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US: Proposed regulations would revamp creditability rules for foreign income taxes

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Executive summary

The latest United States (US) proposed regulations (REG-101657-20) on foreign tax credits would fundamentally revamp the rules for determining the creditability of a foreign tax under Internal Revenue Code[1] Section 901 by requiring a foreign tax to meet a jurisdictional-nexus requirement (which would generally deny a credit for certain extra-jurisdictional taxes). The regulations also provide guidance for allocating and apportioning foreign taxes paid or accrued with respect to certain transactions that are disregarded for US federal tax purposes and address various issues relevant for determining a taxpayer's foreign tax credit limitation.[2]

Additionally, the proposed regulations would:

- Expand the existing rules under Section 901 that allocate foreign taxes between two or more persons in connection with certain "covered events," which would include a conversion of a corporation to a disregarded entity (or vice versa)
- Provide additional guidance for when foreign income taxes, including contested income taxes, are properly accrued for US tax purposes
- Identify the foreign taxes for which a credit or deduction is denied under Section 245A(d)

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In an unrelated topic, the proposed regulations would narrow the scope of services that constitute electronically supplied services for purposes of the foreign-derived intangible income (FDII) rules under Section 250.

The proposed regulations on the creditability of a foreign income tax under Sections 901 and 903, the technical taxpayer rules under Section 901, the proper timing of the accrual of a foreign income tax and the changes from deducting to crediting foreign income taxes (and vice-versa) would generally apply to tax years beginning on or after the date final regulations are filed with the Federal Register. Accordingly, the proposed regulations under Sections 901 and 903 would only prospectively affect the creditability of a foreign tax.[3] The proposed regulations on allocating and apportioning foreign income taxes paid with respect to certain disregarded transactions would generally apply to tax years beginning after 31 December 2019, and ending on or after 2 November 2020, which was the date the proposed regulations were filed with the Federal Register. This date also applies to the proposed regulations on identifying foreign taxes for which a credit or deduction is denied under Section 245A(d). In contrast, the proposed regulations on electronically supplied services under Section 250 would apply to tax years beginning on or after 1 January 2021.

Detailed discussion

Creditable foreign income taxes

Section 901 generally permits a US resident individual or a domestic corporation to claim a credit against its regular US tax liability for "income, war profits, and excess profits taxes" paid or accrued during a tax year to any foreign country or US possession. Under Section 903, a tax paid in lieu of a generally imposed foreign income tax is treated as an income tax for purposes of Section 901 (an in-lieu-of tax).

The Section 901 regulations currently treat a foreign levy as an income tax if (i) the foreign levy is a tax and (ii) the tax's character is predominantly that of an income tax in the US sense (the predominant character test). A foreign levy is a tax if it is a compulsory payment under a foreign country's authority to levy taxes. A payment is not compulsory to the extent it exceeds the taxpayer's tax liability under foreign law; thus, current regulations generally require a taxpayer to reduce, over time, its reasonably expected foreign tax liability. This standard applies separately to each taxpayer. The predominant character test is generally met if the foreign tax is likely to reach net gain in the normal circumstances in which it applies (the net gain requirement).

The net gain requirement is met if the foreign levy satisfies realization, gross receipts and net income requirements. These three requirements are generally satisfied as follows:

- The realization requirement is met if the foreign tax is imposed on or after a realization event in the US sense (or in certain instances, before a realization event).
- The gross receipts requirement is met if the foreign tax is imposed on the basis of gross receipts (or a proxy for gross receipts that is not likely to exceed gross receipts).
- The net income requirement is met if the foreign tax law allows for the recovery of significant costs and expenses (or provides a comparable allowance that equals or exceeds those significant costs and expenses).

A foreign levy qualifies as an in-lieu-of-tax if the foreign levy is a tax and substitutes for, rather than adds to, an income tax or a series of income taxes otherwise generally imposed by the foreign country.

Proposed changes to the net gain requirement

The proposed regulations would modify each element of the net gain requirement by replacing the "normal circumstances" standard with a more objective standard that would base the determination of whether the net gain requirement is met on the terms of the applicable foreign law. The proposed regulations would effectively overrule *PPL Corp. v. Comm'r*, 133 S. Ct. 1897 (2013), which concluded that the UK windfall tax was a creditable tax by examining the economic substance of the tax and rejecting an application of the predominant character test that focused on the tax's technical terms.

