IRS Hearing On Section 965 Implementation

Good morning, my name is Stephen Comstock and I am the Director of Tax and Accounting Policy at the American Petroleum Institute or "API". API represents over 600-member companies involved in all aspects of the nation's natural gas and oil industry. On behalf of those members, I appreciate the opportunity to speak today regarding two issues associated with the Section 965 proposed regulations and follow-up on comments already submitted to the Department of Treasury.

The industry certainly understands that the inclusion of section 965 in the recent tax reform legislation helped address the foreign earnings "lockout" problem and transition the United States toward a modern international taxation system. As a transition provision, rules around section 965 could be approached as stand-alone guidance but we believe that they should still be developed to maintain coherent tax policy and treat similarly situated taxpayers in a consistent manner.

Our first issue focuses on what is considered cash or cash equivalent for purposes of section 965. As you know, section 965(c)(2)(A) applies a lower 8% tax rate to the non-cash assets of a of a deferred foreign income corporation or DFIC. On the other hand section 965(c)(2)(B) applies a 15.5% tax rate to the aggregate foreign cash position of a DFIC. Though the bifurcation of the rates applicable to earnings of a DFIC was driven by several legislative factors, the application of one rate for tangible assets held and another to cash creates the need for considered policy in determining how a DFIC's assets are to be categorized. Some further clarification of what is meant by cash is provided in section 965(c)(3) which defines the

aggregate foreign cash position to include cash and the fair value of cash-like assets. Section 965(c)(3)(B) notes that among these cash-like assets are "personal property which is of a type that is actively traded and for which there is an established financial market."[1]

The scope of "cash-like" equivalents is something our members have been focused on and we believe the proposed regulations have potentially created significant confusion and uneven tax policy by not clearly classifying inventories like physical crude oil and finished product inventories held by a DFIC as non-cash assets. Accordingly, our industry is seeking specific guidance that physical inventories held in a DFIC's trade or business constitutes non-cash property and subject to the rate in section 965(c)(2)(A). We recognize that the preamble to the proposed regulations states that it would not be administrable to create individual regulatory exceptions to this cash definition based upon the liquidity of the asset. However, we believe that Treasury can still implement an approach that would clarify that physical crude and product inventories held by DFICs constitutes non-cash assets.

The bifurcation in the section 965 rate was developed to recognize that reinvestment into a company's business abroad should be treated differently than cash or items easily convertible to cash such as stock. Oil refineries must operate twenty-four hours a day, seven days a week, three hundred sixty-five days a year. Save extreme situations the only time that a refinery is non-operational is when repairs are being made. For this reason large, physical volumes of crude oil must be kept on hand. This is the only reason that, as of the date of the deemed repatriation, a DFIC with refining operations would have had large crude oil and finished

[1] Sec. 965(c)(3)(B)(iii)(I).

product inventories. Since they are so ingrained in the operation, these inventories are much more similar to the physical plant holding them than they are to cash. But instead of focusing on the liquidity of the inventory, we believe that the IRS could focus on whether DFIC assets are non-operational without the physical inventory and whether the going concern is compromised. We expect that this would allow for no difference between various taxpayers with physical inventories supporting DFICs with manufacturing operations.

The second reason crude oil and finished product inventories should be subject to the non-cash tax rate is that the manner in which these items are bought and sold is inconsistent with the category in section 965(c)(3)(B) of personal property that is actively traded on an established financial market. We think that crude oil and finished product inventories fail to meet this definition for two reasons. First, while crude futures contracts are sold on various exchanges such as the New York Mercantile Exchange, the actual physical personal property itself is not what is sold on markets. Rather it is only financial products based on the underlying crude oil and finished products that are actively traded on such exchanges and essentially constitute derivative products, not the actual personal property itself. Second, the manner in which physical crude oil and finished product inventories are bought and sold by refineries is by the use of forward contracts. But, despite the terminology, these contracts are not similar to options, swaps and futures and should not be confused with the definition of derivative financial instruments in the proposed regulations. The Internal Revenue Service itself has gone so far as to declare that forward contracts are not equivalent to contracts sold on a commodity exchange by stating that “the forward market is where oil is bought and sold between two

parties with the delivery of the commodity to be consummated at a future date. This type of transaction does not take place through a commodity exchange."[2]

Adopting a rule that physical inventories of DFICs normally sold by that DFIC under purchase/sale or forward contracts are not cash is consistent with the intent of Congress and would allow for similarly situated taxpayers to be treated consistently. One DFIC with physical widgets in inventory sold via purchase/sale contracts is no different than a DFIC with refining operations holding physical crude and product inventories. Further, adopting this approach should not be open tax optimizing as section 965 is not applicable to future years. Finally, it is auditable by the IRS and constitutes sound tax policy. For these reasons API and its member companies believe that crude oil and finished product inventories should not be considered cash-like assets for purposes of section 965 and seek clarifying language on this point.

The second issue I wish to address is the restriction imposed on taxpayers by the proposed regulations which limits the ability of taxpayers to change their method of accounting or make entity classification elections.

The proposed regulations establish a *per se* rule which invalidates otherwise permissible changes in accounting methods or entity classification elections. The preamble to the proposed regulations stated that at a principal purpose test would not be applied to changes in accounting method. The rationale was that the proposed rule does not affect a taxpayer's ability to change its accounting method, rather it disregards an accounting method only for the limited purpose of determining a taxpayer's section 965 elements.

[2] IRS Market Segment Specialization Program, Oil and Gas Industry, IRS Training 3149-125, 4-5 (May 1996).

A taxpayer has an obligation to report its income in the most clear and accurate way possible. This should require that the taxpayer adopt a change in accounting method regardless of the consequences of section 965. The practical impact of the IRS disregarding an otherwise permissible election is that taxpayers may be required to utilize an otherwise impermissible method of accounting. Furthermore, API and its member companies disagree with the Department of Treasury's assertion that the legislative history of the Conference Report reflects the intent of section 965(o) to allow Treasury to disregard changes in accounting method if there is the effect of a reduction of a taxpayer's tax liability under section 965.

Rather, we believe that Congress intended for a principal purpose test to be applied when there remains the potential for the taxpayer's taxable inclusion under section 965 to be diminished.[3] The desire to apply a principal purpose test was not intended to be ignored merely because a reduction of the taxpayer's tax liability under section 965 could occur. The reduction was one of multiple factors to be considered. If, however, the Department of Treasury is committed to the proposed regulation's language, specific language should be included that a change in accounting method should not be disregarded if there is no decrease in the tax liability under section 965 after considering all of the section 965 elements.

API believes that a similar approach should be taken by the Department of Treasury regarding entity classification elections. For a "check-the-box" election a principal purpose test should be applied, with the election being regarded so long as the principal purpose of the election was not to reduce section 965 tax liability. Alternatively, similar to the change in accounting

[3] H.R. Rep. No 115-466 at 619 (2017).

method, a check the box election should be honored at minimum if it does not reduce section 965 tax liability.

Conclusion:

Thank you for allowing me to speak before the panel this morning. The implementation of the recent tax reform legislation is a complicated and intricate matter and we appreciate the opportunity to provide input into the process.