AMERICANS for TAX REFORM

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Re: Transition Rule for Foreign Tax Credit Carryforwards

August 28, 2018

The Honorable Steven Mnuchin
Secretary
U.S. Treasury Department
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable David Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Dear Secretary Mnuchin and Acting Commissioner Kautter:

I write concerning the administration's transition rule for the application of section 904(d) general limitation category foreign tax credit (FTC) carryforwards following passage of the Tax Cuts and Jobs Act (TCJA).

I understand that the Treasury Department is considering a transition rule that would require mandatory reallocation of existing general limitation FTCs to new foreign branch income and GILTI (Global Intangible Low Taxed Income) categories.

A mandatory reallocation rule for FTC carryforwards would be bad policy. This approach will create significant compliance costs for businesses and the government, will pick winners and losers based on past decisions made, and runs counter to past transition rules for reallocating FTCs.

Instead, Treasury and the IRS should adopt a rule that defaults pre-2018 FTC general income carryforwards so that they are applied against the post-TCJA general category basket. The rule should also allow "elective tracing" so that businesses can reallocate FTCs into the foreign branch income basket if they can prove reallocation is justified. This approach would be far simpler, less arbitrary, and matches the direction set following passage of the Tax Reform Act of 1986 and other laws.

The TCJA significantly improved the nation's tax code after 31 years without significant reform. For instance, the TCJA reduced the tax rate on businesses to a globally competitive rate and modernized the international system of taxation. In the aftermath of this legislation, it is crucial that tax rules are created in a way that promotes investment and economic growth and allows a streamlined transition to the new tax code.

<u>Background</u>

Subject to certain limitations, U.S. taxpayers are permitted a credit for foreign taxes paid. This system exists to mitigate double taxation of foreign-source income. For foreign tax credits accrued over the limitation, a carryback period of one year and carryforward period of ten years exists.

The TCJA significantly modified FTCs. Prior to TCJA, FTCs were divided into two baskets – a general category income basket and passive category income basket. While the passive income basket was unchanged, the general category income basket was split into three baskets.

Under the new system, credits that would have previously been allocable to the general branch are now allocable to either general income, foreign branch, or GILTI baskets. However, the TCJA is silent on the treatment of pre-2018 general limitation FTC carryforwards and this issue must be addressed through a transition rule.

Challenges with Mandatory Reallocation of FTC Carryforwards

Crafting a mandatory reallocation rule that accurately assigns FTC carryforwards into the correct basket would be nearly impossible and would come with significant compliance and administrative challenges.

The TCJA included a comprehensive overhaul of the U.S. international tax system. Subpart F rules were modified, certain types of foreign earnings were exempted from U.S. taxation, the treatment of interest expenses were modified, and several new international tax provisions such as the GILTI were enacted.

Given these changes, a mandatory reallocation rule would force taxpayers to retroactively apply TCJA back ten years to determine the amount of income that should have been allocated to the new baskets, creating significant complexity.

There is also no way to craft a "shortcut approach" to automatically reallocate FTC carryforwards in an appropriate way, as this would involve devising a system that would tell from new basket FTC carryforwards would have emanated from. As such, any rule will yield arbitrary results that pick winners and losers.

Recent Precedent set by FTC Reallocation Transition Rules

In the past, Treasury and IRS have recognized the need for transition rules that can be easily administered and do not pick winners and losers by imposing unnecessary taxation or compliance costs on taxpayers.

FTC transition rules following the passage of tax legislation have historically utilized a default mechanism to allocate FTCs to carryforward into the same basket (or applicable basket). When reallocation of FTCs is necessary, this process is elective and on a case-by-case basis, rather than mandatory.

The most notable case is the Tax Reform Act of 1986, which expanded the general category basket into multiple baskets. The transition rule defaulted pre-1986 FTC carryforwards into the general income basket and reallocation was permitted to new baskets only if the taxpayer could meet conditions as outlined by Treasury.

The American Jobs Creation Act of 2004 took the code in the opposite direction - multiple baskets, in this case eight, were consolidated into two baskets: the passive income basket and the general income basket. Starting after 2006, the transition rule defaulted general income basket FTC carrybacks into the same basket unless the taxpayer chose to allocate to other baskets.

In both cases, Treasury recognized the need for default rules that promote simplicity and equity over mandatory reallocation that results in arbitrary outcomes.

Conclusion

As you continue working to implement the TCJA, I urge you to craft an FTC carryforward transition rule that allows a simple and efficient transition to the new tax code and promotes economic growth and equity.

A mandatory reallocation of existing FTC carryforwards to new GILTI and foreign branch baskets would arbitrarily pick winners and losers based on past decisions and creates uncertainty and complexity for taxpayers.

A better approach would be a rule that retains existing general income FTCs in their current basket while allowing FTCs to be reallocated if the taxpayer can prove reallocation is justified. Indeed, this approach is consistent with past tax reform legislation and would ensure an efficient, equitable transition of FTC carryforwards.

Thank you for your consideration. If you have any questions, please do not hesitate to contact me or ATR's Director of Tax Policy Alex Hendrie at ahendrie@atr.org or at 202-785-0266.

Onward,

Grover G. Norquist
President, Americans for Tax Reform

CC: Mick Mulvaney, Director, Office of Management and Budget, Executive Office of the President
Larry Kudlow, Director, National Economic Council, Executive Office of the President
Shahira Knight, Director, Office of Legislative Affairs, Executive Office of the President