Proposed jurisdictional nexus requirement

In response to challenges posed by the expanding digital economy, novel extraterritorial taxes have proliferated in recent years. These taxes, which include digital services taxes, diverted profits taxes and equalization levies, apply to income that would not, under traditional international tax norms, be subject to tax in the relevant foreign country. Instead, taxing jurisdiction is asserted by referencing factors such as destination, customers and market access.

The Preamble to the proposed regulations explains that the US effectively cedes taxing jurisdiction to a foreign country to the extent that current regulations permit a taxpayer to claim a foreign tax credit against its US tax liability for foreign taxes paid. To prevent this outcome, the proposed regulations would impose a new jurisdictional nexus

requirement that is intended to ensure that taxpayers claim a credit only for foreign taxes that conform to traditional international norms of taxing jurisdiction.

Under the proposed jurisdictional nexus requirement, a credit would be allowed for a foreign tax imposed on nonresidents of a foreign country only if one of the following three standards is met.

- *Activities nexus*. The income subject to the foreign tax includes only income attributable, under reasonable principles, to the nonresident's activities within the foreign country (including functions, assets and risks) without taking into account as a significant factor the location of customers, users or other similar destination-based criteria (Activities Nexus). A foreign country that attributes income under rules similar to those for determining effectively connected income under Section 864(c) would meet this Activities-Nexus standard.
- *Sourcing nexus*. The income (other than income from sales or other dispositions of property) subject to foreign tax on a source-basis is determined based on sourcing rules that are reasonably similar to those that apply for federal income tax purposes (Sourcing Nexus). The proposed regulations would require services income to be sourced based on where the services are performed.
- *Property-situs nexus*. The income from sales or dispositions of property subject to foreign tax includes only gains from the disposition of (i) real property located in the foreign country or (ii) movable property that is part of the business property creating a taxable presence in the foreign country (including, in each case, interests in an entity to the extent attributable to that property) (Property Situs Nexus).

Separate rules would apply for a foreign tax imposed on residents of the foreign country. Those rules would permit imposition of a foreign tax on the resident's worldwide income while requiring profit allocation to be arm's length under transfer pricing rules, without taking customers, users or other destination-based criteria into account as significant factors.

Application to in-lieu-of taxes. The proposed jurisdictional-nexus requirement would apply also to in-lieu-of taxes under Section 903. To qualify as an in-lieu-of tax, a foreign levy would need to satisfy a new "close connection" standard. Under that standard, a foreign country's generally-imposed net income tax must apply by its terms to the income subject to the in-lieu-of tax, but for the fact that it is expressly excluded and subject instead to the in lieu of tax.

The Preamble indicates that a corporate income tax regime would satisfy the close-connection standard if it applies to all corporations but expressly excludes insurance-related income and taxes that income under a separate regime. Absent an express exception, a close connection must be established with proof that the foreign country made a "cognizant and deliberate choice" to impose the separate tax, such as by referencing foreign legislative history.

Options or elections: noncompulsory payments

Subject to various exceptions, the proposed regulations would determine whether a payment is compulsory based on whether the foreign tax law includes options or elections to permanently decrease a foreign income tax liability in the aggregate over time; a taxpayer's failure to use these options or elections may result in a noncompulsory payment. Exceptions to this revised standard include a taxpayer's election to (i) treat an entity as fiscally transparent or non-fiscally transparent under foreign tax law; (ii) file a foreign consolidated return; or (iii) share losses under a foreign group relief or other loss-sharing regime.

Identity of the technical taxpayer

A foreign tax is considered paid by the person on whom foreign law imposes a legal liability for the tax (the technical taxpayer). The current regulations under Section 901 generally provide rules for determining the technical taxpayer of foreign taxes paid or accrued by partnerships and disregarded entities. Special rules apply when these entities undergo ownership changes or certain entity classification changes that do not close the foreign tax year. For example, foreign taxes are allocated between the transferor and transferee following a change in a disregarded entity's ownership during the entity's foreign tax year. Special rules also apply when a partnership converts into a disregarded entity (or vice-versa).

The proposed regulations would also allocate foreign taxes among two or more persons when a partnership, disregarded entity or corporation undergoes one or more "covered events" during its foreign tax year that do not close the foreign tax year. In those cases, a portion of the foreign taxes (other than withholding taxes) paid or accrued by the technical taxpayer would be allocated among all persons that were predecessor entities or prior owners during the foreign tax year, generally using the same allocation method as under existing regulations.

A covered event includes a partnership termination under Section 708(b)(1); a transfer of a disregarded entity; a disregarded entity changing to a corporation (or vice-versa); or a change in a partner's interest in a partnership (a variance). If a foreign corporation elected to be disregarded from its single owner, the proposed regulations would partially allocate to the predecessor entity (the foreign corporation) any foreign taxes that current law would treat as paid or accrued by the single owner. The proposed changes to the technical-taxpayer rules would apply to foreign taxes paid or accrued in tax years beginning on or after the date final regulations are filed with the Federal Register.

