NEW YORK STATE BAR ASSOCIATION
One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

Report No. 1435
February 17, 2020

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1435 – Report on Proposed Foreign Tax Credit Regulations*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1435 commenting on the proposed regulations issued in December 2019 relating to foreign tax credits.

We commend the Internal Revenue Service and the Department of the Treasury for the thoughtful guidance issued with respect to foreign tax credits in the December 2019 final regulations, as well as the new proposed regulations. This Report comments on issues relating to the proposed regulations.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Andrew H. Braiterman
Chair

Enclosure

Cc:

Lafayette "Chip" G. Harter III
Deputy Assistant Secretary – International Tax Affairs
Department of the Treasury

Douglas Poms
International Tax Counsel
Department of the Treasury

Brett York
Associate International Tax Counsel
Department of the Treasury

Brenda Zent
Special Adviser
Department of the Treasury

Erika W. Nijenhuis
Senior Counsel
Department of the Treasury

Peter Blessing
Associate Chief Counsel (International)
Internal Revenue Service

Anne Devereaux
Deputy Associate Chief Counsel (International)
Internal Revenue Service

Daniel McCall
Deputy Associate Chief Counsel (International – Technical)
Internal Revenue Service

Margaret O'Connor
Deputy Associate Chief Counsel (International)
Internal Revenue Service

John Merrick
Senior Level Counsel
Internal Revenue Service

Jeffrey P. Cowan
Attorney-Advisor (Branch 3)
Internal Revenue Service

Jeffrey L. Parry
Attorney-Advisor (Branch 3)
Internal Revenue Service

Susanne M. Walsh
Attorney-Advisor (Branch 3)
Internal Revenue Service

Larry R. Pounders
Attorney-Advisor (Branch 3)
Internal Revenue Service

Karen J. Cate
Tax Law Specialist (Branch 3)
Internal Revenue Service

Report No. 1435

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED FOREIGN TAX CREDIT REGULATIONS

February 17, 2020

TABLE OF CONTENTS

I. Introduction

This Report[1] comments on proposed regulations issued by the Department of Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") on December 17, 2019 (the "**2019 Proposed Regulations**").[2] The 2019 Proposed Regulations offer guidance on a range of issues related to the calculation of the foreign tax credit limitation, allocation and apportionment of foreign income taxes, and redetermination of foreign tax liability in response to the passage of the legislation informally known as the Tax Cuts and Jobs Act (the "**TCJA**").[3] The 2019 Proposed Regulations were issued concurrently with final regulations modifying the determination of the foreign tax credit limitation under Section 904 (the "**2019 Final Regulations**").[4] The 2019 Final Regulations largely adopt in final form regulations proposed on December 7, 2018 (the "**2018 Proposed Regulations**").[5]

We commend Treasury and the IRS for finalizing and proposing rules that address many areas of uncertainty and newfound importance following the passage of the TCJA. Because the 2019 Final Regulations largely adopt the substance of the 2018 Proposed Regulations (upon which we have already extensively commented in a prior Report[6]), this Report's focus is certain aspects of the 2019 Proposed Regulations.

Part II of this Report provides a summary of our recommendations. Part III briefly outlines the changes to the international tax rules of the Code under the TCJA and the contents of the 2019 Final Regulations. Part IV contains a detailed analysis of the 2019 Proposed Regulations and the discussion of our recommendations.

II. Summary of Recommendations

A. Allocation and Apportionment of Expenses Under Section 861

1. Stewardship Expenses

---

[1] The principal author of this Report is Adam Kool, with substantial drafting from Arash Lotfi. Helpful comments were received from Kimberly S. Blanchard, Andy Braiterman, Robert Cassanos, Peter Connors, Charles Cope, Richard Nugent, Joshua Ruland, Michael Schler, Stephen Shay, Joseph Toce, and Shun Tosaka. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee or the House of Delegates of the New York State Bar Association.

[2] 84 Fed. Reg. 69124 (Dec. 17, 2019).

[3] The TCJA is formally known as "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," Pub. L. No. 115-97.

[4] 84 Fed. Reg. 69124 (Dec. 17, 2019). Unless otherwise stated, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "**Code**").

[5] 83 Fed. Reg. 63200 (Dec. 7, 2018).

[6] New York State Bar Tax Section Report No. 1408 (Feb. 5, 2019) (hereinafter, the "**2019 FTC Report**").

a. We recommend that the definition of "stewardship expenses" be clarified and, if necessary, expanded such that expenses in the nature of stewardship may be allocable to interests in disregarded entities, partnerships, and foreign branches in appropriate circumstances.

b. We generally agree that, in light of decisions made in the 2019 Final Regulations, allocation of stewardship expenses to shareholder-level inclusions (including Section 951, Section 951A, and Section 1293 inclusions) may be appropriate in certain circumstances. However, we recommend that Treasury and the IRS reconsider the use of interest expense allocation principles to allocate stewardship expenses.

c. Particularly in the event that the 2019 Proposed Regulations' approach to allocation of stewardship expenses is maintained, we encourage Treasury and the IRS to consider an exception to the general allocation rules for stewardship expenses to account for specific fact patterns in which distortions may be particularly likely (e.g., situations in which certain subsidiaries may require disproportionate stewardship expenditures).

d. We recommend that day-to-day "supportive" expenses otherwise governed by Treas. Reg. § 1.861-8(b)(3) generally be allocated in the same manner as stewardship expenses to the extent not associated with an arm's-length charge required by Section 482.

2. Research and Development Expenses

a. A substantial majority of our executive committee agrees with the provision in the 2019 Proposed Regulations that does not require the allocation of research and development ("**R&D**") expenditures to shareholder-level inclusions from foreign subsidiaries (including Section 951A inclusions).

b. We recommend that the elimination of the gross income method in all cases be reconsidered, as we believe there are situations in which the gross income method provides a clearer and more accurate result than the gross receipts method, and we believe that the ability to use the gross income method may be statutorily mandated.

c. Particularly in the event that the gross income method is not reinstated, we suggest that Treasury and the IRS reconsider the elimination of the opportunity for taxpayers to demonstrate facts and circumstances that justify enhanced exclusive apportionment to the jurisdiction in which R&D is conducted.

3. Interest Expense

a. In response to the request in the preamble of the 2019 Proposed Regulations (the "**Preamble**") for comments regarding the adoption of special rules

under the tax basis method to address deductible expenses such as R&D and advertising, we recommend that no further change be made to the tax basis method to account for these expenses.

b. We reiterate our suggestion from the 2019 FTC Report that interest payments between a foreign branch and its owner generally not be treated as remittances or contributions for purposes of measuring foreign branch gross income.

c. Consistent with recommendations we have made in other contexts, we recommend that a guaranteed payment for capital be treated as interest for purposes of Treas. Reg. § 1.861-9 and Treas. Reg. § 1.954-2(h)(2)(i) only where the payment was structured with a principal purpose of avoiding the operative provision.

B. Allocation and Apportionment of Foreign Income Taxes

1. We recommend clarification and reconsideration of the definition of "base difference" in Prop. Treas. Reg. § 1.860-20(d)(2)(ii)(B). In particular, we recommend that the regulations exclude from the definition of "base difference" certain corporate and partnership transactions that result in basis reduction for U.S. federal income tax purposes.

2. The characterization of certain transactions between a foreign branch and its foreign owner for purposes of apportioning foreign income taxes under the 2019 Proposed Regulations present counterintuitive distinctions that may present traps for the unwary. We recommend applying an approach analogous to the apportionment of foreign taxes with respect to transactions between a foreign branch and its U.S. owner pursuant to Treas. Reg. § 1.904-6 in the 2019 Final Regulations, which produces more appropriate results (albeit at the cost of greater complexity).

C. Redeterminations of Foreign Taxes

1. We recommend adopting a simplified approach to Section 905(c) foreign tax redeterminations with respect to pre-TCJA tax years. However, we suggest consideration of limitations on the use of such a simplified method to mitigate the possibility that it leads to a material distortion of a taxpayer's overall U.S. tax liability, as well as consideration of whether use of the simplified method should be optional or mandatory.

2. We believe that clarification regarding the treatment of successors and transferees for purposes of Section 905(c) redeterminations would be helpful. We agree that it is appropriate to apply general federal income tax principles in this context, although we suggest certain clarifications with respect to the application of these principles. We also highlight certain complex issues related to the treatment of contingent liabilities that are likely to arise in the Section 905(c) context.

III. Background: Post-TCJA Guidance with Respect to Foreign Tax Credits

A. Changes to Foreign Tax Credit Regime Under TCJA

As discussed in greater detail in our prior Report,[7] the TCJA made a number of fundamental changes to the U.S. taxation of non-U.S. income. These changes include a new tax on so-called "global intangible low-taxed income" ("**GILTI**") and a deduction for certain foreign derived intangible income ("**FDII**"). The TCJA also provided for a 100% dividends received deduction for certain dividends from specified foreign corporations under Code Section 245A, with the result that in many cases all of a U.S. taxpayer's non-U.S. income will be taxed by the United States at the time the income is earned or will not be taxed by the United States at all.

Consistent with pre-TCJA law, a taxpayer is generally entitled to a credit for foreign taxes paid or deemed paid by the taxpayer.[8] In measuring a taxpayer's entitlement to the foreign tax credit, Section 904 of the Code limits entitlement based on the amount of a taxpayer's income allocable to specific categories (or "baskets") of taxable income. The general goal of Section 904 is to avoid subsidization of foreign taxing jurisdictions by limiting the amount of the foreign tax credit attributable to each category to the pre-credit U.S. tax on the foreign source-income in the category. For a corporate taxpayer, this generally means that the total credit with respect to each basket is limited to 21% of the actual amount of foreign source net income in that basket. Post-TCJA, the four most relevant baskets to most taxpayers are (1) general income, (2) passive income, (3) GILTI income, and (4) foreign branch income.[9] Measurement of a taxpayer's foreign source income must take into account items of gross income as well as items of deduction allocable to that income, and accordingly the allocation and apportionment of deductions to and among these baskets has significant implications for outcomes under Section 904. While this has always been a complex undertaking, with the introduction of the GILTI regime (which generally looks to the "tested income" of each of the subsidiaries of the taxpayer that is a controlled foreign corporation (a "**CFC**")) and the 100% dividends received deduction under Code Section 245A, the precise allocation and apportionment of foreign taxes to specific types of taxable income has become substantially more complex.

B. The 2019 Final Regulations

The 2019 Final Regulations finalized the 2018 Proposed Regulations with only limited changes. As finalized, the 2019 Final Regulations answer many of the most fundamental questions raised in respect of the foreign tax credit post-TCJA. In particular, the 2019 Final Regulations confirm that for purposes of determining foreign source income in the GILTI basket, deductible expenses incurred by a U.S. taxpayer can and should in certain circumstances be allocated to the GILTI basket. The 2019 Final Regulations also provide clarification with respect to a number of technical issues related to the allocation and apportionment of gross income to GILTI for purposes

---

[7] New York State Bar Tax Section Report No. 1408 (Feb. 5, 2019).

[8] Section 901; Section 960.

[9] In certain cases, income may be subject to other baskets that are generally beyond the focus of this Report. For example, Section 904(d)(6) requires separate baskets for income resourced under a U.S. tax treaty.

of Sections 861 and 904, deductions for GILTI and FDII under Section 250, and the gross-up for credited foreign taxes pursuant to Section 78. The 2019 Final Regulations also offered clarification as to the allocation and apportionment of certain expenses of a U.S. taxpayer post-TCJA, and clarified the operation of the foreign tax credit carryforward under Section 904(c) with respect to tax credits carried from pre-TCJA taxable years to post-TCJA taxable years. A more detailed discussion of the 2018 Proposed Regulations is available in our prior Report.[10]

C. The 2019 Proposed Regulations

The 2019 Proposed Regulations address a number of technical issues left open under the 2019 Final Regulations. In particular, the 2019 Proposed Regulations offer guidance regarding (1) the allocation and apportionment of certain expenses for purposes of Treasury Regulations issued under Section 861, (2) the allocation and apportionment of foreign taxes paid or deemed paid by a taxpayer among baskets, (3) the treatment of certain lending transactions as between partners and partnerships for purposes of the foreign tax credit rules, (4) the application of Section 904(d)(2)(D) to certain financial services entities, (5) the application of Treas. Reg. § 1.904(g)-3 to certain loss recapture transactions, (6) foreign tax redeterminations under Code Section 905(c), (7) specialized issues related to insurance companies, and (8) conforming changes and clarifications related to the overall foreign loss and overall domestic loss rules, the application of Section 965, and certain consolidated return rules. Our recommendations for clarifications and modifications to certain aspects of the 2019 Proposed Regulations are set forth in Part IV, below. We do not comment on (a) the application of Section 904(d)(2)(D) to certain financial services entities, (b) the application of Treas. Reg. § 1.904(g)-3 to certain loss recapture transactions, (c) specialized issues related to insurance companies, or (d) the technical conforming changes and clarifications described above.

IV. Discussion

A. Allocation and Apportionment of Expenses Under Section 861

The 2019 Final Regulations offer guidance as to key structural issues related to expense allocation and apportionment, but left open many technical questions related to specific types of expenses. In this regard, the 2019 Proposed Regulations pick up where the 2019 Final Regulations left off, proposing detailed guidance as to the allocation of stewardship expenses and research and development costs. The Preamble also requests comments regarding certain issues relating to interest expense allocation. We address each of these points in turn.

1. Stewardship Expenses

The allocation and apportionment of stewardship expenses is governed by Treas. Reg. § 1.861-8(e)(4). A stewardship expense is, in essence, an expense incurred by a shareholder that does not provide a benefit to the entity with respect to which the activities are performed. Thus, activities giving rise to stewardship expenses include activities of a shareholder that are duplicative of an entity's activities (such as treasury functions in which a parent corporation engages to manage its own liquidity needs), as well as activities that are undertaken to protect the

[10] 2019 FTC Report, pp. 12-17.

shareholder's capital investment (e.g., compliance with reporting or other regulatory requirements applicable to the parent resulting from ownership of the subsidiary).[11]

Historically, stewardship expenses have been allocated to dividends received or to be received from related corporations, with no specific approach required for apportionment among statutory baskets.[12] The 2019 Proposed Regulations propose expanding the classes of income to which stewardship expenses may be allocated in light of the TCJA, and require a specific method of apportionment of stewardship expenses that roughly tracks the apportionment of interest expense. Specifically, the 2019 Proposed Regulations expand the classes of income to which stewardship expenses may be allocated, capturing other shareholder-level inclusions under Section 78, 951, 951A, 1291, 1293, and 1296. We view this expansion as generally consistent with positions taken in the 2018 Proposed Regulations and 2019 Final Regulations, where Treasury and the IRS concluded that the allocation of expenses to shareholder-level inclusions (including under Section 951A) was appropriate post-TCJA. We therefore support allocation of stewardship to these categories of income as a general matter. However, we believe that some of the details of the determination, allocation and apportionment of stewardship expenses merit reconsideration or modification.

a. *Measurement and Allocation of Stewardship Expenses*

As an initial matter, we note that the 2019 Proposed Regulations do not treat expenses attributable to disregarded entities and foreign branches in the same manner as expenses incurred with respect to corporate stock.[13] In particular, (1) it is not entirely clear whether the definition of "stewardship expenses" in Prop. Treas. Reg. § 1.861-8(e)(4)(ii)(A) is intended to capture expenses incurred with respect to disregarded entities or foreign branches, and (2) regardless of the scope of the definition of "stewardship expenses," the 2019 Proposed Regulations clearly do not contemplate the allocation of stewardship expenses to interests in disregarded entities or foreign branches (notwithstanding that a special rule does exist to apply analogous principles to partnership interests).[14] We believe that this combination of rules results in stewardship expenses being allocated in a manner that in many cases may not accurately reflect economic reality, and we recommend a number of revisions to the 2019 Proposed Regulations to avoid this result.

