KPMG report: Initial impressions of final and proposed foreign tax credit regulations

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Introduction

The U.S. Treasury Department and the IRS (collectively, "Treasury") on September 29, 2020, released an unofficial advance copy of final regulations related to the determination of the foreign tax credit ("FTC") ahead of their being published by the Federal Register. The final regulations (T.D. 9922, or the "2020 Final Regulations") finalize aspects of the proposed regulations published on December 17, 2019 ("2019 Proposed Regulations"). Read the version of the **final regulations** [PDF 1.07 MB] (287 pages) as released on September 29, 2020.

The 2020 Final Regulations provide guidance related to the FTC, including the allocation and apportionment of deductions for stewardship, research and experimental ("R&E") expenditures, damages and other payments arising from litigation, and creditable foreign taxes, the availability of FTCs under the section 965 transition tax, foreign tax redeterminations, and the application of the FTC limitation to consolidated groups. The 2020 Final Regulations also include guidance regarding adjustments to hybrid deduction accounts to take into account certain inclusions in income by a U.S. shareholder, conduit financing arrangements involving hybrid instruments, and the treatment of certain payments under the global intangible low-taxed income ("GILTI") provisions.

Treasury also released an advance copy of proposed regulations (REG-101657-20, or the "2020 Proposed Regulations") that provide additional guidance related to the FTC, including the allocation and apportionment of interest expense and foreign income tax expense, transition rules regarding the impact on loss accounts of net operating loss ("NOL") carrybacks, the definitions of foreign branch category and financial services income, and the definition of a creditable foreign income tax and "in lieu of" tax under section 903. Many aspects of the new definitions of a creditable foreign income tax represent significant departures from existing law and reflect a concern by Treasury that an increasing number of taxes are being adopted worldwide that diverge from traditional international norms of income taxation, including norms as to jurisdictional reach.

The 2020 Proposed Regulations also include guidance with respect to the disallowance of FTCs under section 245A(d) and the determination of GILTI and foreign-derived intangible income ("FDII") under section 250. Read the version of the **proposed regulations** [PDF 1.10 MB] (297 pages) as released on September 29, 2020.

This report of initial impressions is based on the versions of the final regulations and proposed regulations released on September 29, 2020.

Contents

Final regulations

A number of features of the 2020 Final Regulations are noteworthy:

Expense allocation and apportionment

Stewardship expense

- The 2019 Proposed Regulations revised the rules for allocating and apportioning stewardship expenses. The 2020 Final Regulations finalized those rules with notable changes and clarifications.
    - Like the 2019 Proposed Regulations, the 2020 Final Regulations retain the pre-2018 definition of stewardship activities, while also expanding the 2019 Proposed Regulation's application to partnership interests to also include interests in a disregarded entity. Under the 2020 Final Regulations, stewardship deductions cannot, however, exist for a "true" branch because stewardship is defined as relating only to an investment in a "business entity" within the meaning of the entity classification rules.

- With respect to the allocation step, the 2020 Final Regulations clarify, consistent with an interpretation of prior law, that stewardship deductions that factually relate to a subset of the entities owned by a taxpayer are allocated only to the gross income from such entities.

- The 2020 Final Regulations retain the 2019 Proposed Regulations' approach of apportioning stewardship based on the value and characterization of a taxpayer's investment in an entity as determined for interest expense apportionment purposes, but turn off the application of Reg. § 1.861-14 so that members of an affiliated group are not treated as a single corporation. As a result, each member of an affiliated group apportions its stewardship deductions with respect to its direct and indirect investments in entities (including other members of the affiliated group) by reference to the stock or other interests it directly owns. Significantly, the exempt asset rules do not apply for this purpose. Thus, contrary to an interpretation of the 2019 Proposed Regulations, the value of domestic affiliates is fully taken into account.

- **Applicability date**: Tax years that begin after December 31, 2019. See Reg. § 1.861-8(h)(2).

R&E expense

- The 2020 Final Regulations retain the significant aspects of the proposed rules, with notable changes:

  - With respect to the allocation step, the 2020 Final Regulations continue to provide that R&E expenditures (including both deductions under section 174 and amortization of amounts capitalized under section 59(e)) are allocated to "gross intangible income" related to the relevant standard industrial classification (SIC) code category, which excludes dividends and subpart F/GILTI inclusions.

  - The 2020 Final Regulations confirm the elimination of the ability to directly allocate legally mandated R&E, to justify increased exclusive apportionment, and to use the gross income method of apportionment.

  - The 2020 Final Regulations clarify that only R&E activities undertaken during the tax year (without regard to whether the related expenditures are capitalized) are considered in determining whether 50% of R&E expenditures are exclusively apportioned to U.S. or foreign source income for purposes of section 904.