Rules addressing when an accrual-basis taxpayer can claim an FTC

The proposed regulations would formally adopt the modified all-events test under Section 461, which determines when a foreign income tax can be accrued, and incorporate the relation-back doctrine, which specifies that foreign taxes accrue at the end of the tax year to which they relate (the relation-back year). Accordingly, a contested foreign tax accrues only when the underlying dispute is resolved but would be considered to accrue as of the end of the relation-back year.

The Internal Revenue Service (IRS) intends to withdraw existing administrative guidance allowing a taxpayer to claim a credit for the portion of contested taxes that has been paid but remains contested. In its place, however, the proposed regulations would allow taxpayers to elect a "provisional credit" for contested taxes when paid. To claim the credit, taxpayers must agree to notify the IRS when the contest is resolved, file an annual statement with their tax return until that time, and agree not to assert the limitation period on assessment for three years from the time the contest is resolved.

Accrual of foreign income taxes for a 52-53 week US tax year

Generally, a foreign income tax accrues in the US tax year in which or with which the foreign tax year ends. The proposed regulations would treat a 52-53-week US tax year that closes within six calendar days of the taxpayer's foreign tax year as ending on the last day of the foreign tax year for purposes of determining the foreign income taxes that accrue with or within the 52-53-week tax year. The proposed rule would resolve mismatches with 52-53-week US tax years that cause foreign taxes not to accrue within certain US tax years (because no foreign tax year ends within that period) and other years to have two years' worth of accrued foreign income taxes (because two foreign year-ends fall within that period).

Correcting improper methods of accounting for foreign income taxes

A taxpayer's method of accruing foreign income taxes is a method of accounting. Accordingly, a taxpayer must obtain IRS consent to change from an improper method of accruing foreign income taxes (e.g., by accruing foreign income taxes in a year other than the tax year in which the all-events test is satisfied) to the proper method of accruing foreign income taxes. The proposed regulations would use a "modified cut-off" approach to adjust foreign income taxes claimed as a credit or deduction in a year in which an accounting method change is made. Under this approach, a taxpayer would generally adjust the amount of foreign income tax that can be claimed as a credit or deduction in the year of change (in each statutory or residual grouping under Section 904(d)) as follows:

- Adjust downward by the amount (in each grouping) improperly accrued and claimed as a credit or deduction in a pre-change year
- Adjust upward by the amount (in each grouping) that properly accrued in any pre-change year but was not accrued by the taxpayer under its improper method of accounting and claimed as a credit or deduction in any pre-change year. If the downward adjustments exceed the foreign taxes properly accrued in the year of change, carry the excess forward to offset foreign taxes properly accrued in subsequent years.

Deductions allowed in tax years in which a foreign tax credit is claimed

Section 275(a)(4) prohibits taxpayers from deducting foreign income taxes for which they elect to claim a credit (even if a credit is limited under Section 904(a)). If a taxpayer chooses, for any tax year, to claim a credit for foreign income taxes paid or accrued to any extent, the existing regulations under Section 901 apply that choice to all foreign income taxes paid or accrued in that year (including foreign taxes that relate to a prior tax year) and prohibit the taxpayer from deducting those taxes. The proposed regulations would modify this rule to allow an accrual-basis taxpayer electing to claim a credit for foreign income taxes for the year to deduct foreign income taxes that are paid in that year but relate to a prior year in which the taxpayer deducted foreign income taxes.

Changing from deducting to crediting foreign income taxes (and vice-versa)

The proposed regulations would require taxpayers to elect to claim a credit (or change from a deduction to a credit) for foreign income taxes paid or accrued in a tax year before the 10-year refund limitation period under Section 6511(d)(3) expires for that year. In contrast, taxpayers would have to elect to claim a deduction (or change from credit to deduction) for foreign income taxes paid or accrued in a tax year before the three-year refund limitation period under Section 6511(a) expires for that year. The change would be consistent with the IRS's administrative interpretation of Section 6511(d)(3), which has been upheld by one court in litigation.

The proposed regulations would further expand the definition of a foreign tax redetermination under Section 905(c) to treat a change from deducting foreign income taxes to claiming a credit for foreign income taxes (and vice-versa) as a foreign tax redetermination. This expansion would allow the IRS to assess and collect any tax deficiencies resulting from change in election, even if the three-year limitation period has expired under Section 6501(a) (e.g., an election to credit foreign income taxes that were originally deducted in a prior year and increased an NOL deduction carried to another tax year that otherwise would be time-barred by the statute of limitations).

