable income, the section 250 deduction is all about ensuring the competitiveness of U.S. businesses operating overseas. The TCJA is meant to encourage "hardworking families, entrepreneurs, and Main Street innovators," so doubly penalizing small business owners who expand overseas by denying them a corporate rate reduction seems contrary to those goals.
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We hope you consider these comments. Please let us know if you have any questions relating to the aforementioned points.