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US International Tax Alert

Treasury, IRS release final and proposed foreign tax credit regulations

On September 29, 2020 Treasury and the IRS released guidance that finalizes foreign tax credit and expense allocation regulations proposed in 2019. In addition, Treasury and the IRS issued new proposed regulations. This alert provides a summary of the final and proposed regulations.

Effective dates: 2020 Final Regulations

- **In general:** Provisions under §§ 1.861-9, 1.861-12, 1.904-4(c), 1.904(b)-3, 1.905-3, 1.954-1, 1.954-2, 1.965-5, and 301.6689-1 that were included in the 2019 proposed regulations and finalized without significant change generally apply to tax years ending on or after December 16, 2019.
    - Provisions under §§ 1.861-8, 1.861-14, 1.861-17, 1.861-20, 1.904-6, and 1.960-1 apply to tax years beginning after December 31, 2019.
- **Exceptions:**
    - For the allocation and apportionment of R&E expenditures, taxpayers may choose to apply either the 2019 proposed or 2020 final version of § 1.861-17 to all tax years beginning on or after January 1, 2018 and before January 1, 2020, provided that such version is applied in its entirety with respect to all operative sections.
    - Applicability of § 1.861-8 to section 250 is deferred to tax years beginning on or after January 1, 2021.

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- Rules for foreign tax redeterminations of foreign corporations relating to pre-2018 years, other than the forward pooling adjustment rules, generally apply to foreign tax redeterminations that occur in tax years ending on or after the date the final regulations are filed in the Federal Register.
- Rules for the consolidated foreign tax credit apply to taxable years for which the original consolidated federal income tax return is due (without extensions) after December 17, 2019

- In addition to the foreign tax credit rules, certain provisions related to hybrid arrangements and disqualified payments that were proposed in April 2020 were also finalized with varying effective dates:
    - Rules providing for a decrease of hybrid deduction accounts and adjustments of subpart F and GILTI inclusions under § 1.245A(e)-1 apply to tax years ending on or after the date the final regulations are published in the Federal Register. Taxpayers can choose to consistently apply these final regulations to earlier tax years.
    - Revisions to the anti-conduit rules under § 1.881-3 apply to payments made on or after the date the final regulations are published in the Federal Register.
    - New rules relating to "disqualified payments" under section 951A apply to taxable years of foreign corporations ending on or after 4/7/2020 and to tax years of US shareholder in which or with such tax years end.

Final Regulations highlights

1. Allocation and apportionment of expenses
    a. Stewardship
        i. In general, retains approach of 2019 proposed regulations with certain revisions.
        ii. The final regulations generally retain the existing definition of stewardship expenses as either duplicative or shareholder activities as described in § 1.482-9(l)(3)(iii) or (iv).
        iii. Clarify that stewardship expenses can also be incurred with respect to all business entities (whether foreign or domestic) as described in § 301.7701-2(a) and not only those business entities that are classified as corporations or partnerships for Federal income tax purposes.
        iv. Stewardship expenses can be allocated and apportioned to income and assets of all affiliated and consolidated group members; for this purpose, the affiliated group rules in § 1.861-14 do not apply, and

thus stewardship expenses are allocated and apportioned on a separate entity basis. Stock in an affiliate is characterized by the taxpayer in the same ratios in which the affiliate's assets are characterized for purposes of allocating and apportioning the group's interest expense

v. The final regulations at § 1.861-8(e)(4)(ii)(B) clarify that at the allocation step (but before applying the apportionment rules), only the gross income derived from entities to which the taxpayer's stewardship expense has a factual connection are included and, in such cases, the apportionment rule applies based on the tax book value of the taxpayer's investment in those particular entities.

vi. The exempt income and asset rules in section 864(e)(3) and § 1.861-8(d)(2) do not apply for purposes of apportioning stewardship expenses.

b. R&E

i. Consistent with the 2019 proposed regulations, gross intangible income (GII) excludes GILTI or other inclusions attributable to ownership of stock in a CFC. GII includes income giving rise to FDII.

ii. Exclusive apportionment does not apply for purposes of computing FDII.

iii. Final regulations clarify that GII does not include disregarded payments, but to the extent a disregarded payment results in the reattribution of regarded gross income that is GII from the general category to the foreign branch category (or vice versa), that income is treated as GII in the foreign branch category (or the general category).

iv. Legally mandated R&E rule and gross income method are not reinstated.

v. The final regulations permit a taxpayer to aggregate some or all three-digit SIC categories within the same Major Group (defined as a two-digit SIC category), but not any three-digit SIC categories within different Major Groups.