The proposed regulations on accruing and deducting foreign income taxes would apply to foreign taxes paid in tax years beginning after the rules are published as final regulations in the Federal Register.

Section 245A(d): Denial of credit or deduction for certain foreign income taxes

Section 245A(d) generally prohibits taxpayers from claiming credits or deductions for foreign income taxes paid or accrued (or treated as paid or accrued) on dividends for which a Section 245A deduction is allowed. Under Section 245A(e)(3), the same rules apply to foreign income taxes paid or accrued (or treated as paid or accrued) on hybrid dividends (or tiered hybrid dividends). The proposed regulations would disallow a credit or deduction for foreign income taxes attributable to a "specified distribution" or to "specified earnings and profits" of a foreign corporation.

Specified distribution. A specified distribution is the portion of a distribution received by a domestic corporation (i) for which a Section 245A deduction is allowed, (ii) that is a hybrid dividend, or (iii) that is attributable to the corporation's "IRC Section 245A(d) PTEP." Section 245A(d) PTEP is the previously taxed earnings and profits (PTEP) of the foreign corporation resulting from (i) a sale or exchange of stock subject to Section 964(e)(4) or 1248 for which a Section 245A deduction was allowed or (ii) a tiered hybrid dividend that gave rise to an income inclusion to a US shareholder.

Specified earnings and profits. A foreign corporation's specified earnings and profits are those earnings and profits (E&P) that would give rise to a Section 245A deduction, a hybrid dividend, a tiered hybrid dividend, or a distribution of Section 245A(d) PTEP if the foreign corporation distributed cash equal to all its E&P.

The proposed regulations would attribute foreign income taxes to a specified distribution or specified earnings and profits under the provisions of Treas. Reg. 1.861-20 (as modified by the proposed regulations). As a backstop to those general rules, an anti-avoidance rule would attribute foreign taxes to a specified distribution or specified earnings and profits if a transaction, series of transactions or arrangement is undertaken with a principal purpose of avoiding the purposes of Section 245A(d) and the rules for specified earnings and profits.

The proposed regulations under Section 245A(d) would apply to tax years beginning after 31 December 2019 and ending after 2 November 2020 (the date the proposed regulations were filed with the Federal Register).

Source of inclusions under Sections 951, 951A, and 1293 and related dividends under Section 78

The proposed regulations would determine the source of subpart F income, Global Intangible Low-Taxed Income (GILTI), certain passive foreign investment companies' inclusions and associated Section 78 dividends by treating those amounts as a dividend received by the US shareholder directly from the relevant foreign corporation. This sourcing rule would apply for all purposes of the Code. For indirectly owned foreign corporations, the inclusion's source would be determined directly from the lower-tier foreign corporation. The proposed sourcing rule would treat an inclusion as US-source income to the same extent that a dividend from the foreign corporation would be treated as US-source income under Section 861(a)(2)(B); that provision treats, as US-source income, a portion of dividends received from a foreign corporation with significant income that is (or is treated as) effectively connected with the conduct of a US

trade or business. Thus, for example, subpart F income could be treated as partially US-source income even if the subpart F income itself is entirely foreign-source income.

These rules would apply to tax years ending on or after 2 November 2020, which was the date the proposed regulations were filed with the Federal Register.

Revisions to Treas. Reg. Section 1.367(b)-7

Existing Treas. Reg. Section 1.367(b)-7 generally provides rules for carrying over E&P and foreign income taxes when one foreign corporation (foreign acquiring corporation) acquires the assets of another foreign corporation (foreign target corporation) in a Section 381 transaction (the combined corporation, the "foreign surviving corporation").

The proposed regulations would treat all foreign target corporations, foreign acquiring corporations and foreign surviving corporations as "non-pooling corporations" (as defined in Treas. Reg. Section 1.367(b)-2(l)(10)) in tax years beginning on or after 1 January 2018, and for tax years of US shareholders in which or with which the foreign corporations' tax years end (post-2017 tax years). In addition, the regulations would treat post-1986 undistributed earnings and post-1986 foreign income taxes remaining as of the end of the foreign corporation's last tax year beginning before 1 January 2018, as earnings and taxes in a single pre-pooling annual layer in the foreign corporation's post-2017 tax years.