Beginning with the definition of "stewardship expenses," the text of the 2019 Proposed Regulations does not clearly address the treatment of expenses otherwise in the nature of stewardship expenses that are incurred with respect to disregarded entities or foreign branches. Under one reading of Prop. Treas. Reg. § 1.861-8(e)(4)(ii), expenses that would be "stewardship expenses" if incurred with respect to a corporate subsidiary do not constitute "stewardship

---

[11] Treas. Reg. § 1.861-8(e)(4). Stewardship expenses are specifically defined by reference to "duplicative activities" and "shareholder activities," within the meaning of Treas. Reg. §§ 1.482-9(l)(3)(iii) and (l)(3)(iv), respectively.

[12] *See* current Treas. Reg. § 1.861-8(e)(4).

[13] We note that a special rule does exist for partnership interests in Prop. Treas. Reg. § 1.861-8(e)(4)(ii)(D), but this rule would be superseded and would no longer be necessary if our proposals are adopted.

[14] Prop. Treas. Reg. § 1.861-8(e)(4)(ii)(D).

expenses" if the expenses relate to disregarded entities or foreign branches. If this is the intent of the 2019 Proposed Regulations, we question whether this approach is sensible as a policy matter. In particular, if this reading is accurate, expenses incurred with respect to disregarded entities and foreign branches that are economically identical to stewardship expenses with respect to corporations are presumably subject to some separate standard under the general rules of Treas. Reg. § 1.861-8(b) and potentially produce inconsistent results as compared to corporate stewardship expenses. This outcome seems inconsistent with the general approach in Treas. Reg. § 1.861-8 that seeks to treat economically identical expenditures in a similar manner. Furthermore, this artificial line-drawing is likely to lead to ambiguity and uncertainty if a taxpayer is required to determine which specific portion of its stewardship-like expenses relates to corporate stock and which portion relates to non-corporate entities. The following examples highlight many of our key concerns in this area:

> **Example 1a**. USP owns (i) 100% of the stock of CFC1, a controlled foreign corporation which conducts business solely in Country X, and (ii) 79% of the stock of USSub, a domestic corporation.[15]
>
> USP's supervision department incurs deductible expenses of $100 related to stewardship activities with respect to CFC1 during Year 1, but is not required to engage in stewardship activities with respect to USSub. Under the 2019 Proposed Regulations, the $100 of deductible expenses are allocable to dividends and other inclusions arising with respect to the stock of USSub and CFC1.
>
> **Example 1b**. The facts are the same as in Example 1a, but CFC1 has elected pursuant to Treas. Reg. § 301.7701-3(a) to be treated as an entity disregarded as separate from its owner. Under the 2019 Proposed Regulations, it appears that the $100 of deductible expenses may no longer be stewardship expenses. If so, the taxpayer is apparently free to allocate the $100 of expenses based on the more flexible allocation rules contained in Treas. Reg. § 1.861-8(b).

An alternative reading of Prop. Treas. Reg. § 1.861-8(e)(4)(ii) is that the definition of "stewardship expenses" does in fact encompass stewardship-like expenses incurred with respect to disregarded entities and foreign branches, but that these expenses are allocable solely to income inclusions with respect to corporate stock. This reading of the definition of "stewardship expenses" leads to results that appear to be more anomalous than those in Example 1a and Example 1b, as

[15] For purposes of this example, we assume facts such that USSub and USP are not members of the same affiliated group. This is to avoid focus on the application of the apportionment rules when a dividend from USSub would qualify for the 100% dividends received deduction under Section 243(a)(3). This issue is discussed in detail in Section IV.A.1.b.ii, below.

stewardship expenses relating to CFC1 would be arbitrarily allocated in their entirety to corporate stock.[16]

> **Example 1c**. The facts are the same as in Example 1b, but assume that "stewardship expenses" definitionally includes expenses with respect to disregarded entities and foreign branches. In this case the $100 of stewardship expenses incurred with respect to CFC1 are arbitrarily allocated to stock of USSub.

Whether the arguably arbitrary results in the 2019 Proposed Regulations stem from an unduly narrow definition of "stewardship expenses," or whether these results are driven by a requirement to allocate expenses associated with stewardship-like expenses solely to corporate stock, we believe that the approach to defining and allocating stewardship expenses should be reconsidered. In particular, the 2019 Proposed Regulations should be clarified (and, where appropriate, modified), such that all expenses in the nature of stewardship (whether incurred with respect to a corporation, partnership, disregarded entity, or foreign branch) are "stewardship expenses" that are in turn allocated to all of a taxpayer's gross income with respect to interests in corporate stock, partnership interests, disregarded entities, and foreign branches.

We acknowledge that in expanding the types of gross income to which stewardship expenses may be allocated, the methodology for apportioning these expenses among statutory categories would necessarily become more complex. However, we believe this complexity is necessary to achieve results that appropriately reflect the underlying economic reality of an entity owner's stewardship expenses, and accordingly support the allocation of stewardship expenses to a broader class of gross income.

b. *Apportionment of Stewardship Expenses*

Perhaps the most significant change made to the 2019 Proposed Regulation to the treatment of stewardship expenses relates to apportionment. Existing regulations identify a number of permissible methods of apportionment with respect to stewardship expenses, but do not specifically require a particular approach. The 2019 Proposed Regulations, in contrast, mandate the use of a modified version of the asset method for interest expense apportionment under Treas. Reg. § 1.861-9T(g) (and, as relevant, Treas. Reg. §§ 1.861-12 and 1.861-13). However in applying the interest expense apportionment principles with respect to corporate stewardship expenses, assets other than stock assets are not taken into account.[17] Presumably the justification for only taking stock into account in this context rests upon the allocation rule described above, which

16. To the extent that the results in Example 1a are counterintuitive, this is a product of requiring all stewardship expenses to be allocated to income from all stock, regardless of the reason for which the expenses are incurred. This issue is discussed in detail in Section IV.A.1.b.i, below

17 Prop. Treas. Reg. § 1.861-8(e)(4)(ii)(C). In the case of stewardship expenses with respect to partnership interests, the 2019 Proposed Regulations indicate that the stewardship expenses are allocable to the partner's distributive share of partnership income, and that the expenses are apportioned under the principles of the rules applicable to corporate stock.

provides that corporate stewardship expenses are solely allocable to dividends and other inclusions related to stock ownership.

We appreciate that the use of the interest expense allocation rules may have been grounded in the view that objectively determinable rules were desirable with respect to stewardship expenses. Although we appreciate that rules yielding clear results do in fact enhance the administrability of the tax law, we believe that the approach to stewardship expense apportionment in the 2019 Proposed Regulations is problematic in several respects, and that the proposed rules lead to unintended and inappropriate consequences in some cases. We describe our disagreements with the 2019 Proposed Regulations and our recommendations in detail below.

i. Unclear Policy Justification for Use of Interest Expense Apportionment Rules

Our first issue with the approach of the 2019 Proposed Regulations to apportionment of stewardship expenses focuses on the basic decision to tie the allocation of stewardship expenses to the rules governing allocation of interest expenses. The interest expense apportionment rules are premised on the idea that "money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid."[18] Accordingly, rather than applying a tracing approach for interest expense based on facts and circumstances, the interest expense apportionment rules allocate expenses based on the relative values of a taxpayer's assets.

It is not clear to us that the fungibility of money finds an appropriate analog in the context of stewardship expenses. In fact, one would expect that certain subsidiaries require substantially more stewardship than others, and that stewardship expenses with respect to one subsidiary are by no means "fungible" with stewardship expenses related to another subsidiary. While the extent of stewardship a subsidiary requires may roughly correlate with the value of a subsidiary's equity in some cases, there are likely to be many cases in which relative stewardship expenses for a specific subsidiary are almost completely divorced from equity valuation. For example, a Delaware corporation is unlikely to incur material stewardship expenses with respect to a subsidiary incorporated in Delaware that engages in no business other than holding the stock of other subsidiaries.[19] However, the same Delaware corporation may incur very substantial stewardship expenses with respect to a subsidiary incorporated in a foreign country, even if the foreign subsidiary is a limited risk distributor with minimal assets. Similarly, two corporate subsidiaries with identical enterprise values that engage in identical businesses in the same jurisdictions are likely to require similar amounts of stewardship expenses. However, by tying apportionment to relative stock values, the two corporations may attract very different amounts of stewardship expenses in the event one subsidiary has incurred material leverage but the other has not.

---

[18] Treas. Reg. § 1.861-9T(a).

[19] It is of course possible, however, that subsidiaries of the intermediate Delaware holding corporation may require stewardship expenses. And there is a possibility of duplication if the intermediate holding corporation incurs stewardship expenses with respect to the lower tier subsidiaries, although in many cases this duplication may be eliminated pursuant to the affiliated group rules of Treas. Reg. § 1.861-14T.

In light of these potential distortions, we recommend reconsideration of the use of the interest expense apportionment rules in the stewardship context. One option would be to revert to the historic approach to apportionment of stewardship expenses, which merely identified a number of permissible apportionment options rather than mandating a specific method. A second option would be to use the interest expense allocation rules as a starting point, but to adopt a number of modifications designed to address specific situations where a distortive apportionment is particularly likely. For example, Treasury and the IRS might consider making adjustments for subsidiary-level leverage or adding a rule that generally prevents the apportionment of stewardship expenses to subsidiaries that are particularly unlikely to attract stewardship expenses (e.g., domestic subsidiaries acting as holding companies). We note that in practice this second approach is likely to prove quite challenging, and may produce further unintended or inappropriate consequences if every relevant situation is not clearly and adequately addressed. Finally, a third option may be to require a single method of apportionment, but to use something other than the interest expense allocation rules as a base. For example, stewardship expenses could be allocated and apportioned based on a taxpayer's subsidiaries' gross income or gross receipts, analogous to the rules for R&D expenses, described below. Such an approach may provide a more accurate estimation of stewardship expenses attributable to a given subsidiary's business since measurement of gross income or gross receipts generally should not be impacted by internal leverage incurred at the subsidiary level with respect to otherwise identical businesses. This third approach may also be attractive inasmuch as it provides the government and taxpayers with a specific and clear rule for apportioning stewardship expenses, but does not involve adoption of interest expense rules that were specifically designed to address a conceptually distinct set of issues.

ii. Counterintuitive Results Under Proposed Regulations' Approach

Even if Treasury and the IRS decline to adopt our suggestions above and retain an apportionment rule based on relative stock values, the approach taken in the 2019 Proposed Regulations produces counterintuitive results due to the "exempt asset" rules. The 2019 Proposed Regulations appear to take the position that stock which generates dividends described in Section 243(a)(3) (generally, dividends paid from one member of a consolidated group to another) represents an exempt asset under Treas. Reg. § 1.861-8(d)(2)(ii)(B). However, as provided in the 2019 Final Regulations, stock that generates dividends described in Section 245A is not treated as an exempt asset.[20] The result is that stewardships expenses effectively cannot be apportioned to stock of a U.S. subsidiary within a consolidated group, which in many cases will lead to 100% allocation to foreign subsidiaries, as illustrated in the following example (based on Example 18 in Prop. Treas. Reg. § 1.861-8(g)(18)):

[20] The technical reason for this difference rests in the different ways Congress addressed the dividends received deduction under Section 243 and the dividends received deduction under Section 245A. Section 864(e)(3) specifically contemplates that stock eligible for the Section 243 "dividends received deduction" is an exempt asset. The 100% dividends received deduction under Section 245A, in contrast, is separately addressed by Section 904(b)(4), which makes adjustments to income calculations of income for purposes of Section 904, but does not specifically treat stock that potentially generates 245A deductions as an "exempt asset."

> **Example 2**. USP owns (i) 100% of the stock of CFC1, a controlled foreign corporation which conducts business solely in Country X, and (ii) 100% of the stock of USSub, a wholly owned domestic corporation. USP and USSub file a consolidated federal income tax return for all relevant periods. USP's supervision department incurs deductible expenses of $100 related to stewardship activities during Year 1. In Year 1, 100% of the stock of CFC1 is assigned to the Section 951A category under Treas. Reg. § 1.861-12T(c)(3)(ii).
>
> USP's $100 deduction for stewardship expenses is apportioned using the same value for CFC1 and USSub stock that is used for apportioning USP's interest expense. However, the 2019 Proposed Regulations exclude 100% of the value of the USSub stock because USSub generates qualifying dividends deductible under Section 243(a)(3). Accordingly, it appears that 100% of the stewardship expenses are apportioned based on the classification of the stock of CFC1, and therefore all $100 of the deduction for stewardship expenses is allocable to the Section 951A category.

We believe that Example 2 represents a troubling and potentially inappropriate result in a number of respects. First, as a technical matter, is not entirely clear to us it is appropriate to treat the stock of USSub as an exempt asset under Prop. Treas. Reg. § 1.861-8(d)(2)(ii)(B), which provides as follows:

> In the case of stock which generates, has generated, or can reasonably be expected to generate qualifying dividends deductible under section 243(a)(3), <u>such stock does not constitute an exempt asset</u>. However, such stock and the qualifying dividends thereon are eliminated from consideration in the apportionment of interest expense under the consolidation rule set forth in §1.861-11T(c), and in the apportionment of other expenses under the consolidation rules set forth in §1.861-14T (emphasis added).[21]

---

[21] Prop. Treas. Reg. § 1.861-8(d)(2)(ii)(B) is consistent with the existing Treasury Regulations and appears to be based on the statutory language in Section 864(e)(3) which provides:

> For purposes of allocating and apportioning any deductible expense, any tax-exempt asset (and any income from such an asset) shall not be taken into account. A similar rule shall apply in the case of the portion of any dividend (<u>other than a qualifying dividend as defined in section 243(b)</u>) equal to the deduction allowable under section 243 or 245(a) with respect to such dividend and in the case of a like portion of any stock the dividends on which would be so deductible and would not be qualifying dividends (as so defined) (emphasis added).

Neither the Preamble nor Example 18 in Prop. Treas. Reg. § 1.861-8(g)(18) provides a detailed reconciliation of Prop. Treas. Reg. § 1.861-8(d)(2)(ii)(B) and the results reflected in the Example.

One potential explanation for the result is that Treasury and the IRS believe this outcome is limited to a situation in which USP and USSub do not elect to consolidate for U.S. federal income tax purposes (the "**Non-Consolidation Interpretation**"). The technical basis for the Non-Consolidation Interpretation is that intercompany dividends are exempt from federal tax under Regulations issued pursuant to Section 1502 rather than being exempt from tax under Section 243(a)(3), and accordingly the language quoted above regarding Section 243(a)(3) is inapplicable. Under the Non-Consolidation Interpretation it is possible that Treasury and the IRS would disagree with the results in Example 2, and suggest that because Example 2 (unlike Example 18 in the Proposed Regulations) assumes that USP and USSub consolidate, stewardship should be allocated in a manner different from what Example 2 suggests (although what this alternative approach would be is not entirely clear).

