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Report No. 1448
February 9, 2021

The Honorable Mark J. Mazur
Deputy 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 William M. Paul
Chief Counsel (Acting)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1448 – Report on Proposed Regulations Providing Guidance Related to the Foreign Tax Credit*

Dear Messrs. Mazur, Rettig, and Paul:

I am pleased to submit our Report No. 1448 commenting on the proposed regulations published in November 2020 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 November 2020 final regulations, as well as the proposed regulations. This Report comments on issues relating to the proposed regulations.

We appreciate your consideration of this 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,

Gordon Warnke

Gordon E. Warnke
Chair

Enclosure

Report No. 1448

New York State Bar Association Tax Section

Report on Proposed Regulations Providing Guidance Related to the Foreign Tax Credit

February 9, 2021

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I. Introduction

This report (the "**Report**")[1] comments on proposed regulations issued by the Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") on November 12, 2020 (the "**2020 Proposed Regulations**").[2] The 2020 Proposed Regulations offer guidance on a range of issues related to the determination of the foreign tax credit after the passage of the legislation informally known as the Tax Cuts and Jobs Act (the "**TCJA**").[3] The 2020 Proposed Regulations were issued concurrently with final regulations providing guidance related to the allocation and apportionment of deductions and foreign income taxes, foreign tax redeterminations, disallowance under Section 965(g), consolidated groups, hybrid arrangements, and certain payments under Section 951A (the "**2020 Final Regulations**").[4] The 2020 Final Regulations generally adopt proposed regulations issued on December 17, 2019 (the "**2019 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 2020 Final Regulations largely adopt the substance of the 2019 Proposed Regulations (upon which we have already extensively commented in a prior report),[6] this Report's focus is on certain aspects of the 2020 Proposed Regulations.

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[1] The authors of this Report are David Hardy, Rose Jenkins, and Gary Scanlon. Substantial assistance in the preparation of this Report was provided by Robert Cassanos, Richard Reinhold, and Michael Schler. Helpful comments were provided by Jennifer Alexander, Kimberly Blanchard, Peter Connors, Abraham Leitner, Richard Nugent, Stephen Shay, Eric Sloan, Joseph Toce, Shun Tosaka, and Gordon Warnke. 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] REG-101657-20, 85 Fed. Reg. 72078 (Nov. 12, 2020).

[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," P.L. 115–97 (Dec. 22, 2017).

[4] TD 9922, 85 Fed. Reg. 71998 (Nov. 12, 2020).

[5] REG-105495-19, 84 Fed. Reg. 69124 (Dec. 17, 2019).

[6] New York State Bar Tax Section Report No. 1435 (Feb. 17, 2020) (the "**2020 FTC Report**"). *See also* New York State Bar Tax Section Report No. 1408 (Feb. 5, 2019) (the "**2019 FTC Report**"), regarding proposed foreign tax credit regulations issued on December 7, 2018, and New York State Bar Tax

Part II of this Report provides a summary of our recommendations. Part III provides an overview of the foreign tax credit rules after the enactment of the TCJA and a summary of the contents of the 2020 Final Regulations and the 2020 Proposed Regulations. Part IV contains a detailed analysis of the 2020 Proposed Regulations and the discussion of our recommendations.

II. Summary of Recommendations[7]

A. Creditability of Foreign Income Taxes under Sections 901 and 903

1. Consistent with our recommendation in the 2015 Report that a jurisdictional nexus requirement not be adopted,[8] we have concerns about the jurisdictional nexus requirement rules and recommend that they be separated from the remainder of the rules in the 2020 Proposed Regulations and considered subject to an extended comment period and in light of further international developments, particularly the ongoing work at the OECD.

2. If the jurisdictional nexus requirement is adopted in final regulations, we recommend that final regulations allow a foreign levy that assesses a capital gains tax on the stock of a resident corporation to satisfy the property-based nexus standard. If this recommendation is rejected, we recommend that final regulations more specifically address the interaction of the jurisdictional nexus requirement with double tax treaties that historically sanctioned the creditability of such capital gains taxes.

3. We recommend that, in lieu of a specific list of deductions that are necessary to be allowed for a foreign levy to satisfy the cost recovery requirement, the final regulations retain the facts and circumstances inquiry of the existing regulations.

4. If the proposed changes to the cost recovery requirement are adopted in the final regulations, we recommend that the final regulations include examples of disallowances (including those that are not similar to

Section Report No. 1332 (November 24, 2015) (the "**2015 FTC Report**"), regarding the credibility of extraterritorial taxes and the potential adoption of a jurisdictional nexus requirement.

7 Terms used in this Part II have the meaning provided in Parts I, III, and IV of this Report, as applicable.

8 *See* the 2015 FTC Report, pp. 4 and 17 *et seq*.

specific U.S. federal income tax rules) that would and would not be considered “consistent” with U.S. federal income tax principles.

5. We recommend that Treasury and the IRS not finalize the requirement that a “close connection” between the imposition of an in lieu of tax on income and the failure to impose the generally-imposed net income tax on such income must be established “with proof that the foreign country made a cognizant and deliberate choice to impose the tested foreign tax instead of the generally-imposed net income tax.”

6. We recommend that the final regulations clarify that, under the jurisdiction to tax requirement for an in lieu of tax, the hypothetical application of the generally-imposed net income tax to the excluded income need only satisfy the jurisdictional nexus requirement and not also the net gain requirement. If Treasury and the IRS intend to require that such hypothetical application of the generally-imposed net income tax also satisfy the net gain requirement, the final regulations should clarify the nature of this analysis.

7. We recommend that final regulations clarify when components of a foreign tax should be considered separate levies.

8. Some of our members recommend that the rule treating refundable credits as reducing the amount of income tax paid be finalized, while others recommend that the rule not be finalized and instead that guidance be issued treating the use of refundable credits and transferable credits in satisfaction of a foreign income tax as a payment of such tax. If the latter recommendation were adopted, rules could allow payment treatment only for credits that are actually regularly refunded in more than *de minimis* amounts by foreign governments.

9. Consistent with the foregoing recommendation, we recommend that government grants payable in cash and administered outside of the tax system not be treated as a reduction in the amount of tax paid, but rather that a tax satisfied by application of such a grant should be treated as paid. Such a rule could be supplemented by a rule that treats grants that are calculated by reference to a foreign income tax liability or the base thereof as tax credits.

B. Allocation and Apportionment of Foreign Income Taxes

1. We generally support the approach for basketing foreign income taxes related to a Section 301(c)(2) distribution or a disposition of stock based on the TBV method. In order to better conform the FTC consequences of distributions with those of dispositions, we recommend that, to the extent of basis in stock attributable to PTEP under Section 961, foreign gross income in excess of the U.S. dividend amount be assigned to the same grouping as the underlying PTEP.

2. We generally support the approach for basketing foreign income taxes related to a partnership distribution or a disposition of partnership interests based on the TBV method. In order to better align the grouping of foreign income taxes imposed on a Section 733 distribution by a hybrid partnership with the underlying partnership income included in a partner's income, we recommend that partners' distributive shares of the income of a hybrid partnership be tracked and foreign gross income treated as a dividend for foreign law purposes upon a distribution by the hybrid partnership be assigned proportionately to the income included in this partner-level account to the extent thereof. In the alternative, at a minimum, we recommend that foreign gross income arising from a foreign law dividend be attributed based on a partner's distributive share of the current year income of the partnership to the extent thereof.

3. If the foregoing recommendation concerning distributions from hybrid partnerships is adopted, we recommend that in order to conform the FTC consequences of distributions with those of dispositions, in the case of a disposition of a hybrid partnership interest, an amount of foreign gross income equal to the disposing partner's Section 705 basis attributable to undistributed partnership income be assigned to relevant groupings in the same manner as if such amount were distributed.

4. We agree with the approach of the 2020 Proposed Regulations basketing foreign income taxes arising from disregarded payments based on the disregarded payment rules in Treas. Reg. § 1.904-4(f) and Prop. Treas. Reg. § 1.954-1(d).

5. We recommend that, for purposes of assigning foreign gross income arising from a remittance, the assets of a taxable unit include not only stock, but also the assets of any other taxable unit owned by the taxable

unit, and any interest in a partnership or the taxable unit's pro rata share of the assets of the partnership, as applicable.

C. Allocation and Apportionment of Other Expenses

1. We recommend that the election to capitalize R&E and advertising expenses for purposes of allocating and apportioning interest expense be extended to apply for purposes of allocating and apportioning any expense that is apportioned under the asset method, including litigation-related expenses and stewardship expenses.

D. Disallowance of FTCs Related to Section 245A Dividends

1. We recommend that Treasury and the IRS clarify that Section 245A(d) may apply to disallow an FTC with respect to a foreign income tax that arises by reason of a remittance.

2. We recommend that Treasury and the IRS clarify that Treas. Reg. § 1.861-13 does not apply to characterize lower-tier CFC stock in order to disallow FTCs under Section 245A(d).

3. We recommend that the final regulations either maintain an anti-abuse rule or modify the foreign law distribution rule to address successive foreign law distributions rather than adopting an approach based on maintaining accounts for tracking E&P and basis.

E. Determination of Financial Services Income

1. We express reservations regarding the proposed rule that would prevent income of a financial services entity that is treated as passive income under a look-through rule from qualifying as financial services income. If such rule is finalized, we recommend that Treasury and the IRS clarify the purpose for the rule and whether the exclusion from financial services income of passive category income under a look-through rule applies solely to related party payments, or whether it applies to inclusions as well.

2. We recommend that Treasury and the IRS give further consideration to the approach of the 2020 Proposed Regulations with respect to limitations on insurance-related active financing income, including the thresholds applicable for purposes of determining investment asset

limitations and their interaction with the definitions of total insurance liabilities for different categories of companies.

3. We recommend that if the related person income exclusion for purposes of the FSE standalone determination is finalized, the final regulations clarify that active financing income taken into account for purposes of computing the AFI percentage includes insurance income of a U.S. company attributable to a policy of insurance or reinsurance with respect to which the person (directly or indirectly) insured is a related person (within the meaning of Section 953(c)(6)) to the company.

F. Redeterminations of Foreign Income Taxes

1. We recommend that the final regulations treat each partner's distributive share of additional tax paid by an accrual-method partnership as a result of a change in the foreign tax liability as paid or accrued by the partner in its taxable year with which or within which the partnership's relation-back year ends.

2. We recommend that the provisional credit election be available to any partner of an accrual-method partnership without regard to whether the partner is an accrual-method taxpayer or has elected to use the accrual method for purposes of computing FTCs.

3. We recommend that final regulations clarify that, in the event that a provisional credit election for a contested tax liability is made, a CFC-level deduction for the relation-back year should also be provided in advance of accrual.

III. Background

A. The Foreign Tax Credit Regime After the TCJA

As discussed in greater detail in our prior reports,[9] the TCJA made a number of fundamental changes to the U.S. taxation of foreign income. These changes include a

9 *See* the 2019 FTC Report and the 2020 FTC Report.

new tax on United States shareholders ("**U.S. shareholders**")[10] on their "global intangible low-taxed income" ("**GILTI**" or the "**GILTI inclusion**")[11] with respect to their controlled foreign corporations ("**CFCs**")[12] albeit at a reduced rate.[13] The TCJA also introduced a 100% dividends received deduction under Section 245A (the "**Section 245A DRD**") for

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[10] A U.S. shareholder is, with respect to a foreign corporation, a U.S. person (as defined in Section 957(c)) that owns, directly, indirectly, or constructively, 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation, or 10% or more of the total value of shares of all classes of stock of the foreign corporation. Section 951(b).

[11] *See* Section 951A(a); Treas. Reg. § 1.951A-1(b). The amount of a U.S. shareholder's GILTI inclusion is its net CFC tested income over its net deemed tangible income return. Section 951A(b)(1); Treas. Reg. § 1.951A-1(c)(1). A U.S. shareholder's "**net CFC tested income**" is the excess (if any) of its aggregate pro rata share of tested income of its CFCs less its aggregate pro rata share of tested losses. Section 951A(c)(1); Treas. Reg. § 1.951A-1(c)(2). A CFC's "**tested income**" is the excess (if any) of gross tested income over deductions properly allocable to gross tested income. Section 951A(c)(2)(A); Treas. Reg. § 1.951A-2(b)(1). A CFC's "**tested loss**" is the excess of deductions properly allocable to gross tested income over gross tested income. Section 951A(c)(2)(B); Treas. Reg. § 1.951A-2(b)(2). A CFC's "**gross tested income**" is the gross income of the CFC other than (i) income that is effectively connected to a U.S. trade or business ("**effectively connected income**" or "**ECI**"), (ii) gross Subpart F income, (iii) income excluded from gross tested income or gross Subpart F income by reason of an election under Treas. Reg. § 1.951A-2(c)(7) or Treas. Reg. § 1.954-1(d)(5), respectively, (iv) related party dividends, or (v) foreign oil and gas extraction income (as defined in Section 907(c)(1)). Section 951A(c)(2)(A)(i); Treas. Reg. § 1.951A-2(c)(1). A U.S. shareholder's "**net deemed tangible income return**" is 10% of its aggregate pro rata share of the qualified business asset investment of its CFCs, less its aggregate pro rata share of certain interest expense of its CFCs. Section 951A(b)(2); Treas. Reg. § 1.951A-1(c)(3). A CFC's "**qualified business asset investment**" (or "**QBAI**") is the average of its basis in tangible property used in the production of tested income. Section 951A(d); Treas. Reg. § 1.951A-3(b).

[12] A CFC is any foreign corporation if more than 50% of the total combined voting power of all classes of stock of the corporation entitled to vote, or the total value of the stock of the corporation, is owned, directly, indirectly, or constructively, by U.S. shareholders on any day during the taxable year of such foreign corporation. Section 957(a).

[13] Subject to a taxable income limitation under Section 250(a)(2), a domestic corporation is permitted a 50% deduction for its GILTI inclusion and the amount treated as a dividend received under Section 78 (the "**Section 78 gross-up**") that is attributable to the GILTI inclusion. Section 250(a)(1)(B). This results in a U.S. federal income tax rate of 10.5% with respect to GILTI and the Section 78 gross-up before taking into account allocable expenses and foreign tax credits. For tax years beginning in 2026, the deduction is reduced to 37.5%, for a U.S. federal income tax rate of 13.125% before taking into account allocable expenses and foreign tax credits. Section 250(a)(3)(B).

corporate U.S. shareholders on the foreign-source portion[14] of dividends[15] (the portion of a dividend eligible for the Section 245A DRD, a "**Section 245A dividend**") received from specified 10%-owned foreign corporations.[16] The cumulative effect of the adoption of GILTI and Section 245A, in conjunction with the retention of the rules under Subpart F of the Code that tax U.S. shareholders currently on certain mobile income of their CFCs ("**Subpart F**" or the "**Subpart F inclusion**"),[17] is that a domestic corporation's foreign income, whether earned directly or indirectly through a foreign subsidiary, is generally subject to U.S. tax either immediately or not at all.

Consistent with pre-TCJA law, Section 901 permits a taxpayer a credit (a "**foreign tax credit**" or an "**FTC**") for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States" (a "**foreign income tax**") paid or accrued by the taxpayer for the taxable year.[18] In the case of a corporation that is a U.S. shareholder of a CFC, an FTC is also permitted for a foreign income tax paid or accrued by the CFC that is "deemed paid" by the U.S.

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[14] The foreign-source portion of a dividend received from a specified 10%-owned foreign corporation is the amount of such dividend multiplied by a ratio, the numerator of which is undistributed foreign earnings of the corporation and the denominator of which is total undistributed earnings of the corporation. Section 245A(c)(1). The "**undistributed earnings**" of a corporation are its earnings and profits ("**E&P**") computed as of the close of the corporation's taxable year in which the dividend is distributed without diminution by reason of any dividends distributed during the taxable year. Section 245A(c)(2). The "**undistributed foreign earnings**" of a corporation are the portion of its undistributed earnings that are attributable to neither (i) ECI nor (ii) dividends received from a domestic corporation, other than a regulated investment company or real estate investment trust, which is at least 80% owned, directly or indirectly, by the foreign corporation. Section 245A(c)(3).

[15] For this purpose, a dividend includes gain recharacterized as a dividend under Section 1248 on the sale or exchange by a domestic corporation of stock in a foreign corporation held for 1 year or more. Section 1248(j).

[16] A specified 10%-owned foreign corporation is any foreign corporation with respect to which any domestic corporation is a U.S. shareholder, other than a passive foreign investment company (as defined in Section 1297) (**"PFIC"**) with respect to the shareholder that is not a CFC. Section 245A(b).

[17] Section 951 et seq.

[18] As discussed in more detail in Part IV.A.1 of this Report, a foreign income tax includes a tax paid "in lieu of" a foreign income tax. Section 903. For purposes of this Report, an FTC is the amount of a foreign income tax allowable as a credit under Section 901 or Section 903, including by reason of Section 960, but without regard to the limitation in Section 904. In contrast, a reference in this Report to a "foreign income tax" or "foreign income tax expense" is a reference to a foreign income tax paid or accrued, without regard to whether such foreign income tax is allowed as an FTC.

shareholder under Section 960 (an "**indirect FTC**").[19] An indirect FTC of a U.S. shareholder is any foreign income tax paid or accrued by a CFC that is "properly attributable" to either (1) the Subpart F income or tested income of the CFC that gives rise to a Subpart F or GILTI inclusion, respectively, to the U.S. shareholder[20] or (2) a distribution of previously taxed earnings and profits ("**PTEP**") from a CFC arising from a Subpart F or GILTI inclusion to the U.S. shareholder.[21] However, no FTC is permitted for foreign income taxes paid or accrued with respect to any Section 245A dividend or hybrid dividend received by a U.S. shareholder or any tiered hybrid dividend included in the gross income of a U.S. shareholder.[22]

Section 904 limits a taxpayer's ability to credit an otherwise allowable FTC to the pre-credit U.S. tax on the taxpayer's foreign-source income (such limitation, the "**FTC limitation**").[23] The general goal of the FTC regime is to alleviate the burden of double taxation with respect to a taxpayer's foreign-source income, while not permitting a foreign income tax to be credited against the U.S. tax due on U.S.-source income. The FTC

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19 Sections 901 and 960.

20 Section 960(a) and (d); Treas. Reg. § 1.960-2(b) and (c). A foreign income tax that is "properly attributable" to tested income is a "**tested foreign income tax**." *See* Section 960(d)(3); Treas. Reg. § 1.960-2(c)(3). The amount of the indirect FTC permitted a U.S. shareholder with respect to a GILTI inclusion is 80% of the aggregate amount of tested foreign income taxes of its CFCs multiplied by the U.S. shareholder's inclusion percentage. Section 960(d)(1); Treas. Reg. § 1.960-2(c)(1). A U.S. shareholder's "**inclusion percentage**" is the shareholder's GILTI inclusion amount divided by its aggregate pro rata share of tested income of all its CFCs (*i.e.*, its GILTI inclusion determined without regard to its pro rata share of its CFCs' tested losses and QBAI). Section 960(d)(2); Treas. Reg. § 1.960-2(c)(2).

21 Section 960(b); Treas. Reg. § 1.960-3(b).

22 Section 245A(d) and (e)(3). A **"hybrid dividend"** is an amount received from a CFC that would be allowed a Section 245A DRD but for Section 245A(e)(1) and for which the CFC receives a deduction (or other tax benefit) with respect to any foreign income taxes. Section 245A(e)(4); Treas. Reg. § 1.245A(e)-1(b)(2). A **"tiered hybrid dividend"** is an amount received by a receiving CFC from another CFC to the extent that the amount would be a hybrid dividend if the receiving CFC were a domestic corporation. Section 245A(e)(2); Treas. Reg. § 1.245A(e)-1(c)(2). A tiered hybrid dividend is treated as Subpart F income of the receiving CFC and thus included in the gross income of a U.S. shareholder of the receiving CFC as a Subpart F inclusion to the extent of the shareholder's pro rata share of such income. Section 245A(e)(2); Treas. Reg. § 1.245A(e)-1(c)(1).

23 Section 904(a).

limitation furthers this goal by disallowing FTCs in excess of the amount necessary to fully offset the U.S. tax due on foreign-source income.

The Code further limits a taxpayer's ability to cross-credit between separate categories (or simply "**categories**") of foreign-source income by applying the FTC limitation on a category-by-category basis (the "**separate FTC limitation**").[24] Before the TCJA, there were generally just two categories of income – general category income and passive category income.[25] The TCJA added two new categories of income – Section 951A category income and foreign branch category income. Therefore, after the TCJA, most items of foreign-source income (and related foreign income taxes) are assigned to one or more of four categories: (1) Section 951A category,[26] (2) foreign branch category,[27] (3) passive category,[28] or (4) general category.[29]

The separate FTC limitation with respect to a category is determined by multiplying the taxpayer's pre-credit U.S. tax by a fraction, the numerator of which is the taxpayer's foreign-source net income in the category and the denominator of which is worldwide

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24 Section 904(d)(1).