The proposed regulations would also expressly prohibit foreign income taxes from being treated as current-year taxes under Treas. Reg. Section 1.960-1(b)(4) if they were paid or accrued by a foreign target corporation, foreign acquiring corporation or a foreign surviving corporation in tax years preceding the current tax year. This treatment would also apply to foreign income taxes paid or accrued in the foreign target corporation's last tax year and foreign taxes associated with a hovering deficit that is ultimately absorbed. As a result, taxpayers generally could not claim a credit for those taxes under Section 960.

The proposed revisions to Treas. Reg. Section 1.367(b)-7 would apply to a foreign corporation's tax years ending on or after 2 November 2020, which was the date the proposed regulations were filed with the Federal Register.

Section 904(d): Foreign tax credit limitations

Financial services income. The proposed regulations would lower to 70% of gross income the percentage of active financing income that a financial services entity must derive in a tax year and require that income to be earned from unrelated parties. The latter change would limit the circumstances under which internal financing companies are treated as financial services entities, although the Preamble to the proposed regulations requests comments on this issue. The proposed regulations would apply to tax years beginning after 31 December 2019 and ending on or after 2 November 2020 (the date the proposed regulations were filed with the Federal Register).

Foreign branch income. The proposed regulations under Treas. Reg. Section 1.904-4(f)(2)(vi) would clarify how gross income is attributed to a foreign branch, the application of the disregarded-payment rules to disregarded payments between foreign branches, and the treatment of disregarded payments made to or by "non-branch taxable units." A non-branch taxable unit would include a disregarded entity that does not conduct a trade or business, and its owner. Among other things, the revisions would facilitate the application of the disregarded-payment rules in contexts other than the disregarded-payment rules, which apply by cross-reference to Treas. Reg. Section 1.904-4(f)(2)(vi). For example, under the GILTI high-tax exclusion rules, gross income is allocated between a controlled foreign corporation's (CFC) tested units by reference to disregarded payments between those tested units, applying the principles of Treas. Reg. Section 1.904-4(f)(2)(vi).

The proposed regulations also include an example clarifying the interaction of Treas. Reg. Section 1.1502-13(c)'s matching rule and the disregarded-payment rules. Generally, Treas. Reg. 1.1502-13(c) requires the attributes of intercompany transactions (including licenses, services and sales of property among consolidated group members) to be redetermined to produce the same effect on consolidated taxable income as if the members of the consolidated group were divisions of a single corporation. When a foreign branch held by one member of a consolidated group transacts with another member of a consolidated group, the example demonstrates an instance in which the Section 904(d) category of the regarded items arising from the transaction must be determined as though each member of the consolidated group were a division of a single corporation (i.e., by reference to the disregarded-payment rules).

The proposed regulations would apply to tax years beginning after 31 December 2019, and ending on or after 2 November 2020, which was the date the proposed regulations were filed with the Federal Register.

Carryback of post-2017 NOLs to a pre-2018 tax year. The *Coronavirus Aid, Relief, and Economic Security Act* (the CARES Act) generally allows taxpayers to carry back, for five years, NOLs incurred in 2018 through 2020. The proposed regulations would confirm that the generally applicable loss ordering rules of Treas. Reg. 1.904(g)-3(b) apply to post-2017 NOLs carried back to a pre-2018 year, with certain modifications. Taxpayers carrying back a passive category post-2017 NOL and offsetting pre-2018 general category income would recapture any resulting separate limitation loss (SLL) in a post-2017 year as general category income (and not as foreign branch or Section 951A category income). If a taxpayer carries back a post-2018 NOL in the foreign branch or Section 951A categories to a pre-2018 year, the NOL would first offset general category income; the offset would not create a foreign branch or Section 951A category SLL. These rules would apply to carrybacks of NOLs incurred in tax years beginning on or after 1 January 2018.

Allocation and apportionment of foreign income taxes

Generally, foreign income taxes paid or accrued by a taxpayer are allocated and apportioned to statutory or residual groupings based on the statutory or residual groupings to which a taxpayer's foreign gross income would be assigned. If a US gross-income item arises from the same transaction or other realization event as the foreign gross-income item (a corresponding US item), then the foreign gross-income item is assigned to statutory and residual groupings based on the groupings to which the corresponding US item would be assigned. Special rules apply for certain specific foreign gross-income items.

The proposed regulations would introduce new rules for allocating and apportioning foreign income taxes imposed on (i) dispositions of stock and partnership interests, and (ii) disregarded payments made between "taxable units."