The difficulty with the Non-Consolidation Interpretation is that it does not appear to square with the outcomes in current Treas. Reg. 1.861-8(g). Specifically, Example 17 of the current regulations addresses stewardship in the consolidated group context and specifically allocates stewardship expenses to the stock of a subsidiary of the common parent. Example 18 in the current regulations, in turn, addresses stewardship expenses in a situation where a wholly-owned subsidiary appears to file returns on a separate company basis, and concludes that an allocation of stewardship expense to the stock of the domestic subsidiary is appropriate. The examples reach this conclusion notwithstanding that current Treas. Reg. § 1.861-8T(d)(2)(ii)(b) is substantively identical to Prop. Treas. Reg. § 1.861-8(d)(2)(ii)(B) with respect to the treatment of stock of an affiliated group member. Given that the current regulations and the 2019 Proposed Regulations reach different conclusions on substantively identical fact patterns and with substantively identical rules regarding the treatment of affiliated group members, the Non-Consolidation Interpretation appears to be an incomplete explanation for the results of Example 18 in the 2019 Proposed Regulations.

An alternative explanation for the results in Example 18 of the 2019 Proposed Regulations focuses on the use of the interest expense apportionment principles (the "**Interest Apportionment Interpretation**"). In particular, it may be that Example 18 is applying the general principle that stock of an affiliated group member is disregarded for purposes of applying the interest expense apportionment rules. If this is the case, then it would be impossible to ever allocate stewardship expenses to members of an affiliated group, but it would explain why Example 18 in the 2019 Proposed Regulations reaches a different result from that of Example 17 and Example 18 in the current Regulations. We note that under the Interest Apportionment Interpretation, the results with respect to stewardship expenses would almost certainly diverge from the actual apportionment of interest expense under Treas. Reg. § 1.861-14T. For purposes of allocating and apportioning interest expense, the assets of an affiliated group member are taken into account; however, under the Interest Apportionment Interpretation for stewardship expenses, taxpayers would seemingly not be permitted to take into account either the stock or the assets of an affiliated group member (other than possibly stock in non-affiliated corporations owned by affiliated group members).

Leaving aside the uncertain technical basis for Treasury and the IRS's conclusion in Example 18 of the 2019 Proposed Regulations, we find the results in the example inappropriate from a policy perspective, inevitably leading to an apportionment of stewardship expenses with little grounding in economic reality in many cases. For example, assume that in Example 2 above the $100 of stewardship expenses had related exclusively to activities with respect to ownership of USSub—even in this case the 2019 Proposed Regulations effectively foreclose any allocation to the stock of USSub and would require a full allocation of the stewardship expenses to the stock of CFC. This result is difficult to square with the stated goal of Treas. Reg. § 1.861-8 of matching deductions to the gross income to which they are definitely related.

c. *Distinguishing Stewardship Expenses from Other Supportive Expenses*

Finally, the Preamble requests comments regarding the relationship between stewardship activities and day-to-day management activities which are more supportive in nature and would be governed by Treas. Reg. § 1.861-8(b)(3). The Preamble specifically expresses concern that these types of activities may be difficult to distinguish and as a result may give rise to misclassification by taxpayers between these two categories of expenses.

We agree that the concern expressed by Treasury and the IRS merits consideration. However, we note that similar issues related to incorrect classification of these types of expenses exist in a number of contexts throughout the Code and Regulations. For example, day-to-day management activities may attract an arm's-length charge under Treas. Reg. § 1.482-9(l)(3), whereas stewardship expenses generally would not. Similarly, it may not always be clear when a payment made to a shareholder for supportive activities should be treated as an arm's-length fee (which would potentially be required in the case of day-to-day management activities) or as a distribution (which would presumably be required if the only services performed by the shareholder related to stewardship and therefore benefitted only the shareholder). We believe that any articulation of a standard for distinguishing between these types of expenses therefore has implications beyond the foreign tax credit context, and as such we believe that guidance seeking to distinguish supportive activities from stewardship activities is best left to a separate regulatory project that could take each of these contexts into account.

As an alternative to clarifying the distinction between day-to-day management activities and stewardship expenses, Treasury and the IRS might consider revising the supportive expense allocation rules in a manner that, where appropriate, minimizes the importance of the classification of an expense as arising with respect to day-to-day management as opposed to stewardship. The extent to which such an approach is workable depends in part on whether our recommendations regarding the allocation and apportionment of stewardship expenses are accepted, but in any case Treasury and the IRS could consider a two-step process to the allocation of expenses associated with day-to-day supportive management activities. In the first step, expenses arising with respect to specific activities for which a payment was required from a subsidiary would be allocated to the income attributable to the payment from the subsidiary.[22] In the second step, any remaining

[22] Consistent with a number of other provisions in the 2019 Final Regulations, appropriate rules would likely be required in this context to address payments that would be required from a foreign branch or disregarded entity

expenses from day-to-day management activities would be allocated in the same manner as stewardship expenses. Under such an approach, the distinction between day-to-day management activities and stewardship expenses for purposes of Treas. Reg. § 1.861-8 is minimized, thereby decreasing the likelihood that a misclassification of expenses results in an inappropriate apportionment of a shareholder deduction.

2. Research and Development Expenses

The 2019 Proposed Regulations offer a number of modifications to the manner in which research and development expenditures are allocated and apportioned. In particular, the 2019 Proposed Regulations (1) provide for no allocation of any R&D expenditures to amounts included under Section 951, Section 951A, or Section 1293, (2) eliminate the gross income method of apportionment, and (3) eliminate rules addressing legally mandated R&D and increased exclusive apportionment. We address each of these changes in turn below.

a. *Prohibition on Allocation of R&D Expenditures to 951A Inclusions*

Prior to the publication of the 2019 Proposed Regulations, it was not clear whether or to what extent allocations of R&D expenses to shareholder-level inclusions under Section 951A would be required. In taking the position that no allocation of R&D expense to Section 951A income would be required for purposes of Prop. Treas. § Reg. 1.861-17, Treasury and the IRS appear to have been focused on the relationship between Section 951A income and R&D expenses incurred by a U.S. taxpayer.[23] In particular, Treasury and the IRS noted in the Preamble that they believe that any allocation of R&D expenses to Section 951A income is inappropriate because it is not possible for R&D expenses incurred by a U.S. taxpayer to generate Section 951A income unless (1) the CFC compensates the U.S. taxpayer with an arm's-length charge or (2) Section 367(d) applied to impute an arm's-length royalty, in each case resulting in income recognition for the entity that engaged in the R&D.[24]

Below, we lay out arguments in support of and against the position of the 2019 Proposed Regulations. A substantial majority of our executive committee agrees with the position of Treasury and the IRS, while a minority believes that the position should be reconsidered.

i. Arguments in Support of Treasury and the IRS's Position

Arguments in favor of Treasury and the IRS's position are predicated on the view that Section 482 arm's-length principles should be utilized in measuring whether and to what extent R&D expenses of a U.S. parent benefit a CFC. In particular, the approach taken in the 2019 Proposed Regulations reflects an underlying assumption that a taxpayer is free to designate a single entity within a group of affiliates as the group entrepreneur. Under this paradigm, the group

---

under Section 482 in the event the branch or entity were a regarded subsidiary for U.S. federal income tax purposes. *See, e.g.*, Treas. Reg. § 1.904-4(f)(2)(vi)(E).

[23] 84 Fed. Reg. 69129 (Dec. 17, 2019).

[24] *Id.*

entrepreneur incurs all of the risks and bears all of the costs associated with R&D activities, and correspondingly is entitled to all of the benefits associated with those R&D activities. Affiliates of the group entrepreneur may then license the successful R&D from the group entrepreneur at an arm's-length price. As such, where R&D is successful, all income associated with any resulting value will generally be fully taxable to the group entrepreneur in order for the underlying intangible property to be passed on to an affiliate, and where R&D is unsuccessful, the costs of the R&D are borne by the group entrepreneur alone.[25] These results are consistent with the arm's-length standard that underlies the operation of Section 482.

The argument in favor of Treasury and the IRS's position is that these Section 482 principles should be central to the allocation of expenses under Section 861. In particular, when deciding whether R&D expenses should be allocable to a CFC shareholder's Section 951A income, the appropriate focus should be on whether and to what extent those R&D expenses could give rise to tested income of a CFC. As suggested by the Preamble, because in all cases a CFC will be required to pay (or be deemed to pay) an arm's-length royalty to access a U.S. parent's intellectual property (either under Section 482 or Section 367(d)), all of the income associated with the R&D expense will be recognized directly by the U.S. taxpayer (as opposed to through Section 951A inclusions). This matching of R&D expense and R&D income is an appropriate outcome, particularly in light of the general mission of the Section 861 regulations to match deductions to the income to which they definitely relate.

As noted by those who disagree with Treasury and the IRS, the approach taken by the 2019 Proposed Regulations with respect to R&D expenses diverges somewhat from the approach with respect to expenses related to interest or stewardship. While the 2019 Final Regulations and 2019 Proposed Regulations allocate many types of expenses (including interest and stewardship expenses) to Section 951A income, the 2019 Proposed Regulations do not provide for any allocation of R&D expenses to Section 951A income. However, those in support of Treasury and the IRS's position in the 2019 Proposed Regulations believe that this result is entirely appropriate. Rather, the allocation of expenses to a given type of income should in every case should be predicated on a factual relationship between the deduction and the income. In the case of stewardship, the taxpayer is incurring expenses in order to safeguard its right to earn Section 951A income in the future and therefore an appropriate factual relationship exists. In the case of interest expense, the allocation to Section 951A income is premised on the idea that a taxpayer has effectively committed a portion of its borrowed funds to the foreign subsidiary (as measured by tax basis in the subsidiary's stock), which money will potentially be used to generate Section 951A income and again an appropriate factual relationship exists. Under this view R&D expenses simply lack the factual nexus to tested income, and accordingly should not be allocated to Section 951A income.

---

[25] We note, however, that the Proposed Regulations do not necessarily prevent allocation of unsuccessful R&D expense to foreign source income. Because R&D expense is apportioned based upon SIC Codes, it appears that all R&D expense, whether or not successful, is subject to apportionment to foreign source income as long as the taxpayer has foreign source income within the relevant SIC Code. We further acknowledge that there is inevitable potential for distortion because the years in which R&D expenses are incurred may precede the years in which income from the resulting intellectual property incurred; this is especially likely to be an issue in the case of start-up companies that may go years without generating any revenue.

ii. Arguments Against Treasury and the IRS's Position

Those of us who disagree with Treasury and the IRS's position in the 2019 Proposed Regulations reject the arguments described above for several reasons: First, as a substantive matter, they do not accept the proposition that Section 482 provides the appropriate starting point for allocating expenses for purposes of Section 861. In their view, whether and to what extent Section 482 would require an arm's-length charge with respect to the product of any given R&D expense is not relevant to allocation and apportionment of the expense for foreign tax credit purposes. Rather, the fundamental question is whether deductible R&D expenses (regardless of whether the R&D activity is successful) sufficiently benefit (or if unsuccessful had the potential to benefit) the group's foreign subsidiaries that any foreign tax credit with respect to the taxpayer's Section 951A income should be reduced.

Those who disagree with the position in the 2019 Proposed Regulation further contend that the approach to R&D expenses amounts to a special exemption for R&D expenses that lacks a statutory basis and is tantamount to a subsidy for R&D conducted in the United States. They argue that if Congress intended such a subsidy, Congress would have said so much more clearly (as it has in other contexts, such as Sections 41, 174 and 864(g)). Accordingly, rather than trying to justify an outcome for R&D that is different from stewardship, interest expense, or any other expense that can be allocated to Section 951A income, those opposed to Treasury and the IRS's approach propose that R&D expenses be treated like any other expense that benefits the worldwide group by being allocated in part to Section 951A income.

iii. Recommendation

As noted above, a substantial majority of our group supports the government's position. In addition to believing that the 2019 Proposed Regulations are correct as a conceptual matter, requiring allocation of R&D expenses to Section 951A income would likely require more complicated rules in order to assure that proper adjustments are made to reflect the CFC's own R&D expenditures as well as royalties paid or deemed paid under Section 367(d) by the CFC to the U.S. taxpayer. While we believe that the arguments against the government's position merit consideration, we ultimately recommend that the approach of the 2019 Proposed Regulations be maintained when the regulations are finalized.

b. *Elimination of Gross Income Method of Apportionment*

Under current regulations, taxpayers may generally apportion R&D expenses using a gross income method or a gross receipts method. Under the gross income method, a taxpayer compares its gross income from various sources (e.g., U.S.-source and foreign-source royalties, sales of products into the U.S. and into foreign jurisdictions, etc.). The taxpayer then apportions R&D expenses based on the nature of this gross income. In contrast, the gross receipts method requires a taxpayer to analyze sales associated with products to which the R&D expense relates and to apportion R&D expenditures accordingly. In both the existing Regulations and the 2019 Proposed Regulations, this analysis is completed by assigning R&D expenses, royalty income, and gross

receipts to separate categories based on Standard Industrial Classification manual codes ("**SIC Codes**").[26]

The 2019 Proposed Regulations eliminate taxpayers' ability to apportion R&D expenses based on gross income and instead mandate use of the gross receipts method. The Preamble explains that Treasury and the IRS were concerned that the gross income method could lead to anomalous results, and that the gross income method was more easily manipulated than the gross receipts method. In particular, Treasury and the IRS appear to be focused on potential distortions created using a gross income method where a taxpayer's R&D expenses generate intellectual property that in some cases is used as a component of a larger product that the taxpayer sells, and in other cases is simply licensed to third parties.

Although we agree with Treasury and the IRS that minimizing anomalous results and taxpayer manipulation are worthy goals, we believe that the elimination of the gross income method should be reconsidered (at least in certain circumstances) for the three reasons detailed below. In recommending the reinstatement of the gross income method, we note that from a policy perspective it may be sensible to limit the use of this method to specific circumstances where the administrative burden associated with the gross receipts method is particularly high (for example, if the majority of a taxpayer's gross receipts arise from third-party royalties where relevant information may be difficult to obtain), or where the likelihood of distortive apportionment is particularly low (for example, where a majority of the taxpayer's intangible income is incurred in the form of a royalty). In any case, we believe that some form of reinstatement of the gross income method is likely appropriate for the reasons detailed below.

The first reason we recommend reinstating the gross income method in certain cases is that Treasury and the IRS's concern regarding potential distortions can be solved through refinement (rather than elimination) of the gross income method. Treasury and the IRS are of course correct that simply comparing royalty income from a specific item of intellectual property, on the one hand, and gross income from sales of a larger product into which the item is integrated, on the other hand, will likely prove distortive—in such a case, gross income from a product that incorporates the intellectual property will almost always substantially exceed the equivalent amount of royalty income specific to the intellectual property, standing alone. This potential for distortion, however, does not mean that any measurement based on gross income is fundamentally unworkable. Rather, it simply means that an adjustment is appropriate to translate gross receipts into gross income.