25 Both before and after the TCJA, income could be included in other categories that are beyond the focus of this Report. For example, Section 904(d)(6) requires separate categories for income re-sourced under a U.S. tax treaty.

26 Section 904(d)(1)(A). "**Section 951A category income**" is any amount includible in gross income under Section 951A other than passive category income. *Id*; Treas. Reg. § 1.904-4(g).

27 Section 904(d)(1)(B). "**Foreign branch category income**" is defined as the business profits of a U.S. person which are attributable to one or more qualified business units (as defined in Section 989(a)) ("**QBUs**") in one or more foreign countries. Section 904(d)(2)(J); Treas. Reg. § 1.904-4(f)(1).

28 Section 904(d)(1)(C). "**Passive category income**" is either passive income or specified passive category income. Section 904(d)(2)(A)(i); Treas. Reg. § 1.904-4(b)(1). "**Passive income**" is income received or accrued by any person which is of a kind that would be foreign personal holding company income (as defined in Section 954(c)) (**"FPHCI"**). Section 904(d)(2)(B)(i); Treas. Reg. § 1.904-4(b)(2). "**Specified passive category income**" comprises certain dividends from a DISC or former DISC (as defined in Section 992(a)) or a former FSC (as defined in Section 922). Section 904(d)(2)(B)(v); Treas. Reg. § 1.904-4(b)(3).

29 Section 904(d)(1)(D). "**General category income**" is income other than Section 951A category income, foreign branch category income, and passive category income. Section 904(d)(2)(A)(ii); Treas. Reg. § 1.904-4(d).

income.[30] For this purpose, a taxpayer's foreign-source net income in any category and its worldwide income is determined without regard to Section 245A dividends and any expenses allocated and apportioned to either Section 245A dividends or stock that produces Section 245A dividends.[31]

Each foreign income tax, whether paid directly by the taxpayer or deemed paid by the taxpayer under Section 960, must be allocated and apportioned to one or more categories to determine which separate FTC limitation applies with respect to the resulting FTC.[32] In addition, to determine the amount of foreign income taxes of a CFC that are "properly attributable" to a U.S. shareholder's Subpart F or GILTI inclusion, and thus creditable as indirect FTCs under Section 960, the CFC's foreign income taxes must be allocated and apportioned to the CFC's Subpart F income and tested income groups.[33] In addition, a CFC's foreign income tax expense must be allocated and apportioned, like any other CFC-level deduction, to calculate the CFC's Subpart F income and tested income.[34] The allocation and apportionment of foreign income taxes between items of gross income and tested units is also necessary for purposes of determining whether that item qualifies for the Subpart F or GILTI high-tax exception.[35]

The adoption of GILTI and the addition of the Section 951A and foreign branch categories have increased the complexity of accurately apportioning and allocating foreign income taxes. The changes in the TCJA have also substantially increased their importance. Before the enactment of the TCJA, any FTC subject to a limitation could be carried forward or back and thus potentially used in a year where a taxpayer had excess limitation, and any foreign income tax paid or accrued by a CFC not attributable to a Subpart F income inclusion of a U.S. shareholder could be taken into account as an

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30 *See* Treas. Reg. § 1.904-1(a).

31 Section 904(b)(4); Treas. Reg. § 1.904(b)-3(a)(1). The portion of CFC stock that is treated as producing Section 245A dividends for this purpose is determined under Treas. Reg. § 1.861-13, which is discussed in more detail in Part IV.D of this Report.

32 *See* Section 904(d) and Treas. Reg. § 1.904-6(a).

33 Section 960(a) and (d)(3); Treas. Reg. § 1.960-2(b) and (c).

34 *See* Sections 951A(c)(2)(A)(ii) and 954(b)(5).

35 *See* Treas. Reg. §§ 1.954-1(d)(2) and (3) and 1.951A-2(c)(7)(iii) and (vi); Prop. Treas. Reg. § 1.954-1(d)(1)(iv) and (4).

indirect FTC on a subsequent repatriation of the CFC's E&P to such U.S. shareholder.[36] After the enactment of the TCJA, an FTC limitation with respect to the Section 951A category in a taxable year results in a permanent disallowance of Section 951A category FTCs paid or accrued in that taxable year,[37] and any foreign income tax of a CFC that is allocated and apportioned to income that is not Subpart F income or tested income is assigned to the "residual category" and thus cannot be deemed paid by a U.S. shareholder under Section 960.[38] The creditability of a foreign income tax paid or accrued by a CFC, like the U.S. taxation of the foreign income to which such foreign income tax relates, is generally a "now or never" proposition.

B. The 2020 Final Regulations

The 2020 Final Regulations finalized the 2019 Proposed Regulations with only limited changes. As finalized, the 2020 Final Regulations offer guidance regarding (1) the allocation and apportionment of certain expenses, including foreign income taxes, stewardship, research and experimental ("**R&E**") expenditures, interest, and damages and other payments arising from litigation, for purposes of Treasury Regulations issued under Section 861, (2) the treatment of certain lending transactions as between partners and partnerships for purposes of the foreign tax credit rules, (3) the application of Treas. Reg. § 1.904(g)-3 to certain loss recapture transactions, (4) foreign tax redeterminations under Section 905(c), (5) specialized issues related to insurance companies, (6) conforming changes and clarifications related to the overall foreign loss and overall domestic loss rules, (7) the disallowance of a portion of a taxpayer's foreign tax credits attributable to PTEP under Section 965, and (8) the application of the FTC limitation to consolidated groups.

The 2020 Final Regulations also finalized guidance relating to hybrid instruments and entities that was included in proposed regulations released in April 2020, as well as guidance in respect of the treatment of certain deductions attributable to prepayments that were not taken into account in determining the recipient's U.S. shareholder's GILTI.

The 2020 Final Regulations did not finalize the rules in the 2020 Proposed Regulations relating to the determination of financial services income within the meaning of Section 904(d)(2)(D) and provisions relating to the allocation and apportionment of

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[36] *See* former Sections 902 and 904(c) before enactment of the TCJA.

[37] *See* Section 904(c) (final sentence).

[38] *See* Treas. Reg. § 1.960-1(d)(3)(ii) and (e).

foreign income taxes related to disregarded transactions. Instead, as discussed in more detail in Part IV.E of this Report, these rules were re-proposed in the 2020 Proposed Regulations.

C. The 2020 Proposed Regulations

The 2020 Proposed Regulations address a number of technical issues remaining after the 2020 Final Regulations. In particular, the 2020 Proposed Regulations offer guidance regarding (1) the allocation and apportionment of foreign income taxes related to dispositions of stock and partnership interests, partnership distributions, and disregarded transactions; (2) the disallowance of FTCs with respect to Section 245A dividends; (3) the treatment of E&P and foreign incomes taxes of a foreign corporation involved in a post-2017 Section 381 nonrecognition transaction; (4) the definition of financial services income; (5) rules regarding when the FTC can be claimed; (6) the source of inclusions under Sections 951, 951A, and 1293; (7) the allocation of foreign income taxes after certain ownership and entity classification changes; and (8) transition rules for accounting for net operating loss carrybacks. The 2020 Proposed Regulations also propose changes to the definition of electronically supplied services for purposes of calculating foreign-derived intangible income ("**FDII**") and the determination of domestic oil and gas extraction income and foreign oil and gas extraction income for purposes of calculating FDII and GILTI, respectively. Moreover, the 2020 Proposed Regulations propose significant revisions to the Treasury Regulations under Sections 901 and 903 concerning the creditability of foreign income taxes.

Our recommendations for clarifications and modifications to certain aspects of the 2020 Proposed Regulations are set forth in Part IV of this Report. We do not comment on (a) the rules related to FDII, (b) the treatment of E&P and foreign income taxes in post-2017 Section 381 transactions, (c) the source of inclusions under Sections 951, 951A, and 1293; (d) the allocation of foreign income taxes after certain ownership and entity classification changes; and (e) transition rules for accounting for net operating loss carrybacks.

IV. Discussion and Recommendations

A. Creditability of Foreign Income Taxes under Sections 901 and 903

1. Background[39]

As discussed in Part III.A of this Report, Section 901 permits a U.S. taxpayer a credit for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States."[40] In 1938, the Supreme Court indicated that the reference to an "income tax" in the precursor to Section 901 is meant to refer to an income tax "in the U.S. sense."[41] Similarly, the existing regulations under Section 901 provide that in order to be creditable the predominant character of a foreign levy must be that of an income tax in the U.S. sense, which, in turn, requires that the foreign levy be "likely to reach net gain in the normal circumstances in which it applies" (the "**net gain requirement**").[42] A foreign levy is considered to reach net gain and thus satisfy the net gain requirement if, "judged on the basis of its predominant character," the levy satisfies each of three requirements:[43]

> (1) the foreign tax is imposed upon, subsequent to, or, under certain circumstances, before, the occurrence of events that would result in the realization of income under the Code (the "**realization requirement**");[44]
>
> (2) the tax is imposed either on the basis of gross receipts or on the basis of gross receipts computed under a method that is likely to produce an

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[39] The discussion in this Background section is adapted, in significant part, from the Background section of the 2015 FTC Report, pp. 4-10, which also provides a more extensive overview of the history of the Treasury Regulations under Sections 901 and 903.

[40] *See* Section 901(b)(1) and Treas. Reg. § 1.901-1(a)(1)(i).

[41] *See Biddle v. Comm'r*, 302 U.S. 573, 578-79 (1938).

[42] Treas. Reg. § 1.901-2(a)(1)(ii) and (3)(i). A foreign levy to qualify as a net income tax under Section 901 or an in lieu of tax under Section 903 must be a "tax." Treas. Reg. § 1.901-2(a)(1)(i) and 1.903-1(a)(1). In general, a foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. Treas. Reg. § 1.901-2(a)(2).

[43] Treas. Reg. § 1.901-2(b)(1).

[44] Treas. Reg. § 1.901-2(b)(2).

amount that is not greater than the fair market value of gross receipts (the "**gross receipts requirement**");[45] and

(3) the base of the tax is computed by reducing gross receipts in a manner that permits either (a) recovery of the significant costs and expenses attributable, under reasonable principles, to such gross receipts, or (b) recovery of such costs and expenses computed using a method that is likely to produce an amount that approximates, or is greater than, recovery of such costs and expenses (the "**cost recovery requirement**").[46]

Section 903 provides that, for purposes of the FTC regime and Sections 164(a) and 275(a), the term "income, war profits, and excess profits taxes" includes a tax paid "in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States" ("**in lieu of taxes**"). The existing regulation under Section 903 provides that, for a foreign tax to qualify as an in lieu of tax, the tax must be imposed in substitution for, rather than in addition to, a country's generally applicable income tax (the "**substitution requirement**").[47] A creditable in lieu of tax can be imposed on a base that is not net income, such as gross income, gross receipts or sales, or the number of units produced or exported.[48] In addition, it is permissible for the same taxpayer both to pay a generally applicable income tax with respect to certain of its activities and the in lieu of tax with respect to other activities.[49]

The foregoing rules have been relatively stable since their promulgation in 1983.[50] The 2020 Proposed Regulations maintain, for purposes of determining the creditability of a net income tax, the net gain requirement, including the realization requirement, gross receipts requirement, and cost recovery requirement, but with certain significant revisions

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45 Treas. Reg. § 1.901-2(b)(3).

46 Treas. Reg. § 1.901-2(b)(4). This requirement is known as the "net income requirement" in the existing regulations, but the "cost recovery requirement" under the 2020 Proposed Regulations. For purposes of consistency, this Report adopts the term used in the 2020 Proposed Regulations.

47 *See* Treas. Reg. § 1.903-1(b)(1).

48 *See* Treas. Reg. § 1.903-1(a) (flush language).

49 *See* Treas. Reg. § 1.903-1(b)(1).

50 *See* TD 7918, 48 Fed. Reg. 46272.

to each. The 2020 Proposed Regulations also maintain the substitution requirement for in lieu of taxes, though again with significant revisions. However, the 2020 Proposed Regulations also introduce a new requirement that applies with respect to both net income taxes under Section 901 and in lieu of taxes under Section 903, under which a foreign levy would not be creditable unless it requires "a sufficient nexus between the foreign country and the taxpayer's activities or investment of capital or other assets that give rise to the income being taxed" (the "**jurisdictional nexus requirement**").[51] For net income taxes, the jurisdictional nexus requirement is separate from, and in addition to, the net gain requirement. For in lieu of taxes, it represents an additional requirement within the substitution requirement.

The proposed changes to the regulations under Sections 901 and 903, including the addition of the jurisdictional nexus requirement, differ from most of the other proposed changes to the 2020 Proposed Regulations in that they are generally not precipitated by statutory changes enacted as a part of the TCJA. The revisions to the net gain requirement and the substitution requirement and the addition of the jurisdictional nexus requirement are discussed in more detail in Part IV.A.2 of this Report.

2. Discussion

a) Jurisdictional Nexus Requirement

i. In General

To determine whether a foreign levy satisfies the jurisdictional nexus requirement for a net income tax, different standards apply to levies imposed on income of residents and levies imposed on income of nonresidents. In the case of a foreign levy imposed on residents, arm's length transfer pricing principles must apply to determine the resident's income, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.[52] In the case of a foreign levy imposed on nonresidents, the levy is considered to satisfy the jurisdictional nexus requirement if one of the following three conditions is satisfied—

> (1) the levy is imposed on income that is attributable, under reasonable principles, to the nonresident's activities within the taxing jurisdiction (including functions, assets, and risks) and does not take into account as a

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[51] Preamble to the 2020 Proposed Regulations (**"Preamble"**), 85 Fed. Reg. at 72088.

[52] 2020 Prop. Treas. Reg. § 1.901-2(c)(2).

significant factor the location of customers, users, or any other similar destination-based criterion ("**activity-based nexus**");[53]

(2) the levy is imposed on income that is sourced to the jurisdiction under sourcing rules that are "reasonably similar" to U.S. federal income tax law sourcing rules ("**source-based nexus**");[54] or

(3) for income attributable to gains from property dispositions, the levy is imposed only on gains that are attributable to the disposition of real property situated in the jurisdiction or other property that is part of a business with a taxable presence in the country (including interests in a company or other entity to the extent attributable to such real property or business property) ("**property-based nexus**").[55]

As discussed in more detail in Part IV.A.2.c of this Report, the jurisdictional nexus requirement is also incorporated by cross-reference into the substitution requirement for in lieu of taxes.[56] In the case of certain in lieu of taxes that are withholding taxes, the 2020 Proposed Regulations require satisfaction of the standard for source-based nexus to qualify.[57]

ii. Policy

The Preamble acknowledges that existing regulations do not contain a jurisdictional nexus requirement, but indicates that "prior regulations under section 901 did contain jurisdictional limitations on the definition of an income tax."[58] However, the prior regulations referenced in the Preamble did not require specific rules similar to U.S.

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53 2020 Prop. Treas. Reg. § 1.901-2(c)(1)(i).

54 2020 Prop. Treas. Reg. § 1.901-2(c)(1)(ii).

55 2020 Prop. Treas. Reg. § 1.901-2(c)(1)(iii).

56 *See* 2020 Prop. Treas. Reg. § 1.903-1(b)(2)(ii), (c)(1), and (c)(1)(iv).

57 *See* 2020 Prop. Treas. Reg. § 1.903-1(b)(2)(ii), (c)(1), and (c)(2)(iii).

58 Preamble, 85 Fed. Reg. at 72088.

federal income tax law rules, but simply required "reasonable" rules concerning sourcing.[59]

In the Preamble, Treasury and the IRS state that the proposed addition of the jurisdictional nexus requirement is in response to the enactment of a "variety of novel extraterritorial taxes that diverge…from traditional norms" by foreign jurisdictions.[60] According to the Preamble, these "novel" taxes include diverted profits taxes (such as the tax imposed by the United Kingdom), digital services taxes (such as the levies imposed by France and Italy), and equalization levies (such as the Indian equalization levy).[61] In addition, the Organisation for Economic Co-operation and Development ("**OECD**") is currently attempting to forge a new international consensus to confer upon market jurisdictions the right to tax a greater share of the residual profit of multi-national enterprises ("**MNEs**") arising from the transmission of digital services to customers in their jurisdictions ("**OECD Pillar One**").[62] Such digital "nexus" would not be considered to represent a permanent establishment under traditional tax treaty definitions.

We appreciate the government's concern regarding the recent proliferation of extraterritorial taxes and view the proposed jurisdictional nexus requirement as a means for discouraging the maintenance, and continued adoption, of such unilateral measures by U.S. trading partners. In addition, the jurisdictional nexus requirement may reasonably be viewed as consistent with the underlying principles and purposes of the FTC regime. As discussed in Part III.A of this Report, the FTC regime is intended to prevent double taxation with respect to income earned, directly or indirectly, by a domestic corporation in foreign jurisdictions, which double taxation, unrelieved, could discourage foreign investment by U.S. businesses. In contrast, the allowance of an FTC for a foreign income

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59 *Id.* (citing "Treas. Reg. § 4.901-2 (a)(1)(iii) (1980) (requiring that a foreign tax follow 'reasonable rules regarding source of income, residence, or other bases for tax jurisdiction'"). It should be noted, in that regard, that a number of U.S. state and local taxes are imposed on the basis of the location of customers, which might suggest that if U.S. taxes are the barometer of reasonability, the extraterritorial taxes targeted by the 2020 Proposed Regulations could be considered reasonable.

60 *Id.*

61 Preamble, 85 Fed. Reg. at 72089.

62 *See* OECD, Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint (October 14, 2020). The aims of OECD Pillar One could be considered consistent with recent "economic nexus" laws of U.S. states, and the U.S. Supreme Court's endorsement thereof in *South Dakota v. Wayfair*, 138 S. Ct. 2080 (2018), which authorize states to tax sales to in-state customers by "remote sellers" that lack a physical presence in the state.

tax levied on income that does not have a significant connection to the foreign jurisdiction taxing such income, particularly U.S.-source income, could effectively convert the FTC regime into a means of subsidizing foreign jurisdictions at the expense of the U.S. fisc. However, it can also be argued that Congress intended Section 904, rather than the concept of an "income tax" in Section 901, to be the sole mechanism for preventing this abuse of the FTC regime. Moreover, in the case of foreign-source income, but for which one foreign jurisdiction taxes income that the United States views as attributable to another jurisdiction, the failure to provide a credit will result in double taxation in the United States with respect to such income and potentially a corresponding decrease in foreign investment.

Regardless of whether the proposed jurisdictional nexus requirement is appropriate as a policy matter, the proposal represents a significant departure from existing law and thus its adoption would have significant ramifications for U.S. taxpayers. Under the 2020 Proposed Regulations, a foreign levy may satisfy source-based nexus only if the sourcing rules of the foreign tax law are "reasonably similar" to the sourcing rules that apply for U.S. federal income tax purposes.[63] In the Preamble, Treasury and the IRS equate the sourcing rules contained in the Code with "international income tax norms."[64] However, the income tax laws of many U.S. trading partners do not conform to the structure of U.S. income tax laws. For instance, a payment that under U.S. tax law is characterized as a payment for services may be treated under foreign tax law as a royalty. Under existing regulations, non-conformity to U.S. tax principles would not render a levy imposed by such foreign country non-creditable if the "predominant character" of the foreign levy were that of an income tax.[65] Under the 2020 Proposed Regulations, it appears that the different treatment of the income item could render the foreign levy non-creditable, without regard to predominant character.

The conformity principle underlying the jurisdictional nexus requirement also suggests that foreign income tax laws must rely on traditional arm's length pricing as understood in the United States, including U.S. functional analysis standards based on activities, capital, and risks. The Preamble states that if a foreign jurisdiction allocates profits based upon the location of customers or similar destination-based criterion or allocates profits on a formulary basis through the use of fixed margins, its methodology

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63 *See* 2020 Prop. Treas. Reg. § 1.901-2(c)(1)(ii).

64 Preamble, 85 Fed. Reg. at 72109.

65 *See* Treas. Reg. § 1.901-2(a)(1)(ii).

will not be considered consistent with conventional standards.[66] While the insertion of a jurisdictional nexus requirement is reasonable in the abstract, establishing fixed definitional requirements with respect to concepts such as permanent establishment or engagement in a U.S. trade or business may be inconsistent with the developing business models of the future and perhaps contrary to the U.S. goals of fairness and appropriate tax collection. Moreover, such a prescriptive approach regarding the allocation of profits may result in the non-creditability of a foreign income tax, even when much, or even most, of the income subject to the tax is in fact allocated in a manner consistent with such principles. For instance, if a country imposes a generally-imposed net income tax on its residents that in certain instances could apply to income that would be allocated to an entity outside its jurisdiction to tax under traditional arm's length principles, the jurisdictional nexus requirement might render such tax non-creditable with respect to all resident taxpayers, even for taxpayers to whom income subject to the tax is allocated in a manner consistent with arm's length principles.