Dispositions of stock and partnership interests: The proposed rules would assign foreign income taxes from a transaction treated as a sale, exchange or disposition of stock for US tax purposes to the same category as the corresponding US dividend (e.g., Sections 1248 or 964(e) amounts). Foreign law gain that exceeds the US dividend amount would be assigned to the same category as the US capital gain amount (to the extent thereof). Any foreign gross income that exceeds the US dividend and US capital gain amounts would be assigned to groupings based on the tax book value of the transferred corporation's stock, as determined under the asset method of Treas. Reg. Section 1.861-9. Similarly, foreign income taxes associated with the sale of a partnership interest, or a distribution from a partnership under Section 733, would be assigned to the same grouping as the corresponding US capital gain amount (to the extent thereof); any foreign gross income exceeding the US capital gain amount would be assigned based on the tax book value of the partnership interest, or the partner's pro rata share of partnership assets (as applicable) under Treas. Reg. Section 1.861-9(e).

Disregarded payments: Proposed regulations released in December 2019 (REG-105495-19) (the 2019 proposed regulations) included rules for allocating and apportioning foreign income taxes paid or accrued on payments that are disregarded for US federal tax purposes. The 2019 proposed regulations allocated and apportioned foreign taxes paid or accrued on a disregarded payment made by a disregarded entity to statutory and residual income groupings in the same ratio as the tax book value of the payor's assets (including stock) in the groupings, as determined in accordance with Treas. Reg. Section 1.987-6(b)(2). Any foreign taxes paid or accrued on a disregarded payment made to a disregarded entity would be allocated to the "residual income group," denying a credit if the disregarded entity were held by a CFC. See Treas. Reg. Section 1.960-1(e). In response to broad criticism that the 2019 proposed regulations would result in double taxation of US gross-income items by disallowing foreign tax credits too frequently, the proposed regulations withdraw the 2019 proposed rules and introduce new guidance on allocating and apportioning taxes imposed on disregarded payments.

The proposed regulations would allocate and apportion to statutory or residual groupings foreign gross income, and foreign income taxes on that gross income, resulting from a disregarded payment made to or by a taxable unit. A disregarded payment includes a transfer of property to or from a taxable unit in a disregarded transaction that is reflected on the separate books and records of the taxable unit.[4] For individuals or domestic corporations, a taxable unit would be a foreign branch, a foreign branch owner or a non-branch taxable unit (which may include a disregarded entity that does not conduct a trade or business). For foreign corporations, a taxable unit would be a tested unit, as determined under the proposed high-tax exclusion regulations of Section 954.

Different rules would apply depending on whether the disregarded payment is a reattribution payment, a remittance, a contribution or a disregarded sale. A reattribution payment is the portion of a disregarded payment equal to the sum of all reattribution amounts that are attributed to the recipient of the disregarded payment. A reattribution amount is an amount of gross income that is, by reason of a disregarded payment made by that taxable unit, attributed to another taxable unit. Generally, a disregarded payment causes gross income to be attributed to another taxable unit to the extent that a deduction for the payment, if regarded, would be allocated against the payor tested unit's US gross income (but not in excess of its US gross income).[5]

To the extent a disregarded payment results in a reattribution of gross income, it would constitute a "reattribution amount." The payee taxable unit's foreign gross income arising from the disregarded payment would then be assigned to categories based on the federal income tax characterization of the reattribution amount. For example, the passive-category US gross income of the payor taxable unit would be reattributed to the payee taxable unit if the payor taxable unit made a disregarded payment that, if regarded, would have been allocated to that gross income. The payee taxable unit's foreign gross income (and ultimately the foreign income taxes) arising from the disregarded payment would then be assigned to the same categories as the payor taxable unit's US gross income that was reattributed (entirely passive in this example). Disregarded payments made by the payor taxable unit, however, would not affect the allocation and apportionment of its taxes. In other words, the foreign gross income and associated foreign income taxes of a payor taxable unit would be categorized *before* giving effect to reattribution amounts.

A second set of rules would apply to disregarded payments treated as remittances. Foreign income taxes paid on remittances would be treated as having been paid ratably out of all the accumulated after-tax income of the taxable unit. The after-tax income of a taxable unit would be deemed to arise in the statutory and residual groupings in the same proportions that the tax book value of the taxable unit's assets would be assigned under the asset method of Treas. Reg. Section 1.861-9. A taxable unit's assets would be determined under the principles of Treas. Reg. 1.987-6(b) but would include stock and certain assets of other taxable units to the extent gross income of those taxable units has been reattributed to the taxable unit treated as making the remittance.