The 2019 Proposed Regulations in fact seem to acknowledge that some level of translation between gross receipts and gross income is necessary in all cases to avoid a distortive "apples-to-oranges" comparison, and accordingly require a translation in certain cases even when the gross receipts method is used. In particular, the 2019 Proposed Regulations require that in applying the gross receipts method, gross income must be translated into gross receipts using Section 482

[26] Treas. Reg. § 1.861-17(a)(2)(ii); Prop. Treas. Reg. § 1.861-17(b)(3)(i).

principles where information about a licensee's gross receipts is not readily available,[27] as illustrated by the following example[28]:

> **Example 3.** X, a domestic corporation, is engaged in continuous research and experimentation to improve the quality of the products that it manufactures. X incurs $100 of R&D expenditures in Year 1 and acquires a patent for floodlights that X produces in its own manufacturing business.
>
> In Year 1, X generates gross receipts of $300 from sales of floodlights. X also licenses its floodlight patent to Corporation Z, an uncontrolled foreign corporation, for use in Country Z. Corporation Z pays X a royalty of $90 plus $0.30 for each unit sold. Z manufactures 100 units incorporating the floodlight intellectual property in the taxable year, and the royalty is $120 ($90 + $0.30 × 100). The dollar value of Z's gross receipts is not known because the floodlights are not sold separately by Z but are instead used as a component of products sold in Z's manufacturing business. For purposes of applying the gross receipts apportionment method, X is required to determine a reasonable estimate of Z's gross receipts attributable to the units, based on the principles of section 482. X determines that a reasonable estimate of Z's gross receipts is $600. Accordingly, after taking into account exclusive apportionment, the R&D expenses are apportioned 1/3 to domestic source income (i.e., $300 / ($300 + $600)) and 2/3 to foreign source income (i.e., $600 / ($300 + $600)).

We believe that the gross income method of apportionment permits a similar outcome to that of Example 3. To achieve these results, one simply makes inverse adjustments where gross receipts are known, but gross income is not. Stated another way, Example 3 requires Corporation X to determine for purposes of measuring gross receipts that $1 of gross income translates into $5 of gross receipts (i.e., Z's $120 royalty translates into $600 of assumed gross receipts). If Corporation X were entitled to apply the gross income method on the same facts, Corporation X could simply multiply its own gross receipts from direct sales of floodlights by 1/5 to determine that its gross income from such sales that is attributable to the intangible property is $60 (i.e., $300 × 1/5). Regardless of whether the gross receipts or gross income method is applied, a similar translation is required and similar results can be achieved.

The second reason we recommend reinstating the gross income method is that for certain taxpayers the significant majority of (in some cases, perhaps all of) taxable income to which R&D

---

[27] Prop. Treas. Reg. § 1.861-17(d)(3)(iv).

[28] This Example is based on Example 4 in Prop. Treas. Reg. § 1.861-17(g)(4).

expenses are allocated may be derived through royalties as opposed to sales of products or services attributable to the resulting intangible property. In such a case, the 2019 Proposed Regulations would appear to require a translation from gross income to gross receipts, even where gross income is fixed and fully known, opening the door for the type of uncertainty and taxpayer planning Treasury and the IRS had intended to avoid.

> **Example 4.** Corporation K is a domestic corporation engaged in biomedical research in Year 1. Corporation K incurs R&D expenses of $1000 in Year 1 and receives a patent with respect to a chemical compound to be used as a component in medications sold by third parties.
>
> Corporation K enters into third-party license agreements for use of the chemical compound. Each third-party license is with a different counterparty, and permits use of the chemical compound within the jurisdiction in which the licensee operates. Corporation K does not sell any product that incorporates the chemical compound, and Corporation K's gross income in Year 1 is comprised solely of royalties received from third party licensees.
>
> The 2019 Proposed Regulations do not permit Corporation K to apportion R&D expenses based on gross income. Rather, the 2019 Proposed Regulations require Corporation K to analyze the anticipated gross receipts of each counterparty in each jurisdiction based on arm's-length transfer pricing analysis under Section 482.

The results of Example 4 are difficult to square with the goals of producing accurate results that are not susceptible to manipulation. If anything Example 4 invites taxpayer manipulation, since the taxpayer is affirmatively required to use estimates of gross receipts of uncontrolled third parties, rather than being tied to gross income earned in Year 1, which is fully known.

The third reason to reconsider the elimination of the gross income method is statutory. Section 864(g)(1) specifically appears to contemplate a three-step process for allocating and apportioning R&D expenses:

> ***Step One*** (Section 864(g)(1)(A)). R&D expenses incurred solely to meet legal requirements imposed by a local jurisdiction that are not reasonably expected to generate more than de minimis gross income outside of the jurisdiction are apportioned solely to the local jurisdiction.
>
> ***Step Two*** (Section 864(g)(1)(B)). 50% of R&D expenses not apportioned under Step One are apportioned either to domestic source income (if attributable to activities conducted in the United States), or foreign source income (if

> attributable to activities conducted outside of the United States).
>
> ***Step Three*** (Section 864(g)(1)(C)). R&D expenses not apportioned under Step One and Step Two above are apportioned at the annual election of the taxpayer on the basis of gross sales or gross income (subject to a requirement that the allocation based on gross income result in at least 30% of the foreign source income as what that would be apportioned to foreign source income if gross sales were utilized).

This statutory three-step process clearly contemplates the use of a gross income method of apportionment in the case of R&D expenditures. Although Section 864(g)(5) contemplates regulations implementing Section 864(g), it is not clear that this grant of regulatory authority is sufficiently expansive to permit Treasury and the IRS to override the Congressional decision in Section 864(g)(1)(C) to permit use of the gross income method.

Given the broad statutory text, it is arguably the case that the gross income method must be available to all taxpayers, rather than being reserved for situations in which the gross receipts method may invite manipulation or present substantial administrative difficulties. In any case, if Treasury and the IRS do not believe upon further consideration that they have the regulatory authority to eliminate the gross income method and wish to do so (whether in all cases or only in specified fact patterns), consideration may be given to requesting a statutory amendment.

c. *Elimination of Required R&D Apportionment and Enhanced Exclusive Apportionment*

The 2019 Proposed Regulations eliminate two approaches to apportionment that Treasury and the IRS indicate in the Preamble have been infrequently used by taxpayers in the past.[29]

The first of these approaches requires apportionment to a specific jurisdiction in the event R&D is specifically required by the jurisdiction and is not reasonably expected to generate more than de minimis gross income outside of the jurisdiction requiring the R&D. We acknowledge that the circumstances in which jurisdiction-specific R&D is required may be limited, particularly in areas where international regulatory regimes have become more harmonized over time such that jurisdiction-specific R&D becomes less likely. However, we note that the availability of this method of apportionment seems to be specifically required by Section 864(g)(1)(A), and accordingly suggest that Treasury and the IRS reconsider the elimination of this rule.

The second of the apportionment approaches eliminated by the 2019 Proposed Regulations relates to Step Two in the process described above. Under current regulations, although 50% apportionment to domestic sources or foreign sources is required based on where R&D is conducted, Treas. Reg. § 1.861-17(b)(2) permits the taxpayer to establish to the satisfaction of the Commissioner that the facts and circumstances warrant a significantly greater amount of exclusive

[29] 84 Fed. Reg. 69130 (Dec. 17, 2019).

apportionment. The Preamble states that historically this apportionment rule was rarely invoked by taxpayers, and in cases when it was utilized, the rules has led to "hard-to-resolve disagreements between the Commissioner and taxpayers."[30]

We are sympathetic to the justifications provided for the elimination of increased exclusive apportionment, and we believe that elimination of the rule may be appropriate. We would encourage Treasury and the IRS to consider, however, whether it may be more likely that taxpayers would seek to demonstrate that enhanced exclusive apportionment is appropriate in light of decisions made in the 2019 Proposed Regulations. In particular, it is possible that taxpayers who would have been candidates for enhanced exclusive apportionment to the United States instead relied on the application of the gross income method, which historically permitted a significant allocation of R&D expenses to domestic source income. In the event the gross income method is no longer available, these taxpayers may have renewed interest in seeking enhanced exclusive apportionment. It may be the case that the exception would continue to be under-utilized if reinstated, but the exception may also prove a helpful and appropriate safety valve for taxpayers in the event flexibility is otherwise limited when the 2019 Proposed Regulations are finalized. We do note, however, that it may be difficult to establish clear standards for when enhanced exclusive apportionment may be appropriate.

d. *Considerations Regarding Effective Dates*

Finally, we note that the 2019 Proposed Regulations generally permit taxpayers to apply the gross receipts method as reflected in the 2019 Proposed Regulations for the 2018 taxable year so long as the method is applied consistently.[31] The language in the 2019 Proposed Regulations is not entirely clear, however, whether a taxpayer that originally elected to apply the gross income method on its 2018 tax return would be eligible to amend its 2018 tax return to apply the gross receipts method described in the 2019 Proposed Regulations. The 2019 Proposed Regulations do not specifically prohibit such an amendment, but in related contexts the IRS has determined that the "doctrine of election" prevents taxpayers from amending tax returns to change allocation and apportionment elections.[32] Clarification on this point may be particularly helpful given that many calendar year taxpayers were required to file their 2018 tax returns prior to the date that the 2019 Proposed Regulations were originally published.

3. Allocation of Interest Expense

The 2019 Proposed Regulations do not specifically propose new regulations with respect to the interest expense allocation and apportionment rules under Treas. Reg. §§ 1.861-9 through 1.861-13, but Treasury and the IRS have requested comments on a number of issues, including (1) whether capitalization and amortization of certain currently deductible expenses may better reflect asset values for purposes of the tax book value method under Treas. Reg. § 1.861-9, (2) whether

---

[30] *Id.*

[31] 84 Fed. Reg. 69139 (Dec. 17, 2019).

[32] *See* Chief Counsel Advice 200024058 (May 31, 2000) (finding that "doctrine of election" prohibits retroactive election of the fair market value method under Treas. Reg. § 1.861-9T(g)).

additional rules for allocating and apportioning expenses with respect to the foreign branch category are appropriate and (3) the treatment of guaranteed payments as interest for purposes of the interest expense allocation rules (along with certain rules under Section 954).

a. *Capitalization and Amortization of Certain Deductible Expenses*

The Preamble suggests that Treasury and the IRS are considering the adoption of rules that would require capitalization and amortization of certain otherwise deductible expenses for purposes of Treas. Reg. § 1.861-9. Although the Preamble does not precisely spell out Treasury's and the IRS's reasoning with respect to this proposal, it would appear that Treasury and the IRS are envisioning rules analogous to the alternative tax book value method in Treas. Reg. § 1.861-9(i).

As a general matter, the alternative tax book method attempts to neutralize distortions that can arise under Section 168 due to differing treatment between assets used within the United States and assets used predominantly without the United States.[33] In particular, assets used predominantly outside the United States are generally subject to straight-line depreciation, whereas assets used predominantly within the United States are generally eligible for immediate expensing or accelerated depreciation and use of a shorter useful life under Section 168. The alternative tax book value method effectively permits a taxpayer (solely for purposes of Treas. Reg. § 1.861-9) to calculate the tax basis in its assets assuming straight-line depreciation for all assets regardless of the jurisdiction in which the asset is used. Without this rule, the tax book value of assets used in the United States would be lower than the tax book value of identical assets used outside of the United States, resulting in a greater allocation of interest expense to foreign-source income.

Theoretically similar distortions can arise when a taxpayer incurs expenses for which an immediate deduction is permitted, but which in fact have a useful life that extends for multiple tax years. For example, R&D expenses deducted under Section 174 may generate intellectual property with a useful life substantially in excess of one year. Similarly, advertising expenses may create goodwill that serves as a valuable asset to the taxpayer long after the taxable year in which the expense is incurred. As such, it is possible that where a taxpayer incurs a disproportionate amount of R&D or advertising expenses within the United States or a disproportionate amount of such expenses outside of the United States, distortions in tax basis analogous to those arising under Section 168 may be implicated. These theoretical distortions may result in allocations of interest expense that do not mirror the fair market value of assets generated through these expenses.

Although we applaud Treasury's and the IRS's attempt to achieve results that hue to economic reality, we note that applying an approach analogous to the alternative tax book method under Treas. Reg. § 1.861-9(i) is likely to present significant practical difficulties. As an initial matter, establishing the appropriate useful life for an asset generated by a deductible expense is

[33] Treasury Decision 9247 (Jan. 27, 2006) ("The alternative tax book value method, which is elective, allows taxpayers to determine, for purposes of apportioning expenses, the tax book value of all tangible property that is subject to a depreciation deduction under section 168 by using the straight line method, conventions, and recovery periods of the alternative depreciation system under section 168(g)(2). The alternative tax book value method is intended to minimize basis disparities between foreign and domestic assets of taxpayers that may arise when taxpayers use adjusted tax basis to value assets under the tax book value method of expense apportionment.")

likely to be difficult. Unlike the Section 168 context addressed by the alternative tax book value method, there is no clear analog in the tax law for a rule that is intended to actually approximate the useful life of an asset generated by a deductible expense. Rather, an entirely new method would need to be utilized, or a rough generalization would need to apply to all such assets (perhaps using rules analogous to the five-year amortization required under Section 174 beginning in 2022[34] or Section 197's fifteen-year amortization period).

Particularly where a rough generalization is employed to determine the useful life of an asset generated by a deductible expense, if future guidance overstates the useful life of the asset, such guidance would similarly overstate the deemed tax basis associated with the asset, and thereby create the very type of distortion Treasury and the IRS were seeking to avoid. For example, suppose that future regulations assumed all assets arising with respect to identified deductible expenses have a useful life of fifteen years and use straight-line depreciation for purposes of measuring deemed tax basis. If in fact a given asset generated by a deductible expense only has a useful life of five years (with economic straight-line depreciation over those five years), then these future regulations would overstate the value of the asset in all of these fifteen years, resulting in an over- or under-allocation to foreign source income, depending on where the relevant income is earned. The effect would be an overcorrection of the potential distortion, and seems to do little to enhance the accuracy of Treas. Reg. § 1.861-9.

Additionally, we note that requiring capitalization and amortization of deductible expenses goes a step beyond the distortions that are intended to be resolved under the alternative tax book method. That is, the alternative tax book method is specifically focused on equalizing deemed tax basis with respect to economically identical expenditures that are incurred with respect to assets used within the United States and assets used predominantly outside of the United States. As a general matter R&D and advertising expenses are deductible for U.S. federal income tax purposes whether or not they are conducted in the United States or generate an asset used in the United States. Because the location of the activities or the asset to which they give rise is not relevant for measuring a deduction, two taxpayers engaging in otherwise identical transactions should have the same tax basis in their assets, regardless of whether their deductible expenses are incurred within the United States or abroad. While a disproportionate amount of deductible expenses within the United States as compared to deductible expenses abroad has potential to result in an allocation of interest expense that may not perfectly reflect the relative fair market value of a taxpayer's assets, the same is true for any capitalized expense governed by Section 168 where the useful life under straight-line depreciation is longer or shorter than the actual economic useful life.[35]

Accordingly, we generally do not favor the adoption of rules that require or permit capitalization and amortization of deductible expenses for purposes of the interest expense allocation rules. However, in the event Treasury and the IRS issue future regulations requiring capitalization and amortization of such expenses, we encourage Treasury and the IRS to carefully

---

[34] Five-year amortization of research and development expenses is required pursuant to the TCJA for taxable years beginning after December 31, 2021.