The Preamble indicates that the jurisdictional nexus requirement in the 2020 Proposed Regulations may have to be changed "[i]f an agreement [at the OECD] is reached that includes the United States."[67] The Preamble also states that the 2020 Proposed Regulations are not intended to affect the application of the existing regulations to existing extraterritorial taxes.[68] Furthermore, it indicates that the 2020 Proposed Regulations "would not affect the application of existing income tax treaties … with respect to covered taxes … creditable under the treaty."[69]

We believe that the jurisdictional nexus requirements articulated in the 2020 Proposed Regulations represent a reasonable beginning of a necessary conversation regarding the creditability of foreign income taxes in light of the recent proliferation of novel extraterritorial taxes and the OECD's work around the taxation of the digital economy. However, we recommend that Treasury and the IRS hive off this portion of the 2020 Proposed Regulations into a separate proposal with an extended comment period. This recommendation would permit the proposal to be developed with a view toward the ongoing work at the OECD and any new international consensus that may emerge from such work. In addition, an extended comment period would provide Treasury and the IRS

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[66] Preamble, 85 Fed. Reg. at 72088.

[67] Preamble, 85 Fed. Reg. at 72089.

[68] *Id.*

[69] *Id*.

additional time to consider more fully the consequences of the proposed changes,[70] including how and whether such changes would affect the current treaty obligations of the United States.

iii. Gain Sourcing Rules

In addition to raising the foregoing policy considerations relating to the jurisdictional nexus requirement, the sourcing rule requirements contained in the 2020 Proposed Regulations would potentially render uncreditable certain common and well-established foreign income taxes that do not implicate the same concerns as the "novel extraterritorial taxes" identified in the Preamble.[71] In particular, an increasing number of jurisdictions impose taxes on the gain from the sale of shares of corporations that are resident in the jurisdiction, without regard to whether the shares constitute a real property interest or are attributable to a trade or business in the jurisdiction. These regimes would not appear to satisfy any of the prongs of the jurisdictional nexus requirement.

It appears that the standard for property-based nexus is intended to apply to a foreign levy similar to Section 864(c)(8) or the FIRPTA regime under Section 897.[72]

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[70] The time could also be used to develop a list of taxes that would *per se* be considered creditable or not creditable under the rules, which list would not only aid the IRS in examination but could be included in the regulations for improved taxpayer certainty and thus administrability.

[71] We understand that this may be of concern to Treasury and the IRS, given the specific request for comments "on the extent to which the new jurisdictional nexus requirement may impact the treatment of other types of foreign taxes." Preamble, 85 Fed. Reg. at 72089.

[72] However, there is a concern that a foreign levy similar to the FIRPTA regime may not actually satisfy the jurisdictional nexus requirement of the 2020 Proposed Regulations. As discussed in Part IV.A.2.a.i of this Report, a foreign levy may satisfy the property-based nexus standard if it taxes gain on the disposition of "interests in a company or other entity to the extent attributable to [in-country] real property or business property." In the case of FIRPTA, the gain from the sale by a nonresident of shares of a U.S. corporation is treated as U.S. effectively connected income if more than 50% of the U.S. corporation's assets are U.S. real property interests (*i.e.*, the U.S. corporation is a "**U.S. real property holding corporation**" or "**USRPHC**"). *See* Section 897(a) and (c). Because a USRPHC can have significant assets that are not U.S. real property interests, the recognized gain on the disposition of the shares of a USRPHC may not correspond to the unrealized gain with respect to the U.S. real property interests, and thus gain subject to FIRPTA is not necessarily "attributable to" the U.S. real property interests owned by a USRPHC. Thus, it appears that a foreign levy that is identical to the FIRPTA regime would be non-creditable by reason of the jurisdictional nexus requirement, contrary to the assumption underpinning most of the 2020 Proposed Regulations that a foreign tax consistent with U.S. federal income tax principles ought to be creditable. On the other hand, the standard for property-

However, by limiting creditability to such foreign levies, the proposed regulations would prevent long-standing direct and indirect capital gains taxes from being creditable under either Section 901 or Section 903. This significant consequence, unaddressed by Treasury and the IRS in the Preamble, is particularly surprising as it relates to foreign taxation of gains expressly sanctioned by double tax treaties[73] (which also contemplate the availability of a corresponding FTC)[74] and raises questions about regulatory treaty override. Although, as noted in Part IV.A.2.a.ii of this Report, the Preamble indicates that no effect on treaty application is intended, it is unclear how double tax treaties, which often provide that the FTC provided for is subject to U.S. tax law, would be interpreted in light of the unequivocal regulatory text. Even if double tax treaties could generally be understood to ensure creditability of capital gains taxes imposed on transfers of foreign corporation stock by U.S. persons notwithstanding the property-based nexus rule, if a capital gains tax were incurred by an upper-tier CFC on the direct or indirect disposition of a lower-tier CFC, it would not appear that the U.S. shareholder of the upper-tier CFC could rely on the double tax treaty between the United States and the jurisdiction of the lower-tier CFC in order to credit the resulting tax under Section 960.

We recommend that the jurisdictional nexus sourcing rules for gains be modified to continue to treat as creditable historically imposed taxes on gains from the disposition of stock of a corporation sourced on the basis of residence of the corporation. Moreover, we recommend that if the gain-related sourcing rules for purposes of the jurisdictional requirement are finalized in their proposed narrow form, Treasury and the IRS address their interaction with double tax treaties.

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based nexus would apparently permit taxation of gains on disposition of stock of a corporation not resident in the taxing jurisdiction to the extent attributable to real property in the jurisdiction, which is broader than FIRPTA would reach, given its limitation to transfers of domestic corporation stock. Therefore, property-based nexus seems to encompass foreign levies that are both broader and narrower than the FIRPTA regime with respect to the taxation of gain from the disposition of an interest in a real property holding company. Treasury and the IRS should clarify whether it intends to prevent a foreign levy similar to the FIRPTA regime from satisfying property-based nexus or otherwise revise the standard to more closely align with the FIRPTA regime.

[73] *See, e.g.,* Article 12, Paragraph 6, of the Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, signed on April 30, 1984 (the "**U.S.-China Treaty**").

[74] *See, e.g.,* Article 22, Paragraphs 2 and 3 of the U.S.-China Treaty; *see also* the discussion of Article 12 in the Technical Explanation of the U.S.-China Treaty (January 1, 1987).

b) Net Gain Requirement

As discussed in Part IV.A.1 of this Report, under the existing regulations, a foreign tax satisfies the net gain requirement if it "is likely to reach net gain in the normal circumstances in which it applies," which means that it satisfies each of the realization requirement, gross receipts requirement, and cost recovery requirement "judged on the basis of its predominant character."[75] Indeed, this "predominant character" qualifier applies, not only to the net gain requirement in general, but separately to each of the requirements to the net gain requirement.[76] As Treasury and the IRS acknowledge in the Preamble, the existing regulations mandate an empirical analysis to determine whether a foreign levy is an income tax in the U.S. sense.

In contrast to the existing regulations, under the modifications proposed in the 2020 Proposed Regulations, the creditability of a tax would generally be determined based on the four corners of the foreign income tax law, without regard to an empirical analysis of the effect of the tax under "normal circumstances."[77] In particular, for purposes of the gross receipts test, the 2020 Proposed Regulations would eliminate the allowance for an income computation method "likely" to produce an amount not greater than gross receipts.[78]

The existing regulations provide that the cost recovery requirement is satisfied if the tax permits recovery of "significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles" to the income subject to the tax.[79] In addition, a foreign levy whose base is gross receipts or gross income is treated as satisfying the cost recovery requirement if it is "almost certain" to reach net gain under

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[75] Treas. Reg. § 1.901-2(a)(3)(i) and (b)(1).

[76] *See* Treas. Reg. § 1.901-2(b)(2)(i), (3)(i), and (4)(i).

[77] The 2020 Proposed Regulations would not eliminate all empirical analysis for purposes of the net gain requirement. In particular, for purposes of the realization requirement, the 2020 Proposed Regulations would allow a tax imposed in connection with certain nonrealization events to nevertheless be treated as satisfying the realization requirement if "judged based on the application" of the tax, the amount attributable to nonrealization events is "insignificant" relative to income that does meet the realization requirement. 2020 Prop. Treas. Reg. § 1.901-2(b)(2)(i).

[78] *Compare* Treas. Reg. § 1.901-2(b)(3)(i)(B) and 2020 Prop. Treas. Reg. § 1.901-2(b)(3)(i).

[79] Treas. Reg. § 1.901-2(b)(4)(i)(A).

normal circumstances (the "**nonconfiscatory gross basis tax rule**").[80] The 2020 Proposed Regulations would eliminate the nonconfiscatory gross basis tax rule and specify certain deductions and costs that must be allowed. Specifically, the 2020 Proposed Regulations would require that the foreign income tax allow deductions for capital expenditures, interest, rents, royalties, services, and R&E expenditures.[81] A foreign levy that does not permit recovery of one or more of these significant costs or expenses does not meet the cost recovery requirement, "even if it provides alternative allowances that in practice equal or exceed the amount of non-recovered costs or expenses."[82] However, the 2020 Proposed Regulations provide that a partial or full disallowance of one of the enumerated expenses will not disqualify the tax "if such disallowance is consistent with the types of disallowances required under the Internal Revenue Code."[83] The regulations provide, as examples, limitations on expenses similar to those provided under Sections 162, 163(j), and 267A.[84]

As modified, these rules, like the jurisdictional nexus requirement, require conformity with U.S. federal income tax standards relating to realization and cost recovery. The concepts are clearly foundational to the U.S. tax law but their application under the laws of other jurisdictions may be adjusted in ways that are reasonably interpreted to reach "net gain" without necessarily conforming to U.S. federal income tax law, a fact which is acknowledged in the existing regulations but not in the 2020 Proposed Regulations. In addition, while the 2020 Proposed Regulations provide that the cost recovery allowances of the foreign levy must be "consistent" with U.S. federal income tax law, they do not otherwise provide guidance on how closely the foreign income tax rules must conform to U.S. federal income tax principles. Accordingly, this requirement is likely to introduce significant uncertainty for taxpayers in assessing whether a foreign levy makes a sufficient allowance for a cost or expense identified in the 2020 Proposed Regulations. In particular, there may be instances in which the disallowance of a deduction that is not similar to the disallowances provided for U.S. federal income tax

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80 Treas. Reg. § 1.901-2(b)(4)(1)(B). This would be the case if the "costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain." *Id*.

81 2020 Prop. Treas. Reg. § 1.901-2(b)(4)(i)(B)(2).

82 *Id.*

83 *Id.*

84 *Id.*

purposes may nonetheless be necessitated by sound tax policy and not inconsistent with an income tax in the U.S. sense. For instance, if a foreign tax law allows full expensing of capital expenditures, an additional allowance for interest expense would be duplicative in the case of debt-financed investments and potentially result in a negative tax rate. It is unclear whether a disallowance of interest expense in such circumstances would run afoul of the cost recovery requirement under the 2020 Proposed Regulations, because, as a provision necessitated by tax policy, it may not be deemed consistent with the disallowances in Section 162, which are generally based on social policy, rather than tax policy.

It is also unclear whether the disallowance of deductions pursuant to an alternative minimum tax like the tax historically imposed on corporations under Section 55 (**"AMT"**) or the base erosion and anti-avoidance tax (**"BEAT"**) currently imposed under Section 59A, would be deemed consistent with U.S. federal income tax principles for this purpose. Each of the examples provided in the 2020 Proposed Regulations involves a targeted disallowance of a particular deduction (*e.g.*, interest and royalties) as opposed to the wholesale disallowance of categories of deductions (*e.g.*, expenses for related party payments) pursuant to a regime expressly intended not to reach net gain.

We do not believe that the bright-line rule regarding "significant" costs and expenses for purposes of the cost recovery requirement provides any more certainty for taxpayers or the IRS than the "reasonable principles" approach of the existing regulations. It merely shifts the controversy from whether the disallowance or limitation of an expense is "reasonable" to whether it is, in some nebulous way, "consistent" with other provisions in the Code. It also does not eliminate uncertainty as to whether any expense that is not specifically identified would be significant. Moreover, the prohibition against a foreign levy that provides "alternative allowances" that achieve the same result as one or more of the enumerated significant deductions is unnecessarily restrictive. Indeed, the focus on the "four corners" of law may only make it easier for foreign jurisdictions to create levies that, in form, satisfy the cost recovery requirement, but which would not satisfy the requirement under a more principles-based approach. Accordingly, we recommend that the empirical approach of the cost recovery requirement under the existing regulations be retained and that the final regulations not include a specific list of "significant costs or expenses." If, however, Treasury and the IRS determine that the approach of the 2020 Proposed Regulations to the cost recovery requirement is necessary to prevent the creditability of certain taxes that might be considered to satisfy the requirements of the existing regulations, the final regulations should include additional examples of permissible disallowances, including those pursuant to alternative minimum tax regimes as well as those that are not similar to specific U.S. federal income tax rules, that would and would not be considered "consistent" with U.S. federal income tax principles.[85]

c) Substitution Requirement

As discussed in Part IV.A.2.b of this Report, the 2020 Proposed Regulations would modify the net gain requirement of the existing regulations to narrow its focus to the "four corners" of the foreign levy. In contrast, in determining the credibility of an in lieu of tax, the 2020 Proposed Regulations would expand the "facts and circumstances" analysis for the substitution requirement. Under the 2020 Proposed Regulations, a foreign tax (a "**tested foreign tax**") qualifies as an in lieu of tax if it satisfies four requirements—

1. A separate levy that is a net income tax is generally imposed by the same foreign country (the "**generally-imposed net income tax**" or "**GINIT**") that imposes the tested foreign tax (the "**GINIT requirement**").[86]

2. Neither the GINIT nor any other separate levy that is a net income tax is also imposed, in addition to the tested foreign tax, by the same foreign country on any persons with respect to any portion of the income to which the amounts (such as sales or units of production) that form the base of the tested foreign tax relate (the "**excluded income**" and the "**non-duplication requirement**").[87]

3. The imposition of the tested foreign tax bears a close connection to the failure to impose the GINIT on the excluded income. (the "**close connection requirement**").[88]

4. If the GINIT were applied to the excluded income, the GINIT would either continue to qualify as a net income tax or would constitute a separate levy

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85 Consistent with the suggestion in footnote 70, Treasury and the IRS could also consider issuing a list of taxes that would *per se* be considered to satisfy the cost recovery requirement and those that would not.

86 2020 Prop. Treas. Reg. § 1.903-1(c)(1)(i).

87 2020 Prop. Treas. Reg. § 1.903-1(c)(1)(ii).

88 2020 Prop. Treas. Reg. § 1.903-1(c)(1)(iii).

from the GINIT that would itself be a net income tax (the "**jurisdiction to tax requirement**").[89]

The first two requirements in the 2020 Proposed Regulations – the GINIT requirement and the non-duplication requirement – are consistent with existing regulations, whereas the last two requirements – the close connection requirement and the jurisdiction to tax requirement – are new.

The close connection requirement compels taxpayers to prove that, but for the tested foreign tax, the foreign country would have imposed its GINIT with respect to the excluded income. Moreover, this is to be proven through an investigation into the motivation of a foreign legislative body. Specifically, to establish the requisite close connection, it is necessary that the GINIT would apply by its terms to the excluded income, but for the fact that the excluded income is expressly excluded from imposition of the GINIT, or proof (in the form of the foreign tax law itself or legislative history) must be adduced that the foreign country "made a cognizant and deliberate choice" to impose the tested foreign tax instead of the GINIT.[90]

Although in some cases it may be possible to obtain the proof required in the 2020 Proposed Regulations, we do not believe that the creditability of a foreign tax should depend on the explicitness with which a foreign jurisdiction links such tax with the non-application of the GINIT in its statutory text or on the comprehensiveness of such jurisdictions' legislative histories and taxpayers' translation and review thereof. To the contrary, as indicated in the case law cited in the Preamble, not only is evidence of a close connection not necessary,[91] such a connection itself ought not be necessary.[92] These authorities support the view that "in lieu of" in Section 903 does not connote a purpose on the part of the legislative body that enacted the tax, but rather merely that the

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89 2020 Prop. Treas. Reg. § 1.903-1(c)(1)(iv). Special requirements are provided for certain withholding taxes ("**covered withholding taxes**") that constitute a withholding tax (as defined in Section 901(k)(1)(B)) imposed on gross income of nonresidents. *See* 2020 Prop. Treas. Reg. § 1.903-1(c)(2).

90 *Id.*

91 *See Metro. Life Ins. Co,* 375 F.2d 835, 839 (Ct. Cl. 1967) (concluding that the foreign jurisdiction had intended a link between the GINIT and the lieu of tax "without saying so explicitly in the legislation").

92 *See id.* at 838-839 ("There need be no functional connection between the foreign income tax and the 'in lieu' tax.... Congress seems to us to have recognized that taxing jurisdictions, exempting a type of business from the ordinary income tax, often substitute a wholly separate tax grounded in another theory and yielding a different amount.")

base of that tax is not also subject to a GINIT, without regard to any intention. We believe that the non-duplication requirement is sufficient to ensure that a tested foreign tax does not duplicate the tax base of a GINIT. Accordingly, we recommend that final regulations not include the close connection requirement.

The jurisdiction to tax requirement requires an analysis, the contours of which are even less clear. For purposes of the jurisdiction to tax requirement, the taxpayer is instructed to hypothesize that the base of the tested foreign tax is instead subject to the GINIT, and then determine whether that GINIT would still qualify as a net income tax described in 2020 Prop. Treas. Reg. § 1.901-2(a)(3).[93] Although the Preamble description of this requirement describes the jurisdiction to tax requirement as simply incorporating the jurisdictional nexus requirement, 2020 Prop. Treas. Reg. § 1.901-2(a)(3) includes both the jurisdictional nexus requirement and the net gain requirement.[94] It is relatively clear how the jurisdictional nexus requirement might apply in the context of a tested foreign tax – determine whether the income, assets, or activity that comprise the base of the tax would have a sufficient nexus with the foreign jurisdiction imposing the tax. But it is not at all clear how one would determine whether such hypothetical tax would reach net gain. In particular, if the GINIT were already a qualifying net income tax under the 2020 Proposed Regulations, one would assume that, if such GINIT applied to the same base as the tested foreign tax, the GINIT would permit, for example, sufficient cost recovery related to that income. However, an incorporation of the net gain requirement under this interpretation serves no purpose, since in all cases a taxpayer can hypothesize that the net gain requirement would be satisfied.

For the foregoing reasons, we recommend that the cross-reference in the jurisdiction to tax requirement be changed to 2020 Prop. Treas. Reg. § 1.901-2(c), so that only the jurisdictional nexus requirement is incorporated. If the cross-reference to 2020 Prop. Treas. Reg. § 1.901-2(a)(3) is not changed, because it is intended to require analysis other than a determination of whether a tested foreign tax satisfies the jurisdictional nexus requirement, the final regulations should elaborate on the analysis required.

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[93] 2020 Prop. Treas. Reg. § 1.903-1(c)(1)(iv).

[94] In contrast, in the analogous requirement for covered withholding taxes, the 2020 Proposed Regulations cross-reference 2020 Prop. Treas. Reg. § 1.901-2(c)(1)(ii), which refers to the jurisdictional nexus requirement, and specifically source-based nexus. 2020 Prop. Treas. Reg. § 1.903-1(c)(2)(iii).

d) Separate Levy Determination

Whether a foreign levy is a creditable income tax (including an in lieu of tax) is determined independently for each separate levy.[95] The 2020 Proposed Regulations propose modifications to the rules for determining whether a tax constitutes a separate levy for this purpose.[96] Although the 2020 Proposed Regulations contain an extensive provision concerning the identification of a separate levy in the case of different taxable bases,[97] it is generally more illustrative and permissive than prescriptive. Although it indicates that "[a] taxable base of a separate levy **may** consist of a particular type of income,"[98] nothing therein clearly addresses the treatment of tax imposed on a distribution that is in part a dividend and in part treated as giving rise to capital gain nor suggests that a tax generally imposed on all income from such a distribution would necessarily be bifurcated. Nevertheless, the 2020 Final Regulations include an example stating as a fact that the tax imposed on the dividend amount is a separate levy from the tax imposed on the capital gain amount of the distribution.[99] Without further detail, it is unclear whether the separate levy determination is made on the basis of the fact that different tax rates apparently apply to the two amounts, simply by reason of the amounts constituting two different types of income, or for some other reason. If Treasury and the IRS believe that the example reflects the appropriate policy determination, we recommend that final regulations expand upon both the separate levy rules and the example to clarify the analysis that leads to such conclusion and more fully elaborate upon the policy considerations underlying the separate levy rules in order to improve certainty concerning their application.