vi. The final regulations clarify that taxpayers may rebut the presumption that a controlled party will use future IP by demonstrating that prior exploitation of the taxpayer's intangible property is inconsistent with reasonable future expectations.

vii. It is beyond the scope of the final regulations to determine whether contract research expenses are, or are not, eligible to be deducted under either section 162 or 174.

c. Litigation damages awards
    i. Damages awards related to shareholder suits are allocated to all income of the corporation and apportioned based on the relative values of all of the corporation's assets that produce income in the statutory and residual groupings.

d. NOLs
    i. Statutory and residual grouping components of an NOL are determined in the taxable year of the loss.
    ii. In determining the component parts of an NOL, deductions that are considered absorbed in the year the loss arose for purposes of an operative section may differ from the deductions that are considered absorbed for purposes of another provision of the Code that requires determining the components of an NOL.
    iii. The 2019 proposed coordination rule, which provided that for purposes of determining the source and separate category of a net operating loss the separate limitation loss and overall foreign loss rules of section 904(f) and the overall domestic loss rules of section 904(g) are applied without taking into account the adjustments required under section 904(b), was finalized without change.

e. Section 250 deduction
    i. The final regulations clarify that the section 250 deduction is computed as if all members of a consolidated group were a single corporation.
    ii. In the case of an affiliated group that is not a consolidated group, the section 250 deduction of a member of an affiliated group is allocated and apportioned on a separate entity basis under the rules of § 1.861-8(e)(13) and (14).

f. Revisions related to the characterization of assets connected with capitalized, deferred, or disallowed interest in § 1.861-12(f) finalized as proposed in 2019.

2. Allocation and apportionment of foreign taxes (§ 1.861-20)
    a. In general, final § 1.861-20 was finalized consistent with the 2019 proposed regulations. However, provisions related to partnerships and disregarded payments have been removed and re-proposed. (See below discussion of the 2020 proposed regulations.)
    b. The list of items of foreign gross income that constitute a "base difference" was shortened to eliminate distributions from a partnership described in section 733 and distributions from a corporation described in section 301(c)(2) (*i.e.*, return

of capital distributions). Such items are now considered "timing differences."

        i. In general, the final regulations associate a foreign law dividend that gives rise to a return of capital distribution under section 301(c)(2) with hypothetical earnings of the distributing corporation, measured based on the groupings to which the tax book value of the corporation's stock is assigned under the asset method in § 1.861-9.

    c. The remaining provisions related to items with or without a corresponding US item, foreign law distributions, reverse hybrid entities, and foreign law inclusion regimes were finalized with minor changes.

3. Guaranteed payments for the use of capital
    a. Guaranteed payments for the use of capital share many of the characteristics of interest payments that a partnership would make to a lender and, therefore, should be treated as interest equivalents for purposes of allocating and apportioning deductions under §§ 1.861-8 through 1.861-14 and as income equivalent to interest under section 954(c)(1)(E).
4. Foreign tax redeterminations
    a. In general, the final regulations provide very limited relief from the notification/amended return requirement contained in the 2019 proposed regulations, so an amended return generally is needed for each foreign tax redetermination. A limited exception applies where the amended return would not result in a change in US tax liability. No changes were made to the *de minimis* threshold.
    b. A transition rule is added at § 1.905-4(b)(6) to give taxpayers an additional year to file required notifications with respect to foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019 and before the final regulations are published in the Federal Register.
    c. The final regulations under § 1.905-5(e) also provide an irrevocable election for a foreign corporation's controlling domestic shareholders to account for all foreign tax redeterminations that occur in taxable years ending on or after the date the final regulations are filed with the Federal Register, with respect to pre-2018 taxable years of foreign corporations, as if they occurred in the foreign corporation's last taxable year beginning before January 1, 2018 (the last "pooling" year). The election eliminates the need for cascading amended returns for pre-2018 years due to a change in post-1986 undistributed earnings and taxes for one year rolling over and impacting all subsequent years.
5. Exempt assets under section 864(e) – insurance companies

   a. With respect to the effect of certain deduction limitations on the treatment of income and assets generating DRDs and tax-exempt interest held by insurance companies for purposes of allocating and apportioning deductions to such income and assets, no special rule was provided. The policyholder's share or applicable percentage is accounted for either as a reserve adjustment or a reduction to losses incurred.

