

**SJSU/TEI HIGH TECH TAX INSTITUTE**

**U.S. INTERNATIONAL TAX ISSUES AND DEVELOPMENTS**

**November 9, 2020**

**by**

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I. HIGH TAX REGULATIONS.

INTRODUCTION

- A. Regulations adopting the GILTI High-Tax exception s were finalized. They retain the basic approach and structure of the proposed elective GILTI high-tax exclusion regulations under § 951A(c)(2)(A)(i)(III), with important revisions.
- B. A separate notice of proposed rulemaking was published, that proposes to generally conform the rules implementing the Subpart F high-tax exception to the rules implementing the GILTI high-tax exclusion, and provides for a single election under § 954(b)(4) for purposes of both Subpart F income and tested income. This regulation, when finalized, will be a big change.
- C. We also note that the real, unstated issue under these regulations for most taxpayers likely will involve foreign tax credits.

## FINAL GILTI REGULATIONS

- A. Summary. The final regulations provide rules to determine the effective rate of tax on foreign items of income for the purposes of applying the GILTI high-tax exclusion. Unfortunately, the final regulations retain the high tax threshold of 90% of the top corporate rate which is 18.9%. The effective foreign tax rate is determined on a tested unit basis. They also provide rules to determine the net amount of income and the foreign taxes paid or accrued to compute the effective rate of tax. In addition, they indicate how to make the GILTI high-tax exclusion election. The election, if made, must be made for the entire “CFC Group.” The final regulations also provide that taxpayers can make the election annually.
- B. Calculation of Effective Foreign Tax Rate.
1. QBU-by-QBU Determination.
- (a) The 2019 proposed regulations applied based on the effective foreign tax rate imposed on the aggregate of all items of tentative net tested income of a CFC attributable to a single qualified business unit (as defined in § 989(a)) (“QBU”) of the CFC that would be in a single tested income group. They applied on a QBU-by-QBU basis to minimize the “blending” of income subject to different foreign tax rates and, as a result, were intended to more accurately identify income subject to a high rate of foreign tax.
- (b) Treasury and the IRS received several comments regarding the determination of the effective foreign tax rate on a QBU-by-QBU basis. Some comments requested that the effective foreign tax rate test apply on a CFC-by-CFC basis and asserted that this approach would better align the GILTI high-tax exclusion with the Subpart F high-tax exception.
- (c) The final regulations replace the QBU-by-QBU approach with a “tested unit” approach.
2. CFC-level Determination of Foreign Taxes.
- (a) One comment requested that the effective foreign tax rate test be based on the shareholder’s deemed paid credit for taxes properly attributable to tested income, as defined in § 960(d), over the shareholder’s net CFC tested income, as defined in § 951A(c).
- (b) Treasury and the IRS believe that this approach would be inconsistent with § 954(b)(4). Unlike a GILTI inclusion, which is based on the aggregate amounts of a U.S. shareholder’s pro rata shares of items from all the CFCs, § 954(b)(4) applies by its terms to items of income of a single CFC. The preamble states that nothing in § 954(b)(4), or § 951A(c)(2)(A)(i)(III), suggests that the

aggregate approach of the GILTI regime should or could apply for purposes of determining whether an item of income received by a CFC is subject to a sufficiently high level of foreign tax under § 954(b)(4). Thus, the final regulations do not adopt this comment.

3. Effective Foreign Tax Rate.

(a) Threshold Rate of Tax.

- i. The 2019 proposed regulations applied the GILTI high-tax exclusion by comparing the effective foreign tax rate with 90% of the rate that would apply if the income were subject to the maximum rate of tax specified in § 11 (currently 18.9%, based on a maximum rate of 21%).
- ii. Several comments requested that the GILTI high-tax exclusion instead be applied if the effective foreign tax rate is at least 13.125%. The final regulations did not adopt these comments.

(b) Safe Harbors.

- i. One comment said that the “mechanical snapshot” rule for determining the effective foreign tax rate can produce results that are unreasonable given timing differences between the U.S. and foreign tax bases. To address these timing differences, the comment suggested that the final regulations include two new methods, for calculating the effective foreign tax rate, each of which could be safe harbors applied at the discretion of the taxpayer.
- ii. The final regulations did not adopt these safe harbors. Treasury and the IRS believe that the tested unit combination rule should ameliorate some of the expressed concerns.

4. Base and Timing Differences.

- (a) In General. The 2019 proposed regulations generally provided that the effective rate at which taxes are imposed for a taxable year is the U.S. dollar amount of foreign income taxes paid or accrued regarding a tentative net tested income item, over the sum of the U.S. dollar amount of the tentative net tested income item and the amount of foreign income taxes paid or accrued regarding the tentative net tested income item. A tentative net tested income item was generally determined by taking into account items of gross income (determined under federal income tax principles) attributable to a QBU, less deductions (also determined under

federal income tax principles) allocated and apportioned to such gross income. Thus, the effective foreign tax rate was based on the amount of foreign income taxes paid or accrued on income attributable to the QBU as determined for federal income tax purposes, without regard to how the income is determined for foreign income tax purposes

(b) Disregarded Payments.

- i. The proposed regulations generally provided that gross income was attributable to a QBU if it was properly reflected on the books and records of the QBU, determined under federal income tax principles, except that the income was adjusted to account for some disregarded payments.
- ii. One comment suggested that a disregarded payment should not result in the reallocation of income between QBUs for purposes of computing the GILTI high-tax exclusion. Treasury and the IRS believe the comment's concern to be the potential inability to claim the GILTI high-tax exclusion in scenarios where a disregarded payment was made from a high-taxed CFC to a disregarded entity that paid no tax.
- iii. They believe that, if a tested unit makes a disregarded payment to another tested unit, gross income should be reallocated among the tested units to appropriately associate the income with the tested unit in which it is subject to tax. This reallocation would promote conformity between the income attributed to a tested unit and the income of that tested unit that is subject to tax in the foreign country, and, therefore, this rule will result in a more accurate grouping of items of income that are generally subject to the same or similar rates of foreign tax. In addition, treating disregarded payments in this manner is consistent with the treatment of regarded payments. For these reasons, the comment was not adopted.
- iv. The final regulations, however, provide additional rules addressing disregarded payments, including providing additional detail on how the principles of Treas. Reg. § 1.904-4(f)(2)(vi) should be applied. For example, the final regulations provide that a disregarded payment of interest is allocated and apportioned ratably to all of the gross income attributable to the tested unit that is making the disregarded payment. The final regulations also

provide special ordering rules for reallocations regarding multiple disregarded payments.

(c) Foreign NOLs and Other Timing Differences.

- i. Some comments requested that the final regulations allow taxpayers to elect to adjust either the numerator or denominator of the effective foreign tax rate fraction to take into account foreign net operating loss (“NOL”) carryforwards and other similar items.
- ii. Treasury and the IRS believe that adjusting the numerator or denominator of the effective foreign tax rate fraction for foreign NOL carryforwards or other timing differences would result in considerable complexity and would impose a significant burden on both taxpayers and the government. It would require the application of foreign tax accounting rules, and complex coordination rules to reconcile their application with U.S. tax accounting rules, both in the current taxable year and other taxable years, to prevent an item of income, gain, deduction, loss, or credit from being duplicated or omitted. Accordingly, this comment was not adopted.

C. Adoption of Tested Unit Standard.

1. In General.

- (a) In lieu of the QBU standard in the 2019 proposed regulations, the final regulations apply the GILTI high-tax exclusion based on the gross tested income of a CFC that is attributable to a “tested unit.” Unlike the QBU standard that served as a proxy for being subject to foreign tax, the tested unit approach generally applies to the extent an entity, or the activities of an entity, are actually subject to tax, as either a tax resident or a permanent establishment (or similar taxable presence), under the tax law of a foreign country.
- (b) This obviously is an important change, and can give rise to definitional issues.
- (c) The final regulations provide three categories of a tested unit. First, and consistent with the 2019 proposed regulations, a tested unit includes a CFC. Thus, if a CFC, which itself is a tested unit, has no other tested units, the GILTI high-tax exclusion is applied for all the tentative gross tested income items (determined under Treas. Reg. § 1.951A-2(c)(7)(ii)) of the CFC.

- (d) Second, and also consistent with the 2019 proposed regulations, a tested unit generally includes an interest in a pass-through entity held, directly or indirectly, by a CFC. For this purpose, a pass-through entity is defined to include, for example, a partnership or a disregarded entity.
- (e) More specifically, a CFC's interest in a pass-through entity is a tested unit if the pass-through entity meets one of two tests. First, the CFC's interest in the pass-through entity is a tested unit if the pass-through entity is a tax resident of a foreign country because, in these cases, income earned by the CFC indirectly through the pass-through entity may be subject to tax at a rate different from the rate at which income earned by the CFC directly is subject to tax. Second, the CFC's interest in the pass-through entity is a tested unit if the pass-through entity is not subject to tax as a resident, but is treated as a corporation (or as another entity that is not fiscally transparent) for purposes of the CFC's country's tax law, because in these cases income earned by the CFC indirectly through the pass-through entity may not be subject to tax in the foreign country of which the CFC is a tax resident; thus, for example, an interest in a domestic limited liability company that is a partnership for federal income tax purposes would typically be a tested unit. A CFC's interest in a pass-through entity (or the activities of a branch) that is not a tested unit is a "transparent interest."
- (f) Treasury and the IRS believe this treatment of interests in pass-through entities in the final regulations is consistent with a comment suggesting that a pass-through entity should be treated as a tested unit if the entity is treated as a separate entity for purposes of a foreign tax law, but not if the entity is fiscally transparent (and thus not a tax resident) for purposes of the tax law of a foreign country.
- (g) An interest in an entity, rather than the entity itself, is treated as a tested unit (or a transparent interest) because the entity may have multiple owners and the characterization of the interest as a tested unit may depend on each holder's tax treatment regarding the interest. As a result, less than the entire entity may be characterized as a tested unit or a transparent interest. In addition, different interests in an entity held directly or indirectly by the same CFC may be characterized differently. The final regulations include an example that illustrates the application of this rule. Treas. Reg. § 1.951A-2(c)(8)(iii)(D) (Example 4).
- (h) Finally, a tested unit includes a branch, or a portion of a branch, the activities of which are carried on directly or indirectly by a

CFC, provided that either (i) the branch gives rise to a taxable presence in the country in which the branch is located, or (ii) the branch gives rise to a taxable presence under the owner's tax law, and the owner's tax law provides an exclusion, exemption, or other similar relief (such as a preferential rate) for income attributable to the branch.

- (i) In these cases, the income indirectly earned by the owner through the branch is likely subject to tax at a rate different than the rate at which income directly earned by the owner is subject to tax. Treasury and the IRS believe that this branch tested unit rule addresses blending concerns related to an owner's taxable presence in another country in a more targeted manner than the "activities" QBU standard from the 2019 proposed regulations. They also believe that the branch tested unit rule will likely reduce compliance burdens, as compared to the QBU standard, because the tested unit rule depends on how activities are treated under foreign tax law, an analysis of which in most cases would be conducted independently of the final regulations (for example, to determine whether a tax return must be filed because activities in that country give rise to a taxable presence).
- (j) For purposes of the tested unit rules, references to the tax law of a foreign country include statutes, regulations, administrative or judicial rulings, and treaties of the country.
- (k) The final regulations make clear that tested units are determined independently of one another. For example, even though a CFC is itself a tested unit, the CFC may have other tested units, such as a permanent establishment or an interest in a disregarded entity that, subject to the application of the combination rule, must be treated separately for purposes of the GILTI high-tax exclusion.
- (l) The final regulations also provide a rule that addresses cases where the same item is attributable to more than one tested unit in a tier of tested units. This may occur, for example, if an item is properly reflected both on the separate set of books and records of one tested unit, and on the separate set of books and records of a lower-tier tested that is owned (directly or indirectly) by the first tested unit, because the books and records of the two tested units were prepared under different accounting standards. In such a case, the final regulations provide that the item is considered to be attributable only to the lowest-tier tested unit.

2. Combined Tested Units.

- (a) The 2019 proposed regulations applied separately to each QBU of a CFC.
- (b) Several comments recommended combining “same-country” QBUs, on an elective basis, noting it would reduce complexity and compliance burdens. Another comment recommended allowing taxpayers to take into account a fiscal unity or similar grouping in determining the effective foreign tax rate.
- (c) Treasury and the IRS generally agree that a combination rule would reduce compliance burdens and would be consistent with the policies underlying the GILTI high-tax exclusion. A combination rule also could minimize the effect of timing and other differences between the U.S. and foreign tax bases. Accordingly, the final regulations provide that tested units of a CFC (including the CFC tested unit), other than certain nontaxed branch tested units, will be treated as a single tested unit if the tested units are tax residents of, or located in, the same foreign country.
- (d) A nontaxed branch tested unit is a branch tested unit that does not give rise to a taxable presence under the tax law of the foreign country where the branch is located, but gives rise to a taxable presence under the tax law of the foreign country where the home office of the branch is a tax resident and such tax law provides an exclusion, exemption, or similar relief for purposes of taxing income attributable to the branch. The tested unit combination rule does not apply to a nontaxed branch tested unit because such a unit typically would not be subject to tax (or to any meaningful level of tax) in any foreign country. Thus, combining it with other tested units (the income of which may be subject to a meaningful level of tax) could give rise to inappropriate blending.
- (e) The combination rule applies without regard to whether the tested units are subject to the same foreign tax rate because it would be inconsistent with the purpose of the combination rule to require taxpayers to determine the effective foreign tax rate imposed on the tested units separately, and simply comparing the statutory foreign tax rates may not be meaningful.
- (f) The combination rule also is not conditioned on the tested units having the same functional currency because the effective foreign tax rate is calculated in U.S. dollars and any differences in functional currency are unlikely to have a material effect on whether income qualifies for the GILTI high-tax exclusion.



Finally, the combination rule is mandatory, not elective, because providing an election would give rise to additional complexity, and related administrative and compliance burdens.

3. Books and Records.

(a) In General.

- i. Under the 2019 proposed regulations, gross income was attributable to a QBU if it was properly reflected on the books and records of the QBU. For this purpose, gross income was determined under federal income tax principles with certain adjustments to reflect disregarded payments.
- ii. The final regulations adopt a tested unit standard, rather than a QBU standard, for purposes of determining a tentative gross tested income item. Nevertheless, the final regulations retained the general approach of relying on a separate set of books and records (as modified to apply to tested units, rather than QBUs) as the starting point for determining gross income attributable to a tested unit.
- iii. Treasury and the IRS believe that applying a books-and-records approach for tested units is appropriate because it serves as a reasonable proxy for determining the amount of gross income that the tested unit's foreign country is likely to subject to tax. They also believe that relying on a separate set of books and records is consistent with the approach taken under other provisions and, therefore, that doing so should promote administrability for both taxpayers and the Service.
- iv. The final regulations provide that items of gross income of a CFC are attributable to a tested unit of the CFC to the extent they are properly reflected on the separate set of books and records of the tested unit, or of the entity an interest in which is a tested unit (for example, in the case of certain partnerships). The provision starts with the items of gross income of the CFC for federal income tax purposes and then attributes those items to the CFC's tested units to the extent the items are properly reflected on the separate set of books and records of the tested units (with certain adjustments, such as to account for disregarded payments).
- v. For example, if a CFC owns a partnership interest that is a tested unit, the items of gross income that the CFC derives through the partnership interest are attributed to the CFC's

interest in the partnership to the extent that the items are properly reflected on the separate set of books and records of the partnership. Thus, this approach first gives effect to the rules that determine the items of gross income of the CFC, such as the rules under § 704 for purposes of determining a CFC partner's distributive share of items of a partnership, and then attributes those items to the tested units of the CFC depending on whether the items are properly reflected on the separate set of books and records.

(b) Separate Set of Books and Records.

- i. Treasury and the IRS believe that a tested unit, or an entity an interest in which is a tested unit, generally will maintain a separate set of books and records that would be readily available for purposes of the final regulations. This is expected to be the case for a branch tested unit under Treas. Reg. § 1.951A-2(c)(7)(iv)(A)(3) (involving a taxable presence), for example, because a separate set of books and records would ordinarily be required to compute the foreign tax liability arising in the taxing country (or for not taking into account items attributable to the taxable presence if determined only under the owner's tax law). Accordingly, the final regulations retain the general approach taken in the 2019 proposed regulations by defining a "separate set of books and records" by reference to Treas. Reg. § 1.989(a)-1(d).
- ii. The 2020 proposed regulations (discussed below), however, would replace the reference to "books and records" with a more specific standard based on items properly reflected on an "applicable financial statement."

4. Booking Rule for Transparent Interests.

- (a) The final regulations provide a special booking rule that applies to a transparent interest. This rule, generally treats items properly reflected on the separate set of books and records of an entity an interest in which is a transparent interest as being properly reflected on the books and records of a tested unit that holds interests (directly or indirectly through other transparent interests) in the entity.
- (b) The preamble states that this treatment is appropriate because income earned by the tested unit directly, as well as income earned by the tested unit indirectly through the transparent interest, is expected to be subject to residence-based tax in only the tested

unit's country of residence (or location) and, as a result, Treasury and the IRS believe it is unlikely that blending of income subject to different foreign tax rates would occur by reason of the tested unit's ownership of the transparent interest.

- (c) Failure to Maintain Books and Records. The final regulations include a rule that applies if a separate set of books and records is not prepared for a tested unit or transparent interest. In such a case, items required to apply the GILTI high-tax exclusion that would be reflected on a separate set of books and records of the tested unit or transparent interest must be determined and treated as properly reflected on the separate set of books and records. This rule is intended to address cases where a separate set of books and records is not maintained, and to prevent the avoidance of the rules by choosing to not maintain a separate set of books and records.
- (d) Items Not Taken into Account.
  - i. In some cases, items of gross income (determined under federal income tax principles) may not be properly reflected on a separate set of books and records because they are not taken into account for financial accounting purposes. This may occur when items are taken into account for federal income tax purposes and financial accounting purposes in different taxable years, or when items are taken into account for federal income tax purposes but are not taken into account for financial accounting purposes (for example, due to the mark-to-market method of accounting).
  - ii. To ensure that these items of gross income are attributable to a tested unit in a CFC inclusion year, the final regulations clarify that the items are treated as properly reflected on a separate set of books and records if they would be so reflected if they were taken into account for financial accounting purposes. No inference is to be drawn from this clarification regarding other similar rules that attribute items based on books and records, including under Treas. Reg. § 1.904-4(f), Treas. Reg. § 1.987-2(b), or Treas. Reg. § 1.1503(d)-5(c).

5. De Minimis Rules.

- (a) A comment recommended that the final regulations adopt two de minimis rules to simplify the application of the QBU-by-QBU approach. First, the comment suggested that taxpayers should be permitted to elect to treat all CFCs with income below a specified

threshold as a single QBU. Treasury and the IRS believe that aggregating CFCs for this purpose would be inconsistent with § 954(b)(4), which applies regarding items of income of a single CFC. Accordingly, this recommendation was not adopted.

- (b) Second, the comment suggested that taxpayers should be permitted to elect to aggregate QBUs within the same CFC that have a small amount of tested income (measured either in absolute terms or based on a percentage of the CFC's income). Treasury and the IRS believe it is uncertain whether aggregating QBUs with small amounts of tested income will result in a significant amount of simplification because, for example, gross income would still have to be attributed to each QBU (taking into account disregarded payments) to determine whether the de minimis rule applies. The final regulations did not adopt the recommendation, but a de minimis rule is included in the 2020 proposed regulations to allow an opportunity for additional notice and comment.

#### D. Rules Regarding the Election.

##### 1. Consistency Requirement.

- (a) The 2019 proposed regulations provided that if a CFC is a member of a controlling domestic shareholder group ("CFC group"), a GILTI high-tax exclusion election (or revocation) was either made regarding each member of the CFC group or was not made for any member of the CFC group. The final regulations adopted the shorter and more descriptive term "CFC group," instead of the term "controlling domestic shareholder group."
- (b) Several comments requested that the final regulations eliminate the consistency requirement so the GILTI high-tax exclusion election can be made on a CFC-by-CFC basis, which would conform the exclusion to the Subpart F high-tax exception.
- (c) Treasury and the IRS believe that the consistency requirement is necessary due to the collateral effect that the GILTI high-tax exclusion has on the allocation and apportionment of deductions. Specifically, allowing CFC-by-CFC or tested unit-by-tested unit elections would encourage the selective use of the GILTI high-tax exclusion to inappropriately manipulate the § 904 foreign tax credit limitation. In this regard, deductions allocated and apportioned to income excluded under § 954(b)(4) will be subject to § 904(b)(4), and thereby disregarded for purposes of determining a taxpayer's foreign tax credit limitation under § 904.

- (d) Without a consistency requirement, taxpayers would be able to include high-taxed income in GILTI to claim foreign tax credits up to the amount of their § 904 limitation, while electing to exclude the remainder of such income under the GILTI high-tax exclusion. Consequently, the taxpayer's § 904 limitation would not take into account all the deductions attributable to investments generating high-taxed income, resulting in a distortive application of the foreign tax credit limitation under § 904.
- (e) A consistency requirement prevents this result by ensuring that a taxpayer that seeks to cross-credit the foreign tax imposed on high-taxed tentative tested income against low-taxed tentative tested income must take all of its high-taxed tentative tested income into account along with all of the deductions allocated and apportioned to that category of income. This concern does not arise regarding other types of income that are excluded from tested income (for example, foreign oil and gas extraction income) because these items are always excluded (that is, there is no electivity as to whether they are included in tested income), and the foreign taxes attributable to that income can never be claimed as a credit against the U.S. tax imposed on § 951A inclusions.
- (f) Treasury and the IRS agree that the GILTI high-tax exclusion election and the Subpart F high-tax exception election should apply consistently and, have determined that the Subpart F high-tax exception should be conformed to the GILTI high-tax exclusion, as discussed in the preamble to the 2020 proposed regulations discussed below. This is appropriate, in part, due to changes made by the TCJA.
- (g) Before the TCJA, a consistency requirement would have had minimal effect because post-1986 earnings and profits (including income excluded from Subpart F income under § 954(b)(4)) could be distributed and would be included in income of the U.S. shareholder, and foreign taxes would be deemed paid under § 902, subject to the limitations imposed by § 904, which is a result consistent with a Subpart F inclusion.
- (h) Further, before the TCJA, an amount excluded under § 954(b)(4) largely resulted only in the deferral of income and deemed paid foreign taxes, rather than an exclusion of those items from the U.S. tax base, and deductions allocated and apportioned to this income would limit a taxpayer's ability to claim foreign tax credits in the future. After the TCJA, an election under § 954(b)(4) will result in a permanent change in the treatment of high-taxed income and the associated foreign taxes and deductions, increasing the significance, from a policy perspective, of inconsistent treatment.

- (i) Thus, Treasury and the IRS believe that the policy underlying § 954(b)(4) is best furthered through a single election to exclude all high-taxed income from GILTI (and, subject to finalization of the 2020 proposed regulations, Subpart F income) because that income does not pose a base erosion concern and is therefore not the type of income that Congress intended to include in tested income. However, because the application of § 954(b)(4), and the additional administrative burden associated with identifying high-taxed items of income, has always been elective, Treasury and the IRS believe that the exclusion of this income (and to the extent possible any additional burden associated with identifying this income) should continue to be limited to cases where a taxpayer elects the application of § 954(b)(4).
- (j) They also believe that it would be inappropriate to allow a taxpayer to selectively exclude and include income, once it makes an election under § 954(b)(4). Section 951A generally does not permit electivity in the determination of tested income. For example, a taxpayer cannot choose to include in tested income amounts that would be Subpart F income but for the application of § 954(b)(4) (regardless of whether the election is made), nor may a taxpayer choose to include foreign oil and gas extraction income in tested income. Further, contrary to some comments, Treasury and the IRS anticipate that the additional electivity is more likely to increase, rather than reduce, compliance burden as a result of the need for more numerous calculations. As a result, they concluded that the consistency rule should be retained.

2. Definition of CFC Group.

- (a) The 2019 proposed regulations defined a CFC group based on two tests. Under the first test, a CFC group meant two or more CFCs if more than 50% of the total combined voting power of the stock of each CFC was owned (within the meaning of § 958(a)) by the same controlling domestic shareholder (as defined in Treas. Reg. § 1.964-1(c)(5)).
- (b) The second test applied only if no single controlling domestic shareholder satisfied the first test. Under the second test, the 2019 proposed regulations provided that a CFC group meant two or more CFCs if more than 50% of the total combined voting power of the stock of each CFC was owned (within the meaning of § 958(a)) by the same controlling domestic shareholders and each such shareholder owned (within the meaning of § 958(a)) the same percentage of stock in each CFC. For purposes of both tests, a controlling domestic corporate shareholder included a related

person (within the meaning of § 267(b) or 707(b)(1)) (the “related party rule”).

- (c) In response to comments, the final regulations revise the definition of a CFC group. Under the final regulations, a CFC group is an affiliated group, as defined in § 1504(a), with certain modifications that broaden the definition. First, the affiliated group rules in § 1504(a) apply without regard to § 1504(b)(1) through (6) (which exclude certain corporations, such as foreign corporations, from the definition of an “includible corporation”). Second, for purposes of determining whether a CFC is a member of a CFC group, the final regulations incorporate a “more than 50%” threshold instead of the “at least 80%” threshold in § 1504(a). Stock ownership for this purpose is determined by applying the constructive ownership rules of § 318(a), with certain modifications. These constructive ownership rules would, for example, cause two corporations owned directly by the same U.S. individual to be part of a CFC group.
- (d) The final regulations also provide that the determination of whether a CFC is included in a CFC group is made as of the close of the CFC inclusion year of the CFC that ends with or within the taxable years of the controlling domestic shareholders. This rule is intended to address certain changes in ownership of CFCs, such as acquisitions and dispositions. The final regulations further provide that a CFC may be a member of only one CFC group and include a special tie-breaker rule for situations in which a CFC would be a member of more than one CFC group.
- (e) The final regulations also clarify that if a CFC is not a member of a CFC group, a high-tax election is made (or revoked) only regarding the CFC and the rules regarding the election apply by reference to the CFC. If, however, a CFC is a member of a CFC group, a high-tax election is made (or revoked) regarding all members of the CFC group and the rules regarding the election apply by reference to the CFC group.

### 3. Duration of Election.

- (a) The 2019 proposed regulations generally provided that the GILTI high-tax exclusion election was effective for the CFC inclusion year for which it was made and all subsequent CFC inclusion years, unless the election was revoked. The 2019 proposed regulations further provided that, subject to a “change of control” exception, if an election was revoked, then the CFC could not make a new election for any CFC inclusion year that began within

60 months following the close of the CFC inclusion year for which the previous election was revoked (“60-month restriction”).

- (b) Several comments requested that the 60-month restriction be eliminated so that taxpayers would be permitted to make the GILTI high-tax exclusion election on an annual basis.
- (c) Treasury and the IRS agreed with these comments and determined that, given that the final regulations adopt a tested unit-by-tested unit approach (in lieu of the QBU-by-QBU approach) and retain the consistency requirement set forth in the 2019 proposed regulations, the 60-month restriction is not necessary to prevent abuse. Accordingly, the final regulations do not include the 60-month restriction and, subject to the consistency requirement, taxpayers may elect the GILTI high-tax exclusion on an annual basis.

4. Non-Controlling U.S. Shareholders.

- (a) One comment requested that the final regulations include a notice of election and revocation requirement that would require any U.S. shareholder that makes or revokes an election to notify the CFC of this action and require the CFC to notify its other U.S. shareholders of the action taken by the U.S. shareholder and its ownership percentage.
- (b) Treasury and the IRS agree that U.S. shareholders that are not controlling domestic shareholders of a CFC should be informed by the controlling domestic shareholders of the CFC if they make (or revoke) a GILTI high-tax exclusion election regarding the CFC. Therefore, the final regulations provide that the controlling domestic shareholders must provide notice of elections (or revocations), as required by Treas. Reg. § 1.964-1(c)(3)(iii), to each U.S. shareholder that is not a controlling domestic shareholder.

5. Domestic Partnerships as Controlling Shareholders.

- (a) The proposed regulations under § 958 provide, as a general rule, that for purposes of §§ 951 and 951A (and certain related provisions) a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of § 958(a). Under an exception to this general rule, a domestic partnership is treated as owning stock of a foreign corporation within the meaning of § 958(a) for purposes of determining whether any U.S. shareholder is a controlling domestic shareholder. Treasury and the IRS intend



to address comments received when finalizing the proposed regulations under §§ 951, 956, 958, and 1502.

- (b) Under currently applicable Treas. Reg. § 1.951A-1(e)(2), a domestic partnership can be a controlling domestic shareholder—for example, for purposes of determining which party elects the GILTI high-tax exclusion under Treas. Reg. § 1.951A-7(c)(7)(viii)(A), including potentially for taxable years beginning after December 31, 2017, under Treas. Reg. § 1.951A-7(b).

6. Elections on Amended Returns.

- (a) The 2019 proposed regulations allowed a taxpayer to make (or revoke) the GILTI high-tax exclusion election with an amended income tax return.
- (b) One comment indicated that it was unclear how the binding effect of the election on all U.S. shareholders of a CFC operates when the controlling domestic shareholder makes (or revokes) the election on an amended return.
- (c) Treasury and the IRS agreed with the comment that allowing the controlling domestic shareholders to make (or revoke) the GILTI high-tax exclusion election on an amended income tax return may change the amount of U.S. tax due regarding U.S. shareholders other than the controlling domestic shareholders. The election or revocation also could change the amount of U.S. tax due regarding all U.S. shareholders in intervening tax years. If the election were made (or revoked) on an amended return after some or all of these taxable years are no longer open for assessment under § 6501, it could result in the issuance of refunds for certain taxable years of shareholders when corresponding deficiencies could not be assessed or collected.
- (d) As a result, the final regulations provide that the election may be made (or revoked) on an amended federal income tax return only if all U.S. shareholders of the CFC file amended federal income tax returns (unless an original return has not yet been filed, in which case the original federal income tax return may be filed consistently with the election (or revocation)) for the taxable year (and for any other taxable year in which their U.S. tax liabilities would be increased by reason of that election (or revocation))<sup>1</sup> within 24 months of the unextended due date of the original federal income tax return of the controlling domestic shareholder's

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<sup>1</sup> This also applies in the case of a partnership if any item reported by the partnership or any partnership-related item would change as a result of the election (or revocation).

inclusion year with or within which the CFC inclusion year, for which the election is made (or revoked), ends.

- (e) For administrative purposes, the final regulations also provide that amended federal income tax returns for all U.S. shareholders of the CFC for the CFC inclusion year must be filed within a single 6-month period (within the 24-month period). The requirement that all amended federal income tax returns be filed within a 6-month period is to allow the IRS to timely evaluate refund claims or make additional assessments.
- (f) The final regulations also clarify how these rules operate in the case of a U.S. shareholder that is a domestic partnership. For example, the final regulations provide that in the case of a U.S. shareholder that is a partnership, the election may be made (or revoked) with an amended Form 1065 or an administrative adjustment request (as described in § 301.6227-1), as applicable. The final regulations further provide that if a partnership files an administrative adjustment request, a partner that is a U.S. shareholder in the CFC is treated as having complied with these requirements (regarding the portion of the interest held through the partnership) if the partner and the partnership timely comply with their obligations under § 6227 regarding that administrative adjustment request.

## E. Foreign Tax Credit Rules.

### 1. CFC Stock Deductions.

- (a) One comment requested that the final regulations confirm that U.S. shareholder deductions properly allocated and apportioned to income excluded under the GILTI high-tax exclusion should not be taken into account for purposes of § 904 per the application of § 904(b)(4)(B). Treasury and the IRS believe that the regulations are clear regarding the interaction of U.S. shareholder deductions allocated and apportioned to income excluded under the GILTI high-tax exclusion and § 904(b)(4), and that further rules were not necessary.
- (b) Another comment suggested that the final regulations turn off the application of § 904(b)(4) for deductions allocated and apportioned to income or stock that relates to earnings and profits arising from CFC income that is excluded by reason of the GILTI high-tax exclusion. The comment was not adopted.

2. Determination of Taxes Paid or Accrued.

- (a) A comment asserted that the 2019 proposed regulations are unclear as to the determination of the foreign taxes paid or accrued and requested that the final regulations clarify that foreign income taxes include taxes imposed by a country (or countries) on the net item, as provided under current Treas. Reg. § 1.954-1(d)(3)(i).
- (b) The rules provided in Treas. Reg. § 1.951A-2(c)(7)(iii) and (vii) are comparable to those provided in current Treas. Reg. § 1.954-1(d)(3)(i); both sets of rules generally apply Treas. Reg. § 1.904-6 to allocate and apportion foreign taxes to income. Although the GILTI high-tax exclusion requires that foreign taxes be associated with income on a narrower basis -- the tested unit rather than the CFC -- taxes imposed on the CFC that relate to income of the tested unit will generally be associated with the appropriate income under the rules in Treas. Reg. § 1.904-6, regardless of whether such tax is imposed by one or more countries. The 2020 proposed regulations proposed further conformity of the rules applicable for the computation of the effective foreign tax rate for both Subpart F income and tested income.
- (c) Further, in response to this comment, as well as similar comments received in response to the 2019 proposed regulations, the 2019 Final FTC Regulations (T.D. 9882) and these final regulations clarify the rules for associating foreign taxes with income. In particular, these final regulations clarify that the amount of foreign income taxes paid or accrued by a CFC regarding a tentative tested income item is the U.S. dollar amount of the controlled foreign corporation's current year taxes that are allocated and apportioned to the related tentative gross tested income.
- (d) The final regulations also provide that the deductions for current year taxes are allocated and apportioned to a tentative gross tested income item under the principles of Treas. Reg. § 1.960-1(d)(3), by treating each tentative gross tested income item as assigned to a separate tested income group. As a result, the principles of Treas. Reg. § 1.904-6(a)(1) generally apply to allocate and apportion foreign income taxes to a tentative gross tested income item. However, the principles of Treas. Reg. § 1.904-6(a)(2) are applied, in lieu of the principles of Treas. Reg. § 1.904-6(a)(1), to associate foreign taxes with income in the case of disregarded payments between tested units.
- (e) The final regulations provide additional rules for applying the principles of Treas. Reg. § 1.904-6(a)(2) for purposes of the high-tax exception. A new example also illustrates how foreign income

taxes are associated with income in the case of disregarded payments. Treas. Reg. § 1.951A-2(c)(8)(iii)(B) (Example 2).

- (f) Treasury and the IRS also published proposed regulations (REG-105495-19) relating to foreign tax credits that contain more detailed rules for associating foreign taxes with income, including in the case of disregarded payments.

3. Accounting Periods and Foreign Tax Accruals.

- (a) The proposed regulations generally provided that the amount of foreign income taxes paid or accrued regarding a tentative net tested income item were the CFC's current year taxes (as defined in Treas. Reg. § 1.960-1(b)(4)) that would be allocated and apportioned under the principles of Treas. Reg. § 1.960-1(d)(3)(ii) to the tentative net tested income item by treating the item as in a separate tested income group. Taxes accrue, and are taken into account in determining foreign taxes deemed paid under § 960(d), when all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. Therefore, withholding taxes accrue when the payment from which the tax is withheld is made, and net basis taxes on income recognized during a taxable period accrue on the last day of the taxable period.
- (b) Comments suggested that the final regulations provide special rules to address distortions that can arise from a mismatch between the U.S. and foreign taxable years.
- (c) Treasury and the IRS believe that foreign taxes should be associated with U.S. income consistently for all federal income tax purposes, and that deviating from established principles for determining when income and foreign taxes are taken into account for purposes of the GILTI high-tax exclusion would be inappropriate. Allowing foreign taxes to be taken into account in applying the GILTI high-tax exclusion in a different year from the year in which the foreign taxes accrue could lead to double counting, or double-non-counting, of the foreign taxes.
- (d) Similar considerations would apply regarding the adoption of alternative methods of accounting for tentative tested income items, such as the adoption of a foreign fiscal year as the testing period or mark-to-market accounting. The use of these methods would lead to potential double counting of items of income, gain, deduction, or loss in different U.S. taxable years for different purposes, or would require complex coordination rules with material changes to established rules relating to when such items

accrue for federal income tax purposes. The preamble states that changes such as these are beyond the scope of the GILTI rulemaking and were not adopted.

F. Authority. The preamble states that Treasury and the IRS are aware that questions have arisen regarding the statutory authority for the GILTI high-tax exclusion. As described in detail in the preamble to the 2019 proposed regulations, Treasury and the IRS believe that the GILTI high-tax exclusion is a valid interpretation of ambiguous statutory text in § 951A(c)(2)(A)(i)(III) and thus, after considering assertions to the contrary, concluded that this rationale provides authority to finalize the GILTI high-tax exclusion.

G. Applicability Dates.

1. Consistent with the applicability date in the 2019 proposed regulations, the final regulations provide that the GILTI high-tax exclusion applies to taxable years of foreign corporations beginning on or after July 23, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.
2. Several comments requested that taxpayers be permitted to apply the GILTI high-tax exclusion earlier than the proposed regulations would have allowed (for example, to taxable years beginning after December 31, 2017). The final regulations permit taxpayers to choose to apply the GILTI high-tax exclusion to taxable years of foreign corporations that begin after December 31, 2017, and before July 23, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end. Any taxpayer that applies the GILTI high-tax exclusion retroactively must consistently apply the rules in this Treasury decision to each taxable year in which the taxpayer applies the GILTI high-tax exclusion.

## PROPOSED SUBPART F HIGH-TAX REGULATIONS

A. Summary.

1. The new proposed regulations (REG-127732-19) provide for a single election under § 954(b)(4) for purposes of both Subpart F and GILTI, modeled on the final GILTI High Tax Election regulations. The proposed regulations include the requirement that an election is made regarding all CFCs that are members of a CFC group (instead of an election made on a CFC-by-CFC basis) and provide that the determination of whether income is high-taxed is made on a tested unit- by-tested unit basis.
2. They also simplify the determination of high-taxed income and often eliminate the fact intensive analysis by grouping certain income that would otherwise qualify as Subpart F income together with income that

would otherwise qualify as tested income for the purpose of determining the effective foreign tax rate. In addition, they would modify the method for allocating and apportioning deductions to items of gross income for the purposes of the high-tax exception.

3. As stated above, this regulation, when finalized, will be a big change.

B. Conforming the Rules.

1. Commentators recommended that various aspects of the GILTI high-tax exclusion be conformed with the Subpart F high-tax exception to ensure that the goals of the GILTI high-tax exclusion are not undermined.
2. Treasury and the IRS agreed that the GILTI high-tax exclusion and the Subpart F high-tax exception should be conformed but have determined that the rules applicable to the GILTI high-tax exclusion are appropriate and better reflect the changes made as part of the TCJA than the existing Subpart F high-tax exception. Accordingly, the proposed regulations generally revise and conform the provisions of the Subpart F high-tax exception with the provisions of the GILTI high-tax exclusion in the final regulations. This is not the “conforming” that most taxpayers wanted.
3. Another comment on the 2019 proposed regulations suggested that § 954(b)(4) should apply consistently to all of a CFC’s items of gross income. In response to this comment, the proposed regulations provide for a single election under § 954(b)(4) for purposes of both Subpart F income and tested income (the “high-tax exception”).

C. Effective Tax Rate of Tested Units.

1. In General.

- (a) Under Treas. Reg. § 1.954-1(d), effective tax rates and the applicability of the Subpart F high-tax exception are determined on the basis of net foreign base company income of a CFC. Net foreign base company income generally means income described in Treas. Reg. § 1.954-1(c)(1)(iii) reduced by deductions. In general, single items of income tested for eligibility are determined by aggregating items of income of a certain type. For example, the aggregate amount of a CFC’s income from dividends, interests, rents, royalties, and annuities giving rise to non-passive foreign personal holding company income constitutes a single item of income.
- (b) In contrast, under the final regulations, effective tax rates and the applicability of the GILTI high-tax exclusion are determined by aggregating gross income that would be gross tested income (but for the GILTI high-tax exclusion) within a separate category to the

extent attributable to a tested unit of a CFC. For this purpose, the tentative tested income items and foreign taxes of multiple tested units of a CFC (including the CFC itself) that are tax residents of, or located in (in the case of certain branches), the same foreign country, generally are aggregated.

- (c) Applying these rules on a tested unit basis will ensure that high-taxed and low-taxed items of income are not inappropriately aggregated for purposes of determining the effective rate of tax, while at the same time allowing for some level of aggregation to minimize complexity. The preamble states that measuring the effective rate of foreign tax on a tested unit basis is also appropriate in light of the reduction of corporate federal income tax rate.
- (d) For the same reasons that the GILTI high-tax exclusion applies on a tested unit basis, Treasury and the IRS believe that the Subpart F high-tax exception should apply on a tested unit basis. They also believe that for purposes of determining the applicability of § 954(b)(4), it is appropriate to group general category items of income attributable to a tested unit that would otherwise be tested income, foreign base company income, or insurance income. By grouping these items of income, taxpayers making a high-tax exception election may be able to forego the often-complex analysis required to determine whether income would meet the definition of Subpart F income. For example, taxpayers will not be required to determine whether income is foreign base company sales income versus tested income if the high-tax exception applies to the income.
- (e) The proposed regulations generally group passive foreign personal holding company income in the same manner as existing Treas. Reg. § 1.954-1(c)(1)(iii)(B). However, Treasury and the IRS state they may propose conforming changes to the income grouping rules in Treas. Reg. § 1.904-4(c) as part of future guidance. Comments were requested.
- (f) Certain income and deductions attributable to equity transactions (for example, dividends or losses attributable to stock) are also separately grouped for purposes of the high-tax exception if the income is subject to preferential rates or an exemption under the tax law of the country of residence of the recipient. The purpose of this separate equity grouping is to separately test income or loss that is subject to foreign tax at a different rate than other general category income attributed to the tested unit and that may be susceptible to manipulation through, for example, the timing of distributions or losses.

## 2. Income Attributable to Tested Units.

- (a) The final regulations generally use items properly reflected on the separate set of books and records (within the meaning of Treas. Reg. § 1.989(a)-1(d)) as the starting point for determining gross income attributable to a tested unit. Books and records are used for this purpose because they serve as a reasonable proxy for determining the amount of gross income that the foreign country of the tested unit is likely to subject to tax and, given that this approach is consistent with the approach taken in other provisions, it should promote administrability.
- (b) The proposed regulations retain this general approach but replace the reference to “books and records” with a more specific standard based on items of gross income attributable to the “applicable financial statement” of the tested unit. For this purpose, an applicable financial statement refers to a “separate-entity” (or “separate-branch,” if applicable) financial statement that is readily available, with the highest priority within a list of different types of financial statements. These financial statements include, for example, financial statements that are audited or unaudited, and that are prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”), international financial reporting standards (“IFRS”), or the generally accepted accounting principles of the jurisdiction in which the entity is organized or the activities are located (“local-country GAAP”).
- (c) Treasury and the IRS believe that this new standard will provide more accurate and reliable information and will promote certainty in cases where there may be various forms of readily available financial information. This standard is also expected to promote administrability because it is consistent with approaches taken under other provisions. Finally, Treasury and the IRS anticipate that the type of applicable financial statement will, in many cases, be the same from year to year and therefore will result in consistency and minimize opportunities for manipulation.

## 3. Deductions.

- (a) The final regulations generally use items properly reflected on the separate set of books and records as the starting point for determining gross income attributable to a tested unit. In contrast, the final regulations do not allocate and apportion deductions to those items of gross income by reference to the items of deduction that are properly reflected on the books and records of a tested unit. Instead, they apply the general allocation and apportionment rules for purposes of determining a tentative tested income item



regarding a tentative gross tested income item. This is so that deductions are generally allocated and apportioned under the principles of Treas. Reg. § 1.960-1(d)(3) by treating each tentative gross tested income item as income in a separate tested income group, as that term is described in Treas. Reg. § 1.960-1(d)(2)(ii)(C).

- (b) Under these principles, certain deductions, such as interest expense, are allocated and apportioned based on a specific factor (such as assets or gross income) among the separate items of gross income of a CFC so that deductions reflected on the books and records of a single tested unit, and generally taken into account for foreign tax purposes in computing the foreign taxable income, may not be fully taken into account for purposes of determining a tentative tested income item.
- (c) Treasury and the IRS believe that the policy goal of § 954(b)(4) is to identify income of a CFC subject to a high effective rate of foreign tax. Thus, they believe the goal is better served by determining the effective foreign tax rate regarding items of income attributable to a tested unit by reference to an amount of income that approximates taxable income as computed for foreign tax purposes, rather than federal income tax purposes. However, the use of U.S. (rather than foreign) tax accounting rules to determine the amount and timing of items of income, gain, deduction, and loss included in the high-tax exception computation remains appropriate to ensure that the computation is not distorted by reason of foreign tax rules that do not conform to federal income tax principles.
- (d) Therefore, these proposed regulations generally determine tentative net items by allocating and apportioning deductions, determined under federal income tax principles, to items of gross income to the extent the deductions are properly reflected on the applicable financial statement of the tested unit, consistent with the manner in which gross income is attributed to a tested unit. Treasury and the IRS believe that, under this method, a tentative net item better approximates the tax base upon which foreign tax is imposed than would be the case under the allocation and apportionment rules set forth in the regulations under § 861.
- (e) The proposed regulations allocate and apportion deductions to the extent properly reflected on the applicable financial statement only for purposes of § 954(b)(4), and not for any other purpose, such as for determining U.S. taxable income of the CFC under §§ 954(b)(5) and 951A(c)(2)(A)(ii), and the associated foreign tax credits under § 960. In contrast to § 954(b)(4), under which the

rules in the proposed regulations are intended to approximate the foreign tax base, taxable income and items of income for purposes of §§ 954(b)(5), 951A(c)(2)(A)(ii), and 960 continue to be determined using the allocation and apportionment rules set forth in the regulations under § 861.

- (f) Nevertheless, Treasury and the IRS are considering whether for purposes of §§ 954(b)(5), 951A(c)(2)(A)(ii), and 960 it would be appropriate, in limited cases (for example to reduce administrative and compliance burdens), to allocate and apportion deductions incurred by a CFC based on the extent to which they are properly reflected on an applicable financial statement, and requested comments in this regard.
- (g) For example, a rule could allocate and apportion deductions (other than foreign tax expense) only to the extent of the items of gross income attributable to the tested unit, and allocate and apportion any deductions in excess of such gross income to all gross income of the CFC. In addition, applying a method based on applicable financial statements for purposes of the high-tax exception could, in certain circumstances, affect the allocation and apportionment of deductions for purposes of determining the amount of an inclusion regarding gross income of the CFC that is not eligible for the high-tax exception.
- (h) Treasury and the IRS stated that one approach under consideration would be to provide that deductions allocated and apportioned to an item of gross income based on an applicable financial statement for purposes of calculating a tentative net item under the high-tax exception cannot be allocated and apportioned to a different item of gross income that does not qualify for the high-tax exception for purposes of calculating the inclusion under § 951(a) or § 951A.
- (i) Such an approach would be a limited change to the traditional rules for allocating and apportioning deductions and would address concerns that, if deductions were not allocated and apportioned using a consistent method when the high-tax exception has been elected, they could be viewed as effectively being “double counted” by both reducing the tentative net item for purposes of determining whether an item of gross income is eligible for the high-tax exception and also reduce the amount of a U.S. shareholder’s inclusions under §§ 951(a)(1) and 951A(a) regarding a different item of gross income. Comments were requested.

4. Losses: Negative Foreign Tax Rates.

- (a) In certain cases, the effective foreign tax rate at which taxes are imposed on a tentative net item may result in an undefined value or a negative effective foreign tax rate. This may occur, for example, if foreign taxes are allocated and apportioned to the corresponding item of gross income, and the tentative net item (plus the foreign taxes) is negative because the amount of deductions allocated and apportioned to the gross income exceeds the amount of gross income (plus the foreign taxes).
- (b) The proposed regulations provide that the effective rate of foreign tax regarding a tentative net item that results in an undefined value or a negative effective foreign tax rate will be deemed to be high-taxed. As a result, the item of gross income, and the deductions allocated and apportioned to such gross income under the rules set forth in the regulations under § 861, are assigned to the residual grouping, and no credit is allowed for the foreign taxes allocated and apportioned to such gross income. Nevertheless, Treasury and the IRS state they are considering whether this result is appropriate in all cases and request comments in this regard.

5. Combination of De Minimis Tested Units.

- (a) The proposed regulations include a rule that, subject to an anti-abuse provision, combines tested units (on a non-elective basis) that are attributed gross income less than the lesser of 1% of the gross income of the CFC, or \$250,000. This de minimis combination rule applies after the application of the “same foreign country” combination rule in Prop. Treas. Reg. § 1.954-1(d)(2)(iii)(A)(1) and, therefore, combines tested units that are not residents of (or located in) the same foreign country.
- (b) Comments were requested regarding this de minimis combination rule, including whether the rule could be better tailored to reduce administrative burden without permitting an excessive amount of blending.

6. Anti-Abuse Rules.

- (a) Treasury and the IRS are concerned that taxpayers may include, or fail to include, items on an applicable financial statement or make, or fail to make, disregarded payments, to manipulate the application of the high-tax exception. As a result, the proposed regulations include an anti-abuse rule to address such cases if undertaken with a significant purpose of avoiding the purposes of § 951, 951A, 954(b)(4), or Prop. Treas. Reg. § 1.954-1(d).

- (b) Treasury and the IRS are also concerned that taxpayers may enter into transactions with a significant purpose of manipulating the eligibility of income for the high-tax exception. This could occur, for example, if a payment or accrual by a CFC is deductible for federal income tax purposes but not for purposes of the tax laws of the foreign country of the payor. As a result, the deduction would reduce the tentative net items of the CFC but would not reduce the amount of foreign income taxes paid or accrued regarding the tentative net item, which would have the effect of increasing the foreign effective tax rate imposed on the item.
- (c) Accordingly, the proposed regulations include an anti-abuse rule to address transactions or structures involving certain instruments or reverse hybrid entities that are undertaken with a significant purpose of manipulating whether an item of income qualifies for the high-tax exception.
- (d) Treasury and the IRS state that they continue to study other transactions and structures that may be used to inappropriately manipulate the application of the high-tax exception, including transactions and structures with hybrid entities, and may expand the application of the anti-abuse rule in the final regulations such that it is not limited to specific types of transactions or structures.

D. Mechanics of the Election.

1. In General.

- (a) Under current Treas. Reg. § 1.954-1(d), the election for the Subpart F high-tax exception is made separately regarding each CFC, unlike the GILTI high-tax exclusion election, which must be made regarding all of the CFCs that are members of a CFC group. As discussed in the preamble to the final regulations, the consistency requirement contained in the GILTI high-tax exclusion rules is necessary to prevent inappropriate cross-crediting regarding high-taxed income under § 904.
- (b) As a result of the changes made by the TCJA, a consistency requirement is also appropriate for the Subpart F high-tax exception. The benefit of a CFC-specific election before the TCJA was to defer U.S. tax regarding high-tax income items. After the TCJA, the ability to exclude some high-taxed income from Subpart F, while claiming foreign tax credits regarding other high-taxed income, can produce inappropriate results under § 904. As a result, Treasury and the IRS believe that a single high-tax exception election applicable to all income of all CFCs that are

members of a CFC group better reflects the purposes of §§ 904 and 954(b)(4) than a CFC-by-CFC election.

- (c) Accordingly, the proposed regulations include a single unified election that applies for purposes of both Subpart F and GILTI, incorporating a consistency requirement parallel to that in Treas. Reg. § 1.951A-2(c)(7)(viii)(A)(1) and (c)(7)(viii)(E).

2. Contemporaneous Documentation.

- (a) Neither current Treas. Reg. § 1.954-1(d) nor the final regulations specify the documentation necessary for a U.S. shareholder to substantiate either the calculation of an amount excluded by reason of an election under § 954(b)(4) or that the requirements under current Treas. Reg. § 1.954-1(d) or the final regulations were met.
- (b) To facilitate the administration of the rules regarding these elections, Treasury and the IRS believe that U.S. shareholders must maintain specific contemporaneous documentation to substantiate their high-tax exception computations. Accordingly, the proposed regulations include a contemporaneous documentation requirement. They would add this information to the list of information that must be included on Form 5471 (“Information Return of U.S. Persons With Respect to Certain Foreign Corporations”).

E. Other Changes.

1. Coordination Rules.

- (a) Earnings and Profits Limitation.
  - i. Treas. Reg. § 1.954-1(d)(4)(ii) provides that the amount of income that is a net item of income (an input in determining whether the Subpart F high-tax exception applies) is determined after the application of the earnings and profits limitation provided under § 952(c)(1). Section 952(c)(1)(A) generally limits the amount of Subpart F income of a CFC to the CFC’s earnings and profits for the taxable year. In addition, § 952(c)(2) provides that if the Subpart F income of a CFC is reduced by reason of the earnings and profits limitation under § 952(c)(1)(A), any excess of the earnings and profits of the CFC for any subsequent taxable year over the CFC’s Subpart F income for such taxable year is recharacterized as Subpart F income under rules similar to the rules under § 904(f)(5).

- ii. Treasury and the IRS believe that this coordination rule can lead to inappropriate results. When the § 952(c)(1) limitation applies, the effective rate at which taxes are imposed under Treas. Reg. § 1.954-1(d)(2) would be calculated on a smaller net item of income than if the net item of income were determined before the limitation, but the amount of foreign income taxes regarding the net item would be unchanged. They are concerned that this could have the effect of causing a net item of income to qualify for the Subpart F high-tax exception even though the item, without regard to the limitation, would not have so qualified.
- iii. In addition, amounts subject to recharacterization as Subpart F income in a subsequent taxable year under § 952(c)(2) may not qualify for the Subpart F high-tax exception even if the net item of income to which the recapture amount relates did so qualify. As a result, the proposed regulations provide that the high-tax exception applies without regard to the limitation in § 952(c)(1). They also follow current Treas. Reg. § 1.951-1(a)(7), which provides that the Subpart F income of a CFC is increased by earnings and profits of the CFC that are recharacterized under § 952(c)(2) and Treas. Reg. § 1.952-1(f)(2)(ii) after determining the items of income of the CFC that qualify for the high-tax exception.

(b) Full Inclusion Rule.

- i. The current regulations generally provide that, except as provided in § 953, adjusted gross foreign base company income consists of all gross income of the CFC other than gross insurance income (and amounts described in § 952(b)), and adjusted gross insurance income consists of all gross insurance income (other than amounts described in § 952(b)), if the sum of the gross foreign base company income and the gross insurance income for the taxable year exceeds 70% of gross income (the “full inclusion rule”).
- ii. Thus, under the current regulations the full inclusion rule generally applies before the application of the Subpart F high-tax exception (which occurs when adjusted net foreign base company income is determined). Under a special coordination rule, however, full inclusion foreign base company income is excluded from Subpart F income if more than 90% of the adjusted gross foreign base company income and adjusted gross insurance company income of a

CFC (determined without regard to the full inclusion rule) is attributable to net amounts excluded from Subpart F income under the Subpart F high-tax exception.

- iii. Treasury and the IRS believe that these rules could be simplified if the determination of whether income is foreign base company income occurs before the application of the full inclusion rule. Current Treas. Reg. § 1.954-1, for example, requires taxpayers to determine whether income is foreign base company income or insurance income before applying the full inclusion rule or the high tax exception. Applying the high-tax exception first will eliminate the need to perform this factual analysis in many cases.
- iv. Therefore, the proposed regulations provide that the high-tax exception applies before the full inclusion rule and, consequently, the special coordination rule in Treas. Reg. § 1.954-1(d)(6) is eliminated. In addition, the proposed regulations make conforming revisions to the coordination rule for full inclusion income and the high-tax election in the regulations under § 951A. The proposed regulations also would delete Treas. Reg. § 1.951A-2(c)(4)(iii)(C) and (iv)(C) (Example 3).

## 2. Elections on Amended Returns.

- (a) Current Treas. Reg. § 1.954-1(d)(5) generally provides that a controlling U.S. shareholder (as defined in Treas. Reg. § 1.964-1(c)(5)) may make (or revoke) a Subpart F high-tax election by attaching a statement to its amended income tax return and that this election is binding on all U.S. shareholders of the CFC. In conforming the provisions of the Subpart F high-tax exception with the provisions of the GILTI high-tax exclusion in the final regulations (as modified by the proposed regulations), Treasury and the IRS believe that it is also necessary to revise the rules regarding elections on amended returns.
- (b) The final regulations require that amended returns for all U.S. shareholders of the CFC for the CFC inclusion year must be filed within a single 6-month period within 24 months of the unextended due date of the original income tax return of the controlling domestic shareholder's inclusion year with or within which the relevant CFC inclusion year ends. As stated in the preamble to the final regulations, Treasury and the IRS believe that the requirement that all amended returns be filed by the end of this period is necessary to administer the GILTI high-tax exclusion and to allow

the IRS to timely evaluate refund claims or make additional assessments.

- (c) For this reason, the proposed regulations also provide that the high-tax election may be made (or revoked) on an amended federal income tax return only if all U.S. shareholders of the CFC file amended returns (unless an original federal income tax returns has not yet been filed, in which case the original return may be filed consistently with the election (or revocation)) for the year (and for any other tax year in which their U.S. tax liabilities would be increased by reason of that election (or revocation)), within a single 6-month period within 24 months of the unextended due date of the original federal income tax return of the controlling domestic shareholder's inclusion year.
- (d) They also provide that in the case of a U.S. shareholder that is a partnership, the election may be made (or revoked) with an amended Form 1065 or an administrative adjustment request, as applicable. Further, the proposed regulations provide that if a partnership files an administrative adjustment request, a partner that is a U.S. shareholder in the CFC is treated as having complied with these requirements (regarding the portion of the interest held through the partnership) if the partner and the partnership timely comply with their obligations under § 6227.
- (e) Treasury and the IRS state they are aware that changes in circumstances occurring after the 24-month period may cause a taxpayer to benefit from making (or revoking) the election, for example, if there is a foreign tax redetermination regarding one or more CFCs. They request comments on rules that would permit a taxpayer to make (or revoke) an election after the 24-month period in cases where the taxpayer can establish that the election (or revocation) will not result in time-barred tax deficiencies.

F. Section 381(a).

- 1. Section 952(c)(2) generally provides that if Subpart F income of a CFC for a taxable year was reduced by reason of the current earnings and profits limitation in § 952(c)(1)(A), any excess of the earnings and profits of such CFC for any subsequent taxable year over the Subpart F income of such foreign corporation for such taxable year is recharacterized as Subpart F income under rules similar to the rules of § 904(f)(5). Treas. Reg. § 1.904(f)-2(d)(6) generally provides, in part, that in the case of a distribution or transfer described in § 381(a), an overall foreign loss account of the distributing or transferor corporation is treated as an overall foreign loss account of the acquiring or transferee corporation as of the close of the date of the distribution or transfer.



2. Treasury and the IRS believe that, because of some lack of certainty whether recapture accounts carry over in transactions to which § 381(a) applies, it is appropriate to provide clarification. Therefore, the proposed regulations clarify that recapture accounts carry over to the acquiring corporation (including foreign corporations that are not CFCs) in a distribution or transfer described in § 381(a). Treasury and the IRS believe that this clarification is consistent with general successor principles as may be applied under current law in certain successor transactions such as transactions described in § 381(a).

G. Applicability Dates.

1. The proposed regulations under Treas. Reg. § 1.951A-2, 1.952-1(e), and Treas. Reg. § 1.954-1 are proposed to apply to taxable years of CFCs beginning after the date the Treasury decision adopting the rules as final regulations is filed with the Federal Register, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.
2. The proposed regulations under Treas. Reg. § 1.952-1(f)(4) are proposed to apply to taxable years of a foreign corporation ending on or after July 20, 2020. As a result of this applicability date, Prop. Treas. Reg. § 1.952-1(f)(4) would apply regarding recapture accounts of an acquiring corporation for taxable years of the corporation ending on or after July 20, 2020, even if the distribution or transfer described in § 381(a) occurred in a taxable year ending before July 20, 2020.

II. NEW § 163(j) REGULATIONS.

FINAL REGULATIONS: SECTION 163(j)

A. Final Treas. Reg. § 1.163(j)-7.

1. Final Treas. Reg. § 1.163(j)-7(b) states that § 163(j) applies to determine the deductibility of a relevant foreign corporation's business interest expense for purposes of computing its taxable income for U.S. income tax purposes (if any) in the same manner as the § 163(j) regulations apply to determine the deductibility of a domestic C Corporation's business expense for purposes of computing its taxable income.<sup>2</sup>
2. The relevant foreign corporation's gross income and allowable deductions are determined under the principles of Treas. Reg. § 1.952-2 or under the rules of § 882. Treas. Reg. § 1.163(j)-7(g). For purposes of computing

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<sup>2</sup> Final and proposed § 163(j) regulations were filed September 3 with a September 14 publication date. It is these versions of these regulations that we discuss. Prior versions were released on the IRS.gov website and had been widely circulated. There are no substantive changes in the international rules, although the proposed regulations' effective date provisions were materially modified.

Adjusted Taxable Income (“ATI”) of a relevant foreign corporation, any dividend included in gross income that is received from a related person, within the meaning of § 954(d)(3) regarding the distributee, is subtracted from tentative taxable income.

3. The effective date of these rules is taxable years beginning on or after 60 days after the publication of the final regulations in the Federal Register. However, taxpayers may choose to apply them to taxable years beginning after December 31, 2017 so long as the taxpayer and its related parties consistently apply the rules of the § 163(j) regulations and certain other regulations to those years.
4. With one exception, the rest of the international § 163(j) rules are in re-proposed regulations, discussed further below. Taxpayer comments on the old proposed § 163(j)-7 regulations are discussed below in connection with the re-proposed version of those regulations. There are no final § 1.163(j)-8 “Effectively Connected Income” (ECI) regulations. Regulations under that section were completely re-proposed.

**B. Final Treas. Reg. § 163(j)-1(b)(1)(ii)(G).**

1. The one exception referred to above involves Final Treas. Reg. § 1.163(j)-1(b)(1)(ii)(G). This provision requires a subtraction from a U.S. taxpayer’s gross income of “specific deemed inclusions,” specifically those under § 78, Subpart F and GILTI that are properly allocable to a non-excepted trade or business.
2. Some commenters argued that U.S. shareholders, as defined in § 951(b) (U.S. shareholders), of controlled foreign corporations, as defined in § 957(a) (“CFCs”), should be allowed to include in their ATI the amounts included in gross income under § 951(a) (Subpart F inclusions), § 951A(a) global intangible low-taxed income (“GILTI”) inclusions, and § 78 “gross-up” inclusions (collectively, CFC income inclusions) attributable to non-excepted trades or businesses.
3. Because § 163(j) applies to CFCs, Treasury and the IRS believe that allowing a U.S. shareholder to include its CFC income inclusions in its ATI would not be appropriate. The income of the CFC that gives rise to this income is taken into account in computing the ATI of the CFC for purposes of determining its § 163(j) limitation. They believe that allowing the same income to also be taken into account in computing the ATI of a U.S. shareholder would result in an inappropriate double-counting of income.
4. Furthermore, Treasury and the IRS said they question the premise of several comments that, if the business interest expense of a CFC were excluded from the application of § 163(j), including the income of a CFC

in a U.S. shareholder's ATI would be appropriate. Even if § 163(j) did not apply to CFCs, CFCs are entities that also can be leveraged. Thus, they believe that permitting the income of the CFC that gives rise to CFC income inclusions attributable to non-excepted trades or businesses of CFCs to be included in the ATI of U.S. shareholders would be inconsistent with the principles of § 163(j).

5. In particular, stated Treasury and the IRS, consider a case in which a CFC has interest expense of \$100x, trade or business gross income of \$300x treated as Subpart F income, and no foreign tax liability. In such a case, a U.S. shareholder that wholly owns the CFC would have a Subpart F inclusion of \$200x (if § 163(j) did not apply to CFCs). If the \$200x Subpart F inclusion were included in the ATI of the U.S. shareholder, the U.S. shareholder could deduct an additional \$60x of business interest expense (\$200x x 30%). As a result, \$300x of gross income could support \$160x of interest expense deductions rather than the \$90x permitted under § 163(j)(1).
6. Finally, they stated that under the final regulations (and consistent with Prop. Treas. Reg. § 1.163(j)-7(d)(1)(ii)), if a domestic partnership includes amounts in gross income under §§ 951(a) and 951A(a) regarding an applicable CFC and these amounts are investment income to the partnership, then, a domestic C corporation partner's distributive share of these amounts that is properly allocable to a non-excepted trade or business of the domestic C corporation by reason of Treas. Reg. §§ 1.163(j)-4(b)(3) and 1.163(j)-10(c) is excluded from the domestic C corporation partner's ATI.

#### NEW PROPOSED REGULATIONS: § 163(j)-7

- A. Old Prop. Treas. Reg. § 1.163(j)-7. The 2018 proposed regulations provided that, consistent with Treas. Reg. § 1.952-2, § 163(j) and the § 163(j) regulations applied to determine the deductibility of an applicable CFC's Business Interest Expense ("BIE") in the same manner as these provisions apply to determine the deductibility of a domestic C corporation's BIE. Those proposed regulations defined an applicable CFC as a CFC in which at least one U.S. shareholder owned stock within the meaning of § 958(a). However, in certain cases, they allowed certain applicable CFCs to make a CFC group election and be treated as part of a CFC group for purposes of computing the applicable CFC's § 163(j) limitation.

1. CFC Group Election: Old Regs.

- (a) Under the 2018 proposed regulations, if a CFC group election was in effect, the amount of BIE of a CFC group member that was subject to the § 163(j) limitation was limited to the amount of the CFC group member's allocable share of the CFC group's applicable net BIE (which was equal to the sum of the BIE of all

CFC group members, reduced by the BII of all CFC group members). Thus, for example, if a CFC group had no debt other than loans between CFC group members, no portion of the BIE of a CFC group member was subject to the § 163(j) limitation.

- (b) A CFC group member's allocable share was computed by multiplying the applicable net BIE of the CFC group by a fraction, the numerator of which was the CFC group member's net BIE (computed on a separate company basis), and the denominator of which was the sum of the amounts of the net BIE of each CFC group member with net BIE (computed on a separate company basis).
- (c) After applying the CFC group rules to determine each CFC group member's allocable share of the CFC group's applicable net BIE, each CFC group member that had BIE was required to perform a stand-alone § 163(j) calculation to determine whether any BIE was disallowed under the § 163(j) limitation.

## 2. Membership in a CFC Group: Old Regs.

- (a) Under the 2018 proposed regulations, a CFC group meant two or more applicable CFCs if at least 80% of the value of the stock of each applicable CFC was owned, within the meaning of § 958(a), by a single U.S. shareholder or, in the aggregate, by related U.S. shareholders that owned stock of each member in the same proportion. They also generally treated a controlled partnership (in general, a partnership in which CFC group members owned, in the aggregate, at least 80% of the interests) as a CFC group member. For purposes of identifying a CFC group, members of a consolidated group are treated as a single person and stock owned by certain passthrough entities was treated as owned proportionately by the owners or beneficiaries of the passthrough entity.
- (b) The regulations excluded from the definition of a CFC group member an applicable CFC that had any income that was effectively connected with the conducted of a trade or business in the U.S. In addition, if one or more CFC group members conducted a financial services business, those entities were treated as comprising a separate subgroup.
- (c) A CFC group election was made by applying the rules applicable to CFC groups for purposes of computing each CFC group member's deduction for BIE. Once made, the CFC group election was irrevocable.

3. Roll-up of CFC Excess Taxable Income: Old Regs.

- (a) If a CFC group election was in effect regarding a CFC group, then an upper-tier CFC group member took into account a proportionate share of any “CFC excess taxable income” of a lower-tier CFC group member in which it directly owned stock for purposes of computing the upper-tier member’s ATI. The meaning of the term “CFC excess taxable income” was analogous to the meaning of the term “excess taxable income” in the context of a partnership and S corporation, and, in general, meant the amount of a CFC group member’s ATI in excess of the amount needed to prevent any BIE of the CFC group member from being disallowed under § 163(j).
- (b) Under the 2018 proposed regulations, a U.S. shareholder was not permitted to include in its ATI amounts included in gross income under § 951(a) (Subpart F inclusions), § 951A(a) (GILTI inclusions), or § 78 (§ 78 inclusions) that were properly allocable to a non-excepted trade or business (collectively, deemed income inclusions). However, the 2018 Proposed Regulations provided that a portion of CFC excess taxable income of the highest-tier applicable CFC was permitted to be used to increase the ATI of its U.S. shareholders. That portion was equal to the U.S. shareholder’s interest in the highest-tier applicable CFC multiplied by its specified ETI ratio. The numerator of the specified ETI ratio was the sum of the U.S. shareholder’s income inclusions under §§ 951(a) and 951A(a) regarding the specified highest-tier member and specified lower-tier members, and the denominator was the sum of the taxable income of the specified highest-tier member and specified lower-tier members.

B. Summary of Taxpayer Comments.

- 1. Treasury and the IRS requested comments in the preamble to the 2018 proposed regulations regarding whether it would be appropriate to further modify the application of § 163(j) to applicable CFCs and whether there are particular circumstances in which it may be appropriate to exempt an applicable CFC from the application of § 163(j).
- 2. Some commenters recommended that § 163(j) not apply to applicable CFCs. A number of commenters broadly requested changes to the roll-up of CFC excess taxable income. Many of these commenters expressed concern about the administrability of rolling up CFC excess taxable income. Some commenters suggested that the CFC group election be available to a stand-alone applicable CFC in order to allow its CFC excess taxable income to be used to increase the ATI of a U.S. shareholder, or that an applicable CFC be permitted to use any CFC excess taxable

income to increase the ATI of a shareholder without regard to whether it is a CFC group member.

3. Other commenters said that the nature of the roll-up compels multinationals to restructure their operations in order to move CFCs with relatively high amounts of ATI and low amounts of interest expense to the bottom of the ownership chain and CFCs with relatively low amounts of ATI and high amounts of interest expense to the top of the ownership chain, in order to maximize the benefits of the roll-up of CFC excess taxable income.
4. Some commenters said that because multinational organizations may own hundreds of CFCs, applying the § 163(j) limitation on a CFC-by-CFC basis, without regard to whether a CFC group election had been made under the 2018 proposed regulations, represented a significant administrative burden. Many comments suggested that CFC groups should be permitted to apply § 163(j) on a group basis, with a single group-level § 163(j) calculation similar to the rules applicable to a consolidated group. A few commenters suggested that this rule should be applied in addition to the roll-up of CFC excess taxable income, but most commenters recommended that the group rule be applied instead of the roll-up.
5. Commenters also said that the requirements to be a member of a CFC group under the 2018 Proposed Regulations were overly restrictive. Some of these commenters recommended that the 80% ownership threshold be replaced with the ownership requirements of affiliated groups under § 1504(a), the rules of which are well-known and understood. Others recommended that the 80% ownership requirement be reduced to 50%, consistent with the standard for treatment of a foreign corporation as a CFC.
6. Still others said that U.S. shareholders owning stock in applicable CFCs should not each be required to own the same proportion of stock in each applicable CFC in order for their ownership interests to count towards the 80% ownership requirement, or that the attribution rules of § 958(b), rather than § 958(a), should apply for purposes of determining whether the ownership requirements are met. Finally, some commenters requested that a CFC group election be permitted when one applicable CFC meets the ownership requirements for other applicable CFCs, even if no U.S. shareholder meets the ownership requirements for a highest-tier applicable CFC.
7. Some commenters requested the CFC financial services subgroups not be segregated from the CFC group and their BIE and BII be included in the general CFC group.

8. Finally, commenters requested a safe harbor or exclusion providing that if a CFC group would not be limited under § 163(j) either because the CFC group has no net BIE or because its BIE does not exceed 30% of the CFC group's ATI, a U.S. shareholder would not have to apply § 163(j) for the applicable CFC or be subject to applicable CFC § 163(j) reporting requirements.

C. Prop. Treas. Reg. § 1.163(j)-7.

1. Overview.

- (a) Treasury and the IRS believe, based on a plain reading of § 163(j) and Treas. Reg. § 1.952-2, that § 163(j) applies to foreign corporations where relevant under current law and has applied to such corporations since the effective date of the new provision.<sup>3</sup> Congress expressly provided that § 163(j) should not apply to certain small businesses or to certain excepted trades or businesses. Nothing in the Code or legislative history indicates that Congress intended to except other persons with trades or businesses, as defined in § 163(j)(7), from the application of § 163(j).
- (b) Accordingly, Treasury and the IRS believe that, consistent with a plain reading of § 163(j) and Treas. Reg. § 1.952-2, it is appropriate for § 163(j) to apply to applicable CFCs and other foreign corporations whose taxable income is relevant for Federal tax purposes (other than by reason of having ECI or income described in § 881 (FDAP)) (relevant foreign corporations).<sup>4</sup> In the case of CFCs with ECI, Prop. Treas. Reg. § 1.163(j)-8 applies.
- (c) A number of comments stated that there are other mechanisms that eliminate the policy need for § 163(j) to apply to limit leverage in CFCs. For example, some commenters have cited tax rules in foreign jurisdictions limiting interest deductions, including thin capitalization rules (or similar rules intended to implement the Organisation for Economic Co-operation and Development ("OECD") recommendations under Action 4 of the Base Erosion and Profits Shifting Project).
- (d) Treasury and the IRS disagreed with these comments. They noted that these rules are not universally applied in other jurisdictions, that many jurisdictions do not have any meaningful interest

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<sup>3</sup> Treas. Reg. § 1.952-2(b) generally provides that the taxable income for a foreign corporation is determined by treating the foreign corporation as a domestic corporation but with certain enumerated exceptions. Treas. Reg. § 1.952-2(c) provides for a number of exceptions, but none of the exceptions affects the application of § 163(j).

<sup>4</sup> For purposes of Prop. Treas. Reg. § 1.163(j)-7, the term effectively connected income (or ECI) means income or gain that is ECI, as defined in Treas. Reg. § 1.884-1(d)(1)(iii), and deduction or loss that is allocable to, ECI, as defined in Treas. Reg. § 1.884-1(d)(1)(iii).

expense limitation rules, and that some jurisdictions have no interest expense limitation rules of any kind.

- (e) Even if some CFCs owned by a U.S. shareholder are in foreign jurisdictions with meaningful thin capitalization rules, in the absence of § 163(j), it would still be possible to use leverage to reduce or eliminate a U.S. shareholder's global intangible low-taxed income (GILTI) under § 951A for these CFCs. This is because for purposes of computing a U.S. shareholder's GILTI under § 951A, tested income of CFCs may be offset by tested losses of CFCs owned by the U.S. shareholder. § 951A(c).
- (f) The ability to deduct interest without limitation under § 163(j) would result in tested losses in CFCs with significant leverage. Because of this aggregation, one overleveraged CFC in a single jurisdiction that does not have rules limiting interest expense could, without the application of § 163(j), reduce or eliminate tested income from all CFCs owned by a U.S. shareholder regardless of jurisdiction.
- (g) Other comments suggested that, to the extent that debt of a CFC is held by a related party, transfer pricing principles would keep the amount of interest expense at arm's length. Comments also noted that to the extent that debt of a CFC is held by a third party, market forces would limit the leverage present in the CFC.
- (h) Treasury and the IRS said that if Congress believed that market forces and transfer pricing principles were sufficient disciplines to prevent overleverage, § 163(j) would not have been amended as part of TCJA to clearly apply to interest expense paid or accrued to both third parties and related parties. In addition, if transfer pricing were sufficient to police interest expense in the related party context, old § 163(j) (as enacted in 1989 and subsequently revised prior to TCJA) would not have been necessary.
- (i) However, Treasury and the IRS also believe that it is appropriate, while still carrying out the provisions of the statute and the policies of § 163(j), to reduce the administrative and compliance burdens of applying § 163(j) to applicable CFCs. Accordingly, new Prop. Treas. Reg. § 1.163(j)-7 provides for an election to be made to apply § 163(j) on a group basis regarding applicable CFCs that are "specified group members" of a "specified group." If the election is made, the specified group members are referred to as "CFC group members" and all of the CFC group members collectively are referred to as a "CFC group."



- (j) Thus, the new proposed regulations' rules are similar to the old proposed regulations' rules, but with some changes intended to simplify compliance.
- (k) In addition, Prop. Treas. Reg. § 1.163(j)-7 provides a safe harbor election that exempts certain applicable CFCs from application of § 163(j). The safe-harbor election is available for stand-alone applicable CFCs (which is an applicable CFC that is not a specified group member of a specified group) and CFC group members. The election is not available for an applicable CFC that is a specified group member but not a CFC group member because a CFC group election is not in effect. Prop. Treas. Reg. § 1.163(j)-7 also contains an anti-abuse rule that increases ATI in certain circumstances.
- (l) Prop. Treas. Reg. § 1.163(j)-7 allows a U.S. shareholder of a stand-alone applicable CFC or a CFC group member of a CFC group to include a portion of its deemed income inclusions attributable to the applicable CFC in the U.S. shareholder's ATI. This rule does not apply regarding an applicable CFC that is a specified group member but not a CFC group member because a CFC group election is not in effect.
- (m) Treasury and the IRS believe that, in many instances, Prop. Treas. Reg. § 1.163(j)-7 will significantly reduce the administrative and compliance burdens of applying § 163(j) to applicable CFCs relative to the 2018 proposed regulations.
- (n) Unlike Prop. Treas. Reg. § 1.163(j)-8, which provides rules for allocating disallowed BIE to ECI and non-ECI, Prop. Treas. Reg. § 1.163(j)-7 does not allocate disallowed BIE among classes of income. Treasury and the IRS requested comments on appropriate methods of allocating disallowed BIE among classes of income, such as Subpart F income, as defined in § 952, and tested income, as defined in § 951A(c)(2)(A) and Treas. Reg. § 1.951A-2(b)(1), as well as comments on whether and the extent to which rules implementing such methods may be necessary.
- (o) In addition, they requested comments on appropriate methods of allocating disallowed BIE for other purposes, including between items described in Treas. Reg. § 1.163(j)-1(b)(22)(i) and other items described in Treas. Reg. § 1.163(j)-1(b)(22) (defining interest), as well as comments on whether and the extent to which rules implementing such methods may be necessary.
- (p) Treasury and the IRS believe that § 163(j) will not affect the tax liability of a passive foreign investment company, within the

meaning of § 1297(a) (“PFIC”), or its shareholders, solely because the PFIC is a relevant foreign corporation. Treas. Reg. § 1.163(j)-4(c)(1) (providing that § 163(j) does not affect earnings and profits). They requested comments on whether any additional guidance is needed to reduce the compliance burden of § 163(j) on PFICs and their shareholders.

D. CFC Group Members.

1. Single § 163(j) Limitation. Prop. Treas. Reg. § 1.163(j)-7(c) provides rules for applying § 163(j) to CFC group members of a CFC group. Under the proposed regulations, a single § 163(j) limitation is computed for a CFC group. Prop. Treas. Reg. § 1.163(j)-7(c)(2). For this purpose, the current-year BIE, disallowed BIE carryforwards, Business Interest Income (“BII”), floor plan financing interest expense, and ATI of a CFC group are equal to the sums of the current-year amounts of such items for each CFC group member for its specified taxable year regarding the specified period. A CFC group member’s current-year BIE, BII, floor plan financing interest expense, and ATI for a specified taxable year are generally determined on a separate-company basis before being included in the CFC group calculation.
2. Allocation of CFC Group’s § 163(j) Limitation. The extent to which a CFC group’s § 163(j) limitation is allocated to a particular CFC group member’s current-year BIE and disallowed BIE carryforwards is determined using the rules that apply to consolidated groups under Treas. Reg. §§ 1.163(j)-5(a)(2) and (b)(3)(ii) (consolidated BIE rules), subject to certain modifications. Prop. Treas. Reg. § 1.163(j)-7(c)(3)(i). The preamble states that because many CFC groups will be owned by consolidated groups, many taxpayers will be familiar with the consolidated BIE rules.
3. The Operative Group Rules.
  - (a) If the sum of the CFC group’s current-year BIE and disallowed BIE carryforwards exceeds the CFC group’s § 163(j) limitation, then current-year BIE is deducted first. If the CFC group’s current-year BIE exceeds the CFC group’s § 163(j) limitation, then each CFC group member deducts the amount of its current-year BIE not in excess of the sum of its BII and floor plan financing interest expense, if any. Then, if the CFC group has any § 163(j) limitation remaining for the current year, each applicable CFC with remaining current-year BIE deducts a pro rata portion thereof.
  - (b) If the CFC group’s § 163(j) limitation exceeds its current-year BIE, then CFC group members may deduct all of their current-year BIE and may deduct disallowed BIE carryforwards not in excess of

the CFC group's remaining § 163(j) limitation. The disallowed BIE carryforwards are deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year, and disallowed BIE carryforwards that arose in the same taxable year are deducted on a pro rata basis.

- (c) This taxable year ordering rule is consistent with the consolidated BIE rules. However, Prop. Treas. Reg. § 1.163(j)-7 provides special rules for disallowed BIE carryforwards when CFC group members have different taxable years, or a CFC group member has multiple taxable years regarding the specified period of the CFC group. Unlike members of a consolidated group, not all CFC group members will have the same taxable years, and not all CFC group members will have the same taxable year as the parent of the CFC group. A CFC group member is included in a CFC group for its entire taxable year that ends with or within a specified period.

For example, assume a U.S. multinational group parented by a consolidated group with a taxable year that is the calendar year includes applicable CFCs with November 30 taxable years and other applicable CFCs with calendar year taxable years. In this case, the specified period of the CFC group for 2020 would begin on January 1, 2020, and end on December 31, 2020. Furthermore, the specified taxable year of a CFC group member with a taxable year that is the calendar year is its taxable year ending December 31, 2020, and the specified taxable year of a CFC group member with a November 30 taxable year is its taxable year ending November 30, 2020 (the taxable years that end with or within the specified period). A CFC group member can also have multiple taxable years regarding a specified period. For example, a CFC group member may have a short taxable year due to an election under Temp. Treas. Reg. § 1.245A-5T(e)(3)(i) (elective exception to close a CFC's taxable year in the case of an extraordinary reduction).

#### 4. Pre-Group Carryforwards.

- (a) The disallowed BIE carryforwards of a CFC group member when it joins a CFC group (pre-group disallowed BIE carryforwards) are subject to the same CFC group § 163(j) limitation and are deducted pro rata with other CFC group disallowed BIE carryforwards. However, pre-group disallowed BIE carryforwards are subject to additional limitations, similar to the limitations on deducting the disallowed BIE carryforwards of a consolidated group arising in a Separate Return Limitation Year ("SRLY"), as defined in Treas. Reg. § 1.1502-1(f), or treated as arising in a SRLY under the principles of Treas. Reg. § 1.1502-21(c) and (g).

- (b) The rules and principles of Treas. Reg. § 1.163(j)-5(d)(1)(B), which applies SRLY subgroup principles to disallowed BIE carryforwards of a consolidated group, apply to pre-group subgroups. If a CFC group member with pre-group disallowed BIE carryforwards (loss member) leaves one CFC group (former group) and joins another CFC group (current group), the loss member and each other CFC group member that left the former group and joined the current group for a specified taxable year regarding the same specified period consists of a “pre-group subgroup.”
- (c) Unlike SRLY subgroups, it is not required that all members of a pre-group subgroup join the CFC group at the same time, since each applicable CFC that joins a CFC group is treated as joining on the first day of its taxable year. As a result, even if multiple applicable CFCs are acquired on the same day in a single transaction, they would join the CFC group on different days if they have different taxable years.

5. Periods Beginning in 2019 or 2020.

- (a) Prop. Treas. Reg. § 1.163(j)-7(c)(5) provides special rules for applying § 163(j)(10) to CFC groups. The proposed regulations provide that elections under § 163(j)(10) are made for a CFC group (rather than for each CFC group member). For a specified period of a CFC group beginning in 2019 or 2020, unless the election described in Treas. Reg. § 1.163(j)-2(b)(2)(ii)(A) is made, the CFC group § 163(j) limitation is determined by using 50% (rather than 30%) of the CFC group’s ATI for the specified period, without regard to whether the taxable years of CFC group members begin in 2019 or 2020.
- (b) If the election described in Treas. Reg. § 1.163(j)-2(b)(2)(ii)(A) is made for a specified period of a CFC group, the CFC group § 163(j) limitation is determined by using 30% (rather than 50%) of the CFC group’s ATI for the specified period, without regard to whether the taxable years of CFC group members begin in 2019 or 2020. The election is made for the CFC group by each designated U.S. person.
- (c) The election under Treas. Reg. § 1.163(j)-2(b)(3)(i) to use 2019 ATI (that is, ATI for the last taxable year beginning in 2019) rather than 2020 ATI (that is, ATI for a taxable year beginning in 2020) is made for a specified period of a CFC group beginning in 2020 (2020 specified period) and applies to the specified taxable years of CFC group members regarding the 2020 specified period.

- (d) Accordingly, if a specified taxable year of a CFC group member regarding a CFC group's 2020 specified period begins in 2020, then the election is applied to such taxable year using the CFC group member's ATI for its last taxable year beginning in 2019. In some cases, the specified taxable year of a CFC group member regarding a CFC group's 2020 specified period will begin in 2019 or 2021.
- (e) If the specified taxable year of the CFC group member begins in 2019, then the election is applied to such taxable year using the CFC group member's ATI for its last taxable year beginning in 2018; if the specified taxable year of the CFC group member begins in 2021, then the election is applied to such taxable year using the CFC group member's ATI for its last taxable year beginning in 2020.

For example, assume a CFC group has two CFC group members, CFC1 and CFC2, and has a specified period that is the calendar year. CFC1 has a taxable year that is the calendar year, and CFC2 has a taxable year that ends November 30. The election under Treas. Reg. § 1.163(j)-2(b)(3)(i) is in effect for the specified period beginning January 1, 2020, and ending December 31, 2020 (which is the 2020 specified period). As a result, the ATI of the CFC group for the 2020 specified period is determined by reference to the specified taxable year of CFC1 beginning January 1, 2019, and ending December 31, 2019 (the last taxable year beginning in 2019), and the specified taxable year of CFC2 beginning December 1, 2018, and ending November 30, 2019 (the last taxable year beginning in 2018).

Alternatively, assume (i) the same CFC group instead has a 2020 specified period that begins on December 1, 2020, and ends on November 30, 2021; (ii) in 2019 and 2020, CFC1 has a taxable year that is the calendar year, but in 2021, CFC1 has a short taxable year that begins on January 1, 2021, and ends on June 30, 2021; and (iii) CFC2 has a taxable year ending November 30 (for all years). Further assume that the election under Treas. Reg. § 1.163(j)-2(b)(3)(i) is in effect for the 2020 specified period.

In this case, the election applies to the specified taxable year of CFC1 that begins on January 1, 2020, and ends on December 31, 2020; the specified taxable year of CFC1 that begins on January 1, 2021, and ends on June 30, 2021; and the specified taxable year of CFC2 that begins on December 1, 2020, and ends on November 30, 2021. As a result of the election, the ATI of the CFC group for the 2020 specified period is determined by reference to the specified

taxable year of CFC1 beginning January 1, 2019, and ending December 31, 2019, the specified taxable year of CFC1 beginning January 1, 2020, and ending December 31, 2020, and the specified taxable year of CFC2 beginning December 1, 2019, and ending November 30, 2020.

- (f) If the election under Treas. Reg. § 1.163(j)-2(b)(3)(i) to use 2019 ATI rather than 2020 ATI is made for a CFC group, the CFC group's ATI for the 2020 specified period is determined by reference to the 2019 ATI of all CFC group members (except to the extent that 2018 or 2020 ATI is used, as described earlier), including any CFC group member that joins the CFC group during the 2020 specified period.
- (g) Therefore, a CFC group's ATI for the 2020 specified period may be determined by reference to a prior taxable year of a new CFC group member even though the CFC group member was not a CFC group member in the prior taxable year. If a CFC group member leaves the CFC group during the 2020 specified period, the ATI of the CFC group for the 2020 specified period is determined without regard to the ATI of the departing CFC group member.
- (h) Revenue Procedure 2020-22 generally provides the time and manner of making or revoking elections under § 163(j)(10), including elections regarding applicable CFCs. References in the revenue procedure to CFC groups and CFC group members are to CFC groups and applicable CFCs for which a CFC group election is made under the 2018 proposed regulations. The rules described in Prop. Treas. Reg. § 1.163(j)-7(c)(5) modify the application of revenue procedure and the elections under § 163(j)(10) for CFC groups and applicable CFCs for which a CFC group election is made under Prop. Treas. Reg. § 1.163(j)-7.
- (i) Thus, for example, assume a CFC group has two designated U.S. persons that are U.S. corporations. Pursuant to Prop. Treas. Reg. § 1.163(j)-7(c)(5), the election to not apply the 50% ATI limitation to the CFC group for a specified period beginning in 2020 is made for the specified period of the CFC group by each designated U.S. person, and pursuant to Revenue Procedure 2020-22, § 6.01(2), the election to not apply the 50% ATI limitation is made by the each designated U.S. person timely filing a Federal income tax return, including extensions, using the 30% ATI limitation for purposes of determining the taxable income of the CFC group.
- (j) For purposes of applying Treas. Reg. § 1.964-1(c), the elections described in Prop. Treas. Reg. § 1.163(j)-7(c)(5) are treated as if made for each CFC group member. Thus, the requirements to

provide a statement and written notice as provided under Treas. Reg. § 1.964-1(c)(3)(i)(B) and (C) apply.

E. Specified Groups and Group Members.

1. In General. Prop. Treas. Reg. § 1.163(j)-7(d) provides rules for determining a specified group and specified group members. The determination of a specified group and specified group members is the basis for determining a CFC group and CFC group members. This is because a CFC group member is a specified group member of a specified group for which a CFC group election is in effect, and a CFC group consists of all the CFC group members. Prop. Treas. Reg. § 1.163(j)-7(e)(2).
2. Specified Group.
  - (a) Under Prop. Treas. Reg. § 1.163(j)-7(d)(2), a specified group includes one or more chains of applicable CFCs connected through stock ownership with a specified group parent, but only if the specified group parent owns stock meeting the requirements of § 1504(a)(2)(B) (pertaining to value) in at least one applicable CFC, and stock meeting the requirements of § 1504(a)(2)(B) in each of the applicable CFCs (except the specified group parent) is owned by one or more of the other applicable CFCs or the specified group parent.
  - (b) Unlike the general rules in § 1504, in order to avoid breaking affiliation with a partnership or foreign trust or foreign estate, for purposes of determining whether stock in an applicable CFC meeting the requirements of § 1504(a)(2)(B) is owned by the specified group parent or other applicable CFCs, Prop. Treas. Reg. § 1.163(j)-7(d)(2) takes into account both stock owned directly and stock owned indirectly under § 318(a)(2)(A) through a domestic or foreign partnership or under § 318(a)(2)(A) or (a)(2)(B) through a foreign estate or trust (the look-through rule).

For example, assume CFC1 and CFC2 is each an applicable CFC and a specified group member of a specified group. If CFC1 and CFC2 each own 50% of the capital and profits interests in a partnership, and the partnership wholly owns CFC3, an applicable CFC, then, by reason of the look-through rule, CFC3 is also included in the specified group, although the partnership is not.
  - (c) The specified group rules also differ from the affiliated group rules in § 1504 in that they require only that 80% of the total value (pursuant to § 1504(a)(2)(B)), not 80% of both vote and value (pursuant to § 1504(a)(2)(A) and (a)(2)(B)), of an applicable CFC

be owned by the specified group parent or other applicable CFCs in the specified group in order for the applicable CFC to be included in the specified group. Treasury and the IRS believe that limiting the 80% threshold to value is appropriate to prevent taxpayers from breaking affiliation by diluting voting power below 80%.

- (d) The specified group has a single specified group parent, which may be either a qualified U.S. person or an applicable CFC. However, the specified group parent is included in the specified group only if it is an applicable CFC. For this purpose, a qualified U.S. person means a U.S. person that is a citizen or resident of the U.S. or a domestic corporation. For purposes of determining the specified group parent, members of a consolidated group are treated as a single corporation and individuals whose filing status is “married filing jointly” are treated as a single individual (aggregation rule).
- (e) Treasury and the IRS believe these aggregation rules are appropriate because all deemed inclusions regarding applicable CFCs included in gross income of members of a consolidated group or of individuals filing a joint return, as applicable, are reported on a single U.S. tax return. They believe that it is appropriate for an S corporation to be a qualified U.S. person because an S corporation can have only a single class of stock and therefore the economic rights of its shareholders in all applicable CFCs owned by the S corporation are proportionate to share ownership.
- (f) On the other hand, they also believe that it is not appropriate for a domestic partnership to be a qualified U.S. person because of the ability of partnerships to make disproportionate or special allocations and therefore the economic rights of partners in the partnership regarding all applicable CFCs owned by a partnership will not necessarily be proportionate to ownership. However, if, for example, a domestic partnership wholly owns an applicable CFC, which wholly owns multiple other applicable CFCs, and no qualified U.S. person owns stock in the top-tier CFC meeting the requirements of § 1504(a)(2)(B), taking into account the look-through rule, then the applicable CFCs are included in a specified group of which the top-tier CFC is the specified group parent.
- (g) Treasury and the IRS requested comments regarding whether, and to what extent, the definition of a “qualified U.S. person” should be expanded to include domestic estates and trusts or whether and to what extent the look-through rule should apply if stock of applicable CFCs is owned by domestic estates and trusts.



- (h) Each specified group has a specified period. A specified period is similar to a taxable year but determined regarding a specified group. A specified group does not have a taxable year because the specified group members may not have the same taxable year. If the specified group parent is a qualified U.S. person, the specified period generally ends on the last day of the taxable year of the specified group parent and begins on the first day after the last day of the prior specified period.
- (i) Thus, for example, if the specified group parent is a domestic corporation with a calendar year taxable year, the specified period generally begins on January 1 and ends on December 31. If the specified group parent is an applicable CFC, the specified period generally ends on the last day of the required year of the specified group parent, determined under § 898(c)(1), without regard to § 898(c)(2), and begins on the first day after the last day of the prior specified period. However, a specified period never begins before the first day on which the specified group exists or ends after the last day on which the specified group exists. Like a taxable year, a specified period can never be longer than 12 months.
- (j) The principles of Treas. Reg. § 1.1502-75(d)(1), (d)(2)(i) through (d)(2)(ii), and (d)(3)(i) through (d)(3)(iv) (regarding when a consolidated group remains in existence) (Treas. Reg. § 1.1502-75(d) principles) apply for purposes of determining when a specified group ceases to exist. Solely for purposes of applying the Treas. Reg. § 1.1502-75(d) principles, each applicable CFC that is treated as a specified group member for a taxable year of the applicable CFC regarding a specified period is treated as affiliated with the specified group parent from the beginning to the end of the specified period, without regard to the beginning or end of its taxable year. This rule does not affect the general rule that, for purposes other than Treas. Reg. § 1.1502-75(d) (such as the application of § 163(j) to a CFC group), an applicable CFC is a specified group member regarding a specified period for its taxable year ending with or within the specified period.

For example, assume a specified group parent with a specified period that is the calendar year acquires all of the stock of CFC1, an applicable CFC, on June 30, Year 1, and sells all of the stock of CFC1 on June 30, Year 3. CFC1 has a November 30 taxable year, and the specified period is the calendar year. CFC1 is included in the specified group on November 30, Year 1, and November 30, Year 2 (but not November 30, Year 3). As a result, CFC1 is a specified group member for its taxable year ending November 30, Year 1, regarding the specified period ending December 31,

Year 1, and for its taxable year ending November 30, Year 2, regarding the specified period ending December 31, Year 2. Solely for purposes of applying the Treas. Reg. § 1.1502-75(d) principles, CFC1 is treated as affiliated with the specified group parent from the beginning to the end of the specified period ending December 31, Year 1, and from the beginning to the end of the specified period ending December 31, Year 2. In other words, CFC1 is treated as affiliated with the specified group parent from January 1, Year 1, to December 31, Year 2.

- (k) Treasury and the IRS requested comments as to whether any modifications to the Treas. Reg. § 1.1502-75(d) principles should be made for specified groups.

3. Specified Group Members.

- (a) Prop. Treas. Reg. § 1.163(j)-7(d)(3) provides rules for determining specified group members regarding a specified group. The determination as to whether an applicable CFC is a specified group member is made regarding a taxable year of the applicable CFC and specified period of a specified group. Specifically, if the applicable CFC is included in a specified group on the last day of its taxable year that ends with or within the specified period, the applicable CFC is a specified group member regarding the specified period for the entire taxable year.

For example, assume CFC1, an applicable CFC, has a taxable year beginning December 1, Year 1, and ending November 30, Year 2, and a specified group has a specified period beginning January 1, Year 2, and ending December 31, Year 2. If CFC1 is included in the specified group on November 30, Year 2, then CFC1 is a specified group member regarding the specified period for its entire taxable year ending November 30, Year 2. This is the case even if CFC1 is not included in the specified group during part of its taxable year ending November 30, Year 2 (for example, because all of the stock of CFC2 is purchased by the specified group on June 1, Year 2, and its taxable year does not close as a result of joining the specified group), or if CFC1 ceases to be included in the specified group after November 30, Year 2, but before December 31, Year 2 (for example, because all of the stock of CFC1 is sold by the specified group on December 15, Year 2).

- (b) Treasury and the IRS expressed a concern about the potential for abuse that may arise if taxpayers cause an applicable CFC that otherwise would be treated as a specified group member and a CFC group member to avoid being treated as a CFC group

member. For example, they believe that it is not appropriate for taxpayers to prevent an applicable CFC with high ATI and low BIE from being part of a CFC group with a goal of increasing its CFC excess taxable income and its U.S. shareholders' ATI inclusions, rather than allowing the applicable CFC's ATI to be used by the CFC group.

- (c) Accordingly, they requested comments on appropriate methods of preventing an applicable CFC from avoiding being a CFC group member for purposes of increasing the ATI of its U.S. shareholders. They also requested comments on whether a rule similar to the rule in § 1504(a)(3), which prevents domestic corporations from rejoining a consolidated group for 60 months, should apply to prevent applicable CFCs from rejoining a CFC group.

## F. CFC Groups and CFC Group Members.

### 1. In General.

- (a) Prop. Treas. Reg. § 1.163(j)-7(e) provides rules and procedures for treating specified group members as CFC group members and for determining a CFC group. A CFC group member means a specified group member of a specified group for which a CFC group election is in effect. The specified group member is a CFC group member for a specified taxable year regarding a specified period.
- (b) A CFC group means all CFC group members for their specified taxable years regarding a specified period. Prop. Treas. Reg. § 1.163(j)-7(e)(2) (defining CFC group and CFC group member).
- (c) Thus, if a CFC group election is in place, the terms “specified group members,” “CFC group members,” and a “CFC group” refer to the same applicable CFCs. The term “specified group,” which is determined at any moment in time, may not necessarily refer to the exact same applicable CFCs.
- (d) Once a CFC group election is made, the CFC group continues until the CFC group election is revoked or until the end of the last specified period regarding the specified group. Prop. Treas. Reg. § 1.163(j)-7(e)(3). When a CFC group election is in effect, if an applicable CFC becomes a specified group member regarding a specified period of the specified group, the CFC group election applies to the applicable CFC and it becomes a CFC group member. When an applicable CFC ceases to be a specified group member regarding a specified period of a specified group, the CFC

group election terminates solely regarding the applicable CFC. Prop. Treas. Reg. § 1.163(j)-7(e)(4) (joining or leaving a CFC group).

2. Making or Revoking a CFC Group Election.

- (a) Prop. Treas. Reg. § 1.163(j)-7(e)(5) provides rules for making and revoking a CFC group election. Prop. Treas. Reg. § 1.163(j)-7(e)(5)(i) provides that a CFC group election applies regarding a specified period of a specified group. Accordingly, the CFC group election applies to each specified group member for its entire specified taxable year that ends with or within the specified period. In response to comments to the 2018 Proposed Regulations, the CFC group election is not irrevocable.
- (b) Instead, once made, a CFC group election cannot be revoked regarding any specified period of the specified group that begins during the 60-month period following the last day of the first specified period for which the election was made. Similarly, once revoked, a CFC group election cannot be made again regarding any specified period of the specified group that begins during the 60-month period following the last day of the first specified period for which the election was revoked.
- (c) Treasury and the IRS requested comments regarding whether a specified group that does not make a CFC group election when it first comes into existence (or for the first specified period following 60 days after the date of publication of the Treasury decision adopting the regulations as final in the Federal Register) should be prohibited from making the CFC group election for any specified period beginning during the 60-month period following that specified period.
- (d) Thus, under the proposed regulations, in the case of a specified group, taxpayers must choose to apply § 163(j) to specified group members on a CFC group basis or on a stand-alone basis for no less than a 60-month period. Treasury and the IRS believe that requiring a 60-month period provides an appropriate balance between making the choice irrevocable and providing an annual election. They stated a concern that providing for annual elections could facilitate inappropriate tax planning.

3. Specified Financial Services Subgroup Rules. In response to comments, Prop. Treas. Reg. § 1.163(j)-7 does not provide for CFC financial services subgroups. Instead, applicable CFCs that otherwise qualify as CFC group members are treated as part of the same CFC group

4. 2018 CFC Group Election Not Applicable.

- (a) The CFC group election can be made only in accordance with the method prescribed in Prop. Treas. Reg. § 1.163(j)-7(e)(5). The 2018 proposed regulations also contained an election called a “CFC group election” (old CFC group election). The old CFC group election is a different election from the CFC group election contained in Prop. Treas. Reg. § 1.163(j)-7.
- (b) Accordingly, the old CFC group election may be relied on only for taxable years in which the taxpayer relies on the 2018 proposed regulations. Whether an old CFC group election was made under the 2018 Proposed Regulations has no effect on whether a CFC group election under Prop. Treas. Reg. § 1.163(j)-7(e)(5) is in effect for any taxable year in which the taxpayer relies on Prop. Treas. Reg. § 1.163(j)-7.

G. Exclusion of ECI. In response to comments, Prop. Treas. Reg. § 1.163(j)-7 provides that an applicable CFC with ECI is not precluded from being a CFC group member. However, under Prop. Treas. Reg. § 1.163(j)-7(f), only the ATI, BII, BIE, and floor plan financing of the applicable CFC that are not attributable to ECI are included in the CFC group’s § 163(j) calculations. The ECI items of the applicable CFC are not included in the CFC group calculations. Instead, the ECI of the applicable CFC is treated as income of a separate CFC, an “ECI deemed corporation,” that has the same taxable year and shareholders as the applicable CFC, but that is not a CFC group member. The ECI deemed corporation must do a separate § 163(j) calculation for its ECI in accordance with Prop. Treas. Reg. § 1.163(j)-8. Prop. Treas. Reg. § 1.163(j)-8 for rules applicable to foreign corporations with ECI.

H. Treatment of Foreign Taxes for Purposes of Computing ATI. Prop. Treas. Reg. § 1.163(j)-7(g)(3) provides that, for purposes of computing its ATI, tentative taxable income of a relevant foreign corporation is determined by taking into account a deduction for foreign taxes. This rule is consistent with Treas. Reg. § 1.952-2, which provides that the taxable income of a foreign corporation for any taxable year is determined by treating the foreign corporation as a domestic corporation, and § 164(a), which allows a deduction for foreign taxes. Treasury and the IRS requested comments regarding whether, and the extent to which, the ATI of a relevant foreign corporation should be determined by adding to tentative taxable income any deductions for foreign income taxes.

I. Anti-abuse Rule.

- 1. Treasury and the IRS expressed a concern that, in certain situations, U.S. shareholders might inappropriately plan to limit BIE deductions as part of a tax-planning transaction, including by not making a CFC group election for purposes of increasing the disallowed BIE of a specified group

member or of a partnership substantially owned by specified group members of the same specified group.

2. For example, in a taxable year in which a U.S. shareholder would otherwise have foreign tax credits in the § 951A category in excess of the § 904 limitation, a U.S. shareholder might inappropriately cause one specified group member to pay interest to another specified group member in an amount in excess of the borrowing specified group member's § 163(j) limitation. As a result, the U.S. shareholder's pro rata share of tested income of the borrowing specified group member for the taxable year would be increased without increasing the U.S. shareholder's Federal income tax because excess foreign tax credits in the § 951A category in the taxable year that cannot be carried forward to a future taxable year would offset the Federal income tax on the incremental increase in the U.S. shareholder's pro rata share of tested income, while also enabling the borrowing specified group member to generate a disallowed BIE carryforward that may be used in a subsequent taxable year.
3. Accordingly, under Prop. Treas. Reg. § 1.163(j)-7(g)(4), if certain conditions are met, when one specified group member or applicable partnership (specified borrower) pays interest to another specified group member or applicable partnership (specified lender), and the payment is BIE to the specified borrower and income to the specified lender, then the ATI of the specified borrower is increased by the amount necessary such that the BIE of the specified borrower is not limited under § 163(j).
4. This amount is determined by multiplying the lesser of the payment amount or the disallowed BIE (computed without regard to this ATI adjustment) by  $3 \frac{1}{3}$  (or by 2, in the case of taxable years or specified taxable years regarding a specified period for which the § 163(j) limitation is determined by reference to 50% of ATI). A partnership is an applicable partnership if at least 80% of the capital or profits interests is owned, in aggregate, by direct or indirect partners that are specified group members of the same specified group.
5. The conditions for this rule to apply are as follows: (i) the BIE is incurred with a principal purpose of reducing the Federal income tax liability of a U.S. shareholder (including over multiple taxable years); (ii) the effect of the specified borrower treating the payment amount as disallowed BIE would be to reduce the Federal income tax of a U.S. shareholder; and (iii) either no CFC group election is in effect or the specified borrower is an applicable partnership.

#### J. The Safe-harbor Election.

1. Prop. Treas. Reg. § 1.163(j)-7(h) provides a safe-harbor election for stand-alone applicable CFCs and CFC groups. If the safe-harbor election is in

effect for a taxable year, no portion of the BIE of the stand-alone applicable CFC or of each CFC group member, as applicable, is disallowed under the § 163(j) limitation. The safe-harbor election is an annual election. If the election is made, then no portion of any CFC excess taxable income is included in a U.S. shareholder's ATI. Prop. Treas. Reg. § 1.163(j)-7(j)(2)(iv).

2. The safe-harbor election cannot be made regarding any foreign corporation that is not a stand-alone applicable CFC or a CFC group member. As a result, if a CFC group election is not in effect for a specified period, a specified group member of the specified group is not eligible for the safe-harbor election.
3. In the case of a stand-alone applicable CFC, the safe-harbor election may be made for a taxable year of the stand-alone applicable CFC if its BIE does not exceed 30% of the lesser of (i) its tentative taxable income attributable to non-excepted trades or businesses (referred to as “qualified tentative taxable income”), and (ii) its “eligible amount” for the taxable year.
4. In the case of a CFC group, the safe-harbor election may be made for the specified taxable years of each CFC group member regarding a specified period if the CFC group's BIE does not exceed 30% of the lesser of (i) the sum of the qualified tentative taxable income of each CFC group member, and (ii) the sum of the eligible amounts of each CFC group member.
5. For taxable years of a stand-alone applicable CFC or specified periods of a CFC group beginning in 2019 or 2020, the 30% limitation is replaced with a 50% limitation, consistent with the change in the § 163(j) limitation to take into account 50%, rather than 30%, of ATI for such taxable years or specified periods.
6. The “eligible amount” is a CFC-level determination. In general, the eligible amount is the sum of the applicable CFC's Subpart F income plus the approximate amount of GILTI inclusions its U.S. shareholders would have were the applicable CFC wholly owned by domestic corporations that had no tested losses and that were not subject to the § 250(a)(2) limitation on the § 250(a)(1) deduction. Amounts used in the determination of the eligible amount are computed without regard to the application of § 163(j) and the § 163(j) regulations.
7. While the eligible amount of an applicable CFC cannot be negative, qualified tentative taxable income can be negative. Thus, limiting the safe-harbor to 30% of qualified tentative taxable income ensures that losses of a stand-alone applicable CFC or a CFC group are taken into account in determining whether the stand-alone applicable CFC or the CFC group qualifies for the safe-harbor.

For example, assume that, before taking into account BIE, a stand-alone applicable CFC has net income of \$0x, consisting of \$100x of Subpart F income, a \$100x loss attributable to foreign oil and gas extraction income, as defined in § 907(c)(1). It also has \$20x of BIE, no BII, and no floor plan financing interest expense. The ATI of the CFC is zero and the § 163(j) limitation would be zero. However, the eligible amount of the CFC is \$100x. Thus, absent a rule limiting the safe harbor to 30% of qualified tentative taxable income, the CFC would be permitted to deduct its \$20x of business interest expense under the safe harbor, even though none of the BIE would be deductible under the § 163(j) limitation.

8. The safe-harbor election does not apply to Excess Business Interest Expense (“EBIE”), as described in Treas. Reg. § 1.163(j)-6(f)(2), and EBIE is not taken into account for purposes of determining whether the safe-harbor election is available for a stand-alone applicable CFC or a CFC group, until that business interest expense is treated as paid or accrued by an applicable CFC in a succeeding year (that is, until the applicable CFC is allocated excess taxable income or excess business interest income from the partnership in accordance with Treas. Reg. § 1.163(j)-6(g)(2)(i)).
9. The safe-harbor election is intended to reduce the compliance burden on applicable CFCs that would not have disallowed BIE if they applied the § 163(j) calculation. However, Treasury and the IRS are concerned that the safe-harbor election might be used to deduct pre-group disallowed BIE carryforwards that would be limited under Prop. Treas. Reg. § 1.163(j)-7(c)(3)(iv) (rules similar to the consolidated SRLY rules).
10. Accordingly, the proposed regulations provide that a safe-harbor election cannot be made for a CFC group that has pre-group disallowed BIE carryforward. Treasury and the IRS requested comments on whether the safe-harbor election should be available for CFC groups with pre-group disallowed BIE carryforwards and, if so, appropriate methods of preventing pre-group disallowed BIE carryforwards that would be limited under Prop. Treas. Reg. § 1.163(j)-7(c)(3)(iv) from being deductible by CFC group members of CFC groups that apply the safe-harbor election.
11. They also requested comments on appropriate modifications, if any, to the safe-harbor election that would further the goal of reducing the compliance burden on stand-alone applicable CFCs and CFC groups that would not have disallowed BIE if they applied the § 163(j) limitation.