The separate levy determination could also be of critical importance in determining the creditability of taxes imposed under a system that imposes an incremental alternative minimum tax, like the AMT or BEAT, to the extent that it exceeds a regular tax that alone would satisfy the requirements to constitute a creditable net income tax. If it is determined that the alternative minimum tax does not constitute a foreign income tax creditable under

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[95] Treas. Reg. § 1.901-2(a)(1); Prop. Treas. Reg. §§ 1.901-2(a)(1)(i) and (d)(1) and 1.903-1(b)(1).

[96] *See* 2020 Prop. Treas. Reg. § 1.901-2(d)(1).

[97] *See* 2020 Prop. Treas. Reg. § 1.901-2(d)(1)(ii).

[98] *Id.* (emphasis added).

[99] *See* Treas. Reg. § 1.861-20(g)(5).

Section 901 or Section 903,[100] creditability of the net income tax could depend on whether the two amounts are considered separate levies.[101] Given the possible development of minimum taxes in light of the precedent set by the United States' enactment of the BEAT, Treasury and the IRS should give further consideration to the application of the separate levy rules to minimum tax regimes in order to ensure that they do not prevent creditability of amounts that would otherwise be treated as foreign income taxes.

e) Determination of Amount of Tax Paid

A payment to a foreign country is not treated as an amount of tax paid to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, or forgiven.[102] The 2020 Proposed Regulations would eliminate "credited" from that list, providing instead that an amount of foreign income tax paid is not reduced (or treated as refunded) solely by reason of the fact that the amount paid is allowed as a credit to reduce the amount of a different tax owed by the taxpayer.[103] The 2020 Proposed Regulations further provide that a tax is not paid if it is satisfied through the application of a tax credit, even if that credit is potentially refundable in cash to the extent it exceeds the taxpayer's liability for a foreign income tax (*i.e.*, a **"refundable credit"**).[104] Thus, under the 2020 Proposed Regulations, if a taxpayer's payment of a foreign tax liability under one levy gives rise to a credit that the taxpayer uses to reduce a foreign tax liability under a second

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[100] *See, supra*, discussion in Part IV.A.2.b of this Report. An incremental alternative minimum tax, such as the AMT or BEAT, if not a net income tax under Section 901, would presumably not be creditable under Section 903 because of its failure to satisfy the non-duplication requirement given that the incremental tax and the net income tax would apply to the same base.

[101] If instead of being constructed under the foreign jurisdiction's laws as an incremental tax, a noncreditable minimum tax were constructed as an alternative tax that applied instead of the regular tax if higher, no amount of the minimum tax would be creditable under current law. *See* Treas. Reg. § 1.901-2(e)(4)(i) (providing that if the amount of a taxpayer's liability is the greater of amounts computed pursuant to two levies, then the entire amount paid to the foreign country is considered paid pursuant to the levy that imposes such greater amount).

[102] Treas. Reg. § 1.901-2(e)(2)(i).

[103] 2020 Prop. Treas. Reg. § 1.901-2(e)(2)(i) and (iii). The 2020 Proposed Regulations further suggest that it is not reasonably certain that an amount will be refunded, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of the final tax liability to the foreign country. 2020 Prop. Treas. Reg. § 1.901-2(e)(2)(i). Further, an overpayment of a taxpayer's foreign income tax liability that gives rise to a credit that is refundable in cash at the taxpayer's option is not an amount of tax paid. 2020 Prop. Treas. Reg. § 1.901-2(e)(2)(iii).

[104] 2020 Prop. Treas. Reg. § 1.901-2(e)(2)(ii).

levy, the first levy will be treated as paid, and the amount of the second levy treated as paid will be reduced by the credit, regardless of whether any excess of the first levy over the second is refundable in cash.

Current law is unclear as to whether a foreign income tax liability offset by a credit that is computed by reference to amounts other than foreign tax payments (*e.g.*, investment credits) (a "**non-tax credit**") should nonetheless be treated as "paid" for purposes of the FTC regime. An example in the existing regulations concludes that a foreign income tax liability satisfied with a non-tax credit is not paid, but rather is "reduced" by such credit to reflect the taxpayer's "final tax liability."[105] However, the example does not indicate whether the credits at issue are refundable, and the existing regulations are otherwise silent regarding the treatment of credits that offset a foreign income tax liability. Further, as the Preamble to the 2020 Proposed Regulations acknowledges, in determining whether a tax liability offset by a credit is "paid" or, alternatively, "reduced," sub-regulatory guidance has drawn a distinction between refundable credits and nonrefundable credits.[106] The offset of a foreign income tax with a nonrefundable credit has been treated as a reduction in the taxpayer's foreign income tax liability, thus reducing the amount of foreign income taxes paid.[107] In contrast, the offset of a foreign income tax with a refundable credit has been treated as a constructive receipt of cash by the taxpayer from the foreign country in the amount of the refundable credit, followed by a constructive payment by the taxpayer of the foreign income tax, with the result that the foreign income tax offset by the refundable credit is treated as paid.[108]

The 2020 Proposed Regulations would conform the treatment of refundable credits with that of nonrefundable credits, in both cases treating the foreign income tax liability offset by a non-tax credit as reduced by such credit. Treasury and the IRS justify this on the grounds that it may be difficult to ascertain whether purportedly refundable credits are actually refunded in practice.[109] Treasury and the IRS also express concern that foreign countries may design systems that have the same economic effect as reducing tax rates

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105 *See* Treas. Reg. § 1.901-2(e)(2)(ii), Example 2.

106 *See* Preamble, 85 Fed. Reg. at 72093; Rev. Rul. 86-134, 1986–2 C.B. 104. *See also* GCM 39617 (Aug. 27, 1986); TAM 200146001 (Apr. 2, 2001).

107 *Id.*

108 *Id.*

109 Preamble, 85 Fed. Reg. at 72093.

without reducing the amount of tax that is treated as paid for FTC purposes.[110] Consistent with that concern, comments are requested as to the appropriate treatment of government grants that are not administered through the tax system, including the circumstances in which such grants should be treated as a reduction in the amount of tax paid.[111]

We appreciate that the proposed rule would increase certainty concerning the treatment of non-tax credits. Moreover, some of our members agree that it is appropriate to treat non-tax credits that are refundable only to the extent that they exceed a taxpayer's foreign income tax liability consistently with nonrefundable credits.[112] Such treatment may be considered appropriate because, to the extent a partially refundable credit of a taxpayer does not exceed the taxpayer's foreign income tax liability, the liability is reduced in the same dollar-for-dollar manner by the refundable credit as by a nonrefundable credit, and so the amount of the liability treated as paid for purposes of the FTC regime should not depend upon the refundability of the excess.

However, some of our members disagree and instead believe that refundable credits should be treated in the same manner as cash disbursements by the government outside of its tax system.[113] Refundable credits are generally designed to provide incentives for activity, such as investment or R&E activity, that is unrelated to taxes, and such credits are administered through the tax system merely for administrative convenience. Furthermore, in contrast to a nonrefundable credit, a refundable credit represents to its holder a property right, and a commensurate liability of the foreign government, with a value that is wholly independent of the holder's current and future foreign income tax liability. Therefore, these members believe a foreign income tax liability of the taxpayer offset by a refundable credit should be treated as "paid" in the same manner as if the taxpayer had used cash to pay the foreign income tax (the "**cash-equivalent approach**"). To be consistent, a taxpayer that treats a foreign income tax liability as paid to the extent offset by refundable credits should include the full amount of

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110 *Id.*

111 *Id*.

112 Note that such refundable credits are distinguishable from those that can be refunded in full regardless of the taxpayer's foreign income tax liability, although the 2020 Proposed Regulations do not distinguish between the two.

113 For the avoidance of doubt, our recommendation is related to the treatment of a foreign income tax liability offset by a non-tax credit, not the treatment of a foreign income tax that is reasonably certain to be refunded, which both the existing regulations and the 2020 Proposed Regulations treat as not paid. *See* Treas. Reg. § 1.901-2(e)(2)(i) and 2020 Prop. Treas. Reg. § 1.901-2(e)(2)(i).

such credits (not just the portion that is refunded) in its gross income for U.S. federal income tax purposes as if it received a cash grant from the government.[114]

Our members that support the cash-equivalent approach believe that the administrability concerns expressed in the Preamble with respect to distinguishing between nonrefundable and refundable credits could be addressed through additional guidance. Consistent with the IRS's prior informal advice, this guidance could include applying the cash-equivalent approach only with respect to "refundable" credits that are, in practice, regularly refunded in more than *de minimis* amounts by foreign governments, so as to not extend creditability to credits structured to reduce foreign income taxes without reducing the corresponding FTC. Moreover, our members that support the cash-equivalent approach believe that the rules concerning the treatment of subsidies would continue to prevent creditability of refundable credits determined by reference to a taxpayer's foreign income tax liability.[115]

Our members that support the cash-equivalent approach would also extend this approach to transferable credits. Transferable credits, like refundable credits, are generally provided as incentives unrelated to tax and, due to their ability to be monetized by sale, represent a property right to the holder, and a commensurate liability of the foreign government, independent of the holder's tax liability. There does not appear to be a policy justification for treating transferrable credits differently than refundable credits.

If, consistent with the recommendation of some of our members, Treasury and the IRS finalize the proposed rule for refundable credits due to the administrative difficulty of tracking the treatment of various payments made through the tax system, such reasoning would not apply to government grants administered outside of the tax system. Given that it should be clear, in light of the separate administration of tax payments and other government grants, whether a taxpayer is entitled to a grant independent of its tax liabilities, any grants that are payable to a taxpayer in cash should be treated consistent

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[114] *See* Sections 61 and 118. *See also* GCM 39617 (Aug. 27, 1986) (concluding that the refundable credits at issue should be treated as either items of gross income "includable in full" or contributions to capital under Section 118(a) with a corresponding reduction under Section 362(c) in the basis of the qualified asset that gave rise to the credit); TAM 200146001 (Apr. 2, 2001) (agreeing with the taxpayer's treatment of refundable credits received by CFCs as increasing the CFCs' income for E&P purposes and also constituting a payment of foreign income tax by such CFCs). *Cf.* International Financial Reporting Standards, International Accounting Standard 20, *Accounting for Government Grants and Disclosure of Government Assistance* (providing that a grant should either be recognized as income or, in certain circumstances, reduce a related asset's basis).

[115] *See* Treas. Reg. § 1.901-2(e)(3).

with their form as cash for purposes of the foreign tax payment determination. Accordingly, we recommend that such grants should not be treated as a reduction in the amount of tax paid, and a tax satisfied through application of such a grant should be treated as paid. If, however, Treasury and the IRS are particularly concerned that jurisdictions might design grants that are nominally separate from the tax system but in substance are mechanisms for a reduction in tax rates, such concerns might be addressed by means of a rule, similar to the subsidy rules noted above, that treats grants that are calculated by reference to a foreign income tax liability or the base thereof as credits subject to the rules discussed above. In such case, the proposed limitation for cash-equivalent treatment to credits that are regularly paid in cash would provide an additional protection against potential abuse.

B. Allocation and Apportionment of Foreign Income Taxes

1. Background

The allocation and apportionment of foreign income taxes is governed by Treas. Reg. § 1.861-20, except as modified under the rules for an operative section.[116] The 2020 Final Regulations contain the following three-step process for allocating and apportioning foreign income taxes:

- First, items of foreign gross income (as determined under foreign law) are assigned to the relevant statutory and residual groupings.

- Second, items of deduction allowed under foreign law are allocated and apportioned to the foreign gross income in each grouping to determine foreign taxable income.

- Third, foreign income taxes are allocated to the groupings to which the foreign gross income was assigned and, if necessary, apportioned ratably among the statutory and residual groupings in proportion to the foreign taxable income in each.[117]

Most of the complexity in allocating and apportioning foreign income taxes arises in the first step – assigning foreign gross income to the relevant statutory groupings. In

[116] Treas. Reg. § 1.861-20(a) (citing, as an example, Treas. Reg. §§ 1.704-1(b)(4)(viii)(d)(1), 1.904-6, 1.960-1(d)(3)(ii), and 1.965-5(b)(2)).

[117] *See* Treas. Reg. § 1.861-20(c).

general, an item of foreign gross income that also gives rise in the same taxable year to an item of U.S. gross income (a "**corresponding U.S. item**") is assigned to the grouping to which the corresponding U.S. item is assigned.[118] Special rules apply for assigning foreign gross income where there is no corresponding U.S. item (*e.g.*, as a result of a timing or base difference) or where the gross income item arises from a distribution with respect to corporate stock (regardless of whether there is a corresponding U.S. item) or from a foreign law inclusion regime similar to Subpart F or GILTI.[119]

The 2020 Proposed Regulations provide additional special rules for assigning foreign gross income arising from distributions with respect to partnership interests, dispositions of stock or partnership interests, and disregarded payments. Each of these is discussed in more detail in Part IV.B.2 of this Report.

2. Discussion

a) Transactions Involving Stock and Partnership Interests

Under the 2019 Proposed Regulations, an item of foreign gross income arising from a return of basis distribution by a corporation described in Section 301(c)(2) (a "**Section 301(c)(2) distribution**") or a return of basis distribution by a partnership described in Section 733 (a "**Section 733 distribution**") would have been treated as attributable to a "base difference" and thus assigned to the residual category.[120] In response to comments, Treasury and the IRS eliminated these two items from the exclusive list of base differences in the 2020 Final Regulations.[121] The treatment of transactions related to stock and partnership interests under the 2020 Proposed Regulations are discussed separately and in more detail in Part IV.B.2.a.i and ii of this Report.

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[118] Treas. Reg. § 1.861-20(b)(2) and (d)(1).

[119] *See* Treas. Reg. § § 1.861-20(d)(2) and (3).

[120] 2019 Prop. Treas. Reg. § 1.861-20(d)(2)(ii)(B). However, for purposes of the FTC limitation, foreign gross income of a U.S. taxpayer attributable to a base difference is assigned to foreign-source income in the "separate category described in section 904(d)(2)(H)(i)." *See* Treas. Reg. § 1.904-6(b)(1). The separate category described in Section 904(d)(2)(H)(i) is the foreign branch category. However, 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.

[121] *See* Treas. Reg. § 1.861-20(d)(2)(iii)(B).

i. Transactions Involving Stock

As explained in the preamble to the 2020 Final Regulations, foreign gross income arising from a Section 301(c)(2) distribution is likely to represent a timing difference with respect to the recognition of the E&P of the distributing corporation under U.S. and foreign tax laws, rather than a difference in the respective tax bases. Therefore, the 2020 Final Regulations generally associate foreign gross income arising from a Section 301(c)(2) distribution with "hypothetical earnings" (*i.e.*, future E&P) of the distributing corporation, determined by reference to the assets of the distributing corporation in the year of the distribution.[122] Specifically, the 2020 Final Regulations provide that foreign gross income of a taxpayer arising from a Section 301(c)(2) distribution is assigned to the same groupings to which the tax book value ("**TBV**") of the stock of the distributing corporation is (or would be if the taxpayer were a U.S. person) assigned under the asset method in Treas. Reg. § 1.861-9 in the U.S. taxable year in which the distribution is made (the "**TBV method**").[123]

In addition, in order to "minimize differences in the foreign tax credit consequences of a sale or a distribution in redemption of the taxpayer's interest," the 2020 Proposed Regulations extend the principles applicable to distributions to dispositions of stock.[124] Foreign gross income that arises from a transaction that constitutes a sale, exchange, or other disposition of stock under U.S. tax law is assigned according to the following waterfall—

- First, an amount of foreign gross income equal to the amount of gain treated as a dividend under Section 964(e) or Section 1248 (the "**U.S. dividend amount**") is assigned to the same groupings to which the U.S. dividend amount is assigned.

- Second, if the foreign gross income exceeds the U.S. dividend amount, an amount of foreign gross income equal to the amount of capital gain not treated as a dividend under Section 964(e) or Section 1248 (the

[122] Preamble to the 2020 Final Regulations, 85 Fed. Reg. at 72013.

[123] *See* Treas. Reg. § 1.861-20(d)(3)(i)(B)(2).

[124] Preamble to the 2020 Final Regulations, 85 Fed. Reg. at 72013.

"**U.S. capital gain amount**")[125] is assigned to the same groupings to which the U.S. capital gain amount is assigned.

- Third, any excess of the foreign gross income over the sum of the U.S. dividend amount and the U.S. capital gain amount is assigned to the same groupings to which the TBV of the stock of the corporation is (or would be if the taxpayer were a United States person) assigned under the TBV method in the U.S. taxable year in which the disposition occurred.[126]

We support the general approach adopted in the 2020 Final Regulations for Section 301(c)(2) distributions. In particular, we agree that foreign income taxes arising from a Section 301(c)(2) distribution more often relates to a timing difference than to a base difference, and thus should not be assigned *per se* to the residual category. As for the specific method of assigning foreign gross income to the relevant groupings, the TBV method can sometimes result in distortive answers. For instance, if a CFC's income-producing assets consist entirely of self-developed IP or fully depreciated tangible property that have zero or low TBV, and the CFC also has working capital and accounts receivable that have a TBV equal to fair market value and generally earn passive interest income, the foreign gross income arising from a Section 301(c)(2) distribution by the CFC will be disproportionately assigned to the passive category. However, this type of distortion exists generally from the application of the TBV method to assigning expenses (*e.g.*, the apportionment of interest expense), and indeed any allocation and apportionment method can result in distortion under certain facts. On balance, we believe that the adoption of the TBV method represents a reasonable method for associating foreign income taxes on a Section 301(c)(2) distribution to the U.S. gross income to which such taxes ultimately relate.

We also agree with the statement in the Preamble that foreign gross income attributable to the return of capital from a U.S. tax perspective should generally be assigned to the same grouping regardless of whether such basis is returned through a distribution or a disposition. In order to better conform the basketing consequences of a distribution with respect to stock and a disposition of stock, we recommend that, to the

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[125] *See* 2020 Prop. Treas. Reg. § 1.861-20(b)(19). In the case of a partnership, the U.S. capital gain amount means the gain recognized by a taxpayer on the sale, exchange, or other disposition of an interest in the partnership or, in the case of a distribution, the portion of the distribution to which Section 731(a)(1) applies; it includes gain that is subject to Section 751 and Treas. Reg. § 1.751-1. *Id.*

[126] 2020 Prop. Treas. § 1.861-20(d)(3)(i)(D).

extent of basis in stock attributable to PTEP under Section 961 (“**PTEP basis**”), foreign gross income in excess of the U.S. dividend amount be assigned to the same grouping as the underlying PTEP.

> Example 1: USP owns CFC, a Country A corporation. For U.S. federal income tax purposes, USP’s basis in CFC is $150, $100 of which is Section 961(a) basis attributable to Subpart F PTEP in the passive category. CFC has no other E&P for U.S. federal income tax purposes. Under Treas. Reg. §§ 1.861-9 and 1.861-13, the TBV of the stock of CFC is assigned 50% to the Subpart F income group in the passive category and 50% to the Section 245A subgroup in the general category. Under Country A law, USP has a tax basis in CFC of $50, and CFC has E&P of $100.[127]

> Alternative 1: USP sells CFC for $150. For U.S. federal income tax purposes, USP recognizes no capital gain or loss on the sale. Under Country A law, USP recognizes $100 of gain and incurs $10 of Country A nonresident capital gains tax on the sale.

> Alternative 2: USP causes CFC to distribute $100, and then USP sells CFC for $50. For U.S. federal income tax purposes, the distribution is tax-free to USP as a distribution of PTEP under Section 959(a), and USP recognizes no capital gain or loss on the sale. Under Country A law, USP is treated as receiving a $100 dividend, for which USP incurs $10 of Country A withholding tax, and recognizes no gain on the sale.

In Alternative 1, under the 2020 Proposed Regulations, the entire $100 of foreign gross income (*i.e.*, the amount of foreign gross income in excess of the U.S. dividend amount and U.S. capital gain amount) would be assigned to relevant groupings based on the TBV of the CFC stock. Thus, $50 of foreign gross income would be assigned to the passive category and $50 to specified E&P (defined and discussed in Part IV.D.2.a of this Report), with the result that $5 of the Country A tax would be allocated and apportioned

[127] In Example 1, it is clear that the disparity between USP’s basis in CFC for U.S. federal income tax purposes and its basis for foreign law purposes is attributable entirely to the basis increase under Section 961(a). In contrast, the facts in 2020 Prop. Treas. Reg. § 1.861-20(g)(10) (Example 9) do not indicate whether any of the $200 disparity between USP’s basis in CFC for U.S. federal income tax purposes and its basis for foreign law purposes is attributable to PTEP.

to the passive category and $5 of the Country A tax would be disallowed under Section 245A(d).[128]

In contrast, in Alternative 2, none of the foreign gross income would be assigned based on the TBV of the CFC stock and thus none of the capital gains tax would be allocated and apportioned between the passive category and specified E&P based on the TBV method. The $10 of withholding tax paid with respect to the PTEP distribution would be allocated and apportioned entirely to the grouping to which the PTEP relates, that is, the passive category.[129] Therefore, in Alternative 2, none of the Country A tax would be disallowed under Section 245A(d), and the entire $10 of the Country A tax would be allocated and apportioned to the passive category.