Effective dates – 2020 Proposed Regulations

- In general: the proposed regulations are proposed to be effective for tax years beginning on or after the date that *final* regulations adopting these rules are filed in the Federal Register.
- Exceptions:
    - Revisions to CFC netting rule providing that loans between CFCs are not to be treated as related group indebtedness or included in the foreign base period ratio for purposes of the CFC netting rule are proposed to apply for tax years ending on or after the date the *proposed* regulations are filed in the Federal Register.
        - As of the date of this summary, the proposed regulations have not been so filed, but it is expected that the proposed regulations will be published in the Federal Register before the end of October.
    - Rules in § 1.861-20 regarding the allocation and apportionment of foreign income taxes for certain transactions and payments (*e.g.*, dispositions of stock, dispositions of partnership interest, and disregarded payments) are generally effective for tax years beginning after 12/31/19 and ending on or after the date the proposed regulations are filed in the Federal Register
    - Rules disallowing foreign income taxes under section 245A(d) are effective for tax years of a foreign corporation beginning after 12/31/19 and ending on or after the date the proposed regulations are filed in the Federal Register and to tax years of US shareholders in which or with such tax years of CFCs end.
    - Transition rules regarding post-2017 NOL carryback and coordination with OFL and SLL accounts applies to tax years ending beginning on or after 1/1/2018.

Proposed Regulation highlights

1. Disallowance of foreign taxes pursuant to section 245A(d)
    a. In general, proposed § 1.245A(d)-1 will apply the rules in § 1.861-20 for purposes of determining foreign income taxes paid or accrued that are attributable to any dividend for which

a deduction is allowed under section 245A(a), to a hybrid dividend or tiered hybrid dividend, or to certain PTEP that arose as a result of a sale or exchange by reason of section 964(e)(4) or 1248. Such taxes would be disallowed under section 245A(d).

   b. In addition, the rules apply to foreign income taxes that are imposed with respect to certain foreign taxable events, such as a deemed distribution under foreign law or an inclusion under a foreign law CFC inclusion regime, even though such event does not give rise to a distribution or inclusion for Federal income tax purposes.

2. Foreign section 381 transactions
   a. In general, the proposed regulations make updates to § 1.367(b)-7 related to the repeal of section 902 (pooling) on certain attributes of a foreign target or foreign acquiring corporation.
   b. The proposed regulations provide that any amounts remaining in the post-1986 undistributed earnings and post-1986 foreign income taxes of any such corporation as of the end of the foreign corporation's last taxable year beginning before January 1, 2018, are treated as earnings and taxes in a single pre-pooling annual layer in the foreign corporation's post-2017 taxable years.
   c. Foreign income taxes that are related to non-PTEP that were accumulated in taxable years before the current taxable year of the foreign corporation, or in a foreign target corporation's taxable year that ends on the date of the section 381 transaction, are not treated as current year taxes and thus cannot be claimed as credits.
   d. Foreign income taxes related to hovering deficits are not current year taxes in the year that the hovering deficit is absorbed and thus cannot be claimed as credits.
3. Allocation and apportionment of certain expenses
   a. Proposed regulations provide an election to capitalize R&E expenditures and advertising expenses solely for purposes of calculating tax basis for § 1.861-9.
   b. The CFC netting rule was revised to provide that CFC-to-CFC loans do not constitute RGI in the current year or for purposes of the base period ratio.
   c. Interest expense reflected on a foreign banking branch's books and records is directly allocated against the foreign branch category income of that foreign branch, to the extent it has foreign branch category income.
   d. Section 818(f) expenses of life insurance companies must be allocated and apportioned on a life subgroup basis, but a one-time (binding) election is allowed for consolidated groups to choose instead to apply a separate company approach.

4. Allocation and apportionment of foreign income taxes
    a. In general, the new proposed regulations revise and re-propose certain rules relating to disregarded payments, partnerships, and certain distributions.
    b. With respect to a sale or disposition of stock, the new rules assign the foreign gross income and associated foreign tax to statutory and residual groupings first based on any US dividend amount, to the extent thereof. Foreign gross income is next assigned to the grouping to which the US capital gain amount is assigned, to the extent thereof.
    c. The proposed regulations provide new rules on the treatment of distributions from partnerships and sales of partnership interests, including partnerships that are treated as corporations for foreign law purposes. In general, these rules follow similar principles as the rules for distributions from corporations and sales of stock.
    d. The new proposed regulations retain the basic principles of the 2019 proposed disregarded payment rules, but with broader application. In general, the provisions assign foreign gross income arising from the receipt of disregarded payments and the associated foreign tax to the recipient's statutory and residual groupings based on the current or accumulated income of the payor (as computed for US tax purposes) out of which the disregarded payment is considered to be made.
        i. Determination is based on "taxable units," which generally include both foreign branches and non-branch taxable units.
        ii. Foreign tax imposed on foreign gross income that is associated either with a corresponding US item that is initially attributed to a payor taxable unit or with a reattribution amount that is attributed to a recipient taxable unit (before taking into account reattribution payments made by the recipient taxable unit) is allocated and apportioned to the grouping that includes the US gross income of the taxable unit that paid the foreign tax, rather than reattributed.
        iii. When allocating and apportioning taxes with respect to remittances based on assets of the remitting taxable unit, foreign gross income and the associated foreign tax that arise from the receipt of a contribution are assigned to the residual category.
5. Definition of a foreign income tax and in lieu of tax
    a. In general, modifications were made to the definitions of a foreign income tax and a tax in lieu of an income tax, including the addition of a jurisdictional nexus requirement and changes to the net gain requirement, the treatment of certain tax credits, and the substitution requirement under section 903