[35] We note that the most precise way to address these issues would be allocation based on relative fair market value, which Congress clearly and specifically eliminated in the TCJA.

consider the potential distortive effects of imprecise determinations of useful life, and limit the rules to specific situations in which reliable indicia of economic useful life (perhaps under GAAP or a similar accounting method) may be available to achieve an appropriate result for tax purposes.

b. *Treatment of Expenses Involving a Foreign Branch*

The preamble to the 2019 Final Regulations and the Preamble to the 2019 Proposed Regulations each request comments with respect to the treatment of certain expenses involving a foreign branch and a foreign branch owner.[36] The preamble to the 2019 Final Regulations suggests that Treasury and the IRS are focused in particular on the treatment of disregarded interest payments from a foreign branch to its owner, or from the owner to the foreign branch.[37]

As discussed in detail in our report on the 2018 Proposed Regulations, for purposes of determining the amount of taxable income properly categorized as general category and the amount of taxable income properly categorized as foreign branch category, it is appropriate to take into account certain disregarded transactions between a foreign branch and its owner.[38] As a result, disregarded payments that would otherwise be deductible for U.S. federal income tax purposes generally result in a reattribution of gross income from one category to the other depending on the direction of the payment. Thus, a payment from a foreign branch to a foreign branch owner for services provided in the foreign branch's trade or business generally results in a portion of the foreign branch's income being reattributed from the foreign branch category to the general category.[39]

The 2018 Proposed Regulations provided an exception to this rule in the case of payments in the nature of a remittance or contribution, including interest payments. Thus, in the event that a foreign branch borrowed from its owner and incurred interest expense that was otherwise attributable to the foreign branch's trade or business, the deduction did not result in reattribution, and accordingly the interest expense did not decrease foreign branch income. No exceptions to this rule were contemplated by the 2018 Proposed Regulations.

Consistent with the view taken in our prior report, we believe that the exclusion of all interest expense from the foreign branch reattribution rules is overly broad and potentially inappropriately overstates foreign branch income, presenting a trap for the unwary or an inappropriate planning opportunity, depending on the circumstances. For the reasons detailed in our 2019 FTC Report, we continue to encourage Treasury and the IRS to reconsider the approach taken in the 2018 Proposed Regulations, particularly in the case of taxpayers that are engaged in trades or businesses that commonly generate interest income and interest expense (such as financial service entities). As such, we continue to believe that treating disregarded interest

---

[36] 84 Fed. Reg. 69032 (Dec. 17, 2019); 84 Fed. Reg. 69127 (Dec. 17, 2019).

[37] 84 Fed. Reg. 69032 (Dec. 17, 2019).

[38] Report No. 1408, pp. 34-35.

[39] Treas. Reg. § 1.904-6(f)(2)(vi)(A).

expense in the same manner as any other deductible expense, with a strong anti-abuse rule to guard against inappropriate tax planning, represents the best path forward with respect to this issue.

c. *Treatment of Guaranteed Payments*

As we detailed in our prior report on Section 163(j), we do not believe that it is appropriate to treat a guaranteed payment for capital as interest absent an abusive taxpayer motive.[40] Although economically similar to interest payments in some respects, rights to guaranteed payments are for income tax purposes equity interests, and regulations issued under Section 707 narrowly circumscribe the situations in which a guaranteed payment is treated as something other than a distributive share of partnership income.[41] Accordingly, we recommend that any proposed rules under Treas. Reg. §§ 1.861-9 and 1.954-2(h)(2)(i) that treat guaranteed payments for capital as interest be limited in their application to situations in which taxpayers harbor an abusive motive to circumvent the relevant rule.

B. Allocation and Apportionment of Foreign Income Taxes

The addition of new baskets and the adoption of the GILTI regime significantly increased the importance (and associated complexity) of accurately apportioning and allocating creditable foreign taxes. The 2019 Proposed Regulations substantially revise and clarify the rules in current Treas. Reg. § 1.904-6 to account for both the TCJA and other recent international tax developments.

The 2019 Proposed Regulations contemplate a three-step process for allocating foreign taxes. In the first step of the process, items of foreign gross income (as determined under foreign law) are assigned to statutory and residual groupings. In the second step, items of deduction allowed under foreign law are allocated to the foreign gross income in each grouping. Finally, foreign income taxes are allocated and apportioned to each of the foreign taxable income groupings.[42]

Assigning items of foreign gross income to U.S. statutory and residual groupings involves a complex interaction between foreign tax law and U.S. federal income tax law. The 2019 Proposed Regulations clarify that although the amounts of foreign gross income are determined under foreign law, the U.S. federal income tax rules apply to characterize the item and assign it to a grouping. The following example illustrates the general approach taken in the 2019 Proposed Regulations:

> **Example 5**. USP owns 100% of the stock of CFC, which conducts business solely in Country X. USP sells 100% of the stock of CFC to US2 for $1000. For foreign law purposes, USP is treated as having a tax basis of $400 in the stock of

[40] *See* New York State Bar Tax Section Report No. 1412 (Feb. 26, 2019), pp. 29-30.

[41] Treas. Reg. § 1.707-1.

[42] Prop. Treas. Reg. § 1.861-20(c).

> CFC, but for U.S. federal income tax purposes, USP is treated as having tax basis of $200 in the stock of CFC.
>
> Country X imposes a nonresident capital gains tax with respect to USP's $600 gain and as a result USP is subject to a $60 tax in Country X. For U.S. federal income tax purposes, USP recognizes $800 of gain, all of which is included in the gross income of USP as a dividend under Section 1248. Under Treas. Reg. § 1.904-4(d) and 1.904-5(c)(4), the $800 dividend is general category income to USP.
>
> For purposes of allocating and apportioning the $60x of Country X foreign income tax, the $600x of Country X gross income is assigned to the same category as the corresponding U.S. item, which is USP's dividend of $800x. Accordingly, the $600x of Country X gross income is assigned to the general category. This is the case even though the amount of gross income recognized in the two jurisdictions differs, and even though for Country X purposes the $600x of Country X gross income would be characterized as gain from the sale of stock, which would be passive category income under Section 904(d)(2)(B)(i).

The 2019 Proposed Regulations provide guidance on a number of technical issues in connection with the allocation and apportionment of foreign taxes that existing Treasury Regulations do not specifically address. Among these new areas of guidance are a precise definition of what constitutes a "base difference" for purposes of Section 904 and a new set of rules to address foreign taxes charged with respect to disregarded transactions between CFCs and their foreign branches. We discuss each of these new areas of guidance in turn below.

1. Base Differences

In principle, a "base difference" arises when foreign income tax law imposes tax on an item that is excluded from the calculation of U.S. federal income, and U.S. federal income tax rules lack a clear analog to the item taxed under foreign law. Exclusion from U.S. federal income tax alone is not sufficient to create a base difference. Thus, for example, interest that is taxed under foreign tax law but exempt from U.S. taxation under Section 103 is not considered a base difference notwithstanding that the interest is excluded from income under U.S. principles, because the income clearly would constitute interest for U.S. purposes absent the Section 103 exclusion.[43] A base difference generally does not render a foreign tax non-creditable under Section 901,[44] but

[43] Prop. Treas. Reg. § 1.904-6(g)(5) (Example 4).

[44] *See Schering Corp. v. Comm'r*, 69 T.C. 579 (1978); Rev. Rul. 55-505, 1955-2 C.B. 578 ("The Law of 1942 of Venezuela and Law No. 52 of May 23, 1941, of Panama each imposes an income tax upon life insurance companies but includes in their taxable income certain items which are not subject to taxation in the United States. *Held*, such taxes are income taxes within the meaning of section 131 of the Internal Revenue Code of 1939 [i.e.,

may impact the allocation and apportionment of that tax for purposes of Section 904 and Section 960.[45] In the case of a base difference that is allocated pursuant to Section 960, the relevant foreign tax is allocated to the residual category, effectively rendering the foreign tax non-creditable as a practical matter.[46]

The 2019 Proposed Regulations offer a specific and exclusive list of items that constitute "base differences." These items are:

1. Death benefits described in Section 101;
2. Gifts and inheritances described in Section 102;
3. Contributions to capital described in Section 118;
4. The receipt of money or other property in exchange for stock described in Section 1032 (including by reason of a transfer described in section 351(a));
5. The receipt of money or other property in exchange for a partnership interest described in Section 721;
6. The portion of a distribution of property by a corporation to its shareholder with respect to its stock that is described in Section 301(c)(2); and
7. A distribution to a partner described in Section 733.[47]

We believe that this proposed list of base differences provides a helpful start, and we generally agree with the inclusion of many of these items as base differences for purposes of Section 904. However, we believe that clarification of the precise transactions at issue is necessary in certain cases, and in other cases we recommend that Treasury and the IRS reconsider their inclusion in the definition of "base difference" altogether.

a. *Clarification of Base Difference Definition*

As an initial matter, we would recommend clarification of the precise scope of the identified base differences in several respects. First, with respect to references to Section 118 and Section 1032, it appears that the 2019 Proposed Regulations are specifically focused on foreign tax imposed on a transferee corporation in connection with a contribution to capital or a contribution in exchange for stock. That is, it appears that the 2019 Proposed Regulations do not

---

the predecessor to Section 901]."). In the case of Section 960, a base difference is generally apportioned to the residual category and accordingly is effectively not creditable for U.S. federal income tax purposes.

[45] Currently such taxes are allocable to the foreign branch category, although it appears that this cross-reference is a clerical error and that reference to the general category was intended. *See* 2019 FTC Report, pp. 15-16.

[46] Prop. Treas. Reg. § 1.860-20(d)(2)(ii)(B).

[47] Prop. Treas. Reg. § 1.861-20(d)(2)(ii)(B).

intend to treat as a "base difference" foreign tax imposed on the transferor in connection with such a contribution. Similarly, the reference to Section 721 in the 2019 Proposed Regulations seems to be focused on the receipt of money or other property by a partnership in exchange for a partnership interest in determining the scope of a base difference, but does not appear to capture the receipt of a partnership interest by a partner in respect of a contribution.

Similar ambiguities arise with respect to references to Section 301(c)(2) and Section 733. It appears in those cases that Treasury and the IRS are specifically focused on foreign tax imposed on the transferee. In particular, the 2019 Proposed Regulations seem to be focused on transactions that (1) generate a foreign tax liability for a transferee and (2) result in a basis adjustment in the transferee's interest in the entity for U.S. federal income tax purposes. However, the language in the 2019 Proposed Regulations is not entirely clear. In particular, if our reading of the 2019 Proposed Regulations is accurate, we believe that the reference to "[a] distribution described in Section 733" should be revised to refer to "a distribution described in Section 731(a), to the extent such distribution reduces the taxpayer's basis in its interest in the partnership pursuant to Section 733." If another result is intended by the 2019 Proposed Regulations, we recommend further clarification consistent with Treasury and the IRS's desired outcome.

Finally, we suggest that Treasury and the IRS clarify the reference to contributions to capital described in Section 118. While we agree that contributions of cash or other property that are taxable under foreign law to a transferee generally represent a base difference, we recommend clarifying that contributions of indebtedness referenced in Section 118(d)(2) and described in Section 108(e)(6) do not constitute a base difference. In such a case, U.S. tax law does have a natural analog (cancellation of indebtedness income) and as such contributions of indebtedness described in Section 108(e)(6) do not present an appropriate instance in which to apply the base difference regime.

b. *Reconsideration of Treatment of Certain Items as Base Differences*

Turning to the substance of the proposed definition of "base difference," we believe that Treasury and the IRS may wish to reconsider the treatment of distributions described in Section 301(c)(2) ("**Section 301(c)(2) Distributions**") and distributions described in Section 731 that reduce a taxpayer's tax basis in an entity pursuant to Section 733 ("**Section 733 Distributions**").

i. Section 301(c)(2) Distributions

Whether and to what extent Section 301(c)(2) Distributions constitute base differences as opposed to timing differences has been a matter of some historical uncertainty. For example, in Chief Counsel Advice 200210026,[48] the IRS informally addressed a U.S. corporation's receipt of a distribution that was treated as a dividend for foreign law purposes, but was governed by Section 301(c)(2) for federal income tax purposes (and therefore was not taxable from a U.S. perspective). The IRS noted that "the base difference rule is intended to have very narrow application," but nonetheless concluded in the Chief Counsel Advice that the taxpayer's treatment of the item as a

[48] Chief Counsel Advice 200210026 (Dec. 3, 2001).

base difference was "not unreasonable."[49] Commentators have noted, however, that this conclusion is "debatable" and that the transaction arguably constituted a timing difference "because it increases the amount of taxable gain that the U.S. shareholder would recognize on a disposition of the CFC stock."[50]

In similar contexts, the IRS has concluded that differences in basis associated with a Section 338 election result in timing differences, rather than base differences. In particular, in a 1997 Field Service Advice, the IRS concluded that where, as a result of a Section 338 election, a taxpayer recognized a loss on the sale of a subsidiary CFC for U.S. income tax purposes but a gain on the sale of the CFC for French income tax purposes, the differing treatment was attributable to timing differences and accordingly was not governed by the base difference rules.[51] In particular, the Field Service Advice holds that "[w]hile the matter is not free from doubt, we think the better reading of Treas. Reg. § 1.904-6(a)(1)(iv) is that the differing earnings and profits calculations result in a timing difference because the earnings on which the tax would have been imposed had the U.S. recognized income on the sale is readily traceable."[52] As such, the Field Service Advice concludes that the foreign tax is allocable to the passive basket.[53]

We believe that the better view of Section 301(c)(2) Distributions is that they constitute a timing difference with respect to a capital gain transaction. In particular, Section 301(c)(2) Distributions relate to tax basis and effectively defer (rather than exempt) income with respect to the equity interest in question. Stated another way, because Sections 301(c)(2) & (3) require the recognition of taxable gain rather than permitting tax basis to be reduced below zero, the rules governing Section 301(c)(2) can be conceptualized as gain recognition rules with basis-first basis recovery concepts (rather than pro-rata basis recovery or basis-last recovery). These principles are highlighted in the following example:

> **Example 6a.** On January 1, Year 1 USP, a domestic corporation, acquires 100% of the stock of CFC1 for $1000. At the time of the acquisition, CFC1 owns 100% of the stock of CFC2. CFC1 has a tax basis of $50 in the stock of CFC2 for foreign law purposes. USP makes a Section 338(g) election with respect to the acquisition of CFC1, and as a result for U.S. federal income tax purposes CFC1 has a tax basis of $400 in the stock of CFC2.
>
> On December 31, Year 1, CFC2 makes a distribution of $200 to CFC1. Foreign tax law applies rules that are in substance

---

[49] *Id.*

[50] Dirk Suringa, 6060 T.M., The Foreign Tax Credit Limitation Under Section 904 (2019).

[51] 1997 FSA Lexis 186 (May 28, 1997).

[52] *Id.*

[53] *Id.*

> identical to Section 301, and under both foreign tax law and U.S. federal income tax law, CFC2 has a deficit of earnings and profits. However, due to the differences in tax basis under foreign tax law and U.S. tax law, CFC1 recognizes $150 of capital gain for foreign tax purposes, while the entire distribution is treated as a return of basis under Section 301(c)(2) for U.S. federal income tax purposes. CFC1 incurs $15 of foreign tax liability with respect to the capital gain.
>
> Under the 2019 Proposed Regulations, the Section 301(c)(2) Distribution represents a base difference, and accordingly the $15 of foreign tax is allocated to the residual category for purposes of applying Section 960 (and as such the foreign tax credit is effectively denied).