  - For purposes of apportioning based on sales, the 2020 Final Regulations significantly expand the scope of sales of related and unrelated parties that are included so that, in addition to including the sales of entities that are expected to acquire rights to any resulting intangible property (IP), the sales of related and unrelated parties are included if the other entity is reasonably expected to (1) acquire products in which the IP is either embedded or used in connection with the manufacture or sale, or (2) receive services that directly or indirectly benefit from the IP. Thus, gross receipts generally would include those of a related or unrelated limited risk distributor or retailer that has not licensed IP from the taxpayer if the limited risk distributor or retailer purchased products or services that directly or indirectly incorporate or otherwise benefit from the taxpayer's R&E activities. Therefore, the gross receipts taken into account for apportionment generally will reflect the sales made to end users.

  - For R&E activities that relate to more than one SIC code, the final regulations limit the ability to aggregate categories to those that are within the same Major Group (i.e., the two digit SIC code category).

- o Neither the 2020 Final Regulations nor 2019 Proposed Regulations include rules to tailor the application of Reg. § 1.861-17 to address disregarded reallocation transactions to or from a foreign branch. Instead, the 2020 Final Regulations clarify that, when section 250 or section 904 is the operative section, the assignment of sales to the general and foreign branch categories must take into account the assignment of the gross intangible income from those sales as adjusted by reason of disregarded payments under Reg. § 1.904-4(f)(2)(vi). A new example illustrates this requirement. *See* Reg. § 1.861-17(g), *Example 6*.

- o The 2020 Final Regulations do not address whether a taxpayer's expenses associated with performing services under a contract research arrangement are eligible for deduction under section 162 or section 174, and thus there continues to be uncertainty regarding whether Reg. § 1.861-17 applies to such expenses.

- o **Applicability date**: Tax years beginning after December 31, 2019. For tax years beginning on or after January 1, 2018, and before January 1, 2020, taxpayers have three choices:

  - Apply the prior version of final Reg. § 1.861-17

  - Rely on the version of Reg. § 1.861-17 that was proposed in the 2019 Proposed Regulations (*see* 84 Fed. Reg. 69139)

  - Early adopt Reg. § 1.861-17 as revised in the 2020 Final Regulations (*see* Reg. § 1.861-17(h))

  To rely on either of the latter options, taxpayers must apply that version of the regulation in its entirety and for any subsequent year beginning before January 1, 2020.

Foreign income taxes

- The 2020 Final Regulations generally finalize the framework proposed in the 2019 Proposed Regulations for allocating and apportioning foreign income taxes.

  - o Consistent with prior law, the 2020 Final Regulations use a three-step process to allocate and apportion foreign income taxes. The first step requires identifying the items of gross income included in the foreign tax base (from the perspective of foreign law, so referred to as "foreign gross income") and applying U.S. federal income tax principles to characterize those items under the relevant operative provision of U.S. law (e.g., identifying the foreign tax credit category of the item under section 904(d)). If the foreign gross income on which the tax is imposed includes more than one grouping and the foreign tax is a net basis tax, the deductions allowed under foreign law are allocated and apportioned between the foreign gross income in the groupings based on foreign law, or, if foreign law does not provide such rules, using U.S. federal income tax principles. Finally, the foreign income tax is apportioned between the groupings based upon the foreign taxable income in each grouping.

  - o Longstanding conceptual challenges can present themselves in the first step of assigning foreign gross income to groupings based on U.S. federal income tax principles, particularly when U.S. and foreign law tax the same transaction differently. Consistent with the 2019 Proposed Regulations, the 2020 Final Regulations take the approach of replacing the vague but generally principle-based standard of prior law with more mechanical rules for assigning foreign gross income to statutory groupings by providing an exclusive list of "base differences," rules for identifying a "U.S. corresponding item," and a number of special rules for a variety of circumstances where there is no U.S. corresponding item, including because the recognition event occurs in different years for U.S. and foreign purposes.

- o The 2020 Final Regulations remove two items that had been included in the list of "base differences" under the 2019 Proposed Regulations: a distribution by a corporation described in section 301(c)(2) and a distribution by a partnership described in section 733. Instead, these distributions are described in the preamble as timing differences (although this term is not used in the 2020 Final Regulations themselves) and foreign income taxes attributable to such distributions are apportioned to the relevant groupings based upon hypothetical earnings of the distributing entity. For corporations, these hypothetical earnings are assigned to groupings based on the characterization of the tax book value of the stock of the distributing corporation as determined for interest expense apportionment purposes. Similar rules apply for partnerships.