We do not believe that these similar transactions should have such divergent consequences with respect to the allocation and assignment of foreign income taxes. Moreover, while we agree that it is generally appropriate to "look ahead" to resolve a timing difference in the case of a Section 301(c)(2) distribution, such an approach is implicitly predicated on the taxpayer maintaining an interest in the stock to which the timing difference relates. Such an approach is not appropriate where the timing difference arises because of an earlier inclusion under U.S. tax law of the foreign law earnings (*i.e.*, the inclusion under Subpart F of the underlying E&P) and the taxpayer disposes of the stock to which the inclusion relates. In this situation, similar to the basketing of foreign income taxes incurred on a distribution of PTEP, it is more appropriate to resolve the timing difference arising by reason of a Subpart F or GILTI inclusion by "looking back" to basket the foreign income taxes in the same manner as the inclusion.

Our recommendation could be accomplished under Treas. Reg. § 1.861-20 by including in the definition of "U.S. dividend amount," in the case of a disposition, an amount equal to the PTEP attributable to the disposed of stock. This characterization of the underlying PTEP as a dividend would be solely for purposes of assigning the foreign gross income from the sale to statutory and residual groupings (*e.g.*, general category gross tested income or specified E&P), and would not, for instance, permit the underlying PTEP to be added to PTEP accounts of an upper-tier CFC in the case of a sale of a lower-tier CFC. This treatment of PTEP as a dividend in the case of a disposition is similar to the treatment of a PTEP distribution as a U.S. dividend amount under the 2020 Final

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[128] 2020 Prop. Treas. Reg. §§ 1.245A(d)-1(a), (b)(1), and (c)(6) and 1.861-20(d)(3)(i)(D).

[129] Treas. Reg. § 1.904-6(e)(2).

Regulations,[130] notwithstanding that a distribution of PTEP to a U.S. shareholder is not a dividend for purposes of Chapter 1 of the Code.[131]

This approach, while at times taxpayer-favorable, is also necessary to ensure that taxes incurred with respect to Section 245A(d) PTEP are not permitted to be credited. If, in Alternative 1 of Example 1, CFC's PTEP were instead Section 245A(d) PTEP (for instance, PTEP arising from a tiered hybrid dividend), but the TBV characterization of the CFC stock remained unchanged, assigning foreign gross income entirely based on the TBV of CFC stock would effectively permit USP an FTC for foreign income taxes that, if the PTEP were distributed, would have been allocated and apportioned to Section 245A(d) PTEP and thus disallowed under Section 245A(d).

We acknowledge that our recommendation to conform the treatment of PTEP in distributions and dispositions would permit the same PTEP to control basketing with respect to both the foreign income taxes incurred by the seller on disposition and the foreign income taxes incurred by the buyer (as a successor to the PTEP) on distribution of the PTEP. This stems from the same issue discussed in Part IV.D.2.b of this Report with respect to successive foreign law distributions; *i.e.*, that the PTEP are deemed distributed for purposes of basketing foreign income taxes, yet they remain for future basketing purposes. If the government believed that this result would be inappropriate, it could adopt a rule that effectively "denudes" the PTEP in the hands of a successor of its assignment to any separate category, and then baskets the foreign income taxes permitted the successor under Section 960(b)(1) on the distribution of such PTEP in the same manner as if they were taxes incurred with respect to a Section 301(c)(2) distribution (*i.e.*, according to the TBV characterization of the stock).

ii. Transactions Involving Partnership Interests

Rules similar to those for Section 301(c)(2) distributions and dispositions of stock are included in the 2020 Proposed Regulations for Section 733 distributions and dispositions of partnership interests.[132] Foreign gross income arising from a Section 733 distribution is assigned to relevant groupings under the TBV method by reference to the TBV of the partner's pro rata share of the partnership's assets or, in the case of a limited

[130] Treas. Reg. § 1.861-20(b)(20).

[131] Section 959(d).

[132] *See* 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(ii).

partner with less than a 10% interest, the TBV of the partnership interest.[133] The 2020 Proposed Regulations similarly assign foreign gross income in excess of the U.S. capital gain amount on a sale of a partnership interest to statutory groupings under the TBV method.[134] The TBV of partnership assets (or a partnership interest, in the case of a less than 10% limited partner) is treated "as a surrogate for the partner's distributive share of earnings of the partnership that are not recognized in the year in which the distribution is made for U.S. tax purposes."[135] As the Preamble notes, foreign income tax arising from a Section 733 distribution or on a disposition in excess of the U.S. capital gain amount most commonly occurs in the case of entities that are treated as corporations under foreign tax law but partnerships under U.S. federal income tax law ("**hybrid partnerships**").[136] U.S. partners of a hybrid partnership are taxed currently on their share of the partnership income under U.S. tax law and their basis is increased by that share, whereas under foreign tax law such partners are only taxed upon distribution of their share of partnership income and their basis is not increased in their partnership interest on a current basis.

We support the general approach adopted in the 2020 Proposed Regulations for dispositions of, and distributions with respect to, partnership interests. We agree that foreign income tax arising from a Section 733 distribution is particularly likely to occur in the case of a hybrid partnership, in which case U.S. partners would be taxed currently on their share of partnership income under U.S. tax law. However, we recommend refinements to the 2020 Proposed Regulations to better align the groupings to which such foreign income tax would be assigned with the underlying partnership income on which the U.S. partners would be taxed.

Although the TBV characterization of a partnership interest may be a reasonable proxy for the characterization of the foreign gross income arising from a disposition of, or a distribution with respect to, such interest, a more accurate characterization may be made for Section 733 distributions that are out of foreign E&P arising from income included by the partners in the year of the distribution or in prior years. Accordingly, we recommend that final regulations prescribe, in the case of hybrid partnerships, the maintenance of partner-level accounts to track partners' distributive shares of a

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[133] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(B).

[134] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(C).

[135] Preamble, 85 Fed. Reg. at 72084.

[136] *Id.*

partnership's income. The foreign gross income treated as a dividend for foreign law purposes upon a distribution by the hybrid partnership could then be assigned proportionately to the income included in this partner-level account to the extent thereof under a reasonable method. Rules could be provided for determining the earnings in the account out of which a distribution is treated as being made and adjusting the account accordingly. For example, distributions could be treated as pro rata from each category of income in the account, or rules analogous to those provided under Section 316 for a Section 301(c)(1) distribution for U.S. federal income tax purposes could be used, under which a distribution would be treated as out of annual layers of earnings in a partner's account on a last-in, first-out basis.

We believe that the accuracy and improved matching of foreign income taxes to income would generally justify the marginal additional record-keeping requirements of this approach.[137] However, if the Treasury and the IRS are concerned about the complexity, consideration could also be given to a simplified approach pursuant to which, instead of requiring the creation of multi-year accounts, foreign gross income arising from a foreign law dividend could be attributed based on a partner's distributive share of the current year income of the partnership to the extent thereof; the remainder of the foreign gross income arising from the distribution could then be assigned based on the TBV method in the 2020 Proposed Regulations. This would not improve the alignment of the foreign income taxes with the underlying partnership income in fact patterns in which a hybrid partnership distributes earnings in years after they are accrued, but it would at least ensure alignment in the most straightforward fact pattern in which a partnership annually distributes its earnings to its partners. In such a case, it seems particularly inappropriate to use the inaccurate proxy of assets under the TBV method rather than assigning the foreign income taxes to groupings based on readily available income information about the underlying partnership income to which the taxes relate.

In light of the fact that U.S. partners' basis in their partnership interests under Section 705 (**"Section 705 basis"**) will reflect their distributive shares of the partnership's income to the extent not previously distributed (in addition to their contributions and shares of partnership liabilities), we further recommend that such Section 705 basis

[137] Note, however, that the TBV approach of the 2020 Proposed Regulations could be considered more accurate in the case of a partnership with significant Section 752 liabilities. Because a partnership's Section 752 liabilities are reflected in the partners' aggregate outside basis, but the partners' shares of liabilities may not align with their distributive shares of income, the TBV approach could better approximate the income that will be produced by the partnership's assets that are funded by the liabilities than our proposed E&P tracking method.

attributable to undistributed income be treated consistent with PTEP basis in a corporation pursuant to our recommendation in Part IV.B.2.a.i of this Report. That is, in the case of a disposition of a hybrid partnership interest, an amount of foreign gross income equal to the disposing partner's Section 705 basis attributable to undistributed income should be assigned to relevant groupings in the same manner as if such amount were distributed, which, per the recommendation above, would reflect the partnership's underlying income (either all the income or the income in the current year). This would ensure that where the timing difference arises because of an earlier inclusion under U.S. tax law of the foreign law earnings (*i.e.*, a Section 702 inclusion), the foreign income taxes arising by reason of the earnings are basketed in the same manner as the inclusion.

b) Disregarded Payments

Under the 2019 Proposed Regulations, foreign gross income arising from any disregarded payment by a foreign branch (an "**upstream payment**") would have been assigned proportionately to the groupings to which the TBV of the foreign branch's assets, determined in accordance with Treas. Reg. § 1.987-6(b)(2), are assigned.[138] In contrast, any disregarded payment by a foreign branch owner to its foreign branch (a "**downstream payment**") would have been assigned to the residual category.[139] Therefore, a foreign income tax arising from a downstream payment would not have been creditable under Section 960.[140]

In response to comments criticizing this approach, particularly with respect to the assignment of foreign income taxes arising from downstream payments to the residual category, Treasury and the IRS did not finalize these rules. Instead, rules related to allocating and apportioning foreign income taxes arising from disregarded payments (the "**disregarded payment rules**") are re-proposed in the 2020 Proposed Regulations. In the case of a taxpayer that is an individual or a domestic corporation (a "**U.S. taxpayer**"), the disregarded payment rules would assign foreign gross income arising from a disregarded payment between taxable units to the same grouping to which U.S. gross income would

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[138] 2019 Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(A). The rules for an upstream payment applied not only to a disregarded payment from a foreign branch to its owner, but also to a disregarded payment to a foreign branch from another foreign branch owned by the same foreign branch owner.

[139] 2019 Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(B).

[140] *See* Treas. Reg. § 1.960-1(e). A disregarded payment from a foreign branch owner that is a U.S. person or a partnership with U.S. partners could be assigned to the foreign branch category. See 2019 Prop. Treas. Reg. § 1.904-6(b)(2)(ii).

be assigned under the disregarded reattribution transaction rules contained in Treas. Reg. § 1.904-4(f) (the "**DRT rules**").[141] In the case of a taxpayer that is a foreign corporation (a "**foreign taxpayer**"), the disregarded payment rules would assign foreign gross income arising from a disregarded payment between taxable units to the same grouping to which U.S. gross income would be assigned under the attribution rules applicable to the GILTI and Subpart F high-tax exception contained in Prop. Treas. Reg. § 1.954-1(d) (the "**HTE rules**").[142]

A taxable unit in the case of a U.S. taxpayer is a foreign branch, a foreign branch owner, or a non-branch taxable unit (each, a "**U.S. taxable unit**").[143] A taxable unit in the case of a foreign taxpayer is a tested unit within the meaning of the HTE rules ("**foreign taxable unit**").[144] A disregarded payment that results in a reattribution of U.S. gross income under either the DRT rules or the HTE rules is called a "**reattribution payment**."[145] The amount of a disregarded payment that is a reattribution payment is

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[141] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(B)(2).

[142] *Id.* The HTE rules themselves adopt the principles of the DRT rules with certain modifications (*e.g.*, disregarding the exclusion for interest and interest equivalents described in Treas. Reg. § 1.904-4(f)(2)(vi)(C)(1) that are deductible under foreign law). *See* Prop. Treas. Reg. § 1.954-1(d)(1)(iii)(B).

[143] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(E)(9). A non-branch taxable unit is either (i) a person that is not otherwise a foreign branch owner and that is a U.S. individual, a domestic corporation, or a foreign or domestic partnership that is owned by a U.S. individual or U.S. corporation, or (ii) an interest of a foreign branch owner or an interest of a person described above that is not otherwise a foreign branch and is either a disregarded entity or a taxable presence in another jurisdiction. 2020 Prop. Treas. Reg. § 1.904-6(b)(2)(i)(B).

[144] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(E)(9). A tested unit is either (i) a CFC; (ii) an interest held directly or indirectly by a CFC in a pass-through entity (such as a partnership or disregarded entity) if (a) that pass-through entity is a tax resident in a foreign country, or (b) if the pass-through entity is not a tax resident in a foreign country, such pass-through entity is not treated as fiscally transparent (as defined in Treas. Reg. § 1.267A-5(a)(8)) under the law of the country in which the CFC is a tax resident (or, if the interest is held indirectly through a tested unit, the laws of the foreign country in which the tested unit is a tax resident); or (iii) a branch (as defined in Treas. Reg. § 1.267A-5(a)(2)) whose activities are carried on directly or indirectly by the CFC, if either (a) it has a taxable presence in the foreign country in which it is located, or (b) an exclusion, exemption, or other similar relief applies with respect to income attributable to the branch under the laws of the country in which the CFC (or, as relevant, a tested unit that carries out the branch activity) is a tax resident. Prop. Treas. Reg. § 1.954-1(d)(2)(i); *see also* Treas. Reg. § 1.951A-2(c)(7)(iv)(A)(1).

[145] *See* 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(E)(5) and (7).

limited to the U.S. gross income of the payor taxable unit that is recognized in the U.S. taxable year in which the disregarded payment is made.[146]

The rules in the 2019 Proposed Regulations that would have assigned foreign gross income from downstream payments to the residual category and foreign gross income from upstream payments to relevant groupings based on the TBV method are retained in the 2020 Proposed Regulations, but only with respect to downstream payments that are "contributions" and upstream payments that are "remittances," respectively.[147] A **"contribution"** is defined as (i) a transfer of property as defined in Section 317(a) that, if regarded for U.S. federal income tax purposes, would be treated as a contribution to capital under Section 118 or a Section 351 contribution if the recipient taxable unit were a corporation, and (ii) the excess of a disregarded payment made by a taxable unit to another taxable unit that the first taxable unit owns over the portion of the disregarded payment that is a reattribution payment.[148] A **"remittance"** is defined as (i) a transfer of property as defined in Section 317(a) that would be treated as a distribution by a corporation to its shareholder if the taxable unit were treated as a corporation for U.S. federal income tax purposes, and (ii) the excess of a disregarded payment over the portion of the payment that is a reattribution payment and that is not a contribution.[149] Because the amount of a disregarded payment that is a reattribution payment is limited by the U.S. gross income of the payor taxable unit in a taxable year, a disregarded payment that is otherwise not in the nature of a distribution or a contribution may nonetheless be treated as a remittance or a contribution under the 2020 Proposed Regulations to the extent such payment exceeds the payor taxable unit's U.S. gross income for the taxable year.

Under the 2020 Proposed Regulations, the consequences of a contribution depend on whether the payor taxable unit is a foreign taxable unit or a U.S. taxable unit. Foreign gross income arising in connection with a contribution by a foreign taxable unit is assigned

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[146] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(B)(2).

[147] *See* 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(i) and (2).

[148] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(E)(2).

[149] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(E)(8).

to the residual category.[150] Foreign gross income arising in connection with a contribution by a U.S. taxable unit is assigned to the foreign branch category.[151]

Regardless of whether the payor taxable unit is U.S. or foreign, foreign gross income arising from a remittance is deemed to be made ratably out of the payor taxable unit's "accumulated after-tax income."[152] Notwithstanding the reference to "accumulated after-tax income," as under the 2019 Proposed Regulations, the assignment of foreign gross income arising from a remittance to relevant groupings is determined under the TBV method. That is, accumulated after-tax income is deemed to have arisen in statutory and residual groupings based on the characterization of the payor taxable unit's assets under the asset method in Treas. Reg. § 1.861-9 in the year in which the remittance is made.[153] For this purpose, the payor taxable unit's assets are determined in accordance with Treas. Reg. § 1.987-6, except that assets of the taxable unit include stock held by the taxable unit and a portion of the TBV of any asset held by another taxable unit to the extent that the U.S. gross income produced by such asset is reattributed to the payor taxable unit by reason of a reattribution payment (a "**reattribution asset**").[154] The portion of a reattribution asset treated as owned by a taxable unit by reason of a reattribution payment is not treated as an asset of the taxable unit making the reattribution payment for purposes of assigning foreign gross income arising from a remittance by the second taxable unit.[155] If the payor taxable unit is determined to have no assets, then the foreign gross income arising from a remittance by such taxable unit is assigned to the residual grouping.[156]

We commend Treasury and the IRS for adopting the DRT and HTE rules for purposes of assigning foreign gross income arising from a disregarded payment. Consistent with our recommendation in a prior report,[157] these rules would more

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[150] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(2).

[151] 2020 Prop. Treas. Reg. § 1.904-6(b)(2)(ii).

[152] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(i).

[153] *Id.*

[154] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii) and (6).

[155] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii).

[156] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(i).

[157] *See* 2020 FTC Report, p. 40.

accurately associate foreign income taxes with the U.S. gross income to which such taxes relate than treating all disregarded payments as either remittances or contributions. This approach also has the benefit of "stranding" fewer foreign income taxes than under the 2019 Proposed Regulations. While foreign income taxes may still be allocated and apportioned to the residual grouping under the 2020 Proposed Regulations by reason of a contribution, foreign gross income arising from a contribution, as narrowed in scope in the 2020 Proposed Regulations, is more likely to be attributable to a true base difference, and thus the residual characterization of the taxes is more likely to be appropriate.

For the same reasons (and with the same reservations) as expressed in Part IV.B.2.a.i of this Report, we agree with the application of the TBV method to assign foreign gross income arising from a remittance. However, we recommend a single modification to the determination of the assets of a foreign branch for purposes of applying the TBV method to a remittance. As discussed above, under the 2020 Proposed Regulations, a payor taxable unit's assets are determined in accordance with the rules for QBUs in Treas. Reg. § 1.987-6, except that assets of the taxable unit include stock held by the taxable unit. However, the assets of a foreign branch under the 2020 Proposed Regulations, by cross-reference to the regulations under Section 987, do not include the assets of another QBU or interests in a partnership (whether U.S. or foreign).[158] The inclusion of stock in the assets of a QBU, but not interests in other QBUs or partnerships held by the QBU, creates a disparity in the basketing of foreign income taxes arising from similar transactions.

> Example 2: CFC1, a Country X corporation, owns DRE1, a Country B corporation classified as a disregarded entity for U.S. federal income tax purposes. DRE1 owns DRE2, a Country C corporation classified as a disregarded entity for U.S. federal income tax purposes. DRE2 owns CFC2, a Country D corporation classified as a corporation for U.S. federal income tax purposes. DRE1 owns no assets other than its interest in DRE2, and DRE2 owns no assets other than the CFC2 stock. CFC2 distributes property to DRE2, which distributes the property to DRE1, which distributes the property to CFC1. The distribution is subject to a withholding tax imposed by each jurisdiction in the chain, though for U.S. federal income tax purposes the distribution by CFC2 to DRE2 is a Section 301(c)(2) distribution. CFC2 earns solely general category gross tested income.

[158] *See* Treas. Reg. §§ 1.987-1(b)(4) and 1.987-2(b)(2)(ii).

Each of CFC1, DRE1, and DRE2 are tested units under the HTE rules and thus taxable units under the disregarded payment rules. Under the rules of the 2020 Proposed Regulations discussed in Part IV.B.2.a.i of this Report, the foreign gross income arising from the Section 301(c)(2) distribution by CFC2 to DRE2 would be assigned under the TBV method to the same relevant groupings to which the TBV of the CFC2 stock is assigned under Treas. Reg. § 1.861-9. Therefore, the foreign gross income arising from the CFC2-to-DRE2 distribution is assigned to the tested income group within the general category, and the withholding taxes relating to the distribution are allocated and apportioned to CFC1's general category tested income group and thus potentially creditable under Section 960(d).[159] The foreign gross income from the disregarded payment by DRE2 to DRE1, a remittance, would be similarly assigned to the tested income group within the general category, and the related withholding taxes would potentially be creditable, based on the application of the TBV method by reference to the CFC2 stock owned by DRE2.[160] In contrast, it appears that the foreign gross income arising from the disregarded payment by DRE1 to CFC1 would be assigned under the 2020 Proposed Regulations to the residual category, because DRE1 would not be treated as owning the stock of CFC2, an asset of DRE2.[161]

We are not aware of any reason that the foreign income taxes incurred with respect to the DRE1-to-CFC1 distribution should not be creditable in Example 2, in contrast to the result that obtains with respect to the CFC2-to-DRE2 distribution and the DRE2-to-DRE1 distribution. In either case, the disregarded payment represents a timing difference, in which the U.S. gross income that has been, or will eventually be, recognized is gross tested income. The same considerations apply in the case of an interest in a partnership owned by taxable unit. Accordingly, we recommend that, for purposes of assigning foreign gross income arising from a remittance to the statutory and residual groupings to which the assets of a taxable unit are assigned, the assets of a taxable unit include not only stock, but also the assets of any other taxable unit owned by the taxable unit, and any interest in a partnership or the taxable unit's pro rata share of the assets of the partnership, as applicable.