A remittance includes property transfers (within the meaning of Section 317(a)) that are made by a taxable unit and would be treated as a corporate stock distribution to a shareholder if the taxable unit were a corporation for Federal income tax purposes. A remittance also includes the excess of a disregarded payment made by one taxable unit to another over the portion of the disregarded payment that is a reattribution payment (unless the amount would be treated as a contribution). Thus, for example, if a disregarded entity made a $100x disregarded payment to a CFC that owned the disregarded entity, and $90x of the disregarded payment would reattribute gross income from the disregarded entity to the CFC, then the remaining $10x of the disregarded payment would be treated as a remittance.

Foreign income taxes arising from disregarded payments treated as contributions would be allocated to the residual grouping, meaning a credit would effectively be denied if the taxpayer is a CFC. For this purpose, a contribution is a disregarded transfer of property (within the meaning of Section 317(a)) to a taxable unit that would be treated as a contribution to capital described in Section 118 or a transfer described in Section 351 if the taxable unit were a corporation for US Federal income tax purposes. A contribution would also include the excess of a disregarded payment made by a taxable unit to its wholly owned taxable unit over the portion of the disregarded payment that is a reattribution payment. Thus, for example, if a CFC made a $100x disregarded payment to a disregarded entity that it owned, and $90x of the disregarded payment would reattribute gross income from the CFC to the disregarded entity, the remaining $10x would be treated as a contribution.

Finally, a foreign law income item arising from a disregarded sale or exchange of property is assigned to statutory or residual groupings by reference to the grouping to which a corresponding US item (i.e., built-in gain in the property) would have been assigned if the sale were recognized under Federal income tax law.

The proposed regulations under Treas. Reg. Section 1.861-20 would apply to tax years that begin after 31 December 2019, and that end on or after 2 November 2020, which was the date that the proposed regulations were filed with the Federal Register.

Election to capitalize R&E or advertising costs for purposes of interest expense apportionment

The Preamble to the proposed regulations notes that some taxpayers may have internally developed intangible assets that are supported by debt financing and have no tax book value, even though they have continuing economic value. The proposed regulations would allow these taxpayers to elect to capitalize and amortize Section 174 research and experimental (R&E) expenses and advertising expenses for purposes of allocating and apportioning interest expense. For these purposes, the capitalized R&E expenses would be assigned to and among statutory and residual groupings based on the Standard Industrial Classification (SIC) code of the R&E expense and then apportioned based on sales within each such grouping. The capitalized advertising expenses would be apportioned based on the character of the income expected to be generated from product sales or from services provided to persons to whom the advertising is directed.

The provision permitting this election would apply to tax years beginning on or after the date that the rule is finalized. The choice of whether to capitalize Section 174 R&E expenses, however, would only be available until 2022; after that date, capitalization of R&E expenses will be mandatory under Section 174 for tax years beginning after 31 December 2022.

Changes to CFC netting rules

The proposed regulations would no longer treat certain loans made from one CFC to a related CFC (CFC-to-CFC debt) as related-group indebtedness (RGI) for CFC netting calculation purposes (New Proposed CFC Netting Regulations). This rule would affect certain loans that are made by one CFC to another and treated under existing regulations as loans made by a US shareholder to the borrower CFC to the extent the US shareholder makes capital contributions directly or indirectly to the lender CFC.

Under existing regulations, interest income derived from RGI does not include income derived from the US shareholder's ownership of the lender CFC stock (including subpart F inclusions related to the interest income earned by the lender CFC). As a result, interest expense is generally not allocated to income related to the CFC-to-CFC debt. Nevertheless, the debt may increase the amount of allocable RGI for which a reduction in assets is required under Treas. Reg. Section 1.861-10(e)(7).

The Preamble to the proposed regulations explains that the regulation is being changed because 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. Section 1.861-9. Under the New Proposed CFC Netting Regulations, CFC-to-CFC debt would not be treated as RGI for purposes of determining the foreign-base-period ratio. The foreign-base-period ratio is the average of the taxpayer's related-group debt-to-asset ratios for the five tax years preceding the current year. As such, the New Proposed CFC Netting Regulations would not include CFC-to-CFC debt for each tax year included in the foreign base period in the related-group debt-to-asset ratio for purposes of computing the foreign-base-period ratio for tax years ending on or after the date the regulations are finalized. This includes tax years ending before the rule is finalized. According to the Preamble, this treatment is intended to prevent distortions that would otherwise arise in comparing the ratio in a year in which CFC-to-CFC debt was treated as RGI to the ratio in a year in which the CFC-to-CFC debt is not treated as RGI. The changes made by the New Proposed CFC Netting Regulations would apply to tax years ending on or after the date the regulations are finalized.