- o The 2019 Proposed Regulations generally defined a "U.S. corresponding item" narrowly to include only an item of U.S. gross income recognized with respect to the same transaction that gave rise to the foreign gross income in the same U.S. tax year in which the foreign tax was paid or accrued. As under the 2019 Proposed Regulations, the general rule in the 2020 Final Regulations for when there is no U.S. corresponding item, for example in the cases generally referred to as "timing differences" under prior 1.904-6(a)(1)(iv), requires a hypothetical determination of how the U.S. gross income would have been treated had it been recognized in the U.S. tax year in which the tax was paid or accrued. The 2020 Final Regulations somewhat simplify the process of characterizing taxes for corporations with mismatched U.S. and foreign tax years by expanding the definition of U.S. corresponding item in such cases to include an item of gross income recognized in the immediately preceding U.S. tax year, thereby allowing taxpayers to categorize the related foreign tax by looking directly to the U.S. treatment of the foreign income in the U.S. tax year in which it was earned rather than by applying the hypothetical analysis.

- o The 2020 Final Regulations do not adopt a rule in the 2019 Proposed Regulations that would have assigned to the residual grouping (with the result that deemed paid FTCs would not be available under section 960) a foreign gross income item arising from a disregarded payment from a foreign branch owner to a foreign branch. Instead, as discussed below, the 2020 Proposed Regulations modify and re-propose the rules for allocating and apportioning foreign income taxes with respect to payments to or from a foreign branch in order to provide taxpayers additional opportunity to comment on the changes. In the meantime, the final regulations reserve on the allocation and apportionment of foreign tax on disregarded payments.

- **Applicability date**: Tax years that begin after December 31, 2019. *See* Reg. §§ 1.861-20(i), 1.904-6(g).

Litigation damages

- The 2019 Proposed Regulations provided new rules for allocating and apportioning damages and other payments related to claims arising from sales of products or services, events incident to the production of products or services, and shareholder suits. The 2020 Final Regulations largely finalize the proposed rules, including the requirement that deductions related to claims that arose from pre-2018 sales or activities must nevertheless be allocated and apportioned based on how the related gross income would be classified under current law, including potentially as foreign branch income and foreign-derived deduction eligible income.

- The 2020 Final Regulations expand the rules for product liability claims to apply to claims relating to licenses or leases of products and the provision of services. They also clarify that deductions related to such claims are apportioned among the statutory and residual groupings based on the relative amounts of gross income in the relevant class in the year the deductions are allowed.

- Treasury rejected comments that deductions related to shareholder suits should be allocated based on the location of the underlying events or the location of the lawsuit, retaining the rule that treats such deductions as definitely related to all of a corporation's income.

- **Applicability date:** Tax years that begin after December 31, 2019. *See* Reg. § 1.861-8(h)(2).

Exempt income/asset rule for insurance companies

- The 2019 Proposed Regulations provided that exempt income includes dividends for which a deduction is provided by sections 243(a)(1) and (2) and 245, as well as tax-exempt interest, without regard to the proration rules under section 805(a)(4)(A)(ii). In finalizing the rule, Treasury rejected a comment asserting that an adjustment should be allowed to the amount of exempt income for insurance companies.

- **Applicability date:** Tax years that begin after December 31, 2019. *See* Reg. § 1.861-8(h)(2).

Foreign tax redeterminations

- The 2020 Final Regulations largely adopt the framework of the 2019 Proposed Regulations with respect to foreign tax redeterminations required under section 905(c), including guidance related to:

  - The required adjustments for foreign tax redeterminations of foreign corporations

  - The requirements to notify the IRS of foreign tax redeterminations and the related penalty imposed under section 6689 for failing to comply with the notification requirements

  - Transition rules for foreign tax redeterminations with respect to pre-2018 tax years that occur during post-2017 tax years

- Subject to narrow exceptions, the 2019 Proposed Regulations required taxpayers to notify the IRS of a foreign tax redetermination by filing amended returns for the affected tax years by the due date (including extensions) of the tax return for the tax year in which the foreign tax redetermination occurred. Notwithstanding numerous comments requesting alternative procedures, the 2020 Final Regulations retain the amended return requirement, which likely will result in a steep increase in the volume of amended returns.

- The 2020 Final Regulations include two noteworthy changes from the 2019 Proposed Regulations:

  - First, for foreign tax redeterminations occurring in tax years ending on or after December 16, 2019, and before the 2020 Final Regulations are filed in the Federal Register, a new transition rule extends the due date of the amended return (or alternative notification when applicable) to the due date of the original return for the taxpayer's first tax year ending on or after the date the final regulations are filed in the Federal Register.