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159 *See* Treas. Reg. §§ 1.861-20(d)(3)(i)(B)(1) and 1.960-1(d)(3)(ii)(A). However, see Part IV.D.2.a of this Report regarding the ambiguity regarding the potential application of 2020 Prop. Treas. Reg. § 1.245A(d)-1.

160 *See* 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(1) and Treas. Reg. § 1.960-1(d)(3)(ii)(A).

161 *See* 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii). DRE1 does not own any reattribution asset by reason of the distribution from DRE2, because a remittance is not a reattribution payment.

C. Allocation and Apportionment of Other Expenses

1. Background

For purposes of applying Section 904, interest expense is allocated and apportioned based on the adjusted basis of assets, rather than on the fair market value of assets or gross income.[162] Under the asset method, a taxpayer apportions interest expense to the relevant statutory or residual groupings based on the average total value of assets within each grouping for the taxable year as determined under the asset valuation rules of Treas. Reg. § 1.861-9(g) and -9T(g). For purposes of allocating and apportioning interest, the value of an asset is its TBV, which is generally equal to its adjusted basis.[163] However, a taxpayer may elect to determine the value of its assets as if its tangible property were subject to the alternative depreciation system ("**ADS**") of Section 168(g) (the "**alternative tax book value method**" or "**ATBV method**").[164] Because property located in the United States is generally subject to depreciation methods that are accelerated relative to ADS, the effect of the ATBV method is to increase the TBV of U.S. assets relative to the TBV method, thus generally increasing the amount of interest allocated and apportioned to U.S.-source income.

The ATBV method may produce a significant FTC limitation benefit for capital-intensive taxpayers by decreasing the amount of interest expense allocated and apportioned to foreign-source income.[165] However, taxpayers that generate income through self-generated intangible property ("**IP**") obtain little or no benefit from the ATBV method, because the method does not impact the value of IP. Moreover, under current law, R&E and advertising expenses are generally deducted immediately.[166] Thus, self-

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[162] Section 864(e)(2).

[163] Treas. Reg. § 1.861-9(g)(2)(i)(B).

[164] *See* Treas. Reg. § 1.861-9(i).

[165] However, after the TCJA, the ATBV method could also have the deleterious effect of causing more interest expense to be allocated and apportioned to deduction eligible income (as defined in Section 250(b)(3) and Treas. Reg. § 1.250(b)-1(c)(2)) and foreign-derived deduction eligible income (as defined in Section 250(b)(4) and Treas. Reg. § 1.250(b)-1(c)(12)), and thus potentially reduce FDII. *See* Treas. Reg. §§ 1.250(b)-1(d)(2)(i) and 1.861-8(f)(1)(vi)(N) (treating Section 250 as an operative section for purposes of the regulations under Section 861).

[166] *See* Sections 162 and 174. Taxpayers can elect to capitalize their R&E expenditures under Sections 59(e) and 174(b). However, this capitalization would be taken into account for all purposes of the Code,

created IP commonly has zero "value" under either the TBV method or the ATBV method, notwithstanding the fact that, as Treasury and the IRS note in the Preamble, such IP often has significant economic value for which a taxpayer may be incurring debt to create and maintain.[167]

2. Discussion

The 2020 Proposed Regulations would provide taxpayers an election to capitalize their R&E and advertising expenses solely for purposes of allocating and apportioning interest expense.[168] Under the election, R&E expenses would be capitalized and amortized over a 15-year period, and 50% of advertising expenditures would be capitalized and amortized over a 10-year period. This election would be effective only until taxpayers are required to capitalize their R&E expenses under Section 174, which is currently scheduled to be effective in 2022.

We agree that the election to permit the capitalization of R&E and advertising expenses is appropriate in order to more accurately associate expense with income. However, we believe that the justification for this election applies equally to any other expense allocated and apportioned under the asset method. For instance, in the case of payments related to an investor lawsuit, which payments now must be apportioned like interest expense under an asset method,[169] zero basis self-created IP would result in a disproportionate amount of the damage expense being allocated and apportioned to statutory and residual groupings of gross income produced by non-IP (*e.g.*, stock of CFCs assigned to the Section 951A category under Treas. Reg. § 1.861-13). Therefore, we recommend that the proposed election for capitalizing R&E and advertising expenses for purposes of allocating and apportioning interest expense be extended to apply for

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not just for purposes of allocating and apportioning interest expense, and thus would also have the effect of deferring deductions that reduce taxable income. Beginning in 2022, R&E expenditures will be subject to mandatory capitalization under Section 174.

[167] *See* Preamble, 85 Fed. Reg. at 72082.

[168] 2020 Prop. Treas. Reg. § 1.861-9(k).

[169] *See* Treas. Reg. § 1.861-8(e)(5)(iii).

purposes of allocating and apportioning any expense that is apportioned under the asset method, including litigation-related expenses and stewardship expenses.[170]

D. Disallowance of FTCs Related to Section 245A Dividends

1. Background

As discussed in Part III.A of this Report, Section 245A(d) disallows a credit for any foreign income taxes paid with respect to any Section 245A dividend or hybrid dividend received by a U.S. shareholder or any tiered hybrid dividend included in the gross income of a U.S. shareholder. However, until the 2020 Proposed Regulations, Treasury and the IRS had issued no implementing regulations under Section 245A(d).[171]

Treasury and the IRS, however, have created much of the infrastructure necessary to implement Section 245A(d). Treas. Reg. § 1.861-13 subdivides CFC stock between "Section 245A subgroups" and "non-Section 245A subgroups."[172] Until the 2020 Proposed Regulations, this designation was relevant only for purposes of determining the amount of U.S. expenses that are disregarded under Section 904(b)(4).[173] In addition, the

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[170] Stewardship expenses are allocated solely to dividends received or amounts included, or to be received or included, with respect to stock and apportioned solely based on the TBV of stock. *See* Treas. Reg. § 1.864-8(e)(4)(ii)(B). However, the TBV of the stock of the stewarded entity (or, in the case of a stewarded entity that is a lower-tier entity, the stock of the upper-tier entity that owns, directly or indirectly, the stock of the stewarded entity) must be assigned to statutory and residual groupings based on the relative value of the assets of such entity. *See* Treas. Reg. § 1.861-8(e)(4)(ii)(B) and (C). Therefore, a rule that increases the basis of self-created IP can also have an effect on the allocation and apportionment of stewardship expenses.

[171] The regulations under Section 245A(e) cross-reference the FTC disallowance rule of Section 245A(d), but do not provide guidance on how to determine the foreign income taxes that are attributable to hybrid dividends. *See* Treas. Reg. § 1.245A(e)-1(b)(1)(ii) (providing that "[t]he rules of section 245A(d) (disallowance of foreign tax credits and deductions) apply" to hybrid dividends).

[172] *See* Treas. Reg. § 1.861-13(a)(5).

[173] *See* Treas. Reg. §§ 1.861-12(c)(3)(i)(B), 1.861-13(a), and 1.904(b)-3(b) and (c). Before the 2020 Proposed Regulations, Treas. Reg. § 1.861-13 only applied for purposes of Section 904 as an operative section. As discussed in Part IV.D.2.a of this Report, the 2020 Proposed Regulations disallow an FTC for foreign income taxes attributable to specified E&P, which, in the case of dispositions of, or distributions with respect to, stock include E&P "deemed to arise in a section 245A subgroup." See 2020 Prop. Treas. Reg. § 1.245A(d)-1(c)(6); *see also* 2020 Prop. Treas. Reg. § 1.861-20(g)(10) (Example 9) (foreign gross income equal to the U.S. return of capital amount arising from disposition of CFC stock assigned to the Section 245A subgroup under the TBV method). Though the 2020

regulations under Section 960 require PTEP to be assigned to various groups within the annual PTEP accounts, which include groups for PTEP that arise by reason of tiered hybrid dividends under Section 245A(e)(2) or dividends under Section 964(e) or Section 1248 (collectively, "**Section 245A(d) PTEP**").[174] Prior to the 2020 Proposed Regulations, this designation had no substantive effect.

2. Discussion

a) In General

The 2020 Proposed Regulations propose rules under Section 245A(d) to disallow an FTC or deduction for any foreign income tax attributable to a specified distribution or specified E&P.[175] A "**specified distribution**" is, in the case of a distribution to a domestic corporation, the portion of the distribution for which a Section 245A DRD is permitted or that is a hybrid dividend or attributable to Section 245A(d) PTEP, and, in the case of a distribution to a foreign corporation, the portion of the distribution that is attributable to Section 245A(d) PTEP or that is a tiered hybrid dividend.[176] Foreign income taxes are attributable to a specified distribution from a foreign corporation to the extent such taxes are allocated and apportioned under Treas. Reg. § 1.861-20 to foreign taxable income arising from the specified distribution.[177]

"**Specified E&P**" is the portion of the E&P of a foreign corporation that would give rise to a specified distribution (determined without regard to Section 246 or Treas. Reg.

Proposed Regulations clearly contemplate that Treas. Reg. § 1.861-13 and the "Section 245A subgroup" concept applies for purposes of applying 2020 Prop. Treas. Reg. § 1.245A(d)-1, no provision in the 2020 Proposed Regulations or otherwise expressly provides that Treas. Reg. § 1.861-13 applies to Section 245A(d) as an operative section. For the sake of clarity, Treasury and the IRS should explicitly make Section 245A(d) an operative section for purposes of Treas. Reg. § 1.861-13.

[174] Treas. Reg. § 1.960-3(c)(2)(v) and (ix). Under Section 964(e), a sale of CFC stock by another CFC results in a deemed divided to the selling CFC to the extent a sale of the target CFC stock by a U.S. person would result in a deemed dividend under Section 1248. Section 964(e)(1). This dividend is treated as Subpart F income included under Section 951 in the gross income of the U.S. shareholder of the selling CFC, which inclusion is eligible for the Section 245A DRD. Section 964(e)(4).

[175] 2020 Prop. Treas. Reg. § 1.245A(d)-1(a).

[176] 2020 Prop. Treas. Reg. § 1.245A(d)-1(c)(5). However, a disallowance of an FTC or deduction for foreign income taxes paid by a corporation has no effect on the corporation's E&P. 2020 Prop. Treas. Reg. § 1.245A(d)-1(d).

[177] 2020 Prop. Treas. Reg. § 1.245A(d)-1(b)(1).

§ 1.245A-5), if, on the date there is a foreign law distribution or a foreign law inclusion that results in an inclusion of foreign gross income, an amount of money equal to all the E&P of the foreign corporation were distributed.[178] In the event of a Section 301(c)(2) distribution with respect to the stock of a foreign corporation, or a disposition of such stock, specified E&P also include E&P in the amount of the U.S. return of capital amount that are deemed to arise in a Section 245A subgroup under the TBV method.[179] Foreign income taxes are attributable to specified E&P of a foreign corporation to the extent such taxes are allocated and apportioned under Treas. Reg. § 1.861-20 to foreign taxable income arising from a distribution or inclusion under foreign law of specified E&P if the event giving rise to such distribution or inclusion does not give rise to a specified distribution.[180]

Because of the rules related to specified E&P, the FTC disallowance rules of 2020 Prop. Treas. Reg. § 1.245A(d)-1 do not depend on the actual receipt of a Section 245A dividend. Rather, Section 245A(d) could be implicated by reason of a Section 301(c)(2) distribution or even presumably a disregarded payment.

> Example 3: USP owns CFC, a Country A corporation. CFC is a holding company that owns no assets other than the stock in wholly-owned subsidiaries. For U.S. federal income tax purposes, USP's basis in CFC is

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[178] 2020 Prop. Treas. Reg. § 1.245A(d)-1(c)(6).

[179] 2020 Prop. Treas. Reg. § 1.245A(d)-1(c)(6). The **"U.S. return of capital amount"** includes, in the case of the sale, exchange or other disposition of either stock or an interest in a partnership, the taxpayer's adjusted basis of the stock or partnership interest. Treas. Reg. § 1.861-20(b)(23). However, the "U.S. return of capital amount" is never referred to in the operative rule in the 2020 Proposed Regulations relating to the disposition of stock or a partnership interest; these rules only refer to the U.S. dividend amount and the U.S. capital gain amount, and then simply provide that foreign gross income in excess of these amounts is deemed to arise in statutory and residual groupings based on the TBV method. *See* 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(i)(D) and (ii)(C). The concept of the U.S. return of capital amount with respect to an interest in a partnership is not implicated by the 2020 Proposed Regulations under Section 245A(d), which do not appear to address distributions by, or dispositions of the interests in, partnerships giving rise to foreign gross income, notwithstanding the fact that such foreign gross income could be assigned to a Section 245A subgroup under the 2020 Proposed Regulations discussed in Part IV.B.2.a.ii of this Report. Accordingly, it is particularly unclear what purpose the U.S. return of capital concept is intended to serve with respect to a partnership interest. *See, infra,* footnote 183 for further discussion of the lack of guidance concerning Section 245A(d) as it relates to partnerships in the 2020 Proposed Regulations.

[180] 2020 Prop. Treas. Reg. § 1.245A(d)-1(b)(1). In an apparent typographical error, the 2020 Proposed Regulations refer to "1.860-20," rather than "1.861-20."

> $50, and CFC has no E&P. Under Treas. Reg. §§ 1.861-9 and 1.861-13, the TBV of the stock of CFC is assigned 50% to the Section 951A category and 50% to the Section 245A subgroup in the general category. Under Country A law, CFC has E&P of $50. CFC distributes $50 to USP. For U.S. federal income tax purposes, the distribution is a Section 301(c)(2) distribution, but under Country A law, the distribution is a $50 dividend subject to $5 of Country A withholding tax.

In Example 3, half of the $50 of foreign gross income arising from the Section 301(c)(2) distribution is assigned to the Section 245A subgroup based on the TBV of the CFC stock under Treas. Reg. §§ 1.861-9 and 1.861-13, and thus half of the $5 (or $2.5) of the foreign income taxes would be allocated and apportioned to specified E&P and disallowed under Section 245A(d) and Treas. Reg. § 1.245A(d)-1(a).[181] Similar results should obtain for a disregarded payment if a disregarded entity were interposed between USP and CFC.

> Example 4: USP owns DRE, a Country B corporation classified as a disregarded entity for U.S. federal income tax purposes. DRE owns CFC, a Country A corporation. DRE owns no assets other than the CFC stock, and CFC is a holding company that owns no assets other than the stock in wholly-owned subsidiaries. For U.S. federal income tax purposes, USP's basis in CFC is $50. Under Treas. Reg. §§ 1.861-9 and 1.861-13, the TBV of the stock of CFC is assigned 50% to the Section 951A category and 50% to the Section 245A subgroup in the general category. Under Country B law, DRE has E&P of $50. DRE distributes $50 to USP. For U.S. federal income tax purposes, the distribution is disregarded, but under Country B law, the distribution is a $50 dividend subject to $5 of Country B withholding tax.

In Example 4, the $50 distribution by DRE to USP is a remittance under the disregarded payment rules, and thus the $50 of foreign gross income arising from the disregarded distribution is assigned based on the TBV of the assets of DRE, which for this purpose include the CFC stock. Because under Treas. Reg. §§ 1.861-9 and 1.861-13, the CFC stock is assigned 50% to the Section 951A category and 50% to the Section 245A subgroup, it would appear that half of the $5 (or $2.5) foreign income taxes would

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[181] *Cf.* 2020 Prop. Treas. Reg. § 1.861-20(g)(10) (Example 9) (foreign gross income equal to the U.S. return of capital amount arising from disposition of CFC stock assigned to the Section 245A subgroup under the TBV method).

be allocated and apportioned to specified E&P and disallowed under Section 245A(d) and 2020 Prop. Treas. Reg. § 1.245A(d)-1(a).

We believe that disallowing an FTC for the foreign income tax in Examples 3 and 4 is appropriate. The foreign income tax paid by USP will often result from a timing difference between U.S. and foreign law, including by reason of a difference in the U.S. and foreign tax characterization of one or more of the subsidiaries of CFC. Notwithstanding that there has been no actual distribution of a Section 245A dividend, it is reasonable to treat the Section 301(c)(2) distribution in Example 3 and the disregarded payment in Example 4 as attributable to the E&P of the subsidiaries of CFC that will eventually give rise to a Section 245A DRD.

However, Treasury and the IRS should clarify several points related to the operation of this rule in the 2020 Proposed Regulations. With respect to Example 4, the 2020 Proposed Regulations explicitly treat as specified E&P the amount of a U.S. return of capital amount deemed to arise in a Section 245A subgroup by reason of a distribution with respect to, or a disposition of, stock.[182] However, there is no similar provision for the amount of specified E&P deemed to arise in a Section 245A subgroup by reason of a disregarded payment (*i.e.*, a remittance by a taxable unit that owns CFC stock). However, the allocation and apportionment of foreign income taxes to specified E&P by reason of a remittance is clearly contemplated by 2020 Prop. Treas. Reg. § 1.245A(d)-1(b)(1), which cross-references the rule for remittances in 2020 Prop. Treas. § 1.861-20(d)(3)(v)(C)(1)(i). Therefore, Treasury and the IRS should provide that specified E&P may also include an amount deemed to arise in a Section 245A subgroup by reason of a remittance, or otherwise clarify how Section 245A(d) applies in the case of a remittance by a taxable unit that owns stock of a CFC.[183]

In addition, in the case of a distribution or a disposition, the 2020 Proposed Regulations provide that the excess of the foreign gross income over the sum of the U.S. dividend amount and the U.S. capital gain amount is assigned to the same groupings to

[182] *See* 2020 Prop. Treas. Reg. § 1.245A(d)-1(c)(6) (definition of specified E&P).

[183] Foreign income taxes paid by a partner by reason of a distribution with respect to, or a disposition of, its partnership interest, to the extent foreign gross income exceeds the U.S. capital gain amount, can similarly be assigned to a Section 245A subgroup, if such partnership owns stock in CFCs and the partner apportions its interest expense by reference to its pro rata share of partnership assets under Treas. Reg. § 1.861-9(e). *See* 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(B) and (C). While 2020 Prop. Treas. Reg. § 1.245A(d)-1 does not cross-reference these rules, the same considerations would seem to apply as in regard to distributions with respect to, and dispositions of, stock and remittances.

which the TBV of the stock of the corporation "is (or would be if the taxpayer were a United States person) assigned" under Treas. Reg. § 1.861-9.[184] It is not clear what the import is of this language in the context of a CFC shareholder.

> Example 5: USP owns CFC1, a Country A corporation, which owns CFC2, a Country B corporation. CFC2 has $500 of Section 959(c)(3) E&P and $500 of general category GILTI PTEP in a single annual PTEP account. CFC1 has $500 of basis in the CFC2 stock, disregarding any basis under Section 961(c). All of CFC2's assets produce gross tested income in the general category. CFC2 distributes $1,500 to CFC1. Under Country A law, the distribution is a $1,500 dividend and is subject to $150 of Country A tax.

The distribution results in a foreign dividend amount of $1,500, a U.S. dividend amount of $1,000 (to the extent of CFC2's Section 959(c)(3) E&P and GILTI PTEP), and a U.S. return of capital amount of $500 (to the extent of CFC1's basis in CFC2).[185] The first $500 is assigned to the GILTI PTEP, and thus $50 ($150 * $500 / $1,500) of the foreign income taxes paid by CFC1 are allocated and apportioned to the GILTI PTEP group. The next $500 of the foreign dividend amount is assigned to the same grouping as the dividend of the Section 959(c)(3) E&P is assigned. Because the dividend is neither gross Subpart F income due to the application of Section 954(c)(6) nor gross tested income under Section 951A(c)(2)(A)(i)(IV), the dividend is assigned to the residual category, and thus this $500 of foreign dividend amount is also assigned to the residual category. Accordingly, $50 ($150 * $500 / $1,500) of the foreign income taxes paid by CFC1 are assigned to the non-creditable residual category.

Finally, the last $500 of the foreign dividend amount, to the extent of the U.S. return of capital amount with respect to the distribution, is assigned to the same relevant groupings as the TBV to which the CFC2 stock is assigned. In this case, the TBV of the CFC stock is assigned entirely to the gross tested income group in the general category, and thus the foreign dividend amount should also be assigned to the gross tested income group in the general category. Accordingly, assuming CFC1 has tested income for the

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[184] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(i)(D); *see also* similar language in 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(C).