K. Increase in ATI of U.S. Shareholders.

1. As a general matter, a U.S. shareholder does not include in its ATI any portion of its “specified deemed inclusions.” Specified deemed inclusions include the U.S. shareholder’s deemed income inclusions attributable to an



applicable CFC and a non-excepted trade or business of the U.S. shareholder. Treas. Reg. § 1.163(j)-1(b)(2)(ii)(G).

2. Specified deemed inclusions also include amounts included in a domestic C corporation's allocable share of a domestic partnership's gross income inclusions under §§ 951(a) and 951A(a) regarding an applicable CFC that are investment income to the partnership, to the extent that such amounts are treated as properly allocable to a non-excepted trade or business of the domestic C corporation under Treas. Reg. §§ 1.163(j)-4(b)(3) and 1.163(j)-10.<sup>5</sup>
3. However, Prop. Treas. Reg. § 1.163(j)-7(j) allows a U.S. shareholder to include in its ATI a portion of its specified deemed inclusions that are attributable to either a stand-alone applicable CFC or a CFC group member, except to the extent attributable to § 78 gross-up inclusions. That portion is equal to the ratio of the applicable CFC's CFC excess taxable income over its ATI.
4. In the case of a stand-alone applicable CFC, CFC excess taxable income is equal to an amount that bears the same ratio to the applicable CFC's ATI as (i) the excess of 30% of the applicable CFC's ATI over the amount, if any, by which its BIE exceeds its BII and floor plan financing interest expense, bears to (ii) 30% of its ATI. In the case of a CFC group, each applicable CFC's CFC excess taxable income is determined by calculating the excess taxable income of the CFC group and allocating it to each CFC group member pro rata on the basis of the CFC group member's ATI. For any taxable year or specified period to which the 50% (rather than 30%) limitation applies under § 163(j)(10), the formula for calculating CFC excess taxable income is adjusted accordingly.
5. Treasury and the IRS said they are concerned that taxpayers might inappropriately attempt to aggregate debt in certain specified group members for which a CFC group election is not in effect, thereby overleveraging some specified group members and artificially creating CFC excess taxable income in other specified group members for purposes of increasing the ATI of a U.S. shareholder.

For example, assume a U.S. shareholder wholly owns CFC1, which wholly owns CFC2. CFC1 and CFC2 each have \$100x of ATI and no business interest income or floor plan financing interest expense. CFC1 and CFC2 have not made a CFC group election. If CFC1 and CFC2 each have \$35x of business interest expense, under § 163(j),

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<sup>5</sup> Treasury and the IRS anticipate that a domestic partnership's gross income inclusions under §§ 951(a) and 951A(a) will virtually always be investment income to the partnership. See § 163(j)(5), excluding "investment interest" subject to § 163(d) from the definition of business interest, and §§ 163(d)(3)(A) and (d)(5), treating as investment interest any interest properly allocable to "property which produces income of a type described in § 469(e)(1)." See also Temp. Treas. Reg. § 1.469-2T(c)(3).

CFC1 and CFC2 could each deduct \$30x of business interest expense and have a \$5x disallowed business interest expense carryforward. Neither CFC1 nor CFC2 would have CFC excess taxable income. As a result, the U.S. shareholder would have no ATI inclusion from CFC1 or CFC2. However, if the CFCs move all of CFC2's debt to CFC1, CFC1 would deduct \$30x of business interest expense and have a \$40x disallowed business interest expense carryforward. Absent rules providing otherwise, CFC2 would have \$100x of CFC excess taxable income and \$100x of ATI, allowing the U.S. shareholder to include in its ATI its CFC income inclusion attributable to CFC2 (to the extent attributable to a non-excepted trade or business and not attributable to § 78 "gross-up" inclusions).

6. Accordingly, they have determined that any excess taxable income of a specified group member should not become available to increase the ATI of a U.S. shareholder unless a CFC group election is in effect and the CFC group has not exceeded its § 163(j) limitation. Under Prop. Treas. Reg. § 1.163(j)-7(j)(4)(ii), only U.S. shareholders of stand-alone applicable CFCs and CFC group members<sup>6</sup> can increase their ATI for a portion of their specified deemed inclusion. To the extent that a CFC group election is not in effect, a U.S. shareholder may not increase its ATI for any portion of its specified deemed inclusion attributable to a specified group member of the specified group.
7. In addition, if a safe-harbor election is in effect regarding the taxable year of a stand-alone applicable CFC or the specified period of a CFC group, CFC excess taxable income is not calculated for the stand-alone applicable CFC or the CFC group members. As a result, Prop. Treas. Reg. § 1.163(j)-7(j)(4)(i) provides that a U.S. shareholder of a stand-alone applicable CFC or of a CFC group member for which the safe-harbor election is in effect does not increase its ATI for any portion of its specified deemed inclusion attributable to the stand-alone applicable CFC or CFC group member.

L. Prop. Treas. Reg. § 1.163(j)-8.

1. Old Prop. Treas. Reg. § 1.163(j)-8.

- (a) Old Prop. Treas. Reg. § 1.163(j)-8 (2018) provided rules for how § 163(j) applies to a nonresident alien individual or foreign corporation that is not an applicable CFC (specified foreign person) with ECI. Although those regulations generally applied to specified foreign persons, a number of the general rules under § 163(j) needed to be adjusted to take into account the fact that a

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<sup>6</sup> Specified group members are called "CFC group members" if a CFC group election is in effect.

specified foreign person is taxed only on its ECI rather than all of its income.

- (b) Accordingly, the definitions for ATI, BIE, BII, and floor plan financing interest expense were modified to limit such amounts to items that are, or are allocable to, ECI. The 2018 proposed regulations also modified Prop. Treas. Reg. § 1.163(j)-10(c) to provide that a specified foreign person's interest expense and interest income were only allocable to excepted or non-excepted trades or businesses that had ECI.
- (c) Under those regulations, a specified foreign person that was a partner in a partnership that had ECI (specified foreign partner) was required to modify the application of the general allocation rules in Treas. Reg. § 1.163(j)-6 regarding ETI, EBIE, and EBII of the partnership to take into account only the partnership's items that are, or are allocable to, ECI.
- (d) Although the § 163(j) limitation is determined on an entity basis by a partnership, Treasury and the IRS determined that excess items of a partnership should only be used by the specified foreign partner to the extent that the excess items arise from partnership items that are ECI regarding the specified foreign partner.
- (e) The amount of ETI and EBIE that was used by a specified foreign partner was determined by multiplying the amount of the ETI or the EBIE allocated under Prop. Treas. Reg. § 1.163(j)-6 to the specified foreign partner by a fraction, the numerator of which was the ATI of the partnership, with the adjustments described previously to limit such amount to only items that are ECI, and the denominator of which was the ATI of the partnership determined under Prop. Treas. Reg. § 1.163(j)-6(d). The amount of EBII that could be used by a specified foreign partner was limited to the amount of allocable BII that is ECI from the partnership that exceeds allocable BIE that is allocable to income that is ECI from the partnership.
- (f) Lastly, the 2018 proposed regulations provide that an applicable CFC that had ECI had to first apply the general rules of § 163(j) and the § 163(j) regulations to determine how § 163(j) applied to the applicable CFC. If the applicable CFC had disallowed BIE, the applicable CFC then had to apportion a part of its disallowed BIE to BIE allocable to income that is ECI. The amount of disallowed BIE allocable to income that is ECI was equal to the disallowed BIE multiplied by a fraction, the numerator of which was the applicable CFC's ECI ATI, and the denominator of which was the CFC's ATI.

- (g) No comments were received on 2018 Prop. Treas. Reg. § 1.163(j)-8. Nonetheless, Treasury and the IRS state they have become aware of certain distortions that can result under the 2018 proposed regulations. Accordingly, Prop. Treas. Reg. § 1.163(j)-8 has been revised, and re-proposed, to alleviate these distortions and to provide additional guidance and clarity on the manner in which these rules apply to specified foreign partners and CFCs with ECI.

2. New Prop. Treas. Reg. § 1.163(j)-8.

- (a) Prop. Treas. Reg. § 1.163(j)-8 provides rules concerning the application of § 163(j) to foreign persons with ECI.<sup>7</sup> Similar to Prop. Treas. Reg. § 1.163(j)-8(b) in the 2018 proposed regulations, Prop. Treas. Reg. § 1.163(j)-8(b)(1)-(5) provides that, for purposes of applying § 163(j) and the § 163(j) regulations to a specified foreign person, certain definitions (ATI, BIE, BII, and floor plan financing interest expense) must be modified to take into account only ECI items.
- (b) Additionally, Prop. Treas. Reg. § 1.163(j)-8(b)(6) provides that, for purposes of applying Treas. Reg. § 1.163(j)-10(c) to a specified foreign person, only ECI items and assets that are U.S. assets are taken into account in determining the amount of interest income and interest expense allocable to a trade or business.
- (c) Prop. Treas. Reg. § 1.163(j)-8(c) determines the portion of a specified foreign partner's allocable share of ETI, EBIE, and EBII (as determined under Treas. Reg. § 1.163(j)-6) that is treated as ECI and the portion that is not treated as ECI. The portion of the specified foreign partner's allocable share of ETI that is ECI is equal to its allocable share of ETI multiplied by a fraction, the specified ATI ratio (which compares the specified foreign partner's distributive share of the partnership's ECI to its distributive share of the partnership's total income).
- (d) The remainder of the specified foreign partner's allocable share of ETI is not ECI. Prop. Treas. Reg. § 1.163(j)-8(c)(1). Similar to ETI, the portion of the specified foreign partner's allocable share of EBII that is ECI is equal to its allocable share of EBII multiplied by a fraction, the specified BII ratio (which compares the specified foreign partner's allocable share of BII that is ECI to its allocable share of total BII). Prop. Treas. Reg. § 1.163(j)-8(c)(4).

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<sup>7</sup> For purposes of Prop. Treas. Reg. § 1.163(j)-8, the term effectively connected income (or ECI) means income or gain that is ECI, as defined in Treas. Reg. § 1.884-1(d)(1)(iii), and deduction or loss that is allocable to, ECI, as defined in Treas. Reg. § 1.884-1(d)(1)(iii).

- (e) The portion of the specified foreign partner's allocable share of EBIE that is ECI is determined by subtracting the portion of the specified foreign partner's allocable share of deductible BIE that is characterized as ECI from the amount of the specified foreign partner's allocable share of BIE that is characterized as ECI. Prop. Treas. Reg. § 1.163(j)-8(c)(2). A similar rule applies for purposes of determining the portion of EBIE that is not ECI. A specified foreign partner's allocable share of deductible BIE that is characterized as ECI or not ECI is determined by allocating the deductible BIE pro rata between the respective amounts of deductible BIE that the specified foreign partner would have if the specified foreign partner's allocable share of the ECI items of the partnership and the non-ECI items of the partnership were treated as separate partnerships and a 163(j) limitation was applied to each hypothetical partnership.
- (f) However, no more deductible BIE can be characterized as ECI or not ECI than the specified foreign partner's allocable share of BIE that is ECI or the specified foreign partner's allocable share of BIE that is not ECI, respectively. Any deductible BIE in excess of the hypothetical partnership limitations is characterized as ECI or not ECI pro rata in proportion to the remaining amounts of the specified foreign partner's allocable share of BIE that is ECI and not ECI.
- (g) Prop. Treas. Reg. § 1.163(j)-8(d) determines the portion of deductible and disallowed BIE of a relevant foreign corporation (as defined in Treas. Reg. § 1.163(j)-1(b)(33)) that is characterized as ECI or not ECI. These rules are similar to those in Prop. Treas. Reg. § 1.163(j)-8(c) for characterizing a specified foreign partner's allocable share of excess items of a partnership as ECI or not ECI in that they calculate the hypothetical § 163(j) limitation for two hypothetical foreign corporations—a foreign corporation with ECI and a foreign corporation with non-ECI—and allocate the deductible BIE between the two hypothetical limitations.
- (h) The portion of the relevant foreign corporation's disallowed BIE that is ECI is determined by subtracting the portion of the relevant foreign corporation's deductible BIE that is characterized as ECI from the relevant foreign corporation's BIE that is ECI. A similar rule applies for purposes of determining the portion of disallowed BIE that is characterized as not ECI.
- (i) Prop. Treas. Reg. § 1.163(j)-8(e) provides rules regarding disallowed BIE. These rules provide that disallowed BIE is characterized as ECI or not ECI in the year in which it arises and retains its characterization in subsequent years. Additionally, an

ordering rule determines the EBIE that is treated as paid or accrued by a specified foreign partner in a subsequent year. Specifically, the specified foreign partner's allocable share of EBIE is treated as paid or accrued by the specified foreign partner in a subsequent year pursuant to Treas. Reg. § 1.163(j)-6(g)(2)(i) in the order of the taxable years in which the allocable EBIE arose and pro rata between the specified foreign partner's allocable share of EBIE that is ECI and not ECI that arose in the same taxable year.

- (j) Prop. Treas. Reg. § 1.163(j)-8(e)(2) provides that, for purposes of characterizing deductible BIE and EBIE as ECI or not ECI, a specified foreign partner's BIE is deemed to include its allocable share of EBIE of partnerships in which it is a direct or indirect partner. As a result, EBIE of both top-tier partnerships and lower-tier partnerships is characterized as ECI or not ECI in the year in which it arises, even if it is not included in the specified foreign partner's allocable share of EBIE.
- (k) Prop. Treas. Reg. § 1.163(j)-8(f) provides rules coordinating the application of § 163(j) with Treas. Reg. § 1.882-5 and similar rules and with the branch profits tax. Prop. Treas. Reg. § 1.163(j)-8(f)(1)(i) provides that a foreign corporation first determines its interest expense on liabilities that are allocable to ECI under Treas. Reg. § 1.882-5 before applying § 163(j). Similarly, interest expense, as defined in Treas. Reg. § 1.163(j)-1(b)(23), that is not allocable to ECI under Treas. Reg. § 1.882-5 must be allocable to income that is ECI under the regulations under § 861 before § 163(j) is applied.
- (l) Prop. Treas. Reg. § 1.163(j)-8(f)(1)(ii) provides rules for determining the portion of a specified foreign partner's BIE that is ECI, as determined under Treas. Reg. § 1.882-5(b) through (d) or Treas. Reg. § 1.882-5(e) (Treas. Reg. § 1.882-5 interest expense), that is treated as attributable to a partner's allocable share of interest expense of a partnership. As a general matter, the determination as to whether a partnership's items of income and expense are allocable to ECI is made by the partnership.
- (m) However, the determination as to the amount of interest expense that is allocable to ECI is made by a partner, not the partnership. Because § 163(j) applies separately to partnerships and their partners, a determination must be made as to the source of Treas. Reg. § 1.882-5 interest expense. If the BIE is attributable to BIE of the partnership, it is subject to the rules of Treas. Reg. §§ 1.163(j)-6 and 1.163(j)-8(c).

- (n) Treas. Reg. § 1.882-5 interest expense is first treated as attributable to interest expense on U.S. booked liabilities, determined under Treas. Reg. § 1.882-5(d)(2)(vii), of the partner or a partnership. Any remaining Treas. Reg. § 1.882-5 interest expense (excess Treas. Reg. § 1.882-5 interest expense) is treated as attributable to interest expense on liabilities of the partner in proportion to its U.S. assets (other than partnership interests) over all of its U.S. assets, and as attributable to interest expense on liabilities of the partner's direct or indirect partnership interests in proportion to the portion of the partnership interest that is a U.S. asset over all of the partner's U.S. assets.
- (o) The total amount of Treas. Reg. § 1.882-5 interest expense attributed to the partner or a partnership (taking into account both interest expense on U.S. booked liabilities and excess Treas. Reg. § 1.882-5 interest expense) and interest expense on a liability described in Treas. Reg. § 1.882-5(a)(1)(ii)(A) or (B) (direct allocations) may never exceed the amount of the partner's interest expense on liabilities or the partner's allocable share of the partnership's interest expense on liabilities (the interest expense limitation). The interest expense limitation prevents more Treas. Reg. § 1.882-5 interest expense from being attributed to the partner or the partner's allocable share of interest expense of a partnership than the actual amount of such interest expense.
- (p) Any excess Treas. Reg. § 1.882-5 interest expense that would have been attributed to the partner or a partnership, but for the interest expense limitation, is re-attributed in accordance with these attribution rules.
- (q) When excess Treas. Reg. § 1.882-5 interest expense has been attributed to all of the interest expense on liabilities of the foreign corporation and its allocable share of partnership interests that have U.S. assets, the remaining excess Treas. Reg. § 1.882-5 interest expense, if any, is first attributed to interest expense on liabilities of the foreign corporation (but not in excess of the interest expense limitation), and then, pro rata, to its allocable share of interest expense on liabilities of its partnership interests that do not have U.S. assets, subject to the interest expense limitation. Prop. Treas. Reg. § 1.163(j)-8(f)(1)(iii). These rules merely characterize interest expense of the foreign corporation and its partnership interests as ECI or not ECI. These rules do not change the amount of interest expense of the foreign corporation or its partnership interests.
- (r) The rule in Prop. Treas. Reg. § 1.163(j)-8(f)(1) of 2018 proposed regulations providing that the disallowance and carryforwards of

BIE does not affect effectively connected earnings and profits of a foreign corporation was not included in Prop. Treas. Reg. § 1.163(j)-8. This rule is not necessary in Prop. Treas. Reg. § 1.163(j)-8 because the general rule regarding the effect of § 163(j) on earnings and profits in Treas. Reg. § 1.163(j)-4(c)(1) applies to effectively connected earnings and profits.

M. Effective Dates.

1. Subject to the exception below, Prop. Treas. Reg. § 1.163(j)-7 is proposed to apply to tax years of a foreign corporation beginning on or 60 days after the date the Treasury Decision adopting the rules as final regulations is published in the Federal Register. However, also subject to the exception below, taxpayers and their related parties may choose to apply Prop. Treas. Reg. § 1.163(j)-7 to a tax year beginning after December 31, 2017, so long as they consistently apply the rules of that section to each subsequent tax year and the § 163(j) and certain other regulations to that tax year and each subsequent tax year.
2. The exception states that taxpayers and their related parties may choose to apply Prop. Treas. Reg. § 1.163(j)-7 in its entirety for a tax year beginning after December 31, 2017, so long as the taxpayers and their related parties also apply Prop. Treas. Reg. § 1.163(j)-8 for the tax year.
3. For tax years beginning before 60 days after publication in the *Federal Register*, taxpayers and their related parties may *not* choose to apply Prop. Treas. Reg. § 1.163(j)-7 unless they also apply Treas. Reg. §§ 1.163(j)-7 and (g)(1) and (2).
4. Notwithstanding Prop. Treas. Reg. § 1.163(j)-7(e)(5)(iii) (timing of CFC group election) and (h)(5)(i) (timing of safe harbor election), in the case of a specified period of a specified group or a tax year of a stand-alone applicable CFC that ends with or within a tax year of a designated U.S. person ending before 60 days after the date publication in the *Federal Register*, a CFC group election or a safe harbor election may be made on an amended federal income tax return filed on or before the due date (taking into account extensions, if any) of the original federal income tax return for the first tax year of each designated U.S. person ending after the date that is 60 days after the date of publication in the *Federal Register*.
5. Taxpayers and their related parties may choose to apply Prop. Treas. Reg. § 1.163(j)-8 in its entirety for a tax year beginning after December 31, 2017, so long as they also apply Prop. Treas. Reg. § 1.163(j)-7 for the tax year. For a tax year beginning before a date that is 60 days after the publication in the *Federal Register*, taxpayers and their related parties may *not* choose to apply Prop. Treas. Reg. § 1.163(j)-8 unless they also apply Treas. Reg. §§ 1.163(j)-7(b) and (g)(1) and (2).



### III. FINAL FDII AND GILTI REGULATIONS.

A. On July 9, 2020, Treasury and IRS released the final FDII and GILTI regulations in TD 9901. The final regulations retain the basic approach and structure of the proposed regulations, with a number of significant revisions. They considered taxpayer comments and revised the regulations to address many concerns. This was a welcome change compared with a number of other recent final regulations which largely remained unchanged in response to taxpayer comments.

#### B. Summary.

1. One of the most important changes in the final FDII regulations is the elimination of the specific documentation requirements. However, Treasury and the IRS stated that taxpayers have a general requirement to prove they are entitled to deductions, and that requirement applies here as well. These more general substantiation requirements do require certain specific information, but do not specify a narrow set of required documents. The reason to know standard was retained and the final regulations provide more detail on the application of the standard.
2. The final regulations clarify that for purposes of the loss transaction rule, the reason to know standard depends on the information received. The final regulations do not contain a rule specifying that a taxpayer may choose not to claim a FDII deduction.
3. In terms of NOLs, the final regulations do not support ignoring pre-Act NOLS for FDII purposes; however, they clarify that certain provisions that limit deductions and limit carryovers do not apply when allocating and apportioning deductions to gross Deduction Eligible Income (“DEI”) or gross Foreign-Derived Deduction Eligible Income (“FDDEI”). This is consistent with the premise that FDII is calculated based on annual income and expenses.
4. The new regulations clarify how to establish foreign use with specific substantiation requirements for different types of property. They also eliminate the requirement that the taxpayer must have no reason to know of some domestic use. The final regulations also do not define foreign use by reference to whether the property is subject to a domestic use.
5. New special rules for digital content sales and digital services are set forth. The substantiation rules for digital sales provides that foreign use is established if the end user that downloads, installs, received or accesses the digital content on a device outside the US. The substantiation rules for digital and electronic services provides that the consumer is deemed to reside at the location of the device used to receive the service. The final regulations provide that for advertising services, the operations of the

business recipient that benefit from the advertising service are deemed located where the advertisements are viewed.

6. Evidence regarding a business recipient's locations benefits from a service is not required under the final regulations, although the portion of the service that benefits operations outside the US generally.
7. The final regulations made several changes that generally will make it easier to satisfy the foreign use requirement for manufacturing, assembly or other processing outside the US.
8. Finally, Treasury and the IRS acknowledged that the so-called "resale rules" would cause amended return administrative burdens and accordingly modified the regulations to relax those rules.

C. Documentation Requirements.

1. The final regulations significantly relaxed the documentation requirements in response to numerous comments that they were too narrow and too difficult to obtain in many cases.
2. The proposed regulations provided that to establish that a recipient is a foreign person, property is for a foreign use, or a recipient of a general service is located outside the U.S., the taxpayer must obtain specific types of documentation. The proposed regulations also provided a reasonable documentation transition rule for taxable years beginning on or before March 4, 2019.
3. Several comments recommended making the transition rule permanent or extending it. The comments noted that the documentation requirements in the proposed regulations may be difficult, if not impossible, to obtain in the ordinary course of business. The comments noted that customers are highly reluctant to provide some of the types of documents that the proposed regulations described. The documentation rules in the proposed regulations could require taxpayers to renegotiate contracts or make inquiries of their customers that could interfere with the customer relationship. Several comments noted issues for longer-term contracts.
4. Commentators noted that extending the transition rule would allow adequate time for the IRS to gain experience with the types of documentation taxpayers collect in the ordinary course of business, and for taxpayers to gain experience complying with such rules by developing or improving internal compliance systems.
5. Several comments suggested that any list of suitable documents (for either property sales or services) should be non-exclusive and include more documents obtained in the ordinary course of business. Some comments recommended allowing the use of documentation methods similar to those

for sales of fungible mass property such as market research, statistical sampling, economic modeling or other similar methods to show foreign person status or foreign use.

6. The final regulations do not require taxpayers to obtain specific types of documents to establish foreign person status, foreign use regarding sales of certain general property that are made directly to end users, and the location of general services provided to consumers as did the proposed regulations. Treasury and the IRS determined that requiring specific documentation would be difficult given the variations in industry practices and that it should not be necessary to obtain specific documentation to satisfy the purpose of the statute.
7. However, Treasury and the IRS state that as with any deduction, taxpayers claiming a deduction under § 250 bear the burden of demonstrating that they are entitled to the deduction. Therefore, the general requirement for taxpayers to substantiate their deductions will apply without any additional specific requirements as to the content of information or documents.
8. The final regulations also adopt a more flexible approach regarding the types of substantiation required for foreign use regarding sales of general property to non-end users, foreign use regarding sales of intangible property, and for determining whether services are performed for business recipients located outside the U.S. The substantiation requirements in the final regulations require specific information, but they do not provide a narrow set of acceptable documents.
9. In addition, the new regulations do not provide specific reliability requirements because the reliability of documents or information can differ depending on the circumstances. For example, documents created in advance of a sales date (such as a long-term sales contract) may be as reliable as documents created at the time of the sale, depending on the facts and circumstances.
10. The final regulations continue to require that the substantiating documents be supported by credible evidence.
11. Taxpayers are permitted to rely on the proposed regulations for taxable years before the final regulations are applicable, including relying on the transition rules.

D. Specific Substantiation.

1. In lieu of the documentation requirements in the proposed regulations, regarding sales of general property to recipients other than end users, sales of intangible property, and general services provided to business recipients, the final regulations provide substantiation rules that are more

flexible regarding the types of corroborating evidence that may be used. Treas. Reg. § 1.250(b)-3(f). For these transactions, specific substantiation requirements are needed to ensure that taxpayers make sufficient efforts to determine whether the regulatory requirement is met.

2. Therefore, the final regulations describe the type of information necessary to meet these substantiation requirements. The substantiation requirements are modeled after substantiation rules under § 170 (requiring substantiation through receipts for certain charitable deductions) and § 274(d) (requiring substantiation by adequate records or a taxpayer statement with corroborating evidence).
3. Treasury and the IRS believe that requiring a taxpayer to specifically substantiate certain transactions -- in particular transactions where the relevant facts needed to satisfy the rules are generally in the hands of a third party with a business relationship with the taxpayer -- is necessary and appropriate for establishing “to the satisfaction of the Secretary” that property is sold for a foreign use or that services are provided to persons located outside the U.S.

E. Timing.

1. In general, the substantiation rules require that the substantiating documents be in existence by the time the taxpayer files its return (including extensions) regarding the FDDEI transaction (the “FDII filing date”). Treas. Reg. § 1.250(b)-3(f)(1).
2. The final regulations do not impose requirements relating to when substantiating documents must be in existence. However, the timing of when substantiating documents are created may affect the credibility of the substantiating documents. For example, substantiating documents created at or near the time of the transaction generally have a higher degree of credibility as compared to substantiating documents created later in time. Regarding long-term contracts, substantiating documents created when the transaction was entered into will be more credible in later years if the taxpayer periodically confirms that the terms of the long-term contract are being adhered to.
3. Substantiating documents, in any event, must be provided to the IRS upon request, generally within 30 days or some other period agreed upon by the IRS and the taxpayer. Treas. Reg. § 1.250(b)-3(f)(1). Treasury and the IRS believe this is necessary to allow the substantiation requirements to serve their purpose, including to allow the IRS to timely examine the taxpayer’s qualification for the FDII deduction.

F. Substantiation in All Other Cases.

1. For the rules in the final regulations for which there are no specific substantiation requirements, taxpayers are already required under § 6001 to make returns, render statements, and keep the necessary records to show whether such person is liable for tax under the Code. Therefore, a taxpayer claiming a deduction under § 250 will still be required to substantiate that it is entitled to the deduction even if it is not subject to the specific substantiation requirements contained in the final regulations.
2. Treasury and the IRS expect that taxpayers may use a broader range of evidence to substantiate a § 250 deduction under the new substantiation requirements (and § 6001 where no specific substantiation requirements are provided) than they would have been able to use under the more specific documentation requirements detailed in the proposed regulations. In many cases a taxpayer will be able to determine whether it meets the requirements in the final regulations using documents maintained in the ordinary course of its business, as provided in the transition rule. In some circumstances, however, it may be necessary for taxpayers to gather additional information to establish that a requirement is met. Treasury and the IRS are also considering issuing additional administrative guidance on acceptable documentation to substantiate the deduction.

G. Small Business Exception.

1. The final regulations include an exception for small businesses similar to the exceptions from the documentation requirements for small businesses that are in the proposed regulations. The exception provides that the substantiation requirements do not apply if the taxpayer and all related parties of the taxpayer, in the aggregate, receive less than \$25,000,000 in gross receipts during the prior taxable year.
2. In response to comments that the final regulations should allow for broader application of the small business exception, the final regulations modify the threshold amount to qualify for that exception from \$10,000,000 of gross receipts received by the seller of general property or renderer of services in the prior taxable year (the standard used in the proposed regulations) to \$25,000,000 in gross receipts received by the taxpayer and all related parties.
3. As a result of this exception, a small business will not need to satisfy the specific substantiation requirements in the regulations, although it must continue to comply with the general substantiation rules under § 6001.

H. Transition Rules. The final regulations modified the applicability dates of the regulations to give taxpayers additional time to develop systems for complying with the regulations. Generally, the final regulations are applicable for taxable

years beginning on or after January 1, 2021. Treas. Reg. § 1.250-1(b). This applicability date ensures that all taxpayers have at least three full taxable years after the Act was enacted before the final regulations become applicable. For taxable years beginning before January 1, 2021, taxpayers may apply the final regulations or rely on the proposed regulations, except that taxpayers that choose to rely on the proposed regulations may rely on the transition rule for documentation for all taxable years beginning before January 1, 2021 (rather than only for taxable years beginning on or before March 4, 2019, which was the limitation contained in the proposed regulations).

I. Deduction for FDII and GILTI. Prop. Treas. Reg. § 1.250(a)-1 provided general rules to determine the amount of a taxpayer's § 250 deduction and associated definitions that apply for purposes of the proposed regulations.

1. Pre-Act NOLs.

- (a) Section 250 includes limitations based on a taxpayer's taxable income or a percentage of taxable income. The proposed regulations provided an ordering rule for applying §§ 163(j) and 172 in conjunction with § 250 that provided that a taxpayer's taxable income for purposes of applying the taxable income limitation of § 250(a)(2) is determined after all of the corporation's other deductions are taken into account, without distinguishing between pre-Act and post-Act net operating losses ("NOLs").
- (b) Several comments noted that the proposed regulations did not explicitly address the impact of pre-Act NOLs on the deduction under § 250 and recommended that pre-Act NOLs not be taken into account for purposes of determining the deduction limit under § 250(a)(2). This would allow taxpayers to take a deduction under § 250 for FDII in lieu of utilizing available pre-Act NOLs.
- (c) Section 250(a)(2) limits the FDII deduction based on "taxable income," which is defined in § 63 to include gross income minus deductions, including NOL deductions under § 172. Section 250(a)(2) contains no language that would support ignoring pre-Act NOLs for purposes of determining the amount of taxable income for purposes of § 250(a)(2). Therefore, the comments were not adopted.

2. Ordering Rule.

- (a) Prop. Treas. Reg. § 1.250(a)-1(c)(4) provided that the corporation's taxable income is determined with regard to all items of income, deduction, or loss, except for the deduction allowed under § 250.

- (b) Some comments recommended that the regulations eliminate the ordering rule in favor of an approach that used simultaneous equations to compute taxable income for each Code provision that referred to taxable income, whereas other comments expressed concern with the complexity of performing simultaneous equations. One comment recommended that the regulations not consider § 163(j) and § 172(b) carryforwards or carrybacks.
- (c) Treasury and the IRS have determined that further study is required to determine the appropriate rule for coordinating §§ 250(a)(2), 163(j), 172 and other Code provisions (including, for example, §§ 170(b)(2), 246(b), 613A(d) and 1503(d)) that limit the availability of deductions based, directly or indirectly, upon a taxpayer's taxable income. Therefore, the final regulations remove Example 2 in Prop. Treas. Reg. § 1.250(a)-1(f)(2) and reserve a paragraph in Treas. Reg. § 1.250(a)-1(c)(5)(ii) for coordinating § 250(a)(2) with other provisions calculated based on taxable income.
- (d) Treasury and the IRS are considering a separate guidance project to address the interaction of §§ 163(j), 172, 250(a)(2), and other Code sections that refer to taxable income; this guidance may include an option to use simultaneous equations in lieu of an ordering rule. Any separate guidance would take into account the recent addition of § 172(a)(2)(B)(ii)(I) by the CARES Act, which provides that for taxable years beginning after Dec. 31, 2020, the taxable income limitation for purposes of deducting net operating loss carrybacks and carryovers is determined without regard to the deductions under §§ 172, 199A, and 250. Comments were requested in this regard.
- (e) Before further guidance is issued regarding how allowed deductions are taken into account in determining the taxable income limitation in § 250(a)(2), taxpayers may choose any reasonable method (which could include the ordering rule described in the proposed regulations or the use of simultaneous equations) if the method is applied consistently for all taxable years beginning on or after January 1, 2021.

### 3. Carryovers of Excess FDII.

- (a) Consistent with the statute, the proposed regulations did not contain any provision allowing the carryforward or carryback of a tax year's FDII deduction in excess of the taxpayer's taxable income limitation. Commentators said that a provision allowing the carryforward or carryback should be added.

- (b) The preamble notes that the § 250 deduction is an annual calculation and that nothing in the statute or legislative history contemplates the creation of carryforwards or carrybacks or a recapture account. As a result, the final regulations did not adopt these recommendations.
4. Definition of GILTI. The final regulations under § 250 revise the definition of GILTI consistent with the final regulations under § 951A. The term “GILTI” means, regarding a domestic corporation for a taxable year, the corporation’s GILTI inclusion amount under Treas. Reg. § 1.951A-1(c) for the taxable year. Treas. Reg. § 1.250(a)-1(c)(3).

J. Computation of FDII.

1. Financial Services Income.

- (a) Section 250(b)(3)(A)(i)(III) excludes from DEI financial services income as defined in § 904(d)(2)(D).
- (b) One comment requested a clarification that income that falls outside of the definition of § 904(d)(2)(D) should be eligible for inclusion in DEI, such as leasing or financing activities outside of the active conduct of a banking, financing, or similar business.
- (c) Section 250(b)(3)(A)(i)(III) excludes only financial services income as defined in § 904(d)(2)(D). Any leasing or financing activities that are not described in § 904(d)(2)(D) will not fall within this exclusion. Therefore, Treasury and the IRS said that no changes are necessary.
- (d) Another comment suggested that the proposed regulations do not provide enough general guidance on non-active financial services income from financial instruments (such as derivatives and hedges), and, in particular, how to characterize such income (or losses) as a FDDEI transaction.
- (e) Consistent with the proposed regulations, the final regulations provide that, in general, financial instruments are neither general property nor intangible property, and therefore their sales cannot give rise to FDDEI. *See* Treas. Reg. § 1.250(b)-3(b)(10) (excluding from the definition of general property a security defined under § 475(c)(2)) and Treas. Reg. § 1.250(b)-3(b)(11) (intangible property has the meaning set forth in § 367(d)(4)).
- (f) However, the final regulations adopted the suggestion to provide a special rule for hedges to associate the income or loss from the hedges with the underlying transaction. Treas. Reg. § 1.250(b)-4(f).



2. Definition of Foreign Branch Income.

- (a) Section 250(b)(3) excludes from DEI foreign branch income as defined in § 904(d)(2)(J), which provides that foreign branch income is business profits attributable to one or more qualified business units. Prop. Treas. Reg. § 1.250(b)-1(c)(11) defined foreign branch income by cross-reference to Treas. Reg. § 1.904-4(f)(2), which provides that gross income is attributable to a foreign branch if the gross income is reflected on the separate set of books and records of the foreign branch. Prop. Treas. Reg. § 1.250(b)-1(c)(11), however, modified this definition to also include any income from the sale, directly or indirectly, of any asset (other than stock) that produces gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or partnership interest.
- (b) Several comments requested that the final regulations remove the modification to the definition in Prop. Treas. Reg. § 1.904-4(f)(2).
- (c) Treasury and the IRS agreed that there should be one consistent definition of foreign branch income in both Treas. Reg. §§ 1.250(b)-1(c)(11) and 1.904-4(f)(2). Accordingly, the final regulations define foreign branch income by cross reference to Treas. Reg. § 1.904-4(f)(2) and remove the modification to that definition in the proposed regulations that would have included as foreign branch income any income from the sale, directly or indirectly, of any asset (other than stock) that produces gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or partnership interest. Treas. Reg. § 1.250(b)-1(c)(11).
- (d) Under Treas. Reg. § 1.904-4(f)(2), a disposition of an interest in a disregarded entity could still result in foreign branch income. Treas. Reg. § 1.904-4(f)(4)(ii) Example 2.

3. Cost of Goods Sold Allocation.

- (a) The proposed regulations provided that for purposes of determining the gross income included in gross DEI and gross FDDEI, cost of goods sold is attributed to gross receipts regarding gross DEI or gross FDDEI under any reasonable method. The final regulations clarify that the method chosen by the taxpayer must be consistently applied.
- (b) For purposes of this rule, any cost of goods sold associated with activities undertaken in an earlier taxable year cannot be segregated into component costs and attributed disproportionately

to amounts excluded from gross FDDEI or to amounts excluded from gross DEI.

- (c) One comment recommended that the final regulations continue to allow cost of goods sold to be allocated under any reasonable method to provide flexibility to different taxpayers. Another comment agreed with the proposed regulations that cost of goods sold should be allocated between gross FDDEI and gross non-FDDEI regardless of whether any component of the costs was associated with activities undertaken in a prior tax year.
- (d) Sections 451 and 461 provide the general rules on the timing of income recognition and taking a deduction into account, respectively. Treasury and the IRS said that nothing in § 250 suggests that Congress intended to change the scope of generally applicable income recognition rules. Therefore, the final regulations did not adopt the comment to permit an election to create an imputed cost of goods sold deduction in the context of advance payments regarding § 250.

4. Expense Allocation.

- (a) Research and Experimentation Expenditures. Under Treas. Reg. § 1.861-17(b), an exclusive apportionment of research and experimentation (“R&E”) expenditures is made if activities representing more than 50% of the R&E expenditures were performed in a particular geographic location, such as the U.S. After this initial exclusive apportionment, the remainder of the taxpayer’s R&E expenditures are apportioned under either the sales or gross income methods under Treas. Reg. § 1.861-17(c) and (d). Treas. Reg. § 1.861-17(e) provides rules for making a binding election to use either the sales or gross income method.
- (b) Exclusive Apportionment and Direct Apportionment.
  - i. The proposed regulations under § 250 specified that the exclusive apportionment rules in Treas. Reg. § 1.861-17(b) do not apply for purposes of apportioning R&E expenses to gross DEI and gross FDDEI.
  - ii. Several comments requested that the final regulations allow taxpayers to use exclusive apportionment for purposes of determining FDII. Several comments recommended allocating R&E expenditures based on an optional books and records method that could be used when there is a clear factual relationship between the R&E expenditures and a particular amount of income. Several comments also

requested that the final regulations adopt special rules for expenses that are market-restricted or market-required (for example, expenses required only by the U.S. Food and Drug Administration concerning the U.S. market), including where the legally mandated rule in Treas. Reg. § 1.861-17(a)(4) would not apply.

- iii. In light of the issuance of proposed rules under Treas. Reg. § 1.861-17 on December 17, 2019, the final regulations remove the provision stating that the exclusive apportionment rules in Treas. Reg. § 1.861-17(b) do not apply for purposes of apportioning R&E expenses to gross DEI and gross FDDEI, and generally do not provide special rules for applying Treas. Reg. § 1.861-17 for purposes of § 250. Prop. Treas. Reg. § 1.861-17 provides that the exclusive apportionment rule applies only to § 904 as the operative section, and also proposes eliminating the special rule for legally mandated R&E.
- iv. As recommended by comments to the proposed regulations under § 250, Treasury and the IRS will consider the issues raised regarding the application of exclusive apportionment for purposes of § 250 as part of finalizing the 2019 FTC proposed regulations.

(c) Use of Sales or Gross Income Method.

- i. Several comments requested that the final regulations include an election to allocate R&E expenses under either the sales or gross income method. Comments also requested that taxpayers should be permitted to make this election annually. Another comment suggested that the final regulations should provide that the provisions of Treas. Reg. § 1.861-17(c)(3) (requiring sales to third parties by controlled foreign affiliates to be included) should not apply as it might artificially apportion more R&E expense against FDDEI.
- ii. Treasury and the IRS are concerned that the gross income method could in some cases produce inappropriate results. As a result, the 2019 FTC proposed regulations proposed to eliminate the optional gross income method described in Treas. Reg. § 1.861-17(d) and require R&E expenditures in excess of the amount exclusively apportioned under Treas. Reg. § 1.861-17(b) to be apportioned based on gross receipts. Comments addressing the applicability of the

gross income method will be addressed as part of finalizing the 2019 FTC proposed regulations.

(d) Carryovers.

- i. Comments requested additional clarification regarding whether taxpayers are required to apportion expenses incurred before the effective date of the proposed regulations. Multiple comments specifically asked for a clarification that taxpayers are not required to apportion NOLs incurred before the effective date of the proposed regulations or, in some cases, before the effective date of the Act.
- ii. The final regulations provide that the following provisions (which limit certain deductions and provide for the carryover of the amounts not currently allowed) do not apply when allocating and apportioning deductions to gross DEI or gross FDDEI of a taxpayer for a taxable year: §§ 163(j), 170(b)(2), 172, 246(b), and 250. Treas. Reg. § 1.250(b)-1(d)(2)(ii).
- iii. Treasury and the IRS considered a rule that would require expenses incurred in prior years, including in years before the effective date of the proposed regulations, to be allocated to gross DEI and gross FDDEI, but determined that the benefit of the theoretical precision of this approach would be outweighed by the burden on taxpayers and the IRS that would be associated with making retroactive determinations. Further, the approach taken in the final regulations is consistent with the premise that the § 250 deduction is calculated based on annual income and expenses.

(e) Foreign-Derived Ratio.

- i. The proposed regulations clarified that the foreign-derived ratio cannot exceed one. Several comments requested that the final regulations allow the foreign-derived ratio to exceed one and that there is no evidence Congress intended to limit the foreign-derived ratio to no greater than one.
- ii. Treasury and the IRS do not agree that limiting the foreign-derived ratio to no greater than one is inconsistent with the plain meaning of § 250. Specifically, the approach recommended by the comments would be inconsistent with the statutory language of § 250(b)(4), which defines

FDDEI as a subset of DEI, that is, “any deduction eligible income of such taxpayer which is derived in connection with” certain transactions. Allowing the foreign-derived ratio to exceed one could also lead to anomalous results. For example, a cliff effect would arise whereby a taxpayer with significant FDDEI but only \$1 of DEI would have a significant FDII deduction, whereas if it has \$0 or less of DEI, then no FDII deduction would be allowed. This would also create further anomalous results and incentives regarding § 163(j), which is determined taking into account the § 250 deduction.

- iii. In addition, nothing in § 250 provides for FDII to be calculated based on specific product lines or business lines, which would entail significant complexity for taxpayers and administrative burdens for the IRS. Instead, the statute is clear that the FDII deduction is calculated as an aggregate of all FDDEI transactions. Therefore, the final regulations did not adopt this comment.

5. Partnership Reporting Requirements.

- (a) The proposed regulations required partnership information reporting in order to administer § 250. One comment asserted that the partnership information reporting requirements impose unnecessary administrative burdens.
- (b) The final regulations did not include a more limited reporting requirement because Treasury and the IRS are concerned that this might undermine accurate reporting at the partner level. However, the final regulations clarify the reporting rules for tiered-partnership situations as well as provide guidance on certain computational aspects. Treas. Reg. § 1.250(b)-1(e)(2). Similar additions are made to the reporting rules regarding controlled foreign partnerships. Treas. Reg. § 1.6038-3(g)(3).

K. QBAI.

- 1. In General. The proposed regulations provided general rules for determining the QBAI. The § 951A final regulations made certain revisions and clarifications. Accordingly, the final regulations make conforming changes to QBAI for purposes of FDII similar to the changes made in the § 951A final regulations. Treas. Reg. § 1.250(b)-(2).
- 2. Determination of Basis Under ADS.
  - (a) A comment recommended that the final regulations for FDII should permit taxpayers the opportunity to follow U.S. GAAP for

purposes of determining QBAI where the difference between U.S. GAAP and the Alternate Depreciation System (“ADS”) is immaterial. The final regulations did not adopt this recommendation.

- (b) Section 951A(d)(3) (and, by reference, § 250(b)(2)(B)) is clear that the adjusted basis in specified tangible property is determined using ADS under § 168(g). In addition, permitting taxpayers to elect to follow U.S. GAAP in the context of FDII would impose significant administrative burdens on the IRS to determine what would be immaterial and account for different depreciation methods to compute QBAI.

3. QBAI Anti-Avoidance Rule.

- (a) In order to prevent artificial decreases to the Deemed Tangible Income Return (“DTIR”) amount, the proposed regulations disregarded certain transfers of specified tangible property by a domestic corporation to a related party where the corporation continues to use the property in production of gross DEI. Comments recommended that the final regulations contain a transition period for the QBAI anti-avoidance rule for transactions entered into before the date that the proposed regulations were issued. The final regulations adopted this comment. Treas. Reg. § 1.250(b)-2(h)(5).
- (b) Another comment recommended that a taxpayer be able to rebut the presumption that a transfer or leaseback transaction was undertaken for a principal purpose of reducing the transferor’s DTIR if the transfer and leaseback each occurred within a six-month span. The final regulations do not adopt this recommendation because a transfer and lease of the same or similar property that occurs between related parties within six months does not materially change the economic risk of the parties and is unlikely to be motivated by non-tax reasons. In addition, permitting taxpayers to rebut the presumption that such a transaction was undertaken for a principal purpose of reducing the transferor’s DTIR creates significant administrative burdens.

L. FDDEI Transactions.

1. Definition of “General Property.”

(a) Treatment of Commodities.

- i. For purposes of determining what is a FDDEI sale (and relatedly, whether a sale is for a foreign use), the proposed regulations distinguished between “general property” and

certain other types of property. A comment raised a concern that the sale of a physical commodity effected through certain derivative contracts might not be treated as a sale of general property under the proposed regulations.

- ii. Treasury and the IRS generally agree that a sale of a commodity such as an agricultural commodity or a natural resource should be a sale of general property whether it is sold pursuant to a spot contract or sold pursuant to a forward or option contract, other than a § 1256 contract or similar contract that is traded and cleared like a § 1256 contract. The sale of such a commodity through a futures or option contract that is a § 1256 contract or similar contract is not treated as a sale of general property because the interposition of a clearing organization as the counterparty to such contracts severs the connection between the original selling and buying parties to the contract such that no meaningful determination can be made whether the sale through such a contract is for a foreign use. The definition of “general property” in Treas. Reg. § 1.250(b)-3(b)(10) was modified accordingly. The final regulations also clarify that financial instruments or similar assets traded through futures or similar contracts do not qualify as general property.
- iii. Treasury and the IRS are concerned, however, that a taxpayer could manipulate its FDDEI by selectively physically settling only its commodities forward or option contracts in which it has a gain. To prevent this manipulation, the final regulations provide that the sale of a commodity pursuant to a forward or option contract is treated as a sale of general property only to the extent that a taxpayer physically settled the contract pursuant to a consistent practice adopted for business purposes of determining whether to cash or physically settle such contracts under similar circumstances. Treas. Reg. § 1.250(b)-3(b)(10).
- iv. The proposed regulations further provided that a sale of a security (as defined in § 475(c)(2)) or a commodity (as defined in § 475(e)(2)(B) through (D)) is not a FDDEI sale. Prop. Treas. Reg. § 1.250(b)-4(f). This rule is no longer necessary because the final regulations exclude such property from the definition of general property.

(b) Treatment of Interests in Partnerships.

- i. The proposed regulations did not address the conditions under which the sale of a partnership interest that is not described in § 475(c)(2) will satisfy the foreign use requirement. One comment suggested that when a taxpayer sells a partnership interest, a look-through approach should apply such that the sale of a partnership interest would be considered a sale of the partner's proportionate share in the partnership's assets.
- ii. Treasury and the IRS have determined that, like an interest in a corporation (which is a security under § 475(c)(2)(A) and therefore not general property under Treas. Reg. § 1.250(b)-3(b)(10)), interests in a partnership are not the type of property that can be subject to "any use, consumption, or disposition" outside the U.S. Furthermore, a look-through approach would be inconsistent with the fact that title to the partnership's property does not change upon the sale of an interest in a partnership and also would be difficult to administer given that the underlying property that would be tested for foreign use is not actually being transferred. Accordingly, the final regulations provide that an interest in a partnership, as well as an interest in a trust or estate, is not general property. Treas. Reg. § 1.250(b)-3(b)(10).

(c) Exclusion of Intangible Property.

- i. Under the proposed regulations, the rules applicable to the determination of whether a sale of property is for a foreign use depends on whether the property sold is "general property" or "intangible property."
- ii. Two examples in the proposed regulations suggested that a limited use license of a copyrighted article is analyzed under the rules for sales of intangible property. Prop. Treas. Reg. § 1.250(b)-4(e)(4)(ii)(D) and (E) (Example 4 and 5). One comment recommended that if the distinction between sales of tangible and intangible property is maintained, then the final regulations should provide that software transactions involving the sale or lease of copyrighted articles are governed by the general property rules and not the intangible property rules.
- iii. The final regulations made several changes in response to this comment. Consistent with the request in the comment,



the definition of “intangible property” for purposes of § 250 is clarified to not include a copyrighted article as defined in Treas. Reg. § 1.861-18(c)(3). Treas. Reg. § 1.250(b)-3(b)(11).

- iv. However, the rules for determining foreign use that apply to general property are not suitable for sales of digital content, including copyrighted articles, that are transferred electronically, because those rules focus on the physical transfer of property to end users. Therefore, the final regulations provide an additional rule for sales of general property that primarily contain digital content. Treas. Reg. § 1.250(b)-4(d)(1)(ii)(D).
- v. Under the final regulations, “digital content” is defined as a computer program or any other content in digital format. Treas. Reg. § 1.250(b)-3(b)(1). The determination of how a transfer of a copyrighted article is characterized (for example, as a sale or a service) for purposes of applying the final regulations is based on general U.S. tax principles, taking into account the regulations issued under § 861.
- vi. Notwithstanding the final regulations’ treatment of sales of copyrighted articles for purposes of determining foreign use, no inference is intended regarding the treatment of sales of copyrighted articles under other sections of the Code. For example, the fact that a sale of a copyrighted article (or other property) is treated as a FDDEI sale does not necessarily mean that the income from the sale is foreign source under § 861.

## 2. Foreign Military Sales and Services.

- (a) Several comments requested removal of the requirement in Prop. Treas. Reg. § 1.250(b)-3(c) that the resale or on-service to a foreign government or agency or instrumentality thereof must be “on commercial terms.”
- (b) In general, the final regulations adopted the comments. Treas. Reg. § 1.250(b)-3(c) does not include a requirement that the foreign military sale or service be “on commercial terms” or that the contract specifically refer to the resale or on-service to the foreign government. Instead, if a sale of property or a provision of a service is made pursuant to the Arms Export Control Act, then the sale of property or provision of a service is treated as a FDDEI sale or FDDEI service without needing to apply the general rules in Treas. Reg. § 1.250(b)-4 or Treas. Reg. § 1.250(b)-5. Treas.

Reg. § 1.250(b)-3(c). The final regulations also do not require any particular documentation to substantiate that a transaction qualifies under the rule in Treas. Reg. § 1.250(b)-3(c). Taxpayers will continue to be required to substantiate under § 6001 that any foreign military sale or service qualifies for a § 250 deduction.

3. Reliability and Reason to Know.

- (a) The proposed regulations provided that the seller or renderer must not know or have reason to know that the documentation is incorrect or unreliable.
- (b) One comment requested that the final regulations provide more guidance and relevant examples regarding the scope of this rule, in particular what knowledge should be imputed across a large organization and how the standard should apply when relevant information is legally protected by data privacy laws.
- (c) The final regulations replaced the documentation requirements with substantiation rules that are more flexible regarding the types of corroborating evidence that may be used. The knowledge or reason to know standard was retained in Treas. Reg. §§ 1.250(b)-3(f)(3) (treatment of certain loss transactions), 1.250(b)-4(c)(1) (foreign person requirement), (d)(1)(iii)(C) (general property incorporated into a product as a component) and (d)(2)(ii)(C)(2) (sale of intangible property consisting of a manufacturing method or process to a foreign unrelated party), and 1.250(b)-5(d)(1) (general services provided to consumers).
- (d) The final regulations generally provide that a taxpayer has reason to know that a transaction fails to satisfy a substantive requirement if the information that the taxpayer receives as part of the sales process contains information that indicates that the substantive requirement is not met and, after making reasonable efforts, the taxpayer cannot establish that the substantive requirement is met.

4. Sales or Services to a Partnership.

- (a) For purposes of determining a taxpayer's FDII attributable to sales of property or services to a partnership, the proposed regulations adopted an entity approach to partnerships.
- (b) One comment suggested that if a seller of a good has a greater than 10% ownership interest in the recipient domestic partnership, the final regulations should also permit aggregate treatment of the partnership for this limited purpose.

- (c) Regarding a taxpayer's sales of property to a partnership, one comment suggested that the final regulations consider alternatives to a pure entity approach.
- (d) The final regulations did not adopt these comments. The statute is clear that in the case of sales of property, the sale must be to a person that is not a U.S. person, and a domestic partnership is a U.S. person. In addition, requiring taxpayers to trace the ownership, potentially through multiple tiers, of third-party partnership recipients presents significant administrative hurdles. If, alternatively, this regime were elective, it would create the potential for abuse or uneven results for similarly situated taxpayers.

5. Loss Transactions.

- (a) The proposed regulations provided that if a seller or renderer knows or has reason to know that property is sold to a foreign person for a foreign use or a general service is provided to a person located outside the U.S., but the seller or renderer does not satisfy the documentation requirements applicable to such sale or service, the sale of property or provision of a service is nonetheless deemed a FDDEI transaction if treating the sale or service as a FDDEI transaction would reduce a taxpayer's FDDEI. Prop. Treas. Reg. § 1.250(b)-3(f).
- (b) One comment requested a clarification that taking the FDII deduction should be considered an elective action and that this rule does not impact such an election.
- (c) In response to comments, the final regulations adopted a more flexible approach to the FDII-specific documentation rules and instead provide specific substantiation requirements for certain elements of the regulations. Accordingly, the rule regarding loss transactions is revised so that it only applies to transactions for which there is a specific substantiation requirement. Treas. Reg. § 1.250(b)-3(f)(3)(i).
- (d) However, the fact that Treas. Reg. § 1.250(b)-3(f)(3) was narrowed in the final regulations does not mean that the allowed FDII deduction can be determined on a transaction-by-transaction basis. As provided in the final regulations, FDII is determined on a single aggregate basis, not on a transaction-by-transaction basis. Treas. Reg. § 1.250(b)-1.
- (e) The final regulations also clarify that for purposes of the loss transaction rule, whether a taxpayer has reason to know that a sale

of property is to a foreign person for a foreign use, or that a general service is provided to a business recipient located outside the U.S., depends on the information received as part of the sales process. If the information received as part of the sales process contains information that indicates that a sale is to a foreign person for a foreign use or that a general service is to a business recipient located outside the U.S., the requisite reason to know is present unless the taxpayer can prove otherwise. Treas. Reg. § 1.250(b)-3(f)(3)(ii).

- (f) Regarding sales, the final regulations provide a non-exhaustive list of information that indicates that a recipient is a foreign person or that the sale is for a foreign use, such as a foreign address or phone number. While not all sales to a foreign person are for a foreign use (nor are all sales for a foreign use made to foreign persons), the final regulations use the same indicia for both requirements because a foreign person is more likely to make a purchase for a foreign use compared to a U.S. person.
- (g) Regarding general services, information that indicates that a recipient is a business recipient include indicia of a business status, such as “LLC” or “Company,” or similar indicia under applicable law, in its name. Information that indicates that a business recipient is located outside the U.S. includes, but is not limited to, a foreign phone number, billing address, and evidence that the business was formed or is managed outside the U.S. These rules can also apply in the case of sales made by related parties where the foreign related party is treated as the seller and the unrelated party transaction is being analyzed. Treas. Reg. § 1.250(b)-6(c)(2).
- (h) The final regulations do not include a rule specifying that a taxpayer may choose not to claim a FDII deduction. Whether an allowable deduction must be claimed is governed by general tax principles and rules on whether such deduction can be elective is beyond the scope of these regulations.

6. Predominant Character Rule.

- (a) The proposed regulations provided that if a transaction includes both a sale component and a service component, the transaction is classified according to the overall predominant character of the transaction.
- (b) A comment expressed support for the predominant character rule for transactions that contain both sale and service components in general but also suggested that the final regulations allow taxpayers to elect to follow U.S. GAAP accounting, which may in

certain circumstances require the disaggregation of the sale and service components of a single transaction.

- (c) For purposes of simplicity and to avoid the need for complex apportionment rules, Treas. Reg. § 1.250(b)-3(d) provides a rule to determine the predominant character of the transaction when a transaction has multiple elements, such as a sale of general property and a service or sale of general property and sale of intangible property. Treasury and the IRS believe that an elective rule that allows for disaggregation would create significant complexity for taxpayers and be difficult for the IRS to administer, and could lead to whipsaw for the IRS as taxpayers elect to disaggregate when it increases the FDII deduction but not otherwise.
- (d) Accordingly, the final regulations do not adopt the comment to include an election to follow U.S. GAAP to disaggregate a single transaction.

M. FDDEI Sales.

1. End User Requirement.

- (a) The proposed regulations provided that a sale of intangible property is for a foreign use to the extent the intangible property generates revenue from exploitation outside the U.S., which is generally determined based on the location of end users purchasing products for which the intangible property was used in development, manufacture, sale, or distribution.
- (b) Several comments requested that the final regulations clarify the definition of an “end user.”
- (c) The final regulations generally adopt the comment that the end user should be the consumer that purchases the property for its own consumption. Treas. Reg. § 1.250(b)-3(b)(2). Further, the concept of an end user is also incorporated into the rules for determining whether a sale of general property, in addition to intangible property, is for a foreign use. Treas. Reg. § 1.250-4(d). The final regulations thus try to harmonize the rules for sales of general property and intangible property to the extent possible.
- (d) Treas. Reg. § 1.250(b)-3(b)(2) defines the “end user” as the person that ultimately uses the property. Thus, a person who acquires property for resale or otherwise as an intermediary is not an end user. The definition of end user is modified for intangible property used in connection with the sale of general property, provision of services, sale of a manufacturing method or process intangible

property, and for research and development as provided in Treas. Reg. § 1.250(b)-4(d)(2)(ii).

- (e) The final regulations did not adopt the comments that in all cases a finished goods manufacturer may be an end user. However, the final regulations continue to provide that sales of general property for manufacturing, assembly, or other processing outside the U.S. are sales for a foreign use. Treas. Reg. § 1.250(b)-4(d)(1)(iii). In addition, an unrelated manufacturer (such as an original equipment manufacturer) that uses intangible property that consists of a manufacturing method or process, as provided in Treas. Reg. § 1.250(b)-4(d)(2)(ii)(C), is treated as the end user if it has purchased (or licensed) the manufacturing method or process intangible property from an unrelated party.

## 2. Foreign Person.

- (a) Under the proposed regulations, a recipient was treated as a foreign person only if the seller obtained documentation of the recipient's foreign status and did not know or have reason to know that the recipient was not a foreign person. The proposed regulations provided several types of permissible documentation for this purpose, such as a written statement by the recipient indicating that the recipient is a foreign person.
- (b) In response to comments, the final regulations did not include the specific documentation requirements regarding certain requirements, including the foreign person requirement, and further identify the substantive standards by which taxpayers may meet the requirements of the FDII regime.
- (c) To address situations in which taxpayers may not be able to determine whether the recipient is a foreign person within the meaning of § 7701(a)(1), the final regulations provide that the sale of property is presumed made to a recipient that is a foreign person if the sale is as described in one of four categories: (1) foreign retail sales; (2) sales of general property that are delivered to an address outside the U.S.; (3) in the case of general property that is not sold in a foreign retail sale or delivered overseas, the billing address of the recipient is outside the U.S.; or (4) in the case of sales of intangible property, the billing address of the recipient is outside the U.S. Treas. Reg. § 1.250(b)-4(c)(2)(i) through (iv).
- (d) The presumption does not apply if the seller knows or has reason to know that the sale is to a recipient other than a foreign person. Treas. Reg. § 1.250(b)-4(c)(1). The final regulations state that a seller has reason to know that a sale is to a recipient other than a

foreign person if the information received as part of the sales process contains information that indicates that the recipient is not a foreign person and the seller fails to obtain evidence establishing that the recipient is in fact a foreign person. Treas. Reg. § 1.250(b)-4(c)(1). Information that indicates that a recipient is not a foreign person includes, but is not limited to, a U.S. phone number, billing address, shipping address, or place of residence; and, regarding an entity, evidence that the entity is incorporated, formed, or managed in the U.S.

- (e) One comment requested that the final regulations include exceptions similar to the foreign military sales rule in the proposed regulations for other sales or licenses of property through an intermediate domestic person. The comment was not adopted.

3. Foreign Use of General Property.

(a) Determination of Foreign Use.

- i. The proposed regulations provided that the sale of general property is for a foreign use if either the property was not subject to domestic use within three years of delivery of the property or the property was subject to manufacture, assembly, or other processing outside the U.S. before any domestic use of the property. Domestic use was defined in the proposed regulations as the use, consumption, or disposition of property within the U.S., including manufacture, assembly, or other processing within the U.S. In order to establish that general property was for a foreign use, the seller generally had to obtain certain documentation regarding the sale, such as proof of shipment of the property to a foreign address, and the seller could not know or have reason to know that the property was not for a foreign use.
- ii. Several comments noted that the definition of foreign use combined with the narrow documentation requirements would make it difficult for taxpayers to satisfy the foreign use requirement. Several comments interpreted the proposed regulations as requiring taxpayers to determine whether general property that was sold would actually be subject to a domestic use within three years of the date of delivery.
- iii. In response to these comments, the final regulations take a more flexible approach to documentation and provide

specific substantiation requirements for certain transactions.

- iv. For the requirement of “foreign use” for sales of general property, the final regulations clarify the meaning of that term to provide that it generally means the sale (or eventual sale) of the property to end users outside the U.S. or the sale of the property to a person that subjects the property to manufacture, assembly, or other processing outside the U.S.
- v. Treasury and the IRS believe that a more flexible definition of foreign use of general property that accounts for the possibility of some limited domestic use is more reasonable for taxpayers to apply and for the IRS to administer. Accordingly, the final regulations do not include the requirement that the taxpayer must have no “reason to know” of some domestic use for sales of general property. This is a very helpful change.
- vi. The final regulations generally provide that the sale of general property is for a foreign use if the seller determines that such sale is to an end user described in one of five categories. Treas. Reg. § 1.250(b)-4(d)(1)(ii)(A)-(F).

(b) Delivery Outside the U.S.

- i. The first category of sales that are for a foreign use is sales to a recipient that are delivered by a freight forwarder or carrier to an end user if the end user receives delivery of the general property outside the U.S. Treas. Reg. § 1.250(b)-4(d)(1)(ii)(A).
- ii. In general, if an end user receives delivery of general property outside the U.S., the general property will be “for a foreign use” and additional detail regarding the actual use of the property is unnecessary.
- iii. However, Treasury and the IRS believe that it would be inappropriate to treat these sales as FDDEI sales if the seller and buyer arrange for general property to be delivered to a location outside the U.S. only to be redelivered for use or consumption into the U.S. with a principal purpose of causing what would otherwise not be a FDDEI sale to be treated as a FDDEI sale. Therefore, Treas. Reg. § 1.250-4(b)(1)(ii)(A) contains an anti-abuse rule to address these concerns.



(c) Location of Property Outside the U.S.

- i. The second category of sales that are for a foreign use is sales of general property to an end user where the property is already located outside the U.S., and includes foreign retail sales. Treas. Reg. § 1.250(b)-4(d)(1)(ii)(B).
- ii. In general, sales of general property from a foreign retail sale will be treated as used outside the U.S. While it may be possible that some end users will purchase property in a foreign retail store and use it solely within the U.S., Treasury and the IRS believe that requiring a determination of the actual use of these sales would be unnecessarily burdensome.

(d) Resale of Property Outside the U.S.

- i. The third category of sales for a foreign use is sales to a recipient such as a distributor or retailer that will resell the general property, if the seller determines that the general property will ultimately be sold to end users outside the U.S. Treas. Reg. § 1.250(b)-4(d)(1)(ii)(C).
- ii. This category is intended to apply to sales to distributors and retailers, but may also apply to other sales to foreign persons for resale. In addition, the final regulations provide that for purposes of this rule, the seller must substantiate the portion of sales to end users outside the U.S.
- iii. The proposed regulations contained alternative documentation requirements for a sale of multiple items of general property that because of their fungible nature are difficult to specifically trace to a location of use (fungible mass). Under the proposed regulations, a seller had to establish foreign use of a fungible mass through market research, including statistical sampling, economic modeling and other similar methods.
- iv. Prescribing specific methods such as market research, statistical sampling, economic modeling, and other similar methods to determine foreign use from the sale of a fungible mass of general property (or a sale of any general property) is unnecessary given the more flexible approach to documentation.
- v. Treasury and the IRS note that market research or information from public data, such as general internet searches of secondary sources, is generally not a source of

reliable information. In contrast, statistical sampling, economic modeling, or market research based on the taxpayer's own data will be more reliable.

(e) Electronic Transfer of Digital Content Outside the U.S.

- i. The fourth category of sales for a foreign use is for sales of digital content that is transferred electronically. Sales of digital content transferred in a physical medium are for a foreign use if described in one of the first three categories. The final regulations provide that digital content that is transferred electronically is for a foreign use if it is sold to a recipient that is an end user that downloads, installs, receives, or accesses the digital content on the end user's device outside the U.S. Treas. Reg. § 1.250(b)-4(d)(1)(ii)(D).
- ii. However, if this information is unavailable, such as where the device's Internet Protocol address ("IP address") is not available or does not serve as a reliable proxy for the end user's location (for example, using a business headquarters' IP address when it has employees located both within and outside the U.S. who use the digital content), then the sale is for a foreign use if made to an end user with a foreign billing address, but only if the gross receipts from all sales regarding the end user (which may be a business) are in the aggregate less than \$50,000.

(f) International Transportation Property.

- i. The fifth category of sales for a foreign use is sales of international transportation property.
- ii. The proposed regulations provided a special rule for determining whether transportation property like aircraft, railroad rolling stock, vessels, motor vehicles or similar property that travels internationally is sold for foreign use and therefore constitutes a FDDEI sale. One comment suggested supplementing these tests with a rebuttable presumption that any foreign-registered aircraft sold to a foreign person is for foreign use.
- iii. Treasury and the IRS generally agreed with the comment that place of registration is appropriate as evidence of "use."
- iv. Therefore, the final regulations provide that international transportation property used for compensation or hire is

considered for a foreign use if it is sold to an end user that registers the property with a foreign jurisdiction. Treas. Reg. § 1.250(b)-4(d)(1)(ii)(E).

- v. The final regulations provide that other international transportation property is considered for a foreign use if sold to an end user that registers the property with a foreign jurisdiction and the property is hangared or primarily stored outside the U.S. Treas. Reg. § 1.250(b)-4(d)(1)(ii)(F). This rule reflects the fact that many recipients of international transportation property will not be further using the property for the provision of international transportation services. As a result, the property will be primarily used in the place it is registered or otherwise hangared or stored. Even if such property enters the U.S., because it originated in a different country, the use should not be considered domestic use because the international transportation property will generally be located outside the U.S. As a result, Treasury and the IRS believe that there is no need to determine the amount of time or miles that such property is inside or outside the U.S.
- vi. Finally, one comment suggested expanding the definition of transportation property to include parts of transportation property like engines, tires, electronic equipment and spare parts, even if such parts would not otherwise satisfy the foreign use tests for general property. This comment was not adopted. Such a rule would be administratively burdensome and could lead to inconsistency through the application of two sets of rules to the same transaction and property.

(g) Manufacturing, Assembly, or Other Processing Outside the U.S.

- i. The proposed regulations provided that the sale of general property was for a foreign use if either the property was not subject to domestic use within three years of delivery of the property or the property was subject to manufacture, assembly, or other processing outside the U.S. before any domestic use of the property. Under the proposed regulations, general property was subject to manufacturing, assembly, or other processing only if it met either of the following two tests: (1) there was a physical and material change to the property, or (2) the property was incorporated as a component into a second product.

- ii. Several comments recommended that the final regulations provide more flexibility in satisfying the manufacturing, assembly, or other processing rule, especially in the context of sales to foreign unrelated parties where information to establish the two distinct tests might not be readily available.
- iii. In response to comments, the final regulations make several changes to the rule for manufacturing, assembly, and other processing. They clarify that general property is subject to a physical and material change if it is substantially transformed and is distinguishable from and cannot be readily returned to its original state. Treas. Reg. § 1.250(b)-4(d)(1)(iii)(B).
- iv. They also provide a separate substantive rule for the component test and retain the 20% threshold as a safe harbor. Treas. Reg. § 1.250(b)-4(d)(1)(iii)(C). Under this substantive rule, general property is a component incorporated into another product if the incorporation of the general property into another product involves activities that are substantial in nature and generally considered to constitute the manufacture, assembly, or other processing of property based on all the relevant facts and circumstances.
- v. The final regulations also clarify that general property is not considered a component incorporated into another product if it is subject only to packaging, repackaging, labeling, or minor assembly operations. While the structure and some of the mechanics of the rule share similarities with the Subpart F manufacturing component parts test, the rule is different in terms of purpose and substance.
- vi. Finally, in response to comments, the final regulations revise the safe harbor in the component test by specifying that the comparison should be between the fair market value of the property sold by the taxpayer and the fair market value of the final finished goods sold to consumers. Treas. Reg. § 1.250(b)-4(d)(1)(iii)(C). Because some general property could be incorporated into several different finished goods, the final regulations provide that a reliable estimate of the fair market value of the finished good could include the average fair market value of a representative range of the finished goods that could incorporate the component. An example of this is provided in Treas. Reg. § 1.250(b)-4(d)(1)(v)(B)(1) (Example 1).

vii. The final regulations also modify the aggregation rule so that it applies only if the seller sells the property to the buyer and knows or has reason to know that the components will be incorporated into a single item of property (for example, where multiple components are sold as a kit). The final regulations specify that a seller has reason to know that the components will be incorporated into a single item of property if the information received as part of the sales process contains information that indicates that the components will be included in the same second product or the nature of the components compels inclusion into the second product. Treas. Reg. § 1.250(b)-4(d)(1)(iii)(C).

(h) Manufacturing, Assembly, or Other Processing in the U.S.

i. Section 250(b)(5)(B)(i) provides that if a seller sells property to another person (other than a related party) for further manufacture or other modification within the U.S., the property is not treated as sold for a foreign use even if such other person subsequently uses such property for a foreign use. Section 250(b)(5)(B)(i) could apply in the case of a sale directly to a person that is a foreign person if the property is subject to further manufacture or other modification in the U.S. after the sale but before the property is delivered to the end user.

ii. Because the final regulations no longer define “foreign use” by reference to whether the property is subject to a domestic use, the rule in § 250(b)(5)(B)(i) is no longer encompassed within the general rules in the regulations relating to FDDEI sales. Accordingly, the final regulations include a rule that provides that if the seller sells general property to a recipient (other than a related party, for which separate rules apply) for manufacturing, assembly, or other processing within the U.S., such property is not sold for a foreign use even if the requirements for foreign use are subsequently satisfied. Treas. Reg. § 1.250(b)-4(d)(1)(iv).

(i) Specific Substantiation for Foreign Use of General Property.

i. The final regulations specifically require a taxpayer to substantiate foreign use for general property for sales of general property to resellers and manufacturers. Treas. Reg. § 1.250(b)-4(d)(3)(ii) and (iii).

- ii. In the case of sales to resellers, a taxpayer must maintain and provide credible evidence upon request that the general property will ultimately be sold to end users located outside the U.S. This requirement is satisfied if the taxpayer maintains evidence of foreign use such as the following: a binding contract that limits sales to outside of the U.S., proof that the general property is suited only for a foreign market, or proof that the shipping costs would be prohibitively expensive if sold back to the U.S. Treas. Reg. § 1.250(b)-4(d)(3)(ii)(A)-(C).
- iii. Certain information from the recipient or a taxpayer with corroborating evidence that credibly supports the information will also suffice. Treas. Reg. § 1.250(b)-4(d)(3)(ii)(D)-(E).
- iv. Regarding manufacturing outside the U.S., the substantiation requirements are met if a taxpayer maintains proof that the property is typically not sold to end users without being subject to manufacture, assembly or other processing, obtains credible information from a recipient, or, provides a statement containing certain information with corroborating evidence. Treas. Reg. § 1.250(b)-4(d)(3)(iii).

4. Foreign Use of Intangible Property.

- (a) In General. The proposed regulations provided that a sale of intangible property (which includes a license or any transfer of such property in which gain or income is recognized under § 367) was for a foreign use to the extent revenue was earned from exploiting the intangible property outside the U.S. Where the revenue was considered earned was generally determined based on the location of the end user.
- (b) Substantiating Foreign Use of IP.
  - i. Several comments recommended changes to the documentation rules. As a result, the final regulations adopt a more flexible approach to documentation although they nevertheless still require a taxpayer to specifically substantiate foreign use for sales of intangible property. Treas. Reg. § 1.250(b)-4(d)(3)(iv).
  - ii. A taxpayer must maintain and provide credible evidence upon request that a sale of intangible property will be used to earn revenue from end users located outside the U.S. A taxpayer may satisfy the substantiation requirement by

maintaining certain items as specified in the final regulations. Treas. Reg. § 1.250(b)-4(d)(3)(iv).

- iii. For example, a binding contract providing that the intangible property can be exploited solely outside the U.S. would generally satisfy the substantiation requirements demonstrating foreign use of the intangible property. Treas. Reg. § 1.250(b)-4(d)(3)(iv)(A).
- iv. Certain information from the recipient obtained or created in the ordinary course of business or corroborating evidence maintained by the taxpayer that credibly supports the information might also suffice. Treas. Reg. § 1.250(b)-4(d)(3)(iv)(B)-(C).

(c) Determining Foreign Use of IP.

- i. Comments suggested that sales regarding intangible property be divided into several subcategories.
- ii. Consistent with the proposed regulations, the final regulations provide that foreign use of intangible property is determined based on revenue earned from end users located within versus outside the U.S. Treas. Reg. § 1.250(b)-4(d)(2)(i).
- iii. In the case of legally protected intangible property (such as patents or trademarks), the location in which legal rights to the intangible property are granted and exploited generally determines the location of the end users. Therefore, for example, in the case of intangible property such as patents that provide rights only for markets outside the U.S., the end users will generally be located solely outside the U.S. In the case of intangible property that allows for worldwide exploitation (or intangible property that is not legally protected), a more specific determination of end users will generally be necessary to determine the portion of intangible property income that is for a foreign use versus not for a foreign use.
- iv. In response to the comments, the final regulations provide more detailed guidance on determining where revenue is earned from end users of intangible property, including rules for intangible property embedded in general property or used in connection with the sale of general property, intangible property used to provide services, and intangible

property used in research and development. Treas. Reg. § 1.250(b)-4(d)(2)(ii).

- v. The final regulations also include rules for determining revenue earned from sales of a manufacturing method or process, which is similar to the separate rule for “production intangibles” or “manufacturing intangibles” as suggested by comments.
- vi. Revenue is generally earned from intangible property used to manufacture products or provide services through sales of such products or services, or from limited use licenses of the intangible property, whether those sales, services, or limited use licenses are executed by an owner, licensee, or sub-licensee of the intangible property. Until revenue is earned from sales, services, or limited-use licenses to the end user that ultimately consumes the property or receives the service, the intangible property is generally not “exploited.” Consistent with this view, the final regulations generally place the location of use of the intangible property with the location of the end user, which is generally the person who ultimately uses the general property in which the intangible property is embedded or associated with, or, if the intangible property is used to provide a service, the service recipient. These rules provide the same determination of location of end user for sales or licenses of intangible property used in research and development.

(d) Intangible Property Used in Manufacturing.

- i. The preamble to the proposed regulations requested comments regarding whether Treasury and the IRS should adopt a rule for intangible property similar to Prop. Treas. Reg. § 1.250(b)-4(d)(2)(i)(B) (treating a sale of general property as for a foreign use if the property is subject to manufacturing, assembly, or other processing outside the U.S.). Several comments supported a rule that would treat the sale of intangible property as for a foreign use where intangibles are used in manufacturing that takes place outside the U.S.
- ii. Based on comments received, the final regulations provide a special rule for sales to a foreign unrelated party of a manufacturing method or process or for know-how used to put the manufacturing method or process to use in



manufacturing (the “manufacturing method or process rule”). Treas. Reg. § 1.250(b)-4(d)(2)(ii)(C).

- iii. The final regulations provide that when this rule applies, then the foreign unrelated party is treated as an end user located outside the U.S., unless the seller knows or has reason to know that the manufacturing method or process will be used in the U.S., in which case the foreign unrelated party is treated as an end user located within the U.S. For purposes of this rule, reason to know is determined based on the information received from the recipient during the sales process. Treas. Reg. § 1.250(b)-4(d)(2)(ii)(C)(1).
- iv. The manufacturing method or process rule does not apply to sales or licenses of a manufacturing method or process to an unrelated foreign party for purposes of manufacturing products for or on behalf of the seller of the manufacturing method or process or any of the seller’s affiliates. Treas. Reg. § 1.250(b)-4(d)(2)(ii)(C)(2). Applying the manufacturing method or process rule to determine the end user regarding such an arrangement, such as a contract or toll manufacturing arrangement, is not appropriate because the seller or related party to the seller is using the manufacturing method or process in manufacturing for itself. Such use by the seller is effectively a circular transfer of the intangible property back to the seller. However, the sale of the manufactured products by the seller of the manufacturing method or process or the seller’s affiliates can still qualify as a FDDEI sale under other provisions such as Treas. Reg. § 1.250(b)-4(d)(1)(ii).
- v. The manufacturing method or process rule applies only to certain types of intangibles that are used in the manufacturing process. The distinction between the types of intangibles that qualify for this rule and other types of intangibles that may be used by manufacturers is based on a distinction between use of a patented method or process and use of other types of patented items. In all other cases, the foreign use of intangible property is determined based on revenue earned from end users located within versus without the U.S.
- vi. The manufacturing method or process rule applies only to sales to unrelated parties (including sales made through related parties that ultimately result in a sale of the manufacturing method or process to an unrelated party). Section 250(b)(5)(C) provides that sales to related parties

are treated as for a foreign use only if the property is ultimately sold or used in connection with property that is sold to an unrelated party that is not a U.S. person. While Treas. Reg. § 1.250(b)-6(c) gives effect to this rule by providing special rules for sales of general property to related parties (which apply in the case of sales of property to related parties for further manufacturing), those rules do not apply to sales of intangible property.

- vii. Under the final regulations, limiting the manufacturing method or process rule to unrelated party sales serves the purpose of ensuring that such sales are FDDEI sales only to the extent contemplated by § 250(b)(5)(C). For example, if the taxpayer sells to a foreign related party a manufacturing method used to produce general property, then the sale of the manufacturing method is for a foreign use to the extent that the foreign related party's sales of the general property are for a foreign use under the rules applicable to sales of general property. Treas. Reg. § 1.250(b)-4(d)(2)(ii)(A). This result is generally consistent with the result if the related party sale had instead been of general property that was used in manufacturing.

(e) Bundled Intangible Property.

- i. One comment suggested a rule that would provide that where a taxpayer licenses a bundle of intangibles, it should be allowed to elect the application of the potentially applicable rules based either on the predominant feature of the bundle or using any reasonable method. Treasury and the IRS recognize that intangible property is sometimes sold or licensed as a bundle, such as the license of patents, copyrights, trademarks, tradenames, and know-how in a single transaction, without specifying the amount of payment required for each item of intangible property.
- ii. The final regulations provide for a predominant character determination when a transaction has multiple elements, such as a service and sale or a sale of general property and intangible property, to determine whether to apply the provisions for sales of general property, sales of intangible property, or the provision of services. Treas. Reg. § 1.250(b)-3(d).
- iii. In the case of a sale or license of bundled intangible property, the final regulations generally base the location of exploitation on the location of the end user who ultimately

uses the general property in which the intangible property is embedded or associated with, or, if the intangible property is used to provide a service, the location of the service recipient. Treas. Reg. § 1.250(b)-4(d)(2)(ii)(A)-(B), (D).

- iv. Only in an unrelated party transaction involving the manufacturing method or process rule will the end user location be determined differently from a transaction involving intangible property used with general property, services, or research and development. However, the manufacturing method or process rule does not determine the location of the end user of other intangible property bundled with the manufacturing method or process. As a result, the final regulations do not provide for an election to treat or characterize the sale or license of bundled intangible property that includes manufacturing method or process intangibles as well as other intangible property as falling entirely within one of the categories of intangible property specified in Treas. Reg. § 1.250(b)-4(d)(2).

(f) Treatment of Product Intangibles as Components.

- i. One comment suggested that the final regulations include a rule that would treat certain “product intangibles” as a component of the finished product and provide a rule that is analogous to the rule for sales of general property that is incorporated as a component of another product outside the U.S.
- ii. The final regulations did not adopt this suggestion. Intangible property has no physical properties, and therefore cannot be incorporated into a finished good or otherwise be a “component” of the finished good in the same way as items of general property that are considered to be components.

(g) IP Used to Enhance Other IP.

- i. One comment discussed intangibles that are sold to an unrelated foreign person who enhances the intangible (for example, by adapting it to local markets) or uses the intangible property to develop other intangible property and subsequently sells the enhanced or newly created intangible property outside the U.S. In these situations, the comment recommended that the sale of the original intangible property should be presumed to be for foreign use if the

location of the research and development is outside the U.S. and the recipient is unrelated to the original seller.

- ii. The final regulations did not adopt the comment. Revenue is generally earned from intangible property used to manufacture products or provide services through sales of the products or services, or from limited use licenses of the intangible property, whether those sales, services, or limited use licenses are executed by an owner, licensee, or sub-licensee of the intangible property. Until revenue is earned from sales, services, or limited-use licenses to the end user that ultimately consumes the property or receives the service, the intangible property is generally not “exploited.” Although the final regulations provide a limited exception from this end user requirement for intangible property that consists of a manufacturing method or process, no exception is included for intangible property used to enhance or create other intangible property.
- iii. However, in response to comments, the final regulations clarify the rule for sales of intangible property used to develop other intangible property or to modify existing intangible property. Treas. Reg. § 1.250(b)-4(d)(2)(ii)(D). In such a case, the end user of the intangible property (primary IP) used to develop other intangible property or to modify existing intangible property (secondary IP) is the end user of the property in which the secondary IP is embedded. If the secondary IP is used to provide a service, the end user is the unrelated party recipient. If the secondary IP qualifies as a manufacturing method or process, then the rules applicable to sales of a manufacturing method or process apply to determine if the sale of the secondary IP is for a foreign use. Treas. Reg. § 1.250(b)-4(d)(2)(ii)(C).

(h) IP Used to Provide Services.

- i. One comment noted that intangible property may be sold to recipients that provide services, rather than solely to recipients that manufacture and sell goods.
- ii. Revenue may be earned from intangible property through the provision of services, but until that revenue is earned, the intangible property is generally not used or “exploited.” Consistent with this view, the final regulations generally place the location of use of the intangible property with the location of the end user, which in the case of intangible

property used to provide a service, is the service recipient. Treas. Reg. § 1.250(b)-4(d)(2).

- iii. These rules are generally consistent with the location in which legal rights to the intangible property are granted and exploited, with exploitation generally being located where the end user ultimately consumes the property or the services the intangible property is used to provide. Treas. Reg. § 1.250(b)-4(d)(2)(i). The rules in Treas. Reg. § 1.250(b)-5 for FDDEI services generally apply for purposes of determining the location of the end user. Therefore, for example, the location of the end user of intangible property that is used to provide advertising services is determined based on the location of the individuals viewing the advertisements. Treas. Reg. § 1.250(b)-5(e)(2)(ii).
- iv. However, the regulations do not provide a presumption that a sale to a foreign unrelated party that uses that intangible property to provide services outside the U.S. is presumed to be for foreign use. Such a presumption could produce results that would be inconsistent with the general approach for determining the location of use of intangible property by reference to the location of exploitation (which, in the case of intangible property used to provide services, is generally the location of the person or persons receiving such services). Treasury and the IRS have determined that a departure from the general rule is not warranted in this case.

(i) Determination of Revenue

i. Periodic Payments.

- (a) Like the proposed regulations, the final regulations provide that for periodic payments (such as annual royalty payments or fixed installment payments) in exchange for rights to intangible property, other than intangible property consisting of a manufacturing method or process that is sold to a foreign unrelated party, taxpayers may estimate revenue earned by unrelated party recipients from any use of the intangible property based on the principles for determining revenue from lump sum sales, if actual revenue earned by the foreign party cannot be obtained after reasonable efforts. Treas. Reg. § 1.250(b)-4(d)(2)(iii)(A).

- (b) While the proposed regulations required estimated revenue to be determined on an annual basis when a taxpayer relies on this rule, the final regulations eliminate this requirement. Treasury and the IRS believe that when estimated revenue earned by unrelated party recipients must be used, information available at the time of the sale will be more reliable than information available subsequently. In addition, eliminating the requirement to determine estimated revenue annually reduces the administrative burden on the taxpayer. Treas. Reg. § 1.250(b)-4(d)(2)(iii)(A).

ii. Lump Sum Payments.

- (a) One comment recommended that the seller be allowed to use revenue the recipient (rather than the seller) earns or expects to earn from use of the intangible property to determine the extent to which a sale of intangible property in exchange for a lump sum payment qualifies for foreign use because using the recipient's expected or actual revenue is more accurate for determining foreign use.
- (b) In response to the comment, the final regulations allow taxpayers to use net present values using reliable inputs, which may include net present values of revenue that the recipient expected to earn from the exploitation of the intangible property within and outside the U.S. if the seller obtained such revenue data from the recipient near the time of the sale and such revenue data was used to negotiate the lump sum price paid for the intangible property. Treas. Reg. § 1.250(b)-4(d)(2)(iii)(B).
- (c) In determining whether such inputs are reliable, the extent to which the inputs are used by the parties to determine the sales price agreed to between the seller and a foreign unrelated party purchasing the intangible property will be a factor.
- (d) The final regulations do not allow for use of actual revenue earned by the recipient from the use of the intangible property in a lump sum sale because actual revenue earned by the recipient for all the years the recipient uses the intangible property will not be known when the seller files its tax return for

the tax year in which the sale of the intangible property occurred.

iii. Payments for Manufacturing Method or Process.

- (a) Regarding sales to a foreign unrelated party of intangible property consisting of a manufacturing method or process, the final regulations provide that the revenue earned from the end user is equal to the amount received from the recipient in exchange for the manufacturing method or process. Treas. Reg. § 1.250(b)-4(d)(2)(iii)(C).
- (b) In the case of a bundled sale of intangible property consisting of a manufacturing method or process and other intangible property, the value of the manufacturing method or process relative to the total value of the intangible property must be determined using the principles of § 482.

(j) Hedging Transactions.

- i. Several comments recommended that gain or loss from certain hedging transactions regarding commodities be considered gain or loss from sales of general property.
- ii. Treasury and the IRS agree that certain hedging transactions should be treated in a manner that is similar to the treatment of the commodities hedged by those transactions. Furthermore, they believe that the adjustment for qualified hedging transactions should apply to all general property, not only commodities. Hedges of property other than commodities have the same economic effect as hedges of commodities, such that the rationale for determining FDDEI sales income from hedges by reference to hedges of commodities applies equally to other types of property.
- iii. Accordingly, the final regulations generally provide that a corporation's or partnership's gross income resulting from FDDEI sales of general property is adjusted by reference to certain hedging transactions. Treas. Reg. § 1.250(b)-4(f). The hedging transaction must meet the requirements of Treas. Reg. § 1.1221-2, including the identification requirement under Treas. Reg. § 1.1221-2(f), the transaction must hedge price risk or currency fluctuation

regarding ordinary property, and the property being hedged must be general property that is sold in a FDDEI sale.

- iv. Treasury and the IRS are considering issuing more detailed guidance on hedging transactions in the form of future proposed regulations. Comments were requested on this topic.

N. FDDEI Services.

1. Categories of Services.

- (a) The proposed regulations separated all services into five mutually exclusive and comprehensive categories: general services provided to consumers, general services provided to business recipients, proximate services, property services, and transportation services. Prop. Treas. Reg. § 1.250(b)-5(b).
- (b) The final regulations provide additional guidance, regarding services that are “electronically supplied.” Services that are provided electronically typically will be categorized as general services because they will not meet the definitions of proximate services, property services, or transportation services. To provide additional guidance for determining the location of the recipients of services that are electronically supplied, the final regulations create a new category of general services defined as “electronically supplied services,” which includes general services (other than advertising services, described in the following sentence) that are delivered over the internet or an electronic network. Treas. Reg. § 1.250(b)-5(c)(5).
- (c) In addition, the final regulations create a new subcategory of general services for advertising services, including advertising services to display content via the internet, and provide additional guidance for these services. Treas. Reg. § 1.250(b)-5(c)(1).

2. General Services.

- (a) General Services Provided to Consumers.
  - i. The proposed regulations provided that a consumer was located where the consumer resides when the service is provided and required documentation to establish the place of residence.
  - ii. The final regulations adopt a more flexible approach to documentation. While the final regulations include specific substantiation requirements for certain elements of the



regulations, no such rules are provided for general services to consumers.

- iii. Furthermore, to minimize the burden associated with determining the residence of consumers, the final regulations provide that if the renderer does not have (or cannot after reasonable efforts obtain) the consumer's location of residence when the service is provided, the consumer of a general service is treated as residing outside the U.S. if the consumer's billing address is outside of the U.S. Treas. Reg. § 1.250(b)-5(d)(1).
  - iv. However, this rule does not apply if the renderer knows or has reason to know that the consumer does not reside outside the U.S. The final regulations clarify that "reason to know" is determined based only on whether the information received as part of the provision of the service contains information that indicates that the consumer resides in the U.S. Because this rule applies to all services provided to consumers (with the modification for electronically supplied services described in the next paragraph), the final regulations do not provide a special rule for small transactions or small taxpayers.
  - v. Regarding electronically supplied services that are provided to consumers, the final regulations provide that the consumer is deemed to reside at the location of the device used to receive the service, which may be an IP address, if available. However, if the renderer cannot determine the location of that device after reasonable efforts, the general rule based on billing address applies, subject to the renderer not knowing or having reason to know that the consumer does not reside outside the U.S.
- (b) General Services Provided to Business Recipients. The proposed regulations determined the location of a business recipient based on the location of its operations, and the operations of any related party of the recipient, that received a benefit (as defined in Treas. Reg. § 1.482-9(1)(3)) from such service.
- i. Operations of a Business Recipient of General Services.
    - (a) Several comments requested clarification regarding the definition of a business recipient's operations.
    - (b) The location of a business recipient's operations that benefit from a general service is based on the

geographical location where the business recipient's activities are regular and continuous and is not based on the current location of mobile property such as satellites or vessels. The final regulations clarify that an office or other fixed place of business is a fixed facility through which the business recipient engages in a trade or business. Treas. Reg. § 1.250(b)-5(e)(3)(i).

- (c) In the case of services performed regarding a satellite, the location of the business recipient that receives services regarding the satellite is based on where the business recipient remotely performs activities regarding the satellite (which could be within the U.S. or in a foreign country), rather than in space. In addition, services performed for a vessel owned by a business recipient may qualify as proximate services or property services, depending on the nature of the services. Therefore, no further changes to the regulations are necessary.
- (d) One comment requested further clarification of the term "fixed place of business," such as whether it has the same meaning as it does for § 864(c) purposes. Treasury and the IRS believe that it would not be appropriate to adopt the definition that applies for purposes of § 864(c). Because the final regulations define a business recipient as including all related parties of the recipient, whereas § 864(c) applies on a taxpayer-by-taxpayer basis, adopting the definition of an office or other fixed place of business that is in Treas. Reg. § 1.864-7 would cause confusion.
- (e) However, the final regulations clarify that an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility, through which the business recipient engages in a trade or business. Treas. Reg. § 1.250(b)-5(e)(3)(i).
- (f) In addition, the final regulations provide that for purposes of determining the location of the business recipient, the renderer may make reasonable assumptions based on the information available to it. Treasury and the IRS recognize that taxpayers may not be able to obtain precise information about

unrelated business recipients; therefore, the final regulations allow taxpayers to make reliable assumptions based on the information available to them.

- (g) One comment requested guidance on how to determine the location of operations of a business recipient that does not have an office or fixed place of business. To address this comment, the final regulations provide that if the business recipient does not have an identifiable office or fixed place of business (including the office of a principal manager or managing owner), the business recipient is deemed to be located at its primary billing address. Treas. Reg. § 1.250(b)-5(e)(3)(iii). Treasury and the IRS considered using place of formation or place of incorporation, but determined that a business recipient's billing address is generally available to the renderer and often bears a closer connection to the business recipient's location of actual operations.
- (h) Finally, for the sake of concision, the final regulations expand the definition of a "business recipient" to include all related parties of the recipient. However, to avoid circularity in circumstances where the business recipient is a related party of the taxpayer, in these circumstances, the term "business recipient" does not include the taxpayer. Treas. Reg. § 1.250(b)-5(c)(3).

ii. The Meaning of "Benefit."

- (a) One comment expressed concern that the proposed regulations' reliance on the principles of Treas. Reg. § 1.482-9(l)(3), which explains when an activity is considered to provide a "benefit" to a recipient, would be difficult to apply outside the related party context because the renderer may not have the information necessary to perform a detailed analysis of the recipient's operations.
- (b) Treasury and the IRS do not intend that the reference to Treas. Reg. § 1.482-9(l)(3) in the definition of "benefit" be interpreted as suggesting that taxpayers are required to perform a transfer

pricing-like analysis of the recipient's operations. Rather, the reference is intended to clarify, using a concept that is based on existing tax principles, that a service confers a benefit on operations of a recipient only if an uncontrolled party with similar operations would pay for the service under comparable circumstances. For example, if a service benefits particular operations of a business recipient so indirectly or remotely that an unrelated party with similar operations would not pay for the service, the service does not confer a benefit on those operations. Treas. Reg. § 1.482-9(1)(3)(ii). Accordingly, the final regulations retain the reference to Treas. Reg. § 1.482-9(1)(3) in defining "benefit."

- (c) One comment also requested clarification regarding the types of benefits that must be considered in determining the location of the business recipient of a general service. The comment gives the example of a U.S. financial advisor providing advice to a foreign parent that is expected to increase the value of the foreign parent's publicly traded stock, which would also benefit any U.S. subsidiaries by making their equity-based compensation more valuable. The implication of the comment is that it is unclear whether the U.S. subsidiaries receive a compensable benefit from the service provided because their employees are also shareholders of the foreign parent.
- (d) As noted, the reference to Treas. Reg. § 1.482-9(1)(3) in the definition of "benefit" is intended to provide clarity on the meaning of "benefit" using a concept that is based on existing tax principles. An activity is not considered to provide a "benefit" within the meaning of Treas. Reg. § 1.482-9(1)(3) if the benefit to the recipient is "so indirect or remote" that the recipient would not be willing to pay an uncontrolled party to perform a similar activity. Accordingly, in fact patterns such as the one described in the comment (where the service potentially confers a benefit on a related party of the recipient if the employees of the related party are also shareholders of the recipient), taxpayers must determine whether a related party with employees that are shareholders of a company would generally

pay a financial advisor to provide advice to the company or whether the benefit to the related party is too indirect or remote. Treas. Reg. § 1.482-9(l) provides comprehensive guidance, including twenty-one examples, to assist taxpayers in understanding when an activity is considered to confer a benefit on a party other than the direct recipient. Accordingly, the comment was not adopted.

iii. Locations of Operations that Benefit.

- (a) Several comments addressed the proposed regulations' rule for determining the location of the recipient of general services that benefits from the service. One comment suggested that the final regulations include language included in the preamble to the proposed regulations stating that for purposes of this rule, "the location of residence, incorporation, or formation of a business recipient is not relevant." The final regulations adopted this comment. Treas. Reg. § 1.250(b)-5(e)(1).
- (b) Several comments indicated that it would be difficult, if not impossible, for taxpayers to obtain information regarding which of a business recipient's locations benefits from a service. While the proposed regulations allowed taxpayers in these circumstances to assume that the services will benefit all of the business recipient's operations ratably, several comments suggested that this simplification was not sufficient.
- (c) Treas. Reg. § 1.250(b)-5(e)(1) utilizes the same general approach as the proposed regulations for determining the location of the business recipient, with some revisions to be more concise by providing that a service is provided to a business recipient located outside the U.S. to the extent that the service confers a benefit on operations of the business recipient that are located outside the U.S. Like the proposed regulations, the final regulations provide that the determination of which operations of the business recipient benefit from a general service is made under the principles of Treas. Reg. § 1.482-9. Further, the final regulations clarify that in applying these principles, (1) the taxpayer, (2) the

portions of the business recipient's operations within the U.S. (if any) that may benefit from the general service, and (3) the portions of the business recipient's operations outside the U.S. that may benefit from the general service, are treated as if they are each one or more controlled taxpayers.

- (d) For purposes of applying the principles of Treas. Reg. § 1.482-9, the final regulations provide taxpayers with flexibility to determine the extent to which a business recipient's operations within or outside of the U.S. are treated as one or more separate controlled taxpayers, given that taxpayers generally will not have complete information regarding the operations of the business recipient.
- (e) Any reasonable method can be used for determining the set and scope of business recipient operations that are treated as separate controlled taxpayers, for example, by segregating the operations on a per entity or per country basis, or by aggregating all of the business recipient's operations outside the U.S. as one controlled taxpayer. For example, if a business recipient has operations in the U.S., Country X, and Country Y, all of which may benefit from the taxpayer's services, the business recipient's operations in the U.S., Country X, and Country Y may each be treated as separate controlled taxpayers. Alternatively, the business recipient's operations in the U.S., and the business recipient's combined operations in Country X and Country Y, could be treated as two separate controlled taxpayers. The amount of the benefit conferred on each of the business recipient's operations is determined under the principles of Treas. Reg. § 1.482-9(k).
- (f) To simplify the rule, the final regulations do not contain the proposed regulations' provision stating that if a service benefits all of the business recipient's operations, gross income of the renderer is allocated ratably to all of the business locations of the recipient, as that provision was redundant given the general rule.
- (g) The final regulations also do not include the provision that gross income of the renderer is

allocated ratably to all of the business locations of the recipient if the renderer is unable to obtain reliable information regarding the specific locations of the operations of the business recipient to which a benefit is conferred. Treasury and the IRS believe that it would be inappropriate to allow a deduction that is not based on reliable information.

- (h) Comments also suggested that the final regulations should define foreign operations by negation such that a service is considered provided to a business recipient outside the U.S. if that service is not provided to a business recipient inside the U.S. These comments said that this would allow mobile activity performed in outer space, international airspace, or international water to qualify as FDDEI services. Treasury and the IRS believe that evidence that services do not benefit a business recipient's operations within the U.S. is equivalent to demonstrating that the service benefits operations outside the U.S. Therefore, they believe that no changes to the regulations were necessary. However, the location of a business recipient's operations is determined based on whether its activities are regular and continuous in a particular geographical location, which generally would not include activities in outer space or international space, but may include international water (for example, in the case of a drilling rig).
- (i) Several comments requested clarity on how to determine the location of operations that benefit from general services in the case of services that are electronically supplied. In response, the final regulations modify the general rule for determining the location of the business recipient of electronically supplied services and advertising services so that location will be determined based on information that will generally be available to renderers of those types of services. Treas. Reg. § 1.250(b)-5(e)(2)(ii) and (iii).
- (j) Advertising services are different from other general services: the renderer will generally be able to determine where the advertisements are viewed because the renderer controls where the advertisements are displayed. Treasury and the IRS

believe that where the advertisement is viewed serves as a reliable proxy for the locations of the business recipient that benefit from the service.

- (k) They state that, generally, it will be in the business recipient's best interest to advertise its products or services in the locations where it does business. Therefore, the final regulations provide that regarding advertising services, the operations of the business recipient that benefit from the advertising service are deemed to be located where the advertisements are viewed by individuals. Treas. Reg. § 1.250(b)-5(e)(2)(ii).
- (l) The final regulations further provide that if advertising services are displayed via the internet, the advertising services are viewed at the location of the device on which the advertisements are viewed. For this purpose, the IP address may be used to establish the location of that device. The final regulations also include a new example for advertising services. Treas. Reg. § 1.250(b)-5(e)(5)(ii)(C) (Example 3).
- (m) Electronically supplied services are also different from other general services because the renderer will generally be able to determine where the service is accessed by using the recipient's IP address or through other means. Treasury and the IRS believe that the point of access serves as a reliable proxy for where the business recipient receives the benefit of the service. Therefore, the final regulations provide that regarding electronically supplied services provided to a business recipient, the operations of the business recipient that benefit from the general service are deemed to be located where the general service is accessed. Treas. Reg. § 1.250(b)-5(e)(2)(iii).
- (n) The final regulations also provide that if the location where the business recipient accesses the electronically supplied service is unavailable (such as where the location of access cannot be reliably determined using the location of the IP address of the device used to receive the service), and the gross receipts from all services regarding the business recipient (or any related party to the business



recipient) are in the aggregate less than \$50,000, the operations of the business recipient that benefit from the general service provided by the renderer are deemed to be located at the recipient's billing address. The final regulations also include new examples for electronically supplied services. Treas. Reg. § 1.250(b)-5(e)(5)(ii)(E) and (F) (Example 5 and 6).

iv. Business Recipients.

- (a) The final regulations provide that a general service provided to a business recipient is a FDDEI service only if the taxpayer maintains sufficient substantiation to support its determination of the extent to which the service benefits a business recipient's operations outside the U.S. Treas. Reg. § 1.250(b)-5(e)(4).
- (b) A taxpayer can satisfy this requirement by either obtaining credible evidence establishing the extent to which operations of the business recipient benefit from the service or preparing a statement that supports its determination with corroborating evidence. Treas. Reg. § 1.250(b)-5(e)(4).
- (c) The final regulations explain that the determination of the portion of the service that will benefit the business recipient's operations located outside the U.S. may be based on evidence obtained from the business recipient, such as statements made by the recipient regarding the need for the service or data on the sales of the business recipient's operations, or the taxpayer's own records, such as time spent working with the business recipient's different offices. Treas. Reg. § 1.250(b)-5(e)(4)(ii).
- (d) Treasury and the IRS believe that it is unnecessary to delineate which specific methods satisfy substantiation. If the taxpayer substantiates its determination with evidence provided by the business recipient, the final regulations do not specify what information must be included in the statement beyond requiring that it must establish the extent to which the service benefits operations located outside the U.S. Treas. Reg. § 1.250(b)-5(e)(4)(i).

- (e) Treasury and the IRS appreciate that service recipients might not be willing to provide information about their business to taxpayers. Accordingly, the final regulations do not require the evidence to specify which of a business recipient's locations benefit from a service (for example, the business recipient's European operations rather than its Asian operations), just the portion of the service that benefits operations outside the U.S. generally.

(c) Proximate Services.

- i. The proposed regulations provided that the provision of a proximate service to a recipient located outside the U.S. was a FDDEI service.
- ii. Comments requested that the final regulations expand the definition of a proximate service to include services performed in the physical presence of additional persons working for a business recipient, including that business's own employees, the employees of a related party of the recipient, or the recipient's contract workers or agents.
- iii. In response to these comments, Treas. Reg. § 1.250(b)-5(c)(8) expands the definition of a proximate service to provide that it means a service, other than a property service or a transportation service, provided to a recipient, but only if substantially all of the service is performed in the physical presence of the recipient or persons working for the recipient such as employees, contractors, or agents.
- iv. Comments also recommended that the final regulations provide that income received for the provision of proximate services, which must be performed outside the U.S. to qualify as a FDDEI service, is not treated as foreign branch income for purposes of § 250.
- v. In response to comments, the final regulations confirm that there is one consistent definition of foreign branch income in both Treas. Reg. §§ 1.250(b)-1(c)(11) and 1.904-4(f)(2). The fact that the regulations under § 250 otherwise would treat certain income as eligible for FDII is irrelevant for purposes of determining whether the income is foreign branch income under § 904(d)(2)(J).
- vi. Further, as acknowledged by the comments, providing a proximate service (or any other service) outside the U.S.

does not necessarily create a foreign branch; therefore, not all income from proximate services performed outside the U.S. will be foreign branch income. Accordingly, the final regulations do not adopt these comments.

(d) Property Services. The proposed regulations provided that a property service was a FDDEI service if it was provided regarding tangible property located outside the U.S., but only if the property was located outside the U.S. for the duration of the period the service was performed.

i. Qualification as FDDEI Services.

(a) Several comments recommended that the final regulations remove the mutually exclusive categories of services in Prop. Treas. Reg. § 1.250(b)-5(b) because, according to the comments, they are inconsistent with § 250(b)(4)(B). That provision treats as FDDEI services those provided to any person, or regarding property, not located within the U.S. Comments asserted that the statute is disjunctive and requires that a service regarding property gives rise to FDDEI if the service is provided to a person located outside the U.S., regardless of the location of the serviced property.

(b) The final regulations did not adopt these comments. Section 250(b)(4)(B) refers to persons and property disjunctively, which indicates that Congress intended for there to be a category of services provided regarding persons located outside the U.S. that would be FDDEI services and a separate category of services provided regarding property located outside the U.S. that would be FDDEI services. Treasury and the IRS believe the proposed regulations gave effect to this intent. They state that the statute and legislative history are ambiguous, however, as to whether Congress intended for all services provided regarding persons located outside the U.S. and all services provided regarding property located outside the U.S. to be included within the scope of the statute.

(c) They also believe that property services must be provided regarding property located outside the U.S. in order to qualify as FDDEI services. The

purpose of the § 250 deduction is to help neutralize the role that tax considerations play when a taxpayer chooses the location of intangible income attributable to foreign-market activity, that is, whether to earn such income through its U.S.-based operations or through its CFCs.

- (d) Providing a FDII deduction for all property services performed in the U.S. regarding property with owners located outside the U.S., regardless of the property's connection to foreign markets, would not further that purpose. Furthermore, even if the statute required that property services provided to any person located outside the U.S. could qualify as FDDEI services, the statute does not specify how to determine the location of such person. In the case of property services, Treasury and the IRS believe that basing the location of such person on the location of the property that the person owns is most consistent with the nature of a property service and the location of the benefit that is being provided. Therefore, they have determined that property services should be limited to those services provided to property located outside the U.S.
- (e) However, in recognition of the fact that some property services performed within the U.S. may nonetheless be connected to foreign markets, the final regulations expand the circumstances under which property services may qualify as FDDEI services notwithstanding the fact that the services are performed in the U.S.
- (f) Several comments suggested that the final regulations clarify that the property services rules apply only to services that the taxpayer provides regarding completed property that is in use by the property's owner, and thus, that manufacturing-related services (such as toll manufacturing) are not property services, but rather general services. The comments suggested that if manufacturing services are treated as property services, manufacturing services performed in the U.S. will never give rise to FDDEI even if the sale of the same property to a foreign person for a foreign use would have been a FDDEI sale.

- (g) In response to these comments, the final regulations specify that manufacturing services are property services but allow property services performed in the U.S. to qualify as FDDEI services under some circumstances. Treas. Reg. § 1.250(b)-5(c)(7) and (g)(2). Taken together, these changes allow manufacturing services performed in the U.S. to be FDDEI services in some circumstances.
- (h) In addition, one comment suggested that the definition of “property service” should be modified to remove the condition that only tangible property can be the subject of a property service. The comment stated that services can be provided regarding intangible property located outside the U.S., and notes that the statute does not distinguish between services provided regarding tangible and intangible property.
- (i) The final regulations did not adopt this recommendation. Intangible property cannot be “located” outside the U.S. given that intangible property, by definition, does not have physical properties. Accordingly, Treasury and the IRS determined that the general services rules, which look to the location of the recipient, are a more appropriate framework for analyzing these types of services.

ii. Services on Property Temporarily in the U.S.

- (a) The proposed regulations provided that a property service was a FDDEI service only if the tangible property regarding which the service is performed was located outside the U.S. for the duration of the period of performance, but requested comments regarding the treatment of property that is located in the U.S. only temporarily.
- (b) Comments requested that the final regulations provide that a property service is still a FDDEI service in part (or in full) if the property enters the U.S. temporarily while the services are performed, and included various recommendations for a safe harbor, including treating a property service as a FDDEI service if the property is present in the U.S.

for a particular period while the property is out of commercial service.

- (c) The final regulations generally adopted the comments. Treasury and the IRS agreed that in certain circumstances, treating property services as FDDEI services is appropriate even if the service is provided within the U.S.
- (d) Accordingly, the final regulations include an exception for property services performed regarding property that is temporarily located in the U.S. and treats those services as being provided regarding tangible property located outside the U.S. if several conditions are satisfied. Treas. Reg. § 1.250(b)-5(g)(2). Those conditions are that the property must be temporarily located in the U.S. for the purpose of receiving the property service; after the completion of the service, the property will be primarily hangared, docked, stored, or used outside the U.S.; the property is not used to generate revenue in the U.S. at any point during the duration of the service; and the property is owned by a foreign person that resides or primarily operates outside the U.S.

(e) Transportation Services.