The result in Example 6a is in many ways no different from a similar situation in which a taxpayer sells an asset (say, a tractor) that has basis equal to fair market value for U.S. federal income tax purposes, but nonetheless incurs foreign tax due to a built-in gain under foreign tax law. In this case, the 2019 Proposed Regulations are clear that the U.S. corresponding item is gain with respect to the disposition of the asset. We believe that Section 301(c)(2) Distributions should be analyzed using the same approach.

Treating the Section 301(c)(2) Distribution in Example 6a as a timing difference is appropriate even where foreign tax law treats the $200 as a taxable dividend. The 2019 Proposed Regulations clearly contemplate and accept the possibility that foreign tax law and U.S. tax law may characterize the same item of income differently, and provide that the U.S. tax law characterization controls. The result therefore is that the foreign tax imposed on the Section 301(c)(2) Distribution is allocated and apportioned as though it were imposed on an item of capital gain, notwithstanding the treatment under foreign tax law. Treating foreign dividend income as capital gain for foreign tax credit purposes is effectively the inverse of Example 5, in which a foreign capital gain transaction is treated as a dividend pursuant to Section 1248. This is a result the 2019 Proposed Regulations clearly embrace.[54]

Additionally, with respect to disregarded transactions (at least as the 2019 Proposed Regulations are currently drafted), distributions to shareholders from disregarded entities present a superior result for taxpayers as compared to Section 301(c)(2) Distributions, notwithstanding that the transactions in question are economically identical:

> **Example 6b**. The facts are the same as in Example 6a, but CFC2 has filed an election pursuant to Treas. Reg. § 301.7701-3 to be treated as disregarded as separate from CFC1.

[54] *See* Prop. Treas. Reg. § 1.861-20(g)(3) (Example 2).

> As described in greater in Section IV.B.2, tax imposed with respect to a disregarded payment from a foreign branch to a foreign branch owner is not treated as a base difference under the 2019 Proposed Regulations. Rather, the foreign tax is potentially fully creditable under Section 960.

We further note that to the extent that Treasury and the IRS are concerned that Section 301(c)(2) Distributions may represent a permanent difference between U.S. and foreign tax law (e.g., in situations where each jurisdiction has identical rules regarding distributions being treated as dividends, but the U.S. tax rules provide for a greater amount of tax basis that may be recovered), we believe that Section 901(m) already effectively addresses many of these issues; In contrast to the base difference rules, foreign taxes that are not creditable as a result of Section 901(m) can be claimed as deductions. To the extent Treasury and the IRS believe that Section 901(m) and the regulations issued thereunder are not effectively policing the mismatches Congress targeted in Section 901(m), we believe that the better approach is to use regulatory authority under Section 901(m)(7) to target these transactions rather than employing an overly broad definition of "base difference."

Finally, we note that treating Section 301(c)(2) Distributions as timing differences attributable to capital gain transactions permits simplification of the rules described in Treas. Reg. § 1.904-6(d)(3)(i)(B)(2), which generally govern foreign dividend distributions. Because the 2019 Proposed Regulations treat Section 301(c)(2) Distributions as base differences, detailed rules that compare the specifics of foreign law treatment of the distribution to the U.S. federal income tax treatment are required to determine which part of a given distribution should be treated as a dividend, which part should be treated as a base difference, and which part should be treated as capital gain. However, if Treasury and the IRS remove Section 301(c)(2) Distributions from the list of base differences, no special rules are required—rather, the general rule that an item of foreign income is placed in a statutory grouping based on the U.S. corresponding item can apply. In other words, U.S. principles simply control the categorization of the foreign law dividend income in the same way that U.S. principles control any foreign law income tax inclusion under Treas. Reg. § 1.904-6(d)(1).[55]

ii. Section 733 Basis Adjustment Transactions

Although we are not aware of any case law or administrative guidance addressing whether Section 733 Distributions give rise to base differences or timing differences, we believe that the relevant analysis with respect to Section 301(c)(2) Distributions is equally applicable in the Section 733 Distribution context. Thus, for the same reasons that we support treatment of Section 301(c)(2) Distributions as giving rise to timing differences, we recommend that Section 733 Distributions be treated as giving rise to timing differences rather than base differences.

---

[55] As suggested by Example 6 and as contemplated by the 2019 Proposed Regulations, in some cases the amount of a foreign law inclusion will not match the amount of a U.S. inclusion. In these cases, we believe applying the U.S. characterization proportionately based on the U.S. dividend amount under Section 301(c)(1), on the one hand, and amounts subject to Section 301(c)(2) or Section 301(c)(3), on the other hand, should generally provide a sensible outcome.

Foreign taxes attributable to Section 733 Distributions are particularly likely to arise in the case of hybrid entities that are treated as corporations for local tax purposes, but are treated as partnerships for U.S. federal income tax purposes, as reflected in the following example:

> **Example 7a**. USP owns 100% of the stock of CFC1 and CFC 2. CFC1 and CFC2 each owns 50 shares of the equity of FS1, a Country B private limited that has filed an election pursuant to Section 301.7701-3(a) to be treated as a partnership for U.S. federal income tax purposes. Each of CFC1 and CFC2 has a basis of $1,000 in their respective interests in FS1.
>
> FS1 owns Asset A with fair market value of $100 and a tax basis of $100 for both U.S. federal income tax purposes and Country B tax purposes. Asset A does not constitute "money" within the meaning of Section 731(a)(1).
>
> FS1 distributes Asset A to CFC2 in redemption of 5 shares of CFC2's equity. Under the laws of Country B, the distribution constitutes a dividend that is subject to withholding of $10. Under U.S. federal income tax principles, the distribution is a Section 733 Distribution. As such, CFC2 does not recognize gain or loss, but CFC2's U.S. tax basis in its interest in FS1 is reduced from $1,000 to 900.
>
> Under the 2019 Proposed Regulations, the Section 733 Distribution represents a base difference, and accordingly the $10 of foreign tax is allocated to the residual category for purposes of applying Section 960 (and as such the foreign tax credit is effectively denied).

As is the case with Section 301(c)(2) Distributions, the Section 733 Distribution in Example 7a has the effect of reducing the taxpayer's basis in its partnership interest, and accordingly increasing the amount of gain that the taxpayer will one day recognize when it ultimately disposes of the partnership interest. The result reflects the same sort of timing differences that occur in the Section 301(c)(2) Distribution context, and as a result we believe it is equally inappropriate to treat Section 733 Distributions as giving rise to base differences.

The parallels between Section 301(c)(2) Distributions and Section 733 Distributions continue when one compares the results under the 2019 Proposed Regulations to analogous disregarded transactions. In each case, counterintuitive (and in our view, inappropriate) incongruities arise. Example 7b highlights such a situation:

> **Example 7b.** The facts are the same as in Example 7a, but CFC2 owns all 100 shares of FS1 prior to the distribution of Asset A from FS1.

> As described in greater detail in Section IV.B.2, the $10 tax imposed with respect to a disregarded payment from a foreign branch to a foreign branch owner is not treated as a base difference under the 2019 Proposed Regulations. Rather, the foreign tax is potentially fully creditable under Section 960.

We believe that treating Section 733 Distributions as giving rise to base differences is just as inappropriate as such treatment of Section 301(c)(2) Distributions. In each instance, we believe the better view is that U.S. federal income tax principles result in a timing difference, rather than a permanent exclusion. The differences simply do not represent the sort of fundamental incongruity between tax systems where treatment as a base difference may be appropriate. Notwithstanding the similarities between Section 301(c)(2) Distributions and Section 733 Distributions, one salient difference we note is that, in light of the single layer of taxation for U.S. federal income tax purposes, it is arguably inappropriate to treat all foreign taxes imposed in respect of Section 733 Distributions as attributable to capital gain income under U.S. principles. Rather, an alternative approach to Section 733 Distributions would be to allocate and apportion foreign taxes based on the income previously allocated to the distributee partner under U.S. federal income tax principles. This approach is based on the theory that the corresponding U.S. item giving rise to the timing difference is (at least to the extent of previously allocated income) the partner's historic distributive share that was included in income in the past rather than the partner's capital gain income that may be recognized in the future. Foreign tax charged on amounts in excess of a partner's historic distributive share would then be treated as timing differences with respect to capital gain transactions, as we believe should be the case for Section 301(c)(2) Distributions.

2. Disregarded Transactions and Foreign Branches

In addition to providing clarity as to the definition of base differences, the 2019 Proposed Regulations offer substantial guidance with respect to foreign taxes imposed in connection with transactions that are disregarded for U.S. federal income tax purposes. Although transactions between a foreign corporation and its foreign branch do not require allocation into separate categories (which is the case when a U.S. corporation owns a foreign branch and must apportion between the foreign branch basket and other baskets), disregarded transactions nonetheless implicate complex questions as to the allocation of foreign taxes among a foreign corporation's baskets of income.

Outcomes under the 2019 Proposed Regulations can be draconian and counterintuitive. In many cases the 2019 Proposed Regulations allocate foreign taxes with respect to branch transactions to the residual category for purposes of Section 960, effectively rendering the relevant foreign taxes non-creditable. As described in greater detail below, this result appears to be purely form driven and tends to occur whenever a foreign tax is charged with respect to a payment from a foreign branch owner to a foreign branch. Well-advised taxpayers will likely react to these rules by restructuring foreign branches and making entity classification elections to ensure the foreign

taxes remain creditable.[56] Less sophisticated taxpayers are likely to maintain current structures and suffer double taxation without a meaningful economic justification.

Before analyzing the 2019 Proposed Regulations in detail, it is helpful to summarize the approach taken in the 2018 Proposed Regulations and 2019 Final Regulations with respect to disregarded transactions for purposes of allocating and apportioning to the foreign branch basket. Importantly, the 2019 Final Regulations only address the treatment of branches owned by U.S. persons and accordingly we refer to these rules in the 2019 Final Regulations as the "**U.S.-Owned Branch Rules**." In turn, we refer to the provisions in the 2019 Proposed Regulations addressing the treatment of branches owned by controlled foreign corporations as the "**CFC-Owned Branch Rules**."

For purposes of allocating foreign taxes to or away from a foreign branch, the U.S.-Owned Branch Rules effectively segregate disregarded transactions into three categories: (1) ordinary course disregarded transactions allocable to gross income of a foreign branch or a foreign branch owner for which a deduction is generally allowed (and an intercompany payment potentially required) under foreign law, including payments for rent and intercompany services ("**Disregarded Ordinary Course Transactions**"), (2) disregarded transactions in the nature of sales or exchanges of property ("**Disregarded Sale or Exchange Transactions**"), and (3) disregarded transactions in the nature of remittances or contributions ("**Disregarded Shareholder Transactions**").[57]

In the case of Disregarded Ordinary Course Transactions addressed in the context of the foreign branch basket rules, Treas. Reg. § 1.904-6(a)(2)(ii)(A) generally allocates foreign tax charged with respect to the transaction to the class of gross income to which the payment is attributed under the U.S. foreign branch rules, as illustrated by the following example:

> **Example 8**. USP, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch. In Year 1, USP accrues and records on its books and records $1000 of gross income from the performance of services to unrelated parties, all of which is U.S. source income in respect of services performed in the United States. FDE provides services in support of P's gross income from services. USP compensates FDE for its services with an arm's-length payment of $400, which is disregarded for federal income tax purposes. The deduction for the payment of $400 from USP to FDE would be allocated to P's $1000 of general category services income and apportioned entirely to the $1000 of U.S. source services

[56] Restructuring in this context is likely to be relatively easy to accomplish through elections pursuant to Treas. Reg. § 301.7701-3(a) and basic intercompany contributions, highlighting the arbitrary nature of many outcomes under the 2019 Proposed Regulations.

[57] These labels and categorizations are not specifically used in the U.S.-Owned Branch Rules. However, we believe that they provide a helpful and accurate framework for summarizing the approach reflected in the 2019 Final Regulations.

> income under Treas. Reg. § 1.861-8 principles if the payment were regarded for federal income tax purposes. Under Treas. Reg. § 1.904-4(f)(2)(vi), $400 of P's $1000 of gross income is reallocated from U.S. source general category to the foreign branch category.
>
> FDE is required to pay $80 of foreign taxes with respect to the $400 received from P in Year 1. Under Treas. Reg. § 1.904-6(a)(2)(ii)(A), the $80 of foreign taxes is allocable to the same category of income as the $400 payment from USP to FDE was allocated. As such, the $80 of foreign taxes are allocated and apportioned entirely to the foreign branch category.

Disregarded Sale or Exchange Transactions, in turn, are allocated using an approach somewhat analogous to the treatment of intercompany sales within a consolidated group under Treas. Reg. § 1.1502-13. In particular, Treas. Reg. § 1.904-6(a)(2)(ii) takes into account sale or exchange transactions by reattributing income to or from a foreign branch taking into account both the terms of an intercompany transaction and the eventual sale to a third party, but only at the time the asset is actually transferred to a third party.[58] The example below illustrates how the Disregarded Sale or Exchange Rule applies under the U.S.-Owned Branch Rules:

> **Example 9**. USP, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch. USP holds Asset A, a non-depreciable asset, with an adjusted basis of $200. In Year 1, USP sells Asset A, which will be used in FDE's manufacturing business, to FDE for $500. FDE makes no other disregarded payments with respect to Asset A.
>
> In Year 3, FDE sells Asset A to a third party for $600x and reflects $400x of gross income on its separate set of books and records (that is, $600x amount realized less Asset A's $200x adjusted basis).
>
> Under Treas. Reg. § 1.904-4(f)(3)(ii), the full $400 of taxable gain is initially reflected on FDE's books and records. However, as a result of the disregarded transaction in which $300 would have been recognized by USP if the transaction were regarded, USP's general basket income is increased by $300 in the year of the sale, and FDE's foreign branch income is reduced by $300 in the year of the sale.[59]

---

[58] Treas. Reg. § 1.904-6(a)(2)(ii); Treas. Reg. § 1.904-6(a)(2)(iv)(A).

[59] If Asset A were depreciable, adjustments would be made to general basket and foreign branch income during FDE's holding period in order to reflect "disregarded cost recovery deductions." *See* Treas. Reg. § 1.904-4(f)(4)(v) (Example 5).

Finally, the U.S.-Owned Branch Rules apply certain simplifying assumptions to determine the extent to which Disregarded Shareholder Transactions are allocable to the foreign branch basket. In particular, it appears that foreign tax charged to the foreign branch owner in connection with transactions in the nature of a remittance from the branch (such as a distribution or a payment of interest[60]) are treated as allocable to the income of the foreign branch based on the rules of Treas. Reg. § 1.987-6(b) (effectively, a ratable allocation based on the book value of the branch's assets within statutory groupings).[61] In the case of a payment from an owner to a foreign branch, foreign tax imposed on the payment is apportioned to the foreign branch category.[62] The following example illustrates the application of this rule:

> **Example 10**. USP, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch for U.S. federal income tax purposes. FDE distributes $100 to USP. FDE has $750x of general category assets and $250x of passive category assets. Under foreign tax law, the $100 distribution is subject to $10 of withholding. The $10 of foreign taxes is allocated ratably based on the categorization of assets owned by FDE, and accordingly $7.50 of the foreign withholding tax is allocated to the general basket, and $2.50 of the foreign withholding tax is allocated to the passive basket.