Direct allocation of interest expense for foreign bank branches

The proposed regulations include special rules for allocating and apportioning interest expense to foreign branch category income for financial institutions. The proposed regulations would directly allocate interest expense reflected on a foreign banking branch's books and records to foreign branch category income, to the extent of income attributable to the foreign banking branch. The proposed regulations also provide for a corresponding reduction in the value of the foreign branch's assets for purposes of allocating the foreign branch owner's remaining interest expense. The Preamble to the proposed regulations explains that this special rule is appropriate because foreign branches of regulated financial institutions commonly have assets and liabilities bearing interest rates that differ from interest rates on assets and liabilities of the home office in the United States. These rules would apply to tax years beginning on or after the date the final regulations are filed with the Federal Register.

Proposed rule clarifying "electronically supplied services" under Section 250

Final regulations issued on 9 July 2020 under Section 250[6] created a new category of general services defined as "electronically supplied services" to take into account services that are delivered over the internet or an electronic network. The proposed regulations would include a rule under the FDII regulations clarifying that electronically supplied services are services delivered primarily over the internet or an electronic network for which the value to the end user is derived primarily from the service's automation or electronic delivery (2020 FDII Proposed Regulations).

Examples of these services would include the streaming of digital content, provision of access to an internet network and provision of webpage hosting services. The 2020 FDII Proposed Regulations specify that these services would exclude services that primarily involve the application of human effort by the renderer through the internet or an electronic network (other than the effort involved in developing or maintaining the technology to enable the electronic service). Examples of services that would not qualify under this definition include professional services such as legal, accounting, medical or teaching services.

The proposed regulations on the definition of electronically supplied services would apply to tax years beginning on or after 1 January 2021.

Implications

Novel extraterritorial taxes have proliferated in recent years, and US taxpayers' liability for these taxes will continue to grow. The proposed jurisdictional nexus requirement would disallow a credit for many of those novel taxes, increasing the risk of double taxation.

The amended proposals for allocating and apportioning foreign income taxes paid or accrued on disregarded payments are a significant improvement over the prior proposals and would reduce the instances in which a credit is inappropriately denied for such tax. The rules, however, continue to present challenges that must be carefully navigated.

The proposed regulations include a wide range of complex technical refinements beyond those changes. Taxpayers should carefully consider the potential impact of those rules on their existing operations.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. On the same date, the Treasury Department released final regulations addressing a variety foreign tax credit issues. See EY Global Tax Alert, *US: Additional final regulations provide foreign tax credit guidance*, dated 20 October 2020.
3. The Preamble to the proposed regulations indicates that taxpayers should not draw inferences about the tax treatment of novel extraterritorial foreign taxes such as digital services taxes, diverted profits taxes or equalization levies under existing Treas. Reg. Sections 1.901-2 and 1.903-1. Thus, the proposed regulations would not affect the analysis under existing law as to whether any novel extraterritorial foreign tax may be claimed as a credit (for example, for digital services taxes paid or accrued by a 2020 calendar-year taxpayer).
4. A disregarded payment also includes any other amount that is reflected on the separate set of books and records of a taxable unit in connection with a transaction that is disregarded for Federal income tax purposes and that would constitute an item of accrued income, gain, deduction or loss of the taxable unit if the transaction to which the amount is attributable were regarded for Federal income tax purposes. Thus, for example, a disregarded distribution of a note, which would not be "property" because it is disregarded, would also be treated as a disregarded payment.

5. Individuals and domestic corporations determine reattribution amounts under the foreign-branch-category rules, which generally attribute gross income to taxable units based on books and records, as modified to reflect Federal income tax principles. Gross income attributable to a foreign branch (or its owner or certain non-branch taxable units, including disregarded entities) may be reattributed based on certain disregarded payments between a foreign branch and its owner, or another foreign branch, to the extent the disregarded payments would, if regarded, give rise to a deduction that would be allocated and apportioned to the payor's gross income under existing expense apportionment rules (i.e., Treas. Reg. Sections 1.861-8 through 14 & 1.861-17 (subject to certain modifications)). CFCs and other foreign corporations determine reattribution amounts under the proposed high-tax exclusion regulations, which generally follow the principles of the foreign-branch-category rules, subject to certain modifications. In particular, disregarded payments of interest may reallocate gross income to the extent the payments are deductible under foreign law.
6. See EY Global Tax Alert, *US final FDII regulations retain proposed regulations' structure, but reduce documentation burden, defer effective date and make important substantive changes to the computation of the Section 250 deduction*, dated 15 July 2020.

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