Basel, 21 December 2018

"Accidental" Controlled Foreign Corporations (CFCs): Unintended consequence of the Tax Cuts and Jobs Act of 2017 for financial institutions

Ladies and Gentlemen

This letter provides comments of the Swiss Bankers Association (SBA) regarding some supposedly unintended side-effects of the Tax Cuts and Jobs Act of 2017 (TCJA) with far-reaching adverse consequences for some of our members.

In summary, we request the IRS to clarify, as soon as possible, that "accidental" Controlled Foreign Corporations (CFCs) created solely through the repeal of Internal Revenue Code (IRC) Section 956(b)(4):
- will not be treated as US payors; and
- will not be disqualified from the portfolio interest exemption due to their CFC status.

We appreciate the opportunity to present you with our comments. Please find below our elaborations.
Creating "accidental" CFCs through the repeal of IRC Section 958(b)(4)

The issue we would like to draw your attention to is caused by the repeal of IRC Section 958(b)(4) as part of the TCJA. The Repeal was intended to ensure that CFC status could not be avoided by US shareholders entering into so-called "de-control" transactions by transferring stock in a foreign subsidiary to another foreign person. A consequence of this repeal is that a vast number of foreign entities that are part of multinational groups with US subsidiaries are considered CFCs. As such, these foreign entities are suddenly subject to the regulatory requirements designed for CFCs, i.e. for US-controlled entities.

From a technical point of view, our understanding is that the repeal of Section 958(b)(4) requires a "downward attribution" of foreign subsidiaries of a foreign parent to its US subsidiaries. Such "downward attribution" turns the attributed foreign subsidiaries into CFCs. In other words, through the repeal of Section 958(b)(4), any such foreign subsidiary is suddenly viewed as a subsidiary of the US subsidiary and thus a CFC. Prior to the repeal, only CFCs that are foreign subsidiaries of US parent companies were generally considered CFCs. This change has substantial adverse consequences which we would like to examine in more detail below.

Extensive 1099 reporting and backup withholding requirements

Prior to the repeal of Section 958(b)(4), foreign subsidiaries of a foreign parent were generally not CFCs and thus considered non-US payors. Through the repeal, such subsidiaries may turn into CFCs and would now be regarded as US payors.

Affected international financial institutions are particularly concerned about the significantly expanded Form 1099 reporting and backup withholding requirements US payors are subject to.
While non-US payors need to fulfill 1099 tax reporting and backup withholding obligations only for US source income, US payors must file Forms 1099 for all US and non-US source payments that are reportable transactions, even if they have no connection to the US. Moreover, we would like to emphasize that non-US payors’ obligations regarding Form 1099 reporting were significantly reduced or even eliminated by reporting performed under the Foreign Account Tax Compliance Act (FATCA), meaning that 1099-related obligations were largely negligible.

In addition, payments reportable on Form 1099 may also be subject to backup withholding under section 3406. This could be the case if, for example, the payee's US TIN is not provided as required. Implementing procedures for 1099-related backup withholding would be very burdensome for non-US banking groups currently not subject to these rules.

While we are not in a position to elaborate on the initial intentions of the TCJA, we do not see a rationale behind the implementation of these changes and therefore believe that the creation of countless additional CFCs and US payors was not foreseen when repealing Section 958(b)(4).

**Broader 1099-related legal and operational concerns**

Overall, these additional requirements would result in significant legal and operational challenges for affected financial institutions. "Accidental" CFCs face far-reaching legal and operational problems, including the following:

- The requirement to report directly to the IRS may jeopardize local legislation (e.g. privacy protection rights). The same might apply with regard to backup withholding.

- Countries with a Model 2-type FATCA Agreement (like Switzerland) also require reporting financial institutions to report US account holder information, but reporting is made directly to the IRS on Form 8966 in accordance with the terms of an FFI Agreement with the IRS. As CFCs, affected financial institutions would need to conduct additional reporting via Form 1099, even in the case of non-consenting account holders for which individualized reporting is not allowed without a group request from the US. This would undermine the terms of the FFI Agreement.

- The repeal of Section 958(b)(4) further complicates the operational burden stemming from reporting requirements as the information that needs to be reported on Form 1099 is not the same as for FATCA, meaning that “accidental” CFCs need to compile and report additional information.

- In general, we want to emphasize that for banks across the globe, the implementation of FATCA has been extremely onerous. It would be unacceptable to have these efforts nullified by creating countless “accidental” CFCs within multinational banking groups with extensive reporting requirements running contrary to the purpose of FATCA.

- Finally, the repeal puts “accidental” CFCs in a disadvantageous position compared to ac-
tual CFCs that were facing 1099 reporting obligations for decades and had ample time to integrate these requirements into their day-to-day operations.

Potential denial of portfolio interest exemption

A second consequence "accidental" CFCs might be facing is the potential loss of the portfolio interest exemption. "Accidental" CFCs may not be able to benefit from this relief because if the interest is received by a CFC, it does not qualify for the portfolio interest exemption. This could disrupt common intercompany financing transactions.

SBA Proposal

In summary, the repeal of Section 958(b)(4) poses a significant operational burden on many non-US banking groups. Moreover, with the effective date of the TCJA being 2017, the affected entities seem to be non-compliant as of today and in many cases probably are even unaware of their non-compliant status.

In view of the upcoming Qualified Intermediary (QI) certification, which for many QIs is due by 1 March 2019, this non-compliance status is an imminent concern that should be resolved as soon as possible.

Therefore, we urgently request the IRS to issue guidance (e.g. in the form of a notice) that CFCs created due to the repeal of Section 958(b)(4) will:

- not be treated as US payors for purposes of Form 1099 reporting and backup withholding; and
- not be disqualified from the portfolio interest exemption due to their CFC status.

Thank you for considering our comments. Please do not hesitate to contact us (petrit.ismajli@sba.ch / +41 61 295 93 02) if you have additional questions about this letter.

Yours sincerely,
Swiss Bankers Association

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