The treatment of foreign branches in the U.S.-Owned Branch Rules is also broadly consistent with the rules addressing the allocation of creditable foreign tax expenditures ("**CFTEs**") under Section 704(b).[63] Under those rules, there is a safe harbor (the "**CFTE Safe Harbor**") under which an allocation of a CFTE is deemed to be in accordance with the partners' interests in the partnership if, among other things, the "CFTE is allocated . . . to each partner . . . in proportion to the partners' CFTE category shares of income to which the CFTE relates . . . ."[64] For this purpose, a partnership must (1) assign income of the partnership (that is, regarded income as determined for US federal income tax purposes) to CFTE categories on the basis of the activities of the partnership, (2) group those activities into a single CFTE category to the extent the partnership allocates income attributable to those categories using the same allocation percentages

---

[60] As noted above in Section IV.A.3.b, the treatment of interest as a Disregarded Shareholder Transaction in all cases is questionable in our view. However, for purposes of this discussion, we assume interest payments are properly treated as Disregarded Shareholder Transactions.

[61] Treas. Reg. § 1.904-6(a)(2)(iii)(A)..

[62] Although it is not entirely clear, it appears that the allocation of foreign tax charged on the contribution of property to a foreign branch is effectively a base difference and is therefore allocated pursuant to Section 904(d)(1)(H) to the foreign branch category. This is a sensible result in the case of a contribution to equity because the foreign tax charged is analogous to base differences attributable to transactions described in Section 118 and Section 1032.

[63] *See generally* Treas. Reg. §§ 1.704-1(b)(4)(viii); 1.704-1(b)(5) (Example 24).

[64] Treas. Reg. § 1.704-1(b)(4)(viii)(a)(1).

and (3) subdivide activities into different CFTE categories if more than one allocation percentage is applied to that activity.[65] "[D]isregarded payments are not taken into account in determining the amount of net income attributable to an activity, although a special allocation of income used to make a disregarded payment may result in the subdivision of an activity into divisible parts."[66] CFTEs are allocated and apportioned to CFTE categories under the principles of Treas. Reg. 1.904-6.[67]

As the examples in the CFTE Safe Harbor illustrate, the principles of Treas. Reg. 1.904-6 allocate and apportion taxes imposed with respect to payments that are disregarded (for US tax purposes) to the regarded item of income (for US tax purposes) from which those payments were deducted (for non-US tax purposes). Put differently, these rules (like the U.S.-Owned Branch Rules described above) trace the chain of disregarded payments to allocate taxes imposed with respect to disregarded payments to the proper item of regarded income.

The CFC-Owned Branch Rules in the 2019 Proposed Regulations appear to offer a shorthand version of the approach taken in the U.S.-Owned Branch Rules, and ignore the principles governing CFTEs in Treas. Reg. § 1.704-1(b)(4)(viii). Rather than roughly categorizing disregarded transactions into the three types of transactions contemplated by the U.S.-Owned Branch Rules or using an approach analogous to the CFTE rules, the CFC-Owned Branch Rules generally apply the rules for Disregarded Shareholder Transactions under the U.S.-Owned Branch Rules to all transactions (other than Disregarded Sale or Exchange Transactions, for reasons that are not entirely clear).[68] Thus, under the CFC-Owned Branch Rules, except in the case of Disregarded Sale or Exchange Transactions, all payments from foreign branches to foreign branch owners are generally allocated based on the statutory groupings to which the branch's assets are assigned, and all payments from a foreign branch owner to the foreign branch are allocated to the residual category.[69]

---

65 *See* 84 Fed. Reg. 35539, 35540 (July 24, 2019).

66 Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(iv).

67 Treas. Reg. §§ 1.704-1(b)(4)(viii)(d)(1); 1.704-1(b)(6)(iii) (Example 3).

68 The distinction between sales or exchanges and other ordinary course transactions is particularly strange when one takes into account that purchases and sales of inventory among related parties is treated much more favorably than the payment of related party rent, even though both transactions likely play a similar role in the operation of a foreign branch's business.

69. The 2019 Proposed Regulations are not entirely clear as to whether this treatment with respect to payments from a foreign branch to a foreign branch owner is applicable solely to gross basis withholding taxes imposed by the foreign branch jurisdiction, or whether the same rules would also apply in the event that the jurisdiction in which the foreign branch owner is organized taxes the remittance payment. A gross basis withholding tax imposed on a distribution from the foreign branch to the foreign branch owner is clearly described within Treas. Reg. § 1.904-6(a)(2)(iii)(A). It appears (but it is not entirely clear) that tax imposed on the foreign branch owner by the jurisdiction in which the foreign branch owner is organized (e.g., tax on the dividend or capital gain associated with the distribution) would also be subject to the same rule. *See* Prop. Treas. Reg. § 1.860-20(g)(9) (Example 9).

The CFC-Owned Branch Rules also fail to clearly address the treatment of foreign taxes arising with respect to payments from one CFC-owned branch to another. Under one interpretation, foreign taxes imposed with respect to branch-to-branch payments are subject to the rules that apply to payments from the foreign branch owner to the foreign branch. If that were the case, the taxes could be assigned to the residual grouping (therefore rendering them non-creditable). An alternative interpretation is that the payments should be treated as made from a foreign branch to the foreign branch owner. Under this second interpretation, foreign taxes could be assigned in a manner similar to that set forth in Treas. Reg. 1.987-6(b). We recommend that Treasury clarify the appropriate treatment of these taxes with respect to foreign taxes imposed on branch-to-branch payments.

The CFC-Owned Branch Rules lead to somewhat counterintuitive results in the case of payments that would be governed by the Disregarded Ordinary Course Transaction rule described above. In particular, when comparing outcomes under the U.S.-Owned Branch Rules and the CFC-Owned Branch Rules we see widely divergent results, as the following examples illustrate:

> **Example 11a (Foreign Branch of U.S. Corporation)**. USP, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch. In Year 1, USP accrues and records on its books and records $1000 of gross income from the performance of services to unrelated parties, all of which is foreign source general category income in respect of services performed abroad. FDE provides intellectual property in support of USP's gross income from services. USP compensates FDE for its intellectual property with an arm's-length royalty of $400, which is disregarded for federal income tax purposes. The deduction for the payment of $400 from USP to FDE would be allocated to USP's $1000 of general category services income and apportioned entirely to the $1000 of foreign source services income earned by USP under Treas. Reg. § 1.861-8 principles if the payment were regarded for federal income tax purposes. Under Treas. Reg. § 1.904-4(f)(2)(vi), $400 of USP's $1000 of gross income is reallocated from the general category to the foreign branch category.
>
> USP's royalty payment to FDE is subject to $80 of foreign taxes in Year 1. Under Treas. Reg. § 1.904-6(a)(2)(ii), the $80 of foreign taxes is allocable to the same category of income as the $400 payment from USP to FDE was allocated. As such, the $80 of foreign taxes are allocated and apportioned entirely to the foreign branch category.
>
> **Example 11b (Foreign Branch of CFC)**. The facts are the same as in Example 11a, except that USP is a CFC and accordingly the CFC-Owned Branch Rules apply. Under Prop. Treas. Reg. § 1.861-20(d)(3), the $400 of gross income

> attributable to the royalty payment from CFC to FDE, along with the $80 of foreign withholding tax, is entirely allocated to the residual category (and as such, the $80 of foreign tax is effectively not creditable for purposes of Section 960).

We are concerned that the decision to subject Disregarded Ordinary Course Transactions to the rules described above lacks a compelling policy justification. As a general matter, Disregarded Ordinary Course Transactions in which the owner of the disregarded entity is a foreign corporation are likely to be deductible in the foreign jurisdiction in which the payor is organized, and taxable in the jurisdiction in which the recipient is organized. In effect Disregarded Ordinary Course Transactions represent one jurisdiction ceding to another the right to tax a portion of the payor's income. Yet it is clear under Section 960 that the precise jurisdiction to which a tax is paid is generally not relevant so long as the tax can be properly associated with a specific item of income. The U.S.-Owned Branch Rules provide clear requirements for tracing in the case of foreign branches of a U.S. taxpayer, and it is not clear as a policy matter why the same tracing is not appropriate in the case of foreign branches of a CFC. It is also not clear why items of income and deduction related to rent, royalties, or intercompany services should be subject to these draconian results while Disregarded Sales or Exchange Transactions are carved out from this rule under Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(C). That one form of intercompany transaction is unnecessarily penalized while another form is spared speaks to the seemingly arbitrary nature of the CFC-Owned Branch Rules' approach in this area.

Seemingly acknowledging that the simplified method employed by the CFC-Owned Branch Rules could lead to inappropriate results and incentivize tax planning, Treas. Reg. § 1.860-20(d)(3)(ii)(A) provides for two exceptions to the general rule that foreign tax on a payment from a branch is allocated based on the assets of a foreign branch. First, an allocation to the assets of the foreign branch is not valid if "the payment was made with a principal purpose of avoiding the purposes of an operative section."[70] Second, the allocation is not valid if it "results in a material distortion in the association of foreign income tax with U.S. gross income in the same statutory or residual grouping as the foreign gross income from the payment."[71]

As an initial matter, we believe that regardless of whether any of our subsequent suggestions are accepted, it is appropriate to eliminate the exception to the allocation rule for allocations that result in a "material distortion" of associated foreign income tax and U.S. gross income. While we sympathize with Treasury and the IRS's concern that the simplified approach taken in the CFC-Owned Branch Rules may produce counterintuitive and inappropriate results, the existence of a "material distortion" standard only compounds this inherent uncertainty.

The CFC-Owned Branch Rules do not provide guidance as to what constitutes a "material distortion" in this context, and the standard does not require any abusive purpose before it applies. As a result, the question of what constitutes a "material distortion" arises with respect to every payment that a foreign branch makes to its owner, and taxpayers are left without any direction as

---

[70] Prop. Treas. Reg. § 1.860-20(d)(3)(ii)(A).

[71] *Id.*

to measuring when and to what an extent a "material distortion" has occurred. Notably, this ambiguous "material distortion" standard may also potentially be used (perhaps inappropriately) by taxpayers to deviate from the principles contemplated by the CFC-Owned Branch Rules—Prop. Treas. Reg. § 1.904-6(d)(3)(ii)(A) by its terms appears to make the "material distortion" exception available to both the government and taxpayers, enhancing the likelihood that this simplified standard leads to difficult-to-resolve factual disputes.

Furthermore, even if the standard is clarified, applying the "material distortion" standard would presumably affirmatively require taxpayers to actually go through the effort of allocating all of its foreign taxes with respect to branch transactions to determine a baseline from which a "material distortion" should arise. This is the very administrative burden that Treasury and the IRS appear to be attempting to mitigate in proposing a simplified rule for disregarded transactions in this context. In effect, the "material distortion" standard means that the CFC-Owned Branch Rules require all of the complexity of a more burdensome (and presumably more accurate) allocation, but after all of the relevant analysis is undertaken the CFC-Owned Branch Rules arbitrarily force a simplification of the result. We do not believe that taxpayers or the government are well served by the rule as drafted.

In the event Treasury and the IRS decline to implement our suggestion to eliminate the "material distortion" standard (and in any case, assuming the "principal purpose" exception is retained in final regulations), we believe it is important to clarify how allocation and apportionment is intended to operate when ratable allocation across a branch's assets is not permitted. In such a case, it may be appropriate to apply a facts-and-circumstances analysis (although in particular with respect to transactions undertaken with a principal purpose of avoiding the rules of the operative section, we also understand why allocation and apportionment to the residual category may be appropriate). In any case, we believe that a clearer rule with more certain outcomes is important to both taxpayers and the government.

More fundamentally, we believe that the rules proposed for disregarded payments in Treas. Reg. § 1.860-20(d)(3) should be revised to reflect the same categorization principles that underlie the treatment of disregarded transactions for purposes of measuring foreign branch gross income and foreign branch taxes. While we acknowledge that the technical application of the rules vary slightly, our view is that in all cases there is substantial merit to the precision offered by the categorization approach contemplated by the U.S.-Owned Branch Rules. Furthermore, while as a technical matter the principles applicable to branches of foreign corporations need not perfectly mirror the rules applicable to branches of U.S. corporations, as a matter of administrative efficiency, we believe that both taxpayers and the government would benefit from a consistent set of rules applicable to disregarded transactions involving foreign branches. Such an approach reduces complexity, eases the burden of compliance, and provides for more efficient and precise government review in the context of an audit.

In the event that Treasury and the IRS decline to adopt our proposal, we recommend consideration of guardrails that avoid arbitrarily forcing difficult-to-justify results on taxpayers, particularly in the case of Disregarded Ordinary Course Transactions. For example, Treasury and the IRS might consider an approach in which payments from a foreign branch owner to a foreign branch (which would generally be allocable to the residual basket under the CFC-Owned Branch Rules), are only presumed to be allocable to the residual category. Taxpayers would then have an

opportunity to rebut this presumption if the facts and circumstances indicated that the foreign tax factually related to Subpart F income or tested income. Similar exceptions might be contemplated in the event that the "material distortion" standard described above is expanded and clarified such that taxpayers would have an opportunity to demonstrate to Treasury and the IRS that the relevant rules have reached an inappropriate outcome in a given circumstance.

C. Redeterminations of Foreign Taxes Under Section 905(c)

Prior to the enactment of the TCJA, former Section 902 and Section 960 applied a pooling approach to the crediting of foreign taxes in which foreign tax credits were available upon an actual distribution or a deemed distribution of a foreign corporation's earnings and profits. Accordingly, eligibility for foreign tax credits required a taxpayer to maintain multi-year pools for undistributed earnings and the taxes of its foreign subsidiaries.

Under former Sections 902 and 960 prior to the TCJA, a redetermination of foreign taxes of a CFC required an adjustment to the taxpayer's multi-year pool to take into account the increase or decrease of foreign taxes paid as a result of the redetermination. Thus, an additional tax liability assessed in connection with a foreign tax audit would increase the pool of foreign taxes paid, whereas a refund of foreign taxes previously accrued would result in a decrease in the pool of foreign taxes paid. Adjustments to the pool of undistributed earnings and profits would generally be required as well.

Because prior to the TCJA the indirect foreign credits permitted by Sections 902 and Section 960 were based on multi-year pools, Section 905(c) generally contemplated an adjustment to the pool in the year of the foreign tax adjustment. Thus, for example, if a CFC were assessed (and paid) an additional $100 in 2015 with respect to its 2012 tax year, the CFC would adjust its foreign tax pool (and its undistributed earnings and profits) for the 2015 taxable year, notwithstanding that the $100 liability related to income earned in 2012.

Following passage of the TCJA, a taxpayer is generally only permitted an indirect foreign tax credit under Section 960. As revised by the TCJA, Section 960 generally only takes into account foreign taxes "properly attributable" to Subpart F inclusions or tested income accrued in the current taxable year. Corresponding adjustments were therefore required to Section 905(c) to reflect the elimination of the pre-TCJA pooling regime.

Following modifications pursuant to the TCJA, Section 905(c) now generally requires foreign tax redeterminations to be taken into account in the taxable year to which the foreign taxes relate, rather than in the subsequent taxable year in which such foreign taxes are paid or refunded. Thus, if a taxpayer (or its CFC) were assessed (and paid) an additional $100 in 2025 with respect to its 2022 tax year, the taxpayer would make appropriate adjustments to its 2022 tax year when calculating its entitlement to foreign tax credits. This result is appropriate because under the TCJA, Section 960 credits generally are measured on a year-by-year basis, and foreign taxes paid with respect to a prior taxpayer year generally would not be "properly attributable" to the Subpart F or tested income earned in the year of the redetermination.