[185] We do not, in this Report, take any position concerning the treatment of Section 961(c) basis or the potential for application of the principles of Section 961(b)(2) to a CFC-to-CFC distribution.

taxable year,[186] a portion of the $50 of foreign income taxes paid with respect to the U.S. return of capital amount are creditable as tested foreign income taxes under Section 960(d). The portion of these tested foreign income taxes deemed paid by USP under Section 960(d) would be equal to $50 multiplied by 80% and USP's inclusion percentage.[187]

The results above seem correct as a technical matter and as a matter of policy. However, there is some uncertainty that they would obtain, depending on the meaning of the provision in the 2020 Proposed Regulations that the foreign gross income on a disposition of stock of a corporation or partnership interest is assigned to the same groupings that the TBV of the stock is "or would be if the [taxpayer or partner] were a United States person" assigned under the asset method in Treas. Reg. § 1.861-9.[188] Similar language is used for purposes of assigning foreign gross income arising from a Section 301(c)(2) distribution with respect to stock under the 2020 Final Regulations and a return of capital distribution with respect to a partnership interest and disregarded payments that are remittances under the 2020 Proposed Regulations.[189] The "or would be" clause clearly contemplates a distribution by, or a disposition of, a lower-tier CFC, and indicates that the asset method under Treas. Reg. § 1.861-9 should apply as if the upper-tier CFC were a U.S. person.

One way that this language could be interpreted is that it is intended as an implicit cross-reference to the rules in Treas. Reg. § 1.861-13 for characterizing CFC stock owned by a U.S. shareholder, including dividing up the stock into Section 245A subgroups and non-Section 245A subgroups. If the stock of CFC2 were subdivided into Section 245A subgroups, conceivably, 2020 Prop. Treas. Reg. § 1.245A(d)-1 could apply to disallow foreign income taxes paid by CFC1 to the extent attributable to a Section 245A subgroup. This interpretation is further supported by an example in the 2020 Final Regulations illustrating the basketing consequences of a CFC-to-CFC "look-thru" dividend under

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[186] Because tested foreign income taxes are foreign income taxes "that are properly attributable to tested income taken into account by the domestic corporation under section 951A and §1.951A-1," *see* Treas. Reg. § 1.960-2(c)(3), no foreign income taxes paid or accrued by a CFC with a tested loss are tested foreign income taxes within the meaning of Section 960(d)(3).

[187] *See* Section 960(d)(1).

[188] 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(i)(D) and (ii)(C).

[189] Treas. Reg. § 1.861-20(d)(3)(i)(B)(2) and (3); 2020 Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(B) and (v)(C)(1)(i).

Section 954(c)(6), which includes a "see also" cite to Section 245A(d).[190] This cross-reference, which was not in the same example in the 2019 Proposed Regulations, implies that Section 245A(d) can apply to disallow FTCs with respect to a look-thru dividend at the CFC level.

However, we believe that Treas. Reg. § 1.861-13 should not apply to divide stock owned by a CFC into Section 245A subgroups for purposes of disallowing FTCs under Section 245A(d), because that could effectively subject foreign income taxes allocated and apportioned based on the TBV of the stock to a double application of the inclusion percentage. To illustrate, assume in Example 5 that USP's inclusion percentage is 50% and that CFC1 has tested income. In that case, the $50 of foreign income taxes paid by CFC1 with respect to the $500 U.S. return of capital amount is a tested foreign income tax under Section 960(d)(3). Accordingly, USP should be deemed to have paid $20 ($50 * 80% * 50%) of such taxes under Section 960(d), and such taxes should be assigned to the Section 951A category.[191] It is appropriate to assign the foreign income taxes of CFC1 to the Section 951A category and haircut such taxes based on USP's inclusion percentage, on the assumption that the future earnings of CFC2 will be tested income subject to inclusion in GILTI.

In contrast, if Treas. Reg. § 1.861-13 were to apply with respect to the Section 301(c)(2) distribution to cause FTCs to be disallowed under Section 245A(d) and 2020 Prop. Treas. Reg. § 1.245A(d)-1, CFC1's CFC2 stock would be assigned 50% to the Section 245A subgroup and 50% to the gross tested income group based on USP's inclusion percentage,[192] resulting in a disallowance under Section 245A(d) of $25 (50% * $50) of the Country A tax paid by CFC1. The remaining $25 of Country A tax would constitute tested foreign income taxes, but then USP would be deemed to have paid only $10 ($25 * 80% * 50%) of those taxes, *i.e.*, the portion of such taxes multiplied by 80% and USP's inclusion percentage (again). As a result, applying Treas. Reg. § 1.861-13 with respect to the CFC2 stock would subject the foreign income taxes paid by CFC1 to reduction by USP's inclusion percentage twice. There does not appear to be any policy justification for this result.

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[190] Treas. Reg. § 1.861-20(g)(5)(ii)(B) (the "foreign dividend amount" analysis in Example 4) ("See also section 245A(d) for rules that may apply to disallow a credit or deduction for certain foreign taxes.")

[191] See Sections 960(d)(1) and 904(d)(1)(A).

[192] *See* Treas. Reg. § 1.861-13(a)(2) and (5)(ii).

The debate concerning whether a foreign corporation should be permitted a Section 245A DRD is beyond the scope of this Report. However, regardless of whether Section 245A can apply to CFC-to-CFC dividends, foreign income taxes allocated and apportioned under the TBV method by reference to lower-tier CFC stock should not be assigned to a Section 245A(d) subgroup. Accordingly, Treasury and the IRS should clarify that Treas. Reg. § 1.861-13 does not apply to characterize lower-tier CFC stock in order to disallow FTCs under Section 245A(d).

b) Anti-abuse rule

The 2020 Proposed Regulations provide an anti-abuse rule that would attribute foreign income taxes to a specified distribution or specified E&P "if a transaction, series of related transactions, or arrangement is undertaken with a principal purpose of avoiding the purposes of Section 245A(d) and this section, including, for example, by separating foreign income taxes from the income, or earnings and profits, to which such foreign income taxes relate or by making distributions (or causing inclusions) under foreign law in multiple years that give rise to foreign income taxes that are allocated and apportioned with reference to the same previously taxed earnings and profits" (the "**anti-abuse rule**").[193] The following example is based on an example in the 2020 Proposed Regulations illustrating the concern motivating this anti-abuse rule.[194]

> Example 6: USP owns CFC, which has $500 of Subpart F PTEP and $500 of E&P that would give rise to a Section 245A DRD. In each of Year 2 and 3, USP elects to have CFC make a consent dividend under foreign tax law which, for foreign law purposes, is deemed to result in a $500 distribution to USP in each year, each of which is subject to $150 of foreign withholding tax. In Year 4, CFC makes a $1,000 distribution, which is treated as a return of capital distribution under foreign tax law, and thus not subject to additional tax, but it is treated as a distribution of $500 PTEP and a $500 dividend eligible for a Section 245A DRD under U.S. tax law.

Absent the application of the anti-abuse rule, no amount of the foreign income taxes would be disallowed as an FTC under 2020 Prop. Treas. Reg. § 1.245A(d)-1. This is because, under the rule for foreign law distributions (*i.e.*, distributions from a foreign tax law perspective that are not distributions from a U.S. tax law perspective), CFC is deemed in each of Year 2 and Year 3 to make a $500 distribution, with each distribution

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[193] 2020 Prop. Treas. Reg. § 1.245A(d)-1(b)(2).

[194] 2020 Prop. Treas. Reg. § 1.245A(d)-1(e)(4) (Example 3).

coming out of the same $500 of PTEP.[195] As a result, the foreign income taxes paid by USP with respect to the foreign law distribution are attributable to neither a specified distribution (because there is no distribution from a U.S. tax perspective) nor specified E&P (because the deemed distribution would be out of the PTEP, not E&P that can give rise to a Section 245A DRD). However, the example concludes that, because the consent dividends were made with a principal purpose of avoiding the application of Section 245A(d) with respect to CFC's specified E&P, USP is allowed neither an FTC nor a deduction for the $150 of the foreign withholding taxes treated as attributable to the $500 of CFC's specified E&P.

In the Preamble, Treasury and the IRS requested comments on whether potential revisions could be made to address the concerns that the mechanical application of Treas. Reg. § 1.861-20 could permit the separation of specified E&P from the associated taxes to avoid the application of Section 245A(d).[196] The Preamble provides that one example of a revision would involve the creation of separate E&P accounts within each relevant grouping for each taxable unit, "whereby the accounts would be adjusted annually to reflect transactions that occurred under foreign law but not under Federal income tax law."[197]

We appreciate the government's concern regarding successive foreign law distributions. We are also concerned that the rule for foreign law distributions, under slightly different facts, could operate to the detriment of the taxpayer.

> Example 7: USP owns CFC, a Country A corporation, which has $500 of Section 245A(d) PTEP in a 2019 annual PTEP account and $500 of Subpart F PTEP in a 2018 annual PTEP account. In each of Year 2 and Year 3, the Country A taxing authority deems CFC to make a distribution of $500 to USP, subjecting the income to $150 of foreign withholding in each year. In Year 4, CFC makes a $1,000 distribution, all which is treated as a return of capital distribution under foreign tax law, and thus not subject to additional

[195] *See* Treas. Reg. § 1.861-20(d)(2)(ii)(B), which assigns an item of foreign gross income that a taxpayer includes as a result of a foreign law distribution to the groupings to which the foreign gross income would be assigned if a distribution of property in the amount of the taxable distribution under foreign law were made for U.S. federal income tax purposes. The rule does not provide for a commensurate reduction in the E&P deemed distributed.

[196] Preamble, 85 Fed. Reg. at 72079.

[197] *Id*.

tax, but it is treated as a distribution of the $500 Section 245A(d) PTEP and the $500 of Subpart F PTEP under U.S. tax law.

In Example 7, the entire $300 of Country A withholding tax would be treated as attributable to the Section 245A(d) PTEP under the foreign law distribution rule, and thus disallowed under 2020 Prop. Treas. Reg. § 1.245A(d)-1. While this particular fact pattern may not arise frequently, and taxpayers generally will often have the ability to exercise self-help to avoid a foreign law distribution, it does demonstrate that the failure to make CFC-level E&P adjustments to account for previous foreign law distributions can produce results that are not taxpayer favorable as well.

We considered three alternatives with respect to successive foreign law distributions. The first alternative would be to modify the foreign law distribution rule to provide that, if the amount of the E&P of the foreign corporation exceeds the foreign gross income from the foreign law distribution, then the distribution should be treated as coming proportionately out of all the E&P, including PTEP, of the distributing foreign corporation. There is no compelling policy reason that the foreign law distribution rule has to follow the ordering rules for distributions under U.S. tax law, given that no U.S. gross income arises by reason of the deemed distribution and the E&P that "funds" this deemed distribution remain after the deemed distribution. This approach would ensure that no amount of successive foreign law distributions can achieve a better, or worse, result than an actual distribution of all the foreign corporation's E&P.

A second alternative would be to maintain the current rule for foreign law distributions, but then make adjustments to the composition of the E&P of the foreign corporation solely for purposes of applying Treas. Reg. § 1.861-20, and other provisions that rely on Treas. Reg. § 1.861-20, with respect to subsequent distributions. In order to minimize complexity, E&P accounts with respect to each category and PTEP group could be maintained at the level of the foreign corporation. However, we do not recommend this approach, because of the complexity this would entail. The collateral effects of making adjustments to E&P for deemed distributions are daunting. For instance, to the extent all the E&P of a foreign corporation have been deemed distributed through a foreign law distribution, this approach would treat any additional distributions (actual or deemed) as Section 301(c)(2) distributions, and basket the taxes under the TBV method. Therefore, to maintain the "fiction" of an actual distribution, adjustments would also have to be made to the shareholder's basis in the corporation for this purpose.

A third alternative would be to make no substantive changes to the operative rules, and instead continue to rely on the anti-abuse rule. While we appreciate the desire for Treasury and the IRS to create objective rules to provide certainty in compliance and administration, it seems impracticable to draft rules to police the myriad of ways to separate E&P from foreign income taxes, and it appears likely this process will devolve into a decades-long cat-and-mouse game between practitioners and the government, in much the same manner as the effort to separate E&P from cash proved to be pre-TCJA. In this regard, a well-articulated anti-abuse rule may prove a more effective tool than a further contribution to hyperlexis.

E. Determination of Financial Services Income

1. Background

Passive income[198] that is characterized as financial services income is not assigned to the passive category but rather is assigned to the foreign branch category, the Section 951A category, or the general category, as applicable, for purposes of Section 904.[199] In addition, income that is characterized as financial services income is excluded from gross deduction eligible income, and thus is disregarded in computing a domestic corporation's FDII under Section 250(b).[200]

Under existing regulations, "**financial services income**" is income earned by a financial services entity that is (1) income derived in the active conduct of a banking, insurance, financing, or similar business ("**active financing income**");[201] (2) passive income as determined before the application of the high-tax exception in Section 904(d)(2)(B)(iii)(II);[202] or (3) income that is integrally related to active financing income of

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[198] As discussed *supra* in footnote 28, passive income is a subset of passive category income, and is income received or accrued by any person which is of a kind that would be FPHCI.

[199] Treas. Reg. § 1.904-4(e)(1)(i); *see also* Section 904(d)(2)(D). Because foreign branch category income is defined under Section 904(d)(2)(J) as any income of a QBU other than passive category income, financial services income of a QBU that would be general category income because it is financial services income is treated as foreign branch category income. Likewise, Section 951A category income is income included in gross income under Section 951A other than passive category income, and thus a GILTI inclusion of a U.S. shareholder, to the extent attributable to income that is general category income of a CFC because it is financial services income, is treated as Section 951A category income of such shareholder.

[200] *See* Section 250(b)(3)(A)(i)(III).

[201] Treas. Reg. § 1.904-4(e)(1)(ii)(A).

[202] Treas. Reg. § 1.904-4(e)(1)(ii)(B).

a financial services entity ("**incidental income**").[203] A "**financial services entity**" is an individual or entity if either (i) at least 80% of its gross income is active financing income or (ii) the entity is a member of an affiliated group (as defined in Section 1504, but including foreign corporations) and at least 80% of the group's income is active financing income (such percentage in either case, the "**AFI percentage**").[204] The existing regulations specify an exclusive list of 23 items of income that qualify as active financing income, plus a "catch-all" provision for "any similar item of income" that is disclosed by a taxpayer on Form 1118 or 1116.[205]

Active financing income is thus important for two distinct, but related, purposes – (1) the determination of whether an individual or entity is a financial services entity (the "**FSE determination**") by reason of either the standalone income of the individual or entity (the "**FSE standalone determination**") or the income of an affiliated group of which the entity is a member (the "**FSE group determination**") and (2) the determination of whether income earned by a financial services entity is financial services income (the "**FSI determination**"). Active financing income is a necessary, but not an exclusive or even sufficient, source of financial services income. While an individual or entity (or group) must earn a certain amount of active financing income to qualify as a financial services entity, a financial services entity's income that is financial services income includes not only active financing income, but also passive income and, under the existing regulations, incidental income. In contrast, no income of an individual or entity that is **not** a financial services entity can qualify as financial services income, even income that is active financing income.

Under the existing regulations, active financing income derived from related persons (other than certain income received from related persons that themselves are financial services entities) is taken into account for both the FSE standalone determination and the FSI determination in the same manner as income derived from unrelated persons.[206] Thus, for instance, an item of income that is active financing income (*e.g.*, interest income) derived from a related person both increases the AFI percentage for the FSE standalone determination and, if the payee is a financial services entity,

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[203] Treas. Reg. § 1.904-4(e)(1)(ii)(C) and (4).

[204] Treas. Reg. § 1.904-4(e)(3)(i) and (ii).

[205] Treas. Reg. § 1.904-4(e)(2)(i).

[206] Treas. Reg. § 1.904-4(e)(3)(i) (penultimate sentence). However, the FSE group determination is made without regard to transactions between members of the affiliated group. Treas. Reg. § 1.904-4(e)(3)(ii).

qualifies as financial services income.[207] An item of income derived from a related person that is not active financing income (*e.g.,* a royalty or a Subpart F inclusion), but is assigned to passive category income under the look-through rules in Section 904(d)(3) and Treas. Reg. § 1.904-5 (the "**look-through rules**"), does not increase the AFI percentage, but, if earned by a financial services entity, is treated as passive income that qualifies as financial services income.[208]

The 2019 Proposed Regulations would have significantly revised the definition of financial services income and the rules for determining when an individual or corporation is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.[209] In response to comments, the financial services income rules in the 2019 Proposed Regulations were not finalized, and instead new financial services income rules were included in the 2020 Proposed Regulations. These rules generally maintain the structure of the existing regulations while modifying the definitions of financial services income, active financing income, and financial services entities, each as described in Part IV.E.2.a of this Report.

2. Discussion

a) In General

The 2020 Proposed Regulations would significantly modify the FSE determination.[210] First, the 2020 Proposed Regulations would lower the AFI percentage

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[207] *See* Former Treas. Reg. § 1.904-4(e)(3)(iv), Example 1, prior to being removed by T.D. 9882, 84 Fed. Reg. 69022 (Dec. 17, 2019) (concluding that an interest payment from a CFC to its domestic corporate parent "retains it character as active financing income").

[208] Treas. Reg. § 1.904-5(b)(2). Distributions, interest, rents, or royalties received from a related person that is a financial services entity and that would be assigned to the passive category under the look-through rules, but for the fact such amounts are paid by a financial services entity (and, therefore, not attributable to passive category income of the payor), are assigned to foreign branch category or general category, as applicable. Treas. Reg. § 1.904-4(e)(1)(i) (final sentence).

[209] *See* 2019 Prop. Treas. Reg. § 1.904-4(e).

[210] Although not a focus of this discussion, it is unclear why, under the 2020 Proposed Regulations, unlike the existing regulations, a partnership cannot be a financial services entity. *Compare* 2020 Prop. Treas. Reg. § 1.904-4(e)(3)(i) and (iii) and 2020 Prop. Treas. Reg. § 1.904-4(e)(3)(i)(A) and (C).

from “at least 80 percent”[211] to “more than 70 percent.”[212] But then, for purposes of the FSE standalone determination, the 2020 Proposed Regulations would exclude from the numerator of the AFI percentage active financing income derived from any related person within the meaning of Section 267(b) or Section 707, while still including related person income in the denominator.[213] Accordingly, under the 2020 Proposed Regulations, income derived from related persons, whether in the nature of active financing income or derived from related persons that are themselves financial services entities, are treated as “bad” income for purposes of the FSE standalone determination.[214]

The 2020 Proposed Regulations would also significantly change the items of income of a financial services entity that are treated as financial services income. First, the 2020 Proposed Regulations would remove “incidental income” from the list of items of income of a financial services entity that qualify as financial services income.[215] Second, the 2020 Proposed Regulations would provide that passive income does not include “payments” from related persons that are not themselves financial services entities even if attributable to passive category income under a look-through rule.[216] Similarly, the 2020 Proposed Regulations would eliminate the rule in Treas. Reg. § 1.904-5(b)(2) that would allow amounts treated as passive income under a look-through rule to qualify as financial services income.[217]

We have no objection to the elimination of incidental income. The definition of incidental income is vague and uncertain, and the specific types of income that constitute

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[211] Treas. Reg. § 1.904-4(e)(3).

[212] 2020 Prop. Treas. Reg. § 1.904-4(e)(3)(i)(A).

[213] 2020 Prop. Treas. Reg. § 1.904-4(e)(3)(i)(A) and (B).

[214] As under existing regulations, the FSE group determination would be made without regard to transactions with other members, and thus such amounts would be excluded from both the numerator and denominator of the AFI percentage. *See* 2020 Prop. Treas. Reg. § 1.904-4(e)(3)(ii) and Treas. Reg. § 1.904-4(e)(3)(ii).

[215] *Compare* Treas. Reg. § 1.904-4(e)(1)(ii) and 2020 Prop. Treas. Reg. § 1.904-4(e)(1)(ii). However, the items described in 2020 Prop. Treas. Reg. § 1.904-4(e)(2)(i)(P) (income from repackaging mortgages and other financial assets) and (Q) (investment bank income) do include certain income “incidental” to the relevant activity.

[216] 2020 Prop. Treas. Reg. § 1.904-4(e)(1)(ii)(B).

[217] *See* 2020 Prop. Treas. Reg. § 1.904-5(b)(2).

active financing income are generally broad enough to encompass all the relevant items of a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. We do not express a view on the change to the AFI percentage, or the treatment of payments from non-financial services entities that are related persons as *per se* "bad" income for purposes of the FSE determination. While this treatment of related party payments will make it more difficult for a corporation that receives substantial intercompany interest payments (*e.g.*, an internal financing company) to qualify as a financial services entity on a standalone basis, such payments would be disregarded for purposes of the FSE group determination, and thus "true" financial services companies will generally still be able to qualify.