- i. The proposed regulations provided that the provision of a transportation service was a FDDEI service if both the origin and the destination of the service were outside the U.S. Where either the origin or destination (but not both) were outside the U.S., then 50% of the transportation service was considered a FDDEI service. The proposed regulations defined a transportation service as a service to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle, or any similar mode of transportation.
- ii. Comments requested that the final regulations include elections regarding cross-border transportation services, including an election for taxpayers to choose either (i) the 50% FDDEI treatment provided in the proposed regulations, or (ii) a bifurcation method under which the FDDEI treatment of income from the service is based on actual time or mileage, or (iii) a predominant location method in which all of the income from the service is FDDEI if the taxpayer can demonstrate that more than 50%

of the services were provided to a person or regarding property outside the U.S. on a mileage basis. A comment also requested clarification on whether intermediate domestic stops can be disregarded for purposes of determining the origin and destination of a transportation service.

- iii. The final regulations retain the rule in the proposed regulations. Treas. Reg. § 1.250(b)-5(h). Treasury and the IRS believe that the primary benefit of the service relates to servicing the origin or destination market. A 50/50 allocation rule thus provides a simpler and more administrable rule for reflecting the value of each market when the origin or destination is in the U.S.
- iv. In addition, they also believe that an elective rule that allows different taxpayers to choose the rule most favorable to their business models would result in inconsistent treatment of similarly situated taxpayers and lead to whipsaw for the IRS. In addition, the rule in the proposed regulations is clear that only the locations of the origin and destination, and not intermediate stops, are relevant to the determination.
- v. Accordingly, the final regulations did not adopt these comments. However, the final regulations clarify that freight forwarding and similar services are included within the definition of “transportation services.” Treas. Reg. § 1.250(b)-5(c)(9).

O. Related Party Transactions.

1. Related Party Sales.

(a) Amended Return Requirement.

- i. The proposed regulations provided two distinct rules for determining whether a sale of property to a related party (related party sale) is a FDDEI transaction. One rule applied when the related party resold the purchased property in an unrelated party transaction, either without modification or where the related party incorporates the purchased property as a component of property that is then resold in an unrelated transaction. A different rule applied when the related party used the property in an unrelated transaction, either in connection with the sale of altogether different property or to provide a service.

- ii. The rule for resales required that an unrelated party transaction actually occur before the taxpayer can treat the original sale to the related party as a FDDEI transaction. If an unrelated party transaction has not occurred by the filing date of the return that includes the original sale (FDII filing date), the taxpayer cannot immediately treat the sale to the related party as a FDDEI transaction. Instead, in the subsequent year when the unrelated party transaction occurs, the taxpayer can file an amended return for the tax year of the original related party sale treating that sale as a FDDEI transaction and determine its modified FDII benefit accordingly, assuming the period of limitations provided by § 6511 remains open when the unrelated party transaction occurs.
- iii. However the taxpayer was permitted under Prop. Treas. Reg. § 1.250(b)-6(c)(1)(ii) to treat that related party sale as a FDDEI transaction so long as the taxpayer reasonably expected, as of the FDII filing date, that one or more unrelated party transactions would occur regarding the property sold to the related party and that more than 80% of the revenue earned by the foreign related party would be earned from such unrelated party transaction or transactions.
- iv. Several comments noted administrative difficulties with the amended return requirement for resale transactions.
- v. Treasury and the IRS agreed with the concerns expressed by the comments about the administrative burdens that the amended return requirement can cause for both taxpayers and tax administrators. Therefore, the final regulations modify the resale rule to allow a taxpayer to treat a sale to a related party as a FDDEI transaction in the tax year of the related party sale provided that an unrelated party transaction has occurred or will occur in the ordinary course of business regarding the property sold to the related party, whether the property is a completed product or a component of a different product.
- vi. The unrelated party sale can occur at any time in the future so that taxpayers with long production or sales cycles are not unduly prevented from claiming FDII benefits based on the period of limitations for filing an amended return under § 6511. The condition that the unrelated party transaction must be in the ordinary course of business is intended to exclude situations in which the resale is tangential to the



business of the taxpayer and related party (for example, if the taxpayer sells a machine to a related party for the related party's consumption, and the machine is later sold by the related party for scrap or recycling).

- vii. The final regulations also remove the requirement that the FDII filing date is determinative regarding related party sales and use of property in an unrelated party transaction. Taxpayers that engage in related party transactions should generally be able to obtain information after the FDII filing date that will confirm whether a related party sale is in fact a FDDEI sale or service. A rule that depends on the FDII filing date would create uncertainty during examinations if the FDII filing date is inconsistent with actual post-FDII filing date transactions. Therefore, if in fact, an unrelated party transaction does not actually occur in a future year, the related party sale would not be a FDDEI sale. This could also apply to related party services where a substantially similar service that occurs in a future year should be taken into account.
- viii. The final regulations also include guidance on how a taxpayer can demonstrate that an unrelated party sale will later occur. Taxpayers can rely on contractual restrictions or historical practices indicating that the related party only sells products to unrelated foreign customers. Moreover, if the design of a product indicates that it is destined only for foreign customers, taxpayers can establish that an unrelated party sale will occur regarding that product.

(b) Intermediate Sales.

- i. The proposed regulations provided that for purposes of determining whether a related party sale is for a foreign use, all foreign related parties of the seller are treated as if they were a single foreign related party.
- ii. One comment requested that the final regulations clarify how the related party resale rule operates when the foreign related party buyer purchases a semi-finished product from the U.S. parent (or another domestic related party), finishes that product, and resells it to the U.S. parent (or another domestic related party) for ultimate sale to an unrelated person for a foreign use.
- iii. Treasury and the IRS generally agreed with this comment and modified Treas. Reg. § 1.250(b)-6(c)(3) to provide that

a U.S. person (either the seller itself or another U.S. person that is a related party of the seller) is treated as part of a single foreign related party. This rule only applies for purposes of determining whether the related party sale is for a foreign use; it does not modify or eliminate the requirement that a seller must sell property to a foreign person for the sale to be a FDDEI sale.

- iv. However, Treasury and the IRS are concerned that U.S. persons that are members of the same modified affiliated group, but not members of a consolidated group, could use this rule to avoid the requirement that a sale be made to a foreign person by inserting a foreign person, such as a foreign partnership, as an intermediary in the sale from one U.S. person to another U.S. person.
- v. They have determined that it would be inappropriate to use the related party sales rules to expand the types of sales that are eligible to be treated as FDDEI sales in this way. Therefore, the rule does not treat a U.S. person as related to the seller if the U.S. person is not related to the seller under the 80% or more standard for vote or value in § 1504(a). Treas. Reg. § 1.250(b)-6(c)(3).

(c) Use in an Unrelated Party Transaction.

- i. For transactions other than the resale of purchased property, such as where the foreign related party uses the purchased property to produce other property that is sold in unrelated party transactions, or where the foreign related party uses the property in the provision of a service in an unrelated party transaction, the proposed regulations provided that the sale of property did not qualify as a FDDEI sale unless, as of the FDII filing date, the seller reasonably expected that more than 80% of the revenue earned by the foreign related party from the use of the property in all transactions would be earned from unrelated party transactions that are FDDEI transactions (determined without regard to the documentation requirements in Treas. Reg. § 1.250(b)-4 or § 1.250(b)-5).
- ii. One comment expressed concern with the 80% rule of the proposed regulations creating a cliff effect whereby a taxpayer would derive no FDII benefit if its revenues fell below this threshold.

- iii. Treasury and the IRS agreed with the comment that the related party sale and related party use rules should have similar standards. To make this rule consistent with the standard in Treas. Reg. § 1.250(b)-6(c)(1)(i), the final regulations modify the rule to require that one or more unrelated party transactions occurs regarding the property. Treasury and the IRS believe that taxpayers have sufficient control over the supply chain involving controlled transactions to make this determination.
- iv. In addition, to eliminate the potential cliff effect, the final regulations removed the 80% rule and instead require the seller in the related party transaction to allocate the buyer's revenues ratably between related and unrelated party transactions based on revenues reasonably expected to be earned as of the FDII filing date. The final regulations also adopted the suggested clarification that revenue should be measured for this purpose based on the price of all transactions with unrelated parties.
- v. Other comments requested clarifications and relevant examples concerning the definition of a component and how a component can be distinguished from a sale of property for use in connection with property sold to an unrelated party.
- vi. In response to the comments, the final regulations remove the reference to "component" in Treas. Reg. § 1.250(b)-6(b)(5)(ii) and replace it with "constituent part" to avoid any implication that the component rule of Treas. Reg. § 1.250(b)-4(d)(1)(iii)(C) may apply. Further, the final regulations modify the rule for a related party use transaction in Treas. Reg. § 1.250(b)-6(b)(3)(iii) to clarify that it does not include transactions in which the purchased property is a constituent part of the product sold, to eliminate any potential overlap with Treas. Reg. § 1.250(b)-6(b)(5)(ii). Lastly, the final regulations modified the example in Treas. Reg. § 1.250(b)-6(c)(4) to clarify that property that is used in connection with a sale to an unrelated party means property that is not a constituent part of the product that is ultimately sold.

2. Related Party Services.

(a) In General.

- i. The proposed regulations generally provided that a provision of a general service to a business recipient that was a related party qualified as a FDDEI service only if the service is not substantially similar to a service provided by the related party to persons located within the U.S.
- ii. One comment noted that, unlike the related party sales rule, the related party services rules of Prop. Treas. Reg. § 1.250(b)-6(d) did not specify whether the substantially similar service needs to be provided before the FDII filing date for the rule to apply.
- iii. Treasury and the IRS agreed with the recommendation that the related party sales and services rules should be made consistent regarding the timing element of the unrelated transaction. Therefore, the final regulations provide that a related party service is a FDDEI service only if the related party service is not substantially similar to a service that has been or will be provided by the related party to a person located within the U.S. The fact that a substantially similar service will occur in a future year does not prevent that substantially similar service from being considered in the determination of whether a related party service is a FDDEI service.

(b) Benefit and Price Tests.

- i. Under the proposed regulations, a service provided by a renderer to a related party was “substantially similar” to a service provided by the related party to a person located within the U.S. if the renderer’s service (or “related party service”) used by the related party to provide a service to a person located within the U.S. and either the “benefit test” or the “price test” was satisfied. The benefit test was satisfied if 60% or more of the benefits conferred by the related party service are to persons located within the U.S. Under the price test, a service provided by a renderer to a related party was “substantially similar” to a service provided by the related party to a person located within the U.S. if the renderer’s service was used by the related party to provide a service to a person located within the U.S. and 60% or more of the price that persons located within the

U.S. pay for the service provided by the related party was attributable to the renderer's service.

- ii. One comment supported these bright line tests for substantially similar services as practicable but asserted it would be burdensome for taxpayers to have to apply both tests, and therefore requested that the final regulations only retain the price test, or alternatively should apply the tests conjunctively so that only if both tests are met is a service considered substantially similar to a service provided by a related party to a person in the U.S.
- iii. Treasury and the IRS believe that these two tests consider distinct factors, both of which are relevant, and therefore the final regulations did not adopt the suggestion that the benefit test be eliminated or that the tests be made conjunctive. Both tests address concerns with "round tripping" arrangements where the provision of services primarily benefits persons within the U.S., but a related party located outside the U.S. is interposed in order to qualify the initial transaction as a FDDEI transaction.
- iv. While the two tests may overlap, they also serve different purposes and address different concerns. One example that implicates the benefit test is when a related party bundles its own services that provide minimal benefit to persons located outside the U.S. with other services that primarily benefit persons located within the U.S. The price test addresses situations such as when a taxpayer provides a broad range of services to a related party located outside the U.S. but one component of the service is provided unchanged to persons located within the U.S. and this is reflected in the price charged to the U.S. customer compared to the price charged to the related party.
- v. However, the final regulations clarify that the benefit test is met only if 60% or more of the benefits conferred by the related party service are directly used by the related party to confer benefits on consumers or business recipients within the U.S. Treas. Reg. § 1.250(b)-6(d)(2)(i).
- vi. For example, if a business recipient located in the U.S. hires the related party to provide a consulting service, and the related party hires the taxpayer to perform research that is used by the related party in performing the consulting service, the related party will have directly used the taxpayer's research in performing the consulting service for

the business recipient located within the U.S. Services provided to the related party that will only indirectly benefit the related party's service recipients (generally, when the related party's service recipients would not be willing to pay for the related party service) are not "substantially similar" to the services provided by the related party.

- vii. Prop. Treas. Reg. § 1.250(b)-6(d)(3) provided that for purposes of applying the price and benefit tests, the location of a consumer or business recipient regarding a related party service was determined under the principles that apply to FDDEI services.
- viii. One comment requested the addition of a clarifying sentence to Prop. Treas. Reg. § 1.250(b)-6(d)(3) indicating that the benefits conferred and price paid for the related party service that is provided to persons located in the U.S. must be allocated based on the locations of the business recipients that benefit from these services provided by the related party.
- ix. In response to this comment, the final regulations clarify that if the related party provides a service to a business recipient, the business recipient is treated as a person located within the U.S. to the extent that the service confers a benefit on the business recipient's operations located within the U.S. The price paid to the related party is allocated proportionally based on the locations of the business recipient that benefit from the services provided by the related party. Treas. Reg. § 1.250(b)-6(d)(3)(i).
- x. The final regulations also clarified that for purposes of applying the price test, if the benefits conferred by the related party service are to persons located in the U.S. and outside the U.S., the price paid by the related party for the related party service is allocated proportionally based on the locations of the business recipient that benefit from the services provided by the related party. Treas. Reg. § 1.250(b)-6(d)(3)(ii). In addition, the examples have been revised to clarify the application of the rules. Treas. Reg. § 1.250(b)-6(d)(4).

P. Prop. Treas. Reg. § 1.962-1.

- 1. Prop. Treas. Reg. § 1.962-1(b)(1)(i) allowed individuals making an election under § 962 to take into account the deduction for GILTI under

§ 250. Specifically, Prop. Treas. Reg. § 1.962-1(b)(1)(i)(A)(2) provided that “taxable income” for purposes of § 962 includes GILTI inclusions, and Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3) specified that the § 250 deduction for GILTI was permitted as a deduction to arrive at “taxable income.” The final regulations retain these rules without change.

2. One comment noted that the reference to § 960(a)(1) in Treas. Reg. § 1.962-1(b)(2) was obsolete after the revisions to § 960 made by the Act, and that the regulations lacked any reference to foreign tax credits regarding GILTI inclusions. Treasury and the IRS agreed with this comment. Accordingly, Treas. Reg. § 1.962-1(a)(2), (b)(2), and (c) have been updated to replace obsolete cross-references to § 960(a)(1) with cross-references to § 960(a); Treas. Reg. § 1.962-1(b)(2) has been updated to clarify that foreign tax credits regarding GILTI inclusions under § 960(d) are available to individuals making § 962 elections (subject to the limitations of § 904(c) and 904(d)(1)(A)); and Treas. Reg. § 1.962-1(c) has been updated to provide a revised example illustrating the application of Treas. Reg. § 1.962-1. The limitation on the § 11(c) surtax exemption (repealed in 1978<sup>8</sup>) provided in Treas. Reg. § 1.962-1(b)(1)(ii) has also been struck from Treas. Reg. § 1.962-1.
3. Finally, Treasury and the IRS understand that there is uncertainty regarding the situations in which individuals may make a § 962 election on an amended return. They are considering issuing further guidance under § 962. Until further guidance on this issue is published, individuals may make an otherwise valid § 962 election on an amended return for the 2018 tax year and subsequent years, regardless of circumstance, provided the interests of the government are not prejudiced by the delay, as described in Treas. Reg. § 301.9100-3(c).
4. For example, the interests of the government could be prejudiced when a § 962 election is made on an amended return resulting in an overpayment in a year for which the period to file a claim for refund is open under § 6511 and simultaneously increasing the amount of U.S. tax due in years for which the assessment period under § 6501 has expired.

Q. Consolidated § 250.

1. Single-Entity Treatment.

- (a) Two comments addressed the computation of a member’s § 250 deduction. The comments generally supported single-entity treatment. However, one comment recommended permitting a taxpayer to elect out of single-entity treatment regarding the § 250 deduction attributable to GILTI.

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<sup>8</sup> Pub. L. No. 95-600, 92 Stat 2763 (1978).

- (b) Treasury and the IRS declined to adopt this recommendation because single-entity treatment ensures that a consolidated group's income tax liability is clearly reflected, as required by § 1502. Permitting taxpayers to elect out of single-entity treatment would incentivize inappropriate planning regarding the location of CFCs within the consolidated group and undermine the policy behind the enactment of § 250.
- 2. Life-Nonlife Consolidated Groups. The second comment raised concerns that the proposed regulations may be incompatible with the rules and framework of Treas. Reg. § 1.1502-47 for life-nonlife consolidated groups. Treasury and the IRS are studying these concerns and request comments on this topic.
- 3. Qualified Business Asset Investment.
  - (a) Prop. Treas. Reg. § 1.1502-50(c)(1) provided that, for purposes of determining a member's QBAI, the basis of specified tangible property did not include an amount equal to any gain or loss realized regarding such property by another member in an intercompany transaction, whether or not this gain or loss is deferred. This rule was intended to negate the impact (whether positive or negative) of an intercompany sale of property on the computation of DII, in accordance with single-entity treatment.
  - (b) However, in most relevant cases, once an intercompany item has been included in income, there are real, external consequences to the group. For example, if gain has been included in consolidated taxable income (and in the tax system), the group should take the associated increase in tax basis into account.
  - (c) Therefore, the final regulations limit the application of the rule negating the impact of intercompany sales of property to the period during which the intercompany gain or loss remains deferred under Treas. Reg. § 1.1502-13. Treas. Reg. § 1.1502-50(c)(1)(i).
  - (d) Treasury and the IRS are also concerned that single-entity treatment is not achieved in certain intercompany transactions involving the transfer of a partnership interest if such transfers result in an increase or decrease in the basis of specified tangible property under § 743(b) and thus impact the computation of DII.
  - (e) The final regulations therefore provide that a member's partner-specific QBAI basis includes a basis adjustment under § 743(b) resulting from an intercompany transaction only when, and to the extent, gain or loss, if any, is recognized in the transaction and no



longer deferred under Treas. Reg. § 1.1502-13. Treas. Reg. § 1.1502-50(c)(1)(ii).

R. Applicability Dates.

1. As proposed, Prop. Treas. Reg. §§ 1.250(a)-1 through 1.250(b)-6 would apply to taxable years ending on or after March 4, 2019. However, the proposed regulations also provided that, for taxable years beginning on or before March 4, 2019, taxpayers may use any reasonable documentation maintained in the ordinary course of the taxpayer's business that establishes that a recipient is a foreign person, property is for a foreign use (within the meaning of Prop. Treas. Reg. § 1.250(b)-4(d) and (e)), or a recipient of a general service is located outside the U.S. (within the meaning of Prop. Treas. Reg. § 1.250(b)-5(d)(2) and (e)(2)), as applicable, in lieu of the documentation required in Prop. Treas. Reg. §§ 1.250(b)-4(c)(2), (d)(3), and (e)(3) and 1.250(b)-5(d)(3) and (e)(3), provided that the documentation meets the reliability requirements described in Prop. Treas. Reg. § 1.250(b)-3(d). The proposed regulations also provided that taxpayers may rely on Prop. Treas. Reg. §§ 1.250(a)-1 through 1.250(b)-6 for taxable years ending before March 4, 2019.
2. The final regulations modified the applicability dates in Prop. Treas. Reg. §§ 1.250(a)-1 through 1.250(b)-6 as follows. Except for Treas. Reg. § 1.250(b)-2(h), the rules in Treas. Reg. §§ 1.250(a)-1 through 1.250(b)-6 apply to taxable years beginning on or after January 1, 2021. Treas. Reg. § 1.250(b)-2(h), which contains an anti-abuse rule for certain transfers of property, applies to taxable years ending on or after March 4, 2019, consistent with the applicability date in the proposed regulations.
3. However, taxpayers may choose to apply the final regulations to taxable years beginning before January 1, 2021, provided that they apply the final regulations in their entirety (other than the special substantiation requirements in Treas. Reg. § 1.250(b)-3(f) and the applicable provisions in Treas. Reg. § 1.250(b)-4(d)(3) or Treas. Reg. § 1.250(b)-5(e)(4)). § 7805(b)(7). Taxpayers will be required to substantiate under § 6001 that any sale or service qualifies for a § 250 deduction. Alternatively, taxpayers may rely on Prop. Treas. Reg. §§ 1.250(a)-1 through 1.250(b)-6 in their entirety for taxable years beginning before January 1, 2021, except that taxpayers relying on the proposed regulations may rely on the transition rule for documentation for all taxable years beginning before January 1, 2021 (rather than only for taxable years beginning on or before March 4, 2019).
4. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3), which allows individuals making an election under § 962 to take into account the § 250 deduction, applies to taxable years of a foreign corporation ending on or after March 4, 2019,

and regarding a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends.

5. Prop. Treas. Reg. § 1.962-1(b)(1)(i)(A)(2), which updated the regulations to conform to the enactment of § 951A by providing that “taxable income” for purposes of § 962 includes GILTI inclusions, is proposed to apply beginning with the last taxable year of a foreign corporation beginning before January 1, 2018, and regarding a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends. The final regulations provide that Treas. Reg. § 1.962-1(b)(1)(i)(A)(2) applies to taxable years of a foreign corporation ending on or after March 4, 2019, and regarding a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends. Under § 951A(f)(1)(A), GILTI inclusions are treated in the same manner as amounts included under § 951(a)(1)(A) for purposes of § 962. Accordingly, individuals making an election under § 962 were required to include GILTI in “taxable income” for purposes of § 962 irrespective of this update to the regulations.
6. Treas. Reg. § 1.962-1(a)(2), (b)(1)(ii), (b)(2)(i) through (iii), and (c), which update obsolete cross-references to former § 960(a)(1), strike the § 11(c) surtax exemption limitation, update rules on the allowance of foreign tax credits to individuals making an election under § 962 (including regarding the carryback and carryover of such credits), and provide an updated example illustrating the application of Treas. Reg. § 1.962-1, apply to taxable years of a foreign corporation ending on or after the publication, and regarding a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends. Regarding foreign tax credits, § 960(d) provides domestic corporations (which includes individuals making an election under § 962) a credit for taxes attributable to tested income, and § 904(c) and 904(d)(1)(A) prohibit taxpayers from carrying back or carrying over any excess foreign taxes attributable to tested income as a credit in their first preceding taxable years and in any of their first 10 succeeding taxable years. Accordingly, individuals making an election under § 962 that claimed foreign tax credits attributable to tested income were subject to the limitations of §§ 960(d), 904(c), and 904(d)(1)(A) irrespective of the updates to the regulations.
7. One comment requested clarification that Prop. Treas. Reg. § 1.962-1 can be applied for taxable years beginning in 2018. Regarding taxable years before the relevant final regulations are applicable, the final regulations provide that taxpayers may choose to apply the provisions of Treas. Reg. § 1.962-1(a)(2), (b)(1)(i)(A)(2), (b)(1)(i)(B)(3), (b)(1)(ii), (b)(2)(i) through (iii), and (c) for taxable years of a foreign corporation beginning on or after January 1, 2018, and regarding a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends.

8. Prop. Treas. Reg. § 1.1502-50 was proposed to apply to consolidated return years ending on or after publication. The final regulations provide that Treas. Reg. § 1.1502-50 applies to consolidated return years beginning on or after January 1, 2021. Taxpayers that choose to apply the final regulations under Treas. Reg. §§ 1.250(a)-1 through 1.250(b)-6 to taxable years beginning before January 1, 2021, must also apply the provisions in Treas. Reg. § 1.1502-50 to such years. Similarly, taxpayers that rely on Prop. Treas. Reg. §§ 1.250(a)-1 through 1.250(b)-6 for taxable years beginning before January 1, 2021, must also follow Prop. Treas. Reg. § 1.1502-50.
9. Prop. Treas. Reg. §§ 1.6038-2(f)(15) and 1.6038A-2(b)(5)(iv) are proposed to apply regarding information for annual accounting periods beginning on or after March 4, 2019. §§ 6038(a)(3) and 7805(b)(1)(B). Prop. Treas. Reg. § 1.6038-3(g)(4) is proposed to apply to taxable years of a foreign partnership beginning on or after March 4, 2019. § 7805(b)(1)(B). No changes were made to the proposed applicability date in the final regulations.

#### IV. FINAL BEAT REGULATIONS.

- A. The final BEAT regulations retain the basic approach and structure of the proposed regulations, with certain clarifying revisions. They address the provisions dealing with aggregate groups, the important election to waive deductions, and partnerships.
- B. Summary.
  1. When members of an aggregate group join or leave the group, the final regulations like the proposed regulations, implement a cut-off rule that deems the taxable year closed. The proposed regulations used a “time of transaction” rule, but the final regulations contain an “end of the day of transaction” rule. They also contain an annualization rule and a specific anti-abuse provision.
  2. The final regulations continue to allow taxpayers to make or increase a BEAT waiver-of-deductions election on an amended return or during the course of an examination. However, they do not allow taxpayers to decrease the amount of the deductions waiver or revoke the election on an amended return or during examination. Thus, it would seem generally better to underestimate a waiver amount than to overestimate it.
- C. Aggregate Group. BEAT applies only to a taxpayer that is an applicable taxpayer which is determined based upon gross receipts and the base erosion percentage applied on an aggregate group basis. The proposed regulations provided guidance regarding how a taxpayer determines its aggregate group, including rules relating

to short taxable years, members joining and leaving a taxpayer's aggregate group, and predecessors.

1. Short Taxable Year.

- (a) Under the proposed regulations a taxpayer with a short taxable year was required to annualize its gross receipts by multiplying the gross receipts for the short taxable year by 365 and dividing the result by the number of days in the short taxable year. The proposed regulations indicated that, in determining whether the taxpayer's aggregate group satisfied the gross receipts test and base erosion percentage test for the taxpayer's short taxable year, a reasonable approach could be used as long as it neither over-counted nor under-counted the gross receipts, base erosion tax benefits, and deductions of the members of the taxpayer's aggregate group.
- (b) One comment supported the reasonable approach and viewed more detailed guidance regarding short taxable years as unnecessary. The comment stated that the operation of the with-or-within method, in conjunction with a reasonable approach to taking into account gross receipts, base erosion tax benefits, and deductions of aggregate group members, would prevent either the over-counting or under-counting of items in situations involving short taxable years. However, the comment also suggested that a reasonable approach would exclude the gross receipts, base erosion tax benefits, and deductions of an aggregate group member if the member's taxable year did not end with or within a short taxable year of the taxpayer.
- (c) Treasury and the IRS agreed that a reasonable approach should prevent over-counting and under-counting. Therefore, the final regulations retain the rule in the proposed regulations that permits the use of a reasonable approach to determine whether a taxpayer's aggregate group meets the gross receipts test and base erosion percentage test regarding a short taxable year of the taxpayer.
- (d) However, Treasury and the IRS are concerned that when a member does not have a taxable year that ends with or within a short taxable year of a taxpayer, some taxpayers could take the view that excluding the gross receipts, base erosion tax benefits, and deductions of the member from the taxpayer's aggregate group is a reasonable approach. Treasury and the IRS believe this would not be a reasonable approach. Accordingly, the final regulations clarify that such a method would not be a reasonable approach. In addition, to provide guidance for taxpayers in determining whether a particular approach is reasonable and does not over-count nor

under-count, the final regulations include examples of methods addressing reasonable approaches.

2. Aggregate Group Changes.

- (a) The proposed regulations provided guidance regarding how the gross receipts and the base erosion percentage of an aggregate group should be determined when members join or leave a taxpayer's aggregate group, such as through a sale of the stock of a member to a third party. In determining the gross receipts and the base erosion percentage of a taxpayer's aggregate group, only items of members that occurred during the period that they were members of the taxpayer's aggregate group were taken into account. Under this rule, items of a member that occurred before the member joined the aggregate group of the taxpayer or after the member left the aggregate group of the taxpayer were not taken into account in determining the gross receipts or base erosion percentage of the taxpayer's aggregate group.
- (b) To implement this cut-off approach the proposed regulations created a deemed taxable year-end that occurred immediately before the corporation joined or left the aggregate group ("time-of-transaction" rule). The proposed regulations permitted a taxpayer to determine items attributable to this deemed short taxable year by either deeming a close of the corporation's books or, in the case of items other than extraordinary items, making a pro-rata allocation without a closing of the books.
- (c) Comments requested that the deemed taxable year-end occur at the end of the day, rather than immediately before the time of the transaction, to better align with other provisions of the Code and regulations. Comments noted that an end-of-day rule would be more consistent with provisions of the Code and regulations such as § 381 and Treas. Reg. § 1.1502-76(b).
- (d) The final regulations incorporate this recommendation. A new taxable year is deemed to begin at the beginning of the day after the transaction. A taxpayer determines items attributable to the deemed short taxable years ending upon and beginning the day after the deemed taxable year-end by either deeming a close of the corporation's books or, in the case of items other than extraordinary items, making a pro-rata allocation without a closing of the books. Extraordinary items that occur on the day of, but after, the transaction that causes the corporation to join or leave the aggregate group are treated as occurring in the deemed taxable year beginning the next day. For this purpose, the term "extraordinary items" has the meaning provided in Treas. Reg.

§ 1.1502-76(b)(2)(ii)(C). This term is also expanded to include any other payment that is not made in the ordinary course of business and that would be treated as a base erosion payment.

(e) Alternative to Deemed Year-End Approach.

- i. One comment supported the approach in the proposed regulations to the deemed year-end rule, which it noted allowed taxpayers flexibility to choose between the pro-rata allocation or closing of the books methods. The comment also expressed support for a simplified “no-cut-off” alternative to the deemed year-end framework in the proposed regulations, which could reduce the need for sharing information between a selling aggregate group and a purchaser.
- ii. Under the comment’s simplified “no-cut-off” alternative, there would be no deemed year-end upon a corporation’s entry to or exit from an aggregate group; rather, the corporation’s full year would be taken into account by the acquirer’s aggregate group. The comment acknowledged that this simplified approach would result in the “departed” aggregate group including no items for the year and the “acquiring” aggregate group taking into account all of the corporation’s items for the year, which could cause distortions. The comment also suggested that it might be appropriate to backstop this simplified “no-cut-off” rule with an anti-abuse rule that requires a deemed year-end if the transaction is arranged with a principal purpose of enabling a taxpayer to fall below the gross receipts or base erosion percentage thresholds.
- iii. The final regulations did not adopt the simplified “no-cut-off” alternative. Treasury and the IRS believe that such a “no-cut-off” alternative would be inherently less precise and had the potential for abuse.

(f) Members with Different Taxable Years.

- i. A comment expressed concern that the deemed close of the taxable year that occurs when a member joins or leaves an aggregate group would create the potential for over-counting of gross receipts, base erosion tax benefits, and deductions of a member when applied in conjunction with the with-or-within method. This situation could arise when the taxpayer and a member of the aggregate group have different taxable years.

- ii. The comment recommended that an annualization rule or another alternative apply to the gross receipts test so that a taxpayer is not required to take into account more than 12 months of gross receipts of an aggregate group member when a member joins or leaves an aggregate group. The comment also suggested that an annualization rule may be appropriate for the base erosion percentage test because an annualization rule would avoid over-weighting base erosion tax benefits and deductions.
- iii. The final regulations adopted this comment. Treas. Reg. § 1.59A-2(c)(5)(ii)(A) provides that, if a member of a taxpayer's aggregate group has more than one taxable year that ends with or within the taxpayer's taxable year and together those taxable years are comprised of more than 12 months, then the member's gross receipts, base erosion tax benefits, and deductions for those years are annualized to 12 months for purposes of determining the gross receipts and base erosion percentage of the taxpayer's aggregate group. To annualize, the amount is multiplied by 365 and the result is divided by the total number of days in the year or years.
- iv. The final regulations also include a rule to address short taxable years of members. Specifically, if a member of the taxpayer's aggregate group changes its taxable year-end, and as a result the member's taxable year (or years) ending with or within the taxpayer's taxable year is comprised of fewer than 12 months, then for purposes of determining the gross receipts and base erosion percentage of the taxpayer's aggregate group, the member's gross receipts, base erosion tax benefits, and deductions for that year (or years) are annualized to 12 months. This rule does not apply if the change in the taxable year-end is a result of the application of Treas. Reg. § 1.1502-76(a), which provides that new members of a consolidated group adopt the common parent's taxable year.
- v. For example, assume that an aggregate group member and the taxpayer both have calendar-year taxable years; then, in January of 2021, the aggregate group member changes its taxable year-end to January 31. Under these facts, the taxpayer's 2021 calendar year would only include the gross receipts, base erosion tax benefits, and deductions of the one-month short year of the aggregate group member because that is the only taxable year of the member that

ends with or within the taxpayer's calendar year taxable year.

- vi. Gross receipts would be undercounted, and the member's contribution to the aggregate group's base erosion percentage would be given insufficient weight in the taxpayer's 2021 calendar year. This difference would not resolve itself in subsequent years because, in the taxpayer's 2022 taxable year and each taxable year thereafter, the taxpayer will take into account only a 12-month period regarding the aggregate group member – the taxable year from February 1 through January 31.
- vii. Thus, absent this rule, the equivalent of 11 months of the member's contributions to the gross receipts and base erosion percentage would not be taken into account by the aggregate group because the taxpayer's 2021 calendar year computation would only include one month of aggregate group member activity. Accordingly, the final regulations provide that the member's gross receipts, base erosion tax benefits, and deductions for its one-month short-year ending January 31, 2021, are extrapolated and annualized to a full 12-month period solely for purposes of determining the gross receipts and base erosion percentage of the taxpayer's aggregate group when resulting from a change in taxable year.
- viii. The final regulations also include an anti-abuse rule to address other types of transactions that could achieve a similar result of excluding gross receipts or base erosion percentage items of a taxpayer or a member of the taxpayer's aggregate group that are undertaken with a principal purpose of avoiding applicable taxpayer status.
- ix. Assuming a requisite principal purpose, an example that could implicate this rule includes a transaction in which a taxpayer that is close to satisfying the gross receipts test transfers a portion of its revenue-generating assets to a newly formed domestic corporation that is a member of the taxpayer's aggregate group (but not a member of the taxpayer's consolidated group) and that has a different taxable year that does not end with or within the taxpayer's current taxable year. Another example, also assuming a requisite principal purpose, would be a transaction in which the stock of a member of the taxpayer's aggregate group is transferred to a consolidated group that is also a member of the taxpayer's aggregate group but that has a different



taxable year that does not end with or within the taxpayer's current taxable year.

(g) Deferred Deductions.

- i. A comment requested that Treas. Reg. § 1.59A-2(c)(4) be revised to clarify the treatment of items that are paid or accrued in a period before a corporation joins a taxpayer's aggregate group. As an example, the comment described a corporation's payment of interest to a foreign related party that gives rise to a base erosion payment in the taxable year of the payment, but that is not a base erosion tax benefit because the item is not currently deductible due to the limitations on deducting business interest expense in § 163(j). The comment suggested that, if the corporation subsequently becomes a member of an aggregate group of a different taxpayer (for example, because the corporation is sold to an unrelated buyer, and thereafter becomes a member of the buyer's aggregate group), the buyer's aggregate group should not have to take into account the base erosion tax benefit in the buyer's base erosion percentage when the business interest expense becomes deductible under § 163(j).
- ii. Treasury and the IRS did not agree with this comment. Under the statutory framework of the BEAT, whether a deduction is a base erosion tax benefit is determined solely regarding whether the amount was a base erosion payment when it was paid or accrued. Section 59A(c)(2) and Treas. Reg. § 1.59A-3(c)(1) do not retest the base erosion payment to determine whether the payee continues to be a foreign related party of the taxpayer when the taxpayer claims the deduction.

3. Predecessors and Successors.

- (a) Under proposed regulations, in determining gross receipts, any reference to a taxpayer included a reference to any predecessor of the taxpayer, including the distributor or transferor corporation in a transaction described in § 381(a) in which the taxpayer was the acquiring corporation. To prevent over-counting, the proposed regulations provided that, if the taxpayer or any member of its aggregate group was also a predecessor of the taxpayer or any member of its aggregate group, the gross receipts, base erosion tax benefits, and deductions of each member would be taken into account only once.

- (b) A comment recommended taking into account gross receipts of foreign predecessor corporations only to the extent they are taken into account in determining income that is effectively connected with the conduct of a U.S. trade or business (“ECI”) of the foreign predecessor corporation, which would be consistent with the ECI rule for gross receipts of foreign corporations in Treas. Reg. § 1.59A-2(d).
- (c) The final regulations include this comment. Treas. Reg. § 1.59A-2(c)(6)(i) clarifies that the operating rules set forth in Treas. Reg. § 1.59A-2(c) (aggregation rules) and Treas. Reg. § 1.59A-2(d) (gross receipts test) apply to the same extent in the context of the predecessor rule. Thus, the ECI limitation on gross receipts in Treas. Reg. § 1.59A-2(d)(3) continues to apply to the successor.

D. Election to Waive Deductions.

- 1. The proposed regulations provided that a taxpayer can elect to forego a deduction (the “BEAT waiver election”), and that the foregone deduction would not be treated as a base erosion tax benefit. This was a good proposal. It would help to avoid the BEAT rules’ “cliff effect,” including unpleasant surprises during an IRS examination.
- 2. Any deduction waived pursuant to the BEAT waiver election was waived for all U.S. federal income tax purposes. The proposed regulations permitted a taxpayer to make the BEAT waiver election on its original filed Federal income tax return, on an amended return, or during the course of an examination of the taxpayer’s income tax return for the relevant taxable year pursuant to procedures prescribed by the IRS.
- 3. Eligibility for the BEAT Waiver Election.
  - (a) The proposed regulations provided that the BEAT waiver election was the sole method by which a deduction that could be properly claimed by taxpayer for the taxable year would not be taken into account for BEAT purposes (the “primacy rule”).
  - (b) A comment suggested that the phrase “solely for purposes of” in Prop. Treas. Reg. § 1.59A-3(c)(6)(i) was unclear. The comment interpreted the proposed regulations as providing that a taxpayer could make the BEAT waiver election only if the waiver of a deduction, when taken together with any waivers by other members of the taxpayer’s aggregate group, would lower the taxpayer’s base erosion percentage below the base erosion percentage threshold applicable to the taxpayer. The comment also recommended that Treasury and the IRS clarify that the primacy rule and the BEAT waiver election do not affect a taxpayer’s

ability to not claim allowable deductions for tax purposes other than § 59A.

- (c) The final regulations explicitly provide that, in order to make or increase the BEAT waiver election, the taxpayer must determine that the taxpayer would be an applicable taxpayer for BEAT purposes but for the BEAT waiver election. Thus, for example, a controlled foreign corporation that does not have income that is effectively connected with the conduct of a trade or business in the U.S. cannot make a BEAT waiver election because the controlled foreign corporation cannot be an applicable taxpayer.
- (d) In addition, when a taxpayer does not make a BEAT waiver election (or when this waiver is not permitted), Treas. Reg. § 1.59A-3(c)(5) and Treas. Reg. § 1.59A-3(c)(6)(i) have no bearing on whether or how a taxpayer's failure to claim an allowable deduction, or to otherwise "waive" a deduction, is respected or taken into account for tax purposes other than § 59A. In other words, the BEAT waiver election should not affect any existing law addressing "waiver" outside of the specific situation covered by the BEAT waiver (electing not to claim a deduction in order to avoid applicable taxpayer status).

4. Base Erosion Percentage Denominator. A comment said that a waived deduction should be included in the denominator of the base erosion percentage. The final regulations do not reflect this comment.

5. No Reduction of Waived Deductions.

- (a) The proposed regulations provided that a taxpayer could make or increase a BEAT waiver election on an amended Federal income tax return or during the course of an examination of the taxpayer's income tax return. However, a taxpayer could not decrease the amount of deductions waived under the BEAT waiver election or revoke that election on any amended Federal income tax return or during an examination.
- (b) Comments requested that the final regulations permit taxpayers to decrease the amount of deductions that are waived either by filing an amended Federal income tax return or during an examination.
- (c) As noted above, the final regulations do not reflect this comment. Treasury and the IRS believe that providing taxpayers with the ability to decrease waived amounts would not further the policy goal of addressing the cliff effect of applicable taxpayer status. The proposed regulations provided taxpayers significant flexibility through the BEAT waiver election, which permits taxpayers to

choose deductions to waive based on tax optimization and to elect to increase waived deductions at various points after filing their original return, including during an examination.

- (d) Treasury and the IRS are concerned that expanding taxpayer electivity to permit the reduction of waived amounts would increase uncertainty to the IRS as it assesses tax return positions. They believe that this uncertainty about taxpayers' return positions would negatively affect the ability of the IRS to efficiently conduct and close examinations.

6. Waiver of Life and Non-Life Reinsurance Premiums.

- (a) The BEAT waiver election in the proposed regulations specifically referenced deductions. Comments noted that the term "base erosion tax benefits" includes certain reductions to gross income related to reinsurance that may be treated as reductions to gross receipts, not deductions. Because premiums that are reductions to gross income do not technically fit within the terminology used in the waiver provisions, comments requested that final regulations permit a waiver for those items.
- (b) Treasury and the IRS believe that the policy rationale for providing the BEAT waiver election applies to insurance-related base erosion payments, and therefore that the BEAT waiver election should be available regarding base erosion tax benefits described in Treas. Reg. § 1.59A-3(b)(1)(iii). The final regulations thus include a provision for the waiver of amounts treated as reductions to gross premiums and other consideration that would otherwise be base erosion tax benefits within the definition of § 59A(c)(2)(A)(iii) and provide that similar operational and procedural rules apply to this waiver, such as the rule providing that the waiver applies for all purposes of the Code and regulations.
- (c) The BEAT waiver election affects the base erosion tax benefits of the taxpayer, not the amount of premium that the taxpayer pays to a foreign insurer or reinsurer (or the amount received by that foreign insurer or reinsurer). Treasury and the IRS stated that, therefore, for example, the waiver of reduction to gross premiums and other consideration (or of premium payments that are deductions for federal income tax purposes) does not reduce the amount of any insurance premium payments that are subject to insurance excise tax under § 4371.

7. Revoking Elections and Retroactive Elections.

- (a) Comments said that certain taxpayers filed elections in connection with their 2018 tax returns to either (i) elect under § 59(e)(4) to capitalize and amortize over a 10-year period certain research and experimentation (“R&E”) expenditures that would otherwise be deductible in the year incurred, or (ii) elect not to claim an additional allowance for depreciation under § 168(k) (“bonus depreciation”) before the issuance of the proposed regulations that provided taxpayers with the option of the BEAT waiver election.
- (b) The § 59(e)(4) and bonus depreciation elections are revocable only with the consent of the IRS. The comments implied that, if taxpayers had known about the BEAT waiver election when they filed their returns, the taxpayers would not have made the elections under § 59(e)(4) or § 168(k)(7) because the BEAT waiver election would have been a better tax planning technique. The comments recommended that Treasury and the IRS provide automatic relief for taxpayers that seek to revoke their prior elections under § 59(e)(4) or § 168(k)(7) in light of the BEAT waiver election.
- (c) Another comment recommended that Treasury and the IRS also permit taxpayers to make retroactive elections to capitalize and amortize costs under § 59A(e)(4) or to not claim bonus depreciation under § 168(k) to provide relief from “permanent BEAT consequences.” The comment cited an example where the taxpayer is entitled to additional deductions or has less regular taxable income in a taxable year as a result of an audit; consequently, the taxpayer had an “unintended” tax liability under § 59A. The comment proposed that Treasury and the IRS permit a taxpayer to retroactively elect to capitalize costs that were previously reported as deductible in the taxable year.
- (d) The final regulations did not adopt these recommendations to provide guidance permitting taxpayers to automatically revoke prior capitalization elections under sections 59(e)(4) and 168(k) or make late elections. Treasury and the IRS believe that the use of hindsight in elections involves tax policy considerations more broad than the interaction of the BEAT and the elections under § 59(e)(4) and § 168(k).

8. Procedures.

- (a) Documentation Requirements.
  - i. Under the proposed regulations, a taxpayer was required to provide, among other information, a detailed description of

the item or property to which the deduction related, including sufficient information to identify that item or property on the taxpayer's books and records.

- ii. A comment suggested that the final regulations eliminate the information required by Treas. Reg. § 1.59A-3(c)(6)(i)(A) through (C) (the detailed description, the date or period of the payment or accrual; and the citation for the deduction). The comment stated that the final regulations should eliminate Treas. Reg. § 1.59A-3(c)(6)(i)(A) because a streamlined disclosure that includes only the amount deducted (Prop. Treas. Reg. § 1.59A-3(c)(6)(i)(D)), amount waived (Prop. Treas. Reg. § 1.59A-3(c)(6)(i)(E)), tax return line item (Prop. Treas. Reg. § 1.59A-3(c)(6)(i)(F)), and foreign recipient (Prop. Treas. Reg. § 1.59A-3(c)(6)(i)(G)) would provide sufficient information for the IRS to determine the validity of the election without creating an undue burden on taxpayers. While the comment characterized the information reporting requirements as “onerous,” it did not explicitly describe how or why this requirement is onerous.
- iii. The final regulations retain the requirements of Prop. Treas. Reg. § 1.59A-3(c)(6)(i)(A) through (C). Treasury and the IRS believe that the IRS has an interest in obtaining information regarding the deductions being waived and the item or property to which the deduction relates.
- iv. However, they acknowledged that requiring a “detailed” description of the item or property to which the deduction relates is not necessary for this purpose, particularly given that Treas. Reg. § 1.59A-3(c)(6)(ii)(B)(1) requires sufficient information to identify the item or property on the taxpayer's books. Accordingly, Treas. Reg. § 1.59A-3(c)(6)(ii)(B)(1) omits the requirement to provide a “detailed” description. Treas. Reg. § 1.59A-3(c)(6)(ii)(B)(6) and (7) was also revised to make certain non-substantive, clarifying changes.

(b) Partial Waivers.

- i. The proposed regulations provided that if a taxpayer makes the election to waive a deduction, in whole or in part, the election is disregarded for certain purposes.
- ii. A comment observed that the proposed regulations do not expressly provide that the BEAT waiver election permits a

partial waiver of a deduction. The comment also suggested that procedural forms should be clear in this regard.

- iii. The final regulations were revised to state more explicitly that a deduction may be waived in part. Additionally, the IRS plans to revise Form 8991, *Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*, to incorporate reporting requirements relating to the reporting of deductions that taxpayers have partially waived.

(c) BEAT Waiver During an Examination.

- i. A comment said that the final regulations should permit a taxpayer to make the BEAT waiver election at any time during the course of an examination, including after all other adjustments have been agreed upon. Additionally, the comment recommended that the IRS consider providing a streamlined procedure for taxpayers to make the BEAT waiver election in connection with examinations that would not require the filing of an amended return because filing an amended return could be burdensome.
- ii. The final regulations did not adopt these recommendations because the Internal Revenue Manual (“IRM”) already provides a procedure that permits taxpayers to submit informal claims, including the BEAT waiver election, during the course of an examination. *See* IRM § 4.46.3.7. Treasury and the IRS believe the IRM procedure serves an important tax administration function—preserving the IRS’s ability to conduct an audit efficiently and ensuring that the IRS has sufficient time to evaluate the merits of the claims.

9. Application to Partnerships.

- (a) Comments recommended generally that the BEAT waiver election be expanded to expressly permit a waiver in connection with deductions that are allocated from a partnership. Some comments recommended that the final regulations clarify that the BEAT waiver election is made by the partner, rather than by the partnership. These comments suggested certain corresponding changes necessary to coordinate the tax treatment of partners and partnerships.
- (b) Specifically, a comment recommended that the waived deductions be treated as non-deductible expenditures under § 705(a)(2)(B) – thereby reducing the adjusted basis of a partner’s interest in a

partnership – to prevent a corporate partner from subsequently benefitting from waived partnership deductions when disposing of its interest in the partnership.

- (c) The final regulations generally adopted these comments and, subject to certain special rules in connection with the centralized partnership audit regime enacted in the Bipartisan Budget Act of 2015 (the “BBA”), explicitly permit a corporate partner in a partnership to make a BEAT waiver election regarding partnership items. The final regulations also clarify that a partnership may not make a BEAT waiver election. In addition, they provide that waived deductions are treated as non-deductible expenditures under § 705(a)(2)(B).
- (d) The final regulations also provide rules to conform the partner-level waiver with § 163(j). See Treas. Reg. § 1.59A-3(c)(6)(iv)(C). Specifically, the final regulations provide that, when a partner waives a deduction that was taken into account by the partnership to reduce the partnership’s adjusted taxable income for purposes of determining the partnership-level § 163(j) limitation, the increase in the partner’s income resulting from the waiver is treated as a partner basis item (as defined in Treas. Reg. § 1.163(j)-6(b)(2)) for the partner, but not the partnership. Thus, the increase in the partner’s income resulting from the waiver is added to the partner’s § 163(j) limitation computation. Treas. Reg. § 1.59A-3(c)(6)(iv)(C). The partnership’s § 163(j) computations are not impacted by the partner’s waiver.
- (e) Another comment recommended that, if waiver of partnership deductions is permitted, the effect of the waiver should be reconciled with the centralized partnership audit regime enacted by the BBA in sections 6221 through 6241 (the “BBA audit procedures”). Under the BBA audit procedures, adjustments must be made at the partnership level. Generally, the partnership is liable for an imputed underpayment computed on the adjustments unless the partnership elects to “push out” the adjustments to the partners from the year to which the adjustments relate (reviewed year partners).
- (f) The final regulations provide that a partner can make the BEAT waiver election regarding an increase in a deduction that is attributable to an adjustment made under the BBA audit procedures, but only if the partner is taking into account the partnership adjustments either because the partnership elects to have the partners take into account the adjustments under sections 6226 or 6227, or because the partner takes into account the



adjustments as part of an amended return filed pursuant to § 6225(c)(2)(A).

- (g) If the partner makes the BEAT waiver election, the partner must compute its additional reporting year tax (as described in Treas. Reg. § 301.6226-3) or the amount due under Treas. Reg. § 301.6225-2(d)(2)(ii)(A), treating the waived amount as provided in Treas. Reg. § 1.59A-3(c)(6).
- (h) The final regulations do not address the interaction of the BBA audit procedures and the BEAT more generally. As the BBA audit procedures continue to be implemented, Treasury and the IRS will review the implementation and determine whether future BBA audit procedure guidance is required regarding BEAT.
- (i) A comment said that § 6222 generally requires a partner to treat a partnership item on its return consistently with the treatment of the item on the partnership return or otherwise to notify the IRS of this inconsistent treatment. This comment recommended that the final regulations coordinate and streamline the notification procedure under § 6222 and Treas. Reg. § 301.6222-1 with the information required under Prop. Treas. Reg. § 1.59A-3(c)(6)(i)(A) through (G).
- (j) The final regulations do not reflect this comment because the reporting by a partner of the partnership item that is waived pursuant to the procedures set forth in Treas. Reg. § 1.59A-3(c)(6)(ii)(B) is consistent with the reporting of the item for purposes of § 6222. After the election is made, the partnership-related item is being reported properly at the partner level, after taking into account the partner's facts and circumstances and application of the Code and regulations to that item (that is, the waiver). The fact that an item is waived pursuant to Treas. Reg. § 1.59A-3(c)(6) does not constitute inconsistent reporting for purposes of § 6222 but is merely applying the Code and regulations to determine the taxability of that item.
- (k) Application to Consolidated Groups. A comment recommended that the final regulations clarify that waived deductions attributable to a consolidated group member are treated as noncapital, nondeductible expenses that decrease the tax basis in the member's stock for purposes of the stock basis rules in Treas. Reg. § 1.1502-32 to prevent the shareholder from subsequently benefitting from a waived deduction when disposing of the member's stock. The final regulations adopted this comment.

(1) Interaction of Waived Deductions with Other Regulations.

- i. The proposed regulations included specific references to provisions of the Code and regulations that are not affected by the BEAT waiver election. The proposed regulations also provided that waived deductions must be taken into account as necessary to prevent a taxpayer from receiving the benefit of a waived deduction. No comments addressed this aspect of the proposed regulations.
- ii. The final regulations retain these rules, which may apply when other deductible expenses are taken into account for other specific purposes of the Code because the item was an expense (rather than because the item was deducted), such as the fact that waived deductions are still taken into account for purposes of determining the amount of the taxpayer's earnings and profits under Treas. Reg. § 1.59A-3(c)(6)(iii)(B)(6).

E. Application of BEAT to Partnerships. The 2019 final regulations set forth operating rules for applying the BEAT to partnerships. In general, the final regulations provide that a partnership is treated as an aggregate of its partners and, accordingly, deem certain transactions to have occurred at the partner level for BEAT purposes even though they may be treated as having occurred at the partnership level for other tax purposes.

1. Effectively Connected Income.

- (a) The 2019 final regulations provide an exception (the "ECI exception") whereby a base erosion payment does not result from amounts paid or accrued to a foreign related party that are subject to tax as ECI. To qualify for the ECI exception, the taxpayer must receive a withholding certificate on which the foreign related party claims an exemption from withholding under § 1441 or 1442 because the amounts are ECI. The 2019 final regulations do not set out specific rules for applying the ECI exception to transactions involving partnerships.
- (b) A comment generally supported applying an ECI exception to partnership transactions where the taxpayer is treated as making a base erosion payment as a result of a deemed transaction with a foreign related party, and where the foreign related party is subject to U.S. federal income tax on allocations of income from the partnership. Treasury and the IRS generally agreed with this comment and revised the final regulations in Treas. Reg. § 1.59A-3(b)(3)(iii)(C) to expand the ECI exception to apply to certain partnership transactions.

- (c) The expanded ECI exception in Treas. Reg. § 1.59A-3(b)(3)(iii)(C) applies if the exception in Treas. Reg. § 1.59A-3(b)(3)(iii)(A) or (B) would have applied to the payment or accrual as characterized under Treas. Reg. § 1.59A-7(b) and (c) for purposes of § 59A (assuming any necessary withholding certificate were obtained).
- (d) Thus, for example, if a U.S. taxpayer purchases an interest in a partnership from a foreign related party, then under the general BEAT partnership rules for transfers of a partnership interest, this transaction is treated as a transfer by the foreign related party of a portion of the partnership assets to the U.S. taxpayer. To the extent that these partnership assets are used or held for use in connection with the conduct of a trade or business within the U.S., this situation is similar to a situation where the foreign related party directly holds the assets that produce ECI (for example, in a U.S. branch). In that analogous situation, an acquisition of those assets by the U.S. taxpayer from the foreign related party would have been eligible for the ECI exception reflected in Treas. Reg. § 1.59A-3(b)(3)(iii).
- (e) The ECI exception reflected in Treas. Reg. § 1.59A-3(b)(3)(iii)(C) also may apply in other situations, such as when (i) a U.S. taxpayer contributes cash and a foreign related party of the U.S. taxpayer contributes depreciable property to the partnership (see Treas. Reg. § 1.59A-7(c)(3)(iii)), (ii) a partnership with a partner that is a foreign related party of the taxpayer partner engages in a transaction with the taxpayer (*see* Treas. Reg. § 1.59A-7(c)(1)), or (iii) a partnership engages in a transaction with a foreign related party of a partner in the partnership.
- (f) The general ECI exception reflected in Treas. Reg. § 1.59A-3(b)(3)(iii)(A) would not apply if a U.S. person purchased depreciable or amortizable property from a foreign related party and that property was not held in connection with a U.S. trade or business. Similarly, when a U.S. person is treated as purchasing the same depreciable or amortizable property from a foreign related party under Treas. Reg. § 1.59A-7(c)(3)(iii) because the foreign related party contributes that property to a partnership, the ECI exception does not apply even though the property becomes a partnership asset after the transaction and the partnership uses the property in its U.S. trade or business.
- (g) To implement this addition, the final regulations include modified certification procedures similar to those set forth in Treas. Reg. § 1.59A-3(b)(3)(iii)(A) in order for the taxpayer to qualify for this exception. Specifically, the final regulations require a taxpayer to obtain a written statement from a foreign related party that is

comparable to a withholding certification provided under Treas. Reg. § 1.59A-3(b)(3)(iii)(A), but which takes into account that the transaction is a deemed transaction under Treas. Reg. § 1.59A-7(b) or (c) rather than a transaction for which the foreign related party is required to report ECI. The taxpayer may rely on the written statement unless it has reason to know or actual knowledge that the statement is incorrect.

2. Treatment of Curative Allocations.

- (a) The proposed regulations provided that if a partnership adopted the curative method of making § 704(c) allocations under Treas. Reg. § 1.704-3(c), the allocation of income to the contributing partner in lieu of a deduction allocation to the non-contributing partner is treated as a deduction for purposes of § 59A.
- (b) A comment expressed support for the rule and recommended that Treasury and the IRS also clarify that base erosion tax benefits include curative allocations of an item of deduction attributable to a base erosion payment.
- (c) Treasury and the IRS believe that the proposed regulations were already clear in this regard. Therefore, the final regulations retain Treas. Reg. § 1.59A-7(c)(5)(v) along with an example that illustrates when curative allocations are treated as base erosion tax benefits; the final regulations also clarify that curative allocations that arise under § 704(c) as a result of a revaluation are treated in a similar manner.

3. Partnership Anti-Abuse Rules.

- (a) Treas. Reg. § 1.59A-3(b)(3)(ii) provides an exception from base erosion payment status for qualified derivative payments. Treas. Reg. § 1.59A-6(d)(1) defines a derivative for purposes of the QDP rules as a contract whose value is determined by reference to one or more of the following: (1) any shares of stock in a corporation, (2) any evidence of indebtedness, (3) any actively traded commodity, (4) any currency, or (5) any rate, price, amount, index, formula, or algorithm. Prop. Treas. Reg. § 1.59A-9(b)(5) provides an anti-abuse rule relating to derivatives on partnership interests and partnership assets. Under this proposed rule, if a taxpayer acquires a derivative on a partnership interest or partnership assets with a principal purpose of eliminating or reducing a base erosion payment, then the taxpayer is treated as having a direct interest in the partnership interest or partnership asset (instead of a derivative interest) for purposes of applying § 59A.

- (b) A comment recommended that the regulations clarify the interaction of the anti-abuse rule relating to derivatives on partnership assets with the QDP exception that applies regarding certain derivatives.
- (c) The final regulations adopted this comment and provide that the partnership anti-abuse rule for derivatives does not apply when a payment regarding a derivative on a partnership asset qualifies for the QDP exception.

4. Other Issues.

- (a) Prop. Treas. Reg. § 1.6031(a)-1(b)(7) stated:

If a foreign partnership is not required to file a partnership return and the foreign partnership has made a payment or accrual that is treated as a base erosion payment of a partner as provided in Treas. Reg. § 1.59A-7(b)(2), a person required to file a Form 8991 (or successor) who is a partner in the partnership must provide the information necessary to report any base erosion payments on Form 8991 (or successor) or the related instructions. This paragraph does not apply to any partner described in Treas. Reg. § 1.59A-7(b)(4).

- (b) The cross-references contained in this regulation, Treas. Reg. § 1.59A-7(b)(2) and Treas. Reg. § 1.59A-7(b)(4), do not exist. The final regulations clarify which partners are intended to be excluded from the application of Prop. Treas. Reg. § 1.6031(a)-1(b)(7). Treas. Reg. § 1.6031(a)-1(b)(7) is also revised to make certain clarifying changes.
- (c) Finally, Treas. Reg. § 1.59A-9(b)(6) is revised to make certain clarifying changes.

F. Anti-abuse Rules for Basis Step-up.

1. Taxpayers expressed concern about the breadth of the anti-abuse rule. A comment stated that the anti-abuse rule can create a “cliff effect” whereby a minimal amount of pre-transaction basis step-up could disqualify an entire transaction that would have otherwise qualified for the specified nonrecognition transaction exception. The comment recommended that the anti-abuse rule exclude transactions with a relatively small amount of basis step-up or provide taxpayers with an election to forego the basis step-up.
2. Treas. Reg. § 1.59A-9(b)(4) was revised to adopt this comment. First, the anti-abuse rule now provides that when the rule applies, its effect is to turn off the application of the specified nonrecognition transaction exception

only to the extent of the basis step-up amount. This revision addresses the comment's concern regarding the cliff effect of the rule.

3. Second, Treas. Reg. § 1.59A-9(b)(4) has been revised to clarify that the transaction, plan, or arrangement with a principal purpose of increasing the adjusted basis of property must also have a connection to the acquisition of the property by the taxpayer in a specified nonrecognition transaction. This change was made because some taxpayers interpreted the prior version of the rule to potentially apply to certain basis step-up transactions (for example, a qualified stock purchase for which an election is made under § 338(g)), even if that basis step-up transaction had no factual connection with a later specified nonrecognition transaction (for example, the § 338(g) transaction occurred many years before the BEAT was enacted, but the property still has a stepped-up basis that is being depreciated or amortized when the subsequent specified nonrecognition transaction occurs). Treas. Reg. §§ 1.59A-9(c)(11) (Example 10) and 1.59A-9(c)(12) (Example 11) have also been revised to reflect these changes.

G. QDP Reporting Requirements. A comment was submitted that recommended that Treasury address the interaction of the QDP exception, the BEAT netting rule in Treas. Reg. § 1.59A-2(e)(3)(iv) (regarding positions for which a taxpayer applies a mark-to-market method of accounting for U.S. federal income tax purposes), and the QDP reporting requirements in Treas. Reg. § 1.59A-6 and Treas. Reg. § 1.6038A-2(b)(7)(ix) – each in the 2019 final regulations. The comment recommended that the asserted ambiguities be addressed in revised final regulations, a revenue procedure or another type of written authoritative guidance. Treasury and the IRS are studying this submission and considering whether future guidance may be appropriate.

H. Applicability Date.

1. The final regulations generally apply to taxable years beginning on or after the day the regulations are published in the Federal Register. The rules in Treas. Reg. §§ 1.59A-7(c)(5)(v) and (g)(2)(x), and 1.59A-9(b)(5) and (6) apply to taxable years ending on or after December 2, 2019.
2. Taxpayers may apply the final regulations in their entirety for taxable years beginning after December 31, 2017, and before their applicability date, provided that, once applied, taxpayers must continue to apply these regulations in their entirety for all subsequent taxable years. Alternatively, taxpayers may apply only Treas. Reg. § 1.59A-3(c)(5) and (6) for taxable years beginning after December 31, 2017, and before their applicability date, provided that, once applied, taxpayers must continue to apply Treas. Reg. § 1.59A-3(c)(5) and (6) in their entirety for all subsequent taxable years. Taxpayers may also rely on Treas. Reg. §§ 1.59A-2(c)(2)(ii) and (c)(4) through (6), and 1.59A-3(c)(5) and (c)(6) of the proposed

regulations in their entirety for taxable years beginning after December 31, 2017, and before the day the regulations are published in the Federal Register.

V. FINAL HYBRID REGULATIONS.

- A. Treasury and the IRS issued final hybrid regulations in T.D. 9896 on April 7, 2020. The final regulations generally follow the proposed regulations with some important changes and modifications in response to taxpayer comments.
- B. Section 245A(e). Section 245A(e) neutralizes the double non-taxation effects of a hybrid dividend or tiered hybrid dividend by denying the § 245A(a) dividends received deduction or requiring an inclusion under Subpart F with respect to the dividends. Hybrid deduction accounts must be maintained.
- C. Hybrid Deductions.
1. Current Use of Deduction or Other Tax Benefit.
    - (a) One comment requested that for a deduction or other tax benefit allowed under a relevant foreign tax law to be a hybrid deduction, it must be used currently under the relevant foreign tax law and, thus, currently reduce foreign tax liability. The comment noted that a current use might not occur if, for example, the CFC has other deductions or losses under the relevant foreign tax law, or all of a CFC's income is exempt income (for example, if the CFC is a holding company and all of its income benefits from a 100% participation exemption). The comment asserted that absent a current use of a deduction, double non-taxation does not occur.
    - (b) Treasury and the IRS rejected the comment and stated that it would not be appropriate for a deduction to be a hybrid deduction only to the extent it is used currently. Even though a deduction may not be used currently, it could be used in another taxable period – for example, as a result of a net operating loss carrying over to a subsequent taxable year – and thus could produce double non-taxation. In addition, it could be complex or burdensome to determine whether a deduction is used currently (because it could, for example, require a factual analysis of how particular deductions offset items of gross income under the relevant foreign tax law) and then, to the extent not used currently, track the deduction so that it is added to a hybrid deduction account only once it is in fact used.
    - (c) The final regulations clarify that a deduction or other tax benefit may be a hybrid deduction regardless of whether it is used currently under the relevant foreign tax law. Treas. Reg. § 1.245A(e)-1(d)(2).

2. Coordination with Foreign Disallowance Rules.

(a) Thin Capitalization and Other Rules.

- i. A comment requested that a deduction not be a hybrid deduction if under the relevant foreign tax law the deduction is disallowed under a thin capitalization rule or a rule similar to § 163(j). The final regulations do not adopt the comment.
- ii. A thin capitalization rule may suspend rather than disallow a deduction, and thus may not prevent eventual double non-taxation. Moreover, because a thin capitalization rule generally applies to all otherwise allowable deductions, Treasury and the IRS believe it would be unduly complex and burdensome to determine the extent to which an amount disallowed relates to a particular otherwise allowable deduction.
- iii. The final regulations clarify that the determination of whether a deduction or other tax benefit is allowed is made without regard to a rule that disallows or suspends deductions if a certain ratio or percentage is exceeded. Treas. Reg. § 1.245A(e)-1(d)(2)(ii)(A).

(b) Foreign Hybrid Mismatch Rules.

- i. The proposed regulations did not provide rules to take into account the application of foreign hybrid mismatch rules – that is, hybrid mismatch rules under the relevant foreign tax law. Accordingly, if such hybrid mismatch rules deny a deduction to neutralize a deduction/no-inclusion (“D/NI”) outcome, then, because the deduction is not allowed under the relevant foreign tax law, the deduction cannot be a hybrid deduction under the proposed regulations.
- ii. Treasury and the IRS believe that whether a deduction or other tax benefit is a hybrid deduction should be determined without regard to foreign hybrid mismatch rules. In order to prevent a D/NI outcome, the participation exemption under § 245A(a) should not apply to the dividend, as opposed to the participation exemption applying to the dividend to the extent that the foreign hybrid mismatch rules disallow a deduction for the amount in order to neutralize a D/NI outcome.
- iii. This approach more closely aligns the rules of § 245A(e) with the approach set forth in the BEPS Hybrid Mismatch



Report. This prevents circularity or other issues in cases in which the application of foreign hybrid mismatch rules depends on whether an amount will be included in income under U.S. tax law.

- iv. Accordingly, the final regulations provide that the determination of whether a relevant foreign tax law allows a deduction or other tax benefit for an amount is made without regard to the application of foreign hybrid mismatch rules, provided that the amount gives rise to a dividend for U.S. tax purposes or is reasonably expected for U.S. tax purposes to give rise to a dividend that will be paid within 12 months after the taxable period in which the deduction or other tax benefit would otherwise be allowed. Treas. Reg. § 1.245A(e)-1(d)(2)(ii)(B).
- v. As an example, assume that but for foreign hybrid mismatch rules, a CFC would be allowed a deduction under the relevant foreign tax law for an amount paid or accrued pursuant to an instrument issued by the CFC and treated as stock for U.S. tax purposes. If the amount is an actual payment that gives rise to a dividend for U.S. tax purposes (or the amount is an accrual but is reasonably expected to give rise to a dividend for U.S. tax purposes that will be paid within 12 months after the taxable period for which the deduction would otherwise be allowed), then the amount generally gives rise to a hybrid deduction regardless of whether the foreign hybrid mismatch rules may disallow a deduction for the amount. If, on the other hand, the amount would give rise to a dividend in a later period, then the amount would not give rise to a hybrid deduction to the extent that the foreign hybrid mismatch rules disallow a deduction for the amount.

(c) Withholding Taxes.

- i. Under the proposed regulations, the determination of whether a deduction or other tax benefit is a hybrid deduction was generally made without regard to whether the amount is subject to withholding tax under the relevant foreign tax law. Prop. Treas. Reg. § 1.245A(e)-1(g)(2), Example 2 (withholding taxes imposed pursuant to an integration or imputation system may prevent a deduction or other tax benefit from being a hybrid deduction). A comment stated that, to prevent double-taxation, a deduction or other tax benefit under a relevant foreign tax law should not be a hybrid deduction to the extent the

amount giving rise to the deduction or other tax benefit is subject to withholding tax under that tax law.

- ii. The purpose of withholding taxes generally is not to address mismatches in tax outcomes, but rather to allow the source jurisdiction to retain its right to tax the payment. In addition, generally taking withholding taxes into account for purposes of determining whether a deductible amount gives rise to a hybrid deduction could raise administrability issues if the amount is subject to withholding taxes at the time of payment (with the result that the amount is not added to a hybrid deduction account at that time) but the taxes are refunded in a later period; in these cases it could be difficult or burdensome to retroactively add the amount to the hybrid deduction account and make corresponding adjustments. Treasury and the IRS concluded that withholding taxes generally should not be viewed as neutralizing a D/NI outcome and the final regulations do not adopt this comment.

(d) NID.

- i. The proposed regulations provided that a hybrid deduction includes a deduction with respect to equity, such as a notional interest deduction (“NID”). Prop. Treas. Reg. § 1.245A(e)-1(d)(2)(i)(B). Several comments asserted that NIDs should not be hybrid deductions because NIDs do not involve sufficient hybridity so as to be within the intended scope of § 245A(e). These comments noted that NIDs are generally available tax concessions that reflect tax policy decisions, and that NIDs are typically allowed without regard to dividend distributions, if any.
- ii. Another comment said that because NIDs are the equivalent of a lower tax rate on profits, any policy concerns with NIDs are appropriately addressed by the global intangible low-taxed income regime (“GILTI”) under § 951A.
- iii. Other comments raised concerns that treating NIDs as hybrid deductions departs from the Hybrid Mismatch Report and, as a result, could impair the competitiveness of U.S. multinational groups.
- iv. Treasury and the IRS concluded that NIDs should be hybrid deductions, without regard to whether NIDs result from an actual payment, accrual, or distribution. First,

because NIDs offset income but generally do not give rise to a corresponding income inclusion, NIDs produce double non-taxation, and such double non-taxation can occur regardless of whether NIDs result from an actual payment, accrual, or distribution. Second, the double non-taxation resulting from NIDs is in general a result of a mismatch in how different tax laws view an instrument of a CFC; that is, the relevant foreign tax law views the instrument as generating amounts similar to interest – to minimize the disparate treatment of debt and equity – and, were the tax law of the U.S. (the investor jurisdiction of the CFC) to similarly view the instrument as generating amounts treated as interest, there would generally be a corresponding income inclusion in the U.S.

- v. They believe that such a double non-taxation resulting from the mismatch in the treatment of an instrument is the fundamental policy concern underlying § 245A(e). Moreover, including NIDs in the definition of a hybrid deduction is consistent with the broad language of § 245A(e)(4)(B), which refers to any “deduction (or other tax benefit).”
- vi. Thus, the final regulations generally retain the approach of the proposed regulations and treat NIDs as hybrid deductions. However, in response to comments, the final regulations provide that only NIDs allowed to a CFC for taxable years beginning on or after December 20, 2018, are hybrid deductions. Treas. Reg. § 1.245A(e)-1(d)(2)(iv). Treasury and the IRS have determined that this delay (relative to the proposed regulations) is appropriate in order to account for restructurings intended to eliminate or minimize hybridity.

(e) Special Rule.

- i. In the case of a deduction or other tax benefit relating to or resulting from a distribution by a CFC with respect to an instrument treated as stock for purposes of a relevant foreign tax law, a special rule under the proposed regulations provided that the deduction or other tax benefit is a hybrid deduction only to the extent that it has the effect of causing the earnings that funded the distribution to not be included in income or otherwise subject to tax under such tax law. Prop. Treas. Reg. § 1.245A(e)-1(d)(2)(i)(B).

- ii. The final regulations clarify the operation of this special rule. First, the final regulations clarify that the special rule only applies to deductions or other tax benefits relating to or resulting from a distribution by the CFC that is a dividend for purposes of the relevant foreign tax law. Treas. Reg. § 1.245A(e)-1(d)(2)(i)(B). Thus, for example, the special rule does not apply to NIDs as to which withholding tax is imposed under the relevant foreign tax law, because the imposition of withholding tax in these cases is not pursuant to an integration or imputation system (as such systems generally only apply to dividends) and, instead, may be imposed to provide parity between NIDs and an actual interest payment.
- iii. Second, the final regulations clarify that the imposition of withholding tax pursuant to an integration or imputation system can reduce or eliminate the extent to which dividends paid deductions (as well as other similar tax benefits) give rise to a hybrid deduction. Treas. Reg. § 1.245A(e)-1(g)(2), Example 2, alt. facts (imposition of withholding tax at a rate less than the tax rate at the which dividends paid deduction is allowed only prevents a portion of the deduction from being a hybrid deduction).
- iv. Lastly, the final regulations clarify that, as a result of the special rule, dividends received deductions allowed pursuant to regimes intended to relieve double-taxation within a group do not constitute hybrid deductions. Treas. Reg. § 1.245A(e)-1(d)(2)(i)(B).

(f) Related Persons.

- i. Under the proposed regulations, a hybrid deduction of a CFC included certain deductions or other tax benefits allowed under a relevant foreign tax law to a person related to the CFC (such as a shareholder of the CFC). Prop. Treas. Reg. § 1.245A(e)-1(d)(2).
- ii. A comment stated that, although in certain cases it may be appropriate to treat a deduction or other tax benefit allowed to a related person as a hybrid deduction, the related person rule raises issues, including compliance issues, because it could be burdensome to determine whether any person related to a CFC receives certain deductions or other tax benefits.

- iii. Treasury and the IRS determined that, because a deduction or other tax benefit allowed to a person related to a CFC may be economically equivalent to the CFC having been allowed a deduction or other tax benefit, or may otherwise produce a D/NI outcome, the related person rule is necessary to carry out the purpose of § 245A(e). The final regulations therefore retain this rule, including defining relatedness by reference to § 954(d)(3), a well-established standard applicable to controlled foreign corporations and consistent with § 267A, which similarly addresses hybrid mismatches.
- iv. The final regulations under § 954(d)(3) narrow the definition of relatedness for § 954(d)(3) purposes by providing that relatedness is determined without regard to “downward” attribution. *See* TD 9883.
- v. In addition, the final regulations clarify that only deductions allowed under a relevant foreign tax law to a person related to a CFC may be hybrid deductions of the CFC; in general, a relevant foreign tax law is a foreign tax law under which the CFC is subject to tax. Treas. Reg. § 1.245A(e)-1(d)(2)(i) and (f)(5). Thus, for example, in the case of a CFC and a corporate shareholder of the CFC that are tax residents of different foreign countries, a dividends received deduction allowed to the corporate shareholder under its tax law for a dividend received from the CFC is not a hybrid deduction of the CFC.
- vi. The final regulations did not adopt additional criteria to the related person rule. Treasury and the IRS concluded that other aspects of the final regulations generally address the double-counting concerns. In addition, Treasury and the IRS concluded that requiring the IRS to affirmatively demonstrate double non-taxation would impose an excessive burden on the IRS.
- vii. Lastly, the final regulations clarify that a hybrid deduction of a CFC does not include an impairment loss deduction or a mark-to-market deduction allowed to a shareholder of the CFC with respect to its stock of the CFC. This is because such deductions do not relate to or result from an amount paid, accrued, or distributed with respect to an instrument issued by the CFC, and are not deductions allowed to the CFC with respect to equity. Treas. Reg. § 1.245A(e)-1(d)(2)(i)(B).

(g) Relevant Foreign Tax Law.

- i. The proposed regulations defined a relevant foreign tax law as, with respect to a CFC, any regime of any foreign country or possession of the U.S. that imposes an income, war profits, or excess profits tax with respect to income of the CFC, other than a foreign anti-deferral regime under which an owner of the CFC is liable to tax. Prop. Treas. Reg. § 1.245A(e)-1(f). In some countries, however, income taxes imposed by a subnational authority of the country (for example, a state, province, or canton of the country) may constitute a significant portion of a tax resident's overall income tax burden in the country.
- ii. Accordingly, Treasury and the IRS believe that, in cases in which subnational income taxes of a country are covered taxes under an income tax treaty between the country and the U.S. (and therefore are likely to represent a significant portion of the overall income tax paid in the country), the tax law of the subnational authority should be treated as a tax law of a foreign country for purposes of § 245A(e).
- iii. Thus, under the final regulations, a relevant foreign tax law may include a tax law of a political subdivision or other local authority of a foreign country. Treas. Reg. § 1.245A(e)-1(f)(5).

3. Hybrid Deduction Accounts.

(a) Nexus Between Hybrid Dividends and Hybrid Deductions.

- i. Under the proposed regulations, a dividend received by a U.S. shareholder ("U.S. shareholder") from a CFC was generally a hybrid dividend to the extent of the sum of the U.S. shareholder's hybrid deduction accounts with respect to each share of stock of the CFC, even if the dividend is paid on a share that has not had any hybrid deductions allocated to it. Prop. Treas. Reg. § 1.245A(e)-1(b)(2).
- ii. One comment noted that the hybrid deduction account approach in the proposed regulations appropriately safeguards against certain abuse. However, the comment and others said that, at least in certain cases, the approach is overbroad and could lead to inappropriate results, including causing a dividend to be a hybrid dividend even though a hybrid deduction was not allowed for the amount to which

the dividend is attributable but instead was allowed for another amount.

- iii. Treasury and the IRS concluded that the hybrid deduction account approach under the proposed regulations appropriately carries out the purposes of § 245A(e), and prevents the avoidance of § 245A(e), in an administrable manner. Accordingly, the final regulations did not adopt these comments.

(b) Reduction for Certain Amounts Included in Income.

- i. Under the proposed regulations, a hybrid deduction account was reduced only to the extent that an amount in the account gives rise to a hybrid dividend or a tiered hybrid dividend. Prop. Treas. Reg. § 1.245A(e)-1(d). Some comments suggested that Subpart F inclusions or GILTI inclusion amounts (or a distribution of previously taxed earnings and profits) provide a dollar-for-dollar reduction of a hybrid deduction account.
- ii. However, another comment noted that a dollar-for-dollar reduction could give rise to inappropriate results because the inclusions may not be fully taxed in the U.S., given foreign tax credits associated with the amounts or, in the case of a GILTI inclusion amount, the deduction under § 250. One commenter suggested that a hybrid deduction not be added to the hybrid deduction account to the extent that the deduction relates to an amount directly included in U.S. income (for example, under § 882). Finally, comments suggested that, to avoid double-taxation, a hybrid deduction account should also be reduced when an amount is included in a U.S. shareholder's gross income under §§ 951(a)(1)(B) and 956 by reason of the application of § 245A(e) to the hypothetical distribution described in Treas. Reg. § 1.956-1(a)(2).
- iii. Section 245A(e) is generally intended to ensure that to the extent earnings and profits of a CFC have not been subject to foreign tax as a result of certain hybrid arrangements, earnings and profits of the CFC of an equal amount will, once distributed as a dividend, be "included in income" in the U.S. (that is, taken into account in income and not offset by, for example, a deduction or credit particular to the inclusion).

- iv. To the extent the earnings and profits are so included by other means (for example, as a Subpart F inclusion or GILTI inclusion amount), with the result that the double non-taxation effects of the hybrid arrangement are neutralized, § 245A(e) need not apply to a corresponding amount of earnings and profits. Accordingly, in these cases, Treasury and the IRS determined that hybrid deduction accounts with respect to stock of the CFC – which are generally intended to represent earnings and profits of the CFC that have neither been subject to foreign tax nor yet included in income in the U.S. – should be reduced.
- v. They determined that it would be too complex to adjust hybrid deduction accounts based on the extent to which under a relevant foreign tax law a hybrid deduction offsets certain types of income (such as effectively connected income subject to tax under § 882), and thus the final regulations did not adopt the comment suggesting such an approach.

(c) Rules Regarding Transfers of Stock.

- i. Because hybrid deduction accounts are maintained with respect to stock of a CFC, the proposed regulations provide rules that take into account transfers of stock of a CFC, including transfers pursuant to certain nonrecognition exchanges and liquidations. Prop. Treas. Reg. § 1.245A(e)-1(d)(4). In general, and depending on the type of transaction pursuant to which the transfer occurs, the transferee succeeds to the transferor's hybrid deduction accounts with respect to the transferred stock, or hybrid deduction accounts with respect to the transferred stock are tacked onto successor or similar interests. However, if the stock is transferred to a person that is not required to maintain a hybrid deduction account, such as an individual or a foreign corporation that is not a CFC, the hybrid deduction account generally terminates.
- ii. Although a comment noted that these rules generally provide for appropriate results, the comment (and others) recommended that the rules be modified to address certain issues involving transfers of stock. First, a comment recommended that the rules address certain distributions of stock under § 355. The comment suggested that the balance of a hybrid deduction account with respect to stock of the distributing CFC be allocated to a hybrid deduction



account with respect to stock of the controlled CFC in a manner similar to how basis in stock of the distributing CFC is allocated to stock of the controlled CFC under § 358.

- iii. Treasury and the IRS agree that allocation rules should apply with respect to certain § 355 distributions, but concluded that the allocation should be consistent with how earnings and profits of the distributing CFC are allocated between the distributing CFC and the controlled CFC. The final regulations thus provide a rule to this effect. Treas. Reg. § 1.245A(e)-1(d)(4)(iii)(B)(4).
- iv. This rule, like the other rules in Treas. Reg. § 1.245A(e)-1(d)(4)(iii)(B) that adjust hybrid deduction accounts upon certain nonrecognition transactions, is in addition to the general rule of Treas. Reg. § 1.245A(e)-1(d)(4)(iii)(A), pursuant to which an acquirer of stock of a CFC generally succeeds to the transferor's hybrid deduction accounts with respect to the stock. Accordingly, if the § 355 distribution involves a pre-existing controlled CFC, the shareholder's hybrid deductions accounts with respect to the controlled CFC immediately after the distribution are generally equal to the sum of (i) the hybrid deduction accounts with respect to the controlled CFC to which the shareholder succeeds under the rules of Treas. Reg. § 1.245A(e)-1(d)(4)(iii)(A), and (ii) the portions of the hybrid deduction accounts with respect to the distributing CFC that are allocated to hybrid deduction accounts with respect to stock of the controlled CFC under Treas. Reg. § 1.245A(e)-1(d)(4)(iii)(B)(4).
- v. Second, a comment suggested that the final regulations adopt an anti-duplication rule to address cases in which a liquidation of a lower-tier CFC into an upper-tier CFC would in effect result in a duplication of hybrid deductions. Rather than addressing this duplication issue only in the context of transfers of stock of a CFC, the final regulations provide a general anti-duplication rule. Treas. Reg. § 1.245A(e)-1(d)(2)(iii). This rule generally ensures that when deductions or other tax benefits under a relevant foreign tax law are in effect duplicated at different tiers, the deductions or other tax benefits only give rise to a hybrid deduction of the higher-tier CFC. Thus, in the mirror hybrid instrument example, the deduction allowed to the upper-tier CFC, but not the deduction allowed to the lower-tier CFC, would be a hybrid deduction, provided that the deductions arise under the same relevant foreign tax law.

- vi. Lastly, a comment requested clarification that, when a § 338(g) election is made with respect to a CFC target, the shareholder of the new target does not succeed to a hybrid deduction account with respect to a share of stock of the old target. The comment asserted that such a result is appropriate because the old target is generally treated as transferring all of its assets to an unrelated person, and the new target is generally treated as acquiring all of its assets from an unrelated person.
- vii. Treasury and the IRS agreed with this comment because, in general, the new target does not inherit any of the earnings and profits of the old target and, as a result, no distributions by the new target could represent a distribution of earnings and profits of the old target sheltered from foreign tax by reason of hybrid deductions incurred by the old target. Accordingly, the final regulations clarified that, in connection with an election under § 338(g), a hybrid deduction account with respect to stock of the old target generally does not carry over to stock of the new target. Treas. Reg. § 1.245A(e)-1(d)(4)(iii)(B)(5).

(d) Mid-Year Transfers of Stock.

- i. Under the proposed regulations, if there is a transfer of stock of a CFC during the CFC's taxable year, then the determinations and adjustments that would otherwise be made at the close of the CFC's taxable year are generally made at the close of the date of the transfer. Prop. Treas. Reg. § 1.245A(e)-1(d)(5). A comment requested clarification regarding how, in such cases, a hybrid deduction account with respect to a share of stock of the CFC is adjusted on the date of transfer, and whether hybrid dividends and tiered hybrid dividends that arise during the post-transfer period affect such adjustments.
- ii. In response to this comment, the final regulations provide additional rules that, in general, adjust the hybrid deduction account based on the number of days in the taxable year within the pre-transfer period to the total number of days in the taxable year. Treas. Reg. § 1.245A(e)-1(d)(5). The rules also coordinate the end-of-the year adjustments and the adjustments that must be made on the transfer date.

(e) Applicability Date.

- i. The proposed regulations provided that Prop. Treas. Reg. § 1.245A(e)-1, including the hybrid deduction account rules, applies to distributions made after December 31, 2017. However, the preamble to the proposed regulations explained that if Prop. Treas. Reg. § 1.245A(e)-1 is finalized after June 22, 2019, then Treas. Reg. § 1.245A(e)-1 will apply only to distributions made during taxable years ending on or after the date the proposed regulations were issued (December 20, 2018).
- ii. Some comments requested that, given that the statutory language of § 245A(e) does not include the concept of an account, the hybrid deduction account rules apply on a prospective basis to provide taxpayers time to comply with the rules and to prevent harsh results. One comment suggested that the rules apply only to distributions made after the proposed regulations were issued, and another suggested that the rules apply only to distributions made after December 31, 2018.
- iii. The final regulations provide that the hybrid deduction account rules apply to distributions made after December 31, 2017, provided that such distributions occur during taxable years ending on or after the date the proposed regulations were issued. Treas. Reg. § 1.245A(e)-1(h)(1). Treasury and the IRS determined that it would not be appropriate to delay the applicability date of the hybrid deduction account rules because the enactment of § 245A(e) provided notice that D/NI outcomes involving instruments that are stock for U.S. tax purposes – including D/NI outcomes involving a deduction or other tax benefit allowed for an amount on a particular date and a payment of a corresponding amount of earnings and profits as a dividend for U.S. tax purposes on a later date – would be neutralized under § 245A(e) (including in conjunction with the regulatory authority under § 245A(g)), and the hybrid deduction account rules are necessary to ensuring such D/NI outcomes are so neutralized.

4. Miscellaneous Issues.

(a) Treatment of Amounts under Tax Law of Another Foreign Country.

- i. Under the proposed regulations, a tiered hybrid dividend meant an amount received by a CFC (“receiving CFC”) from another CFC to the extent that the amount would be a hybrid dividend under the proposed regulations if the receiving CFC were a domestic corporation. Prop. Treas. Reg. § 1.245A(e)-1(c)(2).
- ii. Comments suggested that the treatment of an amount under another foreign tax law be taken into account in two cases. First, a comment recommended an exception pursuant to which a dividend is not a tiered hybrid dividend to the extent that the receiving CFC includes the dividend in income under its tax law (or is subject to withholding tax under the payer CFC’s tax law).
- iii. Treasury and the IRS believe that not taking into account the treatment of an amount under the receiving CFC’s tax law (or other foreign tax law), as provided in the proposed regulations, is consistent with the plain language of § 245A(e)(2). In addition, they concluded that such an exception could give rise to inappropriate results in certain cases. For example, if the exception applied without regard to tax rates, then an inclusion by the receiving CFC at a low tax rate applicable to all income would discharge the application of § 245A(e) to a dividend even though the payer CFC deducted the amount at a high tax rate. Accordingly, the final regulations do not adopt this comment.
- iv. Second, a comment suggested that, in cases involving tiers of CFCs that are tax residents of different foreign countries, a deduction or other tax benefit allowed to the upper-tier CFC under a relevant foreign tax law not be a hybrid deduction to the extent that the deduction or other tax benefit offsets an amount that the upper-tier CFC includes in its income and that is attributable to a hybrid deduction of a lower-tier CFC.
- v. The final regulations did not adopt this comment because it would be inconsistent with the statute, which does not take into account the overall effect of a deduction or other tax benefit under the relevant foreign tax law.

(b) Tiered Hybrid Dividend Rule to Non-Corporate U.S. Shareholders.

- i. If an upper-tier CFC receives a tiered hybrid dividend from a lower-tier CFC, and a domestic corporation is a U.S. shareholder of both CFCs, then, notwithstanding any other provision of the Code (i) the tiered hybrid dividend is treated for purposes of § 951(a)(1)(A) as Subpart F income of the upper-tier CFC, (ii) the U.S. shareholder must include in gross income its pro rata share of the Subpart F income, and (iii) the rules of § 245A(d) apply to the amount included in the U.S. shareholder's gross income. Prop. Treas. Reg. § 1.245A(e)-1(c)(1). A comment requested that the final regulations address how the tiered hybrid dividend rule applies with respect to a non-corporate U.S. shareholder of the upper-tier CFC.
- ii. The final regulations provide that the tiered hybrid dividend rule applies only as to a domestic corporation that is a U.S. shareholder of both the upper-tier CFC and the lower-tier CFC. Treas. Reg. § 1.245A(e)-1(c)(1). Thus, for example, if a domestic corporation and a U.S. individual equally own all of the stock of an upper-tier CFC, and the upper-tier CFC receives a tiered hybrid dividend from a wholly-owned lower-tier CFC, the tiered hybrid dividend rule does not apply to cause a Subpart F inclusion to the individual U.S. shareholder (though the dividend may otherwise result in a Subpart F inclusion to the individual U.S. shareholder). If the dividend does not give rise to a Subpart F inclusion to the individual U.S. shareholder, the earnings associated with the dividend would generally be subject to full U.S. tax when distributed to the individual as a dividend because individuals are not allowed a deduction under § 245A(a) and, as a result, it would be inappropriate for the tiered hybrid dividend rule to have applied to the individual.

(c) Upper-Tier CFCs Required to Maintain Hybrid Deduction Accounts.

- i. Under the proposed regulations, an upper-tier CFC was generally a specified owner of shares of stock of a lower-tier CFC, and thus the upper-tier CFC must maintain hybrid deduction accounts with respect to those shares. Prop. Treas. Reg. § 1.245A(e)-1(d)(1) and (f)(5). However, in certain cases there may not be a domestic corporation that is a U.S. shareholder of the upper-tier CFC. For example, the only U.S. shareholders of the upper-tier CFC may be individuals, with the result that § 245A(e)(2) would not

apply to a dividend received by the upper-tier CFC from the lower-tier CFC. Or, the upper-tier CFC may be a CFC solely by reason of the repeal of the limitation on the “downward” attribution rule under § 958(b)(4), with the result that even if a dividend received by the upper-tier CFC from the lower-tier CFC were a tiered hybrid dividend, there would be no meaningful U.S. tax consequence because no U.S. shareholder would have a Subpart F inclusion with respect to the upper-tier CFC.

- ii. To obviate the need for hybrid deduction accounts to be maintained in these cases, the final regulations provide that an upper-tier CFC is a specified owner of shares of stock of a lower-tier CFC only if, for purposes of §§ 951 and 951A, a domestic corporation that is a U.S. shareholder of the upper-tier CFC owns (within the meaning of § 958(a), but for this purpose treating a domestic partnership as foreign) one or more shares of stock of the upper-tier CFC. Treas. Reg. § 1.245A(e)-1(f)(6).
- iii. Treasury and the IRS expect that when proposed regulations under § 958 are finalized, the rule described in the preceding sentence treating a domestic partnership as foreign will be removed, as it will no longer be necessary. Prop. Treas. Reg. § 1.958-1(d)(1).

(d) Anti-Avoidance Rule.

- i. The proposed regulations include an anti-avoidance rule that requires appropriate adjustments to be made, including adjustments that would disregard a transaction or arrangement, if a transaction or arrangement is engaged in with a principal purpose of avoiding the purposes of the proposed regulations. A comment suggested that the anti-avoidance rule should not apply to a sale of lower-tier CFC stock before satisfying the holding period if the sale is to an unrelated party, even though the timing of the sale may be driven by tax considerations. Another comment requested clarification that the anti-avoidance rule does not apply to disregard a transaction pursuant to which the hybrid nature of an arrangement is eliminated (for example, a restructuring of a hybrid instrument into a non-hybrid instrument, so as to eliminate the accrual of a hybrid deduction under a relevant foreign tax law).
- ii. Treasury and the IRS believe that the anti-avoidance rule should not be limited to transactions or arrangements with

related parties, as otherwise transactions or arrangements with unrelated parties could lead to the avoidance of § 245A(e) and the regulations thereunder. Accordingly, the final regulations retain the anti-avoidance rule in the proposed regulations, and thus whether the anti-avoidance rule applies to a transaction or arrangement depends solely on a principal purpose of the transaction or arrangement for the avoidance of § 245A(e) and the regulations thereunder and does not take into account the status of a counter party. Treas. Reg. § 1.245A(e)-1(e).

iii. Treasury and the IRS agreed, however, with the comment asserting that the anti-avoidance rule should not apply to disregard a restructuring of a hybrid arrangement into a non-hybrid arrangement and, accordingly, the rule was modified to this effect.

5. § 267A. The proposed regulations disallowed a deduction for any interest or royalty paid or accrued (“specified payment”) to the extent the specified payment produces a D/NI outcome as a result of a hybrid or branch arrangement. The proposed regulations also disallowed a deduction for a specified payment to the extent the specified payment produces an indirect D/NI outcome as a result of the effects of an offshore hybrid or branch arrangement being imported into the U.S. tax system. Finally, the proposed regulations disallowed a deduction for a specified payment to the extent the specified payment produces a D/NI outcome and is made pursuant to a transaction a principal purpose of which is to avoid the purposes of the regulations under § 267A.

6. Hybrid and Branch Arrangements.

(a) Arrangements Giving Rise to Long-Term Deferral.

i. Several provisions of the proposed regulations addressed long-term deferral, which results when there is deferral beyond a taxable period ending more than 36 months after the end of the specified party’s taxable year. In addition, the proposed regulations deem a specified payment as made pursuant to a hybrid transaction if differences between U.S. tax law and the tax law of a specified recipient of the payment (such as differences in tax accounting treatment) result in more than a 36-month deferral between the time the deduction would be allowed under U.S. tax law and the time the payment is taken into account in income under the specified recipient’s tax law. Further, a D/NI outcome is considered to occur with respect to a specified payment if

under a relevant foreign tax law the payment is not included in income within the 36-month period.

- ii. One comment supported these provisions, on balance, noting that long-term deferral can create D/NI outcomes that should be neutralized by § 267A, but recommending certain of the modifications. Other comments suggested that the provisions be eliminated, because according to such comments they are potentially burdensome or are not appropriate since a D/NI outcome should not be viewed as occurring if the amount will eventually be included in income; in addition, one comment asserted that the provision dealing with mismatches in tax accounting treatment is neither supported by § 267A nor within the regulatory authority granted under § 267A(e).
- iii. Treasury and the IRS determined that the final regulations should retain the long-term deferral provisions because long-term deferral can in effect create D/NI outcomes and, absent such provisions, hybrid arrangements could be used to achieve results inconsistent with the purposes of § 267A. In addition, Treasury and the IRS concluded that the provisions are consistent with § 267A and the broad regulatory authority thereunder. Therefore, the final regulations retain the long-term deferral provisions but, in response to comments, modify the provisions.
- iv. Recovery of Basis or Principal.
  - (a) One comment requested that, in the case of a specified payment that is treated as a recovery of basis or principal under the tax law of a specified recipient, the final regulations clarify whether the specified recipient is considered to include the payment in income. The comment asserted that basis or principal should be viewed as a “generally applicable” tax attribute such that recovery of basis or principal should not create a D/NI outcome and, therefore, the specified recipient should be considered to include the payment in income.
  - (b) Treasury and the IRS believe that basis or principal recovery can give rise to long-term deferral and thus can create a D/NI outcome. For example, consider a specified payment that is made pursuant to an instrument treated as indebtedness for U.S. tax purposes and equity for purposes of the tax law of a



specified recipient, and that is treated as interest for U.S. tax purposes and a recovery of basis (under a rule similar to § 301(c)(2)) for purposes of the specified recipient's tax law. If § 267A were to not apply in such a case, then the specified party would generally be allowed a deduction at the time of the specified payment but the specified recipient would not have a taxable inclusion at that time and, indeed, might not have a taxable inclusion, if any, for an extended period.

- (c) Accordingly, the final regulations clarify that a recovery of basis or principal can create a D/NI outcome. Treas. Reg. § 1.267A-3(a)(1)(ii). However, the final regulations modify the long-term deferral provisions. Treasury and the IRS expect that these modifications will in many cases prevent a specified payment from being a disqualified hybrid amount when the payment is treated as a recovery of basis or principal under the tax law of a specified recipient.

v. Defining Long-Term Deferral.

- (a) Some comments noted that under the proposed regulations, to determine whether long-term deferral occurs with respect to a specified payment, the specified party must know at the time of the payment if, under the tax law of a specified recipient, the payment will be taken into account and included in income within the 36-month period. The comments stated that in certain cases this could be difficult or burdensome, including because, after the payment is made, the specified party might need to monitor the payment during the 36-month period to ensure that it is in fact taken into account and included in income (and, if it is not so taken into account and included, the specified party might need to amend its tax return to reflect a disallowance of the deduction). The comments suggested addressing these concerns by providing for a reasonable expectation standard, based on whether, at the time of the specified payment, it is reasonable to expect that the payment will be taken into account and included in income within the 36-month period. Treasury and the IRS agree with these comments and, thus, the final regulations

provide rules to such effect. Treas. Reg. §§ 1.267A-2(a)(2)(ii)(A) and 1.267A-3(a)(1)(i).

- (b) Comments also suggested that, to address certain cases in which there are different ordering or other rules under U.S. tax law and the tax law of a specified recipient, certain amounts related to a specified payment be aggregated for purposes of determining whether long-term deferral occurs.
- (c) For example, under such an approach, if a year 1 \$100x specified payment is interest for U.S. tax purposes and a return of principal for purposes of a specified recipient's tax law, but a year 2 \$100x payment is a repayment of principal for U.S. tax purposes and interest for purposes of the specified recipient's tax law (and is included in income by the specified recipient), then there is no long-term deferral with respect to the year 1 payment and, as a result, the payment is not a disqualified hybrid amount.
- (d) Treasury and the IRS generally agreed that the year 1 \$100x specified payment should not be a disqualified hybrid amount. However, rather than addressing through an aggregation rule, which could give rise to uncertainty in certain cases, the final regulations provide a special rule pursuant to which a specified recipient's no-inclusion with respect to a specified payment is reduced by certain amounts that are repayments of principal for U.S. tax purposes but included in income by the specified recipient. Treas. Reg. § 1.267A-3(a)(4); Treas. Reg. § 1.267A-6(c)(1)(vi).

vi. Hybrid Sale/License Transactions.

- (a) Some comments suggested that hybrid sale/license transactions not be subject to the hybrid transaction rule. A hybrid sale/license transaction can occur, for example, when a specified payment is treated as a royalty for U.S. tax purposes, and a contingent payment of consideration for the purchase of intangible property under the tax law of a specified recipient. In such a case, if under the specified recipient's tax law the payment is treated as a

recovery of basis, then a D/NI outcome would occur.

- (b) Accordingly, if the specified payment is considered made pursuant to a hybrid transaction, then the payment would generally be a disqualified hybrid amount. Comments asserted that these transactions should be excluded because they are common, may be unavoidable, and are not abusive.
- (c) Treasury and the IRS determined that in many cases there might not be a significant difference between the results occurring under a hybrid sale/license transaction and the results that would occur were the specified recipient's tax law to (like U.S. tax law) also view the transaction as a license and the specified payment as a royalty. For example, if the specified recipient's tax law were to view the transaction as a license and the specified payment as a royalty, then the payment could be offset by an amortization deduction attributable to the basis of the intangible property. In such a case, the amortization deduction – a generally available deduction or other tax attribute – would not prevent the specified recipient from being considered to include the payment in income. Treas. Reg. § 1.267A-3(a)(1).
- (d) Thus, regardless of whether the transaction is a hybrid sale/license or an actual license, the specified payment could under the specified recipient's tax law be offset by basis or a deduction that is a function of basis. These cases are generally distinguishable from ones in which a transaction is a hybrid debt instrument, because tax laws typically do not provide amortization or similar deductions with respect to indebtedness.
- (e) Accordingly, Treasury and the IRS concluded that it is appropriate to exempt hybrid sale/license transactions from the hybrid transaction rule. The final regulations thus provide a rule to this effect. Treas. Reg. § 1.267A-2(a)(2)(ii)(B).

vii. Other Modifications or Clarifications.

- (a) Comments suggested several other modifications to the long-term deferral provisions. First, although one comment generally supported a bright-line standard for measuring long-term deferral because it provides certainty, other comments suggested modifying the standard for measuring long-term deferral, either by lengthening the period to, for example, 120 months, or defining long-term deferral as an unreasonable period of time based on all the facts and circumstances.
- (b) The final regulations did not adopt these comments because Treasury and the IRS have concluded that, in general, a bright-line 36-month standard appropriately distinguishes between short-term and long-term deferral and avoids administrability issues that would likely arise if long-term deferral were based on a subjective standard (such as an “unreasonable” period of time).
- (c) Second, a comment suggested that, to balance the benefits of the bright-line standard with the resulting cliff effects, the final regulations provide a rule, similar to § 267(a)(3), that defers a deduction for a specified payment until taken into account under the foreign tax law. The final regulations did not adopt this approach because it would be inconsistent with the plain language of § 267A, which provides for the disallowance of a deduction at the time of the payment, and not a deferral of a deduction. In addition, Treasury and the IRS determined that, if such an approach were adopted, tracking rules would be necessary and such rules would create additional complexity and administrative burden.
- (d) Third, a comment requested that the final regulations clarify that if a specified payment will never be recognized under the tax law of a specified recipient (because, for example, such tax law does not impose an income tax), then the long-term deferral provision does not apply so as to deem the payment as made pursuant to a hybrid transaction. Finally, a comment requested clarification that a specified payment is treated as included in income

if the payment is included in income in a prior taxable period.

- (e) Treasury and the IRS agreed with these comments, and the final regulations thus include these clarifications. Treas. Reg. § 1.267A-2(a)(2)(ii)(A); Treas. Reg. § 1.267A-3(a)(1)(i).

(b) Interest-Free Loans.

- i. An interest free loan includes an instrument that is treated as indebtedness under both U.S. tax law and the tax law of the holder of the instrument but provides no stated interest. If the interest is deductible but not includible, the instrument would give rise to a D/NI result. Because the imputed interest deduction is not regarded under the law of the holder's jurisdiction, the disregarded payment rule of the proposed regulations treated the imputed interest as a disregarded payment and, accordingly, a disqualified hybrid amount to the extent it exceeds the dual inclusion income.
- ii. A comment noted that the Hybrid Mismatch Report generally does not disallow deductions for imputed interest payments, such as interest imputed with respect to interest-free loans, and that imputed interest raises issues that should be further considered on a multilateral basis. The comment thus suggested that the final regulations generally reserve on whether imputed interest is subject to § 267A.
- iii. The final regulations did not adopt this comment because imputed interest can give rise to D/NI outcomes that are no different from D/NI outcomes produced by other hybrid and branch arrangements. However, to more clearly address these transactions, and because interest-free loans are similar to hybrid transactions and are unlikely to involve dual inclusion income, the final regulations address imputed interest under the hybrid transaction rule, rather than the disregarded payment rule. Treas. Reg. § 1.267A-2(a)(4). The rules in the final regulations addressing interest-free loans and similar arrangements apply for taxable years beginning on or after December 20, 2018. Treas. Reg. § 1.267A-7(b)(1).

(c) Disregarded Payments.

i. Dual Inclusion Income.

- (a) In general, the proposed regulations provided that a disregarded payment is a disqualified hybrid amount to the extent it exceeds the specified party's dual inclusion income. For this purpose, an item of income of a specified party is dual inclusion income only if it is included in the income of both the specified party and the tax resident or taxable branch to which the disregarded payment is made (as determined under the rules of Treas. Reg. § 1.267A-3(a)). Prop. Treas. Reg. § 1.267A-2(b)(3).
- (b) A comment suggested that the final regulations address whether an item of income is dual inclusion income even though, as a result of a participation exemption, patent box, or other exemption regime, it is not included in the income of the tax resident or taxable branch to which the disregarded payment is made.
- (c) Treasury and the IRS believe that an item of income of a specified party should be dual inclusion income even though, by reason of a participation exemption or other relief particular to a dividend, it is not included in the income of the tax resident or taxable branch to which the disregarded payment is made, provided that the application of the participation exemption or other relief relieves double-taxation (rather than results in double non-taxation). The final regulations were thus modified to this effect. Treas. Reg. § 1.267A-2(b)(3)(ii); Treas. Reg. § 1.267A-6(c)(3)(iv).
- (d) The final regulations provide a similar rule in cases in which an item of income of a specified party is included in the income of the tax resident or taxable branch to which the disregarded payment is made but not included in the income of the specified party by reason of a dividends received deduction (such as the § 245A(a) deduction).
- (e) These rules do not apply to items that are excluded from income under a patent box or similar regime

because, to the extent the payer of the item is allowed a deduction for the item under its tax law, the deduction and the exclusion, together, result in double non-taxation.

ii. Exception for Payments Otherwise Taken into Account Under Foreign Law.

(a) Under the proposed regulations, a special rule ensures that a specified payment is not a deemed branch payment to the extent the payment is otherwise taken into account under the home office's tax law in such a manner that there is no mismatch. Prop. Treas. Reg. § 1.267A-2(c)(2). Absent such a rule, a deduction for a deemed branch payment could be disallowed even though it does not give rise to a D/NI outcome.

(b) However, the proposed regulations do not provide a similar special rule in analogous cases involving disregarded payments. To provide symmetry between the disregarded payment rule and the deemed branch payment rule, the final regulations add to the disregarded payment rule a special rule similar to the special rule in the deemed branch payment context. Treas. Reg. § 1.267A-2(b)(2)(ii)(B).

(d) Payments by U.S. Taxable Branches.

i. Allocation of Interest Expense to U.S. Taxable Branches.

(a) The proposed regulations provided that a U.S. taxable branch of a foreign corporation is considered to pay or accrue interest allocable under § 882(c)(1) to effectively connected income of the U.S. taxable branch. Prop. Treas. Reg. § 1.267A-5(b)(3). The proposed regulations included rules to identify the manner in which a specified payment of a U.S. taxable branch is considered made. For directly allocable interest described in Treas. Reg. § 1.882-5(a)(1)(ii)(A), or a U.S. booked liability described in Treas. Reg. § 1.882-5(d)(2), a direct tracing approach applies; for any excess interest, the U.S. taxable branch is treated as paying or accruing interest to the same persons and pursuant to the

same terms that the home office paid or accrued such interest on a pro-rata basis.

- (b) The proposed regulations did not, however, contain rules for tracing a foreign corporation's distributive share of interest expense when the foreign corporation is a partner in a partnership that has a U.S. asset, as described in Treas. Reg. § 1.882-5(a)(1)(ii)(B), or rules for tracing interest that is determined under the separate currency pools method, as described in Treas. Reg. § 1.882-5(e).
- (c) The final regulations therefore provide that, like directly allocable interest and U.S. booked liabilities, a U.S. taxable branch must use a direct tracing approach to identify the person to whom interest described in Treas. Reg. § 1.882-5(a)(1)(ii)(B) or Treas. Reg. § 1.882-5(e) is payable. Treas. Reg. § 1.267A-5(b)(3)(ii)(A).
- (d) In addition, Treasury and the IRS believe that a consistent approach should apply for purposes of identifying a U.S. branch interest payment in order to avoid treating similarly situated taxpayers differently under § 267A. Accordingly, similar to the tracing rules provided in the final regulations under § 59A, the final regulations provide that foreign corporations should use U.S. booked liabilities to identify the person to whom an interest expense is payable, without regard to which method the foreign corporation uses to determine its interest expense under § 882(c)(1). Treas. Reg. § 1.59A-3(b)(4)(i)(B).

ii. Interaction with Income Tax Treaties.

- (a) Under the proposed regulations, the deemed branch payment rule addresses a D/NI outcome when, under an income tax treaty, a deductible payment is deemed to be made by a permanent establishment to its home office (or another branch of the home office) and offsets income not taxable to the home office, but the payment is not taken into account under the tax law of the home office or other branch. Prop. Treas. Reg. § 1.267A-2(c)(2). A deemed branch payment is a notional payment that arises from applying Article 7 (Business Profits) of



certain U.S. income tax treaties, which takes into account only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment to determine the business profits that may be taxed where the permanent establishment is situated.

- (b) A comment questioned whether the deemed branch payment rule is a treaty override because it creates a new condition on the allowance of a deduction for purposes of computing the business profits of a U.S. permanent establishment based upon an intervening change in U.S. law. The comment noted that the deemed branch payment rule affects the allocation of taxing rights of business profits under the treaty. Another comment raised a similar concern and requested that the deemed branch payment rule be withdrawn because it is inconsistent with U.S. income tax treaty obligations.
- (c) Treasury and the IRS believe that the deemed branch payment rule is not a treaty override and is consistent with U.S. income tax treaty obligations. The treaties that allow notional payments under Article 7 take into account interbranch transactions and value such interbranch transactions using the most appropriate arm's length methodology. Once expenses are either allocated or determined under arm's length principles to be taken into account in determining the business profits of the permanent establishment under Article 7, domestic limitations on deductibility of such expenses may apply in the same manner as they would if the amounts were paid by a domestic corporation. In other words, §§ 163(j), 267(a)(3), and 267A generally apply to the same extent to the notional payments as they would to actual interest payments by a domestic subsidiary to a foreign parent.
- (d) The commentary to paragraph 2 of Article 7 of the OECD Model Tax Convention adopts a comparable interpretation. *See* Para. 30 and 31 of the commentary to para. 2 of Article 7 of the OECD Model Tax Convention. Accordingly, the final regulations retain the deemed branch payment rule.