b. Deducting v. crediting foreign taxes
    i. § 1.901-1(c)(3) provides an exception to general rule in section 275(a)(4) that a taxpayer cannot deduct creditable foreign taxes in a year it elects the FTC. If a foreign tax redetermination results in an additional foreign tax assessment in a credit year relating to an earlier year when the taxpayer deducted foreign taxes, the additional foreign taxes can be claimed as a deduction in the later credit year.
    ii. Current final regulations allow a taxpayer to file an amended return changing from a credit to a deduction, or a deduction to a credit, for foreign taxes at any time within the 10-year statute of limitations under section 6511(d)(3). Proposed regulations retain this rule for changes from deduction to credit, but require amended returns changing from credit to deduction to be filed within the three-year statute of limitations under section 6511(a) (or longer if extended by section 6511(c)).

c. General creditability rules (§ 1.901-2)
    i. The new proposed regulations introduce significant changes to rules for determining whether a foreign levy is a creditable foreign tax. The basic rules were issued in 1983; the proposed regulations reflect some new thinking and changes in the foreign tax landscape over the past almost-40 years.
    ii. The proposed regulations make changes to the realization, gross receipts, and net gain rules that are the basis for determining whether a foreign tax has the predominant character of an income tax. In addition, proposed regulations provide that a surtax on an income tax generally is creditable.
    iii. A "Jurisdictional Nexus" requirement is added to require a sufficient nexus between the foreign country and the taxpayer's activities or investment of capital or other assets that give rise to the income being taxed. This requirements appears to be aimed at extraterritorial taxing regimes such as digital services taxes and UK diverted profits tax and possibly UK ORIP, which may impose tax on a corporation based on the location of its customers, users, or similar destination-based criteria. These foreign laws use a deemed-PE construct which Treasury objects to; if no activities are conducted by the taxpayer in the foreign country imposing the tax, or no property is located in that foreign country, the tax is not creditable.

    iv. An amount of foreign income tax liability is not an amount of foreign income tax paid to the extent the foreign income tax is reduced, satisfied or otherwise offset by a tax credit, regardless of whether the amount of the tax credit is refundable in cash to the extent it exceeds the taxpayer's liability for foreign income tax. This is a change from a longstanding IRS position that a credit which can be used to satisfy tax liability or is refunded if it exceeds tax liability is a means of paying the tax and does not reduce the amount of creditable foreign tax. See GCM GCM 39617 (Netherlands WIR premiums), TAM 200146001 (French refundable R&D credit).

  d. Noncompulsory payments of foreign tax
    i. The proposed regulations retain the general rule that options or elections to shift the timing of foreign tax liability do not make a tax noncompulsory as long they do not increase overall tax liability.
    ii. The proposed regulations add a rule providing that the use or non-use of entity classification elections, foreign consolidation, and loss sharing regimes is not considered to increase the taxpayer's liability for foreign tax over time.
  e. In-lieu-of taxes
    i. Proposed regulations tighten requirements to qualify as an in-lieu-of tax. A taxpayer must establish that (i) the foreign country made a "deliberate and cognizant choice to impose the in lieu of tax instead of a net income tax;" (ii) the imposition of in-lieu-of tax bears a close connection to the failure to impose the net income tax; and (iii) the tax meets the jurisdictional nexus requirement