We do, however, have some reservations regarding the proposed rule that would prevent passive income of a financial services entity by reason of a look-through rule from qualifying as financial services income. The application of this rule is illustrated in Example 8.

> Example 8: USP, a financial services entity, owns CFC, an entity that is not a financial services entity. USP earns $100 of income for the taxable year, which consists of $90 of active financing income from unrelated customers and $10 of interest income from CFC. CFC earns $10 of FPHCI.

The $10 of interest received from CFC is passive income under the look-through rule for interest.[218] Therefore, under the existing regulations, because the interest income is passive income and USP is a financial services entity, all of USP's income, including the related party interest income, is financial services income and thus general category income. Such treatment is consistent with the policy rationale for the look-through rules, which is to categorize income from related party payments or inclusions in the same manner as if the recipient had earned the underlying income directly. However, under the 2020 Proposed Regulations, the $10 of interest income would retain its passive category treatment under the look-through rule, notwithstanding that the income is passive income of a financial services entity.

The Preamble does not explain the reason for the proposed change to the treatment of look-through payments. One supposition is that the proposed rule is intended to address undue flexibility in basketing income under the existing regulations afforded to

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[218] *See* Treas. Reg. § 1.904-5(c)(2); *see also* Treas. Reg. § 1.904-5(l)(1) (Example 1) (involving interest paid by CFC1 to CFC2 that would be treated as passive category FPHCI under the look-through rule, but, because CFC1 is a financial services entity, the resulting Subpart F inclusion is general category income).

certain taxpayers through, *e.g.*, causing non-financial service entities to make related party payments to financial services entities in order to convert passive category income into general category income. However, in this regard, the 2020 Proposed Regulations would maintain flexibility for such taxpayers by elevating in importance the initial location of the non-related party income item.

> Example 9: USP owns CFC1 and CFC2. CFC1 is a financial services entity, CFC2 is not a financial services entity. CFC2 earns $100 of passive category income, and CFC2 pays $100 of interest to CFC1. The interest is subject to foreign income tax. The interest income satisfies the Subpart F active financing exception of Section 954(h) and is therefore gross tested income of CFC1 and is taken into account in determining USP's GILTI inclusion. USP is subject to an FTC limitation in the Section 951A category, but USP has excess limitation in the passive category.

The interest payment from CFC2 to CFC1 is characterized under the look-through rule for interest as passive category income.[219] Under the 2020 Proposed Regulations, the income would remain passive category income in the hands of CFC1, notwithstanding that it is a financial services entity. As a result, USP's GILTI inclusion (and related Section 78 gross-up) attributable to CFC1's passive category income is treated as passive category income under the look-through rule for GILTI,[220] and the foreign income taxes paid by CFC1 are creditable as passive category FTCs, albeit subject to the haircut for tested foreign income taxes under Section 960(d). If, instead, CFC1 earned the interest income directly, such income would be financial services income, and thus USP's resulting GILTI inclusion would be Section 951A category income. Similarly, under the existing regulations, the income would be Section 951A category income to USP, whether earned directly by CFC1 or through receipt of interest income from CFC2.

If the rule in the 2020 Proposed Regulations is finalized, Treasury and the IRS should clarify the purpose for the change and whether the exclusion from financial services income of passive category income under a look-through rule applies solely to related party payments, or whether it applies to inclusions as well. Specifically, 2020 Prop. Treas. Reg. § 1.904-4(e)(1)(ii)(B) purports to exclude only "payments" subject to a look-through rule, but is silent with respect to Subpart F or GILTI inclusions, which also may be characterized as passive category income under a look-through rule. In contrast, 2020

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[219] *See* Treas. Reg. § 1.904-5(c)(2)(ii)(C).

[220] *See* Treas. Reg. § 1.904-5(c)(6).

Prop. Treas. Reg. § 1.904-5(b)(2) appears to provide that all amounts of income of a financial services entity treated as passive category income under a look-through rule, which would include Subpart F or GILTI inclusions, remain passive category income notwithstanding Treas. Reg. § 1.904-4(e).[221] In addition, Example 1 in Treas. Reg. § 1.904-5(l), which illustrates the treatment of an amount characterized as passive category income under a look-through rule as financial services income of a financial service entity, would have to be modified or eliminated to reflect the approach in the 2020 Proposed Regulations.

b) Insurance Companies

In addition to the changes described in Part IV.E.2.a of this Report, the 2020 Proposed Regulations would make changes specific to insurance companies, including imposing additional limitations on the amount of income of insurance companies that can be considered active financing income and thus financial services income. Under the 2020 Proposed Regulations, the amount of certain insurance-related investment income that constitutes active financing income is limited to amounts "ordinary and necessary to the proper conduct of the insurance business."[222] An amount is considered not "ordinary and necessary" to the extent it exceeds the company's passive category income (including, for this purpose, income excluded from FPHCI under the Section 954(i) exception for insurance income) multiplied by the ratio of the company's investment asset limitation to the value of its passive category assets (as determined under Treas. Reg. §§ 1.861-9 through 13).[223] A company's investment asset limitation equals 200 percent of its total insurance liabilities, in the case of a life insurance company, or 400 percent of its total insurance liabilities, in the case of a non-life insurance company.[224] Total insurance liabilities are defined differently depending on whether an insurance company is a domestic life insurance company, a domestic non-life insurance company, or a CFC.[225]

The Preamble does not explain the basis for the thresholds chosen for purposes of the investment asset limitation and rather requests comments as to whether such

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221 In contrast, the Preamble describes 2020 Prop. Treas. Reg. § 1.904-5(b)(2) as applying to "related party payments," again without mention of inclusions. *See* Preamble, 85 Fed. Reg. at 72099.

222 *See* 2020 Prop. Treas. Reg. § 1.904-4(e)(2)(i)(V) and (W).

223 2020 Prop. Treas. Reg. § 1.904-4(e)(2)(ii) and (ii)(A).

224 *See* 2020 Prop. Treas. Reg. § 1.904-4(e)(2)(ii)(B).

225 *See* 2020 Prop. Treas. Reg. § 1.904-4(e)(2)(ii)(C).

thresholds are appropriate. Although the threshold provided for non-life insurance companies, assets equal to 400 percent of total insurance liabilities, may be consistent with the standard selected by Congress for a qualifying insurance company for purposes of the PFIC rules,[226] it is not clear that such standard would be relevant for purposes of the financial services income rules. Furthermore, the lower ratio that would apply for life insurance companies is not only inconsistent with such general standard, but even more so with the increased assets-to-liabilities ratio that the PFIC rules would allow in certain circumstances, raising questions about the appropriateness of such threshold.[227] If the thresholds were selected based on statistical evaluations of the typical amounts of assets of insurance companies, it is unclear how such evaluations took into account differences between U.S. and foreign insurance companies; if based solely on U.S. companies, it would be inappropriate to extend the thresholds to foreign insurance companies operating under different strictures. More generally, given the differences in the definition of insurance liabilities for U.S. insurance companies and foreign insurance companies, it is not clear that a single threshold applicable for both would be appropriate. We recommend that Treasury and the IRS give further consideration to the approach of the 2020 Proposed Regulations to insurance companies, including the thresholds applicable for purposes of determining their investment asset limitations and their interaction with the definitions of total insurance liabilities for different categories of companies, and clearly articulate the rationale for such rules.

Apart from the addition of the "ordinary and necessary" limitation discussed above, the definitions of insurance income that constitutes active financing income in the 2020 Proposed Regulations are broadly consistent with those in the existing regulations.[228] Under both the existing regulations and the 2020 Proposed Regulations, active financing income includes income of a kind that would be insurance income as defined in Section 953(a)(1), including related person insurance income as defined in Section 953(c)(2) (**"RPII"**), but without regard to the exception for certain same-country income currently in

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[226] *See* Section 1297(f)(1)(A) (providing that the applicable insurance liabilities of a qualifying insurance company must generally constitute more than 25% of its total assets).

[227] *See* Section 1297(f)(2)(A) (allowing, in the case of failure to satisfy the 25% percent requirement of Section 1297(f)(1)(A) due to runoff-related or rating-related circumstances, a 10% ratio of applicable insurance liabilities to total assets).

[228] *Compare* Treas. Reg. § 1.904-4(e)(2)(i)(A) and (B) and 2020 Prop. Treas. Reg. § 1.904-4(e)(2)(i)(V) and (W).

Section 953(e).[229] Although Section 953 is generally only relevant with respect to CFCs, Section 953(a)(1) sets forth a broad definition of insurance income that is not limited to income of a foreign corporation. However, the definition of RPII assumes that the recipient is a foreign corporation with a U.S. shareholder, with income from that U.S. shareholder and related persons (generally within the meaning of Section 954(d)(3))[230] with respect to it constituting RPII,[231] calling into question its applicability to insurance income of a U.S. company from related persons.

Although this issue could also have been raised under the existing regulations, it was irrelevant, as such income clearly constituted active financing income regardless of whether it was RPII. However, as discussed in Part IV.E.2.a of this Report, the 2020 Proposed Regulations would generally exclude from the numerator of the AFI percentage for purposes of the FSE standalone determination any active financing income derived from related persons within the meaning of Section 267(b) or Section 707. An exception to the related person income exclusion is provided, however, for RPII.[232] Thus, while insurance income from related persons received by a foreign corporation would clearly be included in the numerator for purposes of the AFI percentage computation, it is unclear whether such income received by a U.S. corporation would be so included, and, if so, how related persons would be defined in the absence of a U.S. shareholder. We recommend that if the related person income exclusion for purposes of the FSE standalone determination is finalized, the final regulations clarify that active financing income taken into account for purposes of computing the AFI percentage nevertheless includes insurance income of a U.S. company attributable to a policy of insurance or reinsurance with respect to which the person (directly or indirectly) insured is a related person (within the meaning of Section 954(d)(3) as supplemented by Section 953(c)(6)) with respect to the company.

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229 *See* Treas. Reg. § 1.904-4(e)(2)(i)(A) and 2020 Prop. Treas. Reg. § 1.904-4(e)(2)(i)(W).

230 *See* Section 953(c)(6).

231 *See* Section 953(c)(2) (defining RPII as insurance income attributable to a policy of insurance or reinsurance with respect to which the person (directly or indirectly) insured is a U.S. shareholder in the foreign corporation or a related person to such a shareholder).

232 *See* 2020 Prop. Treas. Reg. § 1.904-4(e)(3)(i)(A).

F. Rules Regarding When the FTC Can be Claimed

1. Background

The 2020 Proposed Regulations revise and significantly expand the existing regulations addressing when an FTC can be claimed. Among the noteworthy changes, the 2020 Proposed Regulations clarify the application of the relation-back doctrine and modify the current rules pertaining to the contested tax doctrine.

The timing of a taxpayer's FTC is generally governed by the taxpayer's method of accounting, although the timing of a partner's share of taxes paid by a partnership is generally governed by the partnership's method of accounting.[233] Therefore, an accrual method taxpayer, or a partner in an accrual method partnership, generally takes an FTC for a foreign income tax in the year that the tax accrues.[234] Foreign income taxes accrue in the taxable year in which all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy.[235] Thus, a foreign income tax determined on the basis of a foreign taxable year generally accrues at the close the taxpayer's foreign taxable year.[236]

The 2020 Proposed Regulations address the application of the relation-back doctrine to foreign income taxes paid by an accrual method taxpayer that relate to a prior tax year. Under these rules, additional foreign income tax paid as a result of a change in foreign tax liability, including as the result of the resolution of a contest with a foreign tax authority, relate back and are considered to accrue for FTC purposes at the end of the foreign tax year with respect to which the taxes were imposed (the **"relation-back year"**).[237] Additional withholding taxes resulting from a change in the amount of an item

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233 *See* Treas. Reg. §§ 1.702-1(a)(6) and 1.703-1(b)(2).

234 2020 Prop. Treas. Reg. § 1.905-1(d)(1)(i) and (f)(1). A cash method taxpayer generally takes an FTC for a foreign income tax in the year that the tax is paid, but can make an irrevocable election to use the accrual method for purposes of claiming FTCs. 2020 Prop. Treas. Reg. § 1.905-1(c)(1) and (e).

235 2020 Prop. Treas. Treas. Reg. § 1.905-1(d)(1)(i) (cross-referencing Treas. Reg. §§ 1.446-1(c)(1)(ii)(A) and 1.461-4(g)(6)(iii)(B)); *see also* Treas. Reg. § 1.461–4(g)(6)(i) (economic performance exception for foreign income taxes); *cf.* Rev. Rul. 61-93, 1961-1 C.B. 390 (indicating that foreign income taxes are considered accrued when the liability for such foreign taxes becomes fixed and determinable).

236 *Id.*

237 2020 Prop. Treas. Reg. § 1.905-1(d)(1)(ii).

of foreign gross income also relate back and are considered to accrue in the year in which the relevant payment was made (or treated as made under foreign law).[238]

The liability for an income tax that is contested generally is not fixed, and therefore does not accrue, until the contest is resolved, even if the taxpayer pays the contested tax liability, for instance, in order to toll interest and penalties until the matter is adjudicated.[239] Nonetheless, the IRS has provided an exception in revenue rulings to the contested tax doctrine for FTC purposes, ruling that contested foreign income taxes that have been paid to a foreign country may be accrued and claimed as an FTC, even if the liability for the contested tax has not been resolved.[240] The rulings were predicated on the fact that, in the event that the contested tax liability was resolved in a taxpayer's favor, *i.e.*, the taxpayer was refunded some or all of its payment to the foreign taxing authority, a foreign tax redetermination would be required under Section 905(c).

The 2020 Proposed Regulations would reverse the IRS's position with respect to the contested tax doctrine and provide that an FTC for a contested income tax liability cannot be claimed by an accrual method taxpayer until such time as both the contest is resolved and the tax is actually paid.[241] However, the 2020 Proposed Regulations would then provide an exception to this general rule, under which a taxpayer can claim a provisional FTC in the relation-back year to the extent the taxpayer remits the contested amount to the foreign country pending settlement of the dispute.[242] As a condition to this provisional credit, the taxpayer must enter into an agreement with the IRS that describes the details regarding the contested tax and allows the IRS to audit the claim for credit when the contest is resolved.[243] The taxpayer is also required to provide annual certifications regarding the status of the contest[244] and must agree for a three-year period not to assert the statute of limitations as a defense to the assessment of additional taxes

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[238] *Id.*

[239] *See, e.g., Dixie Pine Products Co. v. Comm'r*, 320 U.S. 516 (1944).

[240] *See* Rev. Rul. 70-290, 1970-1 C.B. 160, and Rev. Rul. 84-125, 1984-2 C.B. 125.

[241] 2020 Prop. Treas. Reg. § 1.905-1(d)(3).

[242] 2020 Prop. Treas. Reg. § 1.905-1(d)(4)(i).

[243] *See* 2020 Prop. Treas. Reg. § 1.905-1(d)(4)(ii).

[244] *See* 2020 Prop. Treas. Reg. § 1.905-1(d)(4)(iii).

relating to the contested tax that may arise from a determination that the contested tax is noncompulsory.[245]

2. Discussion

a) Partnership Taxes

The 2020 Proposed Regulations provide, consistent with existing regulations, that a partner in a partnership may treat its distributive share of the creditable foreign tax expenditures (**"CFTEs"**) of an accrual-method partnership that are accrued by the partnership during the partnership's taxable year ending with or within the partner's taxable year as paid or accrued in that taxable year.[246] However, the 2020 Proposed Regulations further provide that if additional CFTEs result from a change in the partnership's foreign tax liability for a prior taxable year, a cash-method partner may only take into account its distributive share of such additional taxes for credit or deduction purposes in the partner's taxable year with or within which the taxable year of the partnership in which it pays the taxes ends.[247] This rule is subject to the election for cash method taxpayers to use the accrual method for purposes of determining FTCs.[248] Furthermore, a partner that claims FTCs on an accrual basis may make the election to claim a provisional FTC for contested taxes paid by the partnership in advance of the relation-back year.[249]

Under the general rule reflected in the existing regulations, the use of the accrual method by a partnership should control the timing of FTCs and deductions of a partner for foreign income taxes paid by the partnership. However, the special rules provided in the 2020 Proposed Regulations for subsequent changes in a partnership's foreign income tax liability as well as partner eligibility for the provisional credit election significantly limit the applicability of this general rule. No explanation is provided in the Preamble as to why these limitations are included. In the absence of a policy reason to treat additional tax paid by an accrual-method partnership as a result of a change in the foreign tax liability for a year differently from tax originally paid by the partnership with respect to the year,

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245 *See* 2020 Prop. Treas. Reg. § 1.905-1(d)(4)(ii)(D).

246 *See* 2020 Prop. Treas. Reg. § 1.905-1(f)(1).

247 *See id*.

248 *See id.;* 2020 Prop. Treas. Reg. § 1.905-1(e).

249 *See* 2020 Prop. Treas. Reg. § 1.905-1(f)(2).

we believe that the same consequences to a cash-method partner should obtain for both. Accordingly, we recommend that the final regulations extend the application of the principles of the relation-back rule in 2020 Prop. Treas. Reg. § 1.905-1(d)(1)(ii) to partners of an accrual-method partnership by treating each partner's distributive share of additional tax paid by the partnership as a result of a change in the foreign tax liability as paid or accrued by the partner in its taxable year with which or within which the partnership's relation-back year ends. Similarly, we recommend that the provisional credit election be available to any partner of an accrual-method partnership without regard to whether the partner is an accrual-method taxpayer or has elected to use the accrual method for purposes of computing FTCs.

b) Contested Taxes

The 2020 Proposed Regulations permit an electing taxpayer to claim an FTC, "but not a deduction," for contested foreign income tax liability.[250] In the case of a CFC taxpayer, if a contested tax liability election is made, it is not clear whether the CFC would be permitted a deduction for the contested tax in computing its taxable income and E&P in the year to which the tax is treated as relating for FTC purposes.

> Example 10: USP wholly owns CFC. In Year 1, CFC accrues $100 of gross FPHCI with respect to which $10 of foreign income tax is imposed and paid, although a portion of tax such is contested. USP has a Subpart F inclusion with respect to CFC. USP elects to claim the benefit of FTCs in Year 1. The contest is resolved against CFC in Year 3.

In Example 10, under the Proposed Regulations, the contested portion of the foreign income tax liability does not accrue until the Year 3 resolution of the contest.[251] If USP does not make the election in 2020 Prop. Treas. Reg. § 1.905-1(d)(4) to claim a provisional credit for contested taxes, the accrual of the contested tax in Year 3 and corresponding claiming of an FTC would constitute a foreign tax redetermination requiring a redetermination of U.S. tax liability.[252] As a result, CFC's taxable income, E&P, and

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[250] *See* 2020 Prop. Treas. Reg. § 1.905-1(d)(4)(i).

[251] *See* 2020 Prop. Treas. Reg. § 1.905-1(d)(3).

[252] *See* Treas. Reg. § 1.905-3(a) and (b)(2)(i).

current year taxes would also be required to be adjusted to take into account the redetermined amount of tax taking into account the contested tax liability.[253]

If, however, in Example 10, USP were to make a contested tax election for Year 1, USP would be permitted to claim an FTC of $10 under Section 960(a) in Year 1. However, the 2020 Proposed Regulations specifically preclude the accrual of the contested tax in the year of payment for purposes of a deduction. It is reasonable to assume that this limitation on deducting the contested tax was intended apply to a U.S. taxpayer claiming a deduction, rather than an FTC, under Section 164(a)(3). But this limitation could be understood to prevent CFC from deducting the taxes.[254] As a result, USP would have a $100 Subpart F inclusion that is unreduced by the foreign income tax expense, while still including in its income a Section 78 gross-up of $10, which gross-up is predicated on a CFC-level deduction for the taxes, but not conditioned on it. Furthermore, when the contest is resolved in Year 3, there is no foreign tax redetermination, and therefore it would not appear that the $10 of foreign income tax expense would relate back to Year 1 for purposes of computing CFC's taxable income and E&P. Even if the deduction were permitted in Year 3, this would result in a permanent mismatch between the deduction, the income, the taxes, and the Section 78 gross-up.

We recommend that final regulations specifically address the application of the contested tax liability rules to the deductions of CFC taxpayers. Specifically, if a provisional credit election is made, a CFC-level deduction for the relation-back year should also be provided in advance of accrual.

[253] *See* Treas. Reg. § 1.905-3(b)(2)(ii).

[254] It could be argued that, under Section 7701(a)(14), a CFC should not be treated as a taxpayer, and thus, 2020 Prop. Treas. Reg. § 1.905-1(d)(4)(i) should not apply to it. However, that interpretation of the 2020 Proposed Regulations is far from clear.