(e) Reverse Hybrids.

i. Fiscally Transparent.

- (a) A reverse hybrid is an entity that is fiscally transparent for purposes of the tax law of the country in which it is established but not for purposes of the tax law of an investor of the entity. Treas. Reg. § 1.267A-2(d)(2). Under the proposed regulations, whether an entity is fiscally transparent with respect to an item of income is determined under the principles of Treas. Reg. § 1.894-1(d)(3)(ii) and (iii). Prop. Treas. Reg. § 1.267A-5(a)(8).
- (b) The final regulations provide special rules to address certain cases in which, given Treas. Reg. § 1.894-1(d)(3)'s definition of fiscally transparent, an entity might not be considered a reverse hybrid under the proposed regulations with respect to a payment received by the entity, even though neither the entity nor an investor of the entity take the payment into account in income, with the result that the payment gives rise to a D/NI outcome. Pursuant to the special rules, an entity is considered fiscally transparent with respect to the payment under the tax law of the country where it is established if, under such tax law, the entity allocates the payment to an investor, with the result that under such tax law the investor is viewed as deriving the payment through the entity. Treas. Reg. § 1.267A-5(a)(8)(i); Treas. Reg. § 1.267A-6(c)(5)(vi).
- (c) A similar rule applies for purposes of determining whether the entity is fiscally transparent with respect to the payment under an investor's tax law. Treas. Reg. § 1.267A-5(a)(8)(ii). Lastly, to address the fact that under Treas. Reg. § 1.894-1(d)(3)(ii), certain collective investment vehicles and similar arrangements may not be considered fiscally transparent under the tax law of the country where established, a special rule provides that such arrangements are considered fiscally transparent under the tax law of the establishment country if neither the arrangement nor an investor is required to take the payment into account in income. Treas.

Reg. § 1.267A-5(a)(8)(iii); Treas. Reg. § 1.894-1(d)(5), Example 7.

ii. Current-Year Distributions from Reverse Hybrid.

- (a) Under the proposed regulations, when a specified payment was made to a reverse hybrid, it was generally a disqualified hybrid amount to the extent that an investor did not include the payment in income. Prop. Treas. Reg. § 1.267A-2(d)(1). For this purpose, whether an investor includes the specified payment in income is determined without regard to a subsequent distribution by the reverse hybrid. Prop. Treas. Reg. § 1.267A-3(a)(3).
- (b) A comment noted that if a reverse hybrid distributes all of its income during a taxable year, then current year distributions should be taken into account for purposes of determining whether an investor of the reverse hybrid includes in income a specified payment made to the reverse hybrid. The comment said that not doing so would be unduly harsh and could create unwarranted disparities between cases involving current year distributions and anti-deferral inclusions (which are taken into account for purposes of determining whether an investor includes in income a specified payment). The comment also suggested that the final regulations reserve on whether subsequent year distributions are taken into account.
- (c) Treasury and the IRS agreed with the comment that current year distributions should be taken into account in cases in which the reverse hybrid distributes all of its income during the taxable year. The final regulations thus provide that in these cases a portion of a specified payment made to the reverse hybrid during the taxable year is considered to relate to each of the current year distributions from the reverse hybrid. As a result, to the extent that an investor includes in income a current year distribution, the investor is treated as including in income a corresponding portion of a specified payment made to the reverse hybrid during the year. Treas. Reg. § 1.267A-3(a)(3).

- (d) Treasury and the IRS believe that it would be too complex to take into account current year distributions in cases in which the reverse hybrid does not distribute all of its income during the taxable year, as in these cases stacking or similar rules would likely be needed to determine the extent that a specified payment is considered to relate to a distribution. For similar reasons, Treasury and the IRS determined that it would be too complex to take into account subsequent year distributions.

iii. Multiple Investors.

- (a) The final regulations clarify the application of the reverse hybrid rule in cases in which an investor of the reverse hybrid owns only a portion of the interests of the reverse hybrid and does not include in income a specified payment made to the reverse hybrid. In these cases, given the “as a result of” test, only the no-inclusion of the investor that occurs for its portion of the payment may give rise to a disqualified hybrid amount.
- (b) For example, consider a case in which a \$100x specified payment is made to a reverse hybrid 60% of the interests of which are owned by a Country X investor (the tax law of which treats the reverse hybrid as not fiscally transparent) and 40% of the interests of which are owned by a Country Y investor (the tax law of which treats the reverse hybrid as fiscally transparent). If the Country X investor does not include any portion of the payment in income, then \$60x of the payment would generally be a disqualified hybrid amount under the reverse hybrid rule, calculated as \$100x (the no-inclusion that actually occurs with respect to the Country X investor) less \$40x (the no-inclusion that would occur with respect to the Country X investor absent hybridity). Treas. Reg. §§ 1.267A-2(d) and 1.267A-6(c)(5)(iv).

iv. Inclusion by Taxable Branch in Country in Which Reverse Hybrid is Established. The final regulations provide an exception pursuant to which the reverse hybrid rule does not apply to a specified payment made to a reverse hybrid to the extent that, under the tax law of the country in which the reverse hybrid is established, a taxable branch the

activities of which are carried on by an investor of the reverse hybrid includes the payment in income. Treas. Reg. § 1.267A-2(d)(4). Treasury and the IRS determined that, in these cases, the inclusion in the establishment country generally prevents a D/NI outcome and thus it is appropriate for an exception to apply.

D. Exceptions Relating to Disqualified Hybrid Amounts.

1. Effect of Inclusion in Another Foreign Country.

- (a) Under the proposed regulations, a specified payment generally was a disqualified hybrid amount to the extent that a D/NI outcome occurred with respect to any foreign country as a result of a hybrid or branch arrangement, even if the payment was included in income in another foreign country (a “third country”). Absent such a rule, an inclusion of a specified payment in income in a third country would discharge the application of § 267A even though a D/NI outcome occurs in a foreign country as a result of a hybrid or branch arrangement. The preamble to the proposed regulations expressed particular concern with cases in which the third country imposes a low tax rate.
- (b) Comments requested that this rule be eliminated because requiring an income inclusion in multiple jurisdictions is not necessary or appropriate to prevent a D/NI outcome. One of these comments asserted that the rule is unfair and does not effectively prevent rate arbitrage. The comments further asserted that the rule is inconsistent with the policies of § 267A, other provisions of the Code (such as § 894(c) and Treas. Reg. § 1.894-1(d)), and the Hybrid Mismatch Report. One comment stated that the rule is neither included in § 267A nor permissible under the regulatory authority under § 267A(e). Although the comments noted potential concerns associated with an income inclusion in a low-tax third country discharging the application of § 267A, the comments suggested addressing the concerns through the anti-avoidance rule included in the proposed regulations.
- (c) Treasury and the IRS believe that the approach of the proposed regulations should be retained to prevent the avoidance of § 267A by routing a specified payment through a low-tax third country, and to prevent the use of a hybrid or branch arrangement from placing a taxpayer in a better position than it would have been in absent the arrangement. In addition, Treasury and the IRS concluded that the rule is consistent with § 267A and the broad regulatory authority thereunder. Finally, Treasury and the IRS concluded that relying on the anti-avoidance rule would give rise

to uncertainty and be an insufficient remedy, and that a rate test would also be an insufficient remedy because it would give rise to additional complexity and would require taking into account tax rates, which is beyond the scope of hybrid mismatch rules.

2. Amounts Included or Includible in Income in the U.S.

- (a) The proposed regulations provided rules that, in general, ensure that a specified payment is not a disqualified hybrid amount to the extent it is included in the income of a tax resident of the U.S. or a U.S. taxable branch, or is taken into account by a U.S. shareholder under the Subpart F or GILTI rules. Prop. Treas. Reg. § 1.267A-3(b). Several comments suggested retaining these rules, but revising them in certain respects.
- (b) One comment suggested revising the rules relating to amounts taken into account under Subpart F so that the determination is made without regard to the earnings and profits limitation under § 952. Another comment noted that the rules relating to amounts taken into account under GILTI could potentially give rise to rate arbitrage (for example, if the rate on the GILTI inclusion amount is in effect reduced by reason of the deduction under § 250(a)(1)(B), and the deduction for the specified payment offsets income that is not eligible for a reduced rate). Finally, a comment suggested an exception for specified payments received by a qualified electing fund (as described in § 1295) and taken into account by a tax resident of the U.S. under § 1293.
- (c) Treasury and the IRS agreed with these recommendations, and thus the final regulations provide rules to such effect. Treas. Reg. § 1.267A-3(b)(3) through (5).

3. Effect of Withholding Taxes on a Specified Payment.

- (a) Under the proposed regulations, the determination of whether a deduction for a specified payment is disallowed under § 267A is made without regard to whether the payment is subject to U.S. source-based tax under § 871 or 881 and such tax has been deducted and withheld under § 1441 or 1442.
- (b) Several comments recommended that withholding taxes be taken into account for purposes of § 267A. For example, comments suggested that to the extent the U.S. imposes withholding tax on a specified payment, § 267A generally should not apply to the payment because, otherwise, the payment may be effectively taxed twice by the U.S. (once as a result of the withholding tax, and second as a result of the denial of a deduction for the payment).

- (c) Treasury and the IRS believe that it would not be appropriate for withholding taxes to be taken into account for purposes of § 267A. The purpose of withholding taxes is generally not to address mismatches in tax outcomes but, rather, to allow the source jurisdiction to retain its right to tax a payment. In addition, and as explained in the preamble to the proposed regulations, taking withholding taxes into account could create issues regarding how § 267A interacts with foreign hybrid mismatch rules – for example, a foreign country with hybrid mismatch rules may not treat the imposition of U.S. withholding taxes on a specified payment as neutralizing a D/NI outcome and may therefore apply a secondary or defensive rule requiring the payee to include the payment in income.
- (d) Treasury and the IRS stated that had Congress intended for withholding taxes to be taken into account for purposes of § 267A, it could have added a rule similar to the one in § 59A(c)(2)(B), which was enacted at the same time as § 267A. Finally, providing an exception for withholding taxes could raise administrability issues in cases in which a specified payment is subject to U.S. withholding taxes at the time of payment (with the result that a deduction for the payment is not disallowed under § 267A at that time) but the taxes are refunded in a later period; in these cases, it could be difficult or burdensome to retroactively deny the deduction and make corresponding adjustments.
- (e) Thus, Treasury and the IRS determined that the exceptions in Treas. Reg. § 1.267A-3(b) should generally be limited to inclusions similar to those described in the flush language of § 267A(b)(1) (inclusions under § 951(a)), which, unlike U.S. source income that is subject to withholding taxes, are included in the U.S. tax base on a net basis. Accordingly, the final regulations did not adopt the comment.

E. Disqualified Imported Mismatch Amounts.

1. In General.

- (a) Under the proposed regulations, an “imported mismatch rule” prevented the effects of an offshore hybrid arrangement from being imported into the U.S. taxing jurisdiction through the use of a non-hybrid arrangement. Pursuant to this rule, a specified payment was generally a disqualified imported mismatch amount, and therefore a deduction for the payment is disallowed, to the extent that the payment is (i) an imported mismatch payment, and (ii) income attributable to the payment is directly or indirectly offset by a

hybrid deduction of a tax resident or taxable branch. Prop. Treas. Reg. § 1.267A-4(a).

- (b) The extent that a hybrid deduction directly or indirectly offsets income attributable to an imported mismatch payment was determined pursuant to a series of operating rules, including ordering rules, funding rules, and a pro rata allocation rule. Prop. Treas. Reg. § 1.267A-4(c) and (e). Under these rules, a hybrid deduction was considered to offset income attributable to an imported mismatch payment only if the imported mismatch payment directly or indirectly funds the hybrid deduction. Prop. Treas. Reg. § 1.267A-4(c).
- (c) Some comments said that the imported mismatch rule is complex and could be difficult to administer. One comment suggested removing the imported mismatch rule because of the complexity and administrability concerns and also because, according to the comment, the rule exceeds the authority granted under § 267A. Another comment suggested modifying the rule so that an imported mismatch payment is a disqualified imported mismatch amount only if the income attributable to the payment is offset by a hybrid deduction that as a factual matter is connected to the payment; thus, under this approach, the operating rules under the proposed regulations would generally be replaced with a broader facts and circumstances inquiry, possibly supplemented by rebuttable presumptions. Other comments suggested modifications to specific aspects of the imported mismatch rule, such as the operating rules.
- (d) Treasury and the IRS concluded that the general approach of the imported mismatch rule under the proposed regulations should be retained, and that the rule is consistent with the grant of regulatory authority under § 267A(e)(1). Treasury and the IRS determined that the operating rules under the proposed regulations provide more certainty than under alternative approaches.
- (e) In addition, they determined that the general approach under the proposed regulations promotes parity between similarly situated taxpayers. Further, the general approach under the proposed regulations is consistent with the approach recommended under the BEPS Hybrid Mismatch and Branch Mismatch reports.
- (f) However, in response to comments, the final regulations modify certain aspects of the imported mismatch rule in order to reduce complexity and facilitate compliance and administration of the rule.



2. Imported Mismatch Payments.

- (a) Several comments suggested that the imported mismatch rule could result in double U.S. taxation in certain cases.
- (b) For example, assume US1, a domestic corporation, owns all the interests of each of US2, a domestic corporation, and FX, a tax resident of Country X that is a CFC for U.S. tax purposes. Also assume that FX owns all the interests of FY, a tax resident of Country Y that is a disregarded entity for U.S. tax purposes. Lastly, assume that US2 makes a \$100x non-hybrid specified payment to FY, and that FY incurs a \$100x hybrid deduction. In such a case, according to the comments, treating US2's payment as a disqualified imported mismatch amount could result in double U.S. taxation, as the U.S. would be disallowing US2 a deduction for the payment even though the entire amount is indirectly included in US1's income as a Subpart F inclusion.
- (c) Treasury and the IRS agreed with these comments. As a result, the final regulations revise the definition of an imported mismatch payment, which under the proposed regulations is defined as any specified payment to the extent not a disqualified hybrid amount. Under the final regulations, a specified payment is an imported mismatch payment only to the extent that it is neither a disqualified hybrid amount nor included or includible in income in the U.S. (as determined under the rules of Treas. Reg. § 1.267A-3(b)). Treas. Reg. § 1.267A-4(a)(2)(v).
- (d) Thus, in the example above, none of US2's payment would be an imported mismatch payment, calculated as \$100x (the amount of the payment) less \$0 (the disqualified hybrid amount with respect to the payment), less \$100x (the amount of the payment that is included or includible in income in the U.S.). Accordingly, none of the payment would be subject to disallowance under the imported mismatch rule.

3. Hybrid Deductions.

(a) Deductions Constituting Hybrid Deductions.

- i. Under the proposed regulations, for a deduction allowed to a tax resident or taxable branch under its tax law to be a hybrid deduction, it generally had to be one that would be disallowed if such tax law contained rules substantially similar to the rules under Treas. Reg. §§ 1.267A-1 through 1.267A-3 and 1.267A-5. Prop. Treas. Reg. § 1.267A-4(b).

- ii. A comment requested guidance on how this standard applies when the tax law of a tax resident or taxable branch contains hybrid mismatch rules. The comment posited several approaches, including (i) not treating deductions allowed to such a tax resident or taxable branch under its tax law as a hybrid deduction, or (ii) treating deductions allowed to a such a tax resident or taxable branch under its tax law as a hybrid deduction if the deduction would be disallowed if such tax law contained rules nearly identical to those under § 267A. The comment recommended the first approach.
- iii. Treasury and the IRS believe that the first approach could give rise to inappropriate results. For example, in the case of a deduction allowed to a foreign tax resident under its tax law with respect to an interest-free loan, the deduction would not be a hybrid deduction under the first approach if the tax resident's tax law contains hybrid mismatch rules, even though the deduction would be disallowed under § 267A were § 267A to apply to the deduction.
- iv. They also believe that these results could lead to avoidance of the purposes of § 267A. That is, the first approach could incentivize taxpayers to implement certain offshore hybrid arrangements and import the effects of the arrangement into the U.S. taxing jurisdiction, even though a deduction would be disallowed under § 267A were the arrangement to involve the U.S. taxing jurisdiction directly. Accordingly, the final regulations did not adopt this approach.
- v. However, in response to the comment, the final regulations provide an exclusive list of deductions that constitute hybrid deductions with respect to a tax resident or taxable branch the tax law of which contains hybrid mismatch rules. Treas. Reg. § 1.267A-4(b)(2)(i). This list, which represents deductions that would be disallowed under § 267A but may be allowed under the hybrid mismatch rules of the foreign country, includes deductions with respect to (i) equity, (ii) interest-free loans (and similar arrangements), and (iii) amounts that are not included in income in a third foreign country.
- vi. Thus, in the case of a tax resident or taxable branch the tax law of which contains hybrid mismatch rules, a taxpayer need only consider these three types of arrangements when determining whether the tax resident or taxable branch has hybrid deductions for purposes of the imported mismatch

rule. Treasury and the IRS concluded that this approach increases certainty and improves the administration of the imported mismatch rule.

(b) NIDs.

- i. Under the proposed regulations, a hybrid deduction included NIDs allowed to a tax resident under its tax law. Prop. Treas. Reg. § 1.267A-4(b). The comments regarding NIDs in the context of § 267A were substantially similar to the comments regarding NIDs in the context of § 245A(e). Thus, for reasons similar to those discussed in that section (above), the final regulations generally retain the approach of the proposed regulations regarding NIDs, but provide that only NIDs allowed to a tax resident under its tax law for accounting periods beginning on or after December 20, 2018, are hybrid deductions. Treas. Reg. § 1.267A-4(b)(2)(iii).
- ii. In addition, a comment suggested that including NIDs as a hybrid deduction conflicts with nondiscrimination provisions of income tax treaties that require interest and royalties paid by U.S. residents to residents of the other treaty country be deductible under the same conditions as if they had been paid to a resident of the U.S.
- iii. In this case, the disallowance of a deduction is dependent solely on differences in U.S. tax law and the tax law of an imported mismatch payee (or certain other foreign parties), and the tax benefits allowed to the imported mismatch payee (or certain other foreign parties) under foreign tax law. Payments to related domestic persons would always be governed by the same Federal tax laws, and domestic law does not provide hybrid deductions, including NIDs, to domestic persons. Accordingly, Treasury and the IRS concluded that including NIDs as a hybrid deduction does not conflict with the nondiscrimination provision of applicable U.S. income tax treaties.
- iv. The proposed regulations do not provide a rule pursuant to which NIDs are hybrid deductions only to the extent that the double non-taxation produced by the NIDs is a result of hybridity. However, consistent with other aspects of the § 267A regulations, Treasury and the IRS concluded that such a rule is appropriate and the final regulations therefore provide a rule to this effect. Treas. Reg. § 1.267A-4(b)(1)(ii).

- v. Thus, for example, in the case of a tax resident all the interests of which are owned by an investor that is a tax resident of another country, NIDs allowed to the tax resident are not hybrid deductions if the tax law of the investor has a pure territorial regime (that is, only taxes income from domestic sources) or if such tax law does not impose an income tax.

(c) Deemed Branch Payments.

- i. Under the proposed regulations, a hybrid deduction of a taxable branch included a deduction that would be disallowed if the tax law of the taxable branch contained a provision substantially similar to Prop. Treas. Reg. § 1.267A-2(c) (regarding deemed branch payments). Prop. Treas. Reg. § 1.267A-4(b). Prop. Treas. Reg. § 1.267A-2(c) generally disallowed a deduction for a deemed branch payment of a U.S. taxable branch only if the tax law of the home office provides an exclusion or exemption for income attributable to the branch. Prop. Treas. Reg. § 1.267A-2(c) thus provided a simpler standard than the dual inclusion income standard of Prop. Treas. Reg. § 1.267A-2(b) (regarding disregarded payments).
- ii. The simpler standard applies for deemed branch payments because these payments may arise due to simply operating a U.S. trade or business (as opposed to disregarded payments that typically result from structured tax planning), as well as because, given that U.S. permanent establishments cannot consolidate or otherwise share losses with U.S. taxpayers, there is a more limited opportunity for a deduction for such payments to offset non-dual inclusion income.
- iii. A comment noted that under a tax law of a foreign country a taxable branch could be permitted to consolidate or otherwise share losses with a tax resident of that country.
- iv. Treasury and the IRS believe that, in the imported mismatch context, the dual inclusion income standard should apply in cases in which the tax law of the taxable branch permits a loss of the taxable branch to be shared with a tax resident or another taxable branch, because in these cases the excess of the taxable branch's deemed branch payments over its dual inclusion income could offset non-dual inclusion income. The final regulations

therefore provide a rule to this effect. Treas. Reg. § 1.267A-4(b)(2)(ii).

(d) Hybrid Deductions of CFCs.

- i. Under the proposed regulations, only a tax resident or taxable branch that is not a specified party could incur a hybrid deduction. Prop. Treas. Reg. § 1.267A-4(b). Similarly, under the proposed regulations, only a tax resident or a taxable branch that is not a specified party could make a funded taxable payment. Prop. Treas. Reg. § 1.267A-4(c)(3). This approach was generally intended to ensure that § 267A does not result in double U.S. taxation in cases of specified payments involving CFCs, because payments to CFCs are generally includible in income in the U.S. and payments by CFCs are generally subject to disallowance as disqualified hybrid amounts.
- ii. A comment noted that this approach could lead to inappropriate results in certain cases. For example, it could lead to the avoidance of the imported mismatch rule through the use CFCs that are not wholly-owned by tax residents of the U.S. The comment therefore recommended that the final regulations provide that CFCs can incur hybrid deductions and make funded taxable payments. However, to prevent double U.S. taxation, the comment suggested that a payment by a CFC not give rise to a hybrid deduction or a funded taxable payment to the extent that the payment gives rise to an increase in the U.S. tax base.
- iii. Treasury and the IRS agreed with the comment and the final regulations therefore provide that CFCs can incur hybrid deductions and make funded taxable payments. Treas. Reg. § 1.267A-4(b)(1) and (c)(3)(v).
- iv. The final regulations also provide rules to ensure that a hybrid deduction or funded taxable payment of a CFC does not include an amount that is a disqualified hybrid amount or included or includible in income in the U.S. (as determined under the rules of Treas. Reg. § 1.267A-3(b)). Treas. Reg. § 1.267A-4(b)(2)(iv) and (c)(3)(v)(C).
- v. However, in the case of a disqualified hybrid amount of a CFC that is only partially owned by tax residents of the U.S. (or a disqualified hybrid amount a deduction for which would be allocated and apportioned to income not subject to U.S. tax), only a portion of the disqualified hybrid

amount prevents a payment of the CFC from giving rise to a hybrid deduction or a funded taxable payment, as disallowing the CFC a deduction for the disqualified hybrid amount will only partially increase the U.S. tax base (or will not increase the U.S. tax base at all). Treas. Reg. § 1.267A-4(g). A new example illustrates these rules. Treas. Reg. § 1.267A-6(c)(11).

4. Setoff Rules.

- (a) Funded Taxable Payments. Under the proposed regulations, for an imported mismatch payment to indirectly fund a hybrid deduction, the imported mismatch payee had to directly or indirectly make a funded taxable payment to the tax resident or taxable branch that incurs the hybrid deduction. Prop. Treas. Reg. § 1.267A-4(c)(3). A comment requested that the final regulations clarify that, for a payment to be a funded taxable payment, it must be included in income of a tax resident or taxable branch. Treasury and the IRS agreed with the comment and the final regulations thus provide a clarification to this effect. Treas. Reg. § 1.267A-4(c)(3)(v)(B).
- (b) Hybrid Deduction First Offsets Imported Mismatch Payment with Closest Nexus to Deduction.
  - i. Under the proposed regulations, when there are multiple imported mismatch payments, a hybrid deduction was first considered to offset income attributable to the imported mismatch payment that has the closest nexus to the hybrid deduction. Prop. Treas. Reg. §§ 1.267A-4(c)(2) and 1.267A-6(c)(10).
  - ii. For example, in the case of two imported mismatch payments, one of which is made pursuant to a transaction entered into pursuant to the same plan pursuant to which the hybrid deduction is incurred (a “factually-related imported mismatch payment”) and the other of which is not a factually-related imported mismatch payment, the hybrid deduction was first considered to offset income attributable to the factually-related imported mismatch payment.
  - iii. As an additional example, in the case of two imported mismatch payments, one of which is directly connected to a hybrid deduction (because the imported mismatch payee with respect to the payment is the tax resident or taxable branch that incurs the hybrid deduction) and the other of which is indirectly connected to the hybrid deduction (because the imported mismatch payee with respect to the

payment makes a funded taxable payment to the tax resident or taxable branch that incurs the hybrid deduction), the hybrid deduction was first considered to offset income attributable to the imported mismatch payment that is directly connected to the hybrid deduction.

- iv. The final regulations retain this approach and provide two clarifications. First, the final regulations clarify that an imported mismatch payment is a factually-related imported mismatch payment – and therefore is given priority in terms of funding the hybrid deduction over other imported mismatch payments – only if a design of the plan or series of related transactions pursuant to which the hybrid deduction is incurred was for the hybrid deduction to offset income attributable to the payment. Treas. Reg. § 1.267A-4(c)(2)(i).
- v. Second, the final regulations clarify that when there are multiple imported mismatch payments that are indirectly connected to the tax resident or taxable branch that incurs the hybrid deduction, the hybrid deduction is first considered to offset income attributable to an imported mismatch payment that is connected, through the fewest number of funded taxable payments, to the tax resident or taxable branch that incurs the hybrid deduction. Treas. Reg. § 1.267A-4(c)(3)(vii) and (viii). For example, in the case of back-to-back imported mismatch payments, the first such payment is given priority over more removed imported mismatch payments.

(c) Relatedness Requirement.

- i. Under the proposed regulations, a hybrid deduction offset income attributable to an imported mismatch payment only if the tax resident or taxable branch that incurs the hybrid deduction is related to the imported mismatch payer (or is a party to a structured arrangement pursuant to which the payment is made). Prop. Treas. Reg. § 1.267A-4(a).
- ii. A comment requested that, for an imported mismatch payment to indirectly fund a hybrid deduction and thus be offset by the deduction, the imported mismatch payee (and, if applicable, each intermediary tax resident or taxable branch in the chain of funded taxable payments) must be related to the imported mismatch payer (or a party to a structured arrangement pursuant to which the payment is made).

- iii. Treasury and the IRS agreed with the comment and the final regulations therefore provide rules to this effect. Treas. Reg. § 1.267A-4(c)(3)(ii) and (iv).

5. Coordination with Foreign Imported Mismatch Rules.

(a) Certain Payments Deemed to be Imported Mismatch Payments.

- i. The proposed regulations coordinated the U.S. imported mismatch rule with foreign imported mismatch rules, in order to prevent the same hybrid deduction from resulting in deductions for non-hybrid payments being disallowed under imported mismatch rules in more than one jurisdiction. In general, the proposed regulations did so through a special rule pursuant to which certain payments by non-specified parties are deemed to be imported mismatch payments (the “Deemed IMP Rule”). Treas. Reg. § 1.267A-4(f).
- ii. In certain cases, the effect of the Deemed IMP Rule is that the rule reduces the extent to which a payment of a specified party is considered to fund a hybrid deduction (and therefore reduces the extent to which the hybrid deduction is considered to offset the income attributable to the imported mismatch payment).
- iii. For example, a hybrid deduction may be considered directly funded by a payment of a non-specified party, rather than indirectly funded by a payment of a specified party; or, a hybrid deduction may be considered pro rata funded by a payment of a specified party and a payment of a non-specified party, rather than solely funded by the payment of the specified party.
- iv. Under the proposed regulations, the Deemed IMP Rule applied only to payments by a tax resident or taxable branch the tax law of which contains hybrid mismatch rules, and only to the extent that pursuant to an imported mismatch rule under such tax law, the tax resident or taxable branch is denied a deduction for all or a portion of the payment.
- v. Comments recommended modifying the Deemed IMP Rule so that it takes into account payments subject to disallowance under a foreign imported mismatch rule, rather than payments a deduction for which is actually denied under the foreign imported mismatch rule.



According to a comment, this would obviate the need for taxpayers to apply all foreign imported mismatch rules before the U.S. imported mismatch rule, determine which payments are ones for which a deduction is disallowed under the foreign rules, and then treat those payments as imported mismatch payments for purposes of the U.S. imported mismatch rule.

- vi. Treasury and the IRS generally agreed with these comments and the final regulations therefore modify the Deemed IMP Rule to this effect. Treas. Reg. § 1.267A-4(f)(2). However, the final regulations adjust the application of the imported mismatch rule in certain cases, in order to prevent the Deemed IMP Rule from giving rise to inappropriate results.

(b) Special Rules for Applying Imported Mismatch Rule.

- i. In cases in which the U.S. imported mismatch rule treats a deduction as a hybrid deduction but a foreign imported mismatch rule does not, the Deemed IMP Rule could give rise to inappropriate results.
- ii. To address this concern, the final regulations provide that the U.S. imported mismatch rule is first applied by taking into account only certain hybrid deductions – that is, deductions that are unlikely to be treated as hybrid deductions for purposes of a foreign hybrid mismatch rule. Treas. Reg. § 1.267A-4(f)(1). The final regulations provide an exclusive list of such hybrid deductions, which covers the hybrid deductions.
- iii. In addition, for purposes of applying the imported mismatch rule in this manner, the Deemed IMP Rule does not apply. Consequently, such hybrid deductions are considered to offset only income attributable to imported mismatch payments of specified parties. This approach generally ensures that a foreign imported mismatch rule does not turn off the U.S. imported mismatch rule in cases in which the foreign imported mismatch rule is unlikely to neutralize the D/NI outcome produced by the hybrid arrangement.
- iv. For all other hybrid deductions, the imported mismatch rule is applied by taking into account the Deemed IMP Rule. Treas. Reg. § 1.267A-4(f)(2). This generally ensures that, for deductions that are likely to be treated as hybrid

deductions for both the U.S. and a foreign imported mismatch rule, there is a coordination mechanism to mitigate the likelihood of double-tax.

(c) Payments to a Country the Tax Law of Which Contains Hybrid Mismatch Rules.

- i. Several comments suggested a special rule pursuant to which an imported mismatch payment is exempt from the U.S. imported mismatch rule if the tax law of the imported mismatch payee contains hybrid mismatch rules. According to the comments, such an approach would generally rely on an imported mismatch rule of the imported mismatch payee to neutralize the effects of offshore hybrid arrangements that have a closer nexus to the country of the imported mismatch payee than the U.S.
- ii. The final regulations did not incorporate a special rule to this effect because Treasury and the IRS believe that such a rule could give rise to inappropriate results. In addition, they concluded that when the U.S. imported mismatch rule is applied by taking into account the Deemed IMP Rule, the Deemed IMP Rule – in conjunction with other portions of the imported mismatch rule, such as the ordering and funding rules (including the waterfall approach) – generally obviates the need for the special rule.
- iii. That is, when a hybrid deduction has a closer nexus to the country of the imported mismatch payee than the U.S., the hybrid deduction is generally considered to offset income attributable to the imported mismatch payee’s payment, rather than income attributable to the specified party’s payment. As a result, the U.S. imported mismatch rule in effect relies on an imported mismatch rule of the imported mismatch payee to neutralize the effect of the offshore hybrid arrangement. Treas. Reg. § 1.267A-6(c)(10)(iv) and (c)(12).

(d) Priority for Certain Amounts Disallowed Under Foreign Imported Mismatch Rule.

- i. One comment suggested a new coordination rule pursuant to which, to the extent that a foreign tax resident or taxable branch is disallowed a deduction for a payment under a foreign imported mismatch rule, the U.S. imported mismatch rule generally considers a hybrid deduction to offset income attributable to that payment before offsetting

income attributable to other payments. Such an approach would in effect provide as a credit against the U.S. imported mismatch rule amounts disallowed under a foreign imported mismatch rule.

- ii. The final regulations did not adopt this comment. Treasury and the IRS believe that when a hybrid deduction has a closer nexus to the U.S. than a foreign country, the U.S. imported mismatch rule – rather than the foreign imported mismatch rule – should apply to neutralize the effects of the offshore hybrid arrangement. In addition, they determined that, for purposes of administrability, the U.S. imported mismatch rule should not require an analysis of amounts actually disallowed under a foreign imported mismatch rule.

F. Other Issues.

1. Definition of Interest.

- (a) As explained in the preamble to the proposed regulations, the definition of interest in Prop. Treas. Reg. § 1.267A-5(a)(12) was based on, and is similar in scope as, the definition of interest contained in the proposed regulations under § 163(j); no comments were received on this definition.
- (b) However, Treasury and IRS received numerous comments on the definition of interest in the proposed regulations under § 163(j). Taking into account those comments, the final regulations modify the definition of interest for § 267A purposes in certain respects.
- (c) For example, in view of comments recommending modification of the hedging rules, the final regulations under § 267A do not include rules requiring adjustments to the amount of interest expense to reflect the impact of derivatives that alter a taxpayer's effective cost of borrowing. Treas. Reg. § 1.267A-5(a)(12). As another example, in view of comments regarding the treatment of swaps with nonperiodic payments, the final regulations provide exceptions for cleared swaps and for non-cleared swaps subject to margin or collateral requirements. Treas. Reg. § 1.267A-5(a)(12)(ii).

2. Structured Payments Treated as Interest.

- (a) In order to address certain structured transactions, the proposed regulations provided that structured payments are treated as specified payments and therefore are subject to § 267A. Prop. Treas. Reg. § 1.267A-5(b)(5)(i). Under the proposed regulations,

structured payments included certain payments related to, or predominantly associated with, the time value of money, and adjustments for amounts affecting the effective cost of funds. Prop. Treas. Reg. § 1.267A-5(b)(5)(ii).

- (b) A comment noted that under the proposed regulations it is unclear in certain cases whether structured payments are treated as identical to interest for purposes of § 267A. The comment suggested that the final regulations address this ambiguity, including by providing that structured payments are treated as identical to interest or including structured payments within the definition of interest. Treasury and the IRS agreed with the comment, and thus the final regulations clarify that structured payments are treated as identical to interest for purposes of § 267A. Treas. Reg. § 1.267A-5(b)(5)(i).
- (c) In addition, the final regulations modified the definition of a structured payment in light of comments that Treasury and the IRS received regarding the definition of interest in the proposed regulations under § 163(j). Under Prop. Treas. Reg. § 1.267A-5(b)(5)(ii), certain amounts that are closely related to interest and that affect the economic cost of funds, such as commitment fees, debt issuance costs, and guaranteed payments, were treated as structured payments.
- (d) The final regulations do not specifically include these items as part of the definition of structured payments; instead, the final regulations provide an anti-avoidance rule under which any expense or loss that is economically equivalent to interest is treated as a structured payment for purposes of § 267A if a principal purpose of structuring the transaction is to reduce an amount incurred by the taxpayer that otherwise would have been treated as interest or as a structured payment under Treas. Reg. § 1.267A-5(a)(12) or (b)(5)(ii). Treas. Reg. § 1.267A-5(b)(5)(ii)(B).

### 3. Coordination with Capitalization and Recovery Provisions.

- (a) A comment noted that in certain cases a structured payment may not be deductible under the Code and, instead, the payment may be capitalized and give rise to amortization or depreciation deductions. The comment suggested that the final regulations clarify how § 267A applies to such payments, including whether the payments are treated as “paid or accrued” for purposes of the regulations and whether amortization or depreciation deductions for the payments are subject to disallowance under § 267A. The comment said that the disallowance of deductions relating to capitalized costs should be limited to structured payments.

- (b) The final regulations provide that § 267A applies to a structured payment, including a capitalized cost, in the same manner as if it were an amount of interest paid or accrued. Treas. Reg. § 1.267A-5(b)(5)(i). In addition, the final regulations coordinate § 267A with the capitalization and recovery provisions of the Code. Treas. Reg. § 1.267A-5(b)(1)(iii).
- (c) Pursuant to this rule, to the extent a specified payment is described in Treas. Reg. § 1.267A-1(b) (that is, a disqualified hybrid amount, a disqualified imported mismatch amount, or one to which the § 267A anti-avoidance rule applies), a deduction for the payment is considered permanently disallowed for all purposes of the Code and, therefore, the payment is not taken into account for purposes of any capitalization and recovery provision. Treas. Reg. § 1.267A-5(b)(4) (a payment for which a deduction is disallowed may still reduce the corporation's earnings and profits).
- (d) This rule is not limited to structured payments because Treasury and the IRS have determined that, if the rule were so limited, deductions for other specified payments could inappropriately give rise to D/NI outcomes through, for example, depreciation or amortization deductions.

4. Structured Arrangements.

(a) Definition.

- i. Under the proposed regulations, an arrangement was a structured arrangement if either (i) a pricing test is satisfied, meaning that a hybrid mismatch is priced into the terms of the arrangement, or (ii) a principal purpose test is satisfied, meaning that, based on all the facts and circumstances, a hybrid mismatch is a principal purpose of the arrangement. Prop. Treas. Reg. § 1.267A-5(a)(20).
- ii. A comment suggested that the principal purpose test could be difficult to apply, as it requires a subjective analysis of actual motivation or intent. In addition, the comment noted that in certain cases it might not be clear whose actual motivation or intent controls for purposes of the test. Thus, the comment suggested replacing the principal purpose test with an objective test, such as a test that analyzes whether the arrangement was designed to produce the hybrid mismatch. Further, the comment suggested incorporating a “reason to know” standard into the structured arrangement rules, such that a tax resident or taxable branch would not be considered a party to a structured arrangement if the tax

resident or taxable branch (or a related party) could not reasonably have been expected to be aware of the hybrid mismatch. Lastly, the comment noted that having a pricing test as an independent test could potentially lead to confusion if the other test (that is, the principal purpose test or the design test) also takes into account pricing considerations.

- iii. Treasury and the IRS agreed with this comment. Thus, the final regulations provide for an objective design test, incorporate a reason to know standard, and incorporate the pricing test into the design test. Treas. Reg. § 1.267A-5(a)(20).

(b) Applicability Date.

- i. A comment asserted that it may be difficult or costly to unwind a structured arrangement between unrelated parties. In order to facilitate restructuring of these arrangements, the comment suggested transitional relief for specified payments made pursuant to structured arrangements entered into on or before December 20, 2018 (or, alternatively, before December 22, 2017, the date of the Act). For example, the comment suggested that specified payments made pursuant to such arrangements be subject to § 267A beginning January 1, 2021.
- ii. Treasury and the IRS believe that, to facilitate restructurings intended to eliminate or minimize hybridity for structured arrangements entered into before December 22, 2017, the final regulations should apply to specified payments made pursuant to such an arrangement only for taxable years beginning after December 31, 2020. The final regulations therefore provide a rule to this effect. Treas. Reg. § 1.267A-7(b)(2).

(c) De Minimis Exception.

- i. The proposed regulations included a de minimis exception that exempts a specified party from the application of § 267A for any taxable year for which the sum of the specified party's interest and royalty deductions (plus interest and royalty deductions of any related specified parties) is below \$50,000. Treas. Reg. § 1.267A-1(c). This \$50,000 threshold takes into account a specified party's interest or royalty deductions without regard to whether the deductions involve hybrid arrangements and therefore,

absent the de minimis exception, would be disallowed under § 267A.

- ii. A comment suggested that the \$50,000 threshold instead should apply to the total amount of interest or royalty deductions involving hybrid or branch arrangements. The comment suggested that such an approach would produce more equitable results between similarly situated taxpayers.
- iii. Treasury and the IRS agreed with the comment, and the final regulations thus modify the de minimis exception to this effect. Treas. Reg. § 1.267A-1(c). In addition, for purposes of clarity, and because certain specified payments may not be deductible under the Code (but, instead, may be capitalized and give rise to other deductions, such as amortization or depreciation, or loss), the final regulations replace the reference in the de minimis exception to interest or royalty deductions with a reference to specified payments.

(d) Tax Law of a Country.

- i. The proposed regulations defined a tax law of a country to include statutes, regulations, administrative or judicial rulings, and treaties of the country. Treas. Reg. § 1.267A-5(a)(21). Treasury and the IRS believe that it is appropriate to take into account a country's subnational tax laws when such laws impose income taxes that are covered taxes under an income tax treaty with the U.S. (and therefore are likely to comprise a significant amount of a taxpayer's overall tax burden in that country).
- ii. The final regulations therefore provide that the tax law of a country includes the tax law of a political subdivision or other local authority of a country, provided that income taxes imposed under such a subnational tax law are covered by an income tax treaty between that country and the U.S. Treas. Reg. § 1.267A-5(a)(21).

(e) Specified Parties.

- i. Under the proposed regulations, a specified party included a CFC for which there are one or more U.S. shareholders that own (within the meaning of § 958(a)) at least ten percent of the stock of the CFC. Prop. Treas. Reg. § 1.267A-5(a)(17). Treasury and the IRS believe that in certain cases involving CFCs the definition of specified

party could be overbroad. For example, under the proposed regulations, a CFC wholly owned by a domestic partnership was a specified party, even if all the partners of the partnership were foreign persons.

- ii. The final regulations thus provide that a CFC is a specified party only if there is a tax resident of the U.S. that, for purposes of §§ 951 and 951A, owns (within the meaning of § 958(a), but for this purpose treating a domestic partnership as foreign) at least ten percent of the stock of the CFC. Treasury and the IRS expect that when proposed regulations under § 958 (REG-101828-19, 84 FR 29114) are finalized, the rule described in the preceding sentence treating a domestic partnership as foreign will be removed, as it will no longer be necessary. Prop. Treas. Reg. § 1.958-1(d)(1).

(f) Coordination with § 163(j).

- i. The proposed regulations provide a rule to coordinate § 267A with other provisions of the Code. Prop. Treas. Reg. § 1.267A-5(b)(1). A comment requested that the final regulations clarify that § 267A applies to a specified payment before § 163(j) applies to the payment.
- ii. The final regulations provide a clarification to this effect. Treas. Reg. § 1.267A-5(b)(1)(ii). In addition, the final regulations clarify that to the extent a specified payment is not described in Treas. Reg. § 1.267A-1(b) at the time it is subject to § 267A, the payment is not again subject to § 267A at a subsequent time. Treas. Reg. § 1.267A-5(b)(1)(i).
- iii. For example, if for the taxable year in which a specified payment is paid the payment is not described in Treas. Reg. § 1.267A-1(b) but under § 163(j) a deduction for the payment is deferred, the payment is not again subject to § 267A in the taxable year for which § 163(j) no longer defers the deduction.

(g) Anti-Avoidance Rule.

- i. The proposed regulations included an anti-avoidance rule, which provides that a specified party's deduction for a specified payment is disallowed to the extent it gives rise to a D/NI outcome, and a principal purpose of the plan or



arrangement is to avoid the purposes of the regulations under § 267A. Prop. Treas. Reg. § 1.267A-5(b)(6).

- ii. One comment supported a purpose-based anti-avoidance rule, in general, but questioned whether the rule was appropriate in the context of the § 267A regulations. The comment also raised concerns that the anti-avoidance rule may be overly broad because it neither requires hybridity nor that the D/NI outcome be the cause of hybridity. Finally, the comment requested a clearer distinction between the structured arrangement rule and the anti-avoidance rule, and recommended that the anti-avoidance rule focus on the use of a specific structure or terms in order to accomplish a D/NI outcome while avoiding the application of the regulations.
- iii. Treasury and the IRS determined that it is appropriate for the final regulations to retain a general anti-avoidance rule because, even in the context of specific rules that target hybrid and branch arrangements, such rules might be circumvented in a manner that is contrary to the purposes of the § 267A regulations.
- iv. However, Treasury and the IRS agree with the comment that the anti-avoidance rule should focus on the terms or structure of an arrangement and require that the D/NI outcome produced is a result of a hybrid or branch arrangement. The final regulations thus provide rules to this effect. Treas. Reg. § 1.267A-5(b)(6).

(h) Effect of Disallowance on Earnings and Profits.

- i. The proposed regulations provide that the disallowance of a deduction under § 267A does not affect a corporation's earnings and profits. Prop. Treas. Reg. § 1.267A-5(b)(4). Thus, a corporation's earnings and profits may be reduced as a result of a specified payment for which a deduction is disallowed under § 267A.
- ii. One comment stated that this rule is generally appropriate. However, the comment questioned whether the rule is appropriate in the context of a CFC, as the reduction of the CFC's earnings and profits may, because of the limit in § 952(c)(1), limit or prevent a Subpart F inclusion with respect to the CFC, thereby negating the effect of disallowing the CFC's deduction.

iii. Treasury and the IRS agreed with the comment and, accordingly, the final regulations adopt an anti-avoidance rule. Treas. Reg. § 1.267A-5(b)(4). Pursuant to this rule, for purposes of § 952(c)(1) or Treas. Reg. § 1.952-1(c), a CFC's earnings and profits are not reduced by a specified payment for which a deduction is disallowed if a principal purpose of the transaction giving rise to the specified payment is to reduce or limit the CFC's Subpart F income.

(i) Applicable Dates.

i. In general Treas. Reg. §§ 1.267A-1 through 1.267A-6 apply to taxable years ending on or after December 20, 2018, provided that such taxable years begin after December 31, 2017. However, taxpayers may apply the regulations in Treas. Reg. §§ 1.267A-1 through 1.267A-6 in their entirety for taxable years beginning after December 31, 2017, and ending before December 20, 2018. In lieu of applying the regulations in Treas. Reg. §§ 1.267A-1 through 1.267A-6, taxpayers may apply the provisions matching Treas. Reg. §§ 1.267A-1 through 1.267A-6 from the Internal Revenue Bulletin in their entirety for all taxable years ending on or before April 8, 2020.

ii. However, the following special rules apply regarding applicability dates: (a) Treas. Reg. § 1.267A-2(a)(4) payments pursuant to interest-free loans and similar arrangements, (b) disregarded payments, (c) deemed branch payments, and (d) branch mismatch transactions, Treas. Reg. § 1.267A-4 imported mismatch rule, and Treas. Reg. § 1.267A-5(b)(5) structured payments, except interest equivalents, apply to taxable years beginning on or after December 20, 2018.

iii. Treas. Reg. § 1.267A-5(a)(20) (defining structured arrangement), as well as the portions of Treas. Reg. §§ 1.267A-1 through 1.267A-3 that relate to structured arrangements and that are not otherwise described, apply to taxable years beginning on or after December 20, 2018. However, in the case of a specified payment made pursuant to an arrangement entered into before December 22, 2017, Treas. Reg. § 1.267A-5(a)(20), and the portions of Treas. Reg. §§ 1.267A-1 through 1.267A-3 that relate to structured arrangements and that are not otherwise described, apply to taxable years beginning after December 31, 2020.

- iv. Except as provided, the rules provided in Treas. Reg. § 1.267A-5(a)(12)(ii) (swaps with significant nonperiodic payments) apply to notional principal contracts entered into on or after April 8, 2021. However, taxpayers may apply the rules provided in Treas. Reg. § 1.267A-5(a)(12)(ii) to notional principal contracts entered into before April 8, 2021.
- v. For a notional principal contract entered into before April 8, 2021, the interest equivalent rules provided in Treas. Reg. § 1.267A-5(b)(5)(ii)(B) (applied without regard to the references to Treas. Reg. § 1.267A-5(a)(12)(ii)) apply to a notional principal contract entered into on or after April 8, 2020.
- vi. Treas. Reg. § 1.267A-5(b)(5)(ii)(B) (interest equivalent rules) applies to transactions entered into on or after April 8, 2020.

G. DCL and Entity Classification Rules -- §§ 1503(d) and 7701.

1. Domestic Reverse Hybrids.

- (a) To address double-deduction outcomes that result from domestic reverse hybrid structures, the proposed regulations required, as a condition to a domestic entity electing to be treated as a corporation under § 301.7701-3(c), that the domestic entity agree to be treated as a dual resident corporation for purposes of § 1503(d) for taxable years in which certain requirements are satisfied. Prop. Treas. Reg. § 301.7701-3(c)(3).
- (b) A comment agreed with the policy rationale for subjecting domestic reverse hybrids to the § 1503(d) regulations, and recommended that losses of domestic reverse hybrids be treated as dual consolidated losses. However, the comment expressed concern that the approach of the proposed regulations might establish a precedent allowing for a check-the-box election to be conditioned on consenting to any rule, which the comment asserted would be contrary to sound tax policy. Nonetheless, the comment stated that the § 1503(d) regulations are closely connected to the check-the-box regime, and acknowledged that a consent approach had been noted in a comment on regulations under § 1503(d) that were proposed in 2005. *See* TD 9315, 74 FR 12902. The comment recommended that, rather than the approach of the proposed regulations, Treasury and the IRS directly subject domestic reverse hybrids to § 1503(d) or, if Treasury and the IRS

were to determine that there is not sufficient authority to do so, seek a legislative amendment.

- (c) Treasury and the IRS believe that it is appropriate to condition a check-the-box election on consenting to be subject to the § 1503(d) regulations because the double-deduction concerns that result from domestic reverse hybrid structures are closely connected to the check-the-box regime. Moreover, as explained in the preamble to the proposed regulations, the approach of the proposed regulations is narrowly tailored such that the consent applies only for taxable years in which it is likely that losses of the domestic consenting corporation could result in a double-deduction outcome.
- (d) Treasury and the IRS determined that the approach of the proposed regulations is appropriate and consistent with ensuring that the check-the-box regime does not result in double-deduction outcomes. Accordingly, the final regulations retain the approach of the proposed regulations regarding domestic reverse hybrids.

2. Disregarded Payments Made to Domestic Corporations.

- (a) The preamble to the proposed regulations described certain structures involving payments from foreign disregarded entities to their domestic corporate owners that are regarded for foreign tax purposes but disregarded for U.S. tax purposes. The preamble noted that these disregarded payment structures are not addressed under the current § 1503(d) regulations but give rise to significant policy concerns that are similar to those arising under §§ 245A(e), 267A, and 1503(d). In addition, the preamble stated that Treasury and the IRS are studying these structures and request comments. In response to this request, one comment was received.
- (b) Treasury and the IRS continue to study disregarded payment structures and the comment, and may in the future issue guidance addressing these structures. In addition, Treasury and the IRS are studying other issues and comments received regarding the § 1503(d) regulations, such as an issue involving the interaction of the § 1503(d) regulations and the matching rule under Treas. Reg. § 1.1502-13(c).

3. Effective Dates. Treas. Reg. § 1.1503(d)-1(b)(2)(iii) and (c), as well as Treas. Reg. § 1.1503(d)-3(e)(1) and (3), apply to determinations under Treas. Reg. §§ 1.1503(d)-1 through 1.1503(d)-7 relating to taxable years ending on or after December 20, 2018. For taxable years ending before December 20, 2018, see Treas. Reg. § 1.1503(d)-3(e)(1) revised as of April 1, 2018.

VI. NEW FINAL REGULATIONS ON HYBRIDS AND § 951A.

- A. On December 28, 2018, Treasury and the IRS issued proposed regulations (REG-104352-18) relating to hybrid arrangements, including hybrid arrangements to which § 245A(e) applies (the “2018 hybrids proposed regulations”). Those regulations were finalized on April 8, 2020 (the “2020 hybrids final regulations”). On the same date, Treasury and the IRS issued proposed regulations (REG-106013-19) (the “2020 hybrids proposed regulations”).
- B. The 2020 hybrids proposed regulations addressed hybrid deduction accounts under § 245A(e), hybrid instruments used in conduit financing arrangements under § 881, and certain payments under § 951A (relating to global intangible low-taxed income). Treasury and the IRS received written comments regarding the 2020 hybrids proposed regulations. A public hearing on the 2020 hybrids proposed regulations was not held because there were no requests to speak.
- C. These new regulations finalize the 2020 hybrids proposed regulations addressing: (1) the reduction to a hybrid deduction account under § 245A(e) by reason of an amount included in the gross income of a domestic corporation under § 951(a) or 951A(a) regarding a controlled foreign corporation (“CFC”); (2) the treatment of a hybrid instrument as a financing transaction for purposes of the conduit financing rules under § 881; and (3) the treatment under § 951A and Treas. Reg. § 1.951A-2(c)(6) of certain prepayments made to a related CFC after December 31, 2017, and before the CFC's first taxable year beginning after December 31, 2017 (“Disqualified Period Payments”).
- D. § 245A(e).
1. Section 245A(e) was added to the Code by the TCJA. Section 245A(e) and the 2020 hybrids final regulations neutralize the double non-taxation effects of a hybrid dividend or tiered hybrid dividend by either denying the § 245A(a) dividends received deduction regarding the dividend or requiring an inclusion under § 951(a)(1)(A) regarding the dividend, depending on whether the dividend is received by a domestic corporation or a CFC.
  2. The 2020 hybrids final regulations require that certain shareholders of a CFC maintain a hybrid deduction account regarding each share of stock of the CFC that the shareholder owns, and provide that a dividend received by the shareholder from the CFC is a hybrid dividend or tiered hybrid dividend to the extent of the sum of those accounts. A hybrid deduction account regarding a share of stock of a CFC reflects the amount of hybrid deductions of the CFC that have been allocated to the share, reduced by the amount of hybrid deductions that gave rise to a hybrid dividend or tiered hybrid dividend.

3. The 2020 hybrids proposed regulations reduced a hybrid deduction account regarding a share of stock of a CFC by three categories of amounts included in the gross income of a domestic corporation regarding the share, including an “adjusted subpart F inclusion” or an “adjusted GILTI inclusion” regarding the share. Prop. Treas. Reg. § 1.245A(e)-1(d)(4)(i)(B)(1) and (2).
4. An adjusted subpart F inclusion or an adjusted GILTI inclusion regarding a share is intended to measure, in an administrable manner, the extent to which a domestic corporation’s inclusion under § 951(a)(1)(A) (“subpart F inclusion”) or inclusion under § 951A (“GILTI inclusion amount”) attributable to the share is likely “included in income” in the U.S. -- that is, taken into account in income and not offset by, for example, foreign tax credits associated with the inclusion and, in the case of a GILTI inclusion amount, the deduction under § 250(a)(1)(B).
5. The final regulations retained the basic approach and structure of the 2020 hybrids proposed regulations that reduced hybrid deduction accounts, with certain revisions.

E. Computation of Adjusted Subpart F Income Inclusion and Adjusted GILTI Inclusion.

- F. In General. Comments suggested several refinements or clarifications to the computation of an adjusted subpart F inclusion or adjusted GILTI inclusion regarding a share of stock of a CFC, generally so that the adjusted subpart F inclusion or adjusted GILTI inclusion more closely reflects the extent that the subpart F inclusion or GILTI inclusion amount is in fact included in income in the U.S.

G. Section 904 Limitation.

- (a) Under the 2020 hybrids proposed regulations, an adjusted subpart F inclusion or adjusted GILTI inclusion regarding a share of stock was computed by taking into account foreign income taxes that, as a result of the application of § 960(a) or (d), are likely to give rise to deemed paid credits eligible to be claimed by the domestic corporation regarding the subpart F inclusion or adjusted GILTI inclusion. Prop. Treas. Reg. § 1.245A(e)-1(d)(4)(ii)(A) and (B).
- (b) To minimize complexity, the 2020 hybrids proposed regulations did not take into account any limitations on foreign tax credits when computing foreign income taxes that were likely to give rise to deemed paid credits. Prop. Treas. Reg. § 1.245A(e)-1(d)(4)(ii)(D). A comment suggested that the final regulations take into account the limitation under § 904.

- (c) Treasury and the IRS agreed with the comment for computing an adjusted GILTI inclusion. Foreign income taxes that by reason of § 904 do not currently give rise to deemed paid credits eligible to be claimed regarding the GILTI inclusion amount are not creditable in another year through a carryback or carryover. § 904(c). Thus, there is generally no ability for this excess foreign income taxes to reduce the extent that an amount taken into account in income by the domestic corporation is included in income in the U.S.
- (d) The final regulations therefore provide that these foreign income taxes are not taken into account when computing an adjusted GILTI inclusion. Treas. Reg. § 1.245A(e)-1(d)(4)(ii)(D)(2)(iii) and (G). If the application of this rule results in circularity or ordering rule issues, a taxpayer may, solely for purposes of computing the adjusted GILTI inclusion, apply any reasonable method to compute the amount of foreign income taxes the creditability of which is limited by § 904.<sup>9</sup>
- (e) The final regulations did not adopt a similar rule for computing an adjusted subpart F inclusion. This is because foreign income taxes that by reason of § 904 do not currently give rise to deemed paid credits eligible to be claimed regarding the subpart F inclusion may become creditable in another year under § 904(c). Consequently, for example, the foreign income taxes could in a later year reduce the extent that an amount is included in income in the U.S., and could thus inappropriately result in an outcome similar to the one that would have occurred had the foreign income taxes given rise to deemed paid credits in the year of the subpart F inclusion and thereby reduced the extent that the subpart F inclusion was subject to tax in the U.S. at the full statutory rate.
- (f) Treasury and the IRS believe that special rules to prevent these results would be complex or burdensome as they would require, for instance, tracking the creditability of the foreign income taxes over prior or later years (potentially through a 10-year period), and

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<sup>9</sup> For example, in certain cases the § 904 limitation could be affected by the extent to which § 245A(e) applies to a dividend paid by the CFC (in particular, in connection with allocating and apportioning deductions under Treas. Reg. §§ 1.861-8 through 1.861-20); the application of § 245A(e) to the dividend may depend on the extent to which a hybrid deduction account is reduced by reason of an adjusted GILTI inclusion; and the adjusted GILTI inclusion may in turn depend on the § 904 limitation. In such a case, to avoid circularity issues, a taxpayer may compute the § 904 limitation for purposes of determining the adjusted GILTI inclusion by, for instance, using simultaneous equations, or applying an ordering rule pursuant to which, solely for purposes of determining the adjusted GILTI inclusion, the § 904 limitation is determined without regard to the application of § 245A(e) (as well as any other provision the application of which depends on the extent to which § 245A(e) applies).

then adjusting the hybrid deduction account as the foreign income taxes become creditable.

2. Section 250 Deduction.

- (a) Under the 2020 hybrids proposed regulations, an adjusted GILTI inclusion was computed by taking into account the portion of the deduction allowed under § 250 by reason of § 250(a)(1)(B) that the domestic corporation was likely to claim regarding the GILTI inclusion amount. Prop. Treas. Reg. § 1.245A(e)-1(d)(4)(ii)(B). The 2020 hybrids proposed regulations did not take into account any limitations on the deduction under § 250(a)(2)(B). A comment suggested that the final regulations take into account the taxable income limitation under § 250(a)(2).
- (b) Treasury and the IRS agreed with the comment, because taking into account the taxable income limitation results in an adjusted GILTI inclusion that more closely reflects the extent to which the GILTI inclusion amount is included in income in the U.S. The final regulations thus provide a rule to this effect. Treas. Reg. § 1.245A(e)-1(d)(4)(ii)(B) and (H). A taxpayer may, solely for purposes of computing an adjusted GILTI inclusion, apply any reasonable method to compute the extent to which the portion of a deduction allowed under § 250 by reason of § 250(a)(1)(B) is limited under § 250(a)(2)(B).

3. Limit on Reduction of a Hybrid Deduction Account.

- (a) The 2020 hybrids proposed regulations provided a limit to ensure that an adjusted subpart F inclusion or adjusted GILTI inclusion regarding a share of stock of a CFC did not reduce the hybrid deduction account by an amount greater than the hybrid deductions allocated to the share for the taxable year multiplied by a fraction, the numerator of which was the subpart F income or tested income, as applicable, of the CFC for the taxable year and the denominator of which was the CFC's taxable income. Prop. Treas. Reg. § 1.245A(e)-1(d)(4)(i)(B)(1)(ii) and (d)(4)(i)(B)(2)(ii).
- (b) In cases in which the CFC's taxable income is zero or negative, the 2020 hybrids proposed regulations prevented distortions to the fraction – which would otherwise have occurred because the fraction would involve dividing by zero or a negative number – by providing that the fraction was considered to be zero. Prop. Treas. Reg. § 1.245A(e)-1(d)(4)(i)(B)(1)(ii) and (d)(4)(i)(B)(2)(ii).
- (c) Distortions to the fraction could also occur if the CFC's taxable income was greater than zero but less than its subpart F income or



tested income (due to losses in one category of income) because, absent a rule to address, the fraction would be greater than one. The final regulations eliminate these distortions by modifying the fraction so that the numerator and denominator only reflect items of gross income. Treas. Reg. § 1.245A(e)-1(d)(4)(i)(B)(1)(ii) and (d)(4)(i)(B)(2)(ii).

4. Modifications.

- (a) Comments recommended that the final regulations clarify whether an adjusted subpart F inclusion or adjusted GILTI inclusion can be negative and result in an increase to the hybrid deduction account (that is, whether the hybrid deduction account can be reduced by a negative amount). The final regulations provide that an adjusted subpart F inclusion or adjusted GILTI inclusion cannot be negative and thus cannot result in an increase to the hybrid deduction account. Treas. Reg. § 1.245A(e)-1(d)(4)(ii)(A) and (B).
- (b) A comment also recommended that the final regulations clarify whether the computation of an adjusted subpart F inclusion takes into account an amount that the domestic corporation includes in gross income by reason of § 964(e)(4). An amount that the domestic corporation includes in gross income by reason of § 964(e)(4) is in many cases offset by a 100% dividends received deduction under § 245A(a), and thus no portion of the amount is included in income in the U.S. (that is, taken into account in income and not offset by a deduction or credit particular to the inclusion).
- (c) The final regulations provide that the computation of an adjusted subpart F inclusion does not take into account an amount that a domestic corporation includes in gross income by reason of § 964(e)(4), to the extent that a deduction under § 245A(a) is allowed for the amount. Treas. Reg. § 1.245A(e)-1(d)(4)(ii)(A).

H. Comments Outside the Scope of the 2020 Hybrids Proposed Regulations.

- 1. In response to a comment, the 2020 hybrids final regulations clarified that a deduction or other tax benefit may be a hybrid deduction regardless of whether it is used currently under the foreign tax law. Treas. Reg. § 1.245A(e)-1(d)(2). The preamble to the 2020 hybrids final regulations stated that even though a deduction or other tax benefit may not be used currently, it could be used in another taxable period and thus could produce double non-taxation. The preamble also stated that it could be complex or burdensome to determine whether a deduction or other tax benefit is used currently and, to the extent not used currently, to track the

deduction or other tax benefit and add it to the hybrid deduction account if it is in fact used.

2. Comments submitted regarding the 2020 hybrids proposed regulations raised additional issues involving the extent to which a hybrid deduction account should be adjusted based on the availability-for-use of a deduction or other tax benefit under the foreign tax law.
3. These issues include the extent to which (or the mechanism by which) a hybrid deduction account should be adjusted when a deduction or other tax benefit reflected in the account is subsequently disallowed under the foreign tax law (for example, by reason of a foreign audit) or an economically equivalent adjustment is made under the foreign tax law, or the deduction or other tax benefit expires or otherwise cannot be used under the foreign tax law.
4. Treasury and the IRS are studying these comments, which are outside the scope of the 2020 hybrids proposed regulations, and state they might address these issues in a future guidance project.

I. Conduit Financing Rules Under Treas. Reg. § 1.881-3 to Address Hybrid Instruments.

J. Overview.

1. The conduit financing regulations in Treas. Reg. § 1.881-3 allow the IRS to disregard the participation of one or more intermediate entities in a “financing arrangement” where such entities are acting as conduit entities, and to recharacterize the financing arrangement as a transaction directly between the remaining parties for purposes of imposing tax under §§ 871, 881, 1441 and 1442.
2. In general, a financing arrangement exists when through a series of transactions one person advances money or other property (the financing entity), another person receives money or other property (the financed entity), the advance and receipt are effected through one or more other persons (intermediate entities), and there are “financing transactions” linking each of those parties. Treas. Reg. § 1.881-3(a)(2)(i). An instrument that for U.S. tax purposes is stock (or a similar interest, such as an interest in a partnership) is not a financing transaction under the existing conduit financing regulations, unless it is “redeemable equity” or is otherwise described in Treas. Reg. § 1.881-3(a)(2)(ii)(B)(1).
3. The 2020 hybrids proposed regulations expanded the definition of a financing transaction, such that an instrument that for U.S. tax purposes is stock or a similar interest is a financing transaction if: (i) under the tax law of a foreign country where the issuer is a tax resident or has a taxable presence, such as a permanent establishment, the issuer is allowed a

deduction or another tax benefit, including a deduction regarding equity, for an amount paid, accrued, or distributed regarding the instrument; or (ii) under the issuer's tax laws, a person related to the issuer is entitled to a refund, including a credit, or similar tax benefit for taxes paid by the issuer upon a payment, accrual, or distribution regarding the equity interest and without regard to the related person's tax liability in the issuer's jurisdiction. Prop. Treas. Reg. § 1.881-3(a)(2)(ii)(B)(1)(iv) and (v). The 2020 hybrids proposed regulations relating to conduit financing arrangements were proposed to apply to payments made on or after the date that final regulations are published in the Federal Register.

K. Scope of Instruments Treated as Financing Transactions.

1. A comment agreed that a financing transaction should include an instrument that is stock or a similar interest for U.S. tax purposes but debt under the tax law of the issuer's country because, according to the comment, cases of potential conduit abuse are likely to involve "classic" hybrid instruments not covered by the types of equity described in Treas. Reg. § 1.881-3(a)(2)(ii)(B)(1).
2. However, the comment recommended that an instrument that is equity for purposes of both U.S. tax law and the issuer's tax law not be treated as a financing transaction, except in limited circumstances, such as if the instrument is issued by a special purpose company formed to facilitate the avoidance of tax under § 881 and the instrument gives rise to a notional deduction or a refund or credit to a related person.
3. According to the comment, the proposed rule that treated an instrument that is equity for both U.S. and foreign tax purposes as a financing transaction was overbroad – as it could deem an operating company to have entered into a financing transaction simply because foreign tax law provides for notional interest deductions or a similar regime of general applicability – or was unclear or vague in certain cases.
4. If the final regulations were to retain the proposed rules treating other types of equity instruments as financing transactions, the comment requested several clarifications, modifications, and limitations regarding the rules. These included: (i) treating an instrument that is equity in a partnership for U.S. tax purposes and under the issuer's tax law as a financing transaction only if the partnership is a hybrid entity that claims treaty benefits; (ii) either eliminating or clarifying the rule providing that an instrument can be a financing transaction by reason of generating tax benefits in a jurisdiction where the issuer has a permanent establishment; and (iii) modifying the applicability date for payments under existing financing arrangements.

5. Consistent with the comment, the final regulations adopted without substantive change the rule that included as a financing transaction an instrument that is stock or a similar interest (including an interest in a partnership) for U.S. tax purposes but debt under the tax law of the country of which the issuer is a tax resident. Treas. Reg. § 1.881-3(a)(2)(ii)(B)(1)(iv). In addition, the final regulations provide that if the issuer is not a tax resident of any country, such as an entity treated as a partnership under foreign tax law, the instrument is a financing transaction if the instrument is debt under the tax law of the country where the issuer is created, organized, or otherwise established.
6. The final regulations do not include the rules under the 2020 hybrids proposed regulations that treated as a financing transaction an instrument that is stock or a similar interest for U.S. tax purposes but gives rise to notional interest deductions or other tax benefits (such as a deduction or credit allowed to a related person) under foreign tax law. Treasury and the IRS plan to finalize those rules separately, in order to allow additional time to consider the comments received. In addition, they continue to study instruments that generate tax benefits in the jurisdiction where the issuer has a permanent establishment and may address these instruments in future guidance.

L. Disqualified Period Payments.

1. In issuing the 2020 hybrids proposed regulations, Treasury and the IRS state that, in addition to the transactions circumscribed by the rules in Treas. Reg. § 1.951A-2(c)(5) (below), taxpayers also may have entered into transactions in which, for example, a CFC that licensed property to a related CFC received pre-payments of royalties due under the license from the related CFC, which did not constitute Subpart F income. Although the recipient of the pre-payments (“related recipient CFC”) would generally have been required to include the royalties in income upon payment during the disqualified period, when they would not have affected amounts included under § 965 with respect to the related recipient CFC and also would not have given rise to gross tested income under § 951A, the related CFC that made the pre-payment would generally only be allowed to deduct the payment over time as economic performance occurred.
2. Accordingly, the related CFC that made the pre-payment would claim deductions that reduce tested income (or increase tested loss) during taxable years to which § 951A applies, even though the corresponding income would not have been subject to tax under § 951 (including as a result of § 965) or § 951A.
3. Treasury and the IRS believe that the deductions attributable to pre-payments (including, but not limited to, deductions attributable to prepaid

rents and royalties) should be subject to similar treatment as the final GILTI regulations' treatment of deductions or loss attributable to disqualified basis.

4. Accordingly, Treas. Reg. § 1.951A-2(c)(6) treats a deduction by a CFC related to a deductible payment to a related recipient CFC during the disqualified period as allocated and apportioned solely to residual CFC gross income, as defined in Treas. Reg. § 1.951A-2(c)(5)(iii)(B). It also provides that any deduction related to this type of payment is not properly allocable to property produced or acquired for resale under § 263, 263A, or 471, consistent with Treas. Reg. § 1.951A-2(c)(5)(i) and the authority therefor described in the preamble to the final GILTI regulations. This rule applies only to the extent the payments would constitute income described in § 951A(c)(2)(A)(i) and Treas. Reg. § 1.951A-2(c)(1), without regard to whether § 951A applies. Treas. Reg. § 1.951A-2(c)(6)(ii)(A).

M. Applicability Dates.

1. Under the 2020 hybrids proposed regulations, the rules under § 245A(e) relating to hybrid deduction accounts were proposed to be applicable to taxable years ending on or after the date that final regulations are published in the Federal Register, although a taxpayer could choose to consistently apply those final regulations to earlier taxable years. Prop. Treas. Reg. § 1.245A(e)-1(h)(2). In addition, the 2020 hybrids proposed regulations provided that a taxpayer could consistently rely on the proposed rules regarding earlier taxable years.
2. Further, under the 2020 hybrids proposed regulations, the rules under § 881 relating to conduit financing arrangements were proposed to be applicable to payments made on or after the date that final regulations are published in the Federal Register. Prop. Treas. Reg. § 1.881-3(f). Finally, the rules under § 951A relating to disqualified payments were proposed to be applicable to taxable years of foreign corporations ending on or after April 7, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years end. Prop. Treas. Reg. § 1.951A-7(d).
3. A comment recommended modifying the applicability date for the rules under § 881 if the final regulations were to include some of the proposed rules, such as the rule that treated as a financing transaction an instrument that is equity for both U.S. and foreign tax purposes and that gives rise to notional interest deductions.
4. The final regulations did not include those rules. In addition, no comments suggested a modification to the applicability dates for the other rules under the 2020 hybrids proposed regulations.

5. Therefore, the final regulations adopt applicability dates consistent with the proposed applicability dates under the 2020 hybrids proposed regulations. Treas. Reg. §§ 1.245A(e)-1(h)(2); 1.881-3(f); and 1.951A-7(d). The final regulations also clarify that for a taxpayer to apply the final rules under § 245A(e) to a taxable year ending before the regulation was published as final, the taxpayer must consistently apply those rules to that taxable year and any subsequent taxable year ending before that date. Treas. Reg. § 1.245A(e)-1(h)(2).
6. Treas. Reg. § 1.951A-2(c)(6) (“Disqualified Period Payments”) is effective pursuant to Treas. Reg. § 1.951A-7(d), that is, with regard to taxable years of foreign corporations ending after April 7, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years end.

## VII. FINAL AND NEWLY PROPOSED § 245A REGULATIONS.

### FINAL SECTION 245A REGULATIONS

- A. Section 245A provides a 100% deduction to domestic corporations for certain dividends received from foreign corporations after December 31, 2017 (the “§ 245A deduction”). Under the § 954(c)(6) exception, a dividend received by a controlled foreign corporation (a “CFC”) from a related CFC is generally not subject to current tax under §§ 951(a) and 954(c).
- B. Surprising temporary regulations (TD 9865) were issued last year that limited the § 245A deduction and the § 954(c)(6) exception in the case of certain distributions and transactions. These were distributions and transactions viewed by Treasury and the IRS as involving CFC earnings and profits (“E&P”) that were not subject to the so-called “TCJA integrated international tax regime.” At the same time, Treasury and the IRS also issued proposed regulations.
- C. The new final regulations (TD 9909) retain the general approach and structure of the 2019 proposed (and temporary) regulations, with certain revisions, and remove the temporary regulations. Many taxpayers and tax advisors believe the temporary, and now the final, regulations exceed Treasury and the IRS’s authority as the regulations would seem to rewrite the statute. This likely eventually will lead to litigation.
- D. New proposed regulations (REG-103470-19) were also issued addressing the coordination of the new extraordinary disposition rules with the global intangible low-taxed income rules in § 951A (“GILTI”). As discussed further below, these are among the most complicated regulations ever written by Treasury and the IRS, and became necessary to avoid double, or excess, taxation in the context of their efforts to prevent what they perceive to be a tax planning opportunity.

E. Authority.

1. As noted above, several comments stated that Treasury and the IRS lack the authority to issue these § 245A regulations. These comments state that the extraordinary disposition and extraordinary reduction rules in the 2019 temporary and proposed regulations are contrary to the statutory text of § 245A and are therefore not authorized by § 245A(g). We agree with these comments. Some comments also stated that the extraordinary disposition rules are contrary to § 245A because they attempt to alter the effective dates of § 965, which imposed a transition tax on certain untaxed foreign earnings measured as of no later than December 31, 2017, and § 951A (GILTI) the new TCJA category of income that is subject to current U.S. taxation starting in the first taxable year of a CFC beginning on or after January 1, 2018. We also agree with these comments.
2. Other comments stated that the 2019 regulations are not reasonable because the application of the rules may result in excess U.S. taxation in certain situations.
3. Treasury and the IRS believe that §§ 245A(g), 954(c)(6), and 7805(a) provide authority for these regulations. They stated that the phrase “necessary or appropriate” is broad, and its use in §§ 245A(g) and 954(c)(6)(A) reflects Congress’s intent to confer extensive rulemaking authority upon Treasury and the IRS regarding those provisions.
4. They also believe that the § 245A deduction appropriately operates within the statutory framework to complement, not contradict, the application of § 965 and the GILTI and Subpart F regimes. Treasury and the IRS stated that the regulations limit the § 245A deduction in connection with extraordinary dispositions because E&P generated in those transactions is not subject to tax under § 965 or the GILTI and Subpart F regimes and, as a result, is not of the residual type for which the § 245A deduction is intended to potentially be available.
5. Treasury and the IRS stated that regulations limit the § 245A deduction in connection with extraordinary reductions because the § 245A deduction can result in complete avoidance of U.S. tax regarding Subpart F income and tested income that, absent the extraordinary reduction, could be included in income by the selling U.S. shareholder under the Subpart F or GILTI regimes, respectively.
6. They further stated that the regulations limit the § 954(c)(6) exception where its application would otherwise allow E&P that had accrued after December 31, 2017 (the last measurement date for determining the amount of E&P subject to § 965), and that was generated by income that had never been tested under the Subpart F and GILTI regimes, to inappropriately qualify for an exception to the Subpart F regime. Treasury

and the IRS believe that while § 954(c)(6) was added to the Code to allow certain CFCs to reinvest E&P attributable to active foreign activities without incurring current U.S. tax, the § 954(c)(6) exception was not intended to apply where the effect would be to permanently eliminate income from the U.S. tax base, which would constitute an abuse of § 954(c)(6).

7. In the view of Treasury and the IRS, the 2019 regulations and the new final regulations under § 954(c)(6) are intended to ensure that the § 954(c)(6) exception does not apply to permanently eliminate income from the U.S. tax base through certain transactions preventing the taxation of income that would otherwise be taxed under the Subpart F regime when distributed to a CFC. Accordingly, they believe that these regulations are necessary and appropriate to prevent the abuse of the § 954(c)(6) exception.
8. Comments stated that the regulations are an attempt by Treasury and the IRS to rewrite the statute and to apply § 965 or the GILTI regime during the period beginning on January 1, 2018, and ending on the last day of the last taxable year of a CFC before the GILTI regime applies (the “disqualified period”).
9. Treasury and the IRS disagreed with this characterization. They stated that the regulations are not an attempt to change the effective dates of § 965 or the GILTI regime; rather, the regulations limit the availability of the § 245A deduction and the § 954(c)(6) exception in certain limited circumstances where the effect would be contrary to the appropriate application of those provisions in the context of the TCJA’s integrated approach to the taxation of income, or E&P generated by income, of a CFC.
10. They also stated that the extraordinary disposition rules apply to a limited category of transactions -- that is, transactions that take place outside the ordinary course of business, between related parties, and exceed the lesser of \$50 million or 5% of the CFC’s total income for the taxable year. They believe that these exceptions demonstrate that the extraordinary disposition rules do not change the effective dates of § 965 or the GILTI regime; rather, that they ensure the proper coordination of multiple statutory provisions in circumstances in which there is a heightened risk of base erosion.

F. Excess Taxation.

1. Several comments stated that the regulations are unreasonable because they could result in excess U.S. taxation. For example, comments cited the potential for the extraordinary disposition rules and the disqualified basis rules in Treas. Reg. § 1.951A-2(c)(5) to apply to the same



transaction. Comments also stated that, due to the unavailability of foreign tax credits and other tax attributes (such as net deemed tangible income return as defined in § 951A(b)(2)), the extraordinary disposition rules impose a different tax cost on extraordinary disposition E&P than would have been imposed had the income or gain to which the E&P is attributable been subject to tax under the GILTI regime when it was generated.

2. Another comment said that the extraordinary reduction rules are contrary to §§ 1248(j) and 964(e)(4) because those provisions govern extraordinary reductions and the 2019 regulations in effect override those provisions. Finally, one comment stated that the extraordinary reduction rules result in excess U.S. taxation in the context of dividends that partially fail to qualify for the § 954(c)(6) exception because they are partly attributable to Subpart F income.
3. Treasury and the IRS believe that the proposed coordination rules consider the application of the rules of Treas. Reg. §§ 1.245A-5(c) and (d) and 1.951A-2(c)(5) to the same transaction and, accordingly, address excess taxation concerns. They also state that the U.S. tax cost of an extraordinary disposition is not, and is not intended to be, equivalent to the cost of applying § 965 or the GILTI regime to the same transaction. Instead, Treasury and the IRS believe that the extraordinary disposition E&P is not of the type of E&P that Congress intended to qualify for the § 245A deduction and the § 954(c)(6) exception.
4. They stated that as an “act of administrative grace,” the 2019 regulations deny only 50% of the § 245A deduction and the § 954(c)(6) exception to approximate the tax rate that taxpayers may have expected to pay on similar E&P under § 965 or the GILTI regime. This is not intended to place taxpayers in an equivalent position as though they had been subject to those provisions. Instead, it is intended to prevent extraordinary disposition E&P from inappropriately qualifying for the § 245A deduction or the § 954(c)(6) exception.
5. The 2019 regulations also do not override the application of § 1248(j) or 964(e)(4). Both provisions impose taxation on built-in stock gain (to the extent of certain E&P of the CFC) as if it were a dividend, but neither one expressly permits the § 245A deduction. Both provisions envision that there will be contexts in which the deemed dividend under § 1248(j) or 964(e)(4) could fail to qualify for the § 245A deduction. The fact that the statutory text of these provisions ties their eligibility for tax-exemption to their ability to qualify for the § 245A deduction demonstrates that the same policies underlying the application of § 245A to actual dividends is also intended to apply to deemed dividends under § 1248(j) or 964(e)(4). Accordingly, Treasury and the IRS believe that the regulations further the policies underlying §§ 1248(j) and 964(e)(4) by limiting the availability of

the § 245A deduction for both actual and deemed dividends in the same manner.

6. Finally, one comment asserted that the interaction of the extraordinary reduction rules with the rules under Temp. Treas. Reg. § 1.245A-5T(f) (and Prop. Treas. Reg. § 1.245A-5(f)) that limit the § 954(c)(6) exception, could result in Subpart F income being subject to U.S. tax more than once in certain cases where a portion of the amount distributed would not otherwise qualify for the § 954(c)(6) exception. Treasury and the IRS believe that while not discussed in the comment, the same issue could arise in the context of tiered extraordinary disposition amounts. In response, they modified the rules in Treas. Reg. § 1.245A-5(d)(1) and (f)(1) and related provisions of Treas. Reg. § 1.245A-5 that limit application of the § 954(c)(6) exception.

G. Extraordinary Dispositions.

1. Under the 2019 regulations, a specified 10% owned foreign corporation (“SFC”) is generally considered to have undertaken an extraordinary disposition regarding an asset if the SFC (1) disposed of that asset outside of its ordinary course of activities to a related party during its disqualified period and (2) the sum of all extraordinary dispositions undertaken by the SFC exceeded the lesser of \$50 million or 5% of the gross value of the SFC’s assets. Determining whether the disposition of an asset was outside the ordinary course of the SFC’s business was a facts and circumstances determination. Prop. Treas. Reg. § 1.245A-5(c)(3)(ii)(B). In addition, dispositions occurring with a principal purpose of generating E&P during the disqualified period and dispositions of intangible property (as defined in § 367(d)(4)) were per se outside the ordinary course of an SFC’s activities. Prop. Treas. Reg. § 1.245A-5(c)(3)(ii)(C).
2. Comments recommended that transactions occurring pursuant to a plan of integration after the acquisition of an unrelated group be excluded from the definition of extraordinary disposition. One comment suggested that any integration of an acquired group that was acquired within 12 months of January 1, 2018 should be excluded. The comments noted that post-acquisition integration, including through mergers and asset sales, may occur for a variety of non-tax business reasons, including consolidating ownership of certain assets, aligning business segments, creating synergies, and combining legal entities.
3. Further, the comments stated that certain acquisitions and the related post-integration transactions were planned before the TCJA was enacted and would likely have occurred regardless of whether the TCJA was in effect at the time of the acquisition and post-acquisition integration. One comment acknowledged, however, that courts have typically found mergers to not be within the ordinary course of a business’s activities.

4. Treasury and the IRS believe that recently acquired assets are indistinguishable from non-recently acquired assets for the purposes of determining whether an extraordinary disposition has occurred. First, an extraordinary disposition that occurs during the disqualified period implicates the policy concerns of the extraordinary disposition rule regardless of whether the taxpayer intended to avoid tax. That is, regardless of the taxpayer's subjective intent, such transactions, absent rules to address them, could give rise to inappropriate results, such as E&P that are not of the type for which the § 245A deduction was intended to be available giving rise to a § 245A deduction. Second, the regulations apply only to post-acquisition integrations occurring during the disqualified period.
5. Treasury and the IRS state they are aware that some taxpayers undertook extraordinary dispositions for the purpose of increasing the basis of an asset or generating E&P eligible for the § 245A deduction, without being subject to U.S. tax on the recognition of the built-in gain in the asset. There are a number of ways that an asset could be transferred within an organizational structure that, even in the absence of special rules, would not give rise to inappropriate tax results. The fact that an asset was recently acquired does not change this fact; the length of time that an asset was held does not impact the potential ways in which the asset can be transferred within a group of related entities. Therefore, the final regulations did not adopt this recommendation.
6. Intangible Property. A comment requested a general exception for transfers of intangible property stating that (1) the rules as drafted would penalize the repatriation of intangible property to the U.S., contrary to one of TCJA's goals; and (2) other transfers of intangible property (that is, those between related CFCs) are addressed under Treas. Reg. § 1.951A-2(c)(5). The extraordinary disposition rules were issued in response to a concern regarding highly-structured transactions that took place during the disqualified period to create stepped-up basis for the transferee and generate E&P for the transferor. A transfer of intangible property often will fall within these criteria, and thus would raise the same concerns as other highly-structured asset dispositions during the disqualified period. The final regulations thus did not adopt this comment and continue to treat transfers of intangible property as extraordinary dispositions subject to the per se rule.

#### H. Exception for Inventory Property.

1. A comment recommended that the final regulations adopt an exception to the per se rule for transfers of intangible property described in § 1221(a)(1). The comment stated that the disqualified basis rules, which similarly address transfers of property occurring during the disqualified period, provide for an exception regarding property described in

§ 1221(a)(1). Treas. Reg. § 1.951A-2(h)(2)(ii). It further stated that the facts and circumstances test in Temp. Treas. Reg. § 1.245A-5T(c)(3)(ii)(B) (and Prop. Treas. Reg. § 1.245A-5(c)(3)(ii)(B)) would be sufficient to address any concerns of abuse.

2. Treasury and the IRS agreed that it is appropriate to except certain ordinary course transfers of intangible property ultimately sold to unrelated customers from the per se rule. However, they believe that the exception from the per se rule should not be based on whether the property is described in § 1221(a)(1).
3. Accordingly, the final regulations provide that a disposition of certain types of intangible property defined in § 367(d)(4) is not per se treated as an extraordinary disposition if the intangible property is transferred to a related party during the disqualified period with a reasonable expectation that the property will be sold to an unrelated customer within one year of the transfer. Treas. Reg. § 1.245A-5(c)(3)(ii)(C)(2)(i). This rule is intended to apply primarily to routine transfers of limited intangible property rights in furtherance of transactions with unrelated customers.
4. Treasury and the IRS did not include transfers of intangible property described in § 367(d)(4)(C) or (F), such as trademarks and goodwill, in the exception. This is because these types of intangible property are not routinely transferred to unrelated customers. Additionally, transfers of copyright rights within the meaning of Treas. Reg. § 1.861-18 or intangible property described in § 367(d)(4)(A) that qualify for the exception to the per se rule are still subject to a presumption that they occur outside the ordinary course of the transferor SFC's activities. Treas. Reg. § 1.245A-5(c)(3)(ii)(C)(2)(ii). This presumption can be rebutted only if the taxpayer shows that the facts and circumstances clearly establish that the disposition took place in the ordinary course of the SFC's activities.

#### I. Platform Contribution Payments.

1. A comment recommended that transfers of intangible property from a CFC to a related CFC that occur as a result of a platform contribution transaction ("PCT") under Treas. Reg. § 1.482-7 be excluded from the per se rule. The comment noted that, when PCT payments represent payments from a U.S. shareholder to a CFC as consideration for a deemed transfer of intangible property, the result is that intangible property is effectively transferred into the U.S. from abroad.
2. The final regulations did not include this recommendation. The ultimate destination of the intangible property transferred in an extraordinary disposition, and the motivations of the taxpayers involved in the transfer, are generally irrelevant in determining whether a transfer should be treated

as an extraordinary disposition. Whether or not the intangible property is transferred to the U.S. or for non-tax business reasons, a transfer during the disqualified period generates E&P that have not been subject to U.S. tax, and an associated increase in the basis of the transferred property, to the benefit of a related person. Accordingly, the final regulations continue to treat transfers of intangible property as subject to the per se rule without regard to whether the transfers occur in connection with a PCT.

J. Extraordinary Disposition Accounts.

1. The 2019 regulations generally limited the § 245A deduction to the extent the dividend is paid out of the extraordinary disposition account of the § 245A shareholder. For this purpose, those regulations provided an ordering rule pursuant to which a dividend was considered paid out of non-extraordinary disposition E&P before it was considered paid out of the extraordinary disposition E&P account. Similar rules applied regarding the limitation on amounts eligible for the § 954(c)(6) exception. The 2019 regulations generally defined non-extraordinary disposition E&P based on the § 245A shareholder's share of the E&P of the SFC described in § 959(c)(3) in excess of the balance in the § 245A shareholder's extraordinary disposition account determined immediately before the distribution.
2. The 2019 regulations measured a § 245A shareholder's share of the E&P of an SFC described in § 959(c)(3) based on the percentage of stock (by value) of the SFC owned, directly or indirectly, by the § 245A shareholder after the distribution and all related transactions. Thus, in cases in which the § 245A shareholder sold all of its stock of the SFC, the § 245A shareholder's share of E&P described in § 959(c)(3) was considered to be zero regarding any dividend that was related to the sale under the measurement rule.
3. As a result, the measurement rule treated no portion of the dividend as being distributed from non-extraordinary disposition E&P even though, assuming that a dividend was first sourced from E&P other than E&P generated in an extraordinary disposition, none of the dividend was sourced from E&P generated in an extraordinary disposition.
4. The final regulations revised this rule to measure the § 245A shareholder's share of E&P described in § 959(c)(3) based on the percentage of stock of the SFC that the § 245A shareholder owns immediately before the distribution. Treas. Reg. § 1.245A-5(c)(2)(ii)(A)(2).

K. Losses Incurred After Extraordinary Dispositions.

1. One comment stated that a dividend will avoid being sourced from an extraordinary disposition account only to the extent the non-extraordinary

disposition E&P equals or exceeds the amount of the dividend. The comment requested that regulations clarify the determination of non-extraordinary disposition E&P and the sourcing of dividends from an extraordinary disposition account to address cases involving losses generated after the extraordinary disposition and distributions giving rise to “nimble” dividends subject to § 316(a)(2).

2. Treasury and the IRS believe this comment implicates two issues, the first of which is whether losses incurred after the disqualified period should reduce an extraordinary disposition account to the extent that such losses reduce E&P generated in an extraordinary disposition. They believe that losses incurred after the disqualified period should not reduce the extraordinary disposition account because extraordinary disposition E&P that are offset by losses provide a tax benefit to a § 245A shareholder. Specifically, extraordinary disposition E&P prevent offsetting losses from decreasing other E&P or creating a deficit that must be offset by future E&P that could give rise to future dividends. For every dollar of decreased E&P, an additional dollar distributed would be unable to qualify for the § 245A deduction and would instead reduce the distributee’s basis in stock in the distributing corporation under § 301(c)(2) or constitute taxable gain to the distributee under § 301(c)(3).
3. In this way, extraordinary disposition E&P prevents post-extraordinary disposition losses from reducing the SFC’s ability to pay dividends eligible for the § 245A deduction. Thus, the extraordinary disposition E&P provide the same benefit when offset by a loss as they do absent a loss: that E&P increases the SFC’s ability to pay dividends otherwise eligible for the § 245A deduction. Accordingly, like the 2019 regulations, the final regulations do not reduce an extraordinary disposition account by reason of losses incurred after the disqualified period. Treas. Reg. § 1.245A-5(c)(3)(i)(A).
4. The comment also implicates a second issue, which is whether a so-called nimble dividend should be considered paid out of extraordinary disposition E&P when the distributing SFC has an overall deficit in E&P, even factoring in the E&P supporting the nimble dividend. Treasury and the IRS are studying the extent to which nimble dividends should qualify for the § 245A deduction generally and may address this issue in future guidance under § 245A.

L. Prior Extraordinary Disposition Amounts.

1. A § 245A shareholder reduces the balance of its extraordinary disposition account regarding an SFC by the prior extraordinary disposition amount. In general, the prior extraordinary disposition amount is intended to measure the extent to which the § 245A shareholder’s extraordinary disposition account has disallowed the § 245A deduction or caused a

Subpart F inclusion due to prior dividends of an SFC. However, this amount also includes certain other prior dividends of an SFC to generally ensure that the extraordinary disposition account is reduced to the extent a dividend out of extraordinary disposition E&P does not give rise to a § 245A deduction under other provisions (such as under § 245A(e) for hybrid dividends).

2. A comment stated that the definition of a prior extraordinary disposition amount did not appropriately take into account § 956 and as a result, Treas. Reg. § 1.956-1(a)(2) can in effect deny the § 245A deduction regarding the same extraordinary disposition E&P more than once. Treas. Reg. § 1.956-1(a)(2) reduces a U.S. shareholder's § 956 amount to the extent that the U.S. shareholder's tentative amount determined under § 956(a) regarding a CFC for a taxable year would be eligible for a § 245A deduction if the U.S. shareholder received that tentative amount as a distribution from the CFC. The comment recommended reducing the extraordinary disposition account by 200% of the amount included in the income of a § 245A shareholder under § 951(a)(1)(B) by reason of the application of Temp. Treas. Reg. § 1.245A-5T(b) (and Prop. Treas. Reg. § 1.245A-5(b)) to the hypothetical distribution under Treas. Reg. § 1.956-1(a)(2).
3. Treasury and the IRS agreed with this comment. As a result, the final regulations modify the definition of a prior extraordinary disposition amount to take into account certain income inclusions under § 956. Treas. Reg. § 1.245A-5(c)(3)(i)(D)(1)(iv). In addition, the final regulations add a new type of prior extraordinary disposition amount for prior dividends that would have been subject to Treas. Reg. § 1.245A-5(c) but failed to qualify for the § 245A deduction because they did not satisfy the requirement that the recipient domestic corporation be a U.S. shareholder regarding the distributing SFC. Treas. Reg. § 1.245A-5(c)(3)(i)(C). Finally, the final regulations clarify that an extraordinary disposition account is maintained in the same currency as the extraordinary disposition E&P.

M. Successor Rules.

1. Generally, when certain transactions occurred (for example, a transfer of stock of an SFC for which a § 245A shareholder has an extraordinary disposition account), the 2019 regulations provided that the balance of the extraordinary disposition account was preserved by either transferring the account balance to another § 245A shareholder or requiring the § 245A shareholder to maintain the account regarding a different SFC ("successor rules").
2. The purpose of the successor rules was to ensure that a § 245A shareholder succeeds to (or is attributed) an extraordinary disposition account upon certain transactions to the extent, after the transaction, the

§ 245A shareholder would likely be able to access the E&P as to which the extraordinary disposition account relates. Absent these rules, an extraordinary disposition account could be separated from the E&P to which it relates, which could give rise to inappropriate results.

3. A comment recommended that extraordinary disposition accounts should terminate after a certain period. Treasury and the IRS believe that it would be inappropriate to terminate the accounts when a dividend out of extraordinary disposition E&P can still give rise to a § 245A deduction (or the application of the § 954(c)(6) exception). Accordingly, this comment was not adopted.
4. Treasury and the IRS believe that the coordination rules in the proposed regulations alleviate the concerns raised by this comment by generally eliminating a § 245A shareholder's extraordinary disposition account in certain cases as the property that gave rise to the account is amortized or depreciated and those deductions reduce E&P otherwise potentially eligible for the § 245A deduction. The final regulations also alleviate these concerns by generally eliminating the extraordinary disposition account if no person is a § 245A shareholder of the SFC after certain transfers of stock of the SFC.

N. Nonrecognition Transactions.

1. The successor rules under the 2019 regulations addressed certain nonrecognition transactions. Specifically, the 2019 regulations provided that upon certain distributions of stock under § 355 made pursuant to a reorganization described in § 368(a)(1)(D), a § 245A shareholder's extraordinary disposition account regarding the distributing SFC was allocated between the distributing SFC and the controlled SFC.
2. Other than this rule, the 2019 regulations did not provide any other special rules for transfers of extraordinary disposition accounts in nonrecognition transactions where a § 245A shareholder transfers stock of an SFC. In addition, Prop. Treas. Reg. § 1.245A-5(c)(4)(i) provided that a transaction described in Treas. Reg. § 1.1248-8(a)(1) in which a § 245A shareholder transferred a share of stock of an SFC did not result in any transfer of the § 245A shareholder's extraordinary disposition account. This was because after the transfer the § 245A shareholder could access the E&P as to which the extraordinary disposition account relates, by reason of § 1248 and Treas. Reg. § 1.1248-8.
3. A comment recommended that the rule addressing extraordinary disposition account transfers in reorganizations pursuant to §§ 368(a)(1)(D) and 355 be extended to stand-alone § 355 distributions in which E&P of the distributing SFC are allocated to the controlled SFC. Treasury and the IRS agreed with this comment. As the comment noted,



certain stand-alone § 355 distributions could otherwise potentially separate extraordinary disposition accounts from related extraordinary disposition E&P, which could give rise to inappropriate results. Thus, the final regulations provide that a § 245A shareholder's extraordinary disposition account regarding a distributing SFC is allocated between the distributing SFC and the controlled SFC in any § 355 distribution in which E&P of the distributing SFC are decreased and the E&P of the controlled SFC are increased by reason of Treas. Reg. § 1.312-10.

4. To address similar issues, the final regulations also provide rules regarding the transfer of extraordinary disposition accounts in nonrecognition transactions. The final regulations provide that in a transaction described in Treas. Reg. § 1.1248-8(a)(1) where stock of an SFC is transferred to a foreign acquiring corporation in exchange for stock of a foreign corporation, any extraordinary disposition account regarding the SFC remains with the pre-transaction § 245A shareholder.
5. An exception to this rule applies in the case of a transaction described in Treas. Reg. § 1.1248(f)-1(b)(2) or (3); in this type of transaction, the extraordinary disposition account is transferred in the manner provided in Treas. Reg. § 1.245A-5(c)(4)(i), with certain adjustments, in order generally to ensure that a § 245A shareholder succeeds to an extraordinary disposition account to the extent that, after the transaction, the § 245A shareholder would likely be able to access the E&P as to which the extraordinary disposition account relates. Other transactions described in Treas. Reg. § 1.1248-8(a)(1) cause the extraordinary disposition account to be transferred to the extent and in the manner provided under the general rule of Treas. Reg. § 1.245A-5(c)(4)(i).
6. Similarly, the final regulations also provide a rule addressing transactions in which an SFC acquires the assets of another SFC in a triangular asset reorganization and the § 245A shareholder of the target SFC receives stock of a domestic corporation that controls the acquiring SFC. In these triangular reorganizations, the domestic corporation whose stock was issued in the triangular reorganization succeeds to the extraordinary disposition account of the § 245A shareholder regarding the target SFC.

O. Related Domestic Corporations.

1. The 2019 regulations did not provide explicit rules addressing issuances of stock of an SFC. For example, if a § 245A shareholder owns all the stock of an SFC and the SFC issues new stock to another § 245A shareholder, the second § 245A shareholder would not inherit any portion of the first § 245A shareholder's extraordinary disposition account regarding the SFC under the successor rules of the 2019 regulations. Treasury and the IRS were concerned that these issuances can raise the same policy concerns as those addressed by the successor rules and, absent rules to address, could

facilitate the avoidance of the extraordinary disposition rules by separating an extraordinary disposition account from the E&P to which it relates.

2. Consider, for example, a case in which FP, a foreign corporation, owns all the stock of US1 and US2, each of which is a domestic corporation, and US1 owns all the stock of CFC1, an SFC whose E&P is maintained in U.S. dollars and as to which US1 has an extraordinary disposition account of \$100x. In such a case, if US2 contributes property to CFC1 in exchange for stock representing 99% of the stock of CFC1 and thereafter CFC1 pays \$100x of dividends pro rata to US1 and US2, only the \$1x dividend received by US1 would be an extraordinary disposition amount (US2's \$99x dividend would not, as US2 did not inherit any of US1's extraordinary disposition account), even though, as a factual matter, the entire \$100x of dividends may represent E&P generated by CFC1 in an extraordinary disposition. Moreover, for example, if US1 were to subsequently transfer all of its stock of CFC1 to a U.S. individual, the remaining balance of US1's extraordinary disposition account regarding CFC1 may never give rise to an extraordinary disposition amount.
3. Rather than address these transactions solely through the anti-abuse rules in Treas. Reg. § 1.245A-5, the final regulations provide a rule that treats related domestic corporations as a single domestic corporation for purposes of determining the extent to which a dividend is an extraordinary disposition amount or a tiered extraordinary disposition amount. Thus, in the example above, the \$100x of dividends paid by CFC1 are extraordinary disposition amounts regarding both US1 and US2 as a result of US1's extraordinary disposition account. The final regulations also treat related domestic corporations as a single domestic corporation for purposes of reducing a § 245A shareholder's extraordinary disposition account by prior extraordinary disposition amounts.
4. Effect of § 338(g) Election.
  - (a) The 2019 regulations did not address whether a § 245A shareholder of the new target succeeded to an extraordinary disposition account regarding the old target when a § 338(g) election is made regarding an SFC target. The new target does not inherit any of the E&P of the old target. As a result, no distributions by the new target could represent a distribution of E&P of the old target generated in an extraordinary disposition.
  - (b) Thus, the final regulations provide that, in connection with an election under § 338(g), a § 245A shareholder of the new target generally does not succeed to an extraordinary disposition account regarding the old target. Special rules provide for transactions in which a § 338(g) election is made and not all of the stock of the SFC target is subject to the qualified stock purchase.

P. Balance After Certain Stock Transfers.

1. Under the 2019 regulations, if a § 245A shareholder ceased to be a § 245A shareholder regarding a lower-tier CFC as a result of a direct or indirect transfer of stock of the lower-tier CFC by an upper-tier CFC, a special rule preserved the § 245A shareholder's remaining balance of its extraordinary disposition account regarding the lower-tier CFC. Under this rule, the § 245A shareholder's extraordinary disposition account was preserved by increasing the account regarding the upper-tier CFC by the remaining balance.
2. Treasury and the IRS believe that this rule should be revised to address the treatment of the remaining balance of a § 245A shareholder's extraordinary disposition account regarding an SFC when the § 245A shareholder directly or indirectly transfers all of its stock of an SFC (such as the § 245A shareholder, the "transferor"). In cases in which no related party regarding the transferor is a § 245A shareholder of the SFC following the transfer, the transferor's remaining extraordinary disposition account balance is eliminated, to the extent not allocated or attributed to another extraordinary disposition account.
3. In these cases, the remaining balance generally represents an individual's or a foreign (non-CFC) person's share of E&P of the SFC, such that, after the transfer, distributions of the E&P are unlikely to give rise to a dividend eligible for the § 245A deduction. Therefore, there is generally not a policy need to continue tracking such E&P.
4. The elimination rule does not apply, however, if a § 245A shareholder that is a related party with respect to the transferor continues to own stock of the SFC after the transfer; instead the related § 245A shareholder succeeds to the remaining account balance. Moreover, transactions with a principal purpose of avoiding this limitation on the application of the elimination rule are disregarded. For example, if a U.S. individual acquires all of the stock of an SFC from a § 245A shareholder and subsequently, pursuant to a plan that included the acquisition, transfers all of the stock of the SFC to a domestic corporation that is a § 245A shareholder of the SFC, the transfer to the U.S. individual would be disregarded.
5. The final regulations added a rule that a transfer of stock of an SFC otherwise subject to Treas. Reg. § 1.245A-5(c)(4)(iv)(A) is deemed to have been undertaken with a principal purpose of avoiding the purposes described in this anti-abuse rule if stock of the SFC is transferred to a § 245A shareholder within one year after the transaction that would be subject to Treas. Reg. § 1.245A-5(c)(4)(vii).

Q. Tiered Extraordinary Disposition Amounts.

1. The 2019 regulations limited the application of the § 954(c)(6) exception regarding certain dividends attributable to extraordinary disposition E&P from a lower-tier CFC to an upper-tier CFC.
2. A comment stated that this limitation on the § 954(c)(6) exception gives rise to an incentive to avoid making a distribution (or otherwise generating a dividend to shareholders) to avoid Subpart F income. Furthermore, the comment stated that, in certain cases, a dividend subject to this limitation on the § 954(c)(6) exception may nonetheless qualify for an exception under § 954(c)(3), permitting deferral regarding distributed E&P.
3. Accordingly, the comment recommended that the final regulations instead adopt a tracking approach, under which dividends from a lower-tier CFC attributable to extraordinary disposition E&P would be eligible for the § 954(c)(6) exception, and the extraordinary disposition account of an upper-tier CFC receiving a dividend attributable to extraordinary disposition E&P would be increased by the amount of the dividend attributable to extraordinary disposition E&P (while making corresponding downward adjustments to the extraordinary disposition account of the lower-tier CFC).
4. In the alternative, the comment recommended that this approach apply solely regarding lower-tier dividends paid before June 18, 2019 (the date on which the 2019 regulations were published), to provide relief regarding dividends from lower-tier CFCs that were expected to qualify for the § 954(c)(6) exception.
5. Treasury and the IRS believe that limiting the application of the § 954(c)(6) exception in this context is necessary to prevent the inappropriate deferral of tax and minimizes the administrative and compliance burdens associated with a rule that would adjust upper-tier and lower-tier CFCs' extraordinary disposition accounts. The limitation on the § 954(c)(6) exception achieves the appropriate balance between preventing deferral of U.S. tax regarding extraordinary disposition E&P and avoiding incentives to defer distributions.
6. Similar to the rules limiting the application of the § 245A deduction to distributions attributable to extraordinary disposition E&P under Treas. Reg. § 1.245A-5(b), the incentive to defer distributions is mitigated by the fact that the limitation on the § 954(c)(6) exception generally applies only after other E&P (including E&P accumulated after the disqualified period and previously taxed E&P) are distributed.
7. Furthermore, failing to limit the application of the § 954(c)(6) exception would allow taxpayers to use extraordinary disposition E&P to defer U.S.

tax on subsequent taxable transactions. For example, assume that USP owns 100% of the stock of CFC1, CFC1 owns 100% of the stock of CFC2, and CFC2's E&P is maintained in the U.S. dollar. USP has a \$100x extraordinary disposition account regarding CFC2, which has no E&P other than \$100x of extraordinary disposition E&P. Finally, assume that CFC1 has \$100x of built-in gain regarding its stock in CFC2.

8. In the absence of the extraordinary disposition E&P, a sale of the stock of CFC2 by CFC1 generally would result in \$100x of capital gain that is Subpart F income taken into account by USP in the year of sale pursuant to §§ 954(c) and 951(a). With the extraordinary disposition E&P, however, CFC2 could (in the absence of any rule denying the § 954(c)(6) exception) distribute a \$100x dividend to CFC1 before the sale, and the dividend could be eligible for the § 954(c)(6) exception while eliminating the built-in gain in the stock of CFC2.
9. If the rules only transferred the extraordinary disposition account from CFC2 to CFC1, the § 245A shareholder could effectively indefinitely defer recognizing the built-in gain in the stock of CFC2 until it causes CFC1 to pay a \$100x dividend. While similar benefits may be obtained in the case of same-country dividends under § 954(c)(3), Treasury and the IRS believe that the transactions are relatively infrequent.
10. For these reasons, the final regulations did not adopt this recommendation and, accordingly, continue to limit the application of the § 954(c)(6) exception regarding certain dividends attributable to extraordinary disposition E&P from a lower-tier CFC to an upper-tier CFC. The final regulations also provide that transactions structured to use § 954(c)(3) to avoid the purposes of the final regulations are subject to adjustments under the anti-abuse rule.

R. Extraordinary Reductions.

1. Bilateral Election to Close Taxable Year.

- (a) If an extraordinary reduction occurs regarding a CFC and there is an extraordinary reduction amount or tiered extraordinary reduction amount greater than zero, the controlling § 245A shareholder (or shareholders) of a CFC can elect to close the CFC's taxable year for all purposes of the Code and, as a result, be considered to not have undertaken an extraordinary reduction. As a condition for making the election, however, the controlling § 245A shareholders must enter into a written, binding agreement concerning the election with certain U.S. tax resident shareholders of the CFC.

- (b) Because the election can only be made if there is an extraordinary reduction amount or tiered extraordinary reduction amount greater than zero, the election cannot be made if the CFC only has a tested loss for the taxable year.
- (c) A comment stated that it was unclear who is required to enter into this agreement and that only the controlling § 245A shareholders at the time of the extraordinary reduction should be required to make such an election. The final regulations provide that each controlling § 245A shareholder participating in the extraordinary reduction with an extraordinary reduction amount greater than zero, and each U.S. tax resident that is a U.S. shareholder of the CFC at the end of the day of the extraordinary reduction (thus including a person that becomes a U.S. shareholder of the CFC by reason of the extraordinary reduction), must enter into a binding agreement to close the taxable year of the CFC. This rule is reflected in the analysis in an example in Prop. Treas. Reg. § 1.245A-5(j)(4)(iii), which was retained in the final regulations.
- (d) This approach was not modified as requested by the comment because closing the taxable year of a CFC affects the tax consequences of both the transferors and transferees in an extraordinary reduction, and inconsistent treatment could give rise to inappropriate results (for example, both a transferor and transferee could claim to have income inclusions under § 951(a) or 951A(a) and claim deemed-paid foreign credits under § 960(a) or (d), regarding the same income of the CFC).
- (e) The final regulations also allow a U.S. tax resident that owns its interest in the CFC through a partnership to delegate the authority to enter into the binding agreement on its behalf provided that the delegation is pursuant to a written partnership agreement (within the meaning of Treas. Reg. § 1.704-1(b)(2)(ii)(h)).
- (f) Finally, changes were made to the scope of the reference to Treas. Reg. § 1.964-1(c) regarding the election to close the taxable year for extraordinary reductions and to the consistency requirement of Treas. Reg. § 1.245A-5(e)(3)(i)(E).

## 2. Election to Close Taxable Year.

- (a) Comments stated that it might not be clear in certain instances whether an election to close the taxable year is beneficial. Accordingly, the comments recommended that the final regulations provide additional flexibility as to when this election is required to be made.

- (b) The final regulations did not adopt this recommendation. The election is timely made when filed with the controlling § 245A shareholder's timely filed (including extensions) original tax return for the taxable year in which the extraordinary reduction occurred; thus, taxpayers have considerable time to decide whether to make the election. Furthermore, permitting later elections would potentially result in amended tax returns and considerable administrative complexity.