6. Technical taxpayer rules
  a. In general, the proposed regulations modify the current final regulations rule for allocating the liability for foreign income taxes imposed on a partnership or disregarded entity when ownership changes during the year.
  b. Proposed regulations move the § 1.901-2(f)(4) allocation rules that apply in the case of partnership terminations and variances and other ownership and entity classification changes to new § 1.901-2(f)(5), and modify those rules to ensure that they cover any entity classification change under US tax law that does not cause the entity's foreign taxable year to close.
  c. The proposed regulations allocate foreign tax paid or accrued with respect to the continuing foreign taxable year of a

partnership that terminates under section 708(b)(1), a disregarded entity that becomes a partnership or a corporation, and a corporation that becomes a partnership or a disregarded entity. In addition, proposed § 1.901-2(f)(5)(iv) allocates foreign tax paid or accrued with respect to certain changes in a partner's interest in a partnership (a "variance") by treating the variance as a covered event.

    d. Proposed § 1.901-2(f)(5)(i) provides that tax allocated to a predecessor entity is treated as paid or accrued as of the close of the last day of its last US taxable year, and that tax allocated to the prior owner of a disregarded entity is treated as paid or accrued as of the close of the last day of its US taxable year in which the change in ownership occurs.

7. Transition rules to account for the effect on loss accounts of NOL carrybacks allowed under the CARES Act
    a. Any separate limitation loss (SLL) created by reason of a passive category component of a post-2017 NOL that is carried back to offset pre-2018 general category income will be recaptured in post-2017 taxable years as general category income, and not as a combination of post-2017 general, foreign branch, or section 951A category income.
    b. The carryback of a post-2017 NOL component in the foreign branch category or section 951A category to a pre-2018 taxable year ratably offsets a taxpayer's general category income in the carryback year. No SLL account is created because of the offset.
8. The foreign branch category rules
    a. In general, the rules in § 1.904-4(f) are proposed to be modified in accordance with the proposed modifications for disregarded payments in § 1.861-20.
    b. Income arising from US activities and stock under §§ 1.904-4(f)(1)(iii) and (iv), respectively, may be attributable to a foreign branch but is always excluded from foreign branch category income.
    c. Reattribution rules are provided for certain payments of "non-branch taxable units."
        i. For this purpose, a non-branch taxable unit generally includes a foreign branch of a domestic corporation, a foreign or domestic partnership owned directly or indirectly by a US individual or domestic partnership, or an interest in an entity that is not otherwise a "foreign branch" but is a disregarded entity or branch.
        ii. Importantly, this new change would bring disregarded entities which do not themselves carry on activities that give rise to a QBU into the scope of the disregarded payment rules in § 1.861-20.

   d. Reattribution is capped at the amount of current gross income in the payor foreign branch or foreign branch owner.
   e. The regulations add an example to illustrate the matching rule in § 1.1502-13.
9. Financial services entities (§ 1.904-4(e))
   a. 2019 proposed regulations are re-proposed with modifications.
   b. In general, the proposed regulations retain the general approach of the existing § 1.904-4(e) final regulations by providing a numerical test whereby an entity is a financial services entity if more than a threshold percentage of its gross income is derived directly from active financing income, and the regulations continue to contain a list of income that qualifies as active financing income.
   c. The proposed regulations conform the section 904 rules to the section 954(h) active financing exception rules by lowering the threshold from 80% to 70% and providing that active financing income must generally be earned from customers or other counterparties that are not related parties.
   d. The proposed regulations provide that the look-through rules in § 1.904-5 apply in all cases to assign related party payments attributable to passive category income to the passive category, including in the case of related party payments made to a financial services entity.
   e. The proposed regulations address issues related to the application of the rules to insurance companies to reflect comments received on the 2019 proposed regulations.
10. Timing of claiming a foreign tax credit
   a. In general, the proposed regulations expand § 1.905-1 to provide additional rules regarding when foreign taxes may be claimed as a credit.
   b. Accrual method taxpayers
      i. A foreign income tax liability determined on the basis of a foreign taxable year becomes fixed and determinable at the close of the taxpayer's foreign taxable year.
      ii. Foreign withholding taxes that are paid with respect to a foreign taxable year and that represent advance payments of a foreign net income tax liability determined on the basis of that foreign taxable year accrue at the close of the foreign taxable year.
      iii. Foreign withholding taxes imposed on a payment giving rise to an item of foreign gross income accrue on the date the payment from which the tax is withheld is made (or treated as made under foreign tax law)

c. Rev. Rul. 70-290 and Rev. Rul. 84-125 have long allowed a taxpayer to claim a foreign tax credit for a contested foreign tax if the tax is paid before the contest is resolved, even though the all events test is not met until the contest is resolved. The proposed regulations provide as a general rule that contested foreign taxes do not accrue and cannot be claimed as credits until the contest is resolved, but provide an election to claim a "provisional credit for contested foreign taxes." A taxpayer making the election must comply with certain requirements, including filing an annual certification each year until the contest is resolved.

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