The 2019 Proposed Regulations clarify certain technical aspects of the prior-year adjustments now contemplated by Section 905(c). In particular, the 2019 Proposed Regulations

clarify that in the event of a foreign tax redetermination, all relevant inputs for the calculation of a taxpayer's foreign tax credit are recalculated. Thus, adjustments take into account not only the revised amount of foreign taxes paid, but also take into account adjustments to earnings and profits and Section 78 gross-ups. A taxpayer's eligibility for the high-tax exclusion from Subpart F is also redetermined in light of the foreign tax redetermination.[72]

As a technical matter, Section 905(c)(1) contemplates the possibility that multiple tax years would be impacted by a required adjustment of foreign taxes, although as a practical matter multi-year adjustments are less likely in a post-TCJA environment where deemed paid foreign taxes generally are measured on a current basis.[73] However, by its terms Section 905(c) as amended by the TCJA applies to foreign taxes that relate to pre-TCJA tax years as well as those that relate to post-TCJA tax years. As a result, the requirement for multi-year adjustments applies to any post-TCJA foreign tax redetermination that relates to a pre-TCJA taxable year. Thus, in the case of a foreign tax adjustment for 2014 that is accrued and paid in 2021, Section 905(c) appears to contemplate (and the 2019 Proposed Regulations confirm) that the CFC's foreign tax and undistributed earnings pools will be adjusted in 2014 and subsequent tax years. Given the pre-TCJA pooling regime under Section 902 and Section 960, it is likely that an adjustment for 2014 will impact the operation of Section 902 and Section 960 for each subsequent pre-TCJA tax year (until the final pre-TCJA tax year, when such amounts are presumably taken into account under Section 965 if appropriate). As the Preamble acknowledges, the administrative burden imposed by Section 905(c) for adjustments to pre-TCJA taxable years is therefore more substantial as compared to adjustments to post-TCJA taxable years, and accordingly the Preamble requests comments regarding the possibility of a simplified process for addressing pre-TCJA foreign tax redeterminations.

Finally, the 2019 Proposed Regulations offer a number of technical and procedural clarifications regarding the operation of Section 905(c). For example, the 2019 Proposed Regulations include successor and transferee rules that are intended to address situations in which the taxpayer that pays or receives (or in the case of a disregarded entity, the taxpayer is deemed to pay or receive) the foreign tax assessment or refund in the adjustment year is different from the taxpayer that originally accrued the foreign tax liability. The 2019 Proposed Regulations also provide a number of detailed rules clarifying the manner in which notice is to be given to Treasury and the IRS in the event of a foreign tax redetermination.

As a general matter, the 2019 Proposed Regulations appropriately and helpfully clarify the operation of Section 905(c) in light of the TCJA. We generally agree with the view of Treasury and the IRS that in addition to adjusting foreign taxes deemed paid, items such as earnings and profits, Section 78 gross-ups, and eligibility for high-tax exclusions must be appropriately adjusted in a prior year to which a foreign tax redetermination relates. We also agree that Section 905(c) by its terms appears to contemplate a multi-year adjustment, even for pre-TCJA taxable years. The

---

[72] Presumably eligibility for the high-tax exclusion for tested income would be reassessed as well, assuming finalization of Prop. Treas. Reg. § 1.951A-2(c)(6).

[73] We note some limited multi-year adjustments may be required for post-TCJA tax years. For example, in the event that a foreign tax redetermination impacts a CFC's accumulated earnings and profits for a subsequent tax year, the taxpayer's foreign tax credit entitlement in the subsequent tax year may be impacted.

procedural aspects of the 2019 Proposed Regulations related to Section 905(c) are beyond the scope of this Report, and accordingly we do not express a view regarding these matters.

Our comments regarding Section 905(c) are limited to two specific areas. First, we discuss the possibility of a simplified adjustment method for pre-TCJA taxable years. Second, we propose certain technical clarifications to the successor and transferee rules in the 2019 Proposed Regulations.

1. Simplified Adjustment Method for Pre-TCJA Taxable Years

In requesting comments regarding a simplified method under Section 905(c) for adjustments to pre-TCJA tax years, the Preamble specifically suggests that commenters consider the possibility that the entire foreign tax redetermination be taken into account in the last pre-TCJA taxable year of the taxpayer, regardless of the tax year to which the pre-TCJA adjustment relates. Such an approach would in many cases relieve the taxpayer (and the government) from the administrative burden associated with a multi-year analysis involving year-by-year adjustments to foreign tax and undistributed earnings pools.

As a general matter we agree that considerations of administrability and potential simplification are beneficial to both taxpayers and the government so long as the simplification does not materially distort the overall liability of a taxpayer. We believe that the methodology proposed by Treasury and the IRS in the Preamble, in which all pre-TCJA foreign tax redeterminations are taken into account in the taxpayer's final pre-TCJA taxable year, represents a potentially viable approach to simplification.

However, to avoid inappropriate distortions under the simplified method for pre-TCJA taxable years, Treasury and the IRS might consider excluding from the simplified method certain taxpayers for whom the method could inappropriately increase or decrease overall tax liability. For example, in the case of a taxpayer that did not distribute (and was not deemed to distribute) material amounts of earnings and profits during the tax year to which the adjustment relates or subsequent pre-TCJA taxable years, the simplified method likely minimizes administrative burden without materially distorting overall taxable income. However, for a taxpayer that had distributed (or was deemed to distribute) material amounts of earnings and profits in multiple pre-TCJA tax years, the simplified method is likely to be more distortive. Similar issues are likely to arise where a taxpayer had taken advantage of the high-tax Subpart F exclusion in pre-TCJA tax years (in the case of a foreign tax refund), or would be eligible for the exclusion in light of the foreign tax adjustment (in the case of a foreign tax assessment).

Furthermore, we believe that Treasury and the IRS may wish to consider the extent to which the simplified method should be optional or required. In considering this issue, we note that in the event a simplified method is optional, the extent to which the method in fact achieves administrative efficiencies may be limited—in many cases taxpayers are likely to apply both a simplified method and the more complex statutory method to determine which approach yields superior results. Making the simplified method optional will also likely limit efficiencies with respect to use of government resources, since Treasury and the IRS may still need to review a taxpayer's use of the more complex statutory method in many cases. At the same time, we note that affirmatively requiring taxpayers to apply the simplified method arguably deprives those

taxpayers of the more complex methodology that Congress crafted in Section 905(c). We also observe that if the simplified method is generally required but is not available where the result would be distortive, taxpayers and the government will still in many cases have to analyze the effect of the more complex method in order to determine whether use of the simplified method is in fact distortive. As such, in making a simplified method mandatory, Treasury and the IRS should carefully consider the extent to which they may be eroding or subverting the Congressional intent behind Section 905(c), which by its terms clearly contemplates the possibility of multi-year adjustments.[74]

Accordingly, while we support the adoption of a simplified approach to foreign tax adjustments with respect to pre-TCJA tax rules, we encourage Treasury and the IRS to consider exceptions to the utilization of the approach where the simplification is particularly likely to result in an inappropriate increase or decrease in a taxpayer's overall tax liability.

2. Successor and Transferee Rules

As noted above, the 2019 Proposed Regulations contemplate adjustments to take into account situations in which the taxpayer that is the subject of a foreign tax reassessment (whether an additional assessment or a tax refund) is not the same person as the taxpayer that originally accrued the foreign tax in question. Thus, the foreign tax is effectively deemed paid (or the refund deemed received) by the taxpayer that originally accrued the tax, regardless of the person who in fact paid the tax or received the refund. The 2019 Proposed Regulations clarify that background U.S. federal income tax principles generally apply to determine the consequences of the payment of the foreign tax or the receipt of the refund by the successor or transferee.[75]

As an initial matter, we recommend one minor clarification to the technical language of Prop. Treas. Reg. § 1.905-3(c)(3). As drafted, the 2019 Proposed Regulations refer to situations in which the "person with legal liability for the tax (or in the case of a refund, the legal right to such refund) . . . is a different person than the person that had legal liability for the tax in the year to which the redetermined tax relates." As a technical matter, this standard does not clearly address situations in which the ownership of disregarded entities changes hands such that for U.S. federal income tax purposes the person liable for the tax changes, but as a matter of legal liability, the obligation to pay the tax in question in all cases remains with the same person (i.e., the disregarded entity). We believe that Treasury and the IRS clearly intended to refer to the owners of disregarded entities in crafting this standard, and accordingly recommend that Treasury and the IRS clarify that in the case of a disregarded entity, the owner of the entity is treated as the person with legal liability for the tax or the person with the legal right to a refund, as applicable.

Turning to more conceptual points, we also recommend clarification regarding the application of background U.S. federal income tax principles when a successor or transferee pays a foreign tax assessment or receives a foreign tax refund. We generally agree that applying

---

[74] Section 905(c)(1) (requiring the Secretary to "redetermine the amount of the tax for the year or years affected" (emphasis added)).

[75] We note that similar issues were brought up but not specifically resolved in connection with 2007 Temporary Regulations. 72 Fed. Reg. 62775-76 (Nov. 7, 2007).

background tax principles is necessary and appropriate. However, we encourage Treasury and the IRS to clarify the precise operation of these principles. In particular, we believe that an example in the Preamble inappropriately applies background tax principles when discussing the application of federal income tax principles to a redetermination.

The Preamble specifically contemplates the following example[76]:

> **Example 12.** USP owns 100% of the equity interests of FS1, a Country X corporation that for U.S. federal income tax purposes is disregarded as separate from its owner in Year 1. FS1 earns $1000 of income in Year 1 and Country X imposes a $100 tax on FS1, which FS1 pays in Year 2.
>
> In Year 3, USP files an election pursuant to Section 301.7701-3(a) to have FS1 treated as a corporation for U.S. federal income tax purposes. Accordingly, pursuant to Section 301.7701-3(g)(1)(iv), USP is treated as contributing all of its assets and liabilities (including any contingent foreign tax liabilities) to FS1 in exchange for stock of FS1.
>
> In Year 5, Country X assesses an additional $50 of tax on FS1 with respect to its $1000 of income earned in Year 1. FS1 pays the additional $50 of tax in Year 5.
>
> The Preamble suggests the payment of $50 of tax with respect to Year 1 is treated as a taxable distribution from FS1 to USP in Year 5, citing *Enoch*,[77] in which the Tax Court held that a constructive dividend occurred when a corporation discharged its shareholder's personal debts.[78]

We respectfully disagree with the conclusion in the Preamble, and we encourage Treasury and the IRS to clarify their views in future guidance. In particular, we believe the better view from a U.S. federal income tax perspective is that because FS1 assumed the foreign tax liabilities of USP in connection with the transaction deemed to occur pursuant to Section 301.7701-3(g)(1)(iv), background tax principles require the tax treatment of the assumption and discharge of the liability to reflect the circumstances under which the liability was assumed. Accordingly, the assumption and discharge of the foreign tax liability in Example 12 would be governed by Section 357 of the Code, rather than Section 301.

---

[76] 84 Fed. Reg. 69136 (Dec. 17, 2019).

[77] 57 T.C. 781 (1972).

[78] *Id.*

In recommending that background tax principles require the circumstances surrounding the assumption/transfer of a contingent liability to be taken into account in determining the consequences of the discharge, we also note that the general U.S. federal income tax treatment of contingent liabilities and contingent assets remains uncertain in many respects. This topic has attracted substantial commentary from the tax community, but there is relatively little in terms of case law or regulatory authority to guide taxpayers on the issue.[79] Even seemingly simple cases involving contingent liability assumptions do not always yield obvious results.

In particular, we note that substantial uncertainty exists with respect to a transferor's recognition of gain or loss (if any) with respect to an assumed contingent liability, the timing and quantum of any deduction permitted to the transferor with respect to the liability, and whether and to what extent the transferor recognizes taxable income when a contingent liability is discharged. Furthermore, different rules and standards are applicable in different contexts. In the case of transfers of property pursuant to a reorganization described in Section 368(a) or a transfer of property governed by Section 351, Section 357 generally addresses the assumption of any liabilities.[80] As discussed above, we believe these rules must be taken into account in fact patterns like Example 12 (where a disregarded subsidiary files a check-the-box election), and may also be relevant for internal reorganization transactions, such as cross-chain "D reorganizations."[81] In contrast, a typical cash-funded acquisition among unrelated parties is generally governed by Section 1001 and related authorities. Section 1001 and related authorities would apply in the case of an acquisition of a disregarded entity that is treated for U.S. federal income tax purposes as an acquisition of the disregarded entity's assets and an assumption of the disregarded entity's liabilities by the transferee. In such a transaction, Section 357 generally would not be relevant.

We additionally note that not every approach to contingent liabilities is consistent with the Section 905(c) fiction in the 2019 Proposed Regulations that a transferor should be treated as paying a contingent liability when the liability is in fact ultimately discharged. In particular, some approaches to contingent liabilities would treat the transferee as discharging the contingent liability in the year the contingent liability becomes fixed and determinable, without any impact on the transferor.[82] These approaches are not consistent with the fiction imposed by Section 905(c) that

---

[79] *See, e.g.*, Ginsberg, Levin & Rocap, *Mergers, Acquisitions & Buyouts* ¶ 304 (2019); Daniel Halperin, *Assumption of Contingent Liabilities on Sale of a Business*, 2 Fla. Tax Rev. 673 (1996); New York State Bar Association Tax Section, Report No. 671 (Nov. 1, 1990); Schler, *Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10), and More*, 43 Tax L. Rev. 605 (1988); Schwartz, *It Doesn't Get Easier Than This? Liabilities and Asset Sales Reexamined*, Tax Forum No. 641 (Oct. 1, 2012); Youngwood, *The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions*, 44 Tax Law. 765 (1991).

[80] We note in particular that the application of Section 357(c)(3) is particularly complex in this context, given that at the time of the original transaction a foreign tax liability may be described in Section 357(c)(3), but arguably is no longer described in Section 957(c)(3) following the deemed payment of the relevant foreign taxes prior to the transfer.

[81] *See, e.g.*, Rev. Rul. 2015-10, 2015-21 I.R.B. 972.

[82] Ginsberg, Levin & Rocap, *Mergers, Acquisitions & Buyouts* ¶ 304 (2019) ("Accordingly, we think the rule for [transferor] should be . . . that an estimated value at time of sale should be placed on the liability assumption, with this estimated value determining T's amount realized and deduction amount, with no subsequent adjustment being made thereafter."); Schwartz, *It Doesn't Get Easier Than This? Liabilities and Asset Sales Reexamined*, Tax

the transferor in fact accrued the foreign tax liability in the year with respect to which foreign tax relates. We further note that in practice it may be the case that a transferor and a transferee have contractually addressed the foreign tax exposure in connection with the transfer. For example, it is not uncommon for a transferor to indemnify a transferee with respect to taxes associated with tax periods preceding the transfer. Parties may also have contractual arrangements in place with respect to the payment of tax refunds with respect to tax periods preceding a transfer. Presumably these arrangements must also be taken into account applying general income tax principles.

While we do not believe that guidance under Section 905(c) represents the appropriate place to take on these complex unsettled issues, we recommend that in the event future guidance does address the treatment of assumed contingent liabilities more broadly, potential consequences under Section 905(c) should be taken into account as part of a broad regulatory project regarding the treatment of contingent liabilities.

Forum No. 641 (Oct. 1, 2012) ("More specifically, commentators generally appear to assume that a seller must take the value of any Contingent Liabilities assumed by the buyer into account at the time of the sale.").