3. Allocation Between Taxable Periods.

- (a) If an election is made under Treas. Reg. § 1.245A-5(e)(3)(i) to close a CFC's taxable year for all purposes of the Code, then all U.S. shareholders that own (within the meaning of § 958(a)) stock of the CFC on such date compute and take into account their pro rata share of Subpart F income or tested income earned by the CFC as of that date.
- (b) A comment recommended modifying the "closing-of-the-books" approach because of administrative complexity for the CFC, and because the closing-of-the-books method may provide inconsistent results. The comment also suggested that this approach would provide tax planning opportunities and traps for the unwary because an extraordinary item of income (for example, gain from the disposition of a capital asset) might arise pre- or post-sale, but the item would only be allocated to the period in which it arises.
- (c) The comment instead recommended adopting principles similar to those in Treas. Reg. § 1.1248-3 to allocate Subpart F income and tested income of a CFC between the pre- and post-sale portions of the year based on a daily proration. The comment acknowledged, however, that this approach could delay restructuring or commercial decisions and suggested allowing a taxpayer to elect to allocate extraordinary items to the period in which they arise, similar to an approach under Treas. Reg. § 1.1502-76(b).
- (d) The final regulations did not adopt this comment for several reasons. First, the election under Treas. Reg. § 1.245A-5(e)(3)(i) is provided to allow controlling § 245A shareholders and U.S. tax residents to agree to close the CFC's taxable year and take into account their pro rata share of Subpart F or tested income earned by that date in lieu of being subject to the extraordinary reduction rules. Treasury and the IRS believe that closing the taxable year provides a more precise method for determining the amount of Subpart F income and tested income attributable to each owner. Second, the rule provides taxpayers with flexibility, given that controlling § 245A shareholders may choose not to make the

election (or U.S. tax residents may choose not to agree to make the election) when it would not provide the preferred outcome. Finally, the comment's recommended approaches present administrative complexities and may delay commercial transactions.

4. Reporting.

- (a) For purposes of determining a controlling § 245A shareholder's extraordinary reduction amount, the shareholder's pre-reduction pro rata share of Subpart F income or tested income is reduced by certain amounts taken into account by transferee shareholders. A comment indicated that it may be difficult for a controlling § 245A shareholder to determine a transferee's pro rata share of Subpart F income or tested income and recommended that the final regulations provide that a controlling § 245A shareholder may make this determination by relying on information provided by a transferee pursuant to IRS forms and instructions.
- (b) While Treasury and the IRS may consider whether information reporting would be appropriate in this context in future guidance, the final regulations did not adopt this recommendation. Parties to an extraordinary reduction transaction can negotiate to share the needed information, however. Furthermore, in some instances, parties to an extraordinary reduction transaction are related, and therefore readily have access to such information.

5. Nonrecognition Transactions.

- (a) The 2019 regulations did not and the final regulations do not contain special rules for extraordinary reductions occurring as a result of nonrecognition transactions such as reorganizations or transfers subject to § 351(a) or 721(a). Treasury and the IRS continue to study these transactions and the potential to use them to avoid the purposes of the extraordinary reduction rules.
- (b) For example, they are concerned that taxpayers may avail themselves of partnerships to attempt to shift the tax liability, in whole or in part, regarding E&P of a CFC attributable to Subpart F income or tested income to a related foreign partner that is not owned by a U.S. shareholder. Treasury and the IRS requested comments on this matter and other cases in which nonrecognition transactions could be used to avoid the purposes of the extraordinary reduction rules.



S. Anti-Abuse Rule.

1. One comment said that the anti-abuse rule is vague and overly broad. The comment stated that although the policies underlying the extraordinary disposition rules and the extraordinary reduction rules are related, the origins of the transactions giving rise to the concerns and the focus of the two rules differ. Accordingly, the comment recommended that the final regulations clarify the purposes of Treas. Reg. § 1.245A-5 and include examples regarding the applicability of the anti-abuse rule and the scope of the adjustments that may be made pursuant to the rule.
2. In response to this comment, the final regulations include examples illustrating the application of the anti-abuse rule. Treas. Reg. § 1.245A-5(h) and (j)(8)-(10). In addition, Treasury and the IRS determined that the anti-abuse rule should be self-executing, rather than applicable under the discretion of the Commissioner. Accordingly, the anti-abuse rule is modified to this effect.

T. Applicability Date.

1. The proposed regulations incorporated the applicability date of the temporary regulations by cross-reference. The temporary regulations apply to distributions made after December 31, 2017, consistent with the applicability date of § 245A. The temporary regulations were issued under § 7805(b)(2), which permits Treasury and the IRS to issue retroactive regulations within 18 months of the enactment of the statutory provision to which the regulations relate.
2. The final regulations apply to tax periods ending on or after June 14, 2019, the date the proposed regulations were filed with the Federal Register.
3. In a case where both the temporary regulations and the final regulations could apply, only the final regulations apply. Treas. Reg. § 1.245A-5(k)(1). For example, if a CFC has a tax period ending on November 30, 2019, and it made a distribution during that period on December 1, 2018, a portion of which would be an ineligible amount, the final regulations apply to the distribution. Distributions made after December 31, 2017, and before the final regulations apply, continue to be subject to the rules set forth in the temporary regulations. However, a taxpayer may choose to apply the final regulations to distributions made during this period, provided that the taxpayer and all related parties consistently apply the final regulations in their entirety.

PROPOSED SECTION 245A REGULATIONS

- A. As discussed above, Treasury and the IRS issued final § 245A regulations intended either (1) to eliminate a perceived abuse or (2) to re-write the statute's

effective dates, depending upon one's perspective. In doing so, the possibility for excess taxation can result. These proposed regulations are an attempt to ameliorate that result. They are quite complicated.

- B. Specifically, the new proposed § 245A regulations address whether and how to coordinate the extraordinary disposition rule and the disqualified basis rule. In certain cases, the extraordinary disposition rule and the disqualified basis rule, when applied together, can give rise to excess taxation as to a § 245A shareholder (or as to the § 245A shareholder and a related party).
- C. For example, consider a case in which a CFC that is wholly owned by a § 245A shareholder sells an item of specified property during the disqualified period to another CFC that is wholly owned by the § 245A shareholder. There is a single amount of gain (the gain that the transferor CFC recognizes upon the sale), which gives rise to both extraordinary disposition E&P of the transferor CFC (the E&P generated upon the sale) and disqualified basis in the item of specified property held by the transferee CFC (the basis step-up in the item of specified property resulting from the sale).
- D. The gain will in effect be subject to U.S. tax as to the § 245A shareholder when the extraordinary disposition E&P is distributed as a dividend by the transferor CFC. In addition, an amount (such as an amount of future gross tested income of the transferee CFC) equal to the gain might be indirectly taxed as to the § 245A shareholder as a result of not being offset or reduced by deductions or losses attributable to the disqualified basis (because, but for the disqualified basis rule, such deductions or losses would have offset or reduced the amount and sheltered it from U.S. tax).
- E. The disqualified basis rule may in certain cases also have the effect of reducing, in an amount equal to the gain, E&P of the transferee CFC that would otherwise have been eligible for the § 245A deduction when distributed as a dividend to the § 245A shareholder. This could occur because, in general, deductions or losses that are subject to the disqualified basis rule nevertheless reduce E&P.
- F. Treasury and the IRS believe that one approach would permit taxpayers to effectively unwind the tax effect of an extraordinary disposition. Under this approach, a § 245A shareholder's extraordinary disposition account would be eliminated if, regarding each item of specified property taken into account in determining the initial balance of the account, an election were made pursuant to Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(3) to reduce the item's adjusted basis (and thus eliminate the item's disqualified basis), and provided that certain other requirements are met (for example, the person to which the item of specified property was transferred in the extraordinary disposition was a CFC, which remains a CFC for at least five years after the extraordinary disposition).
- G. However, the proposed regulations did not adopt this approach. Treasury and the IRS determined that it could give rise to inappropriate results, such as the

elimination of an extraordinary disposition account in cases in which it is unlikely that the extraordinary disposition rule and the disqualified basis rule, when applied together, would result in excess taxation.

- H. In addition, the approach could be difficult to administer. For example, after the extraordinary disposition, the CFC to which the specified property was transferred might be transferred outside the U.S. taxing jurisdiction but remain a CFC due to the Act's repeal of § 958(b)(4), with the result that in effect there is no or little U.S. tax cost to the CFC having reduced the adjusted basis (and eliminated the disqualified basis) of the item of specified property. Furthermore, because the extraordinary disposition account regarding the transferor CFC would have been eliminated, the E&P attributable to the extraordinary disposition could reduce gain that would otherwise be recognized on the disposition of stock of the transferor CFC as a result of the § 245A deduction.
- I. Moreover, there would be additional administrative and compliance burdens if the regulations adopted an approach pursuant to which an extraordinary disposition account is tentatively eliminated when elections are made pursuant to Treas. Reg. § 1.951A-3(h)(3) to reduce adjusted bases (and eliminate disqualified basis), but then the extraordinary disposition account is retroactively restored if the transferee CFC ceases to be a CFC or becomes a CFC only by reason of the repeal of § 958(b)(4).
- J. The second approach would adjust disqualified basis of an item of specified property to the extent that gain to which the disqualified basis is attributable is in effect subject to U.S. tax by reason of the extraordinary disposition rule. Similarly, an extraordinary disposition account of a § 245A shareholder would be adjusted to the extent that, regarding disqualified basis attributable to gain to which the extraordinary disposition account is also attributable, the disqualified basis gives rise to deductions or losses that are allocated and apportioned to residual CFC gross income of a CFC by reason of the disqualified basis rule.
- K. The proposed regulations utilize a coordination mechanism that is broadly consistent with this approach. The coordination mechanism involves two operative rules, one that reduces disqualified basis in certain cases (the "DQB reduction rule"), and another that reduces an extraordinary disposition account in certain cases (the "EDA reduction rule").
- L. In addition, to reduce burden and to facilitate compliance, the proposed regulations provide two versions of both the DQB reduction rule and the EDA reduction rule, similar to the approach taken in Treas. Reg. §§ 1.1248-2 and 1.1248-3 (providing rules for determining earnings and profits attributable to a block of stock in simple and complex cases). These versions achieve the same results. The first version (Prop. Treas. Reg. § 1.245A-7) may be applied to so-called simple cases, and the second version (Prop. Treas. Reg. § 1.245A-8) applies to complex cases.

- M. As discussed below, the simple case is complex, and the complex case is extraordinarily complex (similar to Treas. Reg. §§ 1.1248-2 and -3). Treasury and the IRS's interest in eliminating a perceived abuse has opened the proverbial door to a whole new universe.
- N. The rules for simple cases may be applied when two conditions are satisfied. These conditions eliminate the need for certain additional rules that are necessary under the version for complex cases. The first condition provides requirements related to the seller SFC regarding which there is an extraordinary disposition account. The second condition provides requirements related to an item of specified property for which an extraordinary disposition occurred and the buyer CFC holding the item.
- O. As an example, the version for simple cases generally applies if (i) the seller SFC is wholly-owned (directly or indirectly, within the meaning of § 958(a)) by the § 245A shareholder at the time of the extraordinary disposition and remains wholly-owned by the § 245A shareholder, (ii) the seller SFC does not succeed to E&P of another SFC regarding which there is an extraordinary disposition account, (iii) the items of specified property for which an extraordinary disposition occurred are acquired by a buyer CFC wholly-owned by the § 245A shareholder and certain related parties and the buyer CFC remains wholly-owned by the § 245A shareholder and certain related parties, and (iv) the buyer CFC retains the items of specified property it acquires in the extraordinary disposition and does not acquire items of specified property with disqualified basis that were transferred in another extraordinary disposition.
- P. The determination as to whether the version for simple cases is available is made regarding a taxable year of a § 245A shareholder. If the conditions for applying the version for simple cases are not satisfied for a taxable year, then the version for complex cases must be applied beginning with that taxable year and all subsequent taxable years. In addition, if the conditions for applying the version for simple cases are satisfied for a taxable year but the § 245A shareholder chooses not to apply the version for simple cases for that taxable year, then the version for complex cases applies to that taxable year. However, for a subsequent taxable year, the § 245A shareholder may apply the version for simple cases, provided that the conditions for applying the version for simple cases are satisfied for that taxable year and have been satisfied for all earlier taxable years.
- Q. Further, for purposes of determining whether the conditions for applying the version for simple cases are satisfied, any requirement that references a § 245A shareholder, an SFC, or a CFC does not include a successor of the § 245A shareholder, the SFC, or the CFC, respectively.
- R. As a result, the version of the rules for simple cases is not available if the § 245A shareholder's extraordinary disposition account regarding an SFC has been adjusted pursuant to the successor rules of Treas. Reg. § 1.245A-5(c)(4). Thus, for example, the version of the rules for simple cases is not available if the assets

of the § 245A shareholder are acquired by another domestic corporation, or if the assets of the seller SFC are acquired by another SFC, in each case, in a transaction described in § 381 and subject to Treas. Reg. § 1.245A-5(c)(4)(i) or (ii), respectively.

S. Rules for Simple Cases.

1. The DQB Reduction Rule.

- (a) The DQB reduction rule provides that when an extraordinary disposition account of a § 245A shareholder gives rise to an extraordinary disposition amount or tiered extraordinary disposition amount, the disqualified bases of certain items of specified property are reduced by the same amount solely for purposes of Treas. Reg. § 1.951A-2(c)(5). This rule is intended to ensure that as the extraordinary disposition rule applies to cause gain to which extraordinary disposition E&P are attributable to in effect be subject to U.S. tax, the disqualified basis rule generally does not apply to the basis of an item of specified property attributable to that gain (because that basis is no longer generated at no U.S. tax cost) and, accordingly, items of deduction or loss attributable to that basis become eligible to offset income subject to U.S. tax.
- (b) For a taxable year of a § 245A shareholder, the disqualified bases of items of specified property that “correspond” to the § 245A shareholder’s extraordinary disposition account are generally reduced by the sum of the extraordinary disposition amounts or tiered extraordinary disposition amounts for the taxable year. This correspondence requirement is intended to ensure that the rule only reduces disqualified basis of an item of specified property that is attributable to gain that was taken into account in determining the initial balance of the account, and thus the rule does not reduce disqualified basis of an item of specified property that is attributable to other gain (for example, disqualified basis of an item of specified property that corresponds to an extraordinary disposition account of another § 245A shareholder or that does not correspond to an extraordinary disposition account).
- (c) The amount of the reduction under the DQB reduction rule is allocated pro rata across the disqualified basis of each item of specified property that corresponds to the § 245A shareholder’s extraordinary disposition account, based on the item’s disqualified basis relative to the aggregate disqualified bases of the items. Treasury and the IRS believe that a pro rata approach is appropriate because the initial balance of the extraordinary disposition account reflects an aggregate of the gain of each item

of specified property that corresponds to the account (reduced by losses regarding certain items of specified property). In addition, alternative approaches would be unduly complex, such as a stacking approach pursuant to which a reduction is applied first regarding disqualified basis of a particular item of specified property, then regarding another item of specified property, and so on.

2. Timing Rules. For purposes of applying the DQB reduction rule for a taxable year of a § 245A shareholder, disqualified basis of an item of specified property is determined as of the beginning of the taxable year of the CFC holding the item that includes the date on which the § 245A shareholder's taxable year ends (and, to avoid circularity issues, without regard to any reductions to disqualified basis of the item of specified property pursuant to the DQB reduction rule for such taxable year of the CFC). Then, disqualified basis of the item of specified property is reduced as of the beginning of the taxable year of the CFC. Thus, for example, disqualified basis of an item of specified property is reduced before any depreciation, amortization, or other cost recovery deduction allowances attributable to the basis of the item are determined for the CFC's taxable year.
3. The EDA Reduction Rule.
  - (a) The EDA reduction rule provides that when items of deduction or loss attributable to disqualified basis of an item of specified property are allocated and apportioned to residual CFC gross income of a CFC and have the effect of reducing certain E&P of the CFC that could otherwise potentially qualify for the § 245A deduction when distributed, the extraordinary disposition account to which the specified property corresponds is reduced by up to the same amount.
  - (b) This rule is generally intended to ensure that as the application of the disqualified basis rule results in income of the CFC being indirectly taxed to a § 245A shareholder (or a related party that is a domestic corporation, a "domestic affiliate") and a reduction in the E&P of the CFC available to be distributed to the § 245A shareholder and any domestic affiliates as a dividend to which the § 245A deduction could be available if distributed, the extraordinary disposition rule no longer applies to E&P attributable to gain to which the disqualified basis is also attributable.
  - (c) Requiring reduction in the capacity to pay dividends for which the § 245A deduction could be available if the E&P were distributed ensures that the EDA reduction rule applies only once the disqualified basis rule has resulted in a tax detriment to the § 245A

shareholder (or a domestic affiliate). To the extent that there has not been a reduction in the CFC's capacity to pay dividends for which the § 245A deduction could be available if the E&P were distributed, the disqualified basis rule might generally not give rise to a tax detriment to the § 245A shareholder (or a domestic affiliate).

- (d) This is because the § 245A shareholder's (or domestic affiliate's) basis in its stock of the CFC is generally increased under § 961 by the amount of the income indirectly taxed to the § 245A shareholder (or a domestic affiliate). Such basis increase is, for example, available to reduce gain that would otherwise be recognized on a disposition of stock of the CFC (including gain that would be taxed at the full corporate tax rate even though, for instance, the basis increase is attributable to an inclusion under § 951A that in effect is taxed at a preferential rate).
- (e) For a taxable year of a CFC, a § 245A shareholder's extraordinary disposition account is generally reduced by the lesser of two amounts. The first amount is intended to approximate in an administrable manner the extent to which the disqualified basis rule (by reason of the allocation and apportionment of items of deduction or loss to residual CFC gross income of the CFC) reduced the E&P of the CFC available to be distributed to the § 245A shareholder and any domestic affiliates as a dividend to which the § 245A deduction could be available. In order to reduce administrative and compliance burdens, the proposed regulations disregard the holding period requirement of § 246(c) for purposes of determining if a § 245A deduction would be available if E&P were distributed.
- (f) To compute the first amount, the CFC's E&P at the end of the taxable year are determined, taking into account distributions during the taxable year. Then, those E&P are adjusted, including by generally increasing the E&P by items of deduction or loss that are or have been allocated to residual CFC gross income of the CFC solely by reason of the disqualified basis rule ("adjusted earnings").
- (g) Lastly, the adjusted earnings are reduced by the sum of the previously taxed earnings and profits accounts regarding the CFC under § 959 (taking into account any adjustments to the accounts for the taxable year) in order to reflect that an amount equal to such sum would not have been eligible for the § 245A deduction were it distributed by the CFC to the § 245A shareholder and any domestic affiliates.

- (h) The second amount necessary to determine the reduction in a § 245A shareholder's extraordinary disposition account is the balance of the § 245A shareholder's residual gross income account ("RGI account") regarding the CFC. The balance of the RGI account generally reflects items of deduction or loss allocated and apportioned to residual CFC gross income of the CFC solely by reason of the disqualified basis rule, to the extent that the allocation and apportionment is likely to increase income of the CFC that is subject to U.S. taxation at the level of the § 245A shareholder and any domestic affiliates pursuant to § 951 or 951A.
- (i) Tracking the items of deduction or loss through an account mechanism allows for a reduction under, and facilitates compliance with, the EDA reduction rule in certain cases – for example, a case in which a CFC does not have any adjusted earnings for its taxable year in which items of deduction or loss are allocated and apportioned to residual CFC gross income (such that there cannot be a reduction under the EDA reduction rule to the § 245A shareholder's extraordinary disposition account that year) but in a later taxable year has sufficient adjusted earnings to allow for a reduction.

4. Timing Rules.

- (a) A reduction to an extraordinary disposition account of a § 245A shareholder by reason of the application of the EDA reduction rule regarding a taxable year of the CFC occurs as of the end of the taxable year of the § 245A shareholder that includes the date on which the CFC's taxable year ends (and, for example, after the determination of any extraordinary disposition amounts or tiered extraordinary disposition amounts for the taxable year). Thus, a reduction to a § 245A shareholder's extraordinary disposition account under the EDA reduction rule occurs after the application of the DQB reduction rule for the taxable year of the § 245A shareholder.
- (b) Absent such an approach, there could be circularity issues because the computation of a reduction under one rule might depend on an amount that is potentially affected by the other rule, and it would be unclear which rule applies first. Applying the EDA reduction rule at the end of a taxable year also ensures that it applies after the full effect of the disqualified basis rule has been taken into account for the year.



T. Rules for Complex Cases.

1. The DQB Reduction Rule. The version of the DQB reduction rule for complex cases uses the same architecture as the version of the rule for simple cases but provides additional rules to address scenarios in which the conditions provided in Prop. Treas. Reg. § 1.245A-6(b)(1) and (2) are not satisfied. Prop. Treas. Reg. § 1.245A-8. For example, the version for complex cases addresses scenarios in which, after the extraordinary disposition of an item of specified property, the item is transferred to another person (whether the transfer is taxable or non-taxable).
2. Ownership Requirement.
  - (a) To address the possibility that an item of specified property may have been transferred after the extraordinary disposition (with the result that the § 245A shareholder or a related party may not directly or indirectly own an interest in the item), the version of the DQB reduction rule for complex cases provides that an ownership requirement must be satisfied for disqualified basis of an item of specified property to be eligible for relief under the DQB reduction rule.
  - (b) The ownership requirement is intended to ensure that the DQB reduction rule applies regarding an item of specified property only if it is likely that the § 245A shareholder (or the § 245A shareholder and a related party) would be meaningfully affected by the application of the disqualified basis rule as to the item of specified property, such that, absent the DQB reduction rule, the extraordinary disposition rule and the disqualified basis rule would, when applied together, result in meaningful excess taxation as to the § 245A shareholder (or the § 245A shareholder and a related party).
  - (c) In addition, the ownership requirement is intended to ensure that the DQB reduction rule takes into account only disqualified bases of items of specified property for which the § 245A shareholder can reasonably be expected to have or obtain the necessary information to accurately apply the DQB reduction rule.
  - (d) The ownership requirement is satisfied regarding an item of specified property if, on one or more days during the taxable year of the § 245A shareholder, the item is held by the § 245A shareholder, a related party, or a specified entity in which the § 245A shareholder or a related party owns directly or indirectly at least a 10% interest. Prop. Treas. Reg. § 1.245A-8(b)(3). As a result, the DQB reduction rule can apply to, for example, an item of specified property that is sold at a loss by a CFC of the § 245A

shareholder to a third party on any day that falls within the taxable year of the § 245A shareholder, such that a reduced portion of the CFC's loss will be attributable to disqualified basis and thus subject to the disqualified basis rule for the CFC's taxable year.

- (e) As an additional example, the DQB rule can also apply to an item of specified property that is held by a CFC of the § 245A shareholder all the stock of which is sold by the § 245A shareholder to a third party on any day that falls within the taxable year of the § 245A shareholder, such that a reduced portion of the CFC's amortization deductions regarding the specified property for its taxable year that includes the sale and its subsequent taxable years will be subject to the disqualified basis rule.

3. Basis Benefit Amounts.

- (a) In certain cases in which an item of specified property with disqualified basis is transferred after the extraordinary disposition of the item, the extraordinary disposition rule and the disqualified basis rule, when applied together, do not give rise to excess taxation as to a § 245A shareholder (or as to the § 245A shareholder and a related party). This may occur, for example, if the § 245A shareholder “benefits” from the disqualified basis of the item of specified property pursuant to a transaction that is not subject to the disqualified basis rule. This could occur through a sale of the item by a CFC of the § 245A shareholder to an unrelated person at a gain (with the result that, but for the use of the disqualified basis, the CFC would have had a greater amount of gain that would have been taken into account in computing the CFC's tested income). In such a case, the DQB reduction rule need not apply to an amount of the § 245A shareholder's extraordinary disposition account equal to the amount of the disqualified basis benefit. Prop. Treas. Reg. § 1.245A-10(c)(2) (Example 2).
- (b) The proposed regulations provide that, for a taxable year of a § 245A shareholder, the amount of the reduction to disqualified bases under the DQB reduction rule is equal to the sum of the extraordinary disposition amounts or tiered extraordinary disposition amounts for the taxable year, less the balance of the § 245A shareholder's “basis benefit account” regarding the extraordinary disposition account. A basis benefit account regarding an extraordinary disposition account generally reflects the extent to which the disqualified basis of one or more items of specified property that correspond to the extraordinary disposition account has been used to offset or reduce income subject to U.S.

tax (the use of disqualified basis to such an extent, a “basis benefit amount”).

- (c) For these purposes, the use of disqualified basis by a U.S. tax resident to offset or reduce taxable income, or the use of disqualified basis by a foreign person (including a CFC) to offset or reduce income effectively connected with a trade or business in the U.S. (“ECTI”), is always considered to offset or reduce income subject to U.S. tax.
- (d) As an example, in the case of an item of specified property that is held by a U.S. tax resident and that has disqualified basis by reason of the application of Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(1)(ii) to a previous transfer of the item of specified property by a related CFC to the U.S. tax resident, there is a basis benefit amount equal to the portion of the disqualified basis that gives rise to an item of depreciation or amortization of the U.S. tax resident for a taxable year of the U.S. tax resident.
- (e) However, the use of disqualified basis by a CFC to offset or reduce income taken into account in computing Subpart F income, tested income, or tested loss is considered to offset or reduce income subject to U.S. tax only if the CFC is described in Treas. Reg. § 1.267A-5(a)(17) and thus a meaningful portion of the CFC’s income is indirectly subject to current U.S. tax.
- (f) Disqualified basis can be used to reduce or offset income subject to U.S. tax regardless of whether the disqualified basis is reduced or eliminated under Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(1). For example, in a case in which a CFC sells an item of specified property with disqualified basis to a related CFC, the rule of Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(1) generally does not prevent the disqualified basis from reducing or offsetting income subject to U.S. tax (for instance, income from the sale that but for the use of the disqualified basis would have been taken into account in computing the seller CFC’s tested income), even though the buyer CFC succeeds to the disqualified basis under the rule. Thus, the proposed regulations provide that a basis benefit amount can be created from the use of disqualified basis regardless of whether the disqualified basis is reduced or eliminated as a result.
- (g) Further, the proposed regulations provide certain timing rules regarding when the use of disqualified basis gives rise to a basis benefit amount. For example, if an item of deduction or loss arising from the use of disqualified basis is deferred under § 267(a)(2), then the determination of whether a basis benefit

amount arises is made when, in a later taxable year, the deduction or loss is no longer deferred.

- (h) Similarly, if an item of deduction or loss arising from the use of disqualified basis of an item of specified property is disallowed under § 267(a)(1), then a basis benefit amount would arise when and to the extent that gain is reduced on the sale of that specified property (or other property with basis determined by reference to that specified property) under § 267(d) in the hands of certain persons whose income is directly or indirectly subject to U.S. tax.

#### 4. Adjustments to a Basis Benefit Account.

- (a) A basis benefit account is adjusted at the end of each taxable year of a § 245A shareholder. Generally, the basis benefit account is increased by a basis benefit amount regarding an item of specified property that corresponds to the extraordinary disposition account, provided that the basis benefit amount is assigned to the taxable year of the § 245A shareholder. However, in the case in which the extraordinary disposition ownership percentage regarding the extraordinary disposition account is less than 100% (such that the initial balance of the extraordinary disposition account reflects only a portion of the gain from the extraordinary disposition of the item of specified property), only the same ratable portion of the basis benefit amount may increase the basis benefit account.
- (b) A basis benefit amount regarding an item of specified property is assigned to a taxable year of a § 245A shareholder if two conditions are satisfied. First, the ownership requirement must be satisfied regarding the item of specified property. As a result of this first condition, a basis benefit amount is assigned to a taxable year of a § 245A shareholder (and thus only limits a potential reduction under the DQB reduction rule) only if the use of the disqualified basis giving rise to the basis benefit amount provides a meaningful benefit to the § 245A shareholder or a related party. This first condition is also intended to ensure that the § 245A shareholder can reasonably be expected to obtain information about the item of specified property necessary to accurately calculate and reflect the basis benefit amount.
- (c) Second, the use of the disqualified basis must occur in the § 245A shareholder's taxable year (in a case in which the § 245A shareholder is the person that uses the disqualified basis) or a taxable year of a person ending with or within – or in certain cases, beginning with or within – the taxable year of the § 245A shareholder (in a case in which the § 245A shareholder is not the person that uses the disqualified basis).

- (d) As a result of these assignment rules, in a case in which a CFC of a § 245A shareholder holds an item of specified property and the CFC sells the item of specified property (or the § 245A shareholder sells all of the stock of the CFC) to a third party on a day that falls within the taxable year of the § 245A shareholder, a use by the CFC of disqualified basis of the specified property to generate a basis benefit amount on a day that falls within the same taxable year of the § 245A shareholder is generally assigned to such taxable year of the § 245A shareholder.
- (e) At the end of each taxable year of a § 245A shareholder, the balance of a basis benefit account is decreased to the extent that the basis benefit account limits a reduction under the DQB reduction rule.

5. Timing Rules for Disqualified Basis.

- (a) To address the possibility that an item of specified property may be held by a person other than a CFC, the timing rules for purposes of the version of the DQB reduction rule for complex cases provide that disqualified basis of an item of specified property is generally determined and reduced as of the beginning of the taxable year of the “specified property owner” of the item. The specified property owner of an item of specified property is generally the person that held the item of specified property on at least one day during the taxable year of the person that includes the date on which the § 245A shareholder’s taxable year ends.
- (b) In addition, to address cases in which, absent a special rule, two or more persons might be considered the specified property owner, a special rule provides that in such cases the specified property owner is the person that held the item of specified property on the earliest date that falls within the § 245A shareholder’s taxable year.
- (c) Thus, for example, if a CFC (“CFC1”) transfers an item of specified property to another CFC (“CFC2”) on a date that falls within the taxable year of a § 245A shareholder and the taxable year of each of CFC1 and CFC2 includes the day of the close of the taxable year of the § 245A shareholder, then CFC1 (and not CFC2) would be the specified property owner for purposes of applying the DQB reduction rule for the taxable year of the § 245A shareholder.

6. The EDA Reduction Rule.

- (a) The version of the EDA reduction rule for complex cases uses the same architecture as the version of the rule for simple cases but provides additional rules to address scenarios in which the conditions provided in Treas. Reg. § 1.245A-6(b) are not satisfied.
- (b) For example, the version for complex cases addresses scenarios in which the CFC that holds an item of specified property that corresponds to an extraordinary disposition account of a § 245A shareholder is not wholly-owned by the § 245A shareholder and any domestic affiliates, or the CFC also holds an item of specified property that corresponds to another extraordinary disposition account.

7. Computing the Reduction.

- (a) The EDA reduction rule depends in part on the extent to which the disqualified basis rule has, as to a CFC that holds items of specified property that correspond to an extraordinary disposition account of a § 245A shareholder regarding an SFC, reduced E&P of the CFC available to be distributed to the § 245A shareholder and any domestic affiliates as a dividend to which the § 245A deduction could be available.
- (b) The EDA reduction rule for complex cases provides several additional rules for purposes of measuring this reduction to the CFC's capacity to pay dividends eligible for the § 245A deduction, to address the possibility that the § 245A shareholder and any domestic affiliates may not own all of the stock of the CFC (including because the § 245A shareholder or a domestic affiliate disposed of stock of the CFC during the CFC's taxable year) as well as other issues.
- (c) First, the version for complex cases provides an ownership requirement pursuant to which, for the § 245A shareholder's extraordinary disposition account to be reduced by reason of the application of the EDA reduction rule regarding a taxable year of the CFC, the § 245A shareholder (or a domestic affiliate) must, on the last day of the CFC's taxable year, be a U.S. shareholder regarding the CFC. The ownership requirement is measured on the last day of a CFC's taxable year because the EDA reduction rule depends on a § 245A shareholder's portion of the CFC's adjusted earnings, which are measured on an annual basis.
- (d) Second, the version for complex cases provides special rules for deficits of the CFC subject to Treas. Reg. § 1.381(c)(2)-1(a)(5).

These rules generally provide that the CFC's adjusted earnings are determined by not taking into account these deficits in determining E&P because, in general, the deficits do not affect or limit the CFC's ability to distribute its other E&P as a dividend.

- (e) In addition, for purposes of determining a CFC's adjusted earnings, the CFC's E&P are reduced by the amount of items of deduction or loss that are attributable to disqualified basis and that give or have given rise to a deficit subject to Treas. Reg. § 1.381(c)(2)-1(a)(5). This is because the application of the disqualified basis rule to these items has not affected or limited the CFC's ability to distribute certain earnings as a dividend and reducing the CFC's E&P by the amount of the items generally ensures that the application of the disqualified basis rule to these items does not give rise to relief under the EDA reduction rule. A CFC could have a deficit subject to Treas. Reg. § 1.381(c)(2)-1(a)(5) and comprised of items of deduction or loss attributable to disqualified basis if, for example, the CFC acquired in a transaction subject to § 381 the assets of another CFC that held items of specified property with disqualified basis.
- (f) Third, the version for complex cases provides a rule that allocates the CFC's adjusted earnings to the § 245A shareholder, based on the percentage of stock of the CFC that the § 245A shareholder and any domestic affiliates own. This allocation serves as a proxy for measuring the portion of the adjusted earnings of the CFC that the § 245A shareholder and any domestic affiliates would receive if the CFC were to distribute all of its adjusted earnings to its shareholders.
- (g) The adjusted earnings as so allocated to a § 245A shareholder are further adjusted to reflect certain previously taxed earnings and profits accounts regarding the CFC, certain hybrid deduction accounts regarding shares of stock of the CFC, and the balance of any extraordinary disposition accounts regarding the CFC (other than, in general, the portion of the balance of an extraordinary disposition account regarding the CFC that, by reason of a merger or similar transaction of the SFC into the CFC or vice versa, is attributable to an extraordinary disposition account regarding the SFC).
- (h) The end result is intended to measure the extent to which the disqualified basis rule has reduced E&P of the CFC available to be distributed to the § 245A shareholder and any domestic affiliates as a dividend to which the § 245A deduction could be available.

8. Computing the Increase to an RGI Account.

- (a) The EDA reduction rule depends in part on the balance of a § 245A shareholder's RGI account regarding a CFC. The EDA reduction rule for complex cases provides several additional rules for purposes of computing an increase to a § 245A shareholder's RGI account regarding a CFC.
- (b) First, to address the possibility that the CFC may hold multiple items of specified property, some of which correspond to an extraordinary disposition account of the § 245A shareholder and others of which correspond to another extraordinary disposition account (or to no extraordinary disposition account), the rule for complex cases provides that the § 245A shareholder's RGI account can be increased only by items of deduction or loss (to which the disqualified basis rule applies) that are attributable to disqualified basis of an item of specified property that corresponds to the § 245A shareholder's extraordinary disposition account.
- (c) In addition, in cases in which the § 245A shareholder owned less than all of the stock of the SFC when the SFC undertook an extraordinary disposition (such that the extraordinary disposition ownership percentage as to the § 245A shareholder's extraordinary disposition account regarding the SFC is less than 100%), the § 245A shareholder's RGI account can be increased by only the same ratable portion of the items of deduction or loss.
- (d) These rules ensure that a reduction under the EDA reduction rule to the § 245A shareholder's extraordinary disposition account can occur only by reason of the application of the disqualified basis rule to the portion of disqualified basis of an item of specified property that is attributable to gain to which the extraordinary disposition account is also attributable.
- (e) Further, to address the possibility that the § 245A shareholder and any domestic affiliates may not own all of the stock of the CFC holding items of specified property that correspond to an extraordinary disposition account of the § 245A shareholder, a limit applies regarding the extent to which an item of deduction or loss (or portion thereof) may increase the § 245A shareholder's RGI account.
- (f) The limit is generally based on the portion of the CFC's Subpart F income or tested income taken into account by the § 245A shareholders and any domestic affiliates under § 951 or 951A. This limit ensures that a reduction under the EDA reduction rule to the § 245A shareholder's extraordinary disposition account can



occur only to the extent that the application of the disqualified basis rule has likely increased income of the CFC that is subject to U.S. taxation at the level of the § 245A shareholder and any domestic affiliates.

9. Allocating Certain Reductions.

- (a) Because a reduction under the EDA reduction rule to an extraordinary disposition account may be a function of certain adjusted earnings of a CFC (that is, an amount that is not regarding the extraordinary disposition account), absent a special rule in certain complex cases, the adjusted earnings could give rise to a reduction to two or more extraordinary disposition accounts that, in aggregate, exceeds the adjusted earnings.
- (b) This could occur, for example, in a case in which a § 245A shareholder has two extraordinary disposition accounts (that is, an extraordinary disposition account regarding two SFCs) and owns all the stock of a CFC, which, in turn, owns the items of specified property that correspond to each of the extraordinary disposition accounts. In that case the aggregate amount of reductions to the extraordinary disposition accounts could exceed the extent to which the application of the disqualified basis rule has, as measured by certain adjusted earnings of the CFC allocated to the § 245A shareholder, reduced the earnings of the CFC available to be distributed to the § 245A shareholder as a dividend to which the § 245A deduction could apply.
- (c) The proposed regulations provide a rule that limits the aggregate reductions to extraordinary disposition accounts by reason of the application of the EDA reduction rule regarding a taxable year of a CFC to certain adjusted earnings of the CFC. The proposed regulations also provide an example illustrating this rule.
- (d) Finally, the proposed regulations provide a rule that prevents an extraordinary disposition account from being reduced below the balance of the basis benefit account that relates to the extraordinary disposition account. This limitation may occur if extraordinary disposition E&P (and therefore the initial balance of the extraordinary disposition account) reflect losses recognized regarding one or more items of specified property transferred in the extraordinary disposition.

10. Items of Specified Property.

- (a) In certain complex cases, an item of property may have disqualified basis even though the item itself was not transferred as

part of an extraordinary disposition. For example, a share of stock may have disqualified basis if the share was received in exchange for an item of specified property with disqualified basis in a transaction to which § 351 applies. Absent special rules, the share of stock would not correspond to an extraordinary disposition account of a § 245A shareholder and thus, for example, the disqualified basis of the share of stock could not be reduced under the DQB reduction rule.

- (b) The proposed regulations provide special rules to address this and similar issues. For instance, the proposed regulations provide that certain items of property that have disqualified basis by reason of Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(2)(i) (increase corresponding to adjustments in other property), (ii) (exchanged basis property), or (iii) (increase by reason of § 732(d)) are generally treated as items of specified property that correspond to an extraordinary disposition account of a § 245A shareholder.
- (c) As a result, the disqualified basis of such items of property may be reduced under the DQB reduction rule, and items of deduction and loss attributable to such disqualified basis and allocated and apportioned to residual CFC gross income of a CFC may give rise to a reduction to an extraordinary disposition account under the EDA reduction rule.
- (d) The proposed regulations also include an anti-duplication rule to ensure that disqualified basis of an item of specified property, as well as disqualified basis of another item of property attributable to that disqualified basis (“duplicate DQB”), are not both taken into account for purposes of the DQB reduction rule, as taking into account both amounts of disqualified basis could inappropriately limit the reductions under the DQB reduction rule. In addition, to the extent that, pursuant to the anti-duplication rule, duplicate DQB is not taken into account for purposes of the DQB reduction, the duplicate DQB is generally reduced to the same extent that the disqualified basis of the item of specified property to which the duplicate DQB is attributable is reduced.
- (e) As an example of the application of these special rules, consider a case in which a single item of specified property (“Item A”) corresponds to an extraordinary disposition account of a § 245A shareholder, and Item A is transferred, in a transaction to which § 351 applies, in exchange for a share of stock (“Item B”). In addition, assume that the extraordinary disposition account gives rise to a \$10x extraordinary disposition amount and that, at that time, Item A has \$10x of disqualified basis and Item B also has

\$10x of disqualified basis (all of which is attributable to the disqualified basis of Item A).

- (f) Here, Item B is considered an item of specified property that corresponds to the extraordinarily disposition account, but generally only the disqualified basis of Item A is taken into account for purposes of the DQB reduction rule, with the result that the entire \$10x reduction under the DQB reduction rule is allocated to Item A (such that Item A's disqualified basis is reduced by \$10x). However, pursuant to the special rule of Prop. Treas. Reg. § 1.245A-8(b)(5)(i)(B), Item B's disqualified basis is then reduced by the same amount.

11. Extraordinary Disposition.

- (a) In certain complex cases, an extraordinary disposition account of a § 245A shareholder may be adjusted pursuant to the rules of Treas. Reg. § 1.245A-5(c)(4), with the result, for example, that another § 245A shareholder succeeds to a portion of the extraordinary disposition account or a portion of the extraordinary disposition account is attributed to another extraordinary disposition account. The proposed regulations provide two sets of special rules to address these cases.
- (b) First, in cases in which a portion of an extraordinary disposition account is attributed (the "attributed account") to another extraordinary disposition account (the "successor account"), the proposed regulations ensure that the disqualified bases of the items of specified property that correspond to the attributed account are eligible to be reduced under the DQB reduction rule by reason of an amount in the successor account that gives rise to an extraordinary disposition amount or tiered extraordinary disposition amount, to the extent attributable to the attributed account.
- (c) This rule also ensures that the successor account, to the extent attributable to the attributed account, may be reduced under the EDA reduction rule by reason of an allocation and apportionment of an item of deduction or loss attributable to disqualified basis of an item of specified property that corresponds to the attributed account. This rule ensures these results by treating the attributed account and successor account as separate extraordinary disposition accounts for purposes of the proposed regulations.
- (d) As an example of this rule, consider a case in which US1, a domestic corporation, owns all of the stock of CFC1, a CFC as to which US1 has an extraordinary disposition account with a \$40x balance (the "CFC1 EDA"), and CFC2, a CFC as to which US1

has an extraordinary disposition account with a \$60x balance (the “CFC2 EDA”). If CFC1 were to merge into CFC2 and thus under the rules of Treas. Reg. § 1.245A-5(c)(4) the \$40x balance of the CFC1 EDA were attributed to the CFC2 EDA (such that the balance of the CFC2 EDA would become \$100x), then \$40x of the \$100x balance of the CFC2 EDA would be treated for purposes of the proposed regulations as an extraordinary disposition account regarding CFC1 (the CFC2 EDA to such extent, the “deemed CFC1 EDA”), even though CFC1 would no longer be in existence.

- (e) As a result, after the merger, the deemed CFC1 EDA would, by reason of the application of the EDA reduction rule to a taxable year of CFC2, generally be reduced by the lesser of (i) the adjusted earnings of CFC2, less the balance of (a) the previously taxed earnings and profits accounts regarding CFC2, (b) the hybrid deduction accounts regarding shares of stock of the CFC2, (c) the balance of the CFC2 EDA (but not including the portion of the balance of the CFC2 EDA that is treated as the deemed CFC1 EDA), to the extent taken into account as described in Prop. Treas. Reg. § 1.245A-8(c)(1)(i)(B)(3), and (d) the balance of the deemed CFC1 EDA, to the extent taken into account as described in Prop. Treas. Reg. § 1.245A-8(c)(1)(i)(B)(3); and (ii) the balance of the RGI account (if any) regarding CFC2 that relates to the deemed CFC1 EDA.
- (f) Second, special rules address the extraordinary disposition ownership percentage. The DQB reduction rule and the EDA reduction rule take into account the extraordinary disposition ownership percentage as to a § 245A shareholder’s extraordinary disposition account, which generally represents the portion of gain on the extraordinary disposition of an item of specified property that is reflected in the initial balance of the extraordinary disposition account. Special rules ensure, after an extraordinary disposition account is adjusted pursuant to Treas. Reg. § 1.245A-5(c)(4), the extraordinary disposition ownership percentage continues to accurately reflect the portion of gain that is reflected in the (adjusted) balance of the extraordinary disposition account.
- (g) As an example of the application of these special rules regarding the extraordinary disposition ownership percentage, consider a case which the extraordinary disposition ownership percentage as to a § 245A shareholder’s extraordinary disposition account regarding an SFC (“EDA 1”) is 80%, and by reason of Treas. Reg. § 1.245A-5(c)(4)(i) another § 245A shareholder (that did not previously have an extraordinary disposition account regarding the SFC) succeeds to a portion of EDA 1 equal to 40% of the balance

of EDA 1 (the portion of EDA 1 to which the other § 245A shareholder succeeds, “EDA 2”).

- (h) Here, the extraordinary disposition ownership percentage as to EDA 1 is thereafter 48% for purposes of the proposed regulations (80%, less 80% multiplied by 40%), and the extraordinary disposition ownership percentage as to EDA 2 is 32% for purposes of the proposed regulations (80% multiplied by 40%). As an additional example, if in the example in the previous sentence the other § 245A shareholder instead had an extraordinary disposition account regarding the SFC and the extraordinary disposition ownership percentage as to such extraordinary disposition account was 20% (“EDA 2”), then, pursuant to Prop. Treas. Reg. § 1.245A-8(e)(1), the extraordinary disposition ownership percentage as to EDA 2 would become 52% for purposes of the proposed regulations (20%, plus the product of 80% and 40%).

#### U. Other Rules.

1. Coordination with Disqualified Payment Rule. The coordination mechanism of the proposed regulations also applies to cases in which a prepayment during the disqualified period gives rise to extraordinary disposition E&P of an SFC under the anti-avoidance rule of Treas. Reg. § 1.245A-5(h) and items of deduction or loss of a CFC are allocated and apportioned to residual CFC gross income under the disqualified payment rule. Prop. Treas. Reg. § 1.245A-5(j)(8) (Example 7). The coordination mechanism generally applies in the same manner as if the disqualified payment had given rise to disqualified basis of an item of specified property that corresponds to the extraordinary disposition account.
2. Currency Translation Rules.
  - (a) Accounts created under the proposed regulations are maintained in the functional currency of the items to which they relate. Therefore, a basis benefit account is maintained in the same functional currency as the extraordinary disposition account to which it relates. Similarly, an RGI account is maintained in the functional currency of the CFC whose allocations to residual CFC gross income are being measured and tracked by that account.
  - (b) The application of the DQB reduction rule and the EDA reduction rule may also require currency translation because these rules require amounts determined in the functional currency of one person to be applied to reduce attributes of another person that may have a different functional currency. In this regard, the proposed regulations provide that the disqualified basis of, and a basis benefit amount regarding, an item of specified property that

corresponds to an extraordinary disposition account are translated into the functional currency in which the extraordinary disposition account is maintained, using the spot rate on the date the extraordinary disposition occurred.

- (c) Moreover, Prop. Treas. Reg. § 1.245A-9(b)(4) provides that a reduction in disqualified basis of an item of specified property under the DQB reduction rule is translated into the functional currency in which the disqualified basis of the item of specified property is maintained, and reductions in an extraordinary disposition account are translated into the functional currency in which the extraordinary disposition account is maintained, in each case using the spot rate on the date the associated extraordinary disposition occurred.
3. Anti-Avoidance Rule. Prop. Treas. Reg. § 1.245A-9(b)(5) contains an anti-avoidance rule providing that appropriate adjustments are made if a transaction or arrangement is engaged in with a principal purpose of avoiding the purposes of these proposed regulations. As an example, the anti-avoidance rule applies if a § 245A shareholder causes its taxable year to end on a particular date with a principal purpose of avoiding a basis benefit amount from being assigned to that taxable year.
  4. Existing Election to Eliminate Disqualified Basis. Taxpayers may have elected to reduce an item of specified property's adjusted basis (and thus eliminate the item's disqualified basis) pursuant to Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(3) (a "basis elimination election") before the proposed regulations were issued. In certain cases, the proposed regulations once finalized may provide more favorable outcomes for taxpayers than a basis elimination election. Therefore, the proposed regulations permit taxpayers to revoke a basis elimination election during a transition period, which under the proposed regulations is 90 days after the proposed regulations are finalized. Prop. Treas. Reg. § 1.245A-9(c)(1). This transition period is intended to provide a taxpayer sufficient time to consider whether it would prefer a basis elimination election or to apply the rules of the proposed regulations. The proposed regulations set forth the procedures for revoking a basis elimination election. These procedures require a taxpayer to file a revocation statement, as well as amended returns reflecting the revocation of the election.
- V. Applicability Dates. The proposed regulations are proposed to apply to taxable years of foreign corporations beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register (the "finalization date"), and to taxable years of a U.S. person in which or with which such taxable years of foreign corporations end. For taxable years beginning before the finalization date, a taxpayer may apply the rules set forth in

the final regulations, provided that the taxpayer and all related parties consistently apply the rules to those taxable years.

## VIII. FOREIGN TAX CREDITS (FINAL AND PROPOSED REGULATIONS).

### FINAL REGS: FOREIGN TAX CREDITS AND RELATED MATTERS

- A. Treasury and the IRS issued final regulations in September 2020 regarding foreign tax credits and certain related matters. The final regulations address the following issues:
1. the allocation apportionment of deductions for research and experimentation (“R&E”), stewardship, legal damages and certain other items;
  2. the allocation and apportionment of foreign income taxes;
  3. the interaction of the branch loss and dual consolidated loss recapture rules with § 904(f) and (g);
  4. the effect of foreign tax redeterminations of foreign corporations, including for purposes of the high tax exception and required notifications under § 905(c);
  5. the definition of foreign personal holding company income under § 954;
  6. the application of the foreign tax credit disallowance under § 965(g); and
  7. the application of the foreign tax credit limitation to consolidated groups.
- B. Certain of those provisions were finalized without substantive change in part because Treasury and IRS did not receive any comments: *See* Treas. Reg. §§ 1.904(b)-3, 1.904(g)-3, 1.1502-4, and 301.6689-1. Those provisions deal with: the disregard of certain dividends and deductions under § 904(b)(4); ordering rules for the allocation of net operating losses, net capital losses, U.S. source losses, and separate limitation losses (“SLLs”) and for the recapture of SLLs, overall foreign losses and overall domestic losses; consolidated foreign tax credits; and the § 6689 penalty regarding a failure to provide notice of a foreign income tax redetermination. They are not further discussed here since there were no changes to those regulations.

- C. Allocation and Apportionment of Deductions.
- D. Stewardship Expenses, Litigation Damages Awards and Settlement Payments, Net Operating Losses, Interest Expense, and Other Expenses.

- 1. Stewardship Expenses.

- (a) The 2019 FTC proposed regulations made several changes to the rules for allocating and apportioning stewardship expenses, which are generally expenses incurred to oversee a related corporation. Although the 2019 FTC proposed regulations did not change the definition of stewardship expenses, the regulations did provide that expenses incurred regarding partnerships are treated as stewardship expenses.
- (b) The 2019 FTC proposed regulations also expanded the types of income to which stewardship expenses were allocated to include not only dividends but also other inclusions received regarding stock. The 2019 FTC proposed regulations further provided that stewardship expenses were to be apportioned based on the relative values of stock held by a taxpayer, as computed for purposes of allocating and apportioning the taxpayer's interest expense. Additionally, the preamble to the 2019 FTC proposed regulations requested comments regarding how to distinguish stewardship expenses from supportive expenses.
- (c) Several comments addressed the definition of stewardship expenses. Some comments recommended that the current regulations' definition be retained without changes. One comment recommended that, because stewardship is among those activities that are not treated as providing a benefit to a related party under the § 482 regulations, these expenses should be treated as supportive expenses. Another recommended that the definition of stewardship expenses be narrowed to apply solely to expenses that result from oversight regarding foreign subsidiaries or non-affiliated domestic entities. Comments also requested clarification on how to identify and distinguish between stewardship and supportive expenses and sought greater flexibility in identifying stewardship expenses. One comment recommended that further guidance be left to a separate project.
- (d) The final regulations retain the existing definition of stewardship expenses as either duplicative or shareholder activities as described in Treas. Reg. § 1.482-9(l)(3)(iii) or (iv). Therefore, stewardship expenses either duplicate an expense incurred by the related entity without providing an additional benefit to that entity or are incurred primarily to protect the taxpayer's investment in another entity or to facilitate the taxpayer's compliance with its own



reporting, legal or regulatory requirements. In contrast, supportive expenses are typically incurred in order to enhance the income-producing capabilities of the taxpayer itself, and so are definitely related and allocable to all, or broad classes, of the taxpayer's gross income. Treas. Reg. § 1.861-8(b)(3).

- (e) The fact that expenses attributable to stewardship activities do not provide a benefit to the related party does not mean that the expenses are supportive of all of the taxpayer's income-producing activity. Instead, expenses categorized under Treas. Reg. § 1.861-8(e)(4)(ii) and Treas. Reg. § 1.482-9(l)(3)(iii) and (iv) as stewardship expenses are properly allocated to income generated by the related party (and included in income of the taxpayer as a dividend or other inclusion), rather than to income earned directly by the taxpayer.
- (f) Comments recommended that the definition of stewardship expenses be expanded to include expenses incurred regarding branches and disregarded entities, in addition to corporations and partnerships. Treasury and the IRS agreed that stewardship expenses can also be incurred regarding all business entities (whether foreign or domestic) as described in § 301.7701-2(a) and not only those business entities that are classified as corporations or partnerships for Federal income tax purposes.
- (g) Therefore, the final regulations at Treas. Reg. § 1.861-8(e)(4)(ii)(A) provide that stewardship expenses incurred regarding oversight of disregarded entities are also subject to allocation and apportionment under the rules of Treas. Reg. § 1.861-8(e)(4). However, Treasury and the IRS believe that it is inappropriate to extend the definition of stewardship expense to include oversight expenses incurred regarding an unincorporated branch of the taxpayer, since the branch's income is income of the taxpayer itself, not income of a separate entity in which the taxpayer is protecting its investment, and any reporting, legal or regulatory requirements that apply to an unincorporated branch of the taxpayer apply to the taxpayer itself.
- (h) Comments also requested that the final regulations make clear that stewardship expenses can be allocated and apportioned to income and assets of all affiliated and consolidated group members, noting that a portion of the dividends and stock regarding domestic affiliates may be treated as exempt income or assets under § 864(e)(3) and Treas. Reg. § 1.861-8(d)(2)(ii) and excluded from the apportionment formula, which could reduce apportionment of expenses to U.S. source income.

- (i) Accordingly, the final regulations at Treas. Reg. § 1.861-8(e)(4)(ii)(A) provide that the affiliated group rules in Treas. Reg. § 1.861-14 do not apply for purposes of allocating and apportioning stewardship expenses. As a result, stewardship expenses incurred by one member of an affiliated group in order to oversee the activities of another member of the group are allocated and apportioned by the investor taxpayer on a separate entity basis, with reference to the investor's stock in the affiliated member. Treas. Reg. § 1.861-8(e)(4)(ii)(A).
- (j) Furthermore, the final regulations at Treas. Reg. § 1.861-8(e)(4)(ii)(C) provide that the exempt income and asset rules in § 864(e)(3) and Treas. Reg. § 1.861-8(d)(2) do not apply for purposes of apportioning stewardship expenses.
- (k) Comments were also received regarding the rules for allocating stewardship expenses solely to income arising from the entity for which the stewardship expenses are being incurred in order to protect that investment. One comment stated that the rule in the prior final regulations for allocating stewardship expenses solely to dividend income should be retained and should not be expanded to include inclusions such as those under the GILTI rules. In contrast, another comment agreed with the approach to expand allocation to include shareholder-level inclusions such as GILTI inclusions in light of the changes made by the TCJA.
- (l) Treasury and the IRS believe that allocating stewardship expenses to all types of income derived from ownership of the entity, rather than solely dividend income, is appropriate because dividends do not fully capture all of the statutory and residual groupings to which income from stock is assigned. Limiting the allocation of stewardship expenses only to dividends would preclude allocation to stock in a CFC or passive foreign investment company ("PFIC") whose income gave rise only to subpart F, GILTI, or PFIC inclusions, even if the expense clearly relates to overseeing activities that generate income in the CFC or PFIC that give rise to such inclusions.
- (m) Therefore, Treasury and the IRS agreed with the comment supporting the expansion of stewardship expense allocation in Prop. Treas. Reg. § 1.861-8(e)(4)(ii)(B) to include shareholder-level inclusions.
- (n) One comment recommended adding dividends eligible for a § 245A deduction to the list of income inclusions to which stewardship expenses are allocable. The existing regulations are already clear, however, that stewardship expenses are allocable to

dividends. This allocation is not affected by the fact that dividends may qualify for the deduction under § 245A, which does not convert the dividends into exempt or excluded income for purposes of allocating and apportioning deductions. Treas. Reg. § 1.861-8(d)(2)(iii)(C). To the extent that stewardship expense is allocated and apportioned to dividend income in the § 245A subgroup, § 904(b)(4) requires certain adjustments to the taxpayer's foreign source taxable income and entire taxable income for purposes of computing the applicable foreign tax credit limitation.

Accordingly, the final regulations were not modified in response to the comment.

- (o) In response to a request for comments in the 2019 FTC proposed regulations on possible exceptions to the general rule for the allocation and apportionment of stewardship expenses, several comments recommended allowing taxpayers to show that stewardship expense factually relates only to the relevant income of a specific income-producing entity or entities.
- (p) Treasury and the IRS agreed that stewardship expenses may be factually related to the taxpayer's ownership of a specific entity (or entities) and should not be allocated and apportioned to the income derived from all entities in a group without taking into account the factual connection between the stewardship expense and the entity being overseen.
- (q) Accordingly, the final regulations at Treas. Reg. § 1.861-8(e)(4)(ii)(B) provide that at the allocation step (but before applying the apportionment rules), only the gross income derived from entities to which the taxpayer's stewardship expense has a factual connection are included and, in such cases, the apportionment rule applies based on the tax book value of the taxpayer's investment in those particular entities. This approach recognizes that stewardship activities are not fungible in the same manner as interest expense.
- (r) Regarding the apportionment of stewardship expenses, several comments recommended retaining the flexibility of the prior final regulations, which provide for several permissible methods of apportionment, or alternatively apportioning stewardship expenses on the basis of gross income, rather than assets. One comment questioned the appropriateness of applying the apportionment rule used for interest expense in the context of stewardship expenses.
- (s) Treasury and the IRS believe that it is appropriate to provide a single, clear rule for the apportionment of stewardship expenses and that the asset-based rule for interest expense apportionment is

the most appropriate method. They also believe that an explicit rule provides certainty for both taxpayers and the IRS and will minimize disputes. By definition, stewardship expenses typically relate to protecting the value of the taxpayer's ownership interest in another entity.

- (t) Therefore, these expenses should be apportioned on the basis of the tax book value (or alternative tax book value) of the taxpayer's interest in the entity (or entities) in question, since that value more closely approximates the income generated by the entity over time, while income distributed from an entity (or entities) and taxed to the owner can vary from year to year and may not properly reflect all the income-generating activity of the entity.
- (u) Although stewardship activities may be definitely related to indirectly-owned entities, Treasury and the IRS believe that apportioning stewardship expenses based on the value of an indirectly-owned entity would lead to unnecessary complexity for taxpayers and administrative burdens for the IRS; instead, these expenses are apportioned based on the values of the entities that are owned directly by the taxpayer. Treas. Reg. § 1.861-8(e)(4)(ii)(C).
- (v) For purposes of determining the value of an entity, the final regulations at Treas. Reg. § 1.861-8(e)(4)(ii)(C) provide that the value of the stock in an affiliated corporation is characterized as if the corporation were not affiliated and the stock is characterized by the taxpayer in the same ratios in which the affiliate's assets are characterized for purposes of allocating and apportioning the group's interest expense. The final regulations also provide that the tax book value of a taxpayer's investment in a disregarded entity is determined and characterized under the rules that would apply if the entity's stock basis were regarded for purposes of allocating and apportioning the investor taxpayer's interest expense.

2. Litigation Damages Awards, Prejudgment Interest, and Settlement Payments.

- (a) The 2019 FTC proposed regulations included special rules for the allocation and apportionment of damages awards, prejudgment interest, and settlement payments incurred in settlement of, or in anticipation of, claims for damages arising from product liability, events incident to the production or sale of goods or provision of services, and investor suits.

- (b) Damages or settlement awards related to product liability, or events incident to the production or sale of goods or provision of services, were allocated to the class of gross income produced by the specific sales of products or services that gave rise to the claims for damages or injury, or to the class of gross income produced by the assets involved in the production or sales activity, respectively. Damages awards related to shareholder suits were allocated to all income of the corporation and apportioned based on the relative values of all of the corporation's assets that produce income in the statutory and residual groupings.
- (c) One comment suggested that the proposed rules lacked clearly articulated rationales, in contrast to, for example, the rules for R&E expenditures. Treasury and the IRS believe that the rules included in the 2019 FTC proposed regulations for specific types of litigation-related expenses are consistent with the general principles of the allocation and apportionment rules, which are based on the factual connection between deductions and the class of gross income to which they relate. Treas. Reg. § 1.861-8(b)(1). Accordingly, no change was made in the final regulations in response to this comment. However, the final regulations at Treas. Reg. § 1.861-8(e)(5)(ii) include a new paragraph heading and a sentence to providing that the damages rule is not limited to product liability claims.
- (d) One comment stated that the 2019 FTC proposed regulations could be interpreted to require a double allocation of deductions to royalty income, for example, if a taxpayer incurs damages from a patent infringement lawsuit and also indemnifies its CFC for damages paid in a separate lawsuit filed against the CFC. Treasury and the IRS believe that indemnification payments, to the extent deductible, are governed by the generally-applicable rules for allocating and apportioning expenses based on the factual relationship between the deduction and the class of gross income to which the deduction relates. The allocation of separate deductions that are both related to the same class of gross income does not constitute a double allocation. Accordingly, no changes were made in the final regulations in response to this comment.
- (e) The 2019 FTC proposed regulations contained an explicit apportionment rule for damages awards in response to industrial accidents and investor lawsuits, but not for product liability and similar claims. The final regulations added a sentence at Treas. Reg. § 1.861-8(e)(5)(ii) to clarify that deductions relating to product liability and similar claims are apportioned among the statutory and residual groupings based on the relative amounts of

gross income in the relevant class in the groupings in the year the deductions are allowed.

- (f) Finally, several comments disagreed with the approach in the 2019 FTC proposed regulations regarding lawsuits filed by investors against a corporation. These comments argued that it is inappropriate to allocate deductions for such payments to income produced by all of the taxpayer's assets, because these expenses can have a closer factual connection to the jurisdiction where the litigation occurs or where the events (for example, any negligence, fraud, or malfeasance) at issue in the lawsuit occurred. Some comments advocated for a more flexible rule, noting that certain shareholder claims may have a very narrow geographic scope, whereas other claims may relate to a broader range of activities.
- (g) Treasury and the IRS believe that it is inappropriate to allocate deductions for payments regarding investor lawsuits on the basis of the situs of the underlying events or the location of the lawsuit. The purpose of direct investor lawsuits against a company is generally to compensate investors for damages to their investment in the entire company.
- (h) Even where the underlying misconduct directly relates to only a portion of the taxpayer's business activities, the harm to the investor is generally attributable to the taxpayer's business more generally and, therefore, any damages payment is related to all of the taxpayer's income-producing activities.
- (i) Moreover, any rule that attempted to quantify the portion of damages or settlements that relate to specific business activities and the portion that relates to more general reputational loss would by its nature be difficult for taxpayers to comply with and for the IRS to administer.
- (j) Treasury and the IRS disagreed with the comments suggesting that award payments should be allocated based on the geographic location in which the lawsuit is filed, which could be governed by contractual terms or choice-of-law rules that have little to no factual relationship to the underlying activities to which the lawsuit relates. Accordingly, the comments are not adopted.

### 3. Net Operating Loss Deductions.

- (a) The 2019 FTC proposed regulations clarified the treatment of net operating losses ("NOLs") by specifying how the statutory and residual grouping components of an NOL are determined in the taxable year of the loss and by clarifying the manner in which the

net operating loss deduction allowed under § 172 is allocated and apportioned in the taxable year in which the deduction is allowed. Comments requested that for purposes of applying Treas. Reg. § 1.861-8(e)(8) to § 250 as the operative section, NOLs arising in taxable years before the TCJA's enactment of § 250 should not be allocated and apportioned to gross FDDEI.

- (b) On July 15, 2020, Treasury and the IRS finalized regulations under § 250, which provide that the deduction under § 172(a) is not taken into account in computing FDDEI. Treas. Reg. § 1.250(b)-1(d)(2)(ii). Therefore, they said the comment is moot. However, a sentence was added to the final regulations at Treas. Reg. § 1.861-8(e)(8)(i) to clarify that in determining the component parts of an NOL, deductions that are considered absorbed in the year the loss arose for purposes of an operative section may differ from the deductions that are considered absorbed for purposes of another provision of the Code that requires determining the components of an NOL. Therefore, for example, a taxpayer's NOL may comprise excess deductions allocated to foreign source general category income for purposes of § 904, even though for purposes of § 172(b)(1)(B)(ii) the NOL is a farming loss comprising excess deductions allocated to U.S. source income from farming.

4. Exempt Income/Asset Rule and Insurance Companies.

- (a) The 2019 FTC proposed regulations provided in Prop. Treas. Reg. § 1.861-8(d)(2)(ii)(B), (d)(2)(v), and (e)(16) the effect of certain deduction limitations on the treatment of income and assets generating dividends-received deductions and tax-exempt interest held by insurance companies for purposes of allocating and apportioning deductions to this income and these assets. Specifically, the 2019 FTC proposed regulations provided that in the case of insurance companies, exempt income includes dividends for which a deduction is provided by §§ 243(a)(1) and (2) and 245, without regard to the proration rules under § 805(a)(4)(A)(ii) disallowing a portion of the deduction attributable to the policyholder's share of the dividends or any similar disallowance under § 805(a)(4)(D). Similarly, the regulations provided that the term exempt income includes tax-exempt interest without regard to the proration rules.
- (b) One comment requested that the final regulations modify Temp. Treas. Reg. § 1.861-8T(d)(2) to permit insurance companies to adjust the amount of income and assets that are exempted in apportioning deductions. The comment said that the adjustment is required in order to reflect the addition of § 864(e)(7)(E) and relied on legislative history to a provision in proposed technical

corrections legislation from 1987 to suggest that Congress intended to create a different result for insurance companies than for other companies.

- (c) Treasury and the IRS stated that the 1987 bill was not enacted, and the language in § 864(e)(7)(E) is not the same as the language proposed in the bill. Section 864(e)(7)(E) provides regulatory authority for the Secretary to issue regulations regarding any adjustments that may be appropriate in applying § 864(e)(3) to insurance companies. They said the legislative history of § 864(e)(7)(E) (which was enacted in 1988) does not contain the same language as did the committee reports from the 1987 bill, and the rule that was proposed in the 1987 bill is contrary to subsequent case law. *See Travelers Insurance Company v. United States*, 303 F.3d 1373 (2002). Therefore, Treasury and the IRS concluded that although § 864(e)(7)(E) provides regulatory authority for a rule applying § 864(e)(3) to insurance companies, there is no indication that Congress intended for Treasury to adopt a rule mirroring the rule in the 1987 bill (which Congress did not enact).
- (d) Section 864(e)(3) is clear that exempt income includes income for which a deduction is allowed under §§ 243 and 245, and no exception is provided in the statute for insurance companies. Furthermore, a special rule for either tax-exempt interest of a life insurance company or dividends-received deductions and tax-exempt interest of a nonlife insurance company is not appropriate because when a policyholder's share or applicable percentage is accounted for as either a reserve adjustment or a reduction to losses incurred, no further modification to the generally applicable rules is required to ensure that the appropriate amount of expenses are apportioned to U.S. source income. Instead, the rule suggested by the comment would inappropriately distort the allocation and apportionment of deductions to U.S. source income. Therefore, the comment was not adopted.

## 5. Treatment of the § 250 Deduction.

- (a) One comment requested clarification on the allocation and apportionment of the deduction allowed under § 250 (“§ 250 deduction”) regarding members of a consolidated group. In general, under Treas. Reg. § 1.1502-50(b), a consolidated group member's § 250 deduction is determined based on the member's share of the sum of all members' positive FDDEI or GILTI. Separate from this determination under Treas. Reg. § 1.1502-50(b), a taxpayer must also allocate and apportion the § 250 deduction to



gross income for purposes of determining its foreign tax credit limitation.

- (b) For this purpose, in allocating and apportioning the § 250 deduction to statutory and residual groupings, under Treas. Reg. § 1.861-8(e)(13) the portion of the § 250 deduction attributable to FDII is treated as definitely related and allocable to the specific class of gross income that is included in the taxpayer's FDDEI and then apportioned between the statutory and residual groupings based on the relative amounts of FDDEI in each grouping. In the context of an affiliated group, under Temp. Treas. Reg. § 1.861-14T(c)(1) expenses are generally allocated and apportioned by treating all members of an affiliated group as if they were a single corporation.
- (c) In response to the comment requesting clarity on the allocation and apportionment of the § 250 deduction regarding members of a consolidated group, the final regulations provide that the § 250 deduction is allocated and apportioned as if all members of the consolidated group are treated as a single corporation. Treas. Reg. § 1.861-14(e)(4). However, in the case of an affiliated group that is not a consolidated group, the § 250 deduction of a member of an affiliated group is allocated and apportioned on a separate entity basis under the rules of Treas. Reg. § 1.861-8(e)(13) and (14).

6. Other Requests for Comments on Expense Allocation.

- (a) The preamble to the 2019 FTC proposed regulations requested comments on whether future regulations should allow taxpayers to capitalize and amortize certain expenses solely for purposes of the rules in Treas. Reg. § 1.861-9 for allocating and apportioning interest expense in order to better reflect asset values under the tax book value method. One comment was received recommending that such a rule be included regarding R&E and advertising expenditures. Treasury and the IRS agreed with this comment and, accordingly, this rule is included in proposed regulations (the “the 2020 FTC proposed regulations”).
- (b) One comment requested that a special rule be adopted in Temp. Treas. Reg. § 1.861-10T to directly allocate certain interest expense related to regulated utility companies. Treasury and the IRS agreed that a special rule was warranted, and included a rule in the 2020 FTC proposed regulations.
- (c) Finally, the preamble to the 2019 FTC proposed regulations requested comments on whether the rules in Treas. Reg. § 1.861-8(e)(6) for allocating and apportioning state income taxes should

be revised in light of changes made by the TCJA and changes to state rules for taxing foreign income. One comment was received requesting that the existing rules, which rely on state law to determine the income to which state taxes relate, be retained. Treasury and the IRS agreed that no changes to the rules in Treas. Reg. § 1.861-8(e)(6) are required at this time.

7. Examples Illustrating Allocation and Apportionment of Certain Expenses of an Affiliated Group of Corporations.

- (a) Examples 1 through 6 in Treas. Reg. § 1.861-14T(j) apply the temporary regulations to fact patterns involving affiliated groups of corporations. However, Examples 1 and 4 of Treas. Reg. § 1.861-14T(j) are no longer consistent with current law, and therefore the final regulations have an informational footnote regarding Treas. Reg. § 1.861-14T(j) to reflect this fact. Treasury and the IRS are also studying whether the remaining examples should be modified and whether new examples should be included in future guidance.

E. Partnership Transactions.

- (a) The 2019 FTC proposed regulations revised Treas. Reg. § 1.861-9(b) and Treas. Reg. § 1.954-2(h)(2)(i) to provide that guaranteed payments for the use of capital described in § 707(c) are treated similarly to interest deductions for purposes of allocating and apportioning deductions under Treas. Reg. §§ 1.861-8 through 1.861-14, and are treated as income equivalent to interest under § 954(c)(1)(E). These rules were intended to prevent the use of guaranteed payments to avoid the rules under Treas. Reg. § 1.861-9(e)(8) and Treas. Reg. § 1.954-2(h) that apply to partnership debt.
2. One comment stated that while guaranteed payments for capital are economically similar to interest payments in some respects, guaranteed payments are, for Federal income tax purposes, payments regarding equity, not debt, and regulations issued under § 707 narrowly circumscribe the situations in which a guaranteed payment is treated as something other than a distributive share of partnership income. The comment recommended that guaranteed payments for capital be treated as interest only in cases when the taxpayer harbors an abusive motive to circumvent the relevant rule.
3. Treasury and the IRS believe that guaranteed payments for the use of capital share many of the characteristics of interest payments that a partnership would make to a lender and, therefore, should be treated as interest equivalents for purposes of allocating and apportioning deductions under Treas. Reg. §§ 1.861-8 through 1.861-14 and as income equivalent to interest under § 954(c)(1)(E). They stated that this treatment is

consistent with other sections of the Code in which guaranteed payments for the use of capital are treated similarly to interest. *See*, for example, Treas. Reg. §§ 1.469-2(e)(2)(ii) and 1.263A-9(c)(2)(iii).

4. They also stated that the fact that a guaranteed payment for the use of capital may be treated as a payment attributable to equity under § 707(c), or that a guaranteed payment for the use of capital is not explicitly included in the definition of interest in Treas. Reg. § 1.163(j)-1(b)(22), does not preclude applying the same allocation and apportionment rules that apply to interest expense attributable to debt. It also does not preclude treating such payments as “equivalent” to interest under § 954(c)(1)(E). Instead, the relevant statutory provisions under §§ 861 and 864, and § 954(c)(1)(E), are clear that the rules can apply to amounts that are similar to interest.
5. Finally, a rule that would require determining whether the transaction had an abusive motive would be difficult to administer. Therefore, the comment was not adopted.

F. Treatment of § 818(f) Expenses for Consolidated Groups.

1. Section 818(f)(1) provides that a life insurance company’s deduction for life insurance reserves and certain other deductions (“§ 818(f) expenses”) are treated as items that cannot definitely be allocated to an item or class of gross income. When the life insurance company is a member of an affiliated group of corporations, Prop. Treas. Reg. § 1.861-14(h)(1) provided that § 818(f) expenses are allocated and apportioned on a separate company basis.
2. One comment stated that the separate company approach was inconsistent with the general rule in § 864(e)(6) that expenses other than interest that are not directly allocable or apportioned to any specific income-producing activity are allocated and apportioned as if all members of the affiliated group were a single corporation. The comment also stated that the separate company approach would encourage consolidated groups to use intercompany transactions, such as related party reinsurance arrangements, to shift their § 818(f) expenses and achieve a more desirable foreign tax credit result. The comment suggested that the regulations instead adopt a single entity approach for life insurance companies that operate businesses and manage assets and liabilities on a group basis (a “life subgroup” approach).
3. Another comment argued that the separate company approach adopted in the proposed regulations was consistent with the fact that life insurance companies are regulated regarding their reserves, investable assets, and capital. The comment, however, acknowledged that a life subgroup approach may be appropriate in certain cases, such as when an affiliated

group of life insurance companies manages similar products on a cross-entity, product-line basis, rather than on an entity-by-entity basis. This comment recommended that final regulations provide a one-time election for taxpayers to choose either the separate company or life subgroup approach for allocating and apportioning § 818(f) expenses.

4. Treasury and the IRS agreed that there are merits and drawbacks to both the separate company and the life subgroup approaches and that a one-time election, as suggested by the comments, should be considered. Therefore, the final regulations at Treas. Reg. § 1.861-14(h) do not include the separate company rule for § 818(f) expenses. The 2020 FTC proposed regulations instead propose a life subgroup approach as well as a one-time election for taxpayers to choose the separate company approach.

G. Allocation and Apportionment of R&E Expenditures. The 2019 FTC proposed regulations proposed several changes to Treas. Reg. § 1.861-17, including eliminating the gross income method of apportionment, eliminating the legally-mandated R&E rule, and limiting the class of income to which R&E expenditures could be allocated to gross intangible income reasonably connected with a relevant Standard Industrial Code (SIC) category. In addition, the rule for exclusive apportionment of R&E expenditures was modified by eliminating the possibility of increased exclusive apportionment based on taxpayer-specific facts and circumstances, and by providing that exclusive apportionment applies solely for purposes of § 904.

1. Scope of Gross Intangible Income.

- (a) Before being revised, Treas. Reg. § 1.861-17(a) provided that R&E expenditures are related to all income reasonably connected to a broad line of business or SIC code category. The 2019 FTC proposed regulations narrowed and clarified the class of gross income to which R&E expenditures are considered to relate. They defined the relevant class of gross income as gross intangible income (“GII”), which is defined as all income attributable, in whole or in part, to intangible property, including sales or leases of products or services derived, in whole or in part, from intangible property, income from sales of intangible property, income from platform contribution transactions, royalty income, and amounts taken into account under § 367(d) by reason of a transfer of intangible property. GII does not include dividends or any amounts included in income under §§ 951, 951A, or 1293.
- (b) One comment disagreed with the exclusion from GII of § 951A inclusions. According to this comment, R&E expenditures ultimately benefit foreign subsidiaries such that allocation to income described in § 904(d)(1)(A) (the “§ 951A category”) is appropriate and should not be treated differently from other

taxpayer expenses that reduce income in the § 951A category. Other comments generally supported the exclusion of GILTI and other income inclusions from GII on the grounds that a taxpayer incurring R&E expenditures to develop intangible property should be fully compensated for the value of that intellectual property and, conversely, the earnings of CFCs should not reflect returns on intellectual property owned by another person.

- (c) Treasury and the IRS believe that GII should continue to exclude GILTI or other inclusions attributable to ownership of stock in a CFC. As described in Treas. Reg. § 1.861-17(b), R&E expenditures, whether or not ultimately successful, are incurred to produce intangible property. Under the rules of §§ 367(d) and 482, the person incurring the R&E expenditures must be compensated at arm's length when such intangible property is licensed, sold, or otherwise gives rise to income of controlled parties, and it is this income that gives rise to GII.
- (d) In transactions not involving the direct transfer of intangible property to a related party, the § 482 regulations require compensation for the intangible property embedded in the underlying transaction. For example, Treas. Reg. § 1.482-3(f) requires that intangible property embedded in tangible property be accounted for when determining the arm's length price for the transaction. Similarly, Treas. Reg. § 1.482-9(m) requires that intangible property used in a controlled services transaction be accounted for in determining the arm's length price for the transaction.
- (e) In contrast to R&E expenditures giving rise to income required by §§ 367(d) and 482, subpart F or GILTI inclusions reflect income earned by a CFC and not the taxpayer incurring the R&E expenditures; the fact that such taxpayer is deemed under § 951 or 951A to have income through an inclusion from a CFC licensee does not mean that such income is a result of the R&E expenditures incurred by the taxpayer, assuming that the CFC pays the taxpayer an arm's length price for the transfer of the intangible property or, in the case of an exchange described in §§ 351 or 361, the taxpayer reports the required annual income inclusion.<sup>10</sup>
- (f) Therefore, including income in the § 951A category in GII would result in a mismatch between the R&E expenditures and the

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<sup>10</sup> TCJA and related technical corrections in the 2018 Consolidated Appropriations Act amended §§ 482 and 367(d) to clarify the methods that may be applied to determine the value of intangible property and that the definition of intangible property includes workforce, goodwill and going concern value, or other items the value or potential value of which is not attributable to tangible property or the services of any individual.

income generated by the expenditures. Although (as noted in a comment) R&E expenditures that are ultimately unsuccessful could be viewed as intended to benefit a taxpayer's foreign subsidiaries more broadly, Treasury and the IRS believe that the GII earned by the taxpayer provides a reasonable proxy for how the taxpayer expects to recover its R&E costs, and providing separate rules for identifying and attributing unsuccessful R&E expenditures to a broader class of income would be unduly burdensome for taxpayers and difficult for the IRS to administer.

- (g) Several comments stated that while income in the § 951A category is excluded from GII, income giving rise to foreign-derived intangible income (“FDII”) is included in GII. These comments generally argued that the exclusion from GII of income in the § 951A category and inclusion of amounts included in FDII created a lack of parity between the two provisions even though the methodology and calculations of both are meant to be similar.
- (h) Treasury and the IRS disagreed with these comments. The allocation and apportionment of R&E expenditures to separate categories for purposes of § 904 as the operative section and the allocation and apportionment of R&E expenditures to FDDEI for purposes of § 250 as the operative section both require identifying the class of income to which the R&E expenditures are attributable.
- (i) R&E expenditures incurred by a United States shareholder (“U.S. shareholder”) are not allocated and apportioned to income in the § 951A category because such income, which relates to an inclusion of income earned by the CFC, is not a return on the U.S. shareholder's R&E expenditures and, thus, is not included in gross intangible income. In contrast, income giving rise to FDII is earned directly by the same taxpayer that incurs R&E expenditures and may include a return on those R&E expenditures. Income that gives rise to FDII is reduced by “the deductions (including taxes) properly allocable to such gross income.” § 250(b)(3)(A)(ii) and Treas. Reg. § 1.250(b)-1(d)(2).
- (j) Treasury and the IRS stated that there is no indication that Congress intended to exclude R&E expenditures from that calculation. Furthermore, because expenses incurred by a CFC are allocated and apportioned to income of the CFC for purposes of computing tested income under § 951A(c)(2)(A)(ii), contrary to the suggestion in the comments, R&E expenditures of the CFC are in fact allocated and apportioned to tested income under Treas. Reg. § 1.861-17 and reduce the ultimate amount of the taxpayer's GILTI inclusion. Accordingly, the comment was not adopted.

- (k) One comment requested modifications to the definition of GII to exclude both acquired intangible property and income from certain platform contribution transactions described in Treas. Reg. § 1.482-7(b)(1)(ii). According to the comment, income from these items should be excluded from GII because a taxpayer's R&E expenditures could not relate to gross income from intangible property acquired from a different taxpayer (as opposed to developed by the taxpayer), or to gross income from certain platform contributions.
- (l) Treasury and the IRS believe that the comment did not accurately describe the premise on which the R&E allocation and apportionment rules are based. R&E expenditures are not reasonably expected to produce any current income in the taxable year in which the expenditures are incurred, and as the regulations explicitly recognize, the results of R&E expenditures are speculative.
- (m) Accordingly, R&E expenditures are allocated to a class of currently recognized gross income only because it generally will be the best available proxy for the income that the current expense is reasonably expected to produce in the future. Specifically, although current R&E expense of a taxpayer likely does not directly contribute to gross intangible income currently recognized, it is reasonable to expect that R&E will contribute to GII earned by the taxpayer group in the future. Treasury and the IRS believe that the definition of GII is not intended to require a strict factual connection between the R&E expenditure and GII earned in the taxable year, but merely that the expenditures be “reasonably connected” with a class of income.
- (n) They also believe that requiring the comment's suggested level of explicit factual connection between R&E expenditures and GII would outweigh the administrative benefit and ease of broadly defining GII. Moreover, in cases in which a taxpayer has a valid cost sharing agreement, even though R&E expenditures may be allocated to PCT payments, those expenses are generally apportioned based on sales by the taxpayer or other entities reasonably expected to benefit from current research and experimentation. This ensures that R&E expenditures offset the categories of income included in GII that are expected to benefit from those expenditures. Accordingly, the comment was not adopted.
- (o) One comment requested clarification of the definition of GII and specifically that the final regulations provide that the services income included in GII does not include gross income allocated to

or from a foreign branch under Treas. Reg. § 1.904-4(f)(2)(vi) by reason of a disregarded payment for services performed by or for the foreign branch that contribute to earning GII of the taxpayer.

- (p) Under Treas. Reg. § 1.904-4(f)(2)(vi)(B), a disregarded payment from a foreign branch owner to its foreign branch to compensate the foreign branch for the provision of contract R&E services that, if regarded, would be allocable to general category gross intangible income attributable to the foreign branch owner under the principles of Treas. Reg. §§ 1.861-8 through 1.861-17, would cause the general category GII attributable to the foreign branch owner to be adjusted downward and the GII attributable to the foreign branch and included in foreign branch category income to be adjusted upward.
- (q) Although a disregarded payment for R&E services does not give rise to gross income for Federal income tax purposes and so does not in and of itself constitute GII, to the extent the disregarded payment results in the reattribution of regarded gross income that is GII from the general category to the foreign branch category (or vice versa), that income is treated as GII in the foreign branch category (or the general category). The final regulations at Treas. Reg. § 1.861-17(b)(2) clarify that although GII does not include disregarded payments, certain disregarded payments that would be allocable to GII if regarded may result in the reassignment of GII from the general category to the foreign branch category or vice versa.
- (r) One comment sought clarification regarding the portion of product sales derived from intangible property that would be considered GII. The final regulations at Treas. Reg. § 1.861-17(b)(2) clarify that GII includes the full amount of gross income from sales or leases of products or services, if the income is derived in whole or in part from intangible property. Under the definition of GII, there is no bifurcation or splitting of sales income between a portion attributable to intangible property and other amounts such as distribution or marketing functions. Additionally, the definition of GII has been modified to more clearly delineate between amounts from sales or leases of products derived from intangible property versus sales or licenses of intangible property itself.

## 2. Allocation of R&E Expenditures.

- (a) One comment requested modifications to the general rule that allocates R&E expenditures to GII that is reasonably connected with one or more relevant SIC code categories. The comment stated that in some cases, taxpayers are restricted by law or



contract from exploiting research, with the result that the research would only generate income in a particular statutory grouping after several years from the date of the contract. Accordingly, the comment requested that these R&E expenditures be allocated to the statutory or residual grouping of income within GII that corresponds to the market restrictions on the use of the R&E. Alternatively, the comment requested that taxpayers be provided with the option to allocate R&E expenditures in a manner consistent with the taxpayer's books and records to the extent there is a clear factual relationship between the expenditures and a particular category of income.

- (b) Treasury and the IRS believe that it would be inappropriate to provide exceptions to the general rule that R&E expenditures are allocated to GII reasonably connected with one or more relevant SIC code categories. The two approaches suggested by the comment are premised on a goal of seeking to "trace" R&E expenditures to the actual income that they are expected to produce in the future. However, R&E expenditures are not reasonably expected to produce any current income in the taxable year in which the expenditures are incurred, and the regulations recognize that the results of R&E expenditures are speculative.
- (c) Instead, Treas. Reg. § 1.861-17 relies on the use of current year sales as a proxy for the income that the expenses are reasonably expected to produce in the future, in recognition of the fact that it is difficult to ascertain the composition of future income that would be generated from R&E expenditures.
- (d) This approach generally already takes into account the types of market or legal restrictions described by the comment -- to the extent that a taxpayer's sales of products in the same SIC code category are generally restricted to a particular market, these restrictions will be reflected in its sales and therefore are already taken into account under the sales method provided in Prop. Treas. Reg. § 1.861-17.
- (e) Moreover, rules that specially allocate particular R&E expenditures based on the reasonableness of speculative expectations about sales that may or may not actually arise several years in the future would be very difficult for taxpayers to comply with and for the IRS to administer.
- (f) Finally, allowing taxpayers to elect the use of a books-and-records method to allocate R&E expenditures to less than all of a taxpayer's GII would lead to inappropriate results, as taxpayers would only elect this option if the additional information reflected

in the taxpayer's books and records improved the tax result; in contrast, the IRS would not have any such information available to it if the taxpayer chose not to make the election. Since this information would generally be in the form of predictions about future income streams, an elective books-and-records rule would create administrability concerns for the IRS, which would have substantial difficulty verifying whether the predictions were reasonable. Accordingly, the comments were not adopted.

- (g) One comment recommended that Treasury and the IRS reconsider the elimination of the "legally mandated R&E" rule from the 2019 FTC proposed regulations, noting that the rule seemed to be required by § 864(g)(1)(A). Treasury and the IRS stated that the legally mandated R&E rule was eliminated in light of changes to the international business environment and to simplify the regulations, and the comment did not argue the change is inappropriate. Additionally, they believe the comment misstates the application of § 864(g)(1)(A), which is not applicable to the taxable years to which the final regulations apply. § 864(g)(6). Accordingly, the comment was not adopted.
- (h) One comment sought clarification on the allocation of R&E expenditures where research is conducted regarding more than one SIC code category. The comment noted that the current final regulations at Treas. Reg. § 1.861-17(a)(2)(iii) mention two digit SIC code categories, or Major Groups in the terminology of the SIC Manual, yet the 2019 FTC proposed regulations omitted references to two digit SIC codes.
- (i) Treasury and the IRS believe that it is appropriate to aggregate some or all three digit SIC categories within the same Major Group, but it is inappropriate to aggregate any three digit SIC categories within different Major Groups. They stated that while R&E expenditures are speculative, it is not reasonable to expect R&E conducted for one broad line of business to benefit an unrelated line of business and, therefore, the allocation and apportionment of expenses should not be determined by aggregating different Major Groups.
- (j) For example, if a taxpayer engages in both the manufacturing and assembling of cars and trucks (SIC code 371) it may aggregate that category with another three digit category in Major Group 37, which includes six other three digit categories (for example, aircraft and parts (SIC code 372) or railroad equipment (SIC code 374)), but taxpayers may not aggregate a three digit SIC code from a Major Group with another three digit SIC code from a different Major Group, except as provided in Treas. Reg. § 1.861-

17(b)(3)(iv) (requiring aggregation of R&E expenditures related to sales-related activities with the most closely related three digit SIC code, other than those within the wholesale and retail trade divisions, if the taxpayer conducts material non-sales-related activities regarding a particular SIC code). The final regulations were modified accordingly.

3. Exclusive Apportionment of R&E Expenditures.

4. Computation of FDII.

- (a) Several comments argued that if Treasury and the IRS determine that GII should include amounts giving rise to FDII, then the rule in the 2019 FTC proposed regulations in Treas. Reg. § 1.861-17(c), which limits exclusive apportionment of R&E expenditures solely for purposes of applying § 904 as the operative section, should be revised to also allow for exclusive apportionment for purposes of calculating a taxpayer's FDII deduction.
- (b) The comments stated that the exclusive apportionment provision be applied such that 50% of a taxpayer's R&E expenditures should be apportioned to income that is not foreign derived deduction eligible income ("FDDEI") provided that at least 50% of the taxpayer's research activities are conducted in the U.S. Comments stated that such an exclusive apportionment rule would encourage R&E activity in the U.S., consistent with the general intent of the TCJA to eliminate tax incentives for shifting activity and intellectual property overseas.
- (c) Additionally, comments said that R&E expenditures provide greater value to the location where R&E is performed and that there is a technology "lag" before successful products are exported to foreign markets.
- (d) Treasury and the IRS believe that it would not be appropriate to apply an exclusive apportionment rule for purposes of computing FDII. R&E expenditures are not reasonably expected to produce any current income in the taxable year in which the expenditures are incurred, and the regulations explicitly recognize that the results of R&E expenditures are speculative. Furthermore, to the extent there is consistently a "lag" before a taxpayer's successful products are exported to foreign markets, then such lag should generally be reflected in current year sales of newly successful products (which relate to R&E incurred in prior taxable years) being weighted towards domestic markets.
- (e) Therefore, the rules' use of current year sales as a proxy for the income that the expense is reasonably expected to produce in the

future already takes into account to some extent the potential for a “lag” between exploiting intangible property in the domestic market versus foreign markets.

- (f) In addition, Treasury and the IRS believe that nothing in the text of the TCJA or its legislative history suggests that Congress intended that existing rules on allocation and apportionment of R&E expenditures be modified in a way to create particular incentives. Section 250(b)(3) requires determining the deductions that are “properly allocable” to deduction eligible income, and Treas. Reg. § 1.250(b)-1(d)(2) confirms that the general rules under Treas. Reg. § 1.861-17 apply for purposes of allocating and apportioning R&E expenditures to deduction eligible income and FDDEI.
- (g) Furthermore, adopting an R&E allocation and apportionment rule solely for purposes of increasing the amount of the FDII deduction to incentivize R&E activity (whether or not such expenditures were “properly” allocable to non-FDDEI income) would be inconsistent with the U.S.’s position, including as stated in forums such as the OECD’s Forum on Harmful Tax Practices, that the FDII regime is not intended to provide a tax inducement to shifting activities or income, but is intended to neutralize the effect of providing a lower U.S. effective tax rate regarding the active earnings of a CFC of a domestic corporation (through a deduction for GILTI) by also providing a lower effective U.S. tax rate regarding FDII earned directly by the domestic corporation. This parity is generally furthered by ensuring that R&E expenditures incurred by a domestic corporation are allocated and apportioned to FDII in the same manner as R&E expenditures incurred by a CFC are allocated and apportioned to tested income that gives rise to GILTI.
- (h) Therefore, the final regulations provide that the exclusive apportionment rule is limited to § 904 as the operative section.

5. Increased Exclusive Apportionment.

- (a) Two comments recommended reinstating the rule allowing for an increased exclusive apportionment of R&E expenditures. Under the increased exclusive apportionment rule, a taxpayer may establish to the satisfaction of the Service that an even greater amount of R&E expenditures should be exclusively apportioned. One comment indicated that there may be circumstances where an even greater amount of R&E expenditures should be apportioned, such as following the termination of a cost sharing arrangement (“CSA”). Another comment pointed out that the 2019 FTC

proposed regulations reduce taxpayer options by eliminating both increased exclusive apportionment and the gross income method.

- (b) Treasury and the IRS believe that a rule allowing for increased exclusive apportionment is not warranted. The facts and circumstances nature of the determination that would be required and the potential for disputes outweigh the benefits of affording taxpayers additional flexibility in rare or unusual cases. Additionally, to the extent that there is a tendency to exploit intellectual property in the same market where the taxpayer conducts R&E, this will already be reflected in current sales, as those in part reflect the results of recently-developed intellectual property. Accordingly, this comment was not adopted.

6. Mandatory Application of Exclusive Apportionment.

- (a) Two comments generally objected to the required application of exclusive apportionment for purposes of § 904. According to the comments, in certain situations where a taxpayer has insufficient domestic source gross income to absorb the apportioned R&E expenditures, the resulting overall domestic loss (“ODL”) would reduce foreign source income in each separate category described in Treas. Reg. § 1.904-5(a)(4)(v), including the § 951A and foreign branch categories, reducing the taxpayer’s ability to claim foreign tax credits.
- (b) The comments recommended that taxpayers either be allowed to elect out of exclusive apportionment or alternatively that it be applied in an amount less than 50% of the taxpayer’s R&E expenditures. One comment alternatively recommended a modification to the ODL and R&E expenditure rules such that the majority of the amounts otherwise subjected to exclusive apportionment would instead be allocated to income in the general category rather than the § 951A or foreign branch categories.
- (c) Treasury and the IRS stated that the TCJA did not modify the operation of § 904(f) or (g) regarding the § 951A or foreign branch categories, nor is there any indication in the TCJA or legislative history that Congress intended the rules under § 904(f) and (g), or the allocation and apportionment rules under § 861, to apply differently in connection with § 951A or foreign branch category income. To the extent an ODL account is created as the result of a domestic loss offsetting foreign source income in the § 951A or foreign branch category under § 904(f)(5)(D), this reduction is reversed in later years through the recapture provisions in § 904(g)(3), when U.S. source income is recharacterized as foreign source income in the separate categories that were offset by the

ODL. Additionally, Treasury and the IRS believe that the consistent application of the exclusive apportionment rule for purposes of § 904 promotes simplicity and certainty, whereas an optional rule would be more difficult to administer. Accordingly, these comments were not adopted.

7. Elimination of the Gross Income Method.

- (a) Several comments requested that the gross income method for apportioning R&E expenditures be retained. In general, these comments recommended allowing taxpayers to choose either the gross income method or the sales method rather than being required to utilize only the sales method, including by allowing taxpayers to choose one method for certain operative sections and another method for other operative sections. Some comments said that the mandatory use of the sales method would inappropriately allocate and apportion more R&E expenditures to FDDEI than under the gross income method in cases where U.S. taxpayers license their intellectual property for foreign use but sell products directly to U.S. customers.
- (b) One comment said that the sales method could be distortive in certain situations where a taxpayer licenses its intellectual property to entities whose sales are at least partially attributable to self-developed intellectual property. Another comment argued that where a taxpayer's primary type of GII is royalty income, it will be difficult to apportion R&E based on sales numbers and that therefore the gross income method should be maintained.
- (c) Treasury and the IRS believe that, on balance, the sales method results in substantially fewer distortions than the gross income method. Before being modified by these final regulations, taxpayers were permitted to apportion R&E expenditures under either a gross income or sales method. The Preamble to 2019 FTC proposed regulations explained that the gross income method could produce inappropriate, distortive results in certain cases.
- (d) In particular, distortions could arise because the gross income method looks only to gross income earned directly by the taxpayer. Gross income that is earned by the taxpayer and that is attributable to one grouping (such as U.S. source income) may reflect value unrelated to intangible property, for example gross income from sales that reflect value from marketing or distribution activities of the taxpayer, whereas gross income of such taxpayer that is attributable to another grouping (such as foreign source income) may exclude such non-IP related value due, for example, to the fact that such gross income is earned solely from licensing

intangible property to a related party without the performance of any marketing or distribution activities.

- (e) The distortions arise both because gross income reflects a reduction of gross receipts for cost of goods sold but not for related deductible expenses, and also because the gross income method does not distinguish between gross income earned from customers (for which the gross income generally captures all of the value related to the product or service arising from the IP) versus from related parties (for which gross income generally only captures an intermediate portion of the value of the relevant product or service, which will generally be enhanced by the related party).
- (f) Treasury and the IRS believe that the sales method provides a consistent, reliable method with fewer distortions than the gross income method. In particular, the sales method focuses on the gross receipts from sales of a product to final customers. This approach is more likely to achieve consistent results in the case of the same or similar final products, and thereby allows for a consistent comparison of value derived from intangible property regarding each grouping.
- (g) That is the case regardless of whether the taxpayer chooses to license its intangible property to other persons (including related parties) for purposes of manufacturing final products, or the taxpayer manufactures products itself, and regardless of whether other persons enhance the product with additional value attributable to other intangible property. Therefore, the sales method ensures that differences in supply chain structures do not alter the nature of how R&E expenditures are allocated and apportioned.
- (h) Alternatively, some comments recommended modifying the gross income method. One comment recommended modifying the gross income method to more accurately match income to related R&E expenditures by using only gross income that is attributable to the intangible property owned by the taxpayer. However, Treasury and the IRS believe that it would lead to complexity for taxpayers and administrative burdens for the IRS to seek to accurately determine the share of gross income that is attributable to intangible property when the intangible property is embedded in a final product.
- (i) In addition, they believe that such a rule would be unlikely to result in significantly different results than under the sales method, because the ratio of gross income among groupings that is attributable solely to intangible property is likely to be broadly

similar to the ratio of gross receipts from sales within those groupings, since the intangible component of gross income from sales is likely to be determined as a fraction of gross receipts, and such fraction would generally be the same for each grouping.

- (j) One comment suggested that the gross income method must be included in the final regulations because it is statutorily required under § 864(g)(1). However, § 864(g) is not applicable to the taxable years covered by the final regulations. § 864(g)(6). Therefore, the comment was not adopted.
- (k) Finally, one comment recommended allowing taxpayers to use the gross income method if using the sales method would otherwise cause the taxpayer to have an ODL. Treasury and the IRS believe that it would be inappropriate to allow for the targeted application of a method solely for the purpose of avoiding the ODL rules, which are statutorily mandated.
- (l) The regulations under § 861, including Treas. Reg. § 1.861-17, are premised on associating deductions in as accurate and reasonable a manner as possible with the income to which such deductions relate. It would be inconsistent with this overall policy of relating deductions to the relevant income to revise the regulations under § 861 simply to achieve a specific result under an operative section. Accordingly, the final regulations eliminate the gross income method.

## 8. Application of Sales Method.

- (a) The 2019 FTC proposed regulations retained the rule in the prior final regulations which provides that for apportionment purposes, the sales method includes certain gross receipts of related and unrelated entities that are reasonably expected to benefit from the taxpayer's R&E expenditures, but does not include the receipts of entities that have entered into a valid CSA with the taxpayer. The 2019 FTC proposed regulations made limited changes to the sales method as it existed under the prior final regulations.
- (b) One comment requested guidance on the application of the sales method in the context of foreign branch category income.
- (c) Two comments asked for a modification to the treatment of controlled entities that terminate an existing CSA with a taxpayer. Under the sales method, gross receipts from sales of products or the provision of services within a relevant SIC code category by controlled parties of the taxpayer are taken into account when apportioning the taxpayer's R&E expenditures if the controlled



party is reasonably expected to benefit from the taxpayer's research and experimentation.

- (d) Under Prop. Treas. Reg. § 1.861-17(d)(4)(iv), the sales of controlled parties that enter into a valid CSA with a taxpayer are generally excluded from the apportionment formula because the controlled party is not expected to benefit from the taxpayer's R&E expenditures. The comments stated that when a CSA is terminated and a taxpayer licenses newly-developed intangibles to a controlled party, all gross receipts from the controlled party are included in the apportionment formula, even though for some post-termination period the controlled party may benefit more from intangibles created by its own R&E expenditures incurred under the previously-existing CSA rather than from the newly-developed and licensed intangibles.
- (e) The comments recommended varying adjustments, including rules specific to CSA terminations or alternatively more generalized adjustments such as the retention of the increased exclusive apportionment rule or the gross income method.
- (f) Treasury and the IRS disagreed with the comments' characterization of Treas. Reg. § 1.861-17 as seeking directly to match R&E expenditures with the income that such expenditures generate. According to the comments, following a CSA termination with a controlled party, a taxpayer's current R&E expenditures should not offset the controlled party's royalty payment to the taxpayer because the controlled party's gross receipts would be attributable to the intangibles funded by the controlled party during the period the CSA existed.
- (g) Treasury and the IRS said that this assertion assumes that current sales are used to apportion R&E expenditures because they result from a taxpayer's current or recent research and, therefore, it is inappropriate to include gross receipts attributable to the research of a different taxpayer. They said that the regulations are based in part on the acknowledgement that R&E is a speculative, forward-looking activity that often does not result in income or sales in the current year, or even in future years. Current sales are nevertheless used because they generally will be the best available proxy for the income R&E expenditures are expected to produce in future years.
- (h) Accordingly, once a CSA is terminated, they believe it is appropriate to include the sales of a controlled party that previously participated in a CSA if that controlled party is reasonably expected to benefit from the taxpayer's current R&E expenditures to generate future sales. Additionally, Treasury and

the IRS believe that attempting to distinguish between the sales attributable to the controlled party's intangible property and those attributable to intangible property licensed from the taxpayer is generally difficult and uncertain and may often lead to disputes, making such a rule difficult for taxpayers to comply with and burdensome for the IRS to administer.

- (i) Because these concerns also exist when a taxpayer and a controlled party enter into a CSA, the final regulations also did not adopt comments requesting such a rule in that context. Furthermore, Treasury and the IRS believe that the tax consequences of terminating a CSA may vary depending on the facts and circumstances and are considering whether it would be appropriate to provide special rules for these transactions, and thus it would not be appropriate to provide special rules in connection with Treas. Reg. § 1.861-17 until these transactions have undergone further study. Therefore, the comments are not adopted.
- (j) Finally, several comments requested a modification to the rule in Prop. Treas. Reg. § 1.861-17(d)(3) and (4) providing that if a taxpayer has previously licensed, sold, or transferred intangible property related to a SIC code category to a controlled or uncontrolled party, then the taxpayer is presumed to expect to do so regarding all future intangible property related to the same SIC code category. The comments said that the 2019 FTC proposed regulations' use of the term "presumption" suggested that taxpayers would be unable to rebut the presumption in appropriate cases. In response to the comments, the final regulations provide that taxpayers may rebut the presumption by demonstrating that prior exploitation of the taxpayer's intangible property is inconsistent with reasonable future expectations.
- (k) In addition, the final regulations make other revisions to the sales method. First, the final regulations specify under what circumstances the sales or services of uncontrolled or controlled parties are taken into account. In particular, the final regulations specify that the gross receipts are taken into account if the uncontrolled or controlled party is expected to acquire (through license, sale, or transfer) intangible property arising from the taxpayer's current R&E expenditures, products in which such intangible property is embedded or used in connection with the manufacture or sale of such products, or services that incorporate or benefit from such intangible property.
- (l) Second, the final regulations revised Treas. Reg. § 1.861-17(d)(4) to refer to sales by controlled parties (which is defined as any person that is related to the taxpayer)), rather than controlled

corporations, to clarify that, for example, sales made by a controlled partnership that is reasonably expected to license intangible property from the taxpayer are fully taken into account under the sales method.

- (m) Finally, the final regulations revised Treas. Reg. § 1.861-17(f)(3) to provide that if a partnership incurs R&E expenditures (and is not also an uncontrolled party or controlled party described in Treas. Reg. § 1.861-17(d)(3) or (4)) and makes related sales, then those sales are considered made by the partners in proportion to their distributive shares of gross income attributable to the sales.

9. Foreign Branch Category Income and R&E Expenditures.

- (a) Two comments addressed the interaction of Treas. Reg. § 1.861-17 and foreign branch category income. One comment requested that a portion of sales earned by a foreign branch should be attributed to the general category for purposes of apportioning R&E expenditures in circumstances where a foreign branch utilizes intellectual property of the foreign branch owner to earn GII and pays a disregarded royalty to its U.S. owner. Under Treas. Reg. § 1.904-4(f)(2)(vi)(A), the amount of foreign branch category income would be adjusted downward and the foreign branch owner's general category income would be adjusted upward by the amount of the disregarded royalty.
- (b) According to the comment, after exclusive apportionment (as applicable), the 2019 FTC proposed regulations would apportion entirely to foreign branch category income the remaining R&E expense, which should instead be apportioned to the general category income originally attributable to the GII of the foreign branch that was reassigned by reason of the disregarded royalty.
- (c) Treasury and the IRS believe that the 2019 FTC proposed regulations, in combination with Treas. Reg. § 1.904-4(f)(2)(vi), already operate in the manner requested by the comment. Under Prop. Treas. Reg. § 1.861-17(d)(1)(iii), gross receipts are assigned to the statutory grouping (or groupings) or residual grouping to which the GII related to the sale, lease, or service is assigned. Adjustments to the amounts of gross income attributable to a foreign branch by reason of disregarded payments change the separate category grouping to which the gross income is assigned, but do not change the total amount, character, or source of a U.S. person's gross income. Treas. Reg. § 1.904-4(f)(2)(vi)(A).
- (d) After application of Treas. Reg. § 1.904-4(f)(2)(vi), GII related to the foreign branch's sales is assigned to the general category in the

amount of the disregarded royalty payment, and only the balance of the GII is assigned to the foreign branch category. Accordingly, a proportionate amount of the gross receipts from sales made by the foreign branch to which a disregarded royalty payment would be allocable is assigned to the general and foreign branch categories in the same ratio as the disregarded royalty payment bears to the gross income attributable to the sales.

- (e) The final regulations in Treas. Reg. § 1.861-17(d)(1)(iii) clarify that the assignment of gross receipts occurs after gross income in the separate categories is adjusted under Treas. Reg. § 1.904-4(f)(2)(vi) and clarify through an example the formula used to reassign gross receipts as a result of a disregarded reallocation transaction. Treas. Reg. § 1.861-17(g)(6) Example 6.
- (f) The second comment requested changes to the treatment of foreign branches that provide contract R&E services for the benefit of the foreign branch owner. According to the comment, when disregarded payments made by the foreign branch owner in respect of the provision of contract R&E services by a foreign branch cause GII to be reallocated to the foreign branch, R&E expenditures incurred by the foreign branch owner may be apportioned to foreign branch category income in a manner inconsistent with the economics of the branch's activities as a services provider, creating disparate tax results compared to those that would obtain if the services were performed by a CFC.
- (g) The comment suggested that the foreign branch's regarded costs of providing the research services that give rise to the disregarded payment from the foreign branch owner should reduce the amount of GII that was assigned to the foreign branch category, or more generally that GII should not be assigned to the foreign branch category by reason of disregarded payments for research services.
- (h) Treasury and the IRS agreed that R&E expenditures, including deductible expenses for the foreign branch's costs in providing research services to the foreign branch owner, may be apportioned to foreign branch category income that is GII, including GII that is treated as attributable to the foreign branch category under Treas. Reg. § 1.904-4(f)(2)(vi) by reason of disregarded payments from the foreign branch owner compensating the foreign branch for its research services that will generate GII for the foreign branch owner, and that the apportionment is based upon gross receipts assigned to the statutory groupings.
- (i) However, as noted in Treas. Reg. § 1.904-4(f)(2)(vi)(A), the reattribution of gross income between the general and foreign

branch categories by reason of disregarded payments cannot change the character of a taxpayer's realized gross income.

- (j) Treasury and the IRS believe that the different characterization of services income earned by a CFC, which may not be GII, and sales income reflecting GII that is attributed to a foreign branch by reason of disregarded payments for services, results from the Federal income tax treatment of disregarded payments, which do not give rise to gross income, and that it is not appropriate effectively to override the characterization of gross income by modifying the rules for allocating and apportioning recognized R&E expenditures. Accordingly, the comment was not adopted.

10. Contract Research Arrangements.

- (a) In the Preamble to the 2019 FTC proposed regulations, Treasury and the IRS requested comments on whether contract research arrangements involving expenditures that are reimbursed by a foreign affiliate are generally paid or incurred by a U.S. taxpayer such that a deduction under § 174 would be allowable for such expenditures, and whether any special rules for such arrangements should be considered. Generally, the comments received stated that where contract research is performed in the U.S. and is connected with a U.S.-based multinational's trade or business, a deduction under § 174, rather than § 162, may be appropriate.
- (b) Treasury and the IRS believe that it is beyond the scope of the final regulations to determine whether contract research expenses are, or are not, eligible to be deducted under either § 162 or 174.

11. Amended Returns and Applicability Dates.

- (a) One comment requested clarification of the applicability date provisions of the Treas. Reg. § 1.861-17 portion of the 2019 FTC proposed regulations. The comment noted that it was unclear whether a taxpayer that originally elected to apply the gross income method on its 2018 tax return would be eligible to amend its 2018 tax return to apply the sales method. The 2019 FTC final regulations included a provision addressing the binding election contained in former Treas. Reg. § 1.861-17(e)(1).
- (b) Under this provision, as modified in the 2019 FTC final regulations at Treas. Reg. § 1.861-17(e)(3), taxpayers otherwise subject to the binding election were permitted to change their election. On May 15, 2020, correcting amendments to the 2019 FTC final regulations were issued in 85 FR 29323. These amendments make clear that the change in method can occur on an

original or an amended return. See also a discussion of the ability for taxpayers to rely on the proposed or final versions of Treas. Reg. § 1.861-17 for taxable years before the years in which the final regulations are applicable. Accordingly, Treasury and the IRS believe that changes to the applicability date provisions are not necessary in response to this comment.

- (c) Finally, one comment requested that the applicability of the regulations under § 250 be deferred until after Treas. Reg. § 1.861-17 is finalized. Because the applicability of the regulations under § 250 has been deferred until taxable years beginning on or after January 1, 2021, which is consistent with the applicability date of Treas. Reg. § 1.861-17, the comment was moot. Treas. Reg. § 1.250-1(b).

