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Global Tax Alert

Report on recent US international tax developments – 2 October 2020

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The United States (US) Treasury and the Internal Revenue Service (IRS) on 29 September 2020 released final regulations (T.D. 9922; Final Regulations) and proposed regulations (REG-101657-20; Proposed Regulations) on determining the foreign tax credit and allocating and apportioning deductions under the IRS Code. The Final Regulations generally follow proposed regulations published on 2 December 2019, but make certain changes.

Highlights of the Final Regulations include provisions that:

- Allocate and apportion foreign income taxes to gross income under Reg. Section 1.861-20, including for purposes of categorizing taxes to separate Internal Revenue Code[1] Section 904(d) categories, by:
  - Allocating taxes on foreign income items with no corresponding US income item
  - Identifying an exclusive list of "base differences" (for which a foreign tax credit under Section 960 is effectively denied) that no longer includes foreign law distributions treated as a return of basis for US federal income tax purposes
  - Describing the treatment of (regarded) distributions
- Retain mandatory sales-based apportionment of research and experimentation (R&E) expense to all gross intangible income related to the relevant product SIC code, specifically excluding Global Intangible Low-Taxed Income (GILTI), subpart F inclusions and dividends

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- Provide that exclusive apportionment of research and experimentation (R&E) expense does not apply for purposes of computing foreign-derived intangible income (FDII)
- Clarify that stewardship expenses are allocated to domestic and foreign dividends, GILTI, and subpart F inclusions, and apportioned based on the value of the domestic and foreign stock
- Add an election under Section 905(c) to account for certain foreign tax redeterminations of a controlled foreign corporation (CFC) for pre-2018 tax years as if they occurred in the CFC's last tax year beginning before 1 January 2018
- Reduce hybrid deduction accounts under Section 245A(e) by reason of certain subpart F income and GILTI, and provide guidance on the treatment of certain stock as a financing transaction under the conduit financing rules of Reg. Section 1.881-3

Notable provisions of the Proposed Regulations would:

- Fundamentally overhaul the creditability requirements of a foreign income tax under Sections 901 and 903 by requiring jurisdictional nexus for the tax to be creditable (without considering the location of customers or users as a significant factor)
- Introduce new rules under Reg. Section 1.861-20 for allocating and apportioning foreign income taxes imposed on: (i) dispositions of stock and partnership interests; and (ii) disregarded payments made between "taxable units" that generally would categorize foreign taxes based on the income of the payor making the disregarded payment
- Disallow foreign tax credits and deny deductions under Section 245A(d) for foreign income taxes attributable to any dividend for which a deduction under Section 245A would be allowed
- Add an election to capitalize and amortize R&E and advertising expenditures for purposes of apportioning interest expense under Reg. Section 1.861-9
- Treat, for purposes of computing the Section 250 FDII deduction, services as electronically supplied services if the value of the service to the end user is derived primarily from the service's automation or electronic delivery, as opposed to human effort (e.g., legal, accounting, medical, or teaching services)

The Government on 29 September also released final regulations (TD 9921) (the Final Regulations) with rules for determining the source of income from sales of inventory produced within the US and sold outside the US, or vice versa. The Final Regulations further include rules for determining whether foreign-source income is effectively connected with the conduct of a US trade or business. Additional rules address the sourcing of a nonresident's income from certain sales of personal property that are attributable to an office maintained in the United States.

The Final Regulations generally follow the proposed regulations issued on 30 December 2019 (REG-100956-19), with certain changes. In particular, the Final Regulations:

- Require taxpayers electing to use the books-and-records method for apportioning gross income between sales and production activities under Reg. Section 1.865-3(d) to use that method for 48 months unless the IRS consents to the election's revocation
- Clarify that the adjusted basis of production assets (used to source income when production occurs both within and outside the United States) is determined by averaging the assets' bases at the beginning and end of the year, unless a change occurred during the year that would materially distort the calculation
- Modify the rules for determining whether a taxpayer's activities constitute production activity by referring to the rules for foreign base company sales income in Reg. Section 1.954-3(a)(4), but without applying the "substantial contribution" rules
- Do not expand the rules for determining the location of production activity to include activities or assets of related parties or unrelated agents
- Modify the anti-abuse rule in Reg. Section 1.863-3(c), and add an example illustrating that the rule may apply to certain acquisitions of domestic production assets by related partnerships (or their subsidiaries) if the acquisition has a principal purpose of reducing Reg. Section 1.863-3 tax liability by treating inventory sales income as subject to Section 862(a)(6) rather than Section 863(b)

The Final Regulations generally apply to tax years ending on or after 23 December 2019. Taxpayers may choose to apply the Final Regulations in their entirety for any tax year beginning after 31 December 2017, if they and all related persons continue to apply the regulations for all subsequent years.

On 24 September 2020, the OECD[2] released the compilation of the outcomes of the third phase of peer reviews of the minimum standard on BEPS[3] Action 13 (*Transfer Pricing Documentation and Country-by-Country Reporting*). As Action 13 is a minimum standard, all members of the Inclusive Framework on BEPS have committed to implement it, and to be reviewed and monitored by their peers. According to the executive summary accompanying the Compilation, over 90 jurisdictions have already introduced legislation to impose a filing obligation for Country-by-Country Reporting (CbCR) on multinational enterprise (MNE) groups, covering almost all MNE groups with consolidated group revenue equal to or exceeding €750 million.

Where legislation is in place, the implementation of CbCR has been found to be largely consistent with the Action 13 minimum standard. However, 41 jurisdictions have received a general recommendation to either put in place or finalize their domestic legal or administrative framework. An EY Global Tax Alert, *OECD releases outcomes of third phase of peer reviews on BEPS Action 13*, dated 29 September 2020, provides details on the peer review reports.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. Organisation for Economic Co-operation and Development.
3. Base Erosion and Profit Shifting.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, International Tax and Transaction Services, Washington, DC

- Arlene Fitzpatrick arlene.fitzpatrick@ey.com
- Joshua Ruland joshua.ruland@ey.com

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