H. Application of § 904(b) to Net Operating Losses.

1. Prop. Treas. Reg. § 1.904(b)-3(d)(2) contained a coordination rule providing that for purposes of determining the source and separate category of a net operating loss, the separate limitation loss and overall foreign loss rules of § 904(f) and the overall domestic loss rules of § 904(g) are applied without taking into account the adjustments required under § 904(b). No comments were received on this provision, which is finalized without change.
2. One comment requested that the final regulations include a rule switching off the application of § 904(b)(4) regarding pre-2018 U.S. source NOLs that offset foreign source income and created ODL accounts in pre-2018 taxable years, because in certain cases the increase in the denominator of the foreign tax credit limitation fraction required by § 904(b)(4) could limit the utilization of foreign tax credits that would otherwise be allowed by reason of the recapture of the ODL.
3. Nothing in § 904(b)(4) allows for the rule to be applied differently in cases when a taxpayer recaptures a pre-2018 ODL versus a post-2017 ODL or has no ODL recapture at all. Instead, the adjustments required by § 904(b)(4) apply in all taxable years beginning after 2017. Therefore, the comment was not adopted

I. Foreign Tax Credit Limitation Under § 904.

J. Definition of Financial Services Entity.

1. In order to promote simplification and greater consistency with other Code provisions that have complementary policy objectives, Treas. Reg. § 1.904-4(e)(2) of the 2019 FTC proposed regulations proposed to define a financial services entity as an individual or a corporation “predominantly engaged in the active conduct of a banking, insurance, financing, or

similar business,” and proposed to define financial services income as “income derived in the active conduct of a banking, insurance, financing, or similar business.” Treasury and the IRS state that these modified definitions are generally consistent with §§ 954(h), 1297(b)(2)(B), and 953(e); the 2019 FTC proposed regulations also included conforming changes to the rules for affiliated groups in Prop. Treas. Reg. § 1.904-4(e)(2)(ii) and partnerships in Prop. Treas. Reg. § 1.904-4(e)(2)(i)(C).

2. Comments stated that the 2019 FTC proposed regulations increased uncertainty and resulted in the disqualification of certain banks or insurance companies that would qualify as financial services entities under the existing final regulations. Comments also suggested that it was inappropriate to seek to align the relevant definitions in § 904 with those in § 954 because of the differing policies and scope of the two rules. Comments suggested various modifications to more closely align the revisions with the existing approach under Treas. Reg. § 1.904-4(e), or in the alternative, withdrawing the proposed rules entirely.
3. Treasury and the IRS believe that revisions to the financial services entity rules in Treas. Reg. § 1.904-4(e) continue to be necessary in light of statutory changes made in 2004 (under the American Jobs Creation Act of 2004) and the changes to the look-through rules in Treas. Reg. § 1.904-5 in the 2019 FTC final regulations, that were a result of the revisions to § 904(d) under the TCJA. However, Treasury and the IRS have determined the changes to Treas. Reg. § 1.904-4(e) should be repropoed to allow further opportunity for comment. Therefore, the 2020 FTC proposed regulations contain new proposed regulations under Treas. Reg. § 1.904-4(e), as well as a delayed applicability date.

K. Allocation and Apportionment of Foreign Income Taxes.

1. Prop. Treas. Reg. § 1.861-20 provided detailed guidance on how to match foreign income taxes with income, particularly in the case of differences in how U.S. and foreign law compute taxable income regarding the same transactions. Prop. Treas. Reg. § 1.861-20(c) provided that foreign tax expense is allocated and apportioned among the statutory and residual groupings by first assigning the items of gross income under foreign law (“foreign gross income”) on which a foreign tax is imposed to a grouping, then allocating and apportioning deductions under foreign law to that income, and finally allocating and apportioning the foreign tax among the groupings. Prop. Treas. Reg. § 1.861-20(c).
2. Prop. Treas. Reg. § 1.861-20(d)(2)(ii)(B) provided that if a taxpayer recognizes an item of foreign gross income that is attributable to a base difference, then the item of foreign gross income is assigned to the residual grouping, with the result that no credit is allowed if the tax on that item is paid by a CFC. The proposed regulations provided an exclusive

list of items that are excluded from U.S. gross income and that, if taxable under foreign law, are treated as base differences.

3. Several comments requested that distributions described in §§ 301(c)(2) and 733, representing nontaxable returns of capital, be removed from the list of base differences on the grounds that foreign tax on such distributions is more likely to result from timing differences. Some comments argued that the foreign law characterization of the distribution should govern the determination of the income group to which the foreign tax is allocated. Other comments suggested that foreign tax on return of capital distributions should be associated with passive category capital gains, because by reducing basis such distributions may increase the amount of capital gain recognized for U.S. tax purposes in the future.
4. Treasury and the IRS believe that the purpose of the rules in Treas. Reg. § 1.861-20, as well as Treas. Reg. § 1.904-6, is to allocate and apportion foreign income taxes to groupings of income determined under Federal income tax law. They also stated that the final regulations at Treas. Reg. § 1.861-20(d)(1), consistent with the approach in former Treas. Reg. § 1.904-6, provide that Federal income tax law applies to characterize foreign gross income and assign it to a grouping. Characterizing items solely based on foreign law, with no comparison to the U.S. tax base, would altogether eliminate base differences, which are expressly referenced in § 904(d)(2)(H)(i).
5. However, Treasury and the IRS also believe that in most cases, a foreign tax imposed on distributions described in §§ 301(c)(2) and 733 is likely to represent tax on earnings and profits of the distributing entity that are accounted for at different times under U.S. and foreign tax law, such as earnings of a hybrid partnership, earnings that are accelerated and subsequently eliminated for U.S. tax purposes by reason of a § 338 election, or earnings and profits of lower-tier entities, rather than tax on amounts that are permanently excluded from the U.S. tax base.
6. Although in some cases involving net basis foreign income taxes imposed at the shareholder level, distributions described in §§ 301(c)(2) and 733 may reflect a timing difference in the recognition of unrealized gain regarding the equity of the distributing entity, Treasury and the IRS believe that these situations are less likely to occur than timing differences in the recognition of earnings subject to withholding taxes because of the prevalence of foreign participation exemption regimes. Moreover, treating the foreign tax on distributions as representing a timing difference on earnings and profits of the distributing entity is more consistent with the general approach in the Code and regulations to the treatment of distributions as representing a tax on the earnings (see, for example, §§ 904(d)(3) and (4), and 960(b)) and with treating gain on stock sales as related in part to earnings and profits (*see* § 1248(a)).



7. Therefore, these distributions are removed from the list of base differences, and the final regulations at Treas. Reg. § 1.861-20(d)(3)(ii)(B)(2) generally associate a foreign law dividend that gives rise to a return of capital distribution under § 301(c)(2) with hypothetical earnings of the distributing corporation, measured based on the groupings to which the tax book value of the corporation's stock is assigned under the asset method in Treas. Reg. § 1.861-9. Similar rules are included in the 2020 FTC proposed regulations for partnership distributions described in § 733.
8. Treasury and the IRS believe that similar rules should apply in appropriate cases to associate a portion of foreign tax imposed on an item of foreign gross income constituting gain recognized on the sale or other disposition of stock in a corporation or a partnership interest with amounts that constitute nontaxable basis recovery for U.S. tax purposes. This similar treatment is appropriate to minimize differences in the foreign tax credit consequences of a sale or a distribution in redemption of the taxpayer's interest. Proposed rules on the allocation of foreign income tax on such dispositions are included in the 2020 FTC proposed regulations.
9. Prop. Treas. Reg. § 1.861-20 addressed the assignment to statutory and residual groupings of foreign gross income arising from *disregarded payments* between a foreign branch (as defined in Treas. Reg. § 1.904-4(f)(3)) and its owner. If the foreign gross income item arises from a payment made by a foreign branch to its owner, Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(A) generally assigned the item by deeming the payment to be made ratably out of the foreign branch's accumulated after-tax income, calculated based on the tax book value of the branch's assets in each grouping. If the item of foreign gross income arises from a disregarded payment to a foreign branch from its owner, Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(B) generally assigned the item to the residual grouping, with the result that any taxes imposed on the disregarded payment would be allocated and apportioned to the residual grouping as well. In addition, Prop. Treas. Reg. § 1.904-6(b)(2) included special rules assigning foreign gross income items arising from certain disregarded payments for purposes of applying § 904 as the operative section.
10. Several comments said that foreign tax on disregarded payments from a foreign branch owner to a foreign branch should not be allocated and apportioned to the residual grouping, which results in an effective denial of foreign tax credits in the case of a branch of a CFC, because items of foreign gross income that arise from disregarded payments of items such as interest or royalties should give rise to creditable foreign income taxes despite being nontaxable for Federal income tax purposes.
11. Some comments recommended adopting a tracing regime similar to the rules in Treas. Reg. § 1.904-4(f) to trace foreign gross income that a

taxpayer includes by reason of a disregarded payment to current year income of the payor for purposes of determining the grouping to which tax on the disregarded payment is allocated and apportioned. Comments also requested that the final regulations clarify whether the rule for remittances or contributions applies in the case of payments between two foreign branches.

12. Treasury and the IRS generally agreed with the comments that rules similar to the rules in Treas. Reg. § 1.904-4(f) should apply under Treas. Reg. § 1.861-20 to trace foreign gross income that a taxpayer includes by reason of a disregarded payment to the current year income of the payor to which the disregarded payment would be allocable if regarded for U.S. tax purposes. However, in order to provide taxpayers additional opportunity to comment, the final regulations reserve on the allocation and apportionment of foreign tax on disregarded payments, and new proposed rules are contained in the 2020 FTC proposed regulations.
  13. Similarly, the special rules in Prop. Treas. Reg. § 1.904-6(b)(2) for assigning foreign gross income items arising from certain disregarded payments for purposes of applying § 904 as the operative section are repropose in the 2020 FTC proposed regulations.
  14. The other special rules in Prop. Treas. Reg. § 1.861-20(d)(3) for allocating foreign tax in connection with a taxpayer's investment in a corporation or a disregarded entity are reorganized, and some of the definitions in Prop. Treas. Reg. § 1.861-20(b) are correspondingly revised, in the final regulations to group the rules on the basis of how the entity is classified, and whether the transaction giving rise to the item of foreign gross income results in the recognition of gross income or loss, for U.S. tax purposes. The rule in Prop. Treas. Reg. § 1.904-6(b)(3) relating to dispositions of property resulting in certain disregarded reallocation transactions is removed and repropose as part of Prop. Treas. Reg. § 1.861-20 as contained in the 2020 FTC proposed regulations.
  15. Finally, one comment requested that Treas. Reg. §§ 1.904-1 and 1.904-6 clarify that the tax allocation rules apply to taxes paid to U.S. territories, which are generally treated as foreign countries for purposes of the foreign tax credit. The final regulations clarified this point by including a cross reference to Treas. Reg. § 1.901-2(g), which defines a foreign country to include the territories. Treas. Reg. § 1.861-20(b)(6).
- L. Foreign Tax Redeterminations Under § 905(c) and Penalty Provisions Under § 6689. Portions of the temporary regulations relating to §§ 905(c), 986(a), and 6689 (TD 9362) (the "2007 temporary regulations") were repropose in order to provide taxpayers an additional opportunity to comment on those rules in light of the changes made by the TCJA. In particular, the rules in the 2007 temporary regulations (which had expired) that were repropose in the 2019 FTC proposed

regulations were: (1) Prop. Treas. Reg. § 1.905-3(b)(2), which addressed foreign taxes deemed paid under § 960, (2) Prop. Treas. Reg. § 1.905-4, which in general provided the procedural rules for how to notify the IRS of a foreign tax redetermination, and (3) Prop. Treas. Reg. § 301.6689-1, which provided rules for the penalty for failure to notify the IRS of a foreign tax redetermination. In addition, the 2019 FTC proposed regulations contained a transition rule in Prop. Treas. Reg. §§ 1.905-3(b)(2)(iv) and 1.905-5 to address foreign tax redeterminations of foreign corporations that relate to taxable years that predated the amendments made by the TCJA.

M. Adjustments to Foreign Taxes Paid by Foreign Corporations.

1. One comment requested clarification on whether multiple payments to foreign tax authorities under a single assessment (for example, payments to stop the running of interest and penalties) each result in a foreign tax redetermination under § 905(c).
2. Under Treas. Reg. § 1.905-3(a) of the 2019 FTC final regulations, each payment of tax that has accrued in a later year in excess of the amount originally accrued results in a separate foreign tax redetermination. However, the 2019 FTC proposed regulations at Treas. Reg. § 1.905-4(b)(1)(iv), which was finalized without change, only required one amended return for each affected prior year to reflect all foreign tax redeterminations that occur in the same taxable year.
3. In the case of payments that are made across multiple taxable years, Treas. Reg. § 1.905-4(b)(1)(iv) of the final regulations also provides that, if more than one foreign tax redetermination requires a redetermination of U.S. tax liability for the same affected year and those redeterminations occur within the same taxable year or within two consecutive taxable years, the taxpayer may file for the affected year one amended return and one statement under Treas. Reg. § 1.905-4(c) regarding all of the redeterminations. Otherwise, separate amended returns for each affected year are required to reflect each foreign tax redetermination.
4. Accordingly, no changes were made in response to this comment.
5. The comment also requested that Treasury and the IRS clarify whether contested taxes that are paid before the contest is resolved are considered to accrue for foreign tax credit purposes when paid or whether they represent an advance payment against a future liability that does not accrue until the final liability is determined. Proposed rules addressing this issue are included in the 2020 FTC proposed regulations.

N. Deductions for Foreign Income Taxes.

1. One comment requested clarification regarding whether the general rules under § 905(c) apply to taxpayers who elect to take a deduction, rather

than a credit, for creditable foreign taxes in the prior year to which the adjusted taxes relate. Additionally, the comment requested that Treasury and the IRS clarify whether the ten-year statute of limitations under § 6511(d)(3)(A) applies to refund claims based on such deductions.

2. In the case of a U.S. taxpayer that directly pays or accrues foreign income taxes, no U.S. tax redetermination is required in the case of a foreign tax redetermination of such taxes if the taxpayer did not claim a foreign tax credit in the taxable year to which such taxes relate. Treas. Reg. § 1.905-3(b)(1) (a redetermination of U.S. tax liability is required regarding foreign income tax claimed as a credit under § 901).
3. However, in the case of a U.S. shareholder of a CFC that pays or accrues foreign income tax, Prop. Treas. Reg. § 1.905-3(b)(2)(i) and (ii), which are finalized without substantive change, provided that a redetermination of U.S. tax liability is required to account for the effect of a foreign tax redetermination even in situations in which the foreign tax credit is not changed, such as for purposes of computing earnings and profits or applying the high-tax exception described in § 954(b)(4), including in the case of a U.S. shareholder that chooses to deduct foreign income taxes rather than to claim a foreign tax credit.
4. Additional guidance addressing the accrual rules for creditable foreign taxes that are deducted or claimed as a credit was included in Treas. Reg. § 1.461-4(g)(6)(B)(iii) and in the 2020 FTC proposed regulations.
5. Treasury and the IRS stated that the question of whether § 6511(d)(3)(A) applies to refunds relating to foreign taxes that are deducted, instead of taken as a foreign tax credit, is beyond the scope of this rulemaking. They cited *Trusted Media Brands, Inc. v. United States*, 899 F.3d 175 (2d. Cir. 2018) (holding that § 6511(d)(3)(A) only applies to refund claims based on foreign tax credits). In addition, the 2020 FTC proposed regulations include proposed amendments to the regulations under § 901(a), which provides that an election to claim foreign income taxes as a credit for a particular taxable year may be made or changed at any time before the expiration of the period prescribed for claiming a refund of U.S. tax for that year.

O. Application to GILTI high-Tax Exclusion.

1. Prop. Treas. Reg. § 1.905-3(b)(2)(ii) provided that the required adjustments to U.S. tax liability by reason of a foreign tax redetermination of a foreign corporation include not only adjustments to the amount of foreign taxes deemed paid and related § 78 dividend, but also adjustments to the foreign corporation's income and earnings and profits and the amount of the U.S. shareholder's inclusions under §§ 951 and 951A in the year to which the redetermined foreign tax relates.

2. One comment requested that final regulations clarify whether a U.S. tax redetermination is required when the foreign tax redetermination affects whether the taxpayer is eligible for the GILTI high-tax exclusion. Specifically, the comment stated that because a redetermination of U.S. tax liability is required when the foreign tax redetermination affects whether a taxpayer is eligible for the subpart F high-tax election under § 954(b)(4), a similar result should apply for taxpayers that make (or seek to make) the GILTI high-tax exclusion election, and that taxpayers should be allowed to make the election on an annual basis. Further, the comment suggested that if taxpayers are allowed to make an annual election under the final GILTI high-tax exclusion regulations, then taxpayers should be permitted to make or revoke the election on an amended return following a foreign tax redetermination.
3. Prop. Treas. Reg. § 1.905-3(b)(2)(ii) provided that the required U.S. tax redetermination applies for purposes of determining amounts excluded from a CFC's gross tested income under § 951A(c)(2)(A)(i)(III), and this provision is retained in the final regulations with minor modifications. Furthermore, under final regulations issued on July 23, 2020, taxpayers may make the GILTI high-tax exclusion election on an annual basis and may do so on an amended return filed within 24 months of the unextended due date of the original income tax return. Treas. Reg. § 1.951A-2(c)(7)(viii)(A)(1)(i).

P. Foreign Tax Redeterminations of Successor Entities.

1. Prop. Treas. Reg. § 1.905-3(b)(3) provided that if at the time of a foreign tax redetermination the person with legal liability for the tax (the “successor”) is a different person from the person that had legal liability for the tax in the year to which the redetermined tax relates (the “original taxpayer”), the required redetermination of U.S. tax liability is made as if the foreign tax redetermination occurred in the hands of the original taxpayer. The proposed regulations further provided that Federal income tax principles apply to determine the tax consequences if the successor remits, or receives a refund of, a tax that in the year to which the redetermined tax relates was the legal liability of, and thus considered paid by, the original taxpayer.
2. One comment suggested that Prop. Treas. Reg. § 1.905-3(b)(3), as drafted, did not clearly address cases where the ownership of a disregarded entity changes. The comment recommended clarifying that in the case of a disregarded entity, the owner of the disregarded entity is treated as the person with legal liability for the tax or the person with the legal right to a refund, as applicable.
3. Treasury and the IRS believe that a clarification is not necessary. Existing regulations make clear that the owner of a disregarded entity is considered

to be legally liable for the tax. Treas. Reg. § 1.901-2(f)(4)(ii) (legal liability for income taxes imposed on a disregarded entity).

4. The same comment stated that the preamble to the proposed regulations incorrectly suggested that under U.S. tax principles the payment of tax by a successor entity owned by the original taxpayer (for example, by a CFC that was formerly a disregarded entity) is treated as a distribution. The comment further recommended addressing the issue of contingent liabilities in future guidance.
5. Treasury and the IRS agreed that there may be multiple ways to characterize the tax consequences of tax paid by a successor in the example described in the preamble to the proposed regulations. They also believe that the issue of contingent foreign tax liabilities in connection with foreign tax redeterminations under § 905(c) requires further study and may be considered as part of future guidance.

Q. Notification to the IRS of Foreign Tax Redeterminations and Related Penalty Provisions.

R. Notification Through Amended Returns.

1. In general, Prop. Treas. Reg. § 1.905-4(b)(1)(i) provided that any taxpayer for which a redetermination of U.S. tax liability is required must notify the IRS of the foreign tax redetermination by filing an amended return.
2. Several comments suggested that taxpayers should be allowed to report adjustments to U.S. tax liability in prior years by reason of foreign tax redeterminations on an attachment to their Federal income tax return for the taxable year in which the redetermination occurs, instead of requiring taxpayers to file amended tax returns for the taxable year in which the adjusted foreign tax was claimed as a credit and any intervening years in which the foreign tax redetermination affected U.S. tax liability.
3. Specifically, comments suggested that taxpayers could be allowed to file a statement with their return for the taxable year in which the foreign tax redetermination occurs notifying the IRS of overpayments or underpayments of U.S. tax and applicable interest due for prior taxable years that resulted from the foreign tax redetermination.
4. One comment suggested that taxpayers could be required to maintain books and records reflecting all the adjustments that would normally accompany an amended return, without actually being required to prepare and file such a return. Another comment suggested that the IRS could amend Schedule E on Form 5471 to include this type of information about the changes to prior year U.S. tax liabilities that result from foreign tax redeterminations. Comments noted that providing an alternative to filing

amended Federal income tax returns would relieve taxpayers from having to file amended state tax returns.

5. Treasury and the IRS believe that, based on existing processes, the only manner in which taxpayers can properly notify the IRS of a change in U.S. tax liability for a prior taxable year that results from a foreign tax redetermination is by filing an amended return reflecting all the necessary U.S. tax adjustments. They also believe that the type of statement suggested by the comments, reflecting a recomputation of Federal income tax liability for a prior year, could be viewed by state tax authorities as the functional equivalent of an amended Federal income tax return that may not necessarily operate to relieve taxpayers of their obligations to file amended state tax returns. In any event, taxpayer requests for relief from state tax filing obligations are properly directed to state tax authorities, rather than to Treasury and the IRS.
6. Therefore, the comments are not adopted. However, Treasury and the IRS continue to study whether new processes or forms can be developed to streamline the filing requirements while ensuring that the IRS receives the necessary information to verify that taxpayers have made the required adjustments to their U.S. tax liability. Under Treas. Reg. § 1.905-4(b)(3) of the final regulations, the IRS may prescribe alternative notification requirements through forms, instructions, publications, or other guidance.
7. Comments also suggested that the notification due date should be extended (for example, to up to three years from the due date of the original return for the taxable year in which the foreign tax redetermination occurred).
8. Treasury and the IRS believe that deferring the due date of the required amended returns beyond the due date (with extensions) of the return for the year in which the foreign tax redetermination occurs would not substantially reduce compliance burdens and could be more difficult for the IRS to administer, because the same filing obligations would be required, though regarding foreign tax redeterminations that occurred three years earlier rather than in the current taxable year.
9. In addition, taxpayers have an economic incentive to promptly file amended returns claiming a refund of U.S. tax in cases where a foreign tax redetermination reduces, rather than increases, U.S. tax liability; Treasury and the IRS have determined that it is appropriate to require comparable promptness when a foreign tax redetermination increases U.S. tax due in order to permit timely verification of the required U.S. tax adjustments when the relevant documentation and personnel are more readily available.

10. Accordingly, the comments were not adopted. However, a transition rule was added at Treas. Reg. § 1.905-4(b)(6) to give taxpayers an additional year to file required notifications regarding foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019, and before the date the regulations were published in the Federal Register.
11. Comments also requested that the final regulations provide that for foreign tax redeterminations below a certain de minimis threshold (for example, 10% of foreign taxes as originally accrued, or \$5 million), taxpayers should be allowed to account for the foreign tax redeterminations by making adjustments to current year taxes and foreign tax credits claimed in the taxable year in which the foreign tax redetermination occurs, rather than by adjusting U.S. tax liability in the prior year or years in which the adjusted foreign taxes were claimed as a credit. Alternatively, some comments requested that for foreign tax redeterminations below a de minimis or materiality threshold, taxpayers should be completely relieved of adjusting U.S. tax liability and from all notification and amended return requirements.
12. Treasury and the IRS believe that, as amended by the TCJA, § 905(c) mandates retroactive adjustments to U.S. tax liability when foreign taxes claimed as credits are redetermined. The TCJA repealed § 902 and the regulatory authority at the end of § 905(c)(1) to prescribe alternative adjustments to multi-year pools of earnings and taxes of foreign corporations in lieu of the required adjustments to U.S. tax liability for the affected years.
13. Recharacterizing prior year taxes as current year taxes would have substantive effects on the amounts of a taxpayer's GILTI and subpart F inclusions, the applicable carryover periods for excess credits, the applicable currency translation conventions, the amounts of interest owed by or due to the taxpayer, and the applicable statutes of limitation for refund or assessment. Therefore, the comments was not adopted.
14. Finally, a comment requested that Treas. Reg. § 1.905-4(b)(1)(ii) be amended to allow a taxpayer that avails itself of special procedures under Revenue Procedure 94-69 to notify the IRS of a foreign tax redetermination when the taxpayer makes a Revenue Procedure 94-69 disclosure during an audit for the taxable year for which U.S. tax liability is increased by reason of the foreign tax redetermination.
15. Treasury and the IRS said that Revenue Procedure 94-69 provides special procedures for a taxpayer in the Large Corporate Compliance program (formerly the Coordinated Examination Program or Coordinated Industry Case program) to avoid the potential application of the accuracy-related penalty currently described in § 6662. Under Revenue Procedure 94-69, a



taxpayer may file a written statement that is treated as a qualified amended return within 15 days after the IRS requests it.

16. However, Revenue Procedure 94-69 does not provide any protection for penalties under § 6689 for failure to file a notice of a foreign tax redetermination,<sup>11</sup> and it requires a statement that is less detailed than the notification statement required under Treas. Reg. § 1.905-4(b)(1)(ii). Further, § 905(c) contemplates that the burden is on the taxpayer to notify the IRS of a foreign tax redetermination, whereas Revenue Procedure 94-69 places the burden on the IRS to request information. Finally, the notification requirement under Treas. Reg. § 1.905-4(b)(1)(ii) affords a taxpayer more time to satisfy its reporting obligation as opposed to the 15-day notification requirement in Revenue Procedure 94-69. Therefore, the comment was not adopted.

S. Foreign Tax Redeterminations of Pass-through Entities.

1. Prop. Treas. Reg. § 1.905-4(b)(2) generally provided that a pass-through entity that reports creditable foreign income tax to its partners, shareholders, or beneficiaries is required to notify the IRS and its partners, shareholders, or beneficiaries if there is a foreign tax redetermination regarding such foreign income tax. Prop. Treas. Reg. § 1.905-4(c) for the information required to be provided with the notification. Additionally, Prop. Treas. Reg. § 1.905-4(b)(2)(ii) provided that if a redetermination of U.S. tax liability would require a partnership adjustment as defined in § 301.6241-1(a)(6), the partnership must file an administrative adjustment request (“AAR”) under § 6227 without regard to the time restrictions on filing an AAR in § 6227(c). Treas. Reg. § 1.6227-1(g).
2. One comment suggested that S corporations should be allowed to follow similar notification procedures as partnerships that are subject to §§ 6221 through 6241 (enacted by the Bipartisan Budget Act (“BBA”).
3. By their terms, the BBA rules only apply to partnerships and not S corporations, except in the limited circumstance in which an S corporation is a partner in a partnership subject to the BBA rules. §§ 6226(b)(4) and 6227(b). But in cases where the S corporation is not a partner in a BBA partnership that made the election, there is no provision under BBA or any other provision of the Code to allow the S corporation to pay the imputed underpayment on behalf of its shareholders.

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<sup>11</sup> The regulations that previously made § 6689 operative were temporary regulations that only existed for three years (2007-2010) and then expired. The section is only operative under regulations. New § 6689 regulations were finalized in this regulations package, but are not discussed here because there were no comments and Treasury and the IRS did not make any substantive changes to the proposed regulations in adopting them as final regulations, as noted above.

4. Because the statute does not generally allow for S corporations to pay imputed underpayments on behalf of its shareholders, the approach suggested by the comment is not viable and therefore the comment is not adopted. However, Treasury and the IRS continue to study whether new processes or forms can be developed to streamline the amended return requirements, including in the case of S corporations that report foreign tax redeterminations to their shareholders.

T. Foreign Tax Redeterminations of LB&I Taxpayers.

1. Prop. Treas. Reg. § 1.905-4(b)(4) provided a limited alternative notification requirement for U.S. taxpayers that are under the jurisdiction of the IRS's Large Business & International ("LB&I") Division. Under Prop. Treas. Reg. § 1.905-4(b)(4)(i)(B), the alternative notification requirement is available only if certain conditions are met, including that an amended return reflecting a foreign tax redetermination would otherwise be due while the return for the affected taxable year is under examination, and that the foreign tax redetermination results in a downward adjustment to the amount of foreign tax paid or accrued, or included in the computation of foreign taxes deemed paid.
2. Several comments suggested broadening the scope of Prop. Treas. Reg. § 1.905-4(b)(4) to include upward adjustments to foreign taxes paid or accrued. The comments also recommended that the special notification rules apply when multiple foreign tax redeterminations involving different foreign jurisdictions occur in the same taxable year and result in offsetting adjustments, for example, if there is an additional payment of foreign tax in one jurisdiction and a refund of a comparable amount in another jurisdiction.
3. The proposed regulations limited the alternative notification requirement to cases where the foreign tax redetermination results in a downward adjustment to the amount of foreign taxes paid or accrued because failure to comply with the notification requirements exposes taxpayers to penalties under § 6689 only if the foreign tax redetermination results in an underpayment of U.S. tax.
4. As provided in Treas. Reg. § 1.905-4(b)(1)(iii), if a foreign tax redetermination results in an overpayment of U.S. tax, in order to claim a refund of U.S. tax the taxpayer must file an amended return within the period specified in § 6511. § 6511(d)(3)(A), providing a special 10-year period of limitations for refund claims based on foreign tax credits.
5. However, in unusual circumstances, an increase in foreign tax liability for a prior year may result in an underpayment (rather than an overpayment) of U.S. tax (for example, if an increase in foreign income tax liability causes a CFC to have a tested loss or to qualify for the high- tax exclusion

of § 954(b)(4), reducing the amount of foreign taxes deemed paid). In addition, in some cases the complexity of the required computations may make it difficult for taxpayers to identify easily which particular foreign tax redeterminations will ultimately result in an underpayment of U.S. tax.

6. Accordingly, the final regulations extend the alternative notification procedures to cover the case of any adjustment (whether upward or downward) of foreign taxes by reason of a foreign tax redetermination that increases U.S. tax liability, and so would otherwise require the filing of an amended return while the affected year of the LB&I taxpayer is under examination.
7. In addition, the final regulations provide that an LB&I taxpayer that has a foreign tax redetermination that decreases U.S. tax liability for an affected year that is under examination may (but is not required to) notify the examiner of the adjustment in lieu of filing an amended return to claim a refund (within the time period provided in § 6511).
8. However, because § 6511(d)(3) generally allows taxpayers 10 years to seek a U.S. tax refund attributable to foreign tax credits and the regulations do not preclude taxpayers from filing such an amended return before the audit of an affected year is completed, the IRS may either accept the alternative notification or require the taxpayer to file an amended return.
9. The additional flexibility added to the final regulations will assure timely notification of, and penalty protection for taxpayers regarding, all foreign tax redeterminations that may increase or decrease U.S. tax liability for an affected taxable year, including in the case of offsetting foreign tax redeterminations that occur in the same taxable year.
10. Finally, comments recommended that examiners should be granted authority to accept notifications of foreign tax redeterminations outside the periods specified in Treas. Reg. § 1.905-4(b)(4)(ii)(A)-(C) and for affected taxable years that are not currently under examination. For example, the comments suggested that the notification deadline for an LB&I taxpayer should be extended upon the taxpayer's request and at the examiner's discretion.
11. Treasury and the IRS believe that amended returns reflecting additional U.S. tax due should be timely filed in order to ensure examiners have sufficient time to take into account any redetermination of U.S. tax liability without prolonging the audit. In addition, the special notification rules are not extended to taxpayers that are not currently under examination.

12. The alternative notification rules in Treas. Reg. § 1.905-4(b)(4) are predicated on the fact that the examiner is in the process of determining whether to propose adjustments to the items included on the taxpayer's return for the taxable year under examination, and it is appropriate to defer the requirement to file an amended return reflecting the effect of a foreign tax redetermination on the taxpayer's U.S. tax liability for that taxable year until the examination has concluded.
13. These considerations do not apply to affected taxable years that are not currently under examination when an amended return would otherwise be due. Accordingly, these comments were not adopted.

U. Transition Rule Relating to the TCJA.

1. Prop. Treas. Reg. §§ 1.905-3(b)(2)(iv) and 1.905-5 provided a transition rule providing that post-2017 redeterminations of pre-2018 foreign income taxes of foreign corporations must be accounted for by adjusting the foreign corporation's taxable income and earnings and profits, post-1986 undistributed earnings, and post-1986 foreign income taxes (or pre-1987 accumulated profits and pre-1987 foreign income taxes, as applicable) in the pre-2018 year to which the redetermined foreign taxes relate.
2. The preamble to the 2019 FTC proposed regulations requested comments on whether an alternative adjustment to account for post-2017 foreign tax redeterminations regarding pre-2018 taxable years of foreign corporations, such as an adjustment to the foreign corporation's taxable income and earnings and profits, post-1986 undistributed earnings, and post-1986 foreign income taxes as of the foreign corporation's last taxable year beginning before January 1, 2018, may provide for a simplified and reasonably accurate alternative.
3. Several comments supported this suggestion. A comment further noted that certain taxpayers should be excluded from any alternative rule where it would be distortive. For example, the comment suggested excluding taxpayers that distributed material amounts of earnings and profits, as well as taxpayers who took advantage of the subpart F high-tax exception in the foreign corporation's final pre-TCJA taxable year. Another comment noted that taxpayers should be allowed to adjust the foreign corporation's final pre-2018 year only if the adjustments would not cause a deficit in the foreign corporation's tax pool in that final year.
4. A comment also suggested that the alternative rule should provide that in case of foreign corporations that ceased to be subject to the pooling regime before 2018 (for example, due to a liquidation or sale to a foreign acquiror), the required adjustments should be made in the foreign corporation's last year in which the pooling rules are relevant). Additionally, several comments suggested that foreign tax

redeterminations of foreign corporations below a certain threshold should not require a redetermination or adjustment of a taxpayer's § 965(a) inclusion or the amount of foreign taxes deemed paid regarding such § 965(a) inclusion. Instead, some comments suggested that the redetermination be taken into account in the post-2017 year of the redetermination.

5. In response to these comments, the final regulations under Treas. Reg. § 1.905-5(e) provide an irrevocable election for a foreign corporation's controlling domestic shareholders to account for all foreign tax redeterminations that occur in taxable years ending on or after finalization of the proposed regulations, regarding pre-2018 taxable years of foreign corporations as if they occurred in the foreign corporation's last taxable year beginning before January 1, 2018 (the "last pooling year"). The rules in Temp. Treas. Reg. §§ 1.905-3T and 1.905-5T (revised as of April 1, 2019) will apply for purposes of determining whether a particular foreign tax redetermination must instead be accounted for in the year to which the redetermined foreign tax relates, instead of in the last pooling year.
6. The election is made by the foreign corporation's controlling domestic shareholders, and is binding on all persons who are, or were in a prior year to which the election applies, U.S. shareholders of the foreign corporation regarding which the election is made for all of its subsequent foreign tax redeterminations, as well as foreign tax redeterminations of other members of the same CFC group as the foreign corporation for which the election is made. For this purpose, the definition of a CFC group in Treas. Reg. § 1.905-5(e)(2)(iv)(B) is modeled off the definition contained in Treas. Reg. § 1.951A-2(c)(7)(viii)(E)(2).
7. No exception is provided that would allow taxpayers to avoid redetermination or adjustment of the amount of a taxpayer's § 965(a) inclusion or foreign income taxes deemed paid regarding such § 965(a) inclusion if under § 905(c) a foreign tax redetermination regarding a foreign corporation's pre-2018 year requires such an adjustment to the taxpayer's U.S. tax liability. Section 905(c) mandates retroactive adjustments to U.S. tax liability when foreign taxes claimed as credits are redetermined, and there is no technical or policy basis on which to exclude such adjustments when the U.S. tax liability arises as a result of § 965 as opposed to another section of the Code.

- V. Protective Claims. One comment requested guidance on how to file protective refund claims to account for contested foreign taxes that may result in foreign tax redeterminations after the expiration of the applicable statute of limitations. Treasury and the IRS stated that providing guidance on the procedures for filing protective claims is beyond the scope of these regulations.
- W. Foreign Income Taxes Taken into Account Under § 954(b)(4).
1. The 2019 FTC proposed regulations included a clarification relating to schemes involving jurisdictions that do not impose corporate income tax on a CFC until its earnings are distributed. The proposed regulations provided that foreign income taxes that have not accrued because they are contingent on a future distribution are not taken into account for purposes of determining the amount of foreign income taxes paid or accrued regarding an item of income.
  2. No comments were received regarding this provision, and the rules were finalized without change. In addition, Prop. Treas. Reg. § 1.905-1(d)(1) in the 2020 FTC proposed regulations further provides that taxes contingent on a future distribution are not treated as accrued.
- X. Applicability Dates.
- Y. Regulations Relating to Foreign Tax Credits.
1. The 2019 FTC proposed regulations provided that the rules in Prop. Treas. Reg. §§ 1.861-8, 1.861-9, 1.861-12, 1.861-14, 1.904-4(c)(7) and (8), 1.904(b)-3, 1.905-3, 1.905-4, 1.905-5, 1.954-1, 1.954-2, 1.965-5(b)(2), and 301.6689-1 are applicable to taxable years that end on or after December 16, 2019. Certain provisions, such as Treas. Reg. §§ 1.704-1(b)(4)(viii)(d)(1), 1.861-17, 1.861-20, 1.904-6, and 1.960-1, were proposed to be applicable to taxable years beginning after December 31, 2019, while Prop. Treas. Reg. §§ 1.904-4(e) and 1.904(g)-3 were proposed to be applicable to taxable years ending on or after the date the final regulations are filed. Prop. Treas. Reg. § 1.1502-4 was proposed to be applicable to taxable years for which the original consolidated Federal income tax return is due (without extensions) after December 17, 2019.
  2. Several comments requested that the applicability dates to the 2019 FTC proposed regulations generally be delayed to taxable years beginning on or after the final regulations are published to allow more time for taxpayers to adapt to the new rules, and also requested that the regulations allow taxpayers the flexibility to rely on either the 2019 FTC proposed regulations or the final regulations for any preceding taxable years.
  3. Treasury and the IRS agreed that the applicability date of the expense allocation rules in Treas. Reg. §§ 1.861-8 and 1.861-14, which particularly in the case of stewardship expenses contain significant changes relative to

the 2019 FTC proposed regulations, should be delayed to allow taxpayers more time to comply with the revisions made in the final regulations. Therefore, the applicability dates of Treas. Reg. §§ 1.861-8 and 1.861-14 were revised to apply to taxable years beginning after December 31, 2019 (consistent with the later applicability date provided for Treas. Reg. §§ 1.861-17, 1.861-20, 1.904-6, and 1.960-1).

4. In addition, although the applicability date of the notification requirements for foreign tax redeterminations in Treas. Reg. § 1.905-4 is adopted as proposed to apply to foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019, a transition rule was added to the final regulations to provide taxpayers an additional year to file required notifications regarding foreign tax redeterminations occurring in taxable years ending before the final regulations were published.
5. However, the other provisions in the 2019 FTC proposed regulations which were proposed to apply to taxable years ending on or after December 16, 2019 (Treas. Reg. §§ 1.861-9, 1.861-12, 1.904-4(c)(7) and (8), 1.904(b)-3, 1.905-3, 1.905-5, 1.954-1, 1.954-2, 1.965-5(b)(2), 1.1502-4, and 301.6689-1), generally received minimal or no comments and were adopted with no or minimal changes. Therefore, Treasury and the IRS believe that taxpayers with 2019 calendar years have been sufficiently on notice of these rules and little benefit would be afforded by providing a delayed applicability date or an election to apply either the proposed or final regulations to preceding years, given that these rules have not significantly changed between the proposed and final regulations.
6. The 2019 FTC proposed regulations provided that, regarding Treas. Reg. § 1.861-17, taxpayers that use the sales method for taxable years beginning after December 31, 2017, and before January 1, 2020 (or taxpayers that use the sales method only for their last taxable year that begins before January 1, 2020), may rely on Prop. Treas. Reg. § 1.861-17 if they apply it consistently regarding such taxable year and any subsequent year. Therefore, a taxpayer using the sales method for its taxable year beginning in 2018 may rely on Prop. Treas. Reg. § 1.861-17 but must also apply the sales method (relying on Prop. Treas. Reg. § 1.861-17) for its taxable year beginning in 2019.
7. The final regulations provide that a taxpayer may choose to apply Treas. Reg. § 1.861-17 (as contained in these final regulations) to taxable years beginning before January 1, 2020, provided that it applies the final regulations in their entirety, and provided that if a taxpayer applies the final regulations to the taxable year beginning in 2018, the taxpayer must also apply the final regulations for the subsequent taxable year beginning in 2019. Alternatively, and consistent with the 2019 FTC proposed regulations, a taxpayer may rely on Prop. Treas. Reg. § 1.861-17 in its entirety for taxable years beginning after December 31, 2017, and

beginning before January 1, 2020. A taxpayer that applies either the proposed or final version of Treas. Reg. § 1.861-17 to a taxable year beginning on or after January 1, 2018, and beginning before January 1, 2020, must apply it regarding all operative sections (including both § 250 and 904). Treas. Reg. § 1.861-8(f).

## PROPOSED REGULATIONS: FOREIGN TAX CREDITS AND RELATED MATTERS

- A. Treasury and the IRS proposed regulations addressing:
1. the determination of foreign income taxes subject to the credit and deduction disallowance provision of § 245A(d);
  2. the determination of oil and gas extraction income from domestic and foreign sources and of electronically supplied services under the § 250 regulations;
  3. the impact of the repeal of § 902 on certain regulations issued under § 367(b) (foreign reorganizations);
  4. the sourcing of inclusions under §§ 951, 951A, and 1293;
  5. the allocation and apportionment of interest deductions, including rules for allocating interest expense of foreign bank branches and certain regulated utility companies, an election to capitalize research and experimental expenditures and advertising expenses for purposes of calculating tax basis, and a revision to the controlled foreign corporation (“CFC”) netting rule;
  6. the allocation and apportionment of § 818(f) expenses of life insurance companies that are members of consolidated groups;
  7. the allocation and apportionment of foreign income taxes, including taxes imposed regarding disregarded payments;
  8. changes to the definitions of a creditable foreign income tax and a tax in lieu of an income tax, including the addition of a jurisdictional nexus requirement and changes to the net gain requirement, the treatment of certain tax credits, the treatment of foreign tax law elections for purposes of the noncompulsory payment rules, and the substitution requirement under § 903;
  9. the allocation of the liability for foreign income taxes in connection with certain mid-year transfers or reorganizations;
  10. transition rules to account for the effect on loss accounts of net operating loss carrybacks to pre-2018 taxable years that are allowed under the Coronavirus Aid, Relief, and Economic Security Act (2020);



11. the foreign branch category rules in Treas. Reg. § 1.904-4(f) and the definition of a financial services entity for purposes of § 904; and
12. the time at which credits for foreign income taxes can be claimed pursuant to §§ 901(a) and 905(a).

**B. Foreign Income Taxes Regarding Dividends for Purposes of § 245A(d).**

1. Section 245A(d)(1) provides that no credit is allowed under § 901 for any taxes paid or accrued (or treated as paid or accrued) regarding any dividend for which a deduction is allowed under that section. Section 245A(d)(2) disallows a deduction for any tax for which a credit is not allowable under § 901 by reason of § 245A(d)(1). Section 245A(e)(3) also provides that no credit or deduction is allowed for foreign income taxes paid or accrued regarding a hybrid dividend or a tiered hybrid dividend.
2. Prop. Treas. Reg. § 1.245A(d)-1(a) provides that neither a foreign tax credit under § 901 nor a deduction is allowed for foreign income taxes (as defined in Treas. Reg. § 1.901-2(a)) that are “attributable to” certain amounts. For this purpose, the proposed regulations rely on the rules in Treas. Reg. § 1.861-20, contained in the 2020 FTC final regulations and proposed to be modified in these proposed regulations, that allocate and apportion foreign income taxes to income for purposes of various operative sections, including §§ 904, 960, and 965(g).
3. Specifically, Prop. Treas. Reg. § 1.245A(d)-1 provides that Treas. Reg. § 1.861-20 (which includes portions contained in these proposed regulations as well as in the 2020 FTC final regulations) applies for purposes of determining foreign income taxes paid or accrued that are attributable to any dividend for which a deduction is allowed under § 245A(a), to a hybrid dividend or tiered hybrid dividend, or to previously taxed earnings and profits that arose as a result of a sale or exchange that by reason of § 964(e)(4) or 1248 gave rise to a deduction under § 245A(a) or as a result of a tiered hybrid dividend that by reason of § 245A(e)(2) gave rise to an inclusion in the gross income of a U.S. shareholder (collectively, such previously taxed earnings and profits are referred to as “§ 245A(d) PTEP”).
4. In addition, the rules apply to foreign income taxes that are imposed regarding certain foreign taxable events, such as a deemed distribution under foreign law or an inclusion under a foreign law CFC inclusion regime, even though such an event does not give rise to a distribution or inclusion for Federal income tax purposes. Prop. Treas. Reg. § 1.245A(d)-1(a) provides that foreign income taxes that are attributable to “specified earnings and profits” are also subject to the disallowance under § 245A(d). Under Prop. Treas. Reg. § 1.245A(d)-1(b), Treas. Reg. § 1.861-20 applies

to determine whether foreign income taxes are attributable to specified earnings and profits.

5. Under Treas. Reg. § 1.861-20, foreign income taxes may be allocated and apportioned by reference to specified earnings and profits, even though the person paying or accruing the foreign income tax does not have a corresponding U.S. item in the form of a distribution of, or income inclusion regarding, those earnings and profits. *See*, for example, Treas. Reg. § 1.861-20(d)(2)(ii)(B), (C), or (foreign law distribution or foreign law disposition and certain foreign law transfers between taxable units), (d)(3)(i)(C) (income from a reverse hybrid), (d)(3)(iii) (foreign law inclusion regime), and Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(i) (disregarded payment treated as a remittance).
6. Specified earnings and profits means earnings and profits that would give rise to a § 245A deduction (without regard to the holding period requirement under § 246 or the rules under Treas. Reg. § 1.245A-5 that disallow a deduction under § 245A(a) for certain dividends), a hybrid dividend, or a tiered hybrid dividend, or a distribution sourced from § 245A(d) PTEP if an amount of money equal to all of the foreign corporation's earnings and profits were distributed.
7. Therefore, for example, a credit or deduction for foreign income taxes paid or accrued by a domestic corporation that is a United States shareholder ("U.S. shareholder") regarding a distribution that is not recognized for Federal income tax purposes (for example, in the case of a consent dividend under foreign tax law that is not regarded for Federal income tax purposes, or a distribution of stock that is excluded from gross income under § 305(a) but is treated as a taxable dividend under foreign tax law) is not allowed under § 245A(d) to the extent those foreign income taxes are attributable to specified earnings and profits.
8. An anti-avoidance rule in Prop. Treas. Reg. § 1.245A(d)-1 addresses situations in which taxpayers engage in transactions with a principal purpose of avoiding the purposes of § 245A(d), which is to disallow a foreign tax credit or deduction regarding foreign income taxes imposed on income that is effectively exempt from tax (due to the availability of a deduction under § 245A(a)) or regarding foreign income taxes imposed on a hybrid dividend or tiered hybrid dividend.
9. These transactions include transactions to separate foreign income taxes from the income to which they relate in situations that are not explicitly covered under Treas. Reg. § 1.861-20 (including, for example, loss sharing transactions under group relief regimes). They also include successive distributions (under foreign law) out of earnings and profits that, under the rules in Treas. Reg. § 1.861-20, are treated as distributed out of previously taxed earnings and profits (and therefore foreign income

taxes attributable to these amounts are not subject to the disallowance under § 245A(d)), when there is no reduction of such previously taxed earnings and profits due to the absence of a distribution under Federal income tax law. Prop. Treas. Reg. § 1.245A(d)-1(e)(4) (Example 3).

10. Treasury and the IRS are concerned that because the rules in Treas. Reg. § 1.861-20(d) addressing foreign law distributions and dispositions do not currently make adjustments to a foreign corporation's earnings and profits to reflect distributions that are not recognized for Federal income tax purposes, these foreign law transactions could be used to circumvent the purposes of § 245A(d).
11. Comments were requested on potential revisions to Treas. Reg. § 1.861-20(d) that could address these concerns, including the possibility of maintaining separate earnings and profits accounts, characterized with reference to the relevant statutory and residual groupings, 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.

C. Clarifications to Regulations Under § 250.

D. Definition of Domestic and Foreign Oil and Gas Extraction Income.

1. Section 250 provides a domestic corporation a deduction (“§ 250 deduction”) for its foreign-derived intangible income (“FDII”) as well as its global intangible low-taxed income (“GILTI”) inclusion amount and the amount treated as a dividend under § 78 that is attributable to its GILTI inclusion. The § 250 deduction attributable to FDII is calculated in part by determining the foreign-derived portion of a corporation's deduction eligible income (“DEI”).
2. DEI is defined as the excess of gross DEI over the deductions (including taxes) properly allocable to such gross income. *See* § 250(b)(3)(A) and Treas. Reg. § 1.250(b)-1(c)(2). Gross DEI is determined without regard to domestic oil and gas extraction income (“DOGEI”), which is defined as income described in § 907(c)(1) determined by substituting “within the U.S.” for “without the U.S.” *See* §§ 250(b)(3)(B) and Treas. Reg. § 1.250(b)-1(c)(7).
3. Similarly, foreign oil and gas extraction income (“FOGEI”) as defined in § 907(c)(1) is excluded from the computation of gross tested income which is used to determine a U.S. shareholder's GILTI inclusion amount. *See* Treas. Reg. § 1.951A-2(c)(1)(v).
4. Treasury and the IRS believe that it would be inappropriate for taxpayers to use inconsistent methods to determine the amounts of DOGEI and FOGEI from the sale of oil or gas that has been transported or processed.

Taxpayers with both types of income may have an incentive to minimize their DOGEI in order to maximize their potential § 250 deduction attributable to FDII, while in contrast maximizing their FOGEI in order to minimize their gross tested income, even though this would also decrease the amount of the § 250 deduction attributable to their GILTI inclusion amount.

5. Accordingly, the proposed regulations provide that taxpayers must use a consistent method for purposes of determining both DOGEI and FOGEI. Prop. Treas. Reg. § 1.250(b)-1(c)(7). Similarly, for purposes of allocating and apportioning deductions, taxpayers are already required under existing regulations to use the same method of allocation and the same principles of apportionment where more than one operative section, for example §§ 250 and 904, apply. *See* Treas. Reg. § 1.861-8(f)(2)(i).

E. Definition of Electronically Supplied Service.

1. Treas. Reg. § 1.250(b)-5(c)(5) defines the term “electronically supplied service” to mean a general service (other than an advertising service) that is delivered primarily over the internet or an electronic network, and provides that such services include, by way of examples, cloud computing and digital streaming services.
2. Since the publication of the § 250 regulations, Treasury and the IRS have determined that the definition of electronically supplied services could be interpreted in a manner that includes services that were not primarily electronic and automated in nature but rather where the renderer applies human effort or judgment, such as professional services that are provided through the internet or an electronic network.
3. Therefore, these proposed regulations provide that the value of the service to the end user must be derived primarily from the service’s automation or electronic delivery in order to be an electronically supplied service.
4. The regulations further provide that services that primarily involve the application of human effort by the renderer to provide the service (not including the effort involved in developing or maintaining the technology to enable the electronic service) are not electronically supplied services. For example, certain services for which automation or electronic delivery is not a primary driver of value, such as legal, accounting, medical, or teaching services delivered electronically and synchronously, are not electronically supplied services.

F. Foreign-to-Foreign Reorganizations: E&P.

1. Treas. Reg. § 1.367(b)-7 provides rules regarding the manner and the extent to which earnings and profits and foreign income taxes of a foreign corporation carry over when one foreign corporation (“foreign acquiring

corporation”) acquires the assets of another foreign corporation (“foreign target corporation”) in a transaction described in § 381 (the combined corporation, the “foreign surviving corporation”). *See* Treas. Reg. § 1.367(b)-7(a). Before the repeal of § 902 in the TCJA, these rules were primarily relevant for determining the foreign income taxes of the foreign surviving corporation that were considered deemed paid by its U.S. shareholder regarding a distribution or inclusion under § 902 or 960, respectively.

2. Treas. Reg. § 1.367(b)-7 applies differently regarding “pooling corporations” and “nonpooling corporations.” A pooling corporation is a foreign corporation regarding which certain ownership requirements were satisfied in pre-2018 taxable years and that, as a result, maintained “pools” of post-1986 undistributed earnings and related post-1986 foreign income taxes. *See* Treas. Reg. § 1.367(b)-2(1)(9).
3. If the foreign surviving corporation was a pooling corporation, the post-1986 undistributed earnings and post-1986 foreign income taxes of the foreign acquiring corporation and the foreign target corporation were combined on a separate category-by-separate category basis. *See* Treas. Reg. § 1.367(b)-7(d)(1).
4. However, the regulations required the foreign surviving corporation to combine the taxes related to a deficit in a separate category of post-1986 undistributed earnings of one or both of the foreign acquiring corporation or foreign target corporation (a “hovering deficit”) with other post-1986 foreign income taxes in that separate category only on a pro rata basis as the hovering deficit was absorbed by post-transaction earnings in the same separate category. *See* Treas. Reg. § 1.367(b)-7(d)(2)(iii).
5. Similarly, a hovering deficit in a separate category of post-1986 undistributed earnings could offset only earnings and profits accumulated by the foreign surviving corporation after the § 381 transaction. Under Treas. Reg. § 1.367(b)-7(d)(2)(ii), the reduction or offset was generally deemed to occur as of the first day of the foreign surviving corporation’s first taxable year following the year in which the post-transaction earnings accumulated.
6. A nonpooling corporation is a foreign corporation that is not a pooling corporation and, as a result, maintains “annual layers” of pre-1987 accumulated profits and pre-1987 foreign income taxes. *See* Treas. Reg. § 1.367(b)-2(1)(10). A foreign surviving corporation maintains the annual layers of pre-1987 accumulated profits and pre-1987 foreign income taxes, and the taxes related to a deficit in an annual layer cannot be associated with post-§ 381 transaction earnings of the foreign surviving corporation.

7. As a result of the repeal of § 902 in the TCJA, post-1986 foreign income taxes and pre-1987 foreign income taxes of foreign corporations are generally no longer relevant for taxable years beginning on or after January 1, 2018. In addition, consistent with the TCJA, Treasury and the IRS issued regulations under § 960 clarifying that only current year taxes are taken into account in determining taxes deemed paid under § 960. See Treas. Reg. § 1.960-1(c)(2). Current year tax means certain foreign income tax paid or accrued by a controlled foreign corporation in a current taxable year. See Treas. Reg. § 1.960-1(b)(4).
8. In light of the changes made by the TCJA and subsequent implementing regulations, the proposed regulations provide rules to clarify the treatment of foreign income taxes of a foreign surviving corporation in taxable years of foreign corporations beginning on or after January 1, 2018, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end (“post-2017 taxable years”).
9. The proposed regulations provide that all foreign target corporations, foreign acquiring corporations, and foreign surviving corporations are treated as nonpooling corporations in post-2017 taxable years and that any amounts remaining in the post-1986 undistributed earnings and post-1986 foreign income taxes of any such corporation as of the end of the foreign corporation’s last taxable year beginning before January 1, 2018, are treated as earnings and taxes in a single pre-pooling annual layer in the foreign corporation’s post-2017 taxable years.
10. They also clarify that foreign income taxes that are related to non-previously taxed earnings of a foreign acquiring corporation and a foreign target corporation that were accumulated in taxable years before the current taxable year of the foreign corporation, or in a foreign target corporation’s taxable year that ends on the date of the § 381 transaction, are not treated as current year taxes (as defined in Treas. Reg. § 1.960-1(b)(4)) of a foreign surviving corporation in any post-2017 taxable year. Furthermore, the proposed regulations clarify that foreign income taxes related to hovering deficits are not current year taxes in the year that the hovering deficit is absorbed, in part because the hovering deficit is not considered to offset post-1986 undistributed earnings until the first day of the foreign surviving corporation’s first taxable year following the year in which the post-transaction earnings accumulated.
11. In addition, because these taxes were paid or accrued by a foreign corporation in a prior taxable year, they are not considered paid or accrued by the foreign corporation in the current taxable year and therefore are not current year taxes under Treas. Reg. § 1.960-1(b)(4). Finally, foreign income taxes related to a hovering deficit in pre-1987 accumulated profits generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to § 905(c);

therefore, these foreign income taxes are never included in current year taxes.

12. In addition to the proposed changes to Treas. Reg. § 1.367(b)-7, the proposed regulations remove some references to § 902 in other regulations issued under § 367(b) that are no longer relevant as a result of the repeal of § 902. For example, pursuant to Treas. Reg. § 1.367(b)-4(b)(2), a deemed dividend inclusion is required in certain cases upon the receipt of preferred stock by an exchanging shareholder, in order to prevent the excessive potential shifting of earnings and profits, notwithstanding that the exchanging shareholder's status as a § 1248 shareholder is preserved.
13. One of the conditions for application of the rule requires a domestic corporation to meet the ownership threshold of § 902(a) or (b) and, thus, be eligible for a deemed paid credit on distributions from the transferee foreign corporation. Treas. Reg. § 1.367(b)-4(b)(2)(i)(B). These proposed rules generally retain the substantive ownership threshold of this requirement, but without reference to § 902 and by modifying the ownership threshold requirement to consider not only voting power but value as well. Specifically, Treas. Reg. § 1.367(b)-4(b)(2)(i)(B) is revised to require that a domestic corporation owns at least 10% of the transferee foreign corporation by vote or value.
14. Treasury and the IRS requested comments as to whether further changes to Treas. Reg. § 1.367(b)-4 or 1.367(b)-7, or any changes to other regulations issued under § 367, are appropriate in order to clarify their application after the repeal of § 902. They also are studying the interaction of Treas. Reg. § 1.367(b)-4(b)(2) with § 245A and other Code provisions and considering whether additional revisions to the regulation are appropriate in light of TCJA generally.
15. Comments were specifically requested regarding the proposed revisions to Treas. Reg. § 1.367(b)-4(b)(2), including whether there is a continuing need to prevent excessive potential shifting of earnings and profits through the use of preferred stock in light of the TCJA generally. For example, Treasury and the IRS are considering, and request comments on, the extent to which, in certain transactions described in Treas. Reg. § 1.367(b)-4(b)(2), (1) an exchanging shareholder who would not qualify for a deduction under § 245A could potentially shift earnings and profits of a foreign acquired corporation to a transferee foreign corporation with a domestic corporate shareholder that would qualify for a deduction under § 245A, or (2) a domestic corporate exchanging shareholder of a foreign acquired corporation with no earnings and profits could access the earnings and profits of a transferee foreign corporation.

G. Source of Inclusions Under §§ 951, 951A, 1293, and Associated § 78 Dividend.

1. Sections 861(a) and 862(a) contain rules to determine the source of certain items of gross income. Section 863(a) provides that the source of items of gross income not specified in §§ 861(a) and 862(a) will be determined under regulations prescribed by the Secretary. As a result of changes to § 960 made by the TCJA, Treasury and the IRS revised the regulations under § 960.
2. As part of that revision, Treasury and the IRS removed former Treas. Reg. § 1.960-1(h)(1), which contained a source rule for the amount included in gross income under § 951 and the associated § 78 dividend. Treas. Reg. § 1.960-1(h)(1) provided that, for purposes of § 904, the amount included in gross income of a domestic corporation under § 951 regarding a foreign corporation, plus any § 78 dividend to which such § 951 inclusion gave rise by reason of taxes deemed paid by such domestic corporation, was derived from sources within the foreign country or possession of the U.S. under the laws of which such foreign corporation, or the first-tier corporation in the same chain of ownership as such foreign corporation, was created or organized.
3. Although § 904(h)(1) treats as from sources within the U.S. certain amounts included in gross income under § 951(a) that otherwise would be treated as derived from sources without the U.S., absent former Treas. Reg. § 1.960-1(h)(1), there is no rule that specifies the source of inclusions under § 951 before the application of § 904(h)(1). In addition, the rule in former Treas. Reg. § 1.960-1(h)(1) only provided for the source of a domestic corporation's § 951 inclusions for purposes of § 904.
4. A similar lack of guidance exists regarding the source of inclusions under § 951A. *See* § 951A(f)(1)(A) (requiring the application of § 904(h)(1) regarding amounts included in gross income under § 951A(a) in the same manner as amounts included under § 951(a)(1)(A)). The removal of former Treas. Reg. § 1.960-1(h)(1) also left uncertain the source of amounts included in gross income as a result of an election under § 1293(a), because under § 1293(f)(1), such amounts are treated for purposes of § 960 as amounts included in gross income under § 951(a).
5. To clarify the source of income inclusions after the removal of former Treas. Reg. § 1.960-1(h)(1), the proposed regulations include a new rule in Treas. Reg. § 1.861-3(d), which provides that for purposes of the sourcing provisions an amount included in the gross income of a U.S. person under § 951 is treated as a dividend received by the U.S. person directly from the foreign corporation that generated the inclusion.
6. This proposed rule differs from former Treas. Reg. § 1.960-1(h)(1). First, former Treas. Reg. § 1.960-1(h)(1) provided that if the foreign corporation



that generated the income included under § 951 was held indirectly through other foreign corporations, the amount included was treated as if it had been paid through such intermediate corporations and as received from the first-tier foreign corporation. Treasury and the IRS believe that, in light of the repeal of § 902, and because a § 951 inclusion regarding a lower-tier CFC is not treated as a deemed distribution through the first-tier CFC, the source of the inclusion should be determined by reference to the lower-tier CFC.

7. Second, former Treas. Reg. § 1.960-1(h)(1) treated the entire amount of the inclusion under § 951 as derived from sources without the U.S. However, Treasury and the IRS believe that because dividends and inclusions of the same earnings and profits should be sourced in the same manner, the general rule for inclusions under § 951 should be consistent with the rule in § 861(a)(2)(B) and Treas. Reg. § 1.861-3(a)(3) that treats dividends as derived from sources within the U.S. to the extent that the dividend is from a foreign corporation with significant income effectively connected with the conduct of a trade or business in the U.S.
8. This is particularly appropriate in circumstances in which effectively connected income is not excluded from subpart F income under § 952(b) (which could arise as a result of a treaty obligation of the U.S. precluding the effectively connected income from being taxed by the U.S. in the hands of the CFC).
9. Treasury and the IRS also believe that the source of a taxpayer's gross income from an inclusion of CFC earnings that are subject to a high rate of foreign tax should be the same, regardless of whether the taxpayer includes the income under subpart F or elects the high-taxed exception of § 954(b)(4) and repatriates the earnings as a dividend. Therefore, the proposed regulations provide that the source of an inclusion under § 951 is determined under the same rules as those for dividends. However, the resourcing rules in § 904(h) and Treas. Reg. § 1.904-5(m) independently operate to ensure that dividends and inclusions under § 951(a) that are attributable to U.S. source income of the CFC retain that U.S. source in the hands of the U.S. shareholder.
10. The proposed regulations also provide that the source of § 78 dividends associated with inclusions under § 951 follows the rules for sourcing dividends. *See also* Treas. Reg. § 1.78-1(a).
11. Finally, and consistent with §§ 951A(f)(1)(A) and 1293(f)(1), the proposed regulations apply the same rules regarding inclusions under §§ 951A and 1293 and the associated § 78 dividend.

H. Allocation and Apportionment of Expenses Under § 861 Regulations.

I. Election to Capitalize R&E and Advertising Expenditures.

1. The preamble to the 2019 FTC proposed regulations stated that Treasury and the IRS continue to study the rules for allocating and apportioning interest deductions, and requested comments on a potential proposal to provide for the capitalization and amortization of certain expenses solely for purposes of Treas. Reg. § 1.861-9 to better reflect asset values under the tax book value method. One comment supported the adoption of such a rule.
2. Treasury and the IRS recognize that internally-developed intangible assets (including intangible assets such as goodwill that are created as a result of advertising) that have no tax book value because the costs of generating them have been currently deducted may nevertheless have continuing economic value, and that debt financing may support the generation and maintenance of that value. Accordingly, Prop. Treas. Reg. § 1.861-9(k) provides an election for taxpayers to capitalize and amortize their research and experimental (“R&E”) and advertising expenditures incurred in a taxable year.
3. This election is analogous to the election under Treas. Reg. § 1.861-9(i) to determine asset values based on the alternative tax book value method, since both elections allow taxpayers to determine the tax book value of an asset in a manner that is different from the general rules that apply under Federal income tax law, but solely for purposes of allocating and apportioning interest expense under Treas. Reg. § 1.861-9, and not for any other Federal income tax purpose (such as determining the amount of any deduction actually allowed for depreciation or amortization).
4. Prop. Treas. Reg. § 1.861-9(k)(1) and (2) generally provides that for purposes of allocating and apportioning interest expense under Treas. Reg. § 1.861-9, an electing taxpayer capitalizes and amortizes its R&E expenditures under the rules in § 174, which will require that beginning in taxable years beginning in 2022, R&E expenditures must be capitalized and then amortized (if it ever becomes effective).
5. Similarly, Prop. Treas. Reg. § 1.861-9(k)(1) and (3) generally requires an electing taxpayer to capitalize and amortize its advertising expenditures. The definition of advertising expenditures and the method of cost recovery contained in Prop. Treas. Reg. § 1.861-9(k)(3) is based on prior legislative proposals (which were not enacted) proposing that certain advertising expenditures be capitalized. Comments were requested on whether a different definition of advertising expenditures or a different method of cost recovery should be adopted for purposes of the election in Prop. Treas. Reg. § 1.861-9(k).

J. Nonrecourse Debt of Certain Utility Companies.

1. Temp. Treas. Reg. § 1.861-10T provides certain exceptions to the general asset-based apportionment of interest expense requirement under § 864(e)(2), including rules that directly allocate interest expense to the income generated by certain assets that are subject to “qualified nonrecourse indebtedness.” Temp. Treas. Reg. § 1.861-10T(b).
2. A comment to the 2019 FTC proposed regulations said that interest expense incurred on certain debt of regulated utility companies should be directly allocated to income from assets of the utility business because the debt must be approved by a regulatory agency and relates directly to the underlying needs of the utility business. The comment suggested that the existing rules for qualified nonrecourse indebtedness were insufficient because utility indebtedness is often subject to guarantees and cross collateralizations that permit the lender to seek recovery beyond any identified property, and because the cash flows of a regulated utility company used to support utility indebtedness are broader than the permitted cash flows described in Temp. Treas. Reg. § 1.861-10T(b).
3. In response to this comment, the proposed regulations provide that certain interest expense of regulated utility companies is directly allocated to assets of the utility business. Prop. Treas. Reg. § 1.861-10(f). The type of utility companies that qualify for the rule, and the rules for tracing debt to assets, are modeled on similar rules provided in regulations under § 163(j). Treas. Reg. §§ 1.163(j)-1(b)(15) and 1.163(j)-10(d)(2).
4. Consistent with the approach taken in Treas. Reg. § 1.163(j)-10(d)(2), the proposed regulations expand the scope of permitted cash flows under Temp. Treas. Reg. § 1.861-10T(b) but do not modify the requirement that the creditor look to particular assets as security for payment on the loan because unsecured debt generally is supported by all of the assets of the borrower.

K. Revision to CFC Netting Rule Relating to CFC-to-CFC Loans.

1. Treas. Reg. § 1.861-10(e)(8)(v) provides that for purposes of applying the CFC netting rule of Treas. Reg. § 1.861-10(e), certain loans made by one CFC to another CFC are treated as loans made by a U.S. shareholder to the borrower CFC, to the extent the U.S. shareholder makes capital contributions directly or indirectly to the lender CFC, and are treated as related group indebtedness. No income derived from the U.S. shareholder’s ownership of the lender CFC stock is treated as interest income derived from related group indebtedness, including subpart F inclusions related to the interest income earned by the lender CFC.

2. As a result, no interest expense is allocated to income related to the CFC-to-CFC debt, but the debt may nevertheless increase the amount of allocable related group indebtedness for which a reduction in assets is required under Treas. Reg. § 1.861-10(e)(7).
3. Treasury and the IRS believe that the failure to account for income related to the CFC-to-CFC debt can distort the general allocation and apportionment of other interest expense under Treas. Reg. § 1.861-9. Therefore, the proposed regulations revise Treas. Reg. § 1.861-10(e)(8)(v) to provide that CFC-to-CFC debt is not treated as related group indebtedness for purposes of the CFC netting rule.
4. Prop. Treas. Reg. § 1.861-10(e)(8)(v) also provides that CFC-to-CFC debt is not treated as related group indebtedness for purposes of determining the foreign base period ratio, which is based on the average of related group debt-to-asset ratios in the five prior taxable years, even if the CFC-to-CFC debt was otherwise properly treated as related group indebtedness in a prior year.
5. This is necessary to prevent distortions that would otherwise arise in comparing the ratio in a year in which CFC-to-CFC debt was treated as related group indebtedness to the ratio in a year in which the CFC-to-CFC debt is not treated as related group indebtedness.

L. Direct Allocation of Interest Expense for Foreign Bank Branches.

1. Under Treas. Reg. §§ 1.861-8 through 1.861-13, the combined interest expense of a domestic corporation and its foreign branches is allocated and apportioned to income categories on the basis of the tax book value of their combined assets. Comments received regarding the 2018 and 2019 FTC proposed regulations said that special rules were needed for financial institutions for allocating and apportioning interest expense to foreign branch category income. The comments said that the general approach under Treas. Reg. §§ 1.861-8 through 1.861-13 fails to take into account the fact that foreign branches of financial institutions have assets and liabilities that reflect interest rates that differ from interest rates related to assets and liabilities of the home office held in the U.S. As a result, the general approach results in over- or under-allocation of interest expense to the foreign branch category income.
2. In response to this comment, the proposed regulations provide that interest expense reflected on a foreign banking branch's books and records is directly allocated against the foreign branch category income of that foreign branch, to the extent it has foreign branch category income. The proposed regulations also provide for a corresponding reduction in the value of the assets of the foreign branch for purposes of allocating other

interest expense of the foreign branch owner. Prop. Treas. Reg. § 1.861-10(g).

3. Comments were requested as to whether additional rules are needed to account for disregarded interest payments between foreign branches and between a foreign branch and a foreign branch owner. Comments were also requested as to whether adjustments to the amount of foreign branch liabilities subject to this rule are necessary to account for differing asset-to-liability ratios in a foreign branch and a foreign branch owner.

M. Treatment of § 818(f) Expenses for Consolidated Groups.

1. Section 818(f)(1) provides that a life insurance company's deduction for life insurance reserves and certain other deductions (“§ 818(f) expenses”) are treated as items which cannot definitely be allocated to an item or class of gross income. Prop. Treas. Reg. § 1.861-14(h) in the 2019 FTC proposed regulations provided that § 818(f) expenses are allocated and apportioned on a separate company basis instead of on a life subgroup basis. In the 2020 FTC final regulations, this rule was withdrawn in response to comments. Treasury and the IRS have determined that there are merits and drawbacks to both the separate company and the life subgroup approaches.
2. The proposed regulations provide that § 818(f) expenses must be allocated and apportioned on a life subgroup basis, but that a one-time election is allowed for consolidated groups to choose instead to apply a separate company approach. A consolidated group's use of the separate entity method constitutes a binding choice to use the method chosen for that year for all members of the group and all taxable years thereafter.

N. Allocation and Apportionment of Foreign Income Taxes.

1. Background.

- (a) The new proposed regulations repropose certain of the 2019 FTC proposed regulations in order to provide more detailed and comprehensive guidance regarding the assignment of foreign gross income, and the allocation and apportionment of the associated foreign income tax expense, to the statutory and residual groupings in certain cases. Comments to the 2019 FTC proposed regulations had requested more detailed guidance regarding the assignment to the statutory and residual groupings of foreign gross income arising from transactions that are dispositions of stock under Federal income tax law.
- (b) In response to these comments, Treasury and the IRS believe that it is appropriate to propose a comprehensive set of rules for dispositions of both stock and partnership interests, as well as rules

that, similar to rules in the 2020 FTC final regulations for distributions regarding stock, provide detailed rules for transactions that are distributions regarding a partnership interest under Federal income tax law.

- (c) The proposed regulations also address comments requesting that the rules for the assignment to the statutory and residual groupings of foreign gross income arising from disregarded payments distinguish between disregarded payments that would be deductible if regarded under Federal income tax law and disregarded payments that would, if the payor (or recipient) were a corporation under Federal income tax law, be distributions regarding stock or contributions to capital.

## 2. Dispositions of Stock.

- (a) Prop. Treas. Reg. § 1.861-20(d)(3)(i)(D) contains rules assigning to statutory and residual groupings the foreign gross income and associated foreign tax that arise from a transaction that is treated for Federal income tax purposes as a sale or other disposition of stock. These rules assign the foreign gross income first to the statutory and residual groupings to which any U.S. dividend amount, a term that applies in the disposition context when there is an amount of gain to which § 1248(a) or 964(e) applies, is assigned, to the extent thereof. Foreign gross income is next assigned to the grouping to which the U.S. capital gain amount is assigned, to the extent thereof.
- (b) Any excess of the foreign gross income recognized by reason of the transaction over the sum of the U.S. dividend amount and the U.S. capital gain amount is assigned to the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the stock is (or would be if the taxpayer were a U.S. person) assigned to the groupings under the rules of Treas. Reg. § 1.861-9(g) in the U.S. taxable year in which the disposition occurs.
- (c) This rule, which uses the asset apportionment percentages of the tax book value of the stock as a surrogate for earnings of the corporation that are not recognized for U.S. tax purposes, associates foreign tax on a U.S. return of capital amount (that is, foreign tax on foreign gain in excess of the amount of gain recognized for U.S. tax purposes) with the same groupings to which the tax would be assigned under Treas. Reg. § 1.861-20(d)(3)(i)(B)(2) of the 2020 FTC final regulations if the item of foreign gross income arose from a distribution made by the corporation, rather than a sale or other disposition of the stock.

- (d) Treasury and the IRS believe that it is appropriate to treat foreign tax on a U.S. return of capital amount resulting from a distribution as a timing difference in the recognition of corporate earnings. The proposed regulations use the same rule in the case of a foreign tax on a U.S. return of capital amount resulting from a disposition of stock. Treasury and the IRS believe that this result is appropriate because a foreign country generally recognizes more gain on a disposition of stock than is recognized for U.S. tax purposes when the shareholder's tax basis in the stock is greater for U.S. tax purposes than for foreign tax purposes, and this disparity typically occurs when the shareholder's U.S. tax basis in the stock has been increased under § 961 to reflect subpart F or GILTI inclusions of earnings attributable to the stock.
- (e) Comments were requested on whether other situations more commonly result in this disparity, such that different rules might be appropriate for distributions and sales in order to better match foreign tax on income included in the foreign tax base with income included in the U.S. tax base.

3. Partnership Transactions.

- (a) The proposed regulations contain new rules on the treatment of distributions from partnerships and sales of partnership interests, including partnerships that are treated as corporations for foreign law purposes. In general, these rules follow similar principles as the rules for distributions from corporations and sales of stock.
- (b) The rule in Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(B), like the rule for assigning foreign tax on a return of capital regarding stock, uses the asset apportionment percentages of the tax book value of the partner's distributive share of the partnership's assets (or, in the case of a limited partner with less than a 10% interest, the tax book value of the partnership interest) 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. Prop. Treas. Reg. § 1.861-20(d)(3)(ii)(C) similarly associates foreign tax on a U.S. return of capital amount in connection with the sale or other disposition of a partnership interest with a hypothetical distributive share.
- (c) Treasury and the IRS believe that this rule is appropriate because foreign tax on a return of capital distribution from a partnership most commonly occurs in the case of hybrid partnerships (that is, entities that are treated as partnerships for U.S. tax purposes but as corporations for foreign tax purposes). In this case, earnings that have been recognized and capitalized into basis by the partner for

U.S. tax purposes as a distributive share of income in prior years are not subject to foreign tax until the earnings are distributed.

- (d) Similarly, the higher U.S. tax basis in an interest in a hybrid partnership accounts for the most common cases where the amount of foreign gross income that results from a sale of a partnership interest exceeds the amount of taxable gain for U.S. tax purposes.
- (e) Comments were requested on whether a different ordering rule or matching convention may better match foreign tax on income included in the foreign tax base with income included in the U.S. tax base. Comments were also requested on whether special rules are needed to associate foreign gross income and the associated foreign tax on distributions from partnerships and sales of partnership interests with items that are subject to special treatment for U.S. tax purposes (such as gain recharacterized as ordinary income under § 751).

4. Disregarded Payments.

5. Background. The proposed regulations contain a new comprehensive set of rules addressing the allocation and apportionment of foreign income taxes relating to disregarded payments. In general, the 2019 FTC proposed regulations assigned foreign gross income included by reason of a disregarded payment by a branch owner to the residual grouping and assigned foreign gross income included by reason of a disregarded payment by a branch to its owner by reference to the asset apportionment percentages of the tax book value of the branch assets in the statutory and residual groupings. Comments said that this rule, in the context of § 960, could lead to the assignment of foreign income taxes to the residual grouping rather than a grouping to which an inclusion under § 951 or 951A is attributable, resulting in the disallowance of foreign tax credits. Comments requested that, for purposes of assigning foreign gross income included by reason of a disregarded payment to a statutory or residual grouping, the rule should identify disregarded payments that should be treated as made out of current earnings, and distinguish those payments from other types of disregarded payments.

6. Reattribution Payments.

- (a) Prop. Treas. Reg. § 1.861-20(d)(3)(v) contains new rules that assign foreign gross income arising from the receipt of disregarded payments and the associated foreign tax to the recipient's statutory and residual groupings based on the current or accumulated income of the payor (as computed for U.S. tax purposes) out of which the disregarded payment is considered to be made.



- (b) For this purpose, the regulations refer to disregarded payments made to or by a taxable unit. In the case of a taxpayer that is an individual or a domestic corporation, a taxable unit means a foreign branch, a foreign branch owner, or a non-branch taxable unit, as defined in Prop. Treas. Reg. § 1.904-4(f)(3). In the case of a taxpayer that is a foreign corporation, a taxable unit means a tested unit as that term is defined in Prop. Treas. Reg. § 1.954-1(d)(2), as contained in proposed regulations addressing the high-tax exception under § 954(b)(4) proposed on July 23, 2020 (the “2020 HTE proposed regulations”). Prop. Treas. Reg. §§ 1.861-20(d)(3)(v)(A) and 1.861-20(d)(3)(v)(E)(10).
- (c) Prop. Treas. Reg. § 1.861-20(d)(3)(v)(B)(1) addresses the assignment of foreign gross income that arises from the portion of a disregarded payment that results in a reattribution of U.S. gross income from the payor taxable unit to the recipient taxable unit. Under Prop. Treas. Reg. § 1.861-20(d)(3)(v)(B)(1), the foreign gross income is assigned to the statutory and residual groupings to which the amount of U.S. gross income that is reattributed (a “reattribution amount”) is initially assigned upon receipt of the disregarded payment by a taxable unit, before taking into account reattribution payments made by the recipient taxable unit.
- (d) For this purpose, under Prop. Treas. Reg. § 1.861-20(d)(3)(v)(B)(2), in the case of a taxpayer that is an individual or a domestic corporation, the attribution rules in Treas. Reg. § 1.904-4(f)(2) apply to determine the § 904 separate categories of reattribution amounts received by foreign branches, foreign branch owners, and non-branch taxable units.
- (e) In the case of a taxpayer that is a foreign corporation, the attribution rules in Prop. Treas. Reg. § 1.954-1(d)(1)(iii) (as contained in the 2020 HTE proposed regulations) apply to determine the reattribution amounts received by a tested unit in the tested income and subpart F income groupings of its tested units for purposes of the applying the high-tax exception of § 954(b)(4). Under Prop. Treas. Reg. § 1.861-20(d)(3)(v)(B)(2), the rules in the 2020 HTE proposed regulations for attributing U.S. gross income to tested units also apply to attribute items of foreign gross income to tested units for purposes of allocating and apportioning the associated foreign income taxes in computing the amount of an inclusion and deemed-paid taxes under §§ 951, 951A, and 960.
- (f) For purposes of applying all other operative sections, the U.S. gross income that is attributable to a taxable unit is determined under the principles of the foreign branch category rules (for U.S.

taxpayers) or the high-tax exception rules (for foreign corporations).

- (g) The foreign branch category rules of Treas. Reg. § 1.904-4(f)(2) attribute U.S. gross income to taxable units on the basis of books and records, as modified to reflect Federal income tax principles, and reattribute U.S. gross income between the general category and the foreign branch category by reason of certain disregarded payments between a foreign branch and its owner, or another foreign branch, that would be deductible if regarded for Federal income tax purposes.
- (h) The reattribution is made by reference to the statutory and residual groupings of the payor to which the disregarded payment would be allocated and apportioned if it were regarded for Federal income tax purposes.
- (i) Prop. Treas. Reg. § 1.954-1(d)(1)(iii), as contained in the 2020 HTE proposed regulations, uses the principles of Treas. Reg. § 1.904-4(f)(2) for purposes of assigning U.S. gross income to tested units of a controlled foreign corporation for purposes of the high-tax exception. However, although Treas. Reg. § 1.904-4(f)(2)(vi) does not treat disregarded interest payments as a disregarded reallocation transaction, under Prop. Treas. Reg. § 1.954-1(d)(1)(iii)(B) of the 2020 HTE proposed regulations, disregarded interest payments are treated as reattribution payments to the extent they are deductible for foreign law purposes in the country where the payor taxable unit is a tax resident.
- (j) Prop. Treas. Reg. § 1.954-1(d)(1)(iii)(B)(4) provides that these disregarded interest payments are treated as made ratably out of the payor's current year U.S. gross income to the extent thereof, and provides ordering rules when the same taxable unit both makes and receives disregarded interest payments. Comments were requested on additional ordering rules that should be included in the final regulations, including rules that apply when multiple taxable units both make and receive disregarded payments, such as rules for determining the starting point for assigning reattribution payments received by taxable units, and the order in which particular types of disregarded payments made by taxable units are allocated and apportioned to U.S. gross income (including income attributable to reattribution payments received by the payor taxable unit) of the payor taxable unit.
- (k) In addition, because Prop. Treas. Reg. § 1.861-20(d)(3)(v) more clearly coordinates with the provisions in Prop. Treas. Reg. § 1.954-1(d)(1), the proposed regulations propose to update Prop.

Treas. Reg. § 1.954-1(d)(1)(iv)(A) (as contained in the 2020 HTE proposed regulations) to provide that the rules in Treas. Reg. § 1.861-20 (rather than the principles of Treas. Reg. § 1.904-6(b)(2)) apply in the case of disregarded payments. In order to achieve consistency with the new tested unit rules in Prop. Treas. Reg. § 1.954-1(d) and taxable unit rules in Treas. Reg. § 1.861-20(d)(3)(v), the proposed regulations also contain a modification to the high-tax kickout rules in Treas. Reg. § 1.904-4(c)(4) to provide that the grouping rules at the CFC level are applied on a tested unit (instead of foreign QBU) basis.

- (l) Prop. Treas. Reg. § 1.861-20(d)(3)(v)(B)(3) provides that the statutory or residual grouping to which foreign gross income of a taxable unit (including foreign gross income that arises from the receipt of a disregarded payment) is assigned is determined without regard to reattribution payments made by the taxable unit, and that no item of foreign gross income is reassigned to another taxable unit by reason of a reattribution payment that reattributes U.S. gross income of the payor taxable unit to another taxable unit by reason of such reattribution payments.
- (m) Under this rule, if foreign gross income is associated under Treas. Reg. § 1.861-20(d)(1) with a corresponding U.S. item initially attributed to a payor taxable unit, that foreign gross income is always assigned to the grouping that includes the U.S. gross income of that payor taxable unit.
- (n) The effect of this rule and Prop. Treas. Reg. § 1.861-20(d)(3)(v)(B)(1) is to allocate and apportion foreign tax imposed on foreign gross income that is associated either with a corresponding U.S. item that is initially attributed to a payor taxable unit or with a reattribution amount that is attributed to a recipient taxable unit (before taking into account reattribution payments made by the recipient taxable unit) to the grouping that includes the U.S. gross income of the taxable unit that paid the foreign tax; no portion of the foreign tax is associated with U.S. gross income that is reattributed to another taxable unit by reason of a reattribution payment.
- (o) In the case of foreign income tax imposed on the basis of foreign taxable income for a taxable period (that is, net basis taxes), this rule will generally produce appropriate results because foreign gross income of a taxable unit will generally be reduced by foreign law deductions for disregarded payments made by that taxable unit. Thus, the amount of the payor's foreign taxable income will approximate the amount of U.S. taxable income attributed to the

taxable unit after accounting for reattribution payments made and received by that taxable unit.

- (p) Foreign gross basis taxes (such as withholding taxes) imposed on foreign gross income of a taxable unit, if not reassigned along with the associated U.S. gross income that is reattributed to another taxable unit as the result of a reattribution payment, however, may in some cases distort the effective foreign tax rate of the payor taxable unit.
- (q) Treasury and the IRS believe that rules reattributing foreign gross basis taxes among taxable units by reason of reattribution payments would require complex ordering rules that would be unduly burdensome for taxpayers to apply and for the IRS to administer. Comments were requested on whether the final regulations should include different rules, including anti-abuse rules, to account for the assignment of foreign gross basis taxes paid by taxable units that make disregarded payments.

7. Remittances and Contributions.

- (a) Similar to the rules in the 2019 FTC proposed regulations, Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(i) assigns foreign gross income that arises from a disregarded payment that is treated as a remittance for U.S. tax purposes by reference to the statutory and residual groupings to which the assets of the payor taxable unit are assigned (or would be assigned if the taxable unit were a U.S. person) under the rules of Treas. Reg. § 1.861-9 for purposes of apportioning interest expense.
- (b) This rule uses the payor's asset apportionment percentages as a proxy for the accumulated earnings of the payor taxable unit from which the remittance is made. Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii) provides that for this purpose the assets of the taxable unit making the remittance are determined in accordance with the rules of Treas. Reg. § 1.987-6(b) that apply in determining the source and separate category of exchange gain or loss on a § 987 remittance, as modified in two respects.
- (c) First, for purposes of Treas. Reg. § 1.860-20(d)(3)(v)(C)(1)(i) the assets of the remitting taxable unit include stock owned by the taxable unit, even though for purposes of § 987 such stock may be treated as owned directly by the owner of the taxable unit. This rule is intended to help ensure that foreign tax on remittances are properly associated with earnings of corporations that may be distributed through the taxable unit.

- (d) Second, Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(1)(ii) modifies the determination of assets under Treas. Reg. § 1.987-6(b)(2) to provide that the assets of a taxable unit that give rise to U.S. gross income that is assigned to another taxable unit by reason of a reattribution payment are treated as assets of the recipient taxable unit. Treasury and the IRS believe that reassigning the tax book value of assets among taxable units in proportion to the U.S. gross income attributed to a taxable unit, after taking into account all reattribution payments made and received by the taxable unit, for purposes of determining the statutory and residual groupings to which foreign tax on a remittance is assigned is appropriate to properly match the foreign tax with the accumulated earnings out of which the remittance is made.
- (e) In addition, because it uses asset values that are already required to be computed and maintained for other Federal income tax purposes, Treasury and the IRS believe this reattribution rule is less complicated to apply than a rule that would treat disregarded assets and liabilities as if they were regarded for U.S. tax purposes in applying this rule.
- (f) However, they acknowledge that any asset method for associating foreign gross income included by the remittance recipient with the payor's accumulated earnings may lead to inexact determinations of the groupings of the accumulated earnings out of which a remittance is paid, particularly when a taxable unit makes a remittance in conjunction with reattribution payments. The potential for distortions exist to the extent the tax book value of assets does not reflect their income-producing value, as in the case of self-developed intangibles the costs of which are currently expensed, as well as to the extent the characterization of the tax book value of an asset based on the income generated by the asset in the current taxable year does not reflect the characterization of the income generated by the asset over time.
- (g) Comments were requested on whether a different method of determining the statutory and residual groupings to which a remittance is assigned, such as the maintenance of historical accounts of accumulated earnings of taxable units, including adjustments to reflect disregarded payments among taxable units, could produce more accurate results without unduly increasing administrative burdens.
- (h) Similar to the rule in the 2019 FTC proposed regulations, Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(2) provides that foreign gross income and the associated foreign tax that arise from the receipt of a contribution are assigned to the residual category, except as

provided under the rules for an operative section (such as under Prop. Treas. Reg. § 1.904-6(b)(2)(ii), which assigns foreign tax on contributions to a foreign branch to the foreign branch category). Prop. Treas. Reg. § 1.861-20(d)(3)(v)(E)(2) defines a contribution as a disregarded transfer of property that would be treated as a transaction described in § 118 or 351 if the recipient taxable unit were treated as a corporation for Federal income tax purposes, or the excess amount of a disregarded payment made to a taxable unit that the payor unit owns over the amount that is treated as a reattribution payment.

- (i) Foreign tax paid by a foreign corporation that is allocated and apportioned to the residual category is not eligible to be deemed paid under § 960. *See* Treas. Reg. § 1.960-1(e). However, because Prop. Treas. Reg. § 1.861-20(d)(3)(v) treats most disregarded payments as reattribution payments or remittances, and contributions (as characterized for corporate law purposes) are rarely subject to foreign tax, Treasury and the IRS believe this rule will have limited application.
- (j) Prop. Treas. Reg. § 1.861-20(d)(3)(v)(C)(3) provides an ordering rule attributing the amount of foreign gross income that arises from the receipt of a disregarded payment that includes both a reattribution payment and a remittance or contribution first to the portion of the disregarded payment that is a reattribution payment. Any excess amount of the foreign gross income item is attributed to the portion of the disregarded payment that is a remittance or contribution.
- (k) In addition, Prop. Treas. Reg. § 1.861-20(d)(2)(ii)(D) provides that if an item of foreign gross income arises from an event that for foreign law purposes is treated as a distribution, contribution, accrual, or payment between taxable units, but that is not treated as a disregarded payment for Federal income tax purposes (for example, a consent dividend from a disregarded entity), the foreign gross income and associated foreign tax are assigned in the same way as if a transfer of property in the amount of the foreign gross income item resulted in a disregarded payment in the year the foreign tax is paid or accrued.
- (l) Finally, in light of the heightened importance of the rules in Treas. Reg. § 1.904-4(f), which are being applied in connection with Treas. Reg. § 1.861-20 as well as the high-tax exception rules in Treas. Reg. § 1.951A-2(c)(7), the proposed regulations include some technical changes to the rules in Treas. Reg. § 1.904-4(f) that will facilitate this interaction.

8. Disregarded Payments Regarding Disregarded Sales of Property.
- (a) Prop. Treas. Reg. § 1.861-20(d)(3)(v)(D) provides that an item of foreign gross income attributable to gain recognized under foreign law by reason of a disregarded payment received in exchange for property is characterized and assigned under Treas. Reg. § 1.861-20(d)(2)(ii)(A) of the 2020 FTC final regulations, that is, as a timing difference in the taxation of the property's built-in gain.
  - (b) Prop. Treas. Reg. § 1.861-20(d)(3)(v)(D) further provides that if a taxpayer recognizes U.S. gross income as a result of a disposition of property that was previously received in exchange for a disregarded payment, any item of foreign gross income that the taxpayer recognizes as a result of that same disposition is assigned to a statutory or residual grouping under the U.S. corresponding item rules in Treas. Reg. § 1.861-20(d)(1) of the 2020 FTC final regulations.
  - (c) In this situation the seller's basis in the property initially acquired in a disregarded sale is not adjusted for U.S. tax purposes, but is assumed to reflect the purchase price for foreign tax purposes. Thus, the assignment of the foreign gross income resulting from the regarded sale of the property is made without regard to any reattribution of the gain that is recognized for U.S. tax purposes under Treas. Reg. § 1.904-4(f)(2)(vi)(A) or (D), which apply to attribute U.S. gross income in the amount of the property's built-in gain at the time of the initial acquisition to the foreign branch or foreign branch owner that originally transferred the property in the disregarded sale. The same result obtains regarding all taxable units under Prop. Treas. Reg. § 1.861-20(d)(3)(v)(B)(3).
9. Group-Relief Regimes. Treasury and the IRS expressed a concern about the use of certain foreign law group-relief regimes (that is, regimes that allow for the sharing of losses of one member of a group with another member) to create a mismatch in how foreign income taxes are characterized under Treas. Reg. § 1.861-20 for purposes of various operative sections, including §§ 245A(d), 904, and 960. Comments were requested on the appropriate treatment of foreign income taxes paid or accrued in connection with the sharing of losses.
- O. Creditability of Foreign Taxes Under §§ 901 and 903.
- P. Definition of Foreign Income Tax.
- 1. Background and Overview.
    - (a) Treasury and the IRS believe that it is necessary and appropriate to require that a foreign tax conform to traditional international norms

of taxing jurisdiction as reflected in the Code in order to qualify as an income tax in the U.S. sense, or as a tax in lieu of an income tax. This requirement will ensure that the foreign tax credit operates in accordance with its purpose to mitigate double taxation of income that is attributable to a taxpayer's activities or investment in a foreign country.

- (b) They also believe that it is necessary and appropriate to revise the net gain requirement in order to better align the regulatory tests with norms reflected in the Code that define an income tax in the U.S. sense, as well as to simplify and clarify the application of the rules. In particular, the existing regulations provide that the net gain requirement is met if a foreign tax reaches net gain in the “normal circumstances” in which it applies.
- (c) However, this rule leads to inappropriate results and presupposes an empirical analysis requiring access to information that is difficult for taxpayers and the IRS to obtain. Therefore, the proposed regulations narrow the situations in which an empirical analysis is relevant in analyzing the nature of a foreign tax.
- (d) The proposed regulations make other changes to improve or clarify the rules, and to address issues that have arisen since the 1983 final foreign tax credit creditability regulations were issued. In particular, the proposed regulations introduce the term “net income tax” to describe foreign levies described in § 901 and the term “foreign income tax” to describe foreign levies described in § 901 or 903. Conforming changes to the terms and definitions cross-referenced in other regulations will be made when the proposed regulations are finalized.
- (e) The proposed regulations specifically address the treatment of surtaxes and the circumstances in which a source-based withholding tax on cross-border income can qualify as a foreign income tax. The proposed regulations also reorganize the existing regulations to address so-called “soak-up” taxes as part of the determination of the amount of tax paid, rather than as part of the definition of a foreign income tax, and clarify the rules for determining when a foreign tax is a separate levy. The proposed regulations addressing the amount of tax paid also modify the treatment of refundable credits, clarify the interaction between the rules addressing refundable amounts and multiple levies, and clarify the application of the noncompulsory payment rules regarding foreign tax law elections. Finally, the proposed regulations revise the definition of a tax in lieu of an income tax.



- (f) The proposed regulations do not include proposed amendments to the rules in Treas. Reg. § 1.901-2A addressing dual capacity taxpayers. However, certain proposed changes to Treas. Reg. §§ 1.901-2 and 1.903-1 may impact Treas. Reg. § 1.901-2A. For example, when the proposed regulations are finalized, certain terms that are defined in Treas. Reg. § 1.901-2 and cross-referenced in Treas. Reg. § 1.901-2A will need to be updated. Comments were requested on whether additional changes to Treas. Reg. § 1.901-2A would be appropriate in light of the proposed revisions to Treas. Reg. §§ 1.901-2 and 1.903-1.

2. Jurisdictional Nexus Requirement.

- (a) As a dollar-for-dollar credit against U.S. income tax, the foreign tax credit is intended to mitigate double taxation of foreign source income. Treasury and the IRS believe that this fundamental purpose is served most appropriately if there is substantial conformity in the principles used to calculate the base of the foreign tax and the base of the U.S. income tax. This conformity extends not just to ascertaining whether the foreign tax base approximates U.S. taxable income determined on the basis of realized gross receipts reduced by allocable expenses, but also to whether there is a sufficient nexus between the income that is subject to tax and the foreign jurisdiction imposing the tax. Although prior regulations under § 901 did contain jurisdictional limitations on the definition of an income tax, *see* 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 taxing jurisdiction”), the existing regulations do not contain such a rule.
- (b) In recent years, several foreign countries have adopted or are considering adopting a variety of novel extraterritorial taxes that diverge in significant respects from traditional norms of international taxing jurisdiction as reflected in the Code. In addition, Treasury and the IRS have received requests for guidance on whether the definition of foreign income tax includes a jurisdictional limitation, and recommending that the regulations adopt a rule requiring that income subject to foreign tax bear an appropriate connection to a foreign country for a foreign tax to be eligible for the foreign tax credit. In light of these developments, Treasury and the IRS believe that it is appropriate to revisit the regulatory definition of a foreign income tax to ensure that to be creditable, foreign taxes in fact have a predominant character of “an income tax in the U.S. sense.”

- (c) They also believe that in order to qualify as a creditable income tax, the foreign tax law must require a sufficient nexus between the foreign country and the taxpayer's activities or investment of capital or other assets that give rise to the income being taxed. For example, a tax imposed by a foreign country on a taxpayer's income that lacks a sufficient nexus to such country (such as the lack of operations, employees, factors of production, or management in that foreign country) is not an income tax in the U.S. sense and should not be eligible for a foreign tax credit if paid or accrued by U.S. taxpayers. Such a nexus is required in order for persons and income to be subject to U.S. income tax, and so a similar nexus reflecting the foreign country's exercise of taxing jurisdiction consistent with Federal income tax principles should be required in order for foreign taxes to be eligible for a dollar-for-dollar credit against U.S. income tax.
- (d) The proposed regulations therefore require that for a foreign tax to qualify as an income tax, the tax must conform with established international norms, reflected in the Code and related guidance, for allocating profit between associated enterprises, for allocating business profits of nonresidents to a taxable presence in the foreign country, and for taxing cross-border income based on source or the situs of property (together, the "jurisdictional nexus requirement").
- (e) Prop. Treas. Reg. § 1.901-2(c)(1)(i) generally provides that in the case of a foreign country imposing tax on nonresidents, the foreign tax law must determine the amount of income subject to tax based on the nonresident's activities located in the foreign country (including its functions, assets, and risks located in the foreign country).
- (f) Thus, for example, rules that are consistent with the rules under § 864(c) for taxing income effectively connected with a U.S. trade or business, or with Articles 5 and 7 of the U.S. Model Income Tax Convention for taxing profits attributable to a permanent establishment, will meet this requirement. However, foreign countries that, for example, impose tax by using as a significant factor the location of customers, users, or any other similar destination-based criterion to allocate profit (for example, by deeming a taxable presence based on the existence of customers) will not satisfy the jurisdictional nexus requirement.
- (g) If the foreign tax law imposes tax on a nonresident's income based on the income arising from sources in the foreign country (for example, tax imposed on interest, rents, or royalties sourced in the foreign country and paid to a nonresident), Prop. Treas. Reg. § 1.901-2(c)(1)(ii) requires the sourcing rules of the foreign tax

law to be reasonably similar to the sourcing rules that apply for Federal income tax purposes. For the avoidance of doubt, the proposed regulations provide that in the case of income from services, the income must be sourced based on the place of performance of the services, not the location of the services recipient.

- (h) The jurisdictional nexus requirement for taxing gains from sales or other dispositions of property is separately addressed in Prop. Treas. Reg. § 1.901-2(c)(1)(iii), which provides that income from sales or other dispositions of property by nonresidents that do not meet the activities requirement in Prop. Treas. Reg. § 1.901-2(c)(1)(i) satisfy the jurisdictional nexus requirement only regarding gains on the disposition of real property in the foreign country or movable property forming part of the business property of a taxable presence in the foreign country (or from interests in certain entities holding such property). This rule is consistent with the fact that Federal income tax law generally does not tax gains of nonresidents that do not have a trade or business in the U.S. *See*, for example, § 865(a)(2) and (e)(2); Treas. Reg. § 1.871-7(a)(1); *see also* U.S. Model Income Tax Convention (2016), Art. 13.
- (i) A similar rule applies under Prop. Treas. Reg. § 1.901-2(c)(2) regarding determining the income of a resident taxpayer in cases where income of a related entity may be allocated under transfer pricing rules to the resident taxpayer. For the jurisdictional nexus requirement to be satisfied in such a case, the foreign tax law's transfer pricing rules must be determined under arm's length principles. Thus, for example, foreign tax laws that contain transfer pricing rules that are consistent with the arm's length standard under the § 482 regulations, or with the arm's length principle under the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, will satisfy this requirement.
- (j) However, foreign transfer pricing rules that allocate profits by taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion will not satisfy the jurisdictional nexus requirement.
- (k) Comments were requested on whether special rules are needed to address foreign transfer pricing rules that allocate profits to a resident on a formulary basis (rather than on the basis of arm's length prices), such as through the use of fixed margins in a manner that is not consistent with arm's length principles. The jurisdictional nexus requirement is not violated when a foreign country imposes tax on the worldwide income of a resident

taxpayer, including under controlled foreign corporation regimes that deem income to be included (or distributed) to a resident shareholder (as opposed to allocated directly to the resident under a transfer pricing adjustment). For this purpose, the terms resident and nonresident are defined in Prop. Treas. Reg. § 1.901-2(g)(6) and in the case of an entity, the classification is generally based on the entity's place of incorporation or management.

- (l) As part of its response to the extraterritorial tax measures, Treasury has been actively engaged in negotiations with other countries, as part of the OECD/G20 Inclusive Framework on BEPS, to explore the possibility of a new international framework for allocating taxing rights. If an agreement is reached that includes the U.S., Treasury recognizes that changes to the foreign tax credit system may be required at that time.
- (m) No inference is intended as to the application of existing Treas. Reg. §§ 1.901-2 and 1.903-1 to the treatment of novel extraterritorial foreign taxes such as digital services taxes, diverted profits taxes, or equalization levies. In addition, the proposed regulations, when finalized, would not affect the application of existing income tax treaties to which the U.S. is a party regarding covered taxes (including any specifically identified taxes) that are creditable under the treaty. Comments were requested on the extent to which the new jurisdictional nexus requirement may impact the treatment of other types of foreign taxes, and on alternative approaches Treasury and the IRS may consider to modify the rules to achieve the policy objectives.

3. Net Gain Requirement.

4. Use of Empirical Analysis.

- (a) The existing regulations provide that the net gain requirement is met if a foreign tax reaches net gain in the “normal circumstances” in which it applies. See Treas. Reg. § 1.901-2(a)(1). As noted in the preamble to the 1983 final regulations, this rule is based on the standard set forth in *Inland Steel Company v. United States*, 677 F.2d 72 (Ct. Cl. 1982), *Bank of America Nat'l Trust and Savings Ass'n v. United States*, 459 F.2d 513 (Ct. Cl. 1972) (“*Bank of America I*”), and *Bank of America Nat'l Trust and Savings Ass'n v. Comm'r*, 61 T.C. 752 (1974), *aff'd*, 538 F.2d 334 (9th Cir. 1976) (“*Bank of America II*”). See TD 7918, 48 FR 46272-01 (1983).
- (b) Treasury and the IRS believe that, in some respects, the empirical analysis contemplated by the existing regulations is unnecessary to identify the essential elements of an income tax in the U.S. sense. In addition, in the absence of specific rules and thresholds in the

regulations on how to evaluate empirical data (if even available), both taxpayers and the IRS have had difficulties in applying the existing regulations to foreign taxes in a consistent and predictable manner.

- (c) In some cases, the reliance on empirical data to determine whether the requirements of the existing regulations are met creates uncertainty and undue burdens for taxpayers and the IRS, considering challenges in obtaining the necessary information.
- (d) Therefore, the proposed regulations limit the relevance of the “normal circumstances” in which the tax applies, as well as the role of the predominant character analysis, in determining whether a tax meets the various components of the net gain requirement. These changes will lead to more accurate and consistent outcomes and reduce the compliance and administrative burdens of the existing law requirement that taxpayers and the IRS obtain from the foreign government empirical information, such as tax return information for persons subject to the tax, to determine the normal circumstances in which the tax applies.
- (e) Instead, Prop. Treas. Reg. § 1.901-2(b)(1) generally provides that whether a tax is a foreign income tax is determined under the terms of the foreign tax law, taking into account statutes, regulations, case law, and administrative rulings or other official pronouncements, as modified by treaties. Accordingly, whether a tax satisfies the net gain requirement is generally based on whether the terms of the foreign tax law governing the computation of the tax base meet the realization, gross receipts, and cost recovery requirements that make up the net gain requirement under Treas. Reg. § 1.901-2(a)(3).
- (f) Treasury and the IRS believe that this approach will better allow taxpayers and the IRS to evaluate the nature of the foreign tax based on objective and readily available information (that is, based on the terms of the foreign tax law, rather than how it is applied in practice), to achieve more consistent and predictable outcomes. Evaluation of the normal circumstances in which the tax applies is still a factor in determining whether specific elements of the net gain requirement are satisfied, but the proposed regulations specifically identify the elements of the requirement for which this type of empirical evidence is relevant.

## 5. Realization Requirement.

- (a) Under the existing regulations, a foreign tax generally satisfies the realization requirement if, judged on the basis of its predominant

character, it is imposed upon or after the occurrence of events (“realization events”) that would result in the realization of income under the Code, or in certain cases, it is imposed on the occurrence of a pre-realization event, such as in the case of a foreign law mark-to-market regime. *See* Treas. Reg. § 1.901-2(b)(2)(i).

- (b) Due to the burdens resulting from the requirement to perform an empirical analysis to ascertain the nature of a tax, the proposed regulations provide more specific rules regarding the elements of the requirement for which this type of empirical evidence is relevant. In particular, Treasury and the IRS believe that the inclusion in the foreign tax base of insignificant amounts of gross receipts that do not meet the realization requirement should not prevent an otherwise-qualifying foreign tax from qualifying as an income tax.
- (c) Accordingly, Prop. Treas. Reg. § 1.901-2(b)(2) provides that if a foreign tax generally meets the various realization requirements described in Prop. Treas. Reg. § 1.901-2(b)(2)(i)(A) through (C), except regarding one or more specific and defined classes of nonrealization events, the tax may still be treated as meeting the realization requirement if the incidence and amounts of gross receipts attributable to the nonrealization events are minimal relative to the incidence and amounts of gross receipts attributable to events covered by the foreign tax that do meet the realization requirement.
- (d) This determination is made based on the application of the foreign tax to all taxpayers subject to the foreign tax (rather than on a taxpayer-by-taxpayer basis). Therefore, for example, if a foreign tax contains all of the same realization requirements as the Code, but also imposes tax on imputed rent regarding owner-occupied housing, the foreign tax may still qualify as a foreign income tax if, relative to all of the income of all taxpayers that are subject to the tax, imputed rental income comprises a relatively small amount (even if for some taxpayers, all of their income may constitute imputed rent).
- (e) Comments were requested on whether the regulations could substitute a more objective standard for identifying acceptable deviations from the realization requirement that would avoid the need for empirical analysis.
- (f) Prop. Treas. Reg. § 1.901-2(b)(2)(i)(C) consolidates the rules relating to pre-realization timing differences, including the rule currently in Treas. Reg. § 1.901-2(b)(2)(ii) that foreign taxes imposed on a shareholder on deemed distributions or inclusions

(such as inclusions similar to those imposed by U.S. law under subpart F) of income realized by the distributing entity satisfy the realization requirement, so long as a second tax is not imposed on the shareholder on the same income upon the occurrence of a later event (such as an actual distribution).

- (g) Under Prop. Treas. Reg. § 1.901-2(b)(2)(i)(C), because a shareholder-level tax on a distribution from a corporation is imposed on a different taxpayer, the shareholder-level tax is not treated as a second tax on the corporation's income (including income arising from a pre-realization event). For this purpose, Prop. Treas. Reg. § 1.901-2(b)(2)(i)(C) provides that a disregarded entity is treated as a taxpayer separate from its owner. Comments were requested on whether there are additional categories of pre-realization timing differences that should be included in the final regulations.
- (h) Finally, Treasury and the IRS expect to update the examples illustrating the realization requirement that are contained in Treas. Reg. § 1.901-2(b)(2)(iv) and include them in the regulations when Prop. Treas. Reg. § 1.901-2(b)(2) is finalized.

6. Gross Receipts Requirement.

- (a) Under existing Treas. Reg. § 1.901-2(b)(3), a foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of (1) gross receipts; or (2) gross receipts computed under a method that is likely to produce an amount that is not greater than the fair market value of actual arm's length gross receipts ("the alternative gross receipts test"). See Treas. Reg. § 1.901-2(b)(3)(ii) Examples 1 and 2.
- (b) The proposed regulations modify the alternative gross receipts test to provide that it is satisfied in the case of tax imposed on deemed gross receipts arising from pre-realization timing difference events described in Prop. Treas. Reg. § 1.901-2(b)(2)(i)(C) (that is, a mark-to-market regime, tax on the physical transfer, processing, or export of readily marketable property, or a deemed distribution or inclusion), or on the basis of gross receipts from a non-realization event that is insignificant and therefore does not cause the foreign tax to fail the realization requirement in Prop. Treas. Reg. § 1.901-2(b)(2).
- (c) Therefore, taxes on insignificant non-realization events or pre-realization timing difference events that satisfy the realization

requirement in Prop. Treas. Reg. § 1.901-2(b)(2)(i)(C) also satisfy the gross receipts test.

- (d) However, the proposed regulations remove the provision referring to gross receipts computed under a method that is “likely” to produce an amount not greater than gross receipts. This rule purports to allow for foreign taxes to be imposed on an amount greater than the amount of income actually realized, or the value of the property being taxed, and Treasury and the IRS believe that such a tax should not be considered to be a tax on income, since it can be imposed on amounts in excess of actual gross receipts.
- (e) Treasury and the IRS also believe that the test is vague, unduly burdensome, and has given rise to controversies requiring taxpayers and the IRS to conduct an empirical evaluation to determine whether a nonconforming statutory method of determining alternative gross receipts is likely not to exceed the fair market value of actual gross receipts. *See*, for example, *Phillips Petroleum v. Comm’r*, 104 T.C. 256 (1995) (applying the former Temp. Treas. Reg. § 1.901-2T (1980) TD 7739).
- (f) Treasury and the IRS further believe that, other than in the case of insignificant non-realization events, only a tax base determined with reference to realized gross receipts or, in the case of a pre-realization timing difference event, the value or amount of a deemed inclusion or accrual (and not an approximation of gross receipts), should qualify as an income tax in the U.S. sense.
- (g) In contrast, a tax based on alternative measurements of gross receipts, such as a foreign tax that requires gross receipts to be calculated by applying a markup to costs, fundamentally diverges from the measurement of realized gross receipts under the Code, and could result in a taxable base that exceeds the amount of income properly attributable to the taxpayer’s activities or investment in the foreign country.
- (h) Treasury and the IRS believe that the revised rule will also minimize the need for empirical analyses, making it simpler for both taxpayers and the IRS to determine whether a tax satisfies the net gain requirement.
- (i) This rule is not intended to implicate the allocation of gross income under transfer pricing or branch profit attribution rules, which are instead addressed under Prop. Treas. Reg. § 1.901-2(c). Prop. Treas. Reg. § 1.901-2(b)(3)(i) provides that in determining a taxpayer’s actual gross receipts, amounts that are properly allocated to such taxpayer under the jurisdictional nexus rules in



Prop. Treas. Reg. § 1.901-2(c), such as pursuant to transfer pricing rules that properly allocate income to a taxpayer on the basis of costs incurred by that entity, are treated as the taxpayer's actual gross receipts.

7. Cost Recovery Requirement.

- (a) Under the net income requirement in the existing regulations, foreign tax law must permit the recovery of the significant costs and expenses attributable, under reasonable principles, to gross receipts included in the taxable base. A foreign tax law permits the recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be under the Code, unless the time of recovery is such that under the circumstances there is effectively a denial of recovery.
- (b) Under the “nonconfiscatory gross basis tax” rule in Treas. Reg. § 1.901-2(b)(4) of the existing regulations, which reflects the standard described in *Bank of America I*, a foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the “rare situation” when the tax is almost certain to reach some net gain in the normal circumstances in which it applies because 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. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement in the existing regulations if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax).
- (c) Treasury and the IRS believe that to constitute an income tax for U.S. tax purposes, that is, a tax on net gain, the base of a foreign tax should conform in essential respects to the determination of taxable income for Federal income tax purposes. See, for example, *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894, 895 (3d Cir. 1943) (holding that the criteria prescribed by U.S. revenue laws are determinative of the meaning of the term “income taxes” in applying the former version of § 901); and *Comm’r v. American Metal Co.*, 221 F.2d 134, 137 (2d Cir. 1955) (providing that “the determinative question is ‘whether the foreign tax is the substantial equivalent of an ‘income tax’ as that term is understood in the U.S.’”).
- (d) Treasury and the IRS believe that any foreign tax imposed on a gross basis is by definition not an income tax in the U.S. sense,

regardless of the rate at which it is imposed or the extent of the associated costs.

- (e) In addition, they also believe that the empirical standards contained in Bank of America I and that are contemplated by the nonconfiscatory gross basis tax rule in the existing regulations create substantial compliance and administrative burdens for taxpayers and the IRS when evaluating whether a foreign tax is an income tax in the U.S. sense. For example, the IRS and taxpayers must obtain foreign tax return information regarding all persons subject to the tax to determine if persons subject to the tax are almost certain never to incur an after-tax loss. *See*, for example, *PPL Corp. v. Comm’r*, 135 T.C. 304 (2010), rev’d, 665 F.3d 60 (3d Cir. 2011), rev’d, 569 U.S. 329 (2013); *Texasgulf, Inc. v. Comm’r*, 107 T.C. 51 (1996), *aff’d*, 172 F.3d 209 (2d Cir. 1999); and *Exxon Corp. v. Comm’r*, 113 T.C. 338 (1999) (applying the empirical analysis required by the regulations).
- (f) Therefore, the proposed regulations remove the nonconfiscatory gross basis tax rule. Instead, the proposed regulations provide that whether a tax meets the net gain requirement is made solely on the basis of the terms of the foreign tax law that define the foreign taxable base, without any consideration of the rate of tax imposed on that base. *See* Prop. Treas. Reg. § 1.901-2(b)(1). In addition, the cost recovery requirement in Prop. Treas. Reg. § 1.901-2(b)(4) requires the deductions allowed under the foreign tax law to approximate the cost recovery provisions of the Code in order for the foreign tax to qualify as an income tax in the U.S. sense.
- (g) Under Prop. Treas. Reg. § 1.901-2(b)(4)(i)(A), a tax that is imposed on gross receipts or gross income, without reduction for any costs or expenses attributable to earning that income, cannot qualify as a net income tax, without regard to whether the empirical impact of the tax is confiscatory, and even if in practice there are no or few costs and expenses attributable to all or particular types of gross receipts included in the foreign tax base. Under this rule, the cost recovery requirement is not satisfied for taxes such as payroll taxes on gross income from wages, but may be satisfied in the case of a personal income tax similar to that imposed under § 1 of the Code on all gross income (including wages), if the foreign country allows taxpayers to reduce such gross income by the substantial costs and expenses that are reasonably attributable to such gross income (taking into account any reasonable deduction disallowance provisions).
- (h) Under the “alternative allowance rule” in Treas. Reg. § 1.901-2(b)(4) of the existing regulations, a foreign tax that does not

permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. Treasury and the IRS believe, however, that the alternative allowance rule fundamentally diverges from the approach to cost recovery in the Code, and thus is inconsistent with an essential element of an income tax in the U.S. sense.

- (i) Moreover, it is unduly burdensome, and may be impossible as a practical matter, for taxpayers and the IRS to determine whether an alternative allowance under foreign tax law effectively compensates for the nonrecovery of significant costs or expenses attributable to realized gross receipts under that foreign law.
- (j) The alternative allowance rule in the existing regulations has given rise to controversies between taxpayers and the IRS, and different interpretations by the courts, over whether the rule requires taxpayers to demonstrate that the alternative allowance exceeds disallowed expense deductions for a majority of persons potentially subject to the tax, a majority of persons that actually pay the tax, or for taxpayers in the aggregate, determined by comparing the aggregate amounts of disallowed deductions and alternative allowances reported on the foreign tax returns of all persons subject to the tax. *See*, for example, *Texasgulf, Inc. v. Comm’r*, 107 T.C. 51 (1996), *aff’d*, 172 F.3d 209 (2d Cir. 1999); and *Exxon Corp. v. Comm’r*, 113 T.C. 338 (1999).
- (k) Therefore, the proposed regulations at Treas. Reg. § 1.901-2(b)(4)(i)(A) modify the alternative allowance rule to treat alternative allowances as meeting the cost recovery requirement only if the foreign tax law expressly guarantees that the alternative allowance will equal or exceed actual costs (for example, under a provision identical to percentage depletion allowed under § 613).
- (l) The proposed regulations at Treas. Reg. § 1.901-2(b)(4)(i)(B)(1) retain the existing rule that foreign tax law is considered to permit the recovery of significant costs and expenses even if the costs and expenses are recovered at a different time than they would be if the Code applied, unless the time of recovery is so much later (for example, after the property becomes worthless or is disposed of) as effectively to constitute a denial of such recovery. The regulations clarify that the different time can be either earlier or later than it would be if the Code applied, and that time value of money considerations relating to the economic cost (or value) of accelerating (or deferring) a foreign tax liability are not relevant in determining the amount of recovered costs and expenses.

- (m) The proposed regulations also add a new rule to allow a tax to satisfy the cost recovery requirement even if recovery of all or a portion of certain costs or expenses is disallowed, if the disallowance is consistent with the types of disallowances required under the Code. Prop. Treas. Reg. § 1.901-2(b)(4)(i)(B)(2). For example, foreign tax law is considered to permit the recovery of significant costs and expenses even if the law disallows interest deductions equal to a certain percentage of adjusted taxable income similar to the limitation under § 163(j) or disallows interest and royalty deductions in connection with hybrid transactions similar to those subject to § 267A. Treasury and the IRS believe that this new provision is consistent with the rule that principles of U.S. law apply to determine whether a tax is a creditable income tax. *See* Treas. Reg. § 1.901-2(a)(1)(ii); *see also*, for example, *Keasbey*, 133 F.2d at 897; and *American Metal*, 221 F.2d at 137.
- (n) Finally, Prop. Treas. Reg. § 1.901-2(b)(4)(i)(B)(2) provides that an empirical analysis of a foreign tax is still pertinent, in part, in determining whether a cost or expense is significant for purposes of the cost recovery requirement. In particular, the significance of a cost or expense is determined based on whether, for all taxpayers to which the foreign tax applies, the item of cost or expense constitutes a significant portion of the total costs or expenses. However, Prop. Treas. Reg. § 1.901-2(b)(4)(i)(B)(2) adds certainty by providing that costs or expenses related to capital expenditures, interest, rents, royalties, services, and research and experimentation are always treated as significant costs or expenses.
- (o) Treasury and the IRS believe that these types of costs represent a substantial portion of expenses typically deducted in computing taxable income for U.S. tax purposes. Requiring a foreign tax law to allow recovery of these costs will increase assurances that the income subject to U.S. and foreign tax is actually subject to double taxation. Because interest expense in particular is a significant cost that under § 864(e)(2) is allocable to all of a taxpayer's worldwide income-producing activities regardless of where it is incurred, a foreign levy that allows, for example, no deduction for interest expense is not an income tax in the U.S. sense, even if U.S. taxpayers record minimal interest expense in foreign countries that restrict its deductibility.
8. Qualifying Surtax. Treasury and the IRS state they have received questions on the appropriate treatment of certain foreign taxes that are computed as a percentage of the tax due under a separate levy that is itself an income tax. To address the treatment of these taxes, Prop. Treas. Reg. § 1.901-2(b)(5) adds a rule providing that a foreign tax satisfies the net

gain requirement if the base of the foreign tax is the amount of a foreign income tax.

9. Soak-Up Taxes.

- (a) The proposed regulations move the soak-up tax rule from the rules that define a creditable levy to the rules for determining the amount of creditable tax that is considered paid. Prop. Treas. Reg. § 1.901-2(e)(6). Because the rules at existing Treas. Reg. §§ 1.901-2(a)(3)(ii) and 1.903-1(b)(2) treat an otherwise creditable levy as a soak-up tax only to the extent it would not be imposed but for the availability of a credit, this change is more consistent with the general structure of the regulations that determine whether a separate levy as a whole qualifies as a creditable tax, and then identifies the amount of a particular taxpayer's foreign tax liability that is paid or accrued and can be claimed as a foreign tax credit.
- (b) In addition, the proposed regulations omit the special rule in Treas. Reg. § 1.903-1(b)(2) that limits the portion of a tax in lieu of an income tax that is a soak-up tax to the amount by which the foreign tax exceeds the income tax that would have been paid if the taxpayer had instead been subject to the generally-imposed income tax. Treasury and the IRS believe that this rule is inconsistent with the rationale for making soak-up taxes not creditable, which is to ensure that the foreign country does not impose a soak-up tax liability that under the existing regulations could be allowed as a foreign tax credit to reduce the taxpayer's U.S. tax liability.
- (c) Finally, Treasury and the IRS are reconsidering the examples illustrating the soak-up tax rules that are contained in Treas. Reg. §§ 1.901-2(c)(2) and 1.903-1(b)(3) (Examples 6 and 7) and expect to include updated examples in the regulations when
- (d) Prop. Treas. Reg. § 1.901-2(e)(6) was finalized. Comments were requested on whether additional issues are presented by currently applicable soak-up taxes that should be addressed in the final regulations.

10. Separate Levy Determination.

- (a) Whether a foreign levy is an income tax is determined independently for each separate foreign levy. For purposes of §§ 901 and 903, whether a single levy or separate levies are imposed by a foreign country depends on U.S. principles and not on whether foreign law imposes the levy or levies in a single or separate statutes. Treas. Reg. § 1.901-2(d)(1) of the existing regulations provides that, where the base of a levy is different in

kind, and not merely in degree, for different classes of persons subject to the levy, the levy is considered for purposes of §§ 901 and 903 to impose separate levies for such classes of persons.

- (b) The proposed regulations revise Treas. Reg. § 1.901-2(d)(1) to clarify the determination of whether a foreign levy is separate from another foreign levy for purposes of determining if a levy meets the requirements of § 901 or 903. Treasury and the IRS believe that the standards under the existing regulations for making this determination are unclear.
- (c) In one place the existing regulations state that the only differentiating factor is if the base of the levy is different in kind, as opposed to degree. *See*, for example, Treas. Reg. § 1.901-2(d)(1) (“foreign levies identical to the taxes imposed by §§ 11, 541, 881, 882, 1491, and 3111 of the Code are each separate levies, because the base of each of those levies differs in kind, and not merely in degree”). However, in the same sentence, the regulations suggest that one levy may be separate from another levy if a different class of taxpayers is subject to each levy, regardless of whether the base of the two levies is different in kind. *See*, for example, (“a foreign levy identical to the tax imposed by § 871(b) of the Code is a separate levy from a foreign levy identical to the tax imposed by § 1 of the Code as it applies to persons other than those described in § 871(b)” (emphasis added)).
- (d) The proposed regulations modify the rules for determining whether a foreign levy is a separate levy to clarify how U.S. principles are relevant in determining whether one foreign levy is separate from another foreign levy. In general, the proposed regulations identify separate levies as those that include different items of income and expense in determining the base of the tax, but in certain circumstances separate levies may result even if the taxable base of each levy is the same.
- (e) In particular, Prop. Treas. Reg. § 1.901-2(d)(1)(i) provides that a foreign levy is always separate from another foreign levy if the levy is imposed by a different foreign tax authority, even if the base of the tax is the same. Prop. Treas. Reg. § 1.901-2(d)(1)(ii) provides the general rule that separate levies are imposed on particular classes of taxpayers if the taxable base is different for those taxpayers. For example, the proposed regulations provide that a foreign levy identical to the tax imposed by § 3101 (employee tax on wage income) is a separate levy from the foreign levy identical to the tax imposed by § 3111 (employer tax on wages paid).

- (f) Prop. Treas. Reg. § 1.901-2(d)(1)(ii) also provides that income included in the taxable base of a separate levy may also be included in the taxable base of another levy (which may or may not also include other items of income); and separate levies are considered to be imposed if the taxable bases are not combined as a single taxable base. Therefore, a foreign levy identical to the tax imposed by § 1411 is a separate levy from a foreign levy identical to the tax imposed by § 1 because tax is separately imposed on the income included in each taxable base.
- (g) The proposed regulations at Treas. Reg. § 1.901-2(d)(1)(iii) also provide that a foreign levy imposed on nonresidents is treated as a separate levy from that imposed on residents of the taxing jurisdiction, even if the base is the same for both levies, and even if the levies are treated as a single levy under foreign tax law.
- (h) Treasury and the IRS stated that these changes are intended to ensure that, in general, if a generally-imposed income tax on residents is also imposed on an extraterritorial basis on some nonresidents, in violation of the jurisdictional nexus requirement, only the portion of the levy that applies to nonresidents will not be treated as a foreign income tax. Otherwise, a foreign country's general income tax regime could fail to qualify as a net income tax if the tax was also imposed on an extraterritorial basis on some nonresidents.
- (i) Finally, Prop. Treas. Reg. § 1.901-2(d)(1)(iii) provides that a withholding tax on gross income of nonresidents is treated as a separate levy regarding each class of gross income (as listed in § 61) to which it applies. This special rule is provided in order to allow withholding taxes that are imposed on several classes of income, based on sourcing rules that meet the jurisdictional nexus requirement regarding only some of the classes of income, to be analyzed as separate levies under the covered withholding tax rule in Treas. Reg. § 1.903-1(c)(2).

Q. Amount of Tax that is Considered Paid.

1. Background.

- (a) Treas. Reg. § 1.901-2(e) of the existing regulations provides rules for determining the amount of foreign tax that is considered paid and eligible for credit under § 901. The existing regulations at Treas. Reg. § 1.901-2(g)(1) and Prop. Treas. Reg. § 1.901-2(g)(5) clarify that the word "paid" as used in Treas. Reg. § 1.901-2(e) means "paid" or "accrued," depending on whether the taxpayer claims the foreign tax credit for taxes paid (that is, remitted) or

accrued (that is, for which the liability becomes fixed) during the taxable year.

- (b) The proposed regulations clarify in several respects the amount of tax that is considered paid (or accrued, as the case may be) and eligible for credit. Under Treas. Reg. § 1.901-2(e)(2)(i) of the existing regulations, 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, abated, or forgiven. That regulation further provides that it is not reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of the final tax liability to the foreign country.
- (c) Treasury and the IRS believe that current law is unclear whether an amount that is not treated as an amount of tax paid under Treas. Reg. § 1.901-2(e)(5)(i) because it is reasonably certain to be credited against a taxpayer's tentative liability for a second foreign tax should be treated as a constructive refund of the credited amount from the foreign country, followed by a constructive payment by the taxpayer of the second foreign tax. They believe the law is similarly unclear as to whether credits allowed under foreign tax law that are computed with reference to amounts other than foreign tax payments (such as, for example, investment tax credits) may be treated as a constructive receipt of cash by the taxpayer from the foreign country, followed by a constructive payment by the taxpayer of foreign income tax.
- (d) The results have sometimes differed depending on whether the credit is refundable under foreign law, that is, whether taxpayers are entitled to receive a cash payment from the foreign country to the extent the credit exceeds the taxpayer's foreign income tax liability. See, for example, Rev. Rul. 86-134, 1986-2 C.B. 104 (investment incentives reduced tentative Dutch income tax liability during period in which such incentives could only be claimed as an offset against the income tax liability, rather than as a refundable credit).
- (e) Treasury and the IRS believe that the current uncertainty as to how to properly account for tax credits leads to varying and inconsistent interpretations and that a single, clear rule regarding the treatment of tax credits would improve the consistency in outcomes for taxpayers. In addition, they expressed concern that if the use of tax credits can be treated as a means of payment of a foreign income tax for foreign tax credit purposes, then foreign countries, rather than reducing their tax rates, could instead offer tax credits that would have the same economic effect without reducing the amount



of foreign income tax that is treated as paid by taxpayers for purposes of the foreign tax credit.

- (f) Treasury and the IRS believe that it is too administratively challenging to determine whether a foreign country whose law provides for nominally refundable credits in practice actually issues cash payments to taxpayers that do not have income tax liabilities equal to the credit. In addition, they believe that the rule in Treas. Reg. § 1.901-2(e)(2)(i) regarding amounts that will be “credited” is ambiguous. Treas. Reg. § 1.901-2(e)(4)(i) of the existing regulations provides that if, under foreign law, a taxpayer’s tentative liability for one levy (the “first levy”) is or can be reduced by the amount of the taxpayer’s liability for a different levy (the “second levy”), then the amount considered paid by the taxpayer to the foreign country pursuant to the second levy is an amount equal to its entire liability for that levy, and the remainder of the amount paid is considered paid pursuant to the first levy. However, Treas. Reg. § 1.901-2(e)(2)(i) suggests that the credited amount of the second levy is not considered paid.
- (g) Therefore, Prop. Treas. Reg. § 1.901-2(e)(2)(i) provides certainty on the treatment of credited amounts by eliminating the provision that suggests that an amount of tax is not treated as paid if it is allowed as a credit. Instead, Prop. Treas. Reg. § 1.901-2(e)(2)(ii) provides that foreign income tax is not considered paid if it is reduced by a tax credit, regardless of whether the amount of the tax credit is refundable in cash.
- (h) Therefore, an amount allowed as a credit (including, but not limited to, an amount paid under one levy that is credited against an amount due under another levy) is not treated as a constructive payment of cash from the foreign country (or a constructive refund of the levy that is paid) followed by a constructive payment of the levy that is reduced by the credit, even if the creditable amount is refundable in cash to the extent it exceeds the taxpayer’s liability for the levy that is reduced by the credit.
- (i) However, Prop. Treas. Reg. § 1.901-2(e)(2)(iii) provides that overpayments of tax (which exceed the taxpayer’s liability and so are not treated as an amount of tax paid) that are refundable in cash at the taxpayer’s option and that are applied in satisfaction of the taxpayer’s liability for foreign income tax may qualify as an amount of such foreign income tax paid.
- (j) Comments were requested on whether additional rules should be provided for government grants that are provided outside of the

foreign tax system, and the circumstances in which such grants should also be treated as a reduction in the amount of tax paid.

- (k) Finally, the multiple levy rule in Treas. Reg. § 1.901-2(e)(4) of the existing regulations provides that when an amount of a second levy is applied as a credit to reduce the taxpayer's liability for a first levy, the full amount of the second levy (and not the amount of the first levy that is offset by the credit) is considered paid. The proposed regulations provide the multiple levy rule by referring to the first levy as the "reduced levy" and to the second levy as the "applied levy." The proposed regulations also modify an existing example and add a new example to illustrate the application of Prop. Treas. Reg. § 1.901-2(e)(2) and (e)(4). Prop. Treas. Reg. § 1.901-2(e)(4)(ii).

2. Noncompulsory Payments.

3. Background.

- (a) Treas. Reg. § 1.901-2(e)(5) provides that an amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of the taxpayer's liability under foreign law for tax (the "noncompulsory payment rule"). Treas. Reg. § 1.901-2(e)(5) further provides that if foreign tax law includes options or elections whereby a taxpayer's liability may be shifted, in whole or part, to a different year, the taxpayer's use or failure to use such options or elections does not result in a noncompulsory payment, and that a settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory amount. In addition, it provides that a taxpayer is not required to alter its form of doing business, its business conduct, or the form of any transaction in order to reduce its liability for tax under foreign law.
- (b) On March 30, 2007, proposed regulations (REG-156779-06) were published that, in part, would amend Treas. Reg. § 1.901-2(e)(5) to treat as a single taxpayer all foreign entities in which the same U.S. person has a direct or indirect interest of 80% or more (a "U.S.-owned foreign group"). The proposed rule (the "2007 proposed regulations") would apply for purposes of determining whether amounts paid are compulsory payments of foreign tax, for example, when one member of a U.S.-owned foreign group surrenders a loss to another member of the group that reduces the foreign tax due from the second member in that year but increases the amount of foreign tax owed by the loss member in a subsequent year.

- (c) In Notice 2007-95, 2007-2 C.B. 1091, Treasury and the IRS announced that, in reviewing comments received, it was determined that the proposed change may lead to inappropriate results in certain cases and that the proposed change would be effective for taxable years beginning after the publication of final regulations, but that taxpayers may rely on that portion of the proposed regulations for taxable years ending on or after March 29, 2007, and beginning on or before the date on which final regulations are published.
- (d) Treas. Reg. § 1.909-2 provides an exclusive list of foreign tax credit splitter arrangements, including a loss-sharing splitter arrangement, which exists under a foreign group relief or other loss-sharing regime to the extent a “usable shared loss” of a “U.S. combined income group” (that is, an individual or corporation and all the entities with which it combines income and expense under Federal income tax law) is used to offset foreign taxable income of another U.S. combined income group. *See* Treas. Reg. § 1.909-1(b)(2).

4. Treatment of Elections and Other Clarifications.

- (a) Treas. Reg. § 1.901-2(e)(5) currently applies on a taxpayer-by-taxpayer basis, obligating each taxpayer to minimize its liability for foreign taxes over time. The 2007 proposed regulations were intended to create a limited exception to the taxpayer-by-taxpayer approach, recognizing that the net effect of a loss surrender in the case of a group relief regime may be to minimize the amount of foreign taxes paid in the aggregate by the group over time.
- (b) However, the 2007 proposed regulations were both overinclusive and underinclusive. Comments criticized the approach taken, including how the U.S.-owned foreign group was defined, and noted that the proposal had created uncertainty over the extent to which noncompulsory payment issues arise in situations not addressed by the proposed regulations. In addition, as noted in Notice 2007-95, Treasury and the IRS believe that the 2007 proposed regulations would lead to inappropriate results in certain cases. Furthermore, a comment received in connection with 2012 temporary regulations issued under § 909 (TD 9597, 77 FR 8127) recommended that the 2007 proposed regulations be withdrawn in light of the coverage of loss-sharing splitter arrangements under the § 909 regulations.
- (c) Treasury and the IRS agreed that the 2007 proposed regulations should be withdrawn. However, withdrawing the 2007 proposed regulations (which taxpayers were permitted to rely on under

Notice 2007-95) without providing additional guidance could result in a disallowance of all foreign tax credits related to loss-sharing arrangements because under Treas. Reg. § 1.901-2(e)(5) the requirement to minimize foreign income tax liability applies on a taxpayer-by-taxpayer basis.

- (d) To address this issue, Prop. Treas. Reg. § 1.901-2(e)(5)(ii)(B)(2) provides that when foreign law permits one foreign entity to join a consolidated group, or to surrender its loss to offset the income of another foreign entity pursuant to a foreign group relief or other loss-sharing regime, a taxpayer's decision to file as a consolidated group, to surrender or not to surrender a loss, or to use or not to use a surrendered loss, will not give rise to a noncompulsory payment.
- (e) Although the proposed regulations will generally exempt loss surrender under group relief or other loss-sharing regimes from the noncompulsory payment regulations, Treasury and the IRS expressed concern that in certain cases loss sharing arrangements, particularly when combined with hybrid arrangements, may be used to separate foreign taxes from the related income.
- (f) For example, if passive category income of a CFC is offset for U.S. tax purposes by a loss recognized by a disregarded entity owned by that CFC, but that loss is surrendered to reduce general category tested income of an affiliated CFC for foreign tax purposes, under Treas. Reg. § 1.909-3(a) the split taxes of the loss CFC may be eligible to be deemed paid if the affiliated CFC's related income is included in the U.S. shareholder's income in the same taxable year, but such taxes may not be properly associated with the related income. Therefore, Treasury and the IRS said they are considering whether additional guidance on loss sharing arrangements, including for example under Treas. Reg. § 1.861-20, is needed. Comments were requested on this and other aspects of the treatment of loss sharing arrangements.
- (g) The existing regulations at Treas. Reg. § 1.901-2(e)(5) provide that where foreign tax law includes options or elections whereby a taxpayer's foreign income tax liability may be shifted to a different year, the taxpayer's use or failure to use such options or elections does not result in a noncompulsory payment. However, the regulations are not clear as to whether the use or failure to use options or elections that result in an overall change in foreign income tax liability over time would result in a noncompulsory payment.
- (h) For example, a taxpayer's choice to capitalize and amortize capital expenditures over time, rather than to claim a current expense

deduction, does not result in a noncompulsory payment; in contrast, a taxpayer's election to compute its tax liability under one of two alternative regimes, one of which qualifies as an income tax and one of which qualifies as a tax in lieu of an income tax, may result in a noncompulsory payment if the taxpayer does not choose the option that is reasonably calculated to minimize its liability for creditable foreign tax over time.

- (i) Accordingly, Prop. Treas. Reg. § 1.901-2(e)(5)(ii) provides that the use or failure to use such an option or election is relevant to whether a taxpayer has minimized its liability for foreign income taxes. However, an exception is provided for elections to surrender losses under a foreign consolidation, group relief or other loss-surrender regime, as well as for an option or election to treat an entity as fiscally transparent or non-fiscally transparent for foreign tax purposes.
- (j) Because these elections and options generally have the effect of shifting to another entity, rather than reducing in the aggregate, a taxpayer group's foreign income tax liability, Treasury and the IRS believe that foreign tax credit concerns related to the use or failure to use such an election or option are more appropriately addressed under other rules. They requested comments on whether there are other foreign options or elections that should be excepted from the general rule.
- (k) Treasury and the IRS state they are aware that some taxpayers have taken the position that because Treas. Reg. § 1.901-2(e)(5) refers to payments of "foreign taxes," rather than "foreign income taxes," the noncompulsory payment regulations only require taxpayers to minimize their total liability for all foreign taxes in the aggregate (including non-income taxes such as excise taxes), as opposed to minimizing foreign income tax.
- (l) Treasury and the IRS disagree with this interpretation, since Treas. Reg. § 1.901-2(e) defines the amount of "taxes paid" for purposes of § 901, which only applies to creditable foreign income taxes. Accordingly, Prop. Treas. Reg. § 1.901-2(e)(5)(i) clarifies that taxpayers are obligated to minimize their foreign income tax liabilities. For example, if a taxpayer may choose to apply a tax credit to reduce either the amount of a creditable income tax or the amount of a non-creditable excise tax, then the proposed regulations require that the taxpayer choose to minimize its liability for the creditable income tax; if instead the taxpayer chooses to apply the credit against the excise tax, income tax in the amount of the applied credit is considered a noncompulsory payment.

- (m) Finally, Prop. Treas. Reg. § 1.901-2(e)(5)(i) clarifies that the time value of money is not relevant in determining whether a taxpayer has met its obligation to minimize the amount of its foreign income tax liabilities over time. This rule is consistent with the rule in Treas. Reg. § 1.901-2(b)(4), providing that the amount of costs that are treated as recovered in computing the base of a foreign tax is the same, regardless of whether a taxpayer chooses to deduct currently, or to capitalize and amortize, a particular expense.
- (n) Therefore, for example, if a taxpayer subject to foreign income tax at a rate of 20% chooses to capitalize a \$100x cost and deduct it ratably over five years rather than to deduct the entire \$100x cost in the first year, the full \$100x cost is considered recovered under either option, and is not affected by the fact that as an economic matter the present value of the \$20x reduction in tax liability by reason of the \$100x deduction in the first year exceeds the discounted present value of the same \$20x reduction in tax spread over five years. Similarly, under Prop. Treas. Reg. § 1.901-2(e)(5)(i), the taxpayer will be treated as paying the same amount of foreign income tax regardless of whether it chooses to pay that amount in the current tax year or in a later year.
- (o) Although Treasury and the IRS understand that time value of money considerations have economic effects, for Federal income tax purposes income and expenses (including taxes) generally are neither discounted nor indexed by reference to time value of money considerations. A regime that required taxpayers to minimize the discounted present value, rather than the nominal amount, of foreign income tax liabilities would be complex, requiring assumptions about future tax rates and appropriate discount rates.
- (p) Similarly, a regime that required taxpayers to compare the discounted present value of a foreign tax credit for a foreign income tax to the discounted present value of a deduction for an alternative payment of non-creditable tax that would be incurred in a different year and select the option that minimized the cost to the U.S. fisc would be comparably complex and burdensome for taxpayers to apply and for the IRS to administer.
- (q) Accordingly, the proposed regulations provide that economic considerations related to the discounted present value of U.S. and foreign tax benefits are not taken into account for purposes of determining the amount of cost recovery or the amount of foreign income tax that is, or would be under foreign tax law options available to the taxpayer, paid or accrued over time.

R. Tax in Lieu of Income Tax.

1. In General.

- (a) Section 903 provides that, for purposes of the foreign tax credit, the term “income, war profits, and excess profits taxes” includes a tax paid in lieu of an income tax otherwise generally imposed by any foreign country or by any possession of the U.S. (an “in lieu of tax”). The existing regulations clarify that the foreign country’s purpose in imposing the foreign tax (for example, whether it imposes the foreign tax because of administrative difficulty in determining the base of the income tax otherwise generally imposed) is immaterial. *See* Treas. Reg. § 1.903-1(a).
- (b) The existing regulations further provide that it is immaterial whether the base of the foreign tax bears any relation to realized net income and that the base may, for example, be gross income, gross receipts or sales, or the number of units produced or sold. *See* Treas. Reg. § 1.903-1(b)(1). The existing regulations also require that the foreign tax meet a substitution requirement, which is satisfied if the tax in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed.
- (c) The proposed regulations revise the substitution requirement by more specifically defining the circumstances in which a foreign tax is considered “in lieu of” a generally-imposed income tax, consistent with the interpretation of the substitution requirement in prior judicial decisions. *See, for example, Metro. Life Ins. Co. v. United States*, 375 F.2d 835, 838-40 (Ct. Cl. 1967). In addition, the proposed regulations provide that an in lieu of tax under § 903, by virtue of the substitution requirement, must also satisfy the jurisdictional nexus requirement described in Prop. Treas. Reg. § 1.901-2(c).
- (d) Although prior regulations under § 903 did contain a jurisdictional limitation regarding in lieu of taxes, *see* § 4.903-1(a)(4) (1980) (requiring that an in lieu of tax follow “reasonable rules of taxing jurisdiction within the meaning of § 4.901-2(a)(1)(iii)”), the existing regulations do not contain such a rule. The reasons for adopting a jurisdictional nexus requirement under Treas. Reg. § 1.901-2, apply equally to in lieu of taxes described in § 903. In addition, this rule is necessary to ensure that a foreign tax that is imposed on net gain but that fails the jurisdictional nexus requirement in Treas. Reg. § 1.901-2 cannot be converted into a creditable tax under § 903 simply by being imposed on a taxable base other than income (such as a tax on gross receipts).

- (e) Furthermore, the proposed regulations include a special rule for certain cross-border source-based withholding taxes in order to clarify the application of the substitution requirement to such taxes. The rules in Prop. Treas. Reg. § 1.903-1 apply independently to each separate levy. Therefore, if a separate levy is an in lieu of tax, and a second levy is later enacted by the same foreign country, such second levy may also qualify as an in lieu of tax if the requirements in Prop. Treas. Reg. § 1.903-1 are met.

## 2. Substitution Requirement.

- (a) The foreign tax that is being analyzed under § 903 (the “tested foreign tax”) satisfies the substitution requirement only if, based on the foreign tax law, four tests are met. First, as under the existing regulations, a separate levy that is a foreign income tax described in Treas. Reg. § 1.901-2(a)(3) (a “foreign net income tax”) must be generally imposed by the same foreign country (a “generally-imposed net income tax”). Prop. Treas. Reg. § 1.903-1(c)(1)(i).
- (b) Second, Prop. Treas. Reg. § 1.903-1(c)(1)(ii) requires that neither the generally-imposed net income tax nor any other separate levy that is a foreign net income tax imposed by the same foreign country that imposes the tested foreign tax is imposed regarding 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”). For example, if a tonnage tax regime applies regarding a taxpayer engaged in shipping, income from shipping must be excluded from the foreign country’s regular net income tax for the tonnage tax to qualify as an in lieu of tax. This requirement is not met if, under the foreign tax law, a net income tax imposed by the same foreign country applies to the excluded income of any persons that are subject to the tested foreign tax, even if not all of the persons subject to the tested foreign tax are subject to the net income tax.
- (c) Third, Prop. Treas. Reg. § 1.903-1(c)(1)(iii) requires that, but for the existence of the tested foreign tax, the generally-imposed net income tax would be imposed on the excluded income. For example, if a tonnage tax regime applies regarding a taxpayer engaged in shipping, it must be shown that, but for the existence of such regime, the regular income tax would apply to income from shipping. This “but for” requirement is met only if the imposition of the tested foreign tax bears a “close connection” to the failure to impose the generally-imposed net income tax on the excluded income. *See Metro. Life Ins. Co.*, 375 F.2d at 840.



- (d) The proposed regulations provide that the close connection requirement is satisfied if the generally-imposed net income tax would apply by its terms to the excluded income but for the fact that it is expressly excluded. For example, if a corporate income tax regime would, by its terms, apply to all corporations, but income of insurance companies is expressly excluded by law under such regime and taxed under a separate regime, then the close connection requirement is met.
- (e) Otherwise, a close connection 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. Such proof may take into account the legislative history of either the tested foreign tax or the generally-imposed net income tax for purposes of ascertaining the intent and purpose of the two taxes in order to determine the relationship between them.
- (f) Not all income derived by persons subject to the tested foreign tax need be excluded income, as long as the tested foreign tax applies only to amounts that relate to the excluded income. For example, if a taxpayer that earns income from operating restaurants and hotels is subject to a generally-imposed net income tax except that, pursuant to an agreement with the foreign country, the taxpayer's income from restaurants is subject to a tax based on number of tables and not to the income tax, the table tax can meet the substitution requirement notwithstanding that the hotel income is subject to the generally-imposed net income tax.
- (g) Fourth, Prop. Treas. Reg. § 1.903-1(c)(1)(iv) requires that, if the generally-imposed net income tax were applied to the excluded income, the generally-imposed net income tax would either continue to qualify as a foreign net income tax, or would itself constitute a separate levy that is a foreign net income tax. This rule is intended to ensure that a foreign tax can qualify as an in lieu of tax only if the foreign country imposing the tax could instead have subjected the excluded income to a tax on net gain that would satisfy the jurisdictional nexus requirement in Treas. Reg. § 1.901-2(c).
- (h) Finally, Prop. Treas. Reg. § 1.861-20(h) provides a rule for allocating and apportioning foreign taxes described in § 903 (other than withholding taxes) to statutory and residual groupings. In general, the rule provides that the in lieu of tax is allocated and apportioned in the same proportions as the excluded income.

3. Covered Withholding Tax.

- (a) Gross-basis taxes, such as withholding taxes, do not satisfy the net gain requirement under Prop. Treas. Reg. § 1.901-2(b). While such withholding taxes may be treated as in lieu of taxes under § 903, the analysis under § 903 and existing Treas. Reg. § 1.903-1 is unclear. Therefore, Prop. Treas. Reg. § 1.903-1(c)(2) provides a special rule for applying the substitution requirement to certain “covered withholding taxes” imposed by a foreign country that also has a generally-imposed net income tax.
- (b) First, the tax must be a withholding tax (as defined in § 901(k)(1)(B)) that is imposed on gross income of persons who are nonresidents of the foreign country imposing the tax. Prop. Treas. Reg. § 1.903-1(c)(2)(i).
- (c) Second, the tax cannot be in addition to a net income tax that is imposed by the foreign country on any portion of the income subject to the withholding tax. Prop. Treas. Reg. § 1.903-1(c)(2)(ii). Thus, for example, if a withholding tax applies by its terms to certain gross income of nonresidents that is also subject to the generally-imposed net income tax if it is attributable to a taxable presence of the nonresident in the foreign country imposing the tax, the withholding tax cannot meet the substitution requirement, including as to nonresidents that do not have a taxable presence in that country.
- (d) Third, the withholding tax must meet the source-based jurisdictional nexus requirement in Prop. Treas. Reg. § 1.901-2(c)(1)(ii), requiring that rules for sourcing income to the foreign country are reasonably similar to the sourcing rules that apply for Federal income tax purposes (including that services income is sourced to the place of performance). Similar to the rule in Prop. Treas. Reg. § 1.903-1(c)(1)(iv) requiring that the generally-imposed net income tax, if expanded to cover the excluded income, would continue to qualify as a net income tax under Treas. Reg. § 1.901-2, Prop. Treas. Reg. § 1.903-1(c)(2)(iii) requires that the income subject to the withholding tax satisfies the source requirement described in Treas. Reg. § 1.901-2(c)(1)(ii).

S. Rules for Allocating Taxes After Certain Ownership and Entity Classification Changes.

T. Background.

- 1. On February 14, 2012, final regulations were issued under § 901 concerning the determination of the person who pays a tax for foreign tax credit purposes (the “2012 final regulations”). The 2012 final regulations

address the inappropriate separation of foreign income taxes from the income on which the tax was imposed in certain circumstances. They provide rules for allocating foreign tax imposed on the combined income of multiple persons, as well as rules for allocating entity-level foreign tax imposed on partnerships and disregarded entities that undergo ownership or certain entity classification changes that do not cause the foreign taxable year of the partnership or disregarded entity (the “continuing foreign taxable year”) to close.

2. Treas. Reg. § 1.901-2(f)(4)(i) of the 2012 final regulations addresses partnership terminations under § 708(b)(1) that do not cause the foreign taxable year to close. Under this provision, foreign tax paid or accrued regarding the continuing foreign taxable year (for example, in the case of a § 708(b)(1) termination, foreign tax paid or accrued by a successor corporation or owner of a disregarded entity) is allocated between each terminating partnership and successor entity (or, in the case of a partnership that becomes a disregarded entity, the owner of the disregarded entity).
3. The allocation is based upon the respective portions of the foreign tax base that are attributable under the principles of Treas. Reg. § 1.1502-76(b) to the period of existence of the terminating partnership and successor entity or the period of ownership by a disregarded entity owner during the continuing foreign taxable year. Treas. Reg. § 1.901-2(f)(4)(i) also provides similar rules for allocating foreign tax paid or accrued by a partnership among the respective portions of the partnership’s U.S. taxable year that end with, and begin after, a change in a partner’s interest in the partnership that does not result in a partnership termination (a variance).
4. Treas. Reg. § 1.901-2(f)(4)(ii) of the 2012 final regulations addresses a change in the ownership of a disregarded entity that does not cause the foreign taxable year of the entity to close. Under this rule, foreign tax paid or accrued regarding the foreign taxable year is allocated between the transferor and transferee of the disregarded entity. The allocation is made based on the respective portions of the foreign tax base that are attributable under the principles of Treas. Reg. § 1.1502-76(b) to the period of ownership of each transferor and transferee.

U. Covered Events.

1. The proposed regulations move the Treas. Reg. § 1.901-2(f)(4) allocation rules that apply in the case of partnership terminations and variances and other ownership and entity classification changes to new Treas. Reg. § 1.901-2(f)(5), and modify those rules to ensure that they cover any entity classification change under U.S. tax law that does not cause the entity’s foreign taxable year to close. The proposed regulations also clarify certain aspects of the 2012 final regulations. The general legal liability rules for

taxes imposed on partnerships and disregarded entities are now contained in Prop. Treas. Reg. § 1.901-2(f)(4) and are generally unchanged from the 2012 final regulations.

2. Prop. Treas. Reg. § 1.901-2(f)(5)(i) provides a single allocation rule that applies to a partnership, disregarded entity, or corporation that undergoes one or more “covered events” during its foreign taxable year that do not result in a closing of the foreign taxable year. Under Prop. Treas. Reg. § 1.901-2(f)(5)(ii), a covered event is a partnership termination under § 708(b)(1), a transfer of a disregarded entity, or a change in the entity classification of a disregarded entity or a corporation.
3. The proposed regulations therefore apply to allocate foreign tax paid or accrued regarding the continuing foreign taxable year of a partnership that terminates under § 708(b)(1), a disregarded entity that becomes a partnership or a corporation, and a corporation that becomes a partnership or a disregarded entity. In addition, Prop. Treas. Reg. § 1.901-2(f)(5)(iv) allocates foreign tax paid or accrued regarding certain changes in a partner’s interest in a partnership (a “variance”) by treating the variance as a covered event.
4. The proposed regulations also ensure that the allocation rules apply not just in the case of one or more covered events of the same type within a continuing foreign taxable year, but also in the case of any combination of covered events. For example, Prop. Treas. Reg. § 1.901-2(f)(5) applies to foreign tax that is paid or accrued regarding a continuing foreign taxable year in which a corporation elects to be treated as a disregarded entity and the disregarded entity subsequently becomes a partnership.
5. A portion of foreign tax is allocated among all persons that were predecessor entities (namely, a terminating partnership or corporation undergoing an entity classification change) or prior owners (namely, the owner of a disregarded entity that is transferred or undergoes an entity classification change) during the continuing foreign taxable year. Like the rules provided in the 2012 final regulations, the allocation is made based on the respective portions of the foreign tax base for the continuing foreign taxable year that are attributable under the principles of Treas. Reg. § 1.1502-76(b) to the period of existence or ownership of each predecessor entity or prior owner during such year.

- V. Timing of the Payment or Accrual of an Allocated Tax. These proposed regulations also provide consistent rules for when allocated tax is treated as paid or accrued. Prop. Treas. Reg. § 1.901-2(f)(5)(i) provides that tax allocated to a predecessor entity is treated as paid or accrued as of the close of the last day of its last U.S. taxable year, and that tax allocated to the prior owner of a disregarded entity is treated as paid or accrued as of the close of the last day of its U.S. taxable year in which the change in ownership occurs.

W. Treatment of Withholding Taxes.

1. The 2012 final regulations do not clearly state whether foreign withholding taxes are subject to the allocation rules. Foreign taxes are allocated based on the portion of the foreign tax base that is attributed to the period of existence or ownership of each predecessor or prior owner during the foreign taxable year, applying the principles of Treas. Reg. § 1.1502-76(b). The principles of Treas. Reg. § 1.1502-76(b) allow taxpayers to use either a closing of the books method or a ratable allocation method in attributing the foreign tax base to these periods.
2. If the ratable allocation method is used, foreign tax is generally allocated to a predecessor entity or prior owner based on its ratable share of the foreign tax base for the continuing foreign taxable year. In the case of net basis foreign tax paid or accrued by a new owner or successor entity regarding a continuing foreign taxable year, the resulting allocation of a portion of the tax to a predecessor entity or prior owner is appropriate because the predecessor entity or prior owner generally took into account for U.S. tax purposes a portion of the related income on which the net basis tax was imposed.
3. However, in the case of withholding tax that is imposed on an amount that accrues for U.S. tax purposes when it is paid, such as a dividend, an allocation of a portion of the withholding tax based on ratably allocating the dividend income over the foreign taxable year to a predecessor entity or prior owner is not appropriate because the predecessor entity or prior owner will not have taken any of the related dividend income into account for U.S. tax purposes. Even if withholding tax is imposed on income, such as interest, that accrues for U.S. tax purposes ratably over a period, an allocation of a portion of the withholding tax to a predecessor entity or prior owner based on ratably allocating the interest income over the foreign taxable year may not be appropriate if the foreign taxable year is not the same period as the accrual period under the terms of the instrument that generated the interest.
4. Treasury and the IRS are concerned that applying the ratable allocation method under Prop. Treas. Reg. § 1.901-2(f)(5) to allocate withholding taxes to a predecessor entity or prior owner may separate withholding taxes from income that accrues when paid. Thus, they may not achieve appropriate matching of withholding taxes and related income in the case of withholding tax imposed on income that accrues over a period. The proposed regulations provide that withholding taxes paid in the foreign taxable year of a covered event are not subject to allocation under Prop. Treas. Reg. § 1.901-2(f)(5).

X. Elections Under §§ 336(e) and 338.

1. Treas. Reg. §§ 1.336-2(g)(3)(ii) and 1.338-9(d) provide rules for allocating foreign tax between old target and new target where a § 336(e) election or 338 election, respectively, is in effect regarding the sale, exchange, or distribution of the target and the transaction does not cause old target's foreign taxable year to close. The proposed regulations clarify that, in the case of a § 338 election, the allocation is made regarding the portions of the foreign tax base that are attributable under Treas. Reg. § 1.1502-76(b) principles to old target and new target, and clarify how the allocation is made if there are multiple transfers of the stock of target that are each subject to a separate § 338 election during the foreign taxable year.
2. The proposed regulations also provide that if a § 338 election is made for target and target holds an interest in a disregarded entity or partnership, the rules of Treas. Reg. § 1.901-2(f)(4) and (5) apply to determine the person who is considered for Federal income tax purposes to pay foreign income tax imposed at the entity level on the income of the disregarded entity or partnership.
3. In addition, they clarify that withholding tax is not subject to allocation. Finally, the proposed regulations make a conforming change to the allocation rules that apply where a § 336(e) election is in effect by providing that withholding taxes are not subject to allocation.

Y. Transition Rules Accounting for NOL Carrybacks.

Z. Background.

1. The 2019 FTC final regulations provide transition rules for assigning any separate limitation loss ("SLL") or overall foreign loss ("OFL") accounts in a pre-2018 separate category to a post-2017 separate category. The regulations also provide transition rules for how an SLL or OFL that reduced pre-2018 general category income is recaptured in post-2017 years, and for how to treat foreign losses that are part of general category net operating losses ("NOLs") incurred in pre-2018 taxable years that are carried forward to post-2017 taxable years. *See* Treas. Reg. § 1.904(f)-12(j).
2. The transition rules in the 2019 FTC final regulations, however, did not address post-2017 NOL carrybacks to pre-2018 taxable years because § 172 generally did not allow for NOL carrybacks when the 2019 FTC final regulations were issued. However, on March 27, 2020, Congress enacted the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136 (the "CARES Act"), which revised § 172(b) to allow taxpayers to carry back, for five years, NOLs incurred in 2018 through 2020.

AA. Rule for Post-2017 NOL Carrybacks.

1. The proposed regulations provide rules analogous to the existing transition rules in Treas. Reg. § 1.904(f)-12(j) to situations involving an NOL arising in a post-2017 taxable year that is carried back to a pre-2018 taxable year. In particular, Prop. Treas. Reg. § 1.904(f)-12(j)(5)(i) confirms that the rules of Treas. Reg. § 1.904(g)-3(b) apply to the NOL carryback, and provides that income in a pre-2018 separate category in the taxable year to which the NOL is carried back is generally treated as if it included only income that would be assigned to the same separate category in post-2017 taxable years.
2. Therefore, any SLL created by reason of a passive category component of a post-2017 NOL that is carried back to offset pre-2018 general category income will be recaptured in post-2017 taxable years as general category income, and not as a combination of post-2017 general, foreign branch, or § 951A category income.
3. However, in order to reduce the potential for creating SLLs by reason of the carryback of a post-2017 NOL component in the foreign branch category or § 951A category to a pre-2018 taxable year, the proposed regulations provide that such losses will first ratably offset a taxpayer's general category income in the carryback year, to the extent thereof, and that no SLL account will be created as a result of that offset. The amount of income in the general category available to be offset under this rule is determined after first offsetting the general category income in the carryback year by a post-2017 NOL component in the general category that is carried back to the same year.

BB. Foreign Tax Credit Limitation Under § 904.

CC. Revisions to Definition of Foreign Branch Category Income.

1. The proposed regulations revise certain aspects of the foreign branch category income rules in Treas. Reg. § 1.904-4(f) to account for a broader range of disregarded payments, as well as to better coordinate with the rules in Treas. Reg. § 1.861-20 and the elective high-tax exception rules in Prop. Treas. Reg. § 1.954-1(d) of the 2020 HTE proposed regulations.
2. Section 904(d)(2)(J)(i) defines foreign branch category income as business profits of a U.S. person that are attributable to qualified business units in foreign countries. Treas. Reg. § 1.904-4(f)(2)(ii) and (iii) of the 2019 FTC final regulations provide that income attributable to a foreign branch does not include income arising from activities carried out in the U.S. or income arising from stock that is not dealer property. Treas. Reg. § 1.904-4(f)(1)(ii) of the 2019 FTC final regulations, reflecting § 904(d)(2)(J)(ii), provides that passive category income is excluded from foreign branch category income. These rules exclude from foreign branch category

income for purposes of § 904 income generated by assets that may be owned through the foreign branch and reflected on its books and records, but that is not properly characterized as business profits attributable to foreign branch activities.

3. In contrast, in the different context of applying the disregarded payment rules in Prop. Treas. Reg. § 1.861-20(d)(3)(v) or Prop. Treas. Reg. § 1.954-1(d), which rely on the rules in Treas. Reg. § 1.904-4(f), such income is properly attributed to a taxable unit or a tested unit, respectively, for purposes of those provisions. In order to facilitate the incorporation by cross-reference of the rules and principles in Treas. Reg. § 1.904-4(f) for attributing income to taxable units for purposes of other provisions, the proposed regulations move the exclusions for income arising from U.S. activities and stock to Treas. Reg. §§ 1.904-4(f)(1)(iii) and (iv), respectively, and modify the language to provide that such income may be attributable to a foreign branch but is always excluded from foreign branch category income.
4. This technical change does not reflect any reconsideration by Treasury and the IRS of the determination in the 2019 FTC final regulations that income arising from U.S. activities and stock do not constitute business profits that are attributable to foreign branches within the meaning of § 904(d)(2)(J).
5. Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(G) provides that the disregarded reallocation payment rules generally apply in the case of disregarded payments made to and from a “non-branch taxable unit” (as defined in Prop. Treas. Reg. §§ 1.904-4(f)(3) and 1.904-6(b)(2)(i)(B)), which includes certain persons and interests that do not meet the definition of a foreign branch or foreign branch owner.
6. This change accounts for the fact that disregarded payments may occur among, for example, foreign branches, foreign branch owners, and disregarded entities that have no trade or business (and are therefore not foreign branches).
7. In order to attribute gross income to a foreign branch or a foreign branch owner, disregarded payments to and from non-branch taxable units must cause the reattribution of current gross income to the same extent as disregarded payments to and from foreign branches and foreign branch owners. The gross income attributed to a non-branch taxable unit after taking into account all the disregarded payments that it makes and receives must then be further attributed to a foreign branch (if it is part of a “foreign branch group”), or foreign branch owner (if it is part of a “foreign branch owner group”), to the extent of its ownership of the non-branch taxable unit. For this purpose, a non-branch taxable unit is part of either a foreign branch group or a foreign branch owner group to the extent it is



owned, including indirectly through other non-branch taxable units, by a foreign branch or a foreign branch owner, respectively.

8. The gross income that is attributed to the members of a foreign branch group is attributed to the foreign branch that owns the group, and the gross income that is attributed to the members of a foreign branch owner group is attributed to the foreign branch owner that owns the group.
9. The proposed regulations also clarify that the reattribution of gross income by reason of disregarded payments is capped at the amount of current gross income in the payor foreign branch or foreign branch owner. *See* Treas. Reg. § 1.904-4(f)(2)(vi)(A).
10. Finally, the proposed regulations include more detailed rules on the treatment of payments between foreign branches, and provide an example illustrating the application of the matching rule in Treas. Reg. § 1.1502-13 to the rules in Treas. Reg. § 1.904-4(f)(2)(vi) in response to a comment received regarding the 2019 FTC proposed regulations. *See* Prop. Treas. Reg. § 1.904-4(f)(4)(xiii) through (xv) (Examples 13 through 15).

DD. Financial Services Entities.

1. Section 904(d)(2)(D)(i) provides that financial services income can only be received or accrued by a person “predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.” The 2019 FTC proposed regulations modified the definition of a financial services entity (“FSE”) by adopting a definition of “predominantly engaged in the active conduct of a banking, insurance, financing, or similar business” and “income derived in the active conduct of a banking, insurance, financing, or similar business.” As discussed in the preamble to the 2020 FTC final regulations, in response to comments made in response to the 2019 FTC proposed regulations, Treasury and the IRS believe that these provisions of the 2019 FTC proposed regulations should be revised and repropose to provide an additional opportunity for comment.
2. The proposed regulations retain the general approach of the existing Treas. Reg. § 1.904-4(e) final regulations by providing a numerical test whereby an entity is a financial services entity if more than a threshold percentage of its gross income is derived directly from active financing income, and the regulations continue to contain a list of income that qualifies as active financing income. However, the proposed regulations lower the threshold from 80% to 70%, and further provide that active financing income must generally be earned from customers or other counterparties that are not related parties.
3. These changes are intended to promote simplification and greater consistency between Code provisions that have complementary policy

objectives, while still taking into account the differences between §§ 954 and 904. Treasury and the IRS believe that the modified rule also makes clear that internal financing companies do not qualify as financial services entities if 70% or less of their gross income meets the unrelated customer requirement. In addition, the proposed regulations modify Treas. Reg. § 1.904-5(b)(2) to provide that the look-through rules in Treas. Reg. § 1.904-5 apply in all cases to assign related party payments attributable to passive category income to the passive category, including in the case of related party payments made to a financial services entity. Comments were requested on the treatment of related party payments in the numerator and denominator of the 70% gross income test, and whether related party payments should in some cases constitute active financing income.

4. In the case of an insurance company's income from investments, Treasury and the IRS state that they recognize that an insurance company must hold passive investment assets to support its insurance obligations, including capital and surplus in addition to insurance reserves, to ensure the company's ability to satisfy insurance liabilities if claims are greater than anticipated or investment returns are less than anticipated. However, Treasury and the IRS believe that limits on the amount of an insurance company's investment income that may be treated as active financing income are appropriate in cases where an insurance company holds substantially more investment assets and earns substantially more passive investment income than necessary to support its insurance business.
5. Thus, Prop. Treas. Reg. § 1.904-4(e)(2)(ii) imposes a cap on the amount of an insurance company's income from investments that may be treated as active financing income. The cap is determined based on an applicable percentage of the insurance company's total insurance liabilities. If investment income exceeds the insurance company's investment income limitation, investment income in excess of the limitation is not considered ordinary and necessary to the proper conduct of the company's insurance business and will not qualify as active financing income.
6. Treasury and the IRS requested comments on the investment income limitation rule and in particular on whether the applicable percentages selected for life and nonlife insurance companies are reasonable.

EE. Sections 901(a) and 905(a)--Rules Regarding When the Foreign Tax Credit Can Be Claimed.

FF. Background.

1. Section 901(a) provides that a taxpayer has the option, for each taxable year, to claim a credit for foreign income taxes paid or accrued to a foreign country in such taxable year, subject to the limitations under § 904. Alternatively, a taxpayer may deduct the foreign income taxes

under § 164(a)(3). The deduction and credit for foreign income taxes are mutually exclusive; § 275(a)(4) provides that no deduction shall be allowed for foreign income taxes if the taxpayer chooses to take to any extent the benefits of § 901. Treas. Reg. § 1.901-1(c) of the existing regulations, which clarifies the application of § 275(a)(4), provides that if a taxpayer chooses regarding any taxable year to claim a credit for taxes to any extent, such choice will be considered to apply to all taxes paid or accrued in such taxable year to all foreign countries, and no portion will be allowed as a deduction in that taxable year or any succeeding taxable year.

2. Section 901(a) further provides that the choice to claim the foreign tax credit for any taxable year “may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year.” Section 6511 prescribes the periods for making a claim for credit or refund of U.S. tax. The default period under § 6511(a) is three years from the time the taxpayer filed the relevant return or two years from when the tax is paid, whichever is later.
3. Section 6511(d) sets forth special periods of limitation for making a claim of credit or refund of U.S. tax that is attributable to particular attributes. Under § 6511(d)(3), if the refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country for which credit is allowed under § 901, the taxpayer has 10 years from the un-extended due date of the return for the taxable year in which the foreign taxes are paid or accrued to file the claim. *See* § 301.6511(d)-3. Section 6511(d)(2) sets out a special limitations period for refund claims “attributable to a net operating loss carryback” of three years from the due date of the return for the year in which the net operating loss originated.
4. The existing regulations at Treas. Reg. § 1.901-1(d) provide that a taxpayer can claim the benefits of § 901 (or claim a deduction in lieu of a foreign tax credit) at any time before the expiration of the period prescribed by § 6511(d)(3)(A).
5. Section 905(a) and Treas. Reg. § 1.905-1(a) of the existing regulations provide that a taxpayer may claim a credit for foreign income taxes either in the year the taxes accrue or in the year the taxes are paid, depending on the taxpayer’s method of accounting. Treas. Reg. §§ 1.446-1(c) and 1.461-1 provide rules for when income and liabilities are taken into account for taxpayers using the cash receipts and disbursement method of accounting (cash method) and for taxpayers using the accrual method of accounting.
6. Under Treas. Reg. § 1.461-1(a)(1), cash method taxpayers generally take into account allowable deductions in the taxable year in which paid. For accrual method taxpayers, Treas. Reg. § 1.461-1(a)(2) provides that

liabilities are taken into account in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred regarding the liability.

7. If the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax. *See* Treas. Reg. § 1.461-4(g)(6)(i). However, in the case of foreign income taxes, economic performance occurs when the requirements of the all events test, other than economic performance, are met, whether or not the taxpayer elects to credit such taxes under § 901. *See* Treas. Reg. § 1.461-4(g)(6)(iii)(B).
8. In the case of foreign income taxes imposed on the basis of a taxable period, because all of the events that fix the fact and amount of liability for the foreign tax with reasonable accuracy do not occur until the end of the foreign taxable year, such foreign income taxes accrue and are creditable in the U.S. tax year within which the taxpayer's foreign taxable year ends. *See* Treas. Reg. § 1.960-1(b)(4); Revenue Ruling 61-93, 1961-1 C.B. 390.
9. Section 905(a) also provides that, regardless of the taxpayer's method of accounting, a taxpayer can elect to claim the foreign tax credit in the year in which the taxes accrue. Once made, this election is irrevocable and must be followed in all subsequent years. In addition, courts have held that the election to claim the foreign tax credit on the accrual basis cannot be made on an amended return. *See Strong v. Willcuts*, 17 AFTR 1027 (D. Minn.) (1935) (holding that taxpayer may not change to accrual basis on an amended return because when the taxpayer made an election that the Government has accepted, the rights of the parties became fixed); *see also* Rev. Rul. 59-101, 1959-1 C.B. 189 (holding that a taxpayer who elected on his original return to claim credit for foreign income tax accrued may not change this election and file amended returns to claim credit for foreign taxes in the year paid).
10. However, for the year the election is made, a taxpayer can claim a credit both for taxes that accrue in that year as well as taxes paid in such year that had accrued in prior years. *See Ferrer v. Comm'r*, 35 T.C. 617 (1961) (holding that a cash method taxpayer is entitled, in the year he elects pursuant to § 905(a) to claim foreign tax credits on the accrual basis, to claim a credit for prior years' foreign income taxes paid as well as foreign income taxes accrued in that year), *rev'd on other grounds*, 304 F.2d 125 (2d Cir. 1962).
11. Regarding the accrual of a contested tax, the U.S. Supreme Court held in *Dixie Pine Products Co. v. Comm'r*, 320 U.S. 516 (1944), that a state income tax that is contested is not fixed, and so does not accrue, until the contest is resolved. *See also* § 461(f) (rule permitting taxpayers to deduct

contested taxes in the year in which they are paid does not apply to foreign income taxes).

12. The contested tax doctrine, however, does not apply in determining when foreign taxes accrue for purposes of the foreign tax credit. *See Cuba Railroad Co. v. United States*, 124 F. Supp. 182, 185 (S.D.N.Y. 1954) (holding that taxes regarding taxpayer's 1943 income accrued for purposes of the foreign tax credit in 1943 even though the tax was contested and paid in a later year).
13. In Revenue Ruling 58-55, 1958-1 C.B. 266, the IRS examined *Dixie Pine* and *Cuba Railroad*, as well as the legislative history and purpose of the foreign tax credit provisions, and concluded that a contested foreign tax does not accrue until the contest is resolved and the liability becomes finally determined, but for foreign tax credit purposes, the foreign tax, once finally determined, is considered to accrue in the taxable year to which it relates. The revenue ruling further clarified that this "relation back" rule does not apply for purposes of determining the taxable year in which foreign taxes may be deducted under § 164, which is governed by the contested tax doctrine.
14. The relation back rule has since been consistently applied by courts. *See*, for example, *United States v. Campbell*, 351 F.2d 336, 338 (2d Cir. 1965) (explaining that if a taxpayer contests his liability for a foreign tax imposed on income in 1960, and the liability is finally adjudicated in 1965, the taxpayer may not claim the credit until 1965, but at that time the credit relates back to offset U.S. tax imposed on taxpayer's 1960 income); *Albemarle Corp. & Subsidiaries v. United States*, 797 F.3d 1011, 1019 (Fed. Cir. 2015) (holding that in the context of determining in what year a taxpayer is eligible to claim a foreign tax credit, the relation back doctrine applies, and thus the 10-year limitations period for filing a refund claim started to run from the un-extended due date for the return for the year to which the tax relates, not the later year in which the contest was resolved).
15. In Revenue Ruling 70-290, 1970-1 C.B. 160, the IRS held that contested taxes that have been paid to the foreign country may be provisionally accrued and claimed as a foreign tax credit, even if the liability has not actually accrued because the taxpayer continues to contest its liability for the tax in the foreign country. The revenue ruling reasons that this is permissible because § 905(c) would require a redetermination of U.S. tax liability if the taxpayer's contest is successful, and the foreign tax is refunded to the taxpayer by the foreign government.
16. Revenue Ruling 84-125, 1984-2 C.B. 125, similarly held that a taxpayer is eligible to claim a credit for the portion of contested taxes that have actually been paid for the taxable year in which the contested liability

relates because such taxes are accruable at the time of payment, even though the amount of the liability is not finally determined.

17. Treasury and the IRS state that they received comments in response to the 2019 FTC proposed regulations asking for clarification on when contested taxes accrue for purposes of the foreign tax credit and for clarification regarding whether the special period of limitations in § 6511(d)(3)(A) applies in the case of a refund claim relating to foreign income taxes that a taxpayer chose to deduct. Questions have also arisen regarding whether taxpayers can make an election to claim the foreign tax credit or revoke such an election (in order to deduct the foreign taxes) on an amended return when making or revoking such election results in a time-barred U.S. tax deficiency in one or more intervening years because the assessment statute under § 6501 does not align with the time for making or changing the election under Treas. Reg. § 1.901-1(d).
18. The new proposed regulations provide rules clarifying when a foreign tax credit may be taken for both cash method taxpayers and for accrual method taxpayers, and in the case of accrual method taxpayers, clarify the application of the relation-back doctrine. The proposed regulations also modify the period during which a taxpayer can change the choice to claim a credit or a deduction for foreign income taxes on an amended return to align with the different refund periods under § 6511.
19. The proposed regulations also clarify that a change from claiming a deduction to claiming a credit, or vice versa, for foreign income taxes results in a foreign tax redetermination under § 905(c). In addition, the proposed regulations address mismatch and time- barred deficiency issues resulting from the application of the relation-back doctrine for the accrual of foreign income taxes for purposes of the foreign tax credit, and the application of the contested tax doctrine for purposes of determining when foreign income taxes can be deducted.

GG. Rules for Choosing to Deduct or Credit Foreign Income Taxes.

1. Application of § 275(a)(4).
  - (a) Treas. Reg. § 1.901-1(c) of the existing regulations, interpreting § 275(a)(4), provides that if a taxpayer chooses to claim a foreign tax credit to any extent regarding the taxable year, such choice applies to all creditable taxes and no deduction for any such taxes is allowed in such taxable year or in any succeeding taxable year. Questions have arisen as to whether this rule prevents taxpayers from claiming either the benefit of a credit or a deduction regarding additional taxes that are paid in a taxable year in which a taxpayer claims a foreign tax credit if those additional taxes relate

(under the relation-back doctrine) to an earlier year in which taxpayer claimed a deduction.

- (b) Additional tax paid by an accrual method taxpayer (or a cash method taxpayer that has elected to claim foreign tax credits using the accrual method) as a result of a foreign tax audit or at the end of a contest relate back and are considered to accrue in the taxable year to which the taxes relate. Thus, the additional taxes are not creditable in the year they are paid and would only be creditable in the relation-back year.
- (c) However, if a taxpayer deducted foreign income taxes in the relation-back year, the taxpayer cannot claim an additional deduction in the earlier year because the additional taxes accrue for deduction purposes in the year the additional taxes are paid.
- (d) Treasury and the IRS believe that this result is not intended by § 275(a)(4), the purpose of which is to prevent taxpayers from claiming the benefits of both a credit and a deduction regarding the same taxes. Thus, the proposed regulations provide an exception which allows a taxpayer that is claiming credits on an accrual basis to claim, in a year in which it has elected to claim a credit for foreign income taxes that accrue in that year, also to deduct additional taxes paid in that year that, for foreign tax credit purposes, relate back and are considered to accrue in a prior year in which the taxpayer deducted foreign income taxes. Prop. Treas. Reg. § 1.901-1(c)(3).

2. Period Within Which an Election to Claim a Foreign Tax Credit Can Be Made or Changed.

- (a) The proposed regulations also modify Treas. Reg. § 1.901-1(d), which sets forth the period during which a taxpayer can make or change its election to claim a foreign tax credit. Existing Treas. Reg. § 1.901-1(d), which was amended in 1987, provides that a taxpayer can, for a particular taxable year, claim the benefits of § 901 or claim a deduction in lieu of a foreign tax credit at any time before the expiration of the period prescribed by § 6511(d)(3)(A) (or § 6511(c) if the period is extended by agreement). The 1987 amendment was preceded by cases in which courts determined that the applicable period of limitations for making an initial election to claim a foreign tax credit under § 901 is the special 10-year period in § 6511(d)(3)(A). See *Woodmansee v. United States*, 578 F.2d 1302 (9th Cir. 1978); *Hart v. United States*, 585 F.2d 1025 (Ct. Cl. 1978) (also holding that prior regulations, which required taxpayers to make the election to claim

a foreign tax credit within the three-year period prescribed by 6511(a), were invalid).

- (b) However, as recent court decisions have made clear, the 10-year statute of limitations in § 6511(d)(3)(A) applies only to claims for credit or refund of U.S. taxes attributable to foreign income taxes for which the taxpayer was allowed a credit; it does not apply in the case of a claim for credit or refund of U.S. taxes attributable to foreign income taxes for which a taxpayer claimed a deduction under § 164(a)(3). *See, for example, Trusted Media Brands, Inc. v. United States*, 899 F.3d 175 (2d Cir. 2018).
- (c) In addition, the reason for the special period of limitations provided by § 6511(d)(3) is to allow taxpayers to seek a refund of U.S. tax if foreign taxes were assessed or increased after the regular three-year statute of limitations period has run, and to better align with the IRS' ability to assess additional U.S. tax under § 905(c) when a taxpayer receives a refund of the foreign income tax claimed as a credit.
- (d) The special period of limitations is not needed when a taxpayer instead claims a deduction, because accrued foreign income taxes do not relate back for deduction purposes, and the additional tax paid as a result of the foreign assessment can be claimed as a deduction in the year the contest is resolved.
- (e) Therefore, Treasury and the IRS believe that the better interpretation of § 901(a) is that the period for choosing or changing the election to claim a credit or a deduction is based on the applicable refund period, depending on the choice made. Thus, an election to claim a credit, or to change from claiming a deduction to claiming a credit, for taxes paid or accrued in a particular year must be made before the expiration of the 10-year period prescribed by § 6511(d)(3)(A) within which a claim for refund attributable to foreign tax credits may be made, but a choice to claim a deduction, or to change from claiming a credit to claiming a deduction, for taxes paid or accrued in a particular year must be made before the expiration of the three-year period prescribed by § 6511(a) within which a claim for refund attributable to a § 164 deduction may be made. Prop. Treas. Reg. § 1.901-1(d).
- (f) The proposed rule eliminates the mismatch between the election and refund periods that exists under the existing regulations, whereby a taxpayer who makes a timely election to change from claiming a credit to claiming a deduction within a 10-year period may in some cases be time-barred from obtaining a refund of U.S.



taxes attributable to the resulting decrease in taxable income for the deduction year.

- (g) In addition, the proposed rule is consistent with the court's decision in each of Hart and Woodmansee, since it allows taxpayers to elect to claim a credit within the 10-year period provided by § 6511(d)(3)(A).

3. Change in Election Treated as a Foreign Tax Redetermination Under § 905(c).

- (a) As part of the 2019 FTC final regulations, Treasury and the IRS issued final regulations under Treas. Reg. § 1.905-3 to provide guidance on when foreign tax redeterminations occur. Treas. Reg. § 1.905-3(a) provides that a foreign tax redetermination means a change in the liability for a foreign income tax or certain other changes that affect a taxpayer's foreign tax credit.
- (b) Consistent with § 905(c), this includes when foreign income taxes for which a taxpayer claimed a credit are refunded, foreign income taxes when paid or later adjusted differ from amounts a taxpayer claimed as a credit or added to PTEP group taxes, and when accrued taxes are not paid within 24 months of the close of the taxable year to which the taxes relate.
- (c) The 2020 FTC final regulations further modify the definition of foreign tax redetermination to include changes to foreign income tax liability that affect a taxpayer's U.S. tax liability even when there is no change to the amount of foreign tax credits claimed, such as when a change to foreign taxes affects subpart F and GILTI inclusion amounts or affects whether or not a CFC's subpart F income and tested income is eligible for the high-tax exception under § 954(b)(4) in the year to which the redetermined foreign tax relates.
- (d) The proposed regulations further amend Treas. Reg. § 1.905-3 to provide that a foreign tax redetermination includes a change by a taxpayer in its decision to claim a credit or a deduction for foreign income taxes that may affect a taxpayer's U.S. tax liability. Section 905(c)(1)(A) provides that a foreign tax redetermination is required "if accrued taxes when paid differ from the amounts claimed as credits by the taxpayer." When a taxpayer changes its election from claiming a credit to claiming a deduction, or vice versa, regarding foreign income taxes paid or accrued in a particular year, the amount of tax that was accrued and paid differs from the amount that has been claimed as a credit by the taxpayer. Accordingly, a change in a taxpayer's election to claim a credit or

a deduction for foreign income taxes is described in § 905(c)(1)(A) even if the foreign income tax liability remains unchanged.

- (e) This interpretation is consistent with the purpose of § 905(c) and within the constraints courts have placed in interpreting the provision. As noted by the court in *Texas Co. (Caribbean) Ltd. v. Comm’r*, 12 T.C. 925 (1949), § 905(c) addresses problems for which the relevant information might not be available within the general period of limitations or ones where the taxpayer has exclusive control of the information, which justify removing these situations from the generally-applicable period of limitations on assessment. The court in *Texas Co.* held that a U.S. tax deficiency that results from a computational error, which was discoverable by the IRS within the normal assessment period, is not within the scope of § 905(c).
- (f) A taxpayer’s decision to change its election can occur outside the normal assessment period under § 6501(a) and is information that is under the exclusive control of the taxpayer. Thus, Treasury and the IRS believe that it is appropriate to treat a change in election as a foreign tax redetermination that requires a redetermination of U.S. tax liability for the affected years and notification of the IRS to the extent required under Treas. Reg. § 1.905-4.
- (g) The effect of treating a change in a taxpayer’s decision to claim a credit or a deduction for foreign income taxes as a foreign tax redetermination is that the IRS may assess and collect any U.S. tax deficiencies in intervening years that result from the taxpayer’s change in election, even if the generally-applicable three-year assessment period under § 6501(a) has expired. *See* § 6501(c)(5).
- (h) This can occur, for example, if a timely change to switch from deductions originally claimed in a loss year (to increase a net operating loss) to credits (in order to claim a carryforward of excess foreign taxes in a later year) would result in a time-barred deficiency in a year to which the net operating loss that was increased by the deductions for foreign taxes was originally carried.
- (i) Currently, the law is unclear how § 274(a)(4), equitable doctrines such as the duty of consistency, or the mitigation provisions under §§ 1311 through 1314 operate to prevent taxpayers from obtaining a double benefit (through both a deduction and a credit) for a single amount of foreign income tax paid. These uncertainties have led taxpayers to request guidance from the IRS to clarify the effect of a timely change in election on their U.S. tax liabilities.

- (j) The proposed regulations provide a clear and efficient process by which taxpayers can eliminate uncertainty regarding the tax consequences of changing from claiming a credit to claiming a deduction, or vice versa, for foreign income taxes, within the time period allowed.

4. Rules for When a Cash Method Taxpayer Can Claim the Foreign Tax Credit.

- (a) Prop. Treas. Reg. § 1.905-1(c) provides rules on when foreign income taxes are creditable for taxpayers using the cash method of accounting. Consistent with Treas. Reg. § 1.461-1(a)(1), which provides that for taxpayers using the cash method, amounts representing allowable deductions are taken into account in the taxable year in which they are paid, Prop. Treas. Reg. § 1.905-1(c)(1) provides that foreign income taxes are creditable in the taxable year in which they are paid. Foreign income taxes are generally considered paid in the year the taxes are remitted to the foreign country. However, foreign income taxes that are withheld from gross income by the payor are considered paid in the year withheld. See Prop. Treas. Reg. § 1.905-1(c)(1). Taxes that are not paid within the meaning of Treas. Reg. § 1.901-2(e) because they exceed a reasonable approximation of the taxpayer's final foreign income tax liability are not eligible for a foreign tax credit.
- (b) The regulations at Treas. Reg. § 1.905-3(a) further provide that a refund of foreign income taxes that have been claimed as a credit in the year paid, or a subsequent determination that the amount paid exceeds the taxpayer's liability for foreign income tax, is a foreign tax redetermination under § 905(c), and the taxpayer must file an amended return and redetermine its U.S. tax liability for the affected years. However, additional taxes that are paid by a cash method taxpayer in a later year regarding a prior year do not relate back to the prior year, nor do they result in a redetermination of foreign income taxes paid and U.S. tax liability under § 905(c) for the prior year; instead, those additional taxes are creditable in the year in which they are paid.
- (c) Prop. Treas. Reg. § 1.905-1(e) sets forth rules for cash method taxpayers electing to claim foreign tax credits on an accrual basis. As provided by § 905(a), this election is irrevocable, and once made, must be followed in all subsequent years, and consistent with the holding in *Strong v. Willcuts*, the election generally cannot be made on an amended return. Prop. Treas. Reg. § 1.905-1(e)(1).
- (d) However, the proposed regulations provide exceptions to these general rules in order to ensure that a taxpayer who makes this

election to switch from claiming credits on a cash basis to an accrual basis is not double taxed in certain situations. First, Prop. Treas. Reg. § 1.905-1(e)(2) provides that a taxpayer who has previously never claimed a foreign tax credit may make the election to claim the foreign tax credit on an accrual basis when the taxpayer claims the credit, even if such initial claim for credit is made on an amended return.

- (e) In addition, following the decision in *Ferrer v. CIR*, Prop. Treas. Reg. § 1.905-1(e)(3) provides that, for the taxable year in which the accrual election is made and for the subsequent years in which a taxpayer claims a foreign tax credit on an accrual basis, that taxpayer can claim a foreign tax credit for taxes paid in the year, if pursuant to the rules for accrual method taxpayers, those taxes paid relate to a taxable year before the taxpayer elected to claim credits on an accrual basis.
- (f) Treasury and the IRS believe that this result is appropriate because otherwise taxpayers that make the accrual election would, in effect, have to forego a credit for prior year taxes, unless the election is made for the very first year in which a credit is claimed.

#### HH. Rules for Accrual Method Taxpayers.

##### 1. In General.

- (a) Prop. Treas. Reg. § 1.905-1(d)(1) provides general rules for when taxpayers using the accrual method of accounting can claim a foreign tax credit. This determination requires applying the all events test contained in Treas. Reg. § 1.461-1. In accordance with Treas. Reg. § 1.461-1(a)(2)(i), foreign income taxes accrue in the taxable year in which all the events have occurred that establish the fact of liability, and the amount of the liability can be determined with reasonable accuracy. *See also* Treas. Reg. § 1.461-4(g)(6)(iii)(B) (economic performance regarding foreign income taxes occurs when the requirements of the all events test, other than the payment prong of the economic performance requirement, are met).
- (b) The proposed regulations confirm that where the all events test has not been met regarding a foreign income tax liability, such as in the case where the tax liability is contingent upon a distribution of earnings, such taxes have not accrued and may not be claimed as a credit. Prop. Treas. Reg. § 1.905-1(d)(1)(i).
- (c) Prop. Treas. Reg. § 1.905-1(d)(1)(ii) incorporates the relation-back doctrine, and provides that, for foreign tax credit purposes, once

the all events test is met, the foreign income taxes relate back and are considered to accrue in the year to which the taxes relate, the “relation-back year.” For example, additional taxes paid as a result of a foreign adjustment relate back and are considered to accrue at the end of the foreign taxable year(s) regarding which the taxes were adjusted. Thus, the additional taxes paid in the later year are creditable in the relation-back year, not in the year in which the additional taxes are paid. *See* Prop. Treas. Reg. § 1.905-1(d)(6)(iii) (Example 3); *see also* Treas. Reg. § 1.905-3(b)(1)(ii)(A) (Example 1).

- (d) Moreover, in the case of foreign income taxes which are treated as refunded pursuant to Treas. Reg. § 1.905-3(a) because they were not paid within 24 months of the close of the taxable year in which they first accrued, Prop. Treas. Reg. § 1.905-1(d)(1)(ii) provides that when payment is later made, the taxes are considered to accrue in the relation-back year.

## 2. Special Rule for 52-53 Week Taxable Years.

- (a) Consistent with Revenue Ruling 61-93, the proposed regulations provide that the liability for a foreign tax becomes fixed on the last day of the taxpayer’s foreign taxable year; thus, foreign income taxes generally accrue and are creditable in the taxpayer’s U.S. taxable year with or within which its foreign taxable year ends. However, Treasury and the IRS believe that it is appropriate to provide a limited exception to this rule in order to address mismatches that occur for taxpayers that elect to use a 52-53 week taxable year for U.S. tax purposes under Treas. Reg. § 1.441-2. Treas. Reg. § 1.441-2 permits certain eligible taxpayers to elect to use a fiscal year that (i) varies from 52 to 53 weeks in length, (ii) always ends on the same day of the week, and (iii) ends either on the same day of the week that last occurs in a calendar month or on whatever date the same day of the week falls that is nearest to the last day of the calendar month.
- (b) A taxpayer that adopts a 52-53 week year, or that changes from a 52-53 week year to another fiscal year, without changing its foreign taxable year, will often have a short taxable year that does not include the foreign year-end. That short U.S. taxable year would include substantially all of the foreign income but none of the related foreign taxes. Similarly, a taxpayer that uses a 52-53 week year for U.S. tax purposes but that uses a foreign tax year that ends on a fixed month-end will in some years have a U.S. taxable year that does not include a foreign year-end and in other years have a U.S. taxable year that includes two foreign year-ends.

- (c) For example, a taxpayer who uses a 52-53 week year that ends on the last Friday of December for U.S. tax purposes would have a tax year that begins Saturday, December 26, 2020, and that ends Friday, December 31, 2021, which includes two calendar year-ends. The following taxable year, which begins on Saturday, January 1, 2022, and ends on Friday, December 30, 2022, would not include a calendar year-end.
- (d) Prop. Treas. Reg. § 1.905-1(d)(2) addresses these mismatches by providing that where a U.S. taxpayer uses a 52-53 week taxable year that ends by reference to the same calendar month as its foreign taxable year, and the U.S. taxable year closes within 6 days of the close of the foreign taxable year, then for purposes of determining the amount of foreign income tax that accrues during the U.S. taxable year, the U.S. taxable year will be deemed to end on the last day of its foreign taxable year.

3. Accrual of Contested Foreign Income Taxes.

- (a) Treasury and the IRS believe that the administrative rulings that allow an accrual method taxpayer to claim a foreign tax credit for a contested tax that has been remitted to a foreign country, notwithstanding the fact that the contest is ongoing, are inconsistent with the all events test (specifically, the test's requirement that all the events must have occurred that establish the fact and amount of the liability with reasonable accuracy).
- (b) In addition, permitting taxpayers to claim a credit for contested taxes before the contest is resolved reduces the incentive for taxpayers to continue to pursue the contest and exhaust all effective and practical remedies, as required under Treas. Reg. § 1.901-2(e)(5)(i), if the period of assessment for the year to which the taxes relate has closed and the IRS would be time-barred from disallowing the foreign tax credit claimed regarding the contested tax paid on noncompulsory payment grounds. Treasury and the IRS have determined that this is an inappropriate result that undermines the longstanding policy for requiring an amount of foreign income tax to be a compulsory payment in order to be creditable.
- (c) Therefore, the proposed regulations provide new rules for when a credit for contested foreign income taxes can be claimed. Following the Supreme Court's holding in *Dixie Pine*, and consistent with the exception to § 461(f) and Treas. Reg. § 1.461-2(a)(2)(i) for foreign income taxes, Prop. Treas. Reg. § 1.905-1(d)(3) provides that contested foreign income taxes do not accrue

until the contest is resolved, because only then is the amount of the foreign income tax liability finally determined.

- (d) Thus, contested foreign income taxes accrue and are creditable only when resolution of the contest establishes the fact and the amount of a liability with reasonable accuracy, even if the taxpayer remits the contested taxes to the foreign country in an earlier year. When the contest is resolved, the liability accrues and, for foreign tax credit purposes, relates back and is considered to accrue in the earlier year to which the liability relates. Once the finally determined liability has been paid, as required by § 905(c)(2)(B) and Treas. Reg. § 1.905-3(a), the taxpayer can claim a foreign tax credit in the relation-back year.

## IX. FINAL REGULATIONS: SOURCE OF INCOME FROM SALES OF PROPERTY.

- A. Overview. Treasury and the IRS finalized regulations dealing with the source of income from certain sales of personal property. The final regulations retain the overall approach of the proposed regulations, with certain revisions.
- B. § 863(b); Prop. Treas. Reg. § 1.863-3.
1. TCJA amended § 863, which provides special sourcing rules for determining the source of income, including income partly from within and partly from without the U.S. Specifically, TCJA amended § 863(b) to allocate or apportion income from the sale or exchange of inventory property produced (in whole or in part) by a taxpayer within the U.S. and sold or exchanged without the U.S. or produced (in whole or in part) by the taxpayer without the U.S. and sold or exchanged within the U.S. (collectively, “§ 863(b)(2) Sales”) solely on the basis of production activities regarding that inventory.
  2. Before TCJA, § 863(b) provided that income from § 863(b)(2) Sales were treated as derived partly from sources within and partly from sources without the U.S. without providing the basis for such allocation or apportionment. Consistent with TCJA’s changes to § 863(b), the proposed regulations amended Treas. Reg. § 1.863-3 to allocate or apportion gross income from § 863(b)(2) Sales based solely on production activity.
  3. Under Treas. Reg. § 1.863-3(c)(1)(ii)(A) (which was redesignated in the final regulations as Treas. Reg. § 1.863-3(c)(2)(i)), where the taxpayer’s production assets are located both within and without the U.S., the amount of income from sources without the U.S. is determined by multiplying all the income attributable to the taxpayer’s production activities by a fraction, the numerator of which is the average adjusted basis of production assets that are located without the U.S. and the denominator of

which is the average adjusted basis of all the production assets located within and without the U.S.

4. For purposes of applying the formula, the adjusted basis of production assets is determined under § 1011, which is adjusted under § 1016 for depreciation deductions allowed. TCJA also amended § 168(k) to allow an additional first-year depreciation deduction of 100% of the basis of certain property placed in service after September 27, 2017, and before January 1, 2023. Therefore, certain new and used production assets placed in service and used predominantly within the U.S. during this period may have an adjusted basis of zero. However, production assets either placed in service or used predominantly without the U.S., or both, do not qualify for this accelerated depreciation and must be depreciated using the straight-line method under the alternative depreciation system (“ADS”) of § 168(g)(2). In light of TCJA’s change to § 168(k) to allow accelerated depreciation in some circumstances, the proposed regulations provided a new rule for computing the adjusted basis of production assets for purposes of applying the allocation formula in Treas. Reg. § 1.863-3.

C. Income Attributable to Sales Activity.

1. Treas. Reg. § 1.863-3, as in effect before the new regulations, provided rules and corresponding methods for allocating or apportioning gross income from § 863(b)(2) Sales between production activity and sales activity. To implement the changes to § 863(b) under TCJA, the proposed regulations proposed removing Treas. Reg. § 1.863-3(c)(2) which allocates and apportions income attributable to sales activity.
2. One comment stated that removing Treas. Reg. § 1.863-3(c)(2) could lead to double taxation when a foreign jurisdiction imposes taxation on the sales activity. TCJA amended § 863(b) to source income from the sale by a taxpayer of inventory produced by that taxpayer based only on production activity. Under the Code, sales activity is no longer a relevant factor for allocating and apportioning such income. Therefore, the final regulations remove Treas. Reg. § 1.863-3(c)(2).
3. Another comment suggested that two aspects of Treas. Reg. § 1.863-3(c)(2) have continued relevance even after TCJA’s changes to § 863(b)(2). First, Treas. Reg. § 1.863-3(c)(2) has a special rule modifying the rule in Treas. Reg. § 1.861-7(c) that generally sources income from the sale of personal property based on the place of sale. Under Treas. Reg. § 1.861-7(c), a sale is generally treated as consummated in the place where the rights, title, and interest of the seller in the property are transferred to the buyer.
4. However, if a taxpayer wholly produces inventory in the U.S. and sells it for use, consumption, or disposition in the U.S., Treas. Reg. § 1.863-



3(c)(2) presumes that the place of sale is in the U.S., even if title passes outside the U.S. The comment recommended the final regulations include a similar rule and expand it to inventory wholly or partly produced in the U.S. that is acquired by a related party and resold for use, consumption, or disposition in the U.S. with title passing outside the U.S.

5. The comment observed that in the absence of such a rule, the sale by the related party would generate foreign source income, notwithstanding the fact that the inventory was produced wholly or partly in the U.S. and ultimately sold for use, consumption, or disposition in the U.S.
6. The final regulations did not adopt this comment. The place of sale rule of Treas. Reg. § 1.861-7(c) already contains a broad anti-abuse rule that would apply to any sales transactions “arranged in a particular manner for the primary purpose of tax avoidance,” which may cover certain related party arrangements about which the comment is concerned. Section 482 also applies to require that compensation paid between related parties is consistent with the arm’s length standard and will take into account the business functions and assets of, and risks assumed by, the related party intermediary.
7. Treasury and the IRS stated that they continue to study issues related to the distribution among related entities of the business functions, assets, and risks that generate business income, including sales income, and might address these issues in future guidance, particularly regarding the sourcing of income from certain digital transactions.
8. Second, the comment said that Treas. Reg. § 1.863-3(c)(2) treats inventory as wholly produced in the U.S. for purposes of determining whether the place of sale is presumed to be in the U.S. if only minor assembly, packaging, repackaging, or labeling occurs outside the U.S. The comment recommended including this rule as part of Prop. Treas. Reg. § 1.863-3(c)(1)(i).
9. The final regulations adopted this comment in Treas. Reg. § 1.863-3(c)(1)(i) by incorporating the “principles of Treas. Reg. § 1.954-3(a)(4)” (other than Treas. Reg. § 1.954-3(a)(4)(iv)). Treas. Reg. § 1.954-3(a)(4) provides rules for determining when a corporation has manufactured, produced, or constructed personal property. Under Treas. Reg. § 1.954-3(a)(4)(iii), packaging, repackaging, labeling, or minor assembly operations do not constitute the manufacture, production, or construction of property. Accordingly, under the final regulations, these principles apply for purposes of determining whether a taxpayer’s activities constitute production activity under Treas. Reg. § 1.863-3(c)(1)(i) as well.

D. Definition of Production Activities.

1. Prop. Treas. Reg. § 1.863-1(b)(2) provided the rule for sourcing gross receipts from the sale of natural resources where the taxpayer performs production activities in addition to its ownership of a farm, mine, oil or gas well, other natural deposit, or uncut timber. Treas. Reg. § 1.863-1(b)(3)(ii) defines such “additional production activities” by reference to the “principles of Treas. Reg. § 1.954-3(a)(4).”
2. One comment supported defining “additional production activities” by reference to “the principles of Treas. Reg. § 1.954-3(a)(4),” as described in Treas. Reg. § 1.863-1(b)(3)(ii), and requested that Treas. Reg. §§ 1.863-3 and 1.865-3 include a similar cross reference.
3. The final regulations adopted this recommendation, in part. Treas. Reg. §§ 1.863-3 and 1.865-3 incorporate the principles of Treas. Reg. § 1.954-3(a)(4), with the exception of the rules regarding a “substantial contribution to the manufacturing of personal property” under Treas. Reg. § 1.954-3(a)(4)(iv). *See* Treas. Reg. §§ 1.863-3(c)(1)(i) and 1.865-3(d)(2). The final regulations also modified Treas. Reg. § 1.863-1(b)(3)(ii) to incorporate the principles of Treas. Reg. § 1.954-3(a)(4), other than the “substantial contribution to the manufacturing of personal property” under Treas. Reg. § 1.954-3(a)(4)(iv).
4. The substantial contribution rules were added to Treas. Reg. § 1.954-3(a)(4) in 2008. While Treasury and the IRS agreed with the comment that the principles of Treas. Reg. § 1.954-3(a)(4) might generally be helpful in determining the location of production activity for sourcing purposes, they stated the substantial contribution rules of Treas. Reg. § 1.954-3(a)(4)(iv) are concerned with whether there is production activity and do not address the geographic location of that production activity, which is relevant for sourcing under §§ 861, 863, and 865.
5. Additionally, the substantial contribution rules are premised on treating a corporation as engaged in production activities even if it is not engaged in the direct use of production assets (other than oversight assets), while Treas. Reg. § 1.863-3 focuses on sourcing income based on the location of a corporation’s production assets that are used for production activities. *See* Treas. Reg. § 1.863-3(c)(1)(ii) (which was redesignated in the final regulations as Treas. Reg. § 1.863-3(c)(2)).
6. Treasury and the IRS believe there is not a clear metric for quantifying production arising from substantial contribution activities, even if these activities are properly identified, in order to assign production activities to a particular geographic location for purposes of determining the place of production under §§ 861, 863, and 865. Therefore, the final regulations provide that the principles of Treas. Reg. § 1.954-3(a)(4), other than the

substantial contribution rules in Treas. Reg. § 1.954-3(a)(4)(iv), apply in determining whether production activities exist.

E. Measuring Adjusted Basis of Production Assets.

1. For inventory produced both within and without the U.S., the proposed regulations continued to allocate or apportion the gross income between U.S. and foreign sources based on the formula in Treas. Reg. § 1.863-3(c)(1)(ii)(A) (redesignated as Prop. Treas. Reg. § 1.863-3(c)(2)(i)). This formula determined the amount of foreign source income by multiplying the total gross income by a fraction, the numerator of which is the average adjusted basis of production assets located outside the U.S. and the denominator of which is the average adjusted basis of all production assets within and without the U.S. The remaining gross income is from U.S. sources.
2. In light of TCJA's changes to § 168(k), Prop. Treas. Reg. § 1.863-3(c)(2)(ii) measured the adjusted basis of the U.S. production assets for purposes of this formula based on the alternative depreciation system ("ADS") of § 168(g)(2). The preamble to the proposed regulations said that this rule allows the basis of both U.S. and non-U.S. production assets to be measured consistently on a straight-line method over the same recovery period, and requested comments on using ADS for this purpose or alternatives for measuring relative U.S. and non-U.S. production assets.
3. One comment suggested that some taxpayers such as partnerships and S corporations would face administrative burdens if they had to maintain separate ADS books that they may not otherwise maintain if § 951A(d)(3) or 250(b)(2)(B) do not apply to them. The comment said that TCJA, in contrast to those other sections, does not mandate the use of ADS in the § 863(b) context. The comment requested that the final regulations maintain the existing rule of Treas. Reg. § 1.863-3(c)(1)(ii)(B) measuring the basis under § 1011 (as adjusted by § 1016), either as the principal rule or, alternatively, at the election of the taxpayer.
4. The final regulations did not adopt this comment. Treasury and the IRS believe that the use of ADS for this purpose will prevent TCJA's modifications to § 168(k) (resulting in accelerated depreciation) from inappropriately skewing the apportionment formula under Treas. Reg. § 1.863-3(c)(2)(i) in favor of foreign source income. While TCJA does not mandate the use of ADS for this purpose, Treasury and the IRS state they have authority to mandate the use of ADS under §§ 863(a) and 7805 and believe that the use of ADS is necessary to accurately measure the place of production using adjusted basis, as other basis measurements might inappropriately inflate foreign production activities.

F. § 865(e)(2); Prop. Treas. Reg. § 1.865-3.

1. Section 865 provides rules for sourcing income from sales of personal property. Section 865(e)(2) applies regarding all sales of personal property (including inventory) by a nonresident, as that term is defined in § 865(g)(1)(B), attributable to an office or other fixed place of business in the U.S. Section 865(e)(2)(A) provides that income from any sale of personal property attributable to such an office or other fixed place of business is sourced in the U.S. An exception is provided in § 865(e)(2)(B) for a sale of inventory for use, disposition, or consumption outside the U.S. if a foreign office of the nonresident “materially participated” in the sale.
2. Section 865(e)(3) provides that the “principles of § 864(c)(5) shall apply” to determine whether a nonresident has an office or other fixed place of business and whether a sale is attributable to such office or other fixed place of business. Where applicable, § 865(e)(2) applies “[n]otwithstanding any other provisions” of subchapter N, part I, including §§ 863(b), 861(a)(6), and 862(a)(6). The proposed regulations under Treas. Reg. § 1.865-3 addressed the application of the principles of § 864(c)(5) in the context of § 865(e)(2) and provided that sales of inventory property produced outside the U.S. and sold through an office maintained by the nonresident in the U.S. must be sourced in the U.S. in part.
3. Prop. Treas. Reg. § 1.865-3(e) also included a cross-reference to the rules for allocating and apportioning expenses to gross income effectively connected with the conduct of a trade or business in the U.S. in Treas. Reg. §§ 1.882-4 and 1.882-5. Since those regulations apply only to foreign corporations, one comment requested that the final regulations also refer to Treas. Reg. § 1.873-1 to cover nonresident alien taxpayers subject to Prop. Treas. Reg. § 1.865-3. In response to this comment, the final regulations broadened the cross-references to include §§ 882(c)(1) and 873(a) for purposes of allocating and apportioning expenses. *See* Treas. Reg. § 1.865-3(e).
4. The final regulations also reorder and revise parts of Treas. Reg. § 1.865-3 in a non-substantive manner solely for purposes of improving clarity and ease of application. The revision also helps to clarify that Treas. Reg. § 1.865-3 applies only if a nonresident maintains an office or other fixed place of business in the U.S. to which a sale of personal property is attributable. Otherwise, the source of the income, gain, or loss from the sale will be determined under other applicable provisions of § 865, such as § 865(b) through (d).
5. The final regulations also retain, with certain modifications, the rules for determining the portion of gross income from sales and production

activities under Treas. Reg. § 1.865-3(d). Under the proposed regulations, the “50/50 method,” described in Treas. Reg. § 1.865-3(d)(2)(i), was the default method because it was “an appropriate and administrable way” to apply § 865(e)(2). The proposed regulations also allowed nonresidents to elect a books and records method that would “more precisely” reflect their gross income from both sales and production activities, if any, in the U.S., provided the nonresidents met certain requirements for maintaining their books of account under Prop. Treas. Reg. § 1.865-3(d)(2)(ii)(B)(1) through (3).

6. Under the final regulations, the 50/50 method continues to be the default method and taxpayers continue to be permitted to elect the books and records method. However, Treasury and the IRS believe that, where taxpayers have demonstrated the ability to use their books of account to determine their U.S. source gross income under the books and records method, a limitation is appropriate to prevent a nonresident from returning to the less precise 50/50 method solely to obtain a better tax result.
7. In addition, Treasury and the IRS believe that revising the election to provide that it remains in effect until revoked would reduce the risk to taxpayers of inadvertently failing to include the election with their Federal income tax return. Accordingly, under the final regulations, an election to apply the books and records method continues until revoked and may not be revoked without the consent of the Service, for any taxable year beginning within 48 months of the end of the taxable year in which the election was made.
8. The final regulations also revised Treas. Reg. § 1.864-5 to clarify the interaction with § 865(e)(2) and (3) and the promulgation of Treas. Reg. § 1.865-3. Gross income, gain, or loss from the sale of personal property treated as from sources within the U.S. under Treas. Reg. § 1.865-3 will generally be effectively connected with the conduct of a trade or business in the U.S. to the extent provided in § 864(c), other than § 864(c)(4) or (5). Gross income, gain, or loss from the sale of personal property treated as from sources without the U.S. under Treas. Reg. § 1.865-3 is not described in Treas. Reg. § 1.864-5(b) and thus will generally not be effectively connected with the conduct of a trade or business in the U.S.
9. The rules of Treas. Reg. §§ 1.864-5, 1.864-6, and 1.864-7 continue to apply, however, in determining whether foreign source income of nonresident aliens and foreign corporations that does not arise from the sale of personal property described in Treas. Reg. § 1.865-3(c) is effectively connected with the conduct of a trade or business in the U.S. The rules of Treas. Reg. §§ 1.864-5, 1.864-6, and 1.864-7 also continue to apply in determining whether foreign source income from the sale of inventory by nonresident aliens, who would be residents under

§ 865(g)(1)(A), is effectively connected with the conduct of a trade or business in the U.S.

G. Determining the Location or Existence of Production Activity.

1. The proposed regulations did not modify the rules in Treas. Reg. § 1.863-3 for determining the location or existence of production activity for purposes of determining the sourcing of income derived from the sale of inventory. Treas. Reg. § 1.863-3(c)(1)(i)(A) (which was redesignated in the final regulations as Treas. Reg. § 1.863-3(c)(1)(i)) provides the rule for sourcing of income where production occurs only within the U.S. or only within foreign countries. That paragraph generally limits the scope of “production activities” to only “those conducted directly by the taxpayer.”
2. Similarly, Treas. Reg. § 1.863-3(c)(1)(i)(B) (which was redesignated in the final regulations as Treas. Reg. § 1.863-3(c)(1)(ii)) provides that production assets are those “owned directly by the taxpayer that are directly used by the taxpayer to produce inventory.” Treas. Reg. § 1.863-3(c)(1)(ii) (which was redesignated in the final regulations as Treas. Reg. § 1.863-3(c)(2)) provides the rule for the sourcing of income where production occurs both within and without the U.S., and, allocates gross income based on the relative adjusted basis of production assets located within and without the U.S., respectively.
3. The final regulations provide the determination of the adjusted basis of production assets under Treas. Reg. § 1.863-3(c)(1)(ii)(B) (which was redesignated in the final regulations as Treas. Reg. § 1.863-3(c)(2)(ii)(A)). Under the final regulations, the adjusted basis of production assets for a taxable year is determined by averaging the basis of the assets at the beginning and end of the year, except in the event that a change during the year would cause the average to “materially distort” the calculation for sourcing of income attributable to production activity under Treas. Reg. § 1.863-3(c)(1)(ii)(A) (which has been redesignated in the final regulations as Treas. Reg. § 1.863-3(c)(2)(i)).
4. This provision uses certain concepts from Treas. Reg. § 1.861-9(g)(2)(i)(A) to further explain when a change might “materially distort” the calculation. For example, the rule applies when an event such as a late-year disposition of substantially all the U.S. production assets of a corporation would cause a material distortion in the corporation’s calculation of the split between U.S. and foreign production activities.
5. One comment provided a range of suggestions to modify the rules of Prop. Treas. Reg. § 1.863-3(c) and 1.865-3(d). This comment suggested that the rules of Prop. Treas. Reg. § 1.863-3(c) and 1.865-3(d) were adequate, in general, where a taxpayer independently manufactured its own inventory, but inadequate regarding other business models that rely on limited risk

contract manufacturers or where multiple members of a group each perform only limited manufacturing functions in various jurisdictions. It observed that apportionment of gross income using the relative adjusted basis of production assets may not reflect high value-adding core production and risk management functions and ownership of production assets by unrelated contract manufacturers.

6. The comment suggested expanding the scope of covered production activities and ownership of production assets to include activities conducted and assets owned by related parties and unrelated agents of the taxpayer. It also recommended that these rules include any activities that constitute a “substantial contribution” within the meaning of Treas. Reg. § 1.954-3(a)(4)(iv) to better conform to the rules under subpart F.
7. In addition, the comment suggested that Treas. Reg. § 1.863-3 should not allocate and apportion gross income using only the relative adjusted basis of production assets located within and without the U.S., and recommended allocation and apportionment based on other metrics, such as the location of personnel involved in the production activities or personnel costs. It suggested that these modifications could, alternatively, be rebuttable presumptions that a taxpayer could overcome by showing that allocating and apportioning gross income based on adjusted basis or some other approach provides a more appropriate result under the taxpayer’s facts.
8. Another comment suggested that the existing allocation and apportionment rules that rely on the relative adjusted basis of production assets encourage businesses to move (or locate additional) production assets outside the U.S. Specifically, the comment expressed concern that treating income from the sale of inventory produced, in whole or in part, in the U.S. as U.S. source income might result in double taxation if the income is also subject to tax in a foreign jurisdiction, since the U.S. source income would be excluded from the numerator of the § 904 limitation, reducing the § 904 limitation, and potentially limiting the U.S. taxpayer’s ability to use its foreign tax credits. The comment requested replacing these rules with a more comprehensive formula, preferably one that minimizes the risk of double taxation. It did not suggest an alternative formula and observed that further legislation may be necessary in this regard.
9. The final regulations did not adopt these comments, but Treasury and the IRS stated they might consider these recommendations as part of a more comprehensive review of the sourcing rules for production activity (for purposes of both Treas. Reg. § 1.863-3 and Treas. Reg. § 1.865-3) in a future notice of proposed rulemaking.

10. Additionally, the anti-abuse rule in Treas. Reg. § 1.863-3(c)(1)(iii) (which was redesignated in the final regulations as Treas. Reg. § 1.863-3(c)(3)) already applies to make appropriate adjustments where taxpayers enter into or structure certain transactions with a principal purpose of reducing U.S. tax liability under Treas. Reg. § 1.863-3, including by using production assets owned by a related party.
11. To clarify the application of this rule, the final regulations provide that the anti-abuse rule applies to transactions inconsistent with the purpose of Treas. Reg. § 1.863-3(b) or (c), and adds as an example that the anti-abuse rule may cover acquisitions of domestic production assets by related partnerships (or subsidiaries thereof) with a principal purpose of reducing the transferor's U.S. tax liability by treating income from the sale of inventory property as subject to § 862(a)(6) rather than § 863(b). Treasury and the IRS requested comments regarding potential approaches to determine the location or existence of production activity or other modifications to Treas. Reg. § 1.863-3 that may be appropriate.

#### H. Income Tax Treaties.

1. The preamble to the proposed regulations included a statement about how Prop. Treas. Reg. § 1.865-3 interacted with U.S. income tax treaties under which the business profits of foreign treaty residents may be taxable in the U.S. only if the profits are attributable to a permanent establishment in the U.S. Specifically, the preamble to the proposed regulations stated, “[w]ith respect to taxpayers entitled to the benefits of an income tax treaty, the amount of profits attributable to a U.S. permanent establishment will not be affected by these regulations.”
2. One comment supported the preamble's statement and requested that, consistent with the statement in the preamble, the final regulations not apply to § 863(b)(2) Sales in a manner that would result in double taxation to U.S. taxpayers engaged in business operations through a permanent establishment in a treaty jurisdiction, notwithstanding TCJA's change to § 863(b). The comment also requested that competent authority relief be provided in this regard.
3. The final regulations do not affect the ability of a taxpayer to rely on treaty provisions to mitigate or relieve double taxation, including treaty provisions that permit a taxpayer to make a request to the competent authority for assistance pursuant to a mutual agreement procedure article of an applicable income tax treaty.

#### I. Comment on Proposed Applicability Date.

1. The proposed regulations were proposed to apply to taxable years ending on or after December 23, 2019, although taxpayers and their related



parties could generally apply the rules in their entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019. One comment requested that the final regulations apply to taxable years ending after December 31, 2019, because some taxpayers have consistently relied on the existing methods of Treas. Reg. § 1.863-3(b) for many years.

2. The final regulations did not adopt this comment. Under § 7805(b)(1)(B), a final regulation can apply to any taxable period ending on or after the date on which the proposed regulation to which such final regulation relates was filed with the Federal Register, which for these final regulations was December 23, 2019. The final regulations implement TCJA's statutory change to § 863(b), which was effective for taxable years beginning after December 31, 2017. To provide certainty to taxpayers and avoid a multiplicity of different interpretations of the statute, Treasury and the IRS believe that it is appropriate for the final regulations to apply as closely as possible to the effective date of the statutory change.

J. Applicability Date.

1. The final regulations generally apply to taxable years ending on or after December 23, 2019. Taxpayers may choose to apply the final regulations for any taxable year beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and all persons that are related to the taxpayer (within the meaning of § 267 or 707) apply the final regulations in their entirety and, once applied, the taxpayer and all persons related to the taxpayer (within the meaning of § 267 or 707) continue to apply the final regulations in their entirety for all subsequent taxable years. *See* § 7805(b)(7).
2. Alternatively, taxpayers may rely on the proposed regulations for any taxable year beginning after December 31, 2017, and ending on or before the date the regulations were posted on IRS.gov, provided that the taxpayer and all persons that are related to the taxpayer (within the meaning of § 267 or 707) rely on the proposed regulations in their entirety and provided that the taxpayer and all persons that are related to the taxpayer (within the meaning of § 267 or 707) have not applied the final regulations to any preceding year.

X. FINAL REGULATIONS: SALE OF PARTNERSHIP INTERESTS.

- A. The final regulations for the sale of partnership interest (T.D. 9919) retain the basic approach and structure of the proposed regulations with certain revisions.

B. Deemed Sale EC Gain or Loss.

1. Section 864(c)(8)(A) provides that gain or loss of a nonresident alien individual or foreign corporation (a “foreign transferor”) from the sale, exchange, or other disposition (“transfer”) of an interest in a partnership that is engaged in a trade or business within the U.S. is treated as effectively connected (EC) gain or loss to the extent such gain or loss does not exceed the amount determined under § 864(c)(8)(B). Section 864(c)(8)(B) limits the amount of effectively connected gain or loss to the portion of the foreign transferor’s distributive share of gain or loss that would have been effectively connected if the partnership had sold all of its assets at fair market value (the “deemed sale limitation”).
2. The proposed regulations illustrated how to determine the deemed sale limitation described in § 864(c)(8)(B), which the proposed regulations referred to as the aggregate deemed sale EC (“ADSEC”) amount. Once the ADSEC amount was determined for each applicable category of gain or loss, the foreign transferor’s outside gain or loss in each category was compared to the relevant ADSEC gain or ADSEC loss amount for that category to determine the amount of effectively connected gain or effectively connected loss under § 864(c)(8).
3. In general, this amount was determined through a three-step process. Step one determined the amount of gain or loss from each partnership asset as if the partnership conducted a deemed sale of all of its assets on the date of transfer (these amounts, deemed sale gain or deemed sale loss). Step two determined the amount of the deemed sale gain or loss that would be treated as effectively connected gain or loss regarding each asset (these amounts are referred to as deemed sale EC gain or deemed sale EC loss). Finally, step three determined the foreign transferor’s distributive share of the deemed sale EC gain or deemed sale EC loss amounts determined in step two.
4. Sourcing determinations are often material in determining whether gain or loss is effectively connected with the conduct of a trade or business within the U.S.
5. Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(i) treated all deemed sale gain and loss as attributable to an office or other fixed place of business maintained by the partnership in the U.S., and did not treat inventory property as sold for use, disposition, or consumption outside the U.S. in a sale in which an office or other fixed place of business maintained by the partnership in a foreign country materially participates. Thus, the rule in Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(i) provided so-called “simplifying factual assumptions” that generally treat deemed sale gain and loss as U.S. source.

6. These so-called “simplifying factual assumptions,” however, are contrary to the statute, as discussed below.
7. An exception to this rule was provided in the proposed regulations if, during the ten-year period ending on the date of transfer, the asset in question produced no income or gain that was taxable as income that was effectively connected with the conduct of a trade or business within the U.S. by the partnership (or a predecessor), and the asset had not been used, or held for use, in the conduct of a trade or business within the U.S. by the partnership (or a predecessor) (the “ten year exception”). Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii).
8. The issue: A comment on the interaction between § 864(c)(8) and the sourcing rules suggested that the simplifying factual assumptions supplied by the rule in Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(i) may overstate the amount of effectively connected gain or loss on a deemed sale of the partnership’s assets, as compared to an actual asset sale, by treating all gain or loss from the deemed sale as attributable to a U.S. office of the partnership, subject only to the ten-year exception.
9. As a result, the proposed regulations would similarly overstate the amount of the deemed sale limitation. To address this concern, the comment suggested that in determining deemed sale EC gain and loss, the final regulations should aim to provide a result that is no better or worse than the result that would occur upon an actual asset sale by the partnership, although the comment acknowledged the difficulty in achieving this objective because the underlying source rules largely rely on fact-specific determinations.
10. Treasury and the IRS generally agree with the broad principles described in the comment regarding Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2). While these final regulations retain the basic framework of the proposed regulations, including the factual determinations regarding office attribution provided in Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(i), the final regulations adjust their effects by adding rules for sourcing gain or loss from specific assets that may be particularly difficult to source in a deemed sale.

C. Ten-Year Exception.

1. The final regulations retain the ten-year exception as an exception to the determination of deemed sale EC gain and loss under Treas. Reg. § 1.864(c)(8)-1(c)(2)(i)(A). The ten-year exception is intended to remove assets that have no nexus to the U.S. from the deemed sale EC gain and loss determination; therefore, for these assets, a foreign transferor does not need to apply the rules described in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii) to determine deemed sale EC gain and loss.

2. One comment requested that the final regulations clarify that the ten-year exception applies to assets that were not held by the partnership for the full ten-year period. As requested by the comment, the final regulations modify the relevant testing period for the ten-year exception to account for a partnership (including a predecessor of the partnership) that has not existed for at least ten years, or that has not held an asset for at least ten years, by shortening the relevant testing period to the lesser of the ten-year period ending on the date of the transfer or the period during which the partnership (and a predecessor of the partnership) held the asset.
3. In addition, to ensure that the ten-year exception is properly applied, the final regulations also modify the relevant testing period to include any period during which the foreign transferor (and a predecessor of the foreign transferor) held the asset. Accordingly, an asset will not qualify for the ten-year exception if it generated effectively connected income or effectively connected gain for the foreign transferor (or a predecessor of the foreign transferor), or if the asset was used in the conduct of a trade or business within the U.S. by the foreign transferor (or a predecessor of the foreign transferor), within the relevant testing period.

D. Sourcing Rules.

1. Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(i) treated all gain or loss from the deemed sale of an asset as attributable to an office or other fixed place of business maintained by the partnership in the U.S.,<sup>12</sup> and did not treat inventory property as sold for use, disposition, or consumption outside the U.S. in a sale in which an office or other fixed place of business maintained by the partnership in a foreign country materially participated. The final regulations made several changes and clarify the scope of this rule.
2. First, the final regulations provide that the general rule applies only for purposes of applying § 865(e)(2)(A) to personal property held by the partnership on the date of the deemed sale. Second, the final regulations provide additional sourcing rules for determining the foreign source portion of deemed sale gain and loss attributable to specific assets included in the deemed sale. The specific assets are inventory, intangibles, and depreciable personal property.
3. Treasury and the IRS believe that additional sourcing rules are needed because gain or loss from actual sales of each of these assets would be subject to specific sourcing rules under the Code, but sourcing deemed

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<sup>12</sup> *Grecian Magnesite Mining v. Commissioner*, 149 T.C. 3 (2017), *aff'd*, \_\_\_ F.3d \_\_\_ (D.C. Cir. 2019), illustrates the statute's rule requiring a factual connection between the gain and a U.S. office. The case rejected Rev. Rul. 91-32, 1991-1 C.B. 107. The Service lost, appealed, and lost again. The proposed regulation effectively attempted to override *Grecian Magnesite*. But, on the "attributable to a U.S. office" issue, the statute has not been changed.

sale gain or loss under those rules would generally require facts that are not determinable in a deemed sale. In our view, this still seems like the statute is being ignored.

4. The final regulations also clarify that if the partnership does not maintain an office or other fixed place of business in the U.S. (within the meaning of § 864(c)(5)(A) and Treas. Reg. § 1.864-7), neither the U.S. office attribution described in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(A), nor the additional sourcing rules described in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(B) through (E), will apply. Finally, the final regulations reorganize the proposed regulations to account for the changes, and the phrase in Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(i) regarding use, disposition, or consumption outside the U.S. is removed to conform with changes made to the general rule and the addition of a specific inventory sourcing rule.
5. The asset-specific rules provided in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(B) through (E) utilize available facts as a proxy for the sourcing results, and the attendant effectively connected determinations, that would occur in an actual sale by the partnership of inventory, intangibles, or depreciable personal property.
6. Specifically, the foreign source portion of deemed sale gain or loss attributable to inventory property (as defined in § 865(i)(1)) is determined using a proxy method that is based on historical data (as suggested by the comment); the foreign source portion of deemed sale gain and loss attributable to intangibles (as defined in § 865(d)(2)) is determined using a proxy method that is based on the partnership's historic income; and the foreign source portion for certain deemed sale gain or loss attributable to depreciable personal property (as defined in § 865(c)(4)(A)) is determined under a recapture principle and, to the extent applicable, a proxy method that is also based on historical data. Additionally, the final regulations add a material change in circumstances rule in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(E) that applies if, based on a material change in circumstances, the asset-specific rules for inventory property or intangibles do not reach an appropriate sourcing result.
7. Thus, to the extent that deemed sale gain or loss is attributable to inventory, intangibles, or depreciable personal property, the sourcing result for these assets is determined by first applying Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(A) and then, to the extent applicable, the asset-specific rules provided in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(B) through (D), or the material change in circumstances rule provided in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(E). Accordingly, the U.S. office attribution rule described in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(A) applies to these assets only to the extent that the deemed sale gain or loss exceeds the relevant

foreign source portion determined under the relevant rule provided in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(B) through (E).

E. Look-Back Rule for Inventory Property.

1. The comment on the interaction between § 864(c)(8) and the sourcing rules recommended that Treasury and the IRS consider a separate rule for sourcing deemed sales of inventory based on historical data showing how inventory sales were sourced by the partnership over a specified period. Treasury and the IRS agreed with the suggestion.
2. Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(B) provides a look-back rule for determining the foreign source portion of deemed sale gain or loss attributable to inventory property (as defined in § 865(i)(1), but not including gain sourced by reference to § 865(c)(2)) that is held by the partnership on the date of the deemed sale.
3. Specifically, the general rule provided in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(A) will not apply, and the deemed sale of inventory property will not be treated as attributable to an office or other fixed place of business maintained by the partnership in the U.S., to the extent of foreign source inventory gain or loss. This amount is determined by multiplying deemed sale gain and loss attributable to inventory by a fraction that determines the foreign source inventory ratio.
4. The numerator of the fraction includes the gross income of the partnership that is attributable to foreign source gain or loss from inventory property (as determined under the rules of §§ 865(b) and 865(e)) sold within the shorter of the period comprised of the partnership's three taxable years immediately preceding the date of the deemed sale, or the existence of the partnership (measured by partnership taxable years); the denominator of the fraction is the total gross income of the partnership that is attributable to inventory over that period.
5. This approach addresses the concerns raised in the comment by looking to the partnership's past operations to determine the relevant sourcing result for inventory property, instead of assuming that all of the gain or loss from the deemed sale of inventory property is attributable to a U.S. office (unless the ten-year exception is met). That is, because sourcing the deemed sale gain or loss attributable to inventory property will require facts that are not available in a deemed sale, this approach sources the deemed sale gain or loss by reference to the actual sourcing results from prior sales of inventory property during the look-back period, as evidenced by the foreign source inventory ratio.

F. Look-Back Rule for Intangibles.

1. The comment on the interaction between § 864(c)(8) and the sourcing rules also discussed how the simplifying factual assumptions supplied by the rule in Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(i) may overstate the amount of effectively connected gain or loss regarding a deemed sale of intangibles held by the partnership.
2. Treasury and the IRS agreed that it is difficult to source deemed sale gain or loss attributable to intangibles and that a single, administrable rule to address this issue is preferable. To minimize the difficulty of applying the sourcing rules to intangible property and to provide more certainty, the final regulations provide a separate rule for intangibles (including going concern value) that determines the foreign source portion of deemed sale gain or loss attributable to intangibles by using a proxy method that is based on the source of the partnership's historic gross ordinary income.
3. Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(C) provides a look-back rule for determining the foreign source portion of deemed sale gain or loss attributable to an intangible (as defined in § 865(d)(2)) held by the partnership on the date of the deemed sale. This rule is similar to the look-back rule for inventory property because it provides that the deemed sale of an intangible will not be treated as attributable to an office or other fixed place of business maintained by the partnership in the U.S. to the extent of a foreign source amount. This amount is determined by multiplying deemed sale gain or loss attributable to an intangible by the foreign source intangible ratio.
4. The approach for determining the foreign source amount regarding intangibles employs the same general approach provided for inventory property, with certain modifications. However, unlike inventory property, intangibles may not have relevant historical data indicating how deemed sale gain and loss would be sourced in an actual sale (for example, some intangibles do not generate an identifiable income stream on which a sourcing proxy could be based).
5. To address this issue, the numerator of the foreign source intangible ratio includes the foreign source gross ordinary income of the partnership (other than from dispositions of depreciable or amortizable property) during the shorter of the period comprised of the partnership's three taxable years preceding the date of the deemed sale or the existence of the partnership (measured by partnership taxable years), to the extent that such income was not effectively connected with the conduct of a trade or business within the U.S.; the denominator includes the total gross ordinary income of the partnership (other than from dispositions of depreciable or amortizable property) during that period.

6. This foreign source intangible ratio looks specifically to the historic gross ordinary income of the partnership (as opposed to all the historic gross income of the partnership) in order to more accurately reflect the partnership's income derived from the use of the intangibles in the ordinary course of its trade or business. This rule does not apply to the extent of any depreciation adjustments (as defined in § 865(c)(4)(B)) regarding an amortizable intangible; instead, the rules regarding depreciable personal property will apply to such adjustments.

G. Special Rules.

1. The foreign source inventory ratio and foreign source intangible ratio may in certain circumstances cause mathematically impossible results or unclear application if cost of goods sold exceed gross receipts. Additional rules were added to address these concerns.
2. First, the foreign source inventory ratio and the foreign source intangible ratio cannot exceed one. Second, if the foreign source gross income attributable to inventory or the foreign gross ordinary income is not positive, then respectively the foreign source inventory ratio or the foreign source intangible ratio is zero. Third, if the foreign source gross income attributable to inventory is positive, but the total gross income attributable to inventory is not positive, or if the foreign gross ordinary income is positive, but the total gross ordinary income is not positive, then respectively the foreign source inventory ratio or the foreign source intangible ratio is one.

H. Depreciable Personal Property.

1. Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(D) provides a two-part approach for determining the foreign source portion of deemed sale gain and loss attributable to depreciable personal property: the first part applies a recapture principle to the extent of depreciation adjustments taken regarding the property, and the second part focuses on where the property is located to the extent the property has deemed sale gain in excess of its depreciation adjustments or if the property has deemed sale loss.
2. Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(D)(1) applies a recapture principle by providing that the deemed sale of depreciable personal property (as defined in § 865(c)(4)(A)), or the deemed sale of an amortizable intangible (as defined in § 865(d)(2)), will not be treated as attributable to an office or other fixed place of business maintained by the partnership in the U.S. to the extent the deemed sale gain is treated as sourced outside the U.S. after applying § 865(c)(1) at the time of the deemed sale. In contrast to the other sourcing rules that could apply to assets held by the partnership on the date of the deemed sale, the recapture rule provided in § 865(c)(1)



can be applied with certainty at the time of the deemed sale because it is based on data that is available at the time of the deemed sale.

3. For deemed sale gain in excess of the depreciation adjustments regarding depreciable personal property (other than an amortizable intangible), or for deemed sale loss from depreciable personal property (other than an amortizable intangible), Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(D)(2) provides that the relevant sourcing determination is made based on where the property is located.
4. Although § 865(c)(2) sources the excess gain as if it were attributable to inventory property, such treatment would require further clarification. Specifically, in contrast to inventory property, depreciable personal property may not have historical data readily available that evidences the location of the economic activity associated with the property or that otherwise indicates how the excess gain or loss would be sourced in an actual sale. To address this issue Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(D)(2) sources the excess gain or loss attributable to depreciable personal property based on the location of the property.

I. Material Change in Circumstances Rule.

1. Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(E) provides a material change in circumstances rule for inventory and intangibles. If this rule applies, the foreign source portion of deemed sale gain or loss attributable to inventory property or intangibles may be determined by applying the relevant rule of Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(B) or (C) by reference to a modified look-back period.
2. Treasury and the IRS believe that the general rule provided in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(A) and the asset-specific determinations provided in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(B) and (C) will reach an appropriate sourcing result in most cases; that is, an actual sale of the partnership's assets has not occurred, so relevant sourcing information regarding an actual sale of the assets on the date of the deemed sale will not be readily determinable in most cases, and the look-back rules use the partnership's past operations as a proxy for reaching a sourcing determination regarding to certain assets included in the deemed sale.
3. Treasury and the IRS stated that they realize, however, that the look-back rules provided in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(B) and (C) for inventory property and intangibles could reach incorrect sourcing results in certain cases; specifically, if a material change in circumstances occurred during the relevant look-back period described in paragraph Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(B)(1) or Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(C)(1), the partnership's historical data for the entire look-back period may not be an accurate proxy for reaching a sourcing determination

regarding deemed sale gain or loss attributable to such property. In these cases, the final regulations allow taxpayers to use this material change in circumstances rule to remedy an incorrect sourcing result regarding inventory property and intangibles.

4. The application of Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(E), therefore, is limited to situations in which a material change in circumstances causes the look-back rule provided in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(B), or the look-back rule provided in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(C), to reach an inappropriate sourcing result; that is, a sourcing result that is materially different from the sourcing result that would occur if the applicable look-back period began on the date on which the material change in circumstance occurred and ended on the last day of the partnership's taxable year immediately preceding the year in which the deemed sale occurs (the modified look-back period).
5. If the material change in circumstances rule applies, the applicable sourcing rule for inventory or intangibles may be applied by reference to the modified look-back period. The determination of whether a sourcing result is materially different is determined by comparing the foreign source inventory ratio or foreign source intangible ratio provided in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(B) or (C) (as applicable) with the foreign source inventory ratio or foreign source intangible ratio if that ratio were determined by reference to the modified look-back period. The sourcing result is not materially different unless the percentage point difference between the two ratios described in the preceding sentence is at least 30 percentage points. See Example 2 in Treas. Reg. § 1.864(c)(8)-1(c)(2)(iii).

#### J. Treaty Coordination.

1. A comment questioned whether the rules provided in Prop. Treas. Reg. § 1.864(c)(8)-1(c) for determining a foreign transferor's deemed sale EC gain or deemed sale EC loss were intended to apply in the treaty context without regard to whether the partnership in fact had a permanent establishment in the U.S. under the terms of an income tax treaty at the time of the transfer.
2. The final regulations provide that the U.S. office attribution rule described in Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii)(A) does not apply unless the partnership maintains an office or other fixed place of business in the U.S. A partnership without a U.S. office or other fixed place of business will also generally not have a permanent establishment in the U.S. In addition, the treaty coordination rule in Treas. Reg. § 1.864(c)(8)-1(f) takes into account an applicable treaty when computing the amount of a foreign transferor's distributive share of a deemed sale EC gain and deemed sale EC loss.

3. As a result, for purposes of Treas. Reg. § 1.864(c)(8)-1(c)(3) (that is, the third step in the three-step process to determine the foreign transferor's aggregate deemed sale EC items), gain or loss derived by the foreign transferor attributable to assets deemed sold that would be exempt from tax under an applicable U.S. income tax treaty if disposed of by the partnership are not taken into account.
4. The final regulations retain the general rule that prevents taxation of gain on assets that do not form part of a permanent establishment, but also address certain gains that may be taxed without regard to whether there is a permanent establishment (for example, gains from the disposition of certain U.S. real property interests). The final regulations also modify the structure of Prop. Treas. Reg. § 1.864(c)(8)-1(f) by consolidating Prop. Treas. Reg. § 1.864(c)(8)-1(f) through (3) into a single paragraph and make three additional changes.
5. First, Treas. Reg. § 1.864(c)(8)-1(f) clarifies that a foreign transferor is eligible for benefits under an income tax treaty only if the transferor meets the requirements of a limitation on benefits article, if any, in the treaty between the jurisdiction in which the foreign transferor is resident and the U.S.
6. Second, Treas. Reg. § 1.864(c)(8)-1(f) modifies Prop. Treas. Reg. § 1.864(c)(8)-1(f)(2), which stated that “[t]reaty provisions applicable to gains from the alienation of property forming part of a permanent establishment, including gains from the alienation of a permanent establishment in the U.S., apply to transfer by a foreign transferor of an interest in a partnership with a permanent establishment in the U.S.”
7. The final regulations provide that a gains article that permits the taxation of gain from the alienation of property forming part of a permanent establishment or fixed place of business in the U.S. also permits the taxation of gain from the alienation of a partnership interest, to the extent the partnership's assets deemed sold under § 864(c)(8) form a part of the U.S. permanent establishment or fixed place of business of the partnership.
8. Thus, the final regulations remove from the description of an applicable gains provision the phrase “including gains from the alienation of a permanent establishment,” as that phrase, as used in certain treaties, merely illustrates one application of the underlying words and is not a separate rule. This approach also is consistent with the statutory framework under § 864(c)(8), which determines the amount of effectively connected gain or loss of a foreign transferor based on the amount of the transferor's distributive share of gain or loss that would have been effectively connected if the partnership had sold all of its assets at fair market value.

9. Finally, Treas. Reg. § 1.864(c)(8)-1(f) contains a rule coordinating these regulations with treaty provisions governing the disposition of U.S. real property interests that allow the U.S. to tax gain derived from the disposition of the U.S. real property interest regarding whether the U.S. real property interest forms a part of a partnership's permanent establishment or fixed place of business in the U.S.
10. Under this coordination rule, if after applying treaty benefits, the only gain or losses that would be taken into account are gains or losses attributable to U.S. real property interests, the foreign transferor determines its effectively connected gain and effectively connected loss pursuant to § 897 and not under § 864(c)(8). This addition is consistent with the approach taken in the proposed regulations that the gain would be computed under § 897 rather than § 864(c)(8).

K. Partner-Specific Exclusions and Exceptions.

1. A comment requested that the final regulations more clearly address the interaction of § 864(c)(8) and Treas. Reg. § 1.864(c)(8)-1 with provisions of the Code providing for an exemption from U.S. federal income tax. Treasury and the IRS agreed with this suggestion; accordingly, the final regulations provide that a foreign transferor's distributive share of deemed sale EC gain or loss does not include any amount that is excluded from the foreign transferor's gross income or otherwise exempt from U.S. Federal income tax by reason of an applicable provision of the Code. Treas. Reg. § 1.864(c)(8)-1(c)(3)(i). For this purpose, the final regulations refer to §§ 864(b)(2), 872(b), and 883 as examples.
2. Similarly, Treas. Reg. § 1.864(c)(8)-1(c)(3) was modified to provide that a foreign transferor's distributive share of deemed sale EC gain or deemed sale EC loss does not include any amount to which an exception under § 897 applies, such as § 897(k) or § 897(l), provided that amount is not otherwise treated as effectively connected income under a provision of the Code. This rule, which was provided in Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2) as part of the determination of a foreign transferor's deemed sale EC gain and deemed sale EC loss, is moved to Treas. Reg. § 1.864(c)(8)-1(c)(3) in these final regulations because the exceptions under § 897(k) and § 897(l) are specific to the foreign transferor.
3. This modification is intended to make the three step-process for determining the foreign transferor's aggregate deemed EC amounts more cohesive by placing all partner-specific adjustments.

L. Section 731 Distributions.

1. Under the proposed regulations, a foreign transferor determined the amount of outside gain and loss recognized on the transfer of a partnership

interest under all relevant provisions of the Code and regulations, including any applicable nonrecognition provision. Although § 864(c)(8)(E) authorizes regulations or other guidance regarding the application of § 864(c)(8) to nonrecognition transactions, the proposed regulations generally did not provide special rules that apply to nonrecognition transactions. *But see* Prop. Treas. Reg. § 1.864(c)(8)-1(h) (the anti-stuffing rule).

2. However, Treasury and the IRS recognize that certain nonrecognition transactions, for example certain § 731 distributions, may have the effect of reducing gain or loss that would be taken into account under the rules provided in the proposed regulations. The preamble to the proposed regulations, therefore, requested comments regarding whether sections of the Code other than § 864(c)(8) adequately address transactions that rely on § 731 distributions to reduce the scope of assets subject to U.S. federal income taxation as a result of § 864(c)(8) and Prop. Treas. Reg. § 1.864(c)(8)-1. A comment identified several relevant Code sections and analyzed the application of these sections to transactions involving § 731 distributions. Treasury and the IRS will continue to study this issue.

M. Information Exchange Between a Partnership and Non-Controlling Partners.

1. A comment requested that foreign partners that do not own a controlling interest in a partnership be permitted to estimate their effectively connected gain or loss for purposes of § 864(c)(8) because non-controlling partners may not be able to obtain from the partnership the information required to perform the computations under these rules. Treasury and the IRS believe that such a rule is not needed under § 864(c)(8) because the proposed withholding regulations address this issue.
2. Specifically, the proposed withholding regulations provide rules in Prop. Treas. Reg. § 1.864(c)(8)-2 that facilitate and encourage the transfer of information between a foreign partner and a partnership for purposes of § 864(c)(8). The information reporting requirements of the proposed withholding regulations require the partnership to provide the foreign partner with the information necessary to perform the computations under these rules, even if the foreign partner does not hold a controlling interest in the partnership. However, this comment will be considered as part of the proposed withholding regulations.

N. Section 754 Elections.

1. A comment requested a special rule for any foreign transferor that has a difference between its basis in the partnership interest and its share of the partnership's inside basis that occurs because no § 754 election is in effect at the time of transfer; this special rule would, in effect, deem a § 754 election. Specifically, the comment indicated that a foreign transferor may

not have negotiated for the partnership to make a § 754 election upon acquisition of an interest in a partnership engaged in a trade or business within the U.S. because the transferor considered Rev. Rul. 91-32, 1991-1 C.B. 107, to be incorrect.

2. As a result, upon a later transfer of the acquired partnership interest, the foreign transferor would have received a different result under the rules in the § 864(c)(8) proposed regulations than if the partnership had instead sold all of its assets and then liquidated. Because this result occurs due to the failure to make a § 754 election and the mismatches that follow from that failure, Treasury and the IRS have determined that it would be inappropriate to adopt a special rule in these circumstances.

O. Nonrecognition Provision Coordination.

1. Prop. Treas. Reg. § 1.864(c)(8)-1(d) coordinates the taxation of U.S. real property interests under § 897(g) with § 864(c)(8) by providing that when a partnership holds U.S. real property interests and a transfer of an interest in that partnership is subject to § 864(c)(8) because the partnership is engaged in the conduct of a trade or business within the U.S. regarding § 897, the amount of the foreign transferor's effectively connected gain or loss will be determined under § 864(c)(8) and not under § 897(g). However, the proposed regulations did not provide explicit guidance on the application of the § 897 coordination rule when a foreign transferor transfers its partnership interest in a nonrecognition transaction.
2. The final regulations provide the interaction between the § 897 coordination rule and the nonrecognition provision described in Treas. Reg. § 1.864(c)(8)-1(b)(2)(ii). Specifically, Treas. Reg. § 1.864(c)(8)-1(d) provides that any transfer of an interest in a partnership as part of a nonrecognition transaction will not be subject to § 864(c)(8) to the extent that the gain or loss on the transfer is not recognized; instead, if the partnership owns one or more U.S. real property interests, § 897(g) and the regulations thereunder will apply regarding the unrecognized gain or loss.

P. Applicability Dates.

1. The proposed regulations were proposed to apply to transfers occurring on or after November 27, 2017. The final regulations generally apply to transfers occurring on or after December 26, 2018 (that is, the date on which the proposed regulations were filed with the Federal Register). While not subject to these final regulations, transfers occurring on or after November 27, 2017, but before December 26, 2018, are subject to § 864(c)(8). In addition, the final regulations apply to amounts taken into account on or after December 26, 2018, pursuant to an installment sale (as

defined in § 453(b)) occurring on or after November 27, 2017, and before December 26, 2018. Treas. Reg. §§ 1.864(c)(8)-1(j) and 1.897-7(c).

XI. DOWNWARD ATTRIBUTION.

FINAL § 958 REGULATIONS

- A. As in effect before its repeal, § 958(b)(4) provided that §§ 318(a)(3)(A), (B), and (C) (providing for downward attribution) were not to be applied so as to consider a U.S. person as owning stock owned by a person who is not a U.S. person (a “foreign person”). TCJA repealed § 958(b)(4), effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of the foreign corporations, and for the taxable years of U.S. shareholders (as defined in § 951(b)) (“U.S. shareholders”) in which or with which such taxable years of the foreign corporations end. As a result of this repeal, stock of a foreign corporation owned by a foreign person can be attributed to a U.S. person under § 318(a)(3) for various purposes, including for purposes of determining whether a U.S. person is a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a controlled foreign corporation (within the meaning of § 957) (“CFC”).
- B. Treasury and the IRS published proposed regulations (REG-104223-18) relating to the repeal of § 958(b)(4). Additional guidance related to the repeal of § 958(b)(4), including relief from certain information reporting requirements and safe harbors for determining whether a foreign corporation is a CFC and for determining certain items of a CFC (such as taxable income and earnings and profits) based on alternative information, was issued along with the proposed regulations. *See* Rev. Proc. 2019-40, 2019-43 I.R.B. 982. A public hearing on the proposed regulations was neither requested nor held. Treasury and the IRS adopted the proposed regulations as final regulations with the modifications discussed below.
- C. Proposed regulations issued with these final regulations address § 954(c)(6) to ensure that the operation of § 954(c)(6) is consistent with its application before TCJA’s repeal of § 958(b)(4). These proposed regulations also modify the regulations under § 367(a) regarding the direct or indirect transfer of stock or securities of a domestic corporation by a U.S. person (as defined in § 7701(a)(30)) to a foreign corporation to ensure the attribution rules are applied consistently following TCJA’s repeal of § 958(b)(4). They are discussed separately below.
- D. Changes in Connection with Repeal of § 958(b)(4).
1. Overview. The final regulations, like the proposed regulations, make modifications to existing regulations to ensure that the operation of certain rules outside of Subpart F are consistent with their application before TCJA’s repeal of § 958(b)(4). Comments generally supported the

approach of the proposed regulations but requested additional modifications.

2. Section 267: Deduction for Certain Payments.

- (a) Section 267(a)(2) sets forth a matching rule that generally provides that if a payment is made to a related person and is not includible in the payee's gross income until paid, the amount is not allowable as a deduction to the taxpayer until the amount is includible in the gross income of the payee ("general matching rule"). Pursuant to regulations issued under § 267(a)(3)(A),<sup>13</sup> subject to certain exceptions, a taxpayer must use the cash method of accounting for deductions of amounts owed to a related foreign person ("foreign payee rule").
- (b) The foreign payee rule does not apply to the following amounts:
  - (i) a foreign source amount, other than interest, that is not effectively connected with the conduct of a U.S. trade or business;
  - (ii) an amount, other than interest, that is exempt from U.S. taxation pursuant to a treaty obligation of the U.S.; and
  - (iii) an amount that is effectively connected with the conduct of a U.S. trade or business (although payments in this clause (iii) are subject to the general matching rule of § 267(a)(2)). *See* Treas. Reg. § 1.267(a)-3(b) and (c)(1) and (2).
- (c) Section 267(a)(3)(B)(i) provides that, notwithstanding the foreign payee rule in § 267(a)(3)(A), in the case of any item payable to a CFC, a deduction is allowable to the payor for any taxable year before the year in which the payment is made only to the extent that an amount attributable to the item is includible during such prior taxable year in the gross income of a U.S. person who owns (within the meaning of § 958(a)) stock in such CFC ("CFC payee rule").
- (d) Under the proposed regulations, however, an amount (other than interest) that was income of a related foreign person and exempt from U.S. taxation pursuant to a treaty obligation of the U.S. was not subject to the CFC payee rule if the related foreign person was a CFC that did not have any U.S. shareholders that owned (within the meaning of § 958(a)) stock in such CFC (a "§ 958(a) U.S. shareholder"). Prop. Treas. Reg. § 1.267(a)-3(c)(4).
- (e) Treasury and the IRS agreed with a comment that, regarding all payments (including interest) subject to § 267(a)(3), the CFC

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<sup>13</sup> In 2004, § 267(a)(3) was amended to redesignate existing § 267(a)(3) as § 267(a)(3)(A), and a new § 267(a)(3)(B) was added. The regulations in Treas. Reg. § 1.267(a)-3 were issued in 1993, under § 267(a)(3) as it existed at the time, currently § 267(a)(3)(A).



payee rule in § 267(a)(3)(B)(i) should not apply if a recipient CFC does not have any § 958(a) U.S. shareholders who are required to include amounts in income regarding the CFC. However, they do not believe that the CFC payee rule should be applied without regard to the repeal of § 958(b)(4), because that could permit the avoidance of the CFC payee rule (and the purposes of the matching rule in general) in foreign-parented structures where a § 958(a) U.S. shareholder is required to include amounts in income regarding a recipient foreign corporation that is a CFC due solely to the repeal of § 958(b)(4).

- (f) Accordingly, the exception from the CFC payee rule in Prop. Treas. Reg. § 1.267(a)-3(c)(4) was expanded in the final regulations to apply to all amounts payable to a related foreign person that is a CFC that does not have any § 958(a) U.S. shareholders. Treas. Reg. § 1.267(a)-3(c)(4). As a result, the foreign payee rule in § 267(a)(3)(A) and the regulations under that section will apply to those payments exempt from the application of the CFC payee rule. However, the CFC payee rule continues to apply to a CFC that has a § 958(a) shareholder even if the foreign corporation is a CFC due solely to the repeal of § 958(b)(4).

3. Section 881(c): Portfolio Interest.

- (a) Section 881(c) exempts from tax under § 881(a) U.S.-source portfolio interest received by a foreign corporation (“portfolio interest exception”). Portfolio interest generally includes interest paid on a debt obligation that is in registered form but excludes, among other things, interest received by a CFC from a related person (within the meaning of § 864(d)(4)). *See* § 881(c)(2) and (3). The repeal of § 958(b)(4) results in foreign corporations that were previously not CFCs (and thus potentially eligible for the portfolio interest exception for interest received from related persons) being ineligible for the exception regarding this interest.
- (b) A comment requested that the general approach of the proposed regulations to exclude, where appropriate, CFCs that are CFCs solely as a result of the repeal of § 958(b)(4) be extended to the portfolio interest exception so that CFCs that were not previously CFCs could continue to be eligible for the portfolio interest exception. The rules set forth in the proposed regulations were issued pursuant to specific grants of regulatory authority, and Treasury and the IRS have determined that there is no statutory or regulatory authority to modify the limitation on the portfolio interest exception for payments received by CFCs from a related person. Accordingly, the recommendation is not adopted.

- (c) The comment also requested that Treasury and the IRS issue guidelines for withholding agents that might not be in a position to know whether a payee was affected by the repeal of § 958(b)(4) and thus might not know whether the payee qualifies for the portfolio interest exception or whether the withholding agent may be required to withhold under § 1442. The comment posited scenarios in which a U.S. payor would not necessarily have the information to determine whether a foreign corporation payee is a CFC and thus would err on the side of withholding as if it were a CFC.
- (d) Treasury and the IRS stated that a withholding agent is generally subject to an actual knowledge or reason to know standard. *See* Treas. Reg. § 1.1441-7(b)(1). A withholding agent is considered to have reason to know regarding a claim relevant to withholding under chapter 3 (including Treas. Reg. § 1442) if “its knowledge of relevant facts or of statements contained in the withholding certificates or other documentation is such that a reasonably prudent person in the position of the withholding agent would question the chapter 3 claims made.” *See* Treas. Reg. § 1.1441-7(b)(2).
- (e) Treasury and the IRS believe that this standard is appropriate for withholding agents, and additional rules applicable only to portfolio interest are not necessary. Moreover, it would be outside of the scope of the rulemaking project to provide rules generally applicable to the standard of diligence applicable to withholding agents. Accordingly, the suggestion was not adopted.

4. Section 1248: Gain from Certain Stock Sales.

- (a) Section 1248(a) provides that certain gain recognized on the sale or exchange of stock of a foreign corporation by a U.S. person is included in the gross income of that person as a dividend if (i) the foreign corporation was a CFC at any time during the five-year period ending on the date of the sale or exchange, and (ii) the U.S. person owned or is considered to have owned, within the meaning of § 958, 10% or more of the total combined voting power of the foreign corporation at any time during that five-year period. A comment suggested that, consistent with the approach taken in the proposed regulations regarding other sections, § 958(b) should be applied without regard to the repeal of § 958(b)(4) for purposes of § 1248 to prevent unintended consequences.
- (b) The final regulations did not adopt this comment because Treasury and the IRS believe that § 958(b), as modified by TCJA, should apply for purposes of § 1248. This treatment is consistent with the

application of § 958(b) for purposes of the Subpart F provisions. Treasury and the IRS believe this consistent treatment is appropriate because one of the types of transactions that the repeal of § 958(b)(4) was intended to address – that is, transactions used to avoid the Subpart F provisions, including decontrolling a foreign subsidiary to convert a CFC to a non-CFC – could also be used to avoid the § 1248 provisions.

5. Section 1297: PFIC Asset Test. The proposed regulations modified the definition of a CFC for purposes of § 1297(e) to disregard downward attribution from foreign persons. *See* Prop. Treas. Reg. § 1.1297-1(d)(1)(iii)(A). Treasury and the IRS published other proposed regulations (REG-105474-18) under Treas. Reg. § 1.1297-1 during 2019 (the “PFIC proposed regulations”) and decided to finalize Prop. Treas. Reg. § 1.1297-1(d)(1)(iii)(A) as part of those regulations.
6. Section 6049: Chapter 61 Reporting Provisions.
  - (a) Generally, under chapter 61 of subtitle F of the Code, a payor must report to the IRS (using the appropriate Form 1099) certain payments or transactions regarding U.S. persons that are not exempt recipients. The regulations under chapter 61 generally provide that the scope of payments or transactions subject to reporting under chapter 61 depends, in part, on whether or not the payor is a U.S. payor (as defined in Treas. Reg. § 1.6049-5(c)(5)(i)), which generally includes U.S. persons and their foreign branches, as well as CFCs. To mitigate the increased Form 1099 reporting by foreign corporations that may have no direct or indirect owners that are U.S. persons, in accordance with the regulatory authority provided in § 6049(a), Prop. Treas. Reg. § 1.6049-5(c)(5)(i)(C) provided that a U.S. payor includes only a CFC that is a CFC without regard to downward attribution from a foreign person.
  - (b) A comment requested that the exception from Form 1099 reporting be expanded to all CFCs, even if they would be CFCs without regard to the repeal of § 958(b)(4), due to the burden of the required reporting and the interaction with the requirements of local law to which CFCs are subject. Because the comment does not relate to the consequences of the repeal of § 958(b)(4), Treasury and the IRS believe it is outside of the scope of these regulations. As a result, the rules in Prop. Treas. Reg. § 1.6049-5 were finalized as proposed.
7. Applicability Dates. These regulations generally apply on or after October 1, 2019. For taxable years before taxable years covered by the regulations, a taxpayer may generally apply the rules set forth in the final

regulations to the last taxable year of a foreign corporation beginning before January 1, 2018, and each subsequent taxable year of the foreign corporation, and to taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporation end, provided that the taxpayer and U.S. persons that are related (within the meaning of § 267 or 707) to the taxpayer consistently apply the relevant rule with respect to all foreign corporations. *See* § 7805(b)(7). Moreover, although Treas. Reg. § 1.958-2 applies to taxable years of foreign corporations ending on or after October 1, 2019, and taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end, the same result applies before such date due to the effective date of the repeal of § 958(b)(4).

PROPOSED § 367 AND § 954(c)(6) REGULATIONS INVOLVING § 958(b)(4)

A. Sections 318 and 958(b)(4).

1. Section 958 provides rules for determining direct, indirect, and constructive stock ownership. Under § 958(a)(1), stock is considered owned by a person if it is owned directly or is owned indirectly through certain foreign entities under § 958(a)(2). Under § 958(b), the constructive stock ownership rules of § 318 apply, with certain modifications, to the extent that the effect is to treat any U.S. person as a U.S. shareholder within the meaning of § 951(b) (“U.S. shareholder”) of a foreign corporation, to treat a person as a related person within the meaning of § 954(d)(3), to treat the stock of a domestic corporation as owned by a U.S. shareholder of a controlled foreign corporation within the meaning of § 957 (“CFC”) for purposes of § 956(c)(2), or to treat a foreign corporation as a CFC.
2. As in effect before its repeal, § 958(b)(4) provided that § 318(a)(3)(A), (B), and (C) (providing for so-called “downward attribution”) was not to be applied so as to consider a U.S. person as owning stock owned by a person who is not a U.S. person (a “foreign person”). Effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of the foreign corporations, and for the taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end, § 958(b)(4) was repealed by TCJA.
3. As a result of this repeal, as discussed above, stock of a foreign corporation owned by a foreign person can be attributed to a U.S. person under § 318(a)(3) for various purposes, including for purposes of determining whether a U.S. person is a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. Thus, § 958(b) now provides for downward attribution from a foreign person to a U.S. person in circumstances in which § 958(b), before TCJA, did not so provide. As a result, among other consequences, U.S. persons

that were not previously treated as U.S. shareholders may be treated as U.S. shareholders, and foreign corporations that were not previously treated as CFCs may be treated as CFCs.

4. Treasury and the IRS published proposed regulations in 2019 relating to the repeal of § 958(b)(4) that since were finalized, as discussed above. Consistent with the purpose underlying the 2019 proposed regulations, the new proposed regulations propose additional changes that are intended to ensure that certain rules under §§ 367(a) and 954(c)(6) apply in the same manner in which they applied before the repeal of § 958(b)(4).

B. Section 367(a).

1. Section 367(a)(1) generally provides that if a U.S. person transfers property to a foreign corporation in connection with an exchange described in § 332, 351, 354, 356, or 361, the foreign corporation will not be treated as a corporation for purposes of determining the extent to which gain is recognized on the transfer.
2. Treas. Reg. § 1.367(a)-3 provides rules regarding the treatment of transfers of stock or securities by a U.S. person to a foreign corporation in an exchange described in § 367(a)(1) (“outbound transfer”). Treas. Reg. § 1.367(a)-3(b)(1) generally requires a U.S. person to enter into a gain recognition agreement, pursuant to rules under Treas. Reg. § 1.367(a)-8, to obtain nonrecognition treatment on an outbound transfer of stock or securities of a foreign corporation if the U.S. person owns at least 5% (applying the attribution rules of § 318, as modified by § 958(b)) of the transferee foreign corporation immediately after the transfer.
3. To obtain nonrecognition treatment on outbound transfers of stock or securities of a domestic corporation (the “U.S. target company”), Treas. Reg. § 1.367(a)-3(c)(1) requires the U.S. target company to meet certain reporting requirements and that each of four conditions is satisfied: (1) fifty percent or less of both the total voting power and the total value of the stock of the transferee foreign corporation is received in the transaction, in the aggregate, by U.S. transferors; (2) fifty percent or less of each of the total voting power and the total value of the stock of the transferee foreign corporation is owned, in the aggregate, immediately after the transfer by U.S. persons that are either officers or directors of the U.S. target company or that are five-percent target shareholders (as defined in Treas. Reg. § 1.367(a)-3(c)(5)(iii)); (3) either the U.S. person is not a 5% transferee shareholder (as defined in Treas. Reg. § 1.367(a)-3(c)(5)(ii)), or the U.S. person enters into a gain recognition agreement as provided in Treas. Reg. § 1.367(a)-8; and (4) the active trade or business test (as defined in Treas. Reg. § 1.367(a)-3(c)(3)) is satisfied.

4. For purposes of applying these tests, Treas. Reg. § 1.367(a)-3(c)(4)(iv) states that, except as otherwise provided, the stock attribution rules of § 318, as modified by § 958(b), apply in determining the ownership or receipt of stock, securities, or other property.

C. Section 954(c)(6).

1. Section 954(c)(6)(A) generally provides that for purposes of § 954(c), dividends, interest, rents, and royalties received or accrued by a CFC from a CFC that is a related person are not treated as foreign personal holding company income to the extent attributable or properly allocable (determined under rules similar to the rules of § 904(d)(3)(C) and (D)) to income of the related person that is neither Subpart F income nor income treated as effectively connected with the conduct of a trade or business in the U.S. (the “§ 954(c)(6) exception”).
2. Subject to certain limitations, the § 954(c)(6) exception is intended to make U.S.-based multinational corporations more competitive with foreign-based multinational corporations by allowing U.S.-based multinational corporations to reinvest their active foreign earnings where they are needed without giving rise to immediate additional taxation under the Subpart F provisions.
3. Section 954(c)(6)(A) provides that Treasury and the IRS shall prescribe such regulations as may be necessary or appropriate to carry out the provision, including regulations to prevent the abuse of the purposes of the provision. As most recently extended by the Further Consolidated Appropriations Act (2020), § 954(c)(6) applies to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2021, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.
4. Notice 2007-9, 2007-5 I.R.B. 401, describes guidance that Treasury and the IRS intend to issue regarding the application of § 954(c)(6), including certain anti-abuse rules. That notice, in § 7(d), provides, in relevant part:

When the use of options or similar interests causes a foreign corporation to become a CFC payor, and a principal purpose for the use of the options or similar interests is to qualify dividends, interest, rents, or royalties paid by the foreign corporation for the § 954(c)(6) exception, the dividends, interest, rents, or royalties received or accrued from such foreign corporation will not be treated as being received or accrued from a CFC payor and, therefore, will not be eligible for the § 954(c)(6) exception.

5. A rule similar to that in § 7(d) of Notice 2007-9 was included in Treas. Reg. § 1.954-1(f)(2)(iv) in 2019.
6. Explanation of Provisions.
7. Changes Regarding § 367(a).
  - (a) As discussed in the preamble, Treas. Reg. § 1.367(a)-3(c)(4)(iv) states that, except as otherwise provided, the constructive stock ownership rules of § 318, as modified by § 958(b), apply for purposes of determining the ownership or receipt of stock, securities or other property under Treas. Reg. § 1.367(a)-3(c). The repeal of § 958(b)(4) and the resulting application of § 318(a)(3)(A), (B), and (C) to the stock ownership tests under Treas. Reg. § 1.367(a)-3(c)(1) can cause a transfer that previously would have satisfied the conditions set forth in Treas. Reg. § 1.367(a)-3(c)(1) to no longer qualify for the exception to § 367(a)(1) because, for example, more shareholders are now considered to be five-percent target shareholders as a result of downward attribution. The conditions set forth in Treas. Reg. § 1.367(a)-3(c)(1) and the attribution rule in Treas. Reg. § 1.367(a)-3(c)(4)(iv) were promulgated when § 958(b)(4) did not allow for downward attribution from foreign persons.
  - (b) Treasury and the IRS believe that, for purposes of applying Treas. Reg. § 1.367(a)-3(c)(1)(i), (ii), and (iv), a U.S. person's constructive ownership interest should not include an interest that is treated as owned as a result of downward attribution from a foreign person as it would inappropriately treat the U.S. person as owning an interest it would not have owned under the rules in effect when those regulations were promulgated.
  - (c) They also believe that the constructive ownership rules as they apply to the condition set forth in Treas. Reg. § 1.367(a)-3(c)(1)(iii) (which requires that either the U.S. person is not a 5% transferee shareholder or the U.S. person must enter into a gain recognition agreement) should not be modified, and thus should continue to take into account downward attribution.
  - (d) The continued application of downward attribution for purposes of Treas. Reg. § 1.367(a)-3(c)(1)(iii) results in a consistent application of the gain recognition agreement provisions for outbound transfers of stock or securities of domestic and foreign corporations. Although TCJA's repeal of § 958(b)(4) may require a U.S. person to enter into a gain recognition agreement in connection with an outbound transfer of stock or securities of a foreign corporation to obtain nonrecognition treatment when no such agreement would have been required before TCJA, no

changes were proposed to Treas. Reg. § 1.367(a)-3(b)(1) because Treasury and the IRS believe this result is appropriate in light of the policies of § 367(a) and TCJA.

- (e) Therefore, the proposed regulations revise Treas. Reg. § 1.367(a)-3(c)(4)(iv) to apply the attribution rules of § 318, as modified by § 958(b) but without applying § 318(a)(3)(A), (B), and (C) to treat a U.S. person as owning stock that is owned by a foreign person, for all purposes of Treas. Reg. § 1.367(a)-3(c) other than for purposes of determining whether a U.S. person is a 5% transferee shareholder under Treas. Reg. § 1.367(a)-3(c)(1)(iii).

8. Changes Regarding § 954(c)(6).

- (a) As discussed above, Congress enacted § 954(c)(6) to generally allow U.S.-based multinational corporations to reinvest their active foreign earnings (in other words, earnings of CFCs subject to U.S. tax deferral) where they are needed outside the U.S. without giving rise to immediate additional taxation under the Subpart F provisions. Accordingly, the § 954(c)(6) exception is intended to apply to payments between CFCs of a U.S.-based multinational group that have active foreign earnings that are subject to the Subpart F provisions.
- (b) If a foreign corporation is a CFC solely by reason of downward attribution from a foreign person, however, most or all of that foreign corporation's earnings typically are not under U.S. taxing jurisdiction (that is, subject to the Subpart F and GILTI provisions or, in some cases, taxed in the U.S. when distributed to its owners) and, as a result, amounts paid or accrued by that foreign corporation to another foreign corporation that is a CFC (without regard to downward attribution) should not be eligible for the § 954(c)(6) exception.
- (c) For example, assume a foreign corporation ("FC1") is a CFC (without regard to downward attribution) and a member of a foreign parent multinational group, the common parent of which is not a CFC, and another foreign corporation ("FC2") that is also a member of the multinational group is a CFC but solely by reason of downward attribution and does not have any U.S. shareholders that own (within the meaning of § 958(a)) stock in such CFC (a "§ 958(a) U.S. shareholder"). FC1 makes a loan to FC2. In the absence of regulations, interest received by FC1 from FC2 would be eligible for the exception under § 954(c)(6) even though the income of FC2 is not taxed by the U.S. In comparison, if FC1 made a loan to the foreign parent instead of to FC2, interest



received by FC1 from the foreign parent would not be eligible for the exception under § 954(c)(6).

- (d) Therefore, the proposed regulations limit the application of the § 954(c)(6) exception to amounts received or accrued from foreign corporations that are CFCs without applying § 318(a)(3)(A), (B), and (C) to treat a U.S. person as owning stock that is owned by a foreign person. The modification in these proposed regulations is consistent with the treatment of interest received by FC1 in the example if instead of making the loan to FC2, FC1 made the loan to the foreign parent of the group and with the purposes of the anti-abuse rules set forth in § 7(d) of Notice 2007-9 and Treas. Reg. § 1.954-1(f)(2)(iv).
- (e) Comments were requested as to whether, and if so, to what extent, the § 954(c)(6) exception should be available in cases in which a related foreign payor corporation (that is a CFC solely as a result of downward attribution) has § 958(a) U.S. shareholders and therefore is partially under U.S. taxing jurisdiction.

9. Applicability Dates.

- (a) The regulations under § 367(a) are proposed to apply to transfers made on or after September 21, 2020.
- (b) Subject to special rules for certain entity classification elections and changes in taxable years, the regulations under § 954(c)(6) are proposed to apply to payments or accruals of dividends, interest, rents, and royalties made by a foreign corporation during taxable years of the foreign corporation ending on or after September 21, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporation end.
- (c) The proposed regulations further provide that taxpayers may choose to apply the rules under § 367 or 954(c)(6), once they are issued as final regulations to the last taxable year of a foreign corporation beginning before January 1, 2018, and each subsequent taxable year of the foreign corporation, subject to a consistency requirement. *See* § 7805(b)(7).
- (d) Finally, a taxpayer may rely on the proposed regulations under § 367 or 954(c)(6) with respect to any taxable year before the date that these regulations are published as final regulations in the Federal Register, provided that the taxpayer and persons that are related (within the meaning of § 267 or 707) to the taxpayer consistently rely on the proposed regulations under § 367 or 954(c)(6), respectively, with respect to all foreign corporations.

## XII. OTHER REGULATIONS.

### A. Final § 385 Regulations.

1. Treasury and the IRS finalized the 2016 proposed § 385 debt equity regulations without any substantive changes. T.D. 9897. Those regulations address the treatment of qualified short-term debt instruments, transactions involving controlled partnerships, and application of the rules to consolidated group members. Previously, on November 4, 2019, Treasury and the IRS removed the § 385 documentation regulations that were in Treas. Reg. § 1.385-2. *See* T.D. 9880. That action and the documentation regulations were not affected by the new final regulations.
2. However, the controversial Distribution Regulations issued in Treas. Reg. § 1.385-3, Temp. Treas. Reg. §§ 1.385-3T, and 1.385-4T, were left outstanding in proposed form since the temporary regulations expired. The proposed Distribution Regulations treat certain indebtedness as stock that is issued by a corporation to a controlling shareholder in a distribution or in another related-party transaction that achieves an economically similar result.
3. On November 4, 2019, Treasury and the IRS published an advance notice of proposed rulemaking (the “ANPRM”) that announced they intended to propose more streamlined and targeted Distribution Regulations. The ANPRM also announced that taxpayers may rely on the proposed Distribution Regulations until further notice is given in the Federal Register, provided they are applied consistently.
4. Applicability Dates.
  - (a) The final regulations amendments to Treas. Reg. § 1.385-3, other than Treas. Reg. § 1.385-3(f)(4)(iii), apply to taxable years ending after January 19, 2017. Treas. Reg. §§ 1.385-3(f)(4)(iii) and 1.385-4 provide rules applicable to members of consolidated groups and are issued under § 1502. Section 1503(a) provides in general, that in any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under § 1502 prescribed before the last day prescribed by law for the filing of such return. Thus, Treas. Reg. §§ 1.385-3(f)(4)(iii) and 1.385-4 apply to taxable years for which the U.S. Federal income tax return is due, without extensions, after the date of publication of the final regulations in the federal register.
  - (b) Treas. Reg. § 1.1503(d)-6(f)(5)(i) through (iii) applies to transfers that occur on or after December 20, 2018. For transfers occurring before December 20, 2018, *see* Treas. Reg. § 1.1503(d)-6(f)(5)(i)

through (iii) revised as of April 1, 2018. However, taxpayers may consistently apply Treas. Reg. § 1.1503(d)-6(f)(5)(i) through (iii) to transfers occurring before December 20, 2018.

B. Downward Attribution.

1. The Senate Republicans released proposed legislation relating to Coronavirus relief. In one version (but not the final version), a TCJA technical correction included a proposal that would have restored § 958(b)(4) as a general rule retroactive to the effective date of its initial repeal so that downward attribution would have never applied in most instances. If enacted, downward attribution of stock owned by a foreign person to a U.S. person would generally have continued to be blocked as though § 958(b)(4) had never been repealed.
2. However, the bill also provided an exception for limited downward attributions consistent with the narrow intent of the TCJA. To accomplish this, the technical correction includes a new § 951B titled “Amounts Included in Gross Income of Foreign Controlled United States Shareholders.
3. The proposed legislation was originally introduced in a discussion draft as a technical correction. Former House Ways and Means Committee chair, Kevin Brady, R-Texas, released the discussion draft and the Joint Committee on Taxation prepared an explanation dated January 2, 2019 (JCX119). The proposed legislation did not make any changes to the discussion draft.
4. It is important to note that certain types of downward attribution from a foreign person would continue to apply under new § 951B. Section 951B would cause Subpart F to generally apply to a “foreign controlled United States shareholder” (FC US Shareholder) of a “foreign controlled foreign corporation” (FCFC). These are important new terms: “FC US Shareholder” and “FCFC.”
5. A FCFC is a foreign corporation that would be a controlled foreign corporation (CFC) if more than 50% of its vote or value is held by FC US Shareholders. The reinstated § 958(b)(4) does not apply for purposes of testing for FCFC status.
6. A FC US Shareholder is a U.S. person who would be a § 951(b) United States shareholder of a foreign corporation without application of § 958(b)(4), but only if the U.S. person owns more than 50% of the vote or value of the foreign corporation. A foreign parent company with wholly owned U.S. and non-U.S. subsidiaries, the non-U.S. subsidiaries would no longer be treated as CFCs. Instead they would be treated as FCFCs, and the U.S. subsidiary would be treated as a FC US Shareholder.

7. Generally, the U.S. subsidiary would not have Subpart F or GILTI inclusions for the FCFCs. The U.S. subsidiary would be subject to Subpart F, GILTI, and reporting requirements if it owned stock of the FCFC directly or indirectly (not solely by attribution). Thus, the new § 951B would be narrowly targeted to inverted or acquired U.S. companies with decontrolled CFCs.
8. If the foreign parent has a single 10% U.S. shareholder, the U.S. shareholder would no longer be treated as indirectly holding the stock of CFCs.
9. If the foreign parent (which owns a US. subsidiary) also held an interest in a foreign joint venture corporation, with a U.S. party holding a 10-50% interest, the foreign joint venture corporation would no longer be treated as a CFC, and the U.S. party, under the statute, would no longer be treated as a § 951(b) United States shareholder of a CFC. Therefore the U.S. party would not have Subpart F or GILTI inclusions with respect to its ownership of the joint venture corporation.
10. For example, if US owns 40 percent of FC (a JV entity) and US has no foreign ownership, it cannot be an FC US Shareholder. FP, simply an unrelated foreign corporation in this example, owns 60 percent of FC (the JV entity) and 100 percent of A, a U.S. corporation. Section 951B does not operate regarding US since it's not an FC US Shareholder, so pre-2017 law is restored as to it, and, as to it, FC is not a CFC or an FCFC. Section 951B does operate regarding A — an FC US Shareholder — and thus FC becomes an FCFC, but only as to A.

C. Covered Asset Acquisitions.

1. The IRS and Treasury released the final 901(m) regulations in T.D. 9895. The final regulations largely adopt the 2016 proposed regulations, Notice 2014-44 and Notice 2014-45, but there are some important revisions. They also adopted the 2016 proposed regulations under § 704 without revision. The final regulations are generally effective prospectively, except for the provisions that relate to the guidance in Notice 2014-44 and Notice 2014-45.
2. Scope of covered asset acquisitions (CAAs).
  - (a) Prop. Treas. Reg. § 1.901(m)-2(b) identified six categories of transactions that constitute CAAs, three of which are specified in the statute and three of which are additional categories of transactions that are identified as CAAs pursuant to the authority granted under § 901(m)(2)(D).
  - (b) One comment requested that an exemption to § 901(m) be provided for CAAs in which all or substantially all of the gains and

losses with respect to the relevant foreign assets (RFAs) are recognized by members of the U.S.-parented group that includes the § 901(m) payor. The comment suggested that the policies of § 901(m) are not implicated in such a situation because if the same group takes into account the gains on the RFAs up front and then, in the future recognizes offsetting cost recovery items on those assets, over time, the U.S. income tax base is unchanged.

- (c) Treasury and IRS agreed that an exemption would be appropriate in certain cases, but determined that the comment's suggestion was overbroad and would apply to U.S. members of an affiliated group that do not file a consolidated return and to related controlled foreign corporations. This would open the possibility of manipulation of foreign tax credits. For example, in the case of affiliated but non-consolidated U.S. entities, the entity recognizing the U.S. gain on the assets up front may be an entity that is exempt from tax under § 501 while the entity recognizing the offsetting cost recovery items may be in a position to take advantage of the excess foreign taxes related to the basis difference.
- (d) Treasury and IRS determined that the exemption should apply only if a domestic § 901(m) payor or a member of its consolidated group recognized the gains or losses or took into account a distributive share of the gains or losses recognized by a partnership for U.S. tax purposes as part of the original CAA. Accordingly, the definition of aggregate basis difference was modified to take into account allocated basis difference adjustments determined based on gain or loss recognized with respect to an RFA as a result of a CAA. *See* Treas. Reg. § 1.901(m)-1(a)(1), (6), (48), and (49). For example, if one domestic corporation, USS1, sold a foreign disregarded entity ("FDE") that held an asset to another member of its consolidated group, USS2, the transaction is a CAA, because it is an asset sale for U.S. income tax purposes and an acquisition of stock of the FDE for foreign tax purposes. As a result, the asset is an RFA owned by USS2 subject to § 901(m). However, any aggregate basis difference USS2 determines with respect to the RFA will be adjusted to take into account the gain recognized for U.S. income tax purposes by USS1 on the original sale, provided USS1 and USS2 are still members of the same consolidated group in the year the allocated basis difference is determined.
- (e) Another comment suggested that the final category of transactions, which includes any asset acquisition for U.S. and foreign income tax purposes that results in an increase in the U.S. basis without a corresponding increase in the foreign basis, be replaced with one or more specifically defined transactions. The comment recommended that new CAAs be limited to specific transactions

that are likely to achieve the same hyping of foreign tax credits as the three categories of CAAs specified in the statute and that typically involve intensive U.S. tax planning. The comment also suggested that if Treasury and IRS found a list of specific transactions to be too limited, they could add an anti-abuse rule that would treat any transaction as a CAA if it was structured with a principal purpose of avoiding the specific categories of transactions set forth in the revised list of transactions.

- (f) Treasury and IRS stated that they do not agree that the final category of transactions is overbroad. The preamble states that Section 901(m) is designed to address transactions that result in a basis difference for U.S. and foreign income tax purposes. There is no intent test. Prop. Treas. Reg. § 1.901(m)-7 provides a de minimis exception that relieves the burden of applying § 901(m) to ordinary course transactions below the threshold provided in that rule. Treasury and IRS determined there is no policy justification for exempting transactions to which this exception does not apply on the grounds that the transaction lacked an intent to hype foreign taxes, and replacing this category of transactions with an anti-abuse rule would inappropriately introduce an intent component that is not required by the statute. Accordingly, the preamble states that the comment was not adopted.

3. Aggregate Basis Difference Carryover.

- (a) Prop. Treas. Reg. § 1.901(m)-3(c) provided rules for determining the amount of aggregate basis difference carryover for a given U.S. taxable year of a § 901(m) payor that will be included in the § 901(m) payor's aggregate basis difference for the next U.S. taxable year. The carryover reflects the extent to which the aggregate basis difference for a U.S. taxable year has not yet given rise to a disqualified tax amount.
- (b) A comment requested that the aggregate basis difference carryover rule be eliminated due to the increased compliance costs resulting from the added complexity of tracking the carryover amounts. The comment argued that these compliance costs are unjustified, given that Congress enacted an administrable approach in the statute and did not express any intent that carryover rules could apply.
- (c) The preamble states that the aggregate basis difference carryover rule is necessary to prevent the avoidance of the purpose of § 901(m), particularly in the case of timing differences. For example, assume a § 901(m) payor that is also a foreign payor has a foreign taxable year ending on March 31 and a U.S. taxable year ending on December 31. Assume further that the § 901(m) payor

recognizes foreign gain on the disposition of an RFA on November 30, in U.S. tax year 1. For U.S. income tax purposes, because the disposition occurs in U.S. tax year 1, the § 901(m) payor will have allocated basis difference in U.S. tax year 1, requiring a calculation of a disqualified tax amount. For foreign income tax purposes, the foreign tax on the gain is not imposed until the end of the foreign taxable year, which is March 31, in U.S. tax year 2. Assuming the § 901(m) payor does not pay any other foreign taxes, the disqualified tax amount for U.S. tax year 1 will be zero, because the foreign taxes are not taken into account by the § 901(m) payor for U.S. income tax purposes until U.S. tax year 2.

- (d) Because the allocated basis difference in U.S. tax year 1 does not give rise to a disqualified tax amount, the aggregate basis difference carryover rule requires that the allocated basis difference be carried into U.S. tax year 2 and be used to calculate a disqualified tax amount with respect to the foreign taxes taken into account in U.S. tax year 2. Without the aggregate basis difference carryover rule, there would be no disqualified tax amount in U.S. tax year 1, because there are not foreign taxes taken into account in that year, and no disqualified tax amount in U.S. tax year 2, because there is no allocated basis difference in that year.
- (e) The preamble states that this would allow avoidance of the application of § 901(m) to a fact pattern that is clearly meant to be covered by the statute. The aggregate basis difference carryover rule also prevents taxpayers from avoiding the application of § 901(m) by timing dispositions of RFAs to coincide with offsetting unrelated foreign losses. For these reasons, the comment was not adopted.

#### 4. Foreign Basis Election.

- (a) Basis difference with respect to an RFA is generally equal to the U.S. basis in the RFA immediately after a CAA less the U.S. basis in the RFA immediately before the CAA. Prop. Treas. Reg. § 1.901(m)-4(c) provides that a taxpayer may instead elect to determine basis difference as the U.S. basis in the RFA immediately after the CAA less the foreign basis in the RFA immediately after the CAA. Paragraphs (c) and (g)(3) of Prop. Treas. Reg. § 1.901(m)-4 provided that taxpayers may apply the foreign basis election retroactively to CAAs that have occurred on or after January 1, 2011, provided that the taxpayer applies all of the rest of the rules in the 2016 proposed regulations retroactively, with a few limited exceptions.

- (b) One comment suggested that though this consistency requirement is appropriate for tax years that remain open, the requirement is unfair if some tax years of the taxpayer or its affiliates are already closed. The comment recommended the consistency requirement be modified to permit taxpayers to apply the foreign basis election as long as they apply the rules in the 2016 proposed regulations consistently to all relevant tax years that remain open.
- (c) Treasury and IRS agree that taxpayers should not be denied the choice to retroactively apply the foreign basis election because a closed tax year is preventing them from satisfying the consistency requirement. However, because the statute of limitations for refunds attributable to foreign tax credits is ten years while the statute of limitations for assessment is generally only three years, the only relevant tax years of the taxpayer or its affiliates that would be closed are the tax years in which a consistent application of the regulations would result in an assessment.
- (d) Treasury and IRS do not believe taxpayers should be able to obtain the benefits of retroactive application of the regulations while avoiding the negative consequences. Accordingly, the preamble states that while the consistency requirement has been modified to apply only for tax years that remain open, an additional requirement is added that any deficiencies be taken into account that would have resulted from the consistent application of the final regulations for a tax year that is closed. *See* Prop. Treas. Reg. § 1.901(m)-4(g)(3).
- (e) For example, assume a taxpayer chooses to make a retroactive foreign basis election that would give rise to a \$6 million refund in a prior year that is open under the statute of limitations for refunds but that a consistent retroactive application of another provision of the final regulations would give rise to a \$1 million deficiency in another prior year that is closed under the statute of limitations for assessment. In this case, in order to meet the consistency requirement, the taxpayer would need to reduce its refund claim in the open year from \$6 million to \$5 million to take into account the \$1 million deficiency that would have resulted in the closed tax year.

## 5. Successor Rules.

- (a) The successor rules in Prop. Treas. Reg. § 1.901(m)-6(b) provided that § 901(m) continues to apply to any unallocated basis difference with respect to an RFA after there is a transfer of the RFA for U.S. income tax purposes, regardless of whether the transfer is a disposition, a CAA, or a non-taxable transaction. For



example, if a § 901(m) payor contributes an RFA with respect to a prior CAA to a partnership, any unallocated basis difference in the RFA remains subject to the § 901(m) in the hands of the partnership. One comment suggested that Treasury and IRS consider whether it would be appropriate to apply principles similar to those of § 704(c) to treat the § 901(m) “taint” in the RFA as a built-in item that is allocated back to the contributing partner.

- (b) Treasury and IRS have determined that the provisions in Prop. Treas. Reg. § 1.901(m)-5 for allocating basis difference to partners in a partnership that owns RFAs reflect the most appropriate approach, whether the RFAs are contributed to the partnership in a successor transaction or the partnership acquires them directly in a CAA. These allocation rules are based on the principle that the partner that takes into account the basis difference is the one that should be subject to § 901(m). For example, if there is a cost recovery amount of 20x due to increased depreciation deductions related to a U.S. basis step-up in a CAA, § 901(m) basically operates to disallow a credit for foreign taxes on that 20x differential created between income for U.S. and foreign tax purposes. The 2016 proposed regulations take the approach that the partner to whom the 20x of increased depreciation is allocated is the one that benefits from the income differential and is therefore the one to whom the § 901(m) disallowance should apply. If some other partner contributed the RFA to the partnership but does not get an allocation of the increased depreciation deductions, Treasury and IRS see no policy reason to nevertheless subject the contributing partner to the § 901(m) disallowance.

6. De Minimis Threshold.

- (a) Prop. Treas. Reg. § 1.901(m)-7 describes de minimis rules under which certain basis differences are not taken into account for purposes of § 901(m). In general, under the 2016 proposed regulations, a basis difference with respect to an RFA is not taken into account for purposes of § 901(m) if either (i) the sum of the basis differences for all RFAs with respect to the CAA is less than the greater of \$10 million or 10 percent of the total U.S. basis of all RFAs immediately after the CAA; or (ii) the RFA is part of a class of RFAs for which the sum of the basis differences of all RFAs in the class is less than the greater of \$2 million or 10 percent of the total U.S. basis of all RFAs in the class immediately after the CAA. The threshold dollar amounts and percentages to meet the de minimis exemptions for related-party CAAs are lower than those for unrelated party CAAs, replacing the terms “\$10 million,”

“10 percent,” and “\$2 million” with the terms “\$5 million,” “5 percent,” and “\$1 million,” respectively.

- (b) One comment expressed the view that the threshold amounts for the de minimis rules were too low, noting that the potential basis differential with respect to transactions of those magnitudes would not generate a sufficient foreign tax credit benefit to justify intensive tax planning. The comment suggested raising the \$10 million threshold to \$15 million. The comment also recommended eliminating the reduced de minimis thresholds in the context of related-party transactions. The comment argued that the test should be different for related parties only if the fact that the parties are related somehow makes the rules less burdensome than they are for unrelated parties or makes the likelihood of tax arbitrage higher. The comment suggested that this was unlikely to be the case in the context of § 901(m).
- (c) Although Treasury and the IRS do not believe that the comment made a compelling argument for increasing the threshold for the cumulative basis difference exemption, they agree that it is appropriate to extend the scope of the de minimis rules in order to further reduce the burden of compliance with the rules. However, rather than increasing the threshold amount, they decided to add an additional exclusion, such that a basis difference with respect to an individual RFA is not taken into account for purposes of § 901(m) if the basis difference is less than \$20,000. *See* Treas. Reg. § 1.901(m)-7(b)(4).
- (d) Like the de minimis exceptions contained in the 2016 proposed regulations, this de minimis exception applies independently of the other de minimis exceptions. Moreover, the reduced thresholds for related-party transactions are eliminated, as suggested by the comment. *See* Treas. Reg. § 1.901(m)-7(c).

7. Interaction with § 909.

- (a) One comment requested adding a priority rule to the regulations to address transactions to which both § 901(m) and § 909 apply, such as, for example, the acquisition of a reverse hybrid with respect to which a § 338 election is made. The acquisition is a CAA under § 901(m), and the reverse hybrid structure is a specified foreign tax credit splitting event under the § 909 regulations. The comment recommended that, given the complexity of the calculation of disqualified tax amounts under § 901(m), those calculations should be made first and § 909 should then be applied to determine whether any of the remaining foreign taxes are suspended.

- (b) Treasury and IRS agree with the comment that if § 901(m) and § 909 apply to the same transaction, the § 901(m) calculations should be undertaken before applying § 909. However, the comment's recommendation implied that only the portion of the foreign taxes that are not disqualified under § 901(m) are subject to potential suspension under § 909. Treasury and IRS disagree with this implication. Section 909 defers taking into account foreign taxes for purposes of claiming a foreign tax credit or claiming a deduction. Foreign taxes that are disqualified for foreign tax credit purposes under § 901(m) but remain eligible to be deducted may be subject to deferral under § 909 as well. The comment's suggestion is adopted with these clarifications. *See* Treas. Reg. § 1.901(m)-8(d).

8. Applicability Dates.

- (a) The 2016 proposed regulations were generally proposed to apply to CAAs occurring on or after the date of publication of the final regulations. However, the 2016 proposed regulations also provided that taxpayers could rely on the rules therein before they would otherwise be applicable, provided that taxpayers consistently applied Prop. Treas. Reg. § 1.901(m)-2 (excluding Treas. Reg. § 1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016, and consistently applied Treas. Reg. § 1.704-1(b)(4)(viii)(c)(4)(v) through (vii), Treas. Reg. § 1.901(m)-1, and Treas. Reg. §§ 1.901(m)-3 through 1.901(m)-8 (excluding Treas. Reg. § 1.901(m)-4(e)) to all CAAs occurring on or after January 1, 2011. For this purpose, persons that are related (within the meaning of § 267(b) or 707(b)) were treated as a single taxpayer.
- (b) In order to be consistent with the revised applicability of the foreign basis election, and allow the rules in the final regulations to be applied retroactively, the final regulations provide that taxpayers may choose to apply the rules before they would otherwise be applicable, provided that the consistency requirements described in the preceding paragraph are met, on any original or amended tax return for each taxable year for which the application of the provisions affects the tax liability and for which the statute of limitations does not preclude assessment or the filing of a claim for refund, as applicable.

### XIII. OTHER U.S. DEVELOPMENTS.

#### A. Altera: Cert. Denied.

1. The Supreme Court did not grant certiorari in *Altera*. This action could have long-lasting consequences and likely will lead to substantial future litigation.
2. The Ninth Circuit’s decision expanded agency deference far beyond that which could have ever been intended (*Altera Corp. v. Commissioner*, 926 F.3d 1061 (9th Cir. 2019)). The IRS took one position in rulemaking, and another in litigation. It made a major change in the tax law dealing with transfer pricing without providing any notice of the change.
3. The arm’s-length standard depends on how unrelated parties behave in the real world, and nothing in the administrative record gave notice of an intent to abandon that settled standard. The government used a new rationale in litigation, and the Ninth Circuit deferred to the new government position. The Ninth Circuit used *Chevron* to excuse compliance with the Administrative Procedure Act. This never seemed right to us.
4. The long-standing arm’s-length standard has a settled meaning based on comparability: A transaction meets the arm’s-length standard if it is consistent with evidence regarding how unrelated parties behave in comparable arm’s-length transactions.<sup>14</sup> Treasury abandoned this standard in its litigating position concerning stock-based compensation. Further, the Ninth Circuit severed the commensurate with income standard from the arm’s-length standard. However, nothing in all the other underlying law, which has been well established for decades (whether the statute, all other regulations and official Treasury pronouncements, and all other case law), has changed this fundamental arm’s-length standard.
5. Unfortunately, the Ninth Circuit’s decision left the United States with two transfer pricing methods: the long-standing rule based on comparability, as affirmed and reinforced by a unanimous Tax Court in *Altera* (“East of the Rockies”), and a new approach that is not based on comparability or rooted in any other demonstrable standard other than what the IRS or a court believes is the correct answer (“West of the Rockies”).
6. The denial of a writ of certiorari has never been understood to mean that the Supreme Court has expressed a view on the underlying legal issue. So the present state of one nation with two transfer pricing standards will

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<sup>14</sup> The Ninth Circuit’s *Xilinx* decision made that very clear. Curiously, its *Altera* decision is inconsistent with its previous holding in *Xilinx*.

persist unless and until there is an official circuit split and the Supreme Court then steps in to resolve it.

7. In base erosion and profit shifting and post-BEPS negotiations, the United States has argued for the traditional East of the Rockies arm's-length standard – it benefits the United States in its competent authority negotiations with other nations that are seeking to abandon the arm's-length standard as a means of raising revenue. However, the negotiating position of the United States is no doubt further weakened by the Supreme Court's denial of certiorari.
8. Treaty questions also will arise. What does this West of the Rockies transfer pricing method mean for the arm's-length standard in treaties? Does the West of the Rockies method override the definition of the arm's-length standard in treaties? *Altera's* facts did not involve a treaty country. Would the case have been different if it did? The Ninth Circuit decision in *Xilinx* considered the Irish treaty issue. It was an important factor (*Xilinx Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010)).
9. These kinds of questions apparently will have to be addressed in future litigation. It is unfortunate that the Supreme Court declined to address them in *Altera*.

B. Whirlpool Branch Rule Case.

1. The Tax Court ruled against Whirlpool in its branch income Subpart F income dispute holding that the company's income earned through its Mexican branch was foreign base company sales income ("FBCSI"). The tax year was 2009 and the new § 954 substantial contribution and branch rule regulations did not apply.
2. Through a branch in Mexico, Whirlpool used a maquiladora structure and its Luxembourg CFC acted as the manufacturer of the appliances and sold the appliances to Whirlpool's U.S. parent company and Whirlpool's Mexican CFC, which distributed the appliances for sale to consumers.
3. The IRS asserted that the income earned by the Luxembourg CFC from sales of appliances constituted FBCSI under § 954(d) and was Subpart F income.
4. Whirlpool filed a motion for partial summary judgment contending that the sales income was not FBCSI because the appliances sold by the Luxembourg CFC were substantially transformed by its Mexican branch from the component parts and raw materials it had purchased.
5. The Tax Court held that whether or not the appliances sold by the Luxembourg CFC were actually manufactured by it, the sales income was FBCSI because the Mexican branch was treated as a subsidiary of the

Luxembourg CFC under the manufacturing branch rule, and the sales income earned by the Luxembourg CFC constituted FBCSI.

6. The threshold question was whether Whirlpool Luxembourg carried on activities in Mexico “through a branch or similar establishment.”
7. Section 954(d)(2) establishes two preconditions for its application: (1) the CFC must be carrying on activities “through a branch or similar establishment” outside its country of incorporation, and (2) the conduct of activities in this manner must have “substantially the same effect” as if the branch were a wholly owned subsidiary of the CFC.
8. The IRS argued that Whirlpool Luxembourg did business in Mexico through a branch or similar establishment, and that it would be difficult to contend otherwise.
9. The court held that the first precondition was clearly met here: Whirlpool Luxembourg was incorporated in Luxembourg, and it carried on its manufacturing activities “through a branch or similar establishment” in Mexico. The Tax Court agreed with the IRS and held that, although Whirlpool Luxembourg had no employees in Mexico, it owned assets in Mexico, acted as a “contract manufacturer” in Mexico, and sold to related parties the products that it manufactured in Mexico. Its presence in Mexico necessarily took the form of a branch or division of itself. The Tax Court also noted the fact that Whirlpool represented to Luxembourg tax authorities (and received a ruling from them) that it had a “permanent establishment” in Mexico. Whirlpool had also received a maquiladora ruling in Mexico. The Tax Court held that the conclusion was thus inescapable that Whirlpool Luxembourg carried on activities in Mexico “through a branch or similar establishment.”
10. The court concluded that second precondition was met because this manner of operation had “substantially the same effect,” for U.S. tax purposes, as if the Mexican branch were a wholly owned subsidiary of Whirlpool Luxembourg.
11. It stated that by carrying on its activities “through a branch or similar establishment” in Mexico, Whirlpool Luxembourg avoided any current taxation of its sales income. Whirlpool thus achieved “substantially the same effect” – deferral of tax on its sales income—that it would have achieved under U.S. tax rules if its Mexican branch were a wholly owned subsidiary deriving such income.
12. To determine whether the tax effect is substantially the same, the regulations dictate a two-phase inquiry. The first phase requires an income allocation between the branch and the remainder of the CFC. The second phase requires a comparison between the actual and hypothetical

effective rates of tax applicable to the sales income allocated to the remainder.

13. The court stated that proper allocation of income between the branch and the remainder was intuitively clear: The Mexican branch earned all of the manufacturing income, and all of the sales income was allocable to the remainder. The regulation, of course, applies specific rules in this regard and they do not lead to this result.
14. The court stated that the regulations yield the same result but by a more complicated process which is designed to ensure that only sales income (and not manufacturing income) is allocated to the remainder in this scenario and that while the objective seems clear, the process is somewhat “tedious.” We do not think the regulations lead to this result, but this is what the IRS wanted as a result in the court case.
15. In short, the Service successfully argued that because all of the remainder’s income would be FBCSI under the general rules of § 954(d)(1), all of the non-manufacturing income should be allocated to it. We believe the allocation is a factual matter, perhaps to be resolved by applying arm’s length rules. This is how a previous case docketed in the Tax Court was settled. *Copper Industries v. Commissioner*. The IRS’s APA attorneys once said they would entertain a case on this subject to resolve the matter using § 482 functional analysis principles.
16. The regulation next mandates a comparison of tax rates. In effect, it asks whether the sales income allocated to Whirlpool Luxembourg was taxed at an appreciably lower tax rate than the rate at which Mexico would have taxed that income.
17. The court concluded sales income that the regulation allocates to the remainder of Whirlpool Luxembourg was taxed during 2009 at a rate of 0%. Although Mexico imposed a 17% tax rate on the manufacturing income, Whirlpool Luxembourg, as a foreign principal under the maquiladora decree, was deemed to have no PE in Mexico and was thus immune from Mexican tax. But for Luxembourg tax purposes Whirlpool Luxembourg was deemed to have a PE in Mexico, and it was thus immune from Luxembourg tax. Thus, Whirlpool Luxembourg paid no tax to either jurisdiction in 2009.
18. The regulation requires a comparison of the 0% actual rate of tax to the effective rate of tax that would apply to the sales income, under Mexican law, if Whirlpool Luxembourg were a Mexican corporation doing business in Mexico through a PE in Mexico and deriving all of its income from Mexican sources allocable to that PE. Under these assumptions the court determined Whirlpool Luxembourg would not have qualified for the 17% reduced rate of tax applicable to maquiladora companies. The court stated

that its income would therefore have been taxed by Mexico at a 28% rate, the rate applicable to Mexican corporations generally.

19. The court determined that the tax rate disparity test was satisfied because the 0% rate at which Whirlpool Luxembourg's allocated sales income was actually taxed during 2009 was less than 90% of, and more than 5 percentage points below, the 28% rate at which its income would have been taxed by Mexico on the assumptions mandated by the regulation. Thus, the court concluded Whirlpool Luxembourg's use of a branch in Mexico is considered to have had "substantially the same tax effect as if the branch" if it were a wholly owned subsidiary corporation.
20. Having determined that Whirlpool Luxembourg (the remainder) and its Mexican branch are to be treated as separate corporations, the court stated that the next step is to determine whether the remainder has foreign base company sales income.
21. The court concluded that products were manufactured outside of Luxembourg and sold for use or consumption outside Luxembourg and thus the sales income derived by Whirlpool Luxembourg constituted FBCSI under § 954(d) and was taxable as Subpart F income under § 951(a).
22. The court stated this conclusion comports with the overall statutory structure and with Congress's purpose in enacting Subpart F. The sales income with which Congress was concerned was income of a selling subsidiary which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income. The court concluded that this is precisely the objective that Whirlpool aimed to achieve here.
23. Whirlpool argued that because Whirlpool Luxembourg (the remainder) had only one part-time employee, that the remainder performed no sales or purchasing activities and hence that the manufacturing branch rule was inapplicable.
24. The court stated that Whirlpool's asserting that Luxembourg's activities were insubstantial "is a classic example of an attempt to have one's cake and eat it too." The court said that in making a separate § 954(d)(1) argument, Whirlpool had argued that Luxembourg's activities were substantial. Whirlpool's Mexican ruling also indicated that Whirlpool performed no selling activities in its Mexican branch. The court also held that making sales is necessarily a "sales activity." The court stated that under that structure Whirlpool Luxembourg was the company that owned the products and sold the products and that it is not plausible that Whirlpool Luxembourg "performed no sales activities."



25. Whirlpool contended that there was no tax rate disparity and that the effective Luxembourg tax rate should be 24.2% rather than 0% and that the hypothetical Mexican tax rate should be 0.56% rather than 28%. The hypothetical Mexican rate of 0.56% assumes that, if all of Whirlpool Luxembourg's income were taxed by Mexico, Whirlpool Luxembourg would still qualify for Mexican tax incentives under the maquiladora program.
26. The court disagreed with that assumption. If Whirlpool Luxembourg had a PE in Mexico and all of its income were allocable to that PE, it would be taxed in Mexico at a rate of 28%.
27. Whirlpool asserted that it derived a 24.2% Luxembourg tax rate by noting that Whirlpool Luxembourg in 2009 paid Luxembourg tax of €6,566 on income (mostly interest income) of €27,135.
28. The court stated this argument ignores the instructions of the regulations, which require an allocation of sales income to Whirlpool Luxembourg as "the remainder" of the CFC, and then consider the rate at which the income allocated to the remainder is, by statute, treaty obligation, or otherwise, taxed in the year when earned. The court held you do not look to the rate of tax that Whirlpool Luxembourg paid on its miscellaneous other income; the regulation directs you look to the worldwide rate of tax that was actually imposed on its allocated sales income.
29. Whirlpool argued that the "same country exception" applied since Whirlpool Luxembourg purchased the raw materials and component parts used to manufacture the products, and it held title to the work-in-process inventory throughout the manufacturing process.
30. The court rejected that argument and stated that Whirlpool Luxembourg was organized in Luxembourg and the products were manufactured in Mexico. The court held that the "same country manufacturing exception" thus has no application to Whirlpool Luxembourg's activities or income.
31. Finally, as an alternative Whirlpool contended that the regulations were invalid and that the manufacturing branch rule of Treas. Reg. § 1.954-3(b)(1)(ii) exceeded the scope of the authority granted by the plain language of § 954(d)(2).
32. The court stated that there is nothing in the statute that prevents the Secretary from prescribing regulations that address manufacturing branches. Thus, whether the court treated the statute as ambiguous or silent on the matter, the question was whether the manufacturing branch regulations are valid under *Chevron* step two.
33. The court stated that the legislative history of Subpart F left no doubt that Congress's intent in enacting the foreign base company provisions was to

capture sales income that had been artificially separated from the manufacturing activities of a related entity.

34. Regardless of whether § 954(d)(2) is viewed as ambiguous or silent on the “manufacturing branch” issue, the court concluded that the manufacturing branch regulations were a “reasonable interpretation” of the statute.

C. Transfer Pricing FAQ.

1. The IRS released new transfer pricing documentation best practices guidance in the form of a FAQ on April 14, 2020. The FAQ is a follow on to the 2018 Directive on transfer pricing penalties and compliance. The guidance in the FAQ is very good.
2. The six FAQs are based on the IRS’s observations of best practices and common mistakes in preparing transfer pricing documentation. The suggestions and recommendations are consistent with the regulatory requirements.
3. The IRS notes that many taxpayers would benefit from insights on the information that could be provided to the IRS to increase the chance of audit deselection or more efficient audits. The IRS believes the potential for deselection of issues earlier in the examination process could be a powerful incentive for many taxpayers to improve their transfer pricing documentation. The FAQs are designed to encourage cooperative compliance by taxpayers.
4. FAQ 1.
  - (a) The FAQ states that the question is, what benefit in addition to penalty protection, is there for taxpayers who invest in robust transfer pricing? The FAQ notes that it is important to have high-quality transfer pricing documentation in order to avoid further examination. High-quality transfer pricing documentation allows the examining agent to rely on the taxpayer’s analysis of functions, risks, intangibles, value drivers, etc., saving both the taxpayer and the IRS time examining low-risk transfer pricing issues.
  - (b) The FAQ provides an example, where a U.S. company distributes heavy machinery it purchases from its foreign parent. The U.S. distributor had significant losses in 2017, indicating that the pricing may be incorrect. Under the intercompany agreements, the prices are set so the U.S. distributor would expect to earn a return of X% of sales under normal business circumstances. During 2017, the demand for the company’s heavy machinery dropped unexpectedly, and the U.S. distributor sold a lower than expected number of machines. This reduction in sales volume resulted in losses for the U.S. distributor. The loss was caused by an

unexpected change in the company's business circumstances, not by non-arm's length intercompany prices.

- (c) The IRS notes that in the example, the documentation should thoroughly explain how the unforeseen business circumstances created the losses and that they were not caused by the intercompany prices. This approach would address a core issue in the transfer pricing analysis and facilitate an efficient examination. By contrast, it would be counterproductive if, rather than addressing the business circumstances that caused the loss, the taxpayer instead manipulated its set of comparable companies in order to fall within the interquartile range. This approach would result in additional rounds of Information Document Requests ("IDRs") and a lengthy analysis of the reliability of the comparable companies selected by the taxpayer, which could lengthen the audit period considerably.

5. FAQ 2.

- (a) The second FAQ is how can a self-assessment of the potential indicators of transfer pricing non-compliance can help. If taxpayers undertake a basic sensitivity analysis around the parameters of their application of the best method, they can potentially anticipate and proactively address concerns the IRS might raise. A starting point is a sensitivity analysis of the parameters used.
- (b) For example, if the tested party's results would fall outside the benchmark range with the removal of just one company from the comparable company set, the taxpayer should consider re-evaluating the strength of the comparability analysis of the benchmark companies.
- (c) Comparing the tested party's results against a variety of profit level indicators ("PLIs") is another form of self-assessment. Taxpayers should ensure their selection of PLIs is fully supported in comparison to other PLIs that might indicate a different conclusion about the arm's length nature of the intercompany transactions.
- (d) For example, a foreign subsidiary of a U.S. company licenses technology from its U.S. parent to manufacture widgets for sale in Europe. The foreign subsidiary earns an operating margin that on its own does not necessarily indicate high transfer pricing risk. However, based on data available on the foreign subsidiary's form 5471, the foreign subsidiary earns a higher return on assets ("ROA") than the comparable companies used in the taxpayer's operating margin analysis, suggesting the royalty paid by the

foreign subsidiary may be too low. The taxpayer should be prepared to address potential inconsistencies between PLI results.

- (e) Finally, a taxpayer self-assessment may also benefit from proactively evaluating how system profits are shared between related parties and addressing whether such allocations are reasonable based on each party's contributions.

6. FAQ 3.

- (a) The third FAQ is what is the IRS's guiding principle in establishing arm's-length prices were charged in intercompany transactions.
- (b) Where the same information for evaluating pricing is available to both taxpayers and the IRS, it follows compliance with the transfer pricing regulations should be self-enforcing because the taxpayer and the tax authority should reach a materially similar conclusion about the arm's-length nature of the intercompany pricing. Under such (ideal) conditions of information symmetry, a transfer pricing report prepared in good faith by the taxpayer would be sufficient to demonstrate compliance.
- (c) In the ideal case, once the documentation report is reviewed by the tax authority and after a small number of clarifying questions, the transfer pricing audit would be over.
- (d) However, the IRS notes that it might be very difficult to find direct and close comparable companies, or they might not exist. Where there are no perfect comparable companies, there may be good comparable companies for which it is necessary to make adjustments to compensate for the imperfect comparability.
- (e) In other cases, there may be no comparable company close enough to allow reliable adjustments, and another transfer pricing method must be used. When there are good, yet imperfect, comparable companies, comparability adjustments should be applied rationally and consistently and follow basic economic principles. Inclusion of a thorough analysis of how and why comparability adjustments were selected and applied is required by the regulations, and that analysis facilitates risk assessment and examination.

7. FAQ 4. In the fourth FAQ, the IRS outlines areas that generally need improvement in most taxpayer reports. The more complex the transaction, the greater the need for detailed analysis and documentation.

8. Industry and Company Analysis.

- (a) Industry and company analysis sections of the report should be clear and provide context for related party transactions. These sections educate the IRS about the industry in which the taxpayer operates and how the relevant related parties fit into the taxpayer's operations. They are, in effect, a place (along with the functional analysis narrative) for a taxpayer to "tell its story." This analysis of the context in which the intercompany transactions take place should provide a sense of the total value the multinational enterprise has created.
- (b) For example, the number of years of analysis used in the application of the CPM could be different depending on the taxpayer's industry. In this part of the report, it may be helpful to provide information as to expectations versus reality. For example, is the industry experiencing a downturn? If so, adjustments may be needed to separate the effects of bad risk realization from the effects of intercompany pricing.
- (c) The IRS's ability to efficiently and effectively conduct and rapidly conclude transfer pricing risk assessments and examinations should be better in situations where the taxpayer's transfer pricing documentation, includes a robust analysis of:
  - Special business circumstances that might have affected results,
  - Effects of discrepancy, if any, between the pricing policy and documentation method analysis (e.g., cost plus policy but test is CPM on distributor returns) and any year-end adjustments, and
  - Any comparability adjustments made to the CPM (e.g., excess capacity).

9. Functional Analysis.

- (a) Functional analysis narratives should be robust and link facts to analysis. Sometimes taxpayers include a list of facts in their documentation with no real analysis to connect the business description to the method selection.
- (b) For example, some taxpayers present a "functional analysis" checklist of who does what with very little attention to the "analysis." Failing to link the business operational structure to the subject transactions and intercompany pricing or not explaining

how and where the value is created that supports the allocation of profits among the parties does not substantially advance an examination toward a conclusion.

- (c) The functional analysis should be well-supported factually and should not rely on broad assumptions about the business. Strengthening this analysis can benefit a taxpayer by answering questions before they are asked by the IRS.

10. Risk Analysis.

- (a) Risk analysis should be consistent with intercompany agreements. Every business faces risks. From a transfer pricing perspective, risks must be identified and then allocated between the controlled parties. Intercompany agreements and the assignment of rights and responsibilities between the parties generally establish how risks are allocated.
- (b) For example, under an intercompany agreement, a distributor may have the right to return all unsold inventory to the related supplier, thus shifting some risk to the supplier. The transfer pricing documentation should address such allocations of risk, how the risk allocations compare to the comparable companies used, and why the resulting pricing is consistent with the agreement.
- (c) If an adjustment is made to the comparable companies based on risk allocations, the quantification of the risk and method for computing the adjustment should be clearly explained.

11. Best Method.

- (a) Support for best method selection must be provided, as well as the reason for rejecting specified methods. In many cases, the best method analysis and conclusions should be more robust and more specific to a taxpayer's circumstances.
- (b) For example, a sentence that simply states "there are no Comparable Uncontrolled Prices ("CUPs") so we did not apply the CUP method" is not helpful. Instead, a description of why such comparable transactions do not exist and/or how such determination was made should be included.
- (c) When eliminating methods, documentation should include a complete description of the search for internal and/or external data. Multinationals often maintain internal databases of legal agreements with unrelated parties. Documentation of a thorough method selection process should describe as clearly as possible the internal and external data requested and reviewed in the process of

selecting a method. Preparing this documentation contemporaneously should facilitate preparation of the transfer pricing report and could be helpful to a taxpayer in the future, including in its interactions with the IRS.

- (d) For example, assume a taxpayer determined a royalty using a residual profit split method (“RPSM”) after concluding, based on a search of an external royalty database, there were no Comparable Uncontrolled Transactions (“CUTs”) available. The taxpayer’s legal department maintains a list of hundreds of internal uncontrolled agreements in which royalties are paid and that could have potentially served as internal CUTs, but the tax department and outside advisors did not request this internal information as part of their documentation analysis.
- (e) The taxpayer’s failure to adequately consider and address the availability of internal data would call into question whether the selection of the RPSM method was reasonable.
- (f) The IRS notes that frequently taxpayers fail to provide a reasoned basis for rejection of the specified methods when an unspecified method is selected.

12. Profit Level Indicators. Analysis should be provided to support the PLI conclusion. Conclusive statements such as “We selected the Operating Margin as the PLI in the application of the CPM, because distributors typically measure their profits as a function of sales” are not helpful. The examiner’s evaluation of the taxpayer’s pricing may very well depend on the choice of PLI, which should therefore be substantively supported as thoroughly as possible.

13. Comparability.

- (a) Complete comparability analysis should be provided. Taxpayers often fail to thoroughly address the comparability criteria enumerated in the regulations.
- (b) For example, in cases where taxpayers use the CUT method, they often do not thoroughly address profit potential. While profit potential may be a difficult criterion to analyze in some cases, it may not be ignored. Even if a numeric analysis of profit potential may not be possible, strong indications the profit potential of controlled and uncontrolled transactions is similar (e.g., the controlled brand and brands of the comparable company are middle of the road brands) would improve the usefulness of the analysis. While different methods impose different comparability requirements, differences between the controlled transaction or

party and the uncontrolled transactions or parties should always be addressed.

- (c) For example, if the purportedly comparable companies distribute different products from a different industry, an explanation should be provided to support the appropriateness of the comparability conclusion.

14. Differences in Risks or Functions.

- (a) The impact of differences in risks or functions between the tested party and the comparable companies should be provided. One of the purposes of performing a risk analysis is to ensure the risks borne by the tested party are comparable to those borne by comparable companies.
- (b) For example, in a CPM analysis, if the risk analysis establishes the tested party does not bear inventory risk and the selected comparable companies do bear that risk, the report should either demonstrate the effect of the difference in risk is inconsequential or perform an adjustment that would increase the reliability of the CPM analysis, if possible. The same logic applies to differences in functions.

15. Adjustments.

- (a) Detailed well-reasoned support for proposed adjustments to the application of a specified method should be provided. Adjustments should be made for differences in comparability factors, characteristics that would likely have an impact on prices in uncontrolled transactions. Those adjustments, including the reasons for the adjustments, should be explained in the report.
- (b) For example, if the tested party's operating expenses to sales ratio is higher than that of the comparable companies, an adjustment might be appropriate for the differences in operating expenses. In this case, a taxpayer might show first the larger expenses of the tested party would be remunerated in the marketplace. What are these excess expenses? Are they related to additional services provided to customers or inefficiencies? Is it just an expense classification issue (e.g., treatment as cost of goods sold versus operating expenses)?

16. FAQ 5. The fifth question covers common features in good transfer pricing reports.



17. Data Explanation.

- (a) The IRS recommends a full explanation of the data used in the analysis. If segmented data is used, include a description of how the data was constructed, tie data used in the analysis to financial data, and provide complete income statements and balance sheets of the tested party (not just sales, total costs, and profits).
- (b) When documentation is requested, taxpayers should provide data in a functional format that preserves their calculations (e.g., spreadsheets rather than pdf files), which can speed up the examiner's review.

18. Business Risk.

- (a) Descriptions of the general business risks of the transaction and then more detailed descriptions of how these risks are allocated among the controlled participants to the transaction based on the intercompany policies/agreements is helpful.
- (b) For example, if manufacturing volume is a risk to the profitable operations, a policy that "ensures" the distributor makes a fixed profit margin allocates more volume risk to the manufacturer/supplier.

19. Allocation of Profits.

- (a) Results from the application of a particular method must be reasonable. If they are not, there is something missing in the analysis. After the application of the selected method, one of the parties may end up with returns that may seem too high or too low.
- (b) For example, a manufacturer sells to a related distributor. The taxpayer selects the CPM as its pricing method with the distributor as the tested party based on the taxpayer's position that the distributor performs less complex and more benchmarkable functions. In fixing the return of the distributor by using the CPM, the controlled manufacturer ends up with much higher returns than suggested by its manufacturing contributions. The relative contribution of manufacturing activities to distribution activities may not be enough to entitle the related party manufacturer to such high returns. In this example, the documentation should explain where the excess returns come from and which controlled party is entitled to these returns. This issue is not limited to the application of the CPM but also is present in applications of the CUT method or the RPSM.

20. Other Useful Features. The IRS listed a few other useful features of a transfer pricing documentation report:
- Reports that provide a functional and risk analysis for each transaction.
  - Analysis of special business circumstances that may have affected profitability.
  - Description of challenges of the analysis (e.g., the combined profits were negative, and the challenge is to allocate losses among the controlled participants).
21. FAQ 6.
- (a) The sixth and last pointer in the FAQ is that the reports need to be more user friendly. In general, making transfer pricing documentation more “user friendly” will make the IRS’s review and assessment of the return positions as efficient as possible.
  - (b) Providing something as simple as a summary of information about the intercompany transactions at the beginning of the transfer pricing documentation helps IRS examiners understand the taxpayer’s transactions. An intercompany transaction summary can help focus review and examination on the most significant transactions. A summary presentation can be very useful for risk assessment purposes to deselect transactions from audit or establish the scope of the transfer pricing audit, which can save a significant amount of examiner time at the beginning of an audit.
  - (c) Transfer pricing documentation should be easy to read and understand, you are not going to win points with the IRS by making it more complex than it needs to be.

D. USMCA Treaty Issue.

1. In Announcement 2020-06, Treasury and the IRS stated that once the agreement between the United States of America, the United Mexican States, and Canada (“USMCA”) replaces the North American Free Trade Agreement (“NAFTA”), they will interpret any references to NAFTA in a U.S. income tax treaty as a reference to the USMCA.
2. Most U.S. bilateral income tax treaties contain Limitation on Benefits (“LOB”) articles with provisions designed to prevent entities resident in a treaty jurisdiction from inappropriately accessing tax treaty benefits. Most LOB articles provide a series of objective tests. A number of these LOB tests contain explicit references to the NAFTA.

3. For example, under the LOB derivative benefits test, a resident company may claim treaty benefits if it is at least 95% owned by seven or fewer equivalent beneficiaries. In order to be an equivalent beneficiary, a person generally must be a resident of a country that is a party to either the NAFTA, the European Union, or the European Economic Area.
4. As another example, some treaties permit U.S. companies to qualify for benefits if its principal class of shares is primarily traded on a recognized stock exchange located in the U.S. or another country that is a party to the NAFTA.
5. Where U.S. tax is at issue, this should eliminate the concern for U.S., Mexico, and Canada residents after NAFTA is replaced. However, where foreign tax is at issue, the foreign treaty partner will have to agree. The Announcement states that “The Treasury Department and the IRS will reach out to countries that have an applicable tax treaty containing NAFTA references to confirm that they agree with this interpretation. This is helpful. It is also helpful that the IRS interprets the USMCA as merely modernizing NAFTA, supporting the argument that the U.S., Mexico, and Canada have remained parties to NAFTA.

#### XIV. OTHER DEVELOPMENTS.

##### A. OECD Financial Transactions Guidance.

1. The OECD released important new final guidance on financial transactions which is in the form a new chapter in the OECD transfer pricing guidelines. This is the first final OECD guidelines guidance on the transfer pricing aspects of financial transactions. The OECD had released a discussion draft on July 3, 2018. The discussion draft received more than 75 comments including very good comments by TEI and The Silicon Valley Tax Directors Group (SVTD) raising a number concerns with the discussion draft. It is not clear that the final OECD guidelines fixed all of the problems.
2. The report describes the transfer pricing aspects of financial transactions, including a number of examples. The basic principles of the OECD transfer pricing report were adapted to cover financial transactions including loans, treasury functions, guarantees, cash pooling, captive insurance and hedging. The new guidance reiterates the OECD transfer pricing concept of accurate delineation analyzing risks and functions.
3. Debt Characterization.
  - (a) The report first discusses whether a purported loan should be regarded as a loan for tax purposes. The report states that particular labels or descriptions assigned to financial transactions do not constrain the transfer pricing analysis.

- (b) The report notes that the following economically relevant characteristics may be useful indicators, depending on the facts and circumstances: (1) the presence or absence of a fixed repayment date; (2) the obligation to pay interest; (3) the right to enforce payment of principal and interest; (4) the status of the funder in comparison to regular corporate creditors; (5) the existence of financial covenants and security; (6) the source of interest payments; (7) the ability of the recipient of the funds to obtain loans from unrelated lending institutions; (8) the extent to which the advance is used to acquire capital assets; (9) and the failure of the purported debtor to repay on the due date or to seek a postponement.
- (c) While most of these debt factors are similar to the US common law debt factors, some of them are different. For example, under US common law the US the obligation to pay interest is important, but the source of the interest payment is traditionally not a factor. Under US common law, the ability obtain the loan on a similar economical term is a very important factor, but courts typically do not look as much at the extent to which the advanced is used to acquire capital assets.
- (d) The report notes that this guidance is not intended to prevent countries from implementing approaches to address the balance of debt and equity funding of an entity and interest deductibility under domestic legislation, nor does it seek to mandate the only approach for determining whether purported debt should be respected as debt.
- (e) The report provides an example were a portion of the loan should be treated as equity. Company B receives an advance of funds from related Company C, denominated as a 10 year loan. The example states that assume that, in light of all good-faith financial projections of Company B for the next 10 years, it is clear that Company B would be unable to service the loan. Based on facts and circumstances, it can be concluded that an unrelated party would not be willing to provide the loan to Company B due to its inability to repay. Accordingly, the accurately delineated amount of Company C's loan to Company B for transfer pricing purposes would be a function of the maximum amount that an unrelated lender would have been willing to advance to Company B, and the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow from Company C, including the possibilities of not lending or borrowing any amount.

4. Treasury Function.

- (a) The guidelines state that when evaluating the transfer pricing issues related to treasury activities, as with any case, it is important to accurately delineate the actual transactions and determine exactly what functions an entity is carrying on rather than to rely on a general description such as “treasury activities.”
- (b) In considering the commercial and financial relations between the borrower and lender, and in an analysis of the economically relevant characteristics of the transaction, both perspectives should be taken into account, acknowledging that these perspectives may not align in every case. The guidelines discuss the use of credit ratings. The creditworthiness of the borrower is one of the main factors that independent investors take into account in determining the interest rate.
- (c) Different approaches to intragroup loan transfer pricing methods are discussed. The guidelines discuss the Comparable uncontrolled price method (CUP method) to determine arm’s length interest rates. The report states that in the absence of comparable uncontrolled transactions, the cost of funds approach could be used as an alternative to price intra-group loans in some circumstances.
- (d) The report notes that certain industries rely on economic models to price intra-group loans by constructing an interest rate as a proxy to an arm’s length interest rate. In their most common variation, economic models calculate an interest rate through a combination of a risk-free interest rate and a number of premiums associated with different aspects of the loan – e.g. default risk, liquidity risk, expected inflation or maturity. The reliability of economic models’ outcomes depends upon the parameters factored into the specific model and the underlying assumptions adopted.
- (e) In some circumstances taxpayers may seek to evidence the arm’s length rate of interest on an intra-group loan by producing written opinions from independent banks, sometimes referred to as a “bankability” opinion, stating what interest rate the bank would apply were it to make a comparable loan to that particular enterprise. Such an approach would represent a departure from an arm’s length approach based on comparability since it is not based on comparison of actual transactions.
- (f) The use of a cash pool is popular among multinational enterprises as a way of achieving more efficient cash management. The accurate delineation of cash pooling arrangements would need to

take into account not only the facts and circumstances of the balances transferred but the wider context of the conditions of the pooling arrangement as a whole. The appropriate reward of the cash pool leader will depend on the facts and circumstances, the functions performed, the assets used and the risks assumed in facilitating a cash pooling arrangement. Determining the arm's length interest rates for the cash pool intra-group transactions may be a difficult exercise due to the lack of comparable arrangements between unrelated parties.

- (g) As part of the cash pooling arrangement, cross-guarantees and rights of set-off between participants in the cash pool may be required. This raises the question of whether guarantee fees should be payable. Cross-guarantees and set-off rights are a feature of an arrangement which would not occur between independent parties.
- (h) Where the centralised treasury function arranges a hedging contract that the operating entity enters into, that centralised function can be seen as providing a service to the operating entity, for which it should receive compensation on arm's length terms. Difficult transfer pricing issues arise if the positions are not matched within the same entity, although the MNE group position is protected.

## 5. Financial Guarantees.

- (a) The accurate delineation of financial guarantees requires initial consideration of the economic benefit arising to the borrower beyond the one that derives from passive association. From the borrower perspective, a financial guarantee may affect the terms of the borrowing. From the perspective of a lender, the consequence of one or more explicit guarantees is that the guarantor(s) are legally committed; the lender's risk would be expected to be reduced by having access to the assets of the guarantor(s) in the event of the borrower's default.
- (b) The report states that the CUP method could be used where there are external or internal comparables; independent guarantors providing guarantees in respect of comparable loans to other borrowers or where the same borrower has other comparable loans which are independently guaranteed.
- (c) The yield approach quantifies the benefit that the guaranteed party receives from the guarantee in terms of lower interest rates. The method calculates the spread between the interest rate that would have been payable by the borrower without the guarantee and the interest rate payable with the guarantee.

- (d) The cost approach method aims to quantify the additional risk borne by the guarantor by estimating the value of the expected loss that the guarantor incurs by providing the guarantee (loss given default). Alternatively, the expected cost could be determined by reference to the capital required to support the risks assumed by the guarantor.
- (e) The valuation of expected loss method would estimate the value of a guarantee on the basis of calculating the probability of default and making adjustments to account for the expected recovery rate in the event of default. This would then be applied to the nominal amount guaranteed to arrive at a cost of providing the guarantee. The guarantee could then be priced based on an expected return on this amount of capital based on commercial pricing models such as the Capital Asset Pricing Model (CAPM).
- (f) The capital support method may be suitable where the difference between the guarantor's and borrower's risk profiles could be addressed by introducing more capital to the borrower's balance sheet. It would be first necessary to determine the credit rating for the borrower without the guarantee (but with implicit support) and then to identify the amount of additional notional capital required to bring the borrower up to the credit rating of the guarantor. The guarantee could then be priced based on an expected return on this amount of capital to the extent that the expected return so used appropriately reflects only the results or consequences of the provision of the guarantee rather than the overall activities of the guarantor-enterprise.

6. Captive Insurance.

- (a) In the guidance, the term captive insurance is intended to refer to an insurance undertaking or entity substantially all of whose insurance business is to provide insurance policies for risks of entities of the group to which it belongs. The principles of accurate delineation of the actual transactions and allocation of risk apply to captive insurance and reinsurance in the same manner that they apply to any other intra-group transactions.
- (b) The report states that a frequent concern when considering the transfer pricing of captive insurance transactions is whether the transaction concerned is genuinely one of insurance. The following are indicators, all or substantially all of which would be found if the captive insurance was found to undertake a genuine insurance business:

- there is diversification and pooling of risk in the captive insurance;
  - the economic capital position of the entities within the MNE group has improved as a result of diversification and there is therefore a real economic impact for the MNE group as a whole;
  - both the captive insurance and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk assumption and appropriate capital levels;
  - the insured risk would otherwise be insurable outside the MNE group;
  - the captive insurance has the requisite skills, including investment skills, and experience at its disposal;
  - the captive insurance has a real possibility of suffering losses.
- (c) The report notes that there may be internal comparables if the captive insurance has suitably similar business with unrelated customers, or there may be external comparables. The application of the CUP method to a transaction involving a captive insurance may encounter practical difficulties to determine the need for and quantification of comparability adjustments.
- (d) Alternatively, actuarial analysis may be an appropriate method to independently determine the premium likely to be required at arm's length for insurance of a particular risk.
- (e) The remuneration of the captive insurance can be arrived at by considering the arm's length profitability of the captive insurance by reference to a two staged approach which takes into account both profitability of claims and return on capital.
- (f) Where the captive insurance insures the risk and reinsures it in the open market, it should receive an appropriate reward for the basic services it provides. The remaining group synergy benefit should be allocated among the insured participants by means of discounted premiums.

7. Risk Free and Risk-Adjusted Rates.

- (a) If the accurate delineation of the actual transaction shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a



financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain. A risk-free rate of return is the hypothetical return which would be expected on an investment with no risk of loss. Ultimately, there is no investment with zero risk, and the reliability of available proxies for approximating a risk-free rate of return will depend on prevailing facts and circumstances.

- (b) The report notes that in determining the risk-adjusted rate, it is important to identify and differentiate the financial risk which is assumed by the funder in carrying on its financing activity, and the operational risk that is assumed by the funded party and is connected to the use of the funds, e.g. for developing an intangible asset.

B. Apple State Aid Case Rules in Favor of Apple.

1. The European General Court invalidated the European Commission's state aid recovery order against Apple.
2. The Court held that the European Commission did not succeed in showing that in light of the activities and functions actually performed by the Irish branches and that the strategic decisions taken and implemented outside of those branches, that the Apple Group IP should have been allocated to those Irish branches.
3. The Court also held that the Commission did not succeed in showing that, by issuing the contested tax rulings, the Irish tax authorities granted an advantage.

C. OECD Model Rules for Platform Operators.

1. On July 3, 2020, the OECD published model rules for platform operators to collect data on their sellers and report that information to tax administrations for compliance purposes. The OECD stated that the "sharing" and "gig" economies are growing rapidly and that rules are needed to collect information. As a result, the report states that tax administrations may wish to consider adapting the OECD platform operator compliance strategies.
2. The objective is to ensure timely access to high-quality and relevant information on the consideration earned by platform sellers, in order to enhance compliance and minimize compliance burdens. At the same time, the rules also aim to ensure that activities by such sellers do not remain undetected by tax administrations in instances where such sellers do not declare income earned through the platforms. They also promote standardization of reporting rules between jurisdictions and international cooperation. While the primary focus is on facilitating and enhancing

compliance with direct tax obligations, the information reported may also have relevance for other domains, such as indirect taxes, local taxes and social security contributions.

3. The Model Rules have three dimensions: (i) a targeted scope of transactions to be reported, focusing on accommodation, transport and other personal services; (ii) a broad scope of platform operators and sellers, to ensure that as many relevant transactions as possible are being reported; and (iii) due diligence and reporting rules that ensure that accurate information gets reported without imposing overly burdensome procedures on platform operators.
4. A broad and generic definition of the term platform covers all software products that are accessible by users and allow sellers to be connected to other users for the provision of relevant services, including arrangements for the collection of consideration on behalf of sellers.
5. Platform operators are defined as entities that contract with sellers to make available all or part of a platform. There are optional exclusions for small-scale platform operators, in particular targets at start-ups, and platforms that do not allow sellers to derive a profit from the consideration received or that do not have reportable sellers.
6. The scope of sellers covers both entities and individuals, although exclusions are foreseen for hotel businesses, publicly-traded entities and governmental entities.
7. The information required includes the name, address, TIN (including the jurisdiction of issuance) and the seller's date of birth or business registration number.