- o Second, the 2020 Final Regulations add an irrevocable election that, subject to certain exceptions, allows a taxpayer to account for foreign tax redeterminations that relate to pre-2018 tax years but occur in tax years that end on or after the date the 2020 Final Regulations are filed in the Federal Register in its last tax year that begins prior to January 1, 2018. This election likely would reduce the number of amended returns required for pre-2018 tax years by instead requiring the adjustments with respect to such years to be made in a single tax year (i.e., the taxpayer's section 965 inclusion year) to the extent that a prospective adjustment could have been made under the prior temporary regulations. The election must be made by all controlling shareholders of the relevant foreign corporation and must be made consistently for all foreign corporations that are members of the same CFC group.

- **Applicability date:** Reg. §§ 1.905-3 and 1.905-4 apply to foreign tax redeterminations that occur in tax years ending on or after December 16, 2019, and to foreign tax redeterminations of foreign corporations occurring in tax years that end with or within a tax year of a U.S. shareholder ending on or after December 16, 2019, and for purposes of Reg. § 1.905-3, that relate to tax years of foreign corporations beginning after December 31, 2017. Reg. § 1.905-5 applies to foreign tax redeterminations that relate to tax years of foreign corporations and successor entities beginning before January 1, 2018, that occur in tax years of such foreign corporations that end with or within tax years of a U.S. shareholder or other U.S. person ending on or after the date the 2020 Final Regulations are filed in the Federal Register.

Application of FTC limitation to consolidated groups

- The 2020 Final Regulations include rules for determining a consolidated group's consolidated foreign tax credit and foreign tax credit limitation in each separate category. Also, a rule is provided for determining the source and separate category of any CNOL that is carried to a separate return year of a member. Finally, rules are provided with respect to the absorption by the consolidated group of unused foreign tax credits in a carryback or carryover year.

- **Applicability date:** Tax years for which the original consolidated federal income tax return is due (without extensions) after December 17, 2019. *See* Reg. § 1.1502-4(f).

Interaction of the branch loss and dual consolidated loss recapture rules with section 904(f) and (g)

- When assets used predominantly outside of the United States are disposed of (including upon incorporation of such assets into a foreign corporation, as well as other nonrecognition transactions), section 904(f)(3) may require gain recognition if the taxpayer has an overall foreign loss account, in order to facilitate the recapture of that account. Additionally, the disposition of such assets may trigger other operative rules that require additional gain recognition and the recapture of certain losses that flowed directly onto a U.S. return. Such rules include the dual consolidated loss recapture rules under section 1503, branch loss recapture rules under section 91 (for post-TCJA losses), and section 367 (for pre-TCJA losses). Generally, gain recognition in accordance with section 904(f)(3) occurs first and may reduce or eliminate the amount of loss required to be recaptured under these other sections. The recognition of additional income under these sections may increase the amount of an NOL deduction carried to such year and therefore may, in turn, cause the creation of or increase in an overall and separate limitation loss accounts under sections 904(f) and (g). Existing regulations under section 904(g) already contain a rule that coordinates any gain recognition required by section 904(f)(3) with the mechanical rules for computing and maintaining a taxpayer's overall and separate limitation loss accounts. The 2020 Final Regulations include, without change, a rule provided in the 2019 Proposed Regulations that similarly coordinates any additional loss recapture under section 91, section 367, or section 1503 with the taxpayer's overall and separate limitation loss accounts. This rule is necessary where gain recognition under section 904(f)(3) does not fully eliminate loss recapture under those sections.

- **Applicability date:** Tax years ending on or after the date the 2020 Final Regulations are filed with the Federal Register. *See* Reg. § 1.904(g)-3(l).

Definition of foreign personal holding company income under section 954

- Under the 2020 Final Regulations, income equivalent to interest, as defined for purposes of the subpart F regime, includes a guaranteed payment for the use of capital.

- **Applicability date:** Tax years of CFCs ending on or after December 16, 2019, and tax years of U.S. shareholders in which or with which such tax years end. See Reg. § 1.954-2(i)(2).

Application of the foreign tax credit disallowance under section 965(g)

- The 2020 Final Regulations adopt without change a proposed rule referencing the principles of Reg. § 1.904-6(a)(1)(iv) or Reg. § 1.861-20, depending on the relevant year, for purposes of attributing taxes to section 959(a) distributions of section 965 PTEP. This rule is intended to address planning to accrue foreign income taxes on distributions recognized for foreign but not U.S. federal income tax purposes (such as consent dividends) in order to treat such taxes as not subject to the section 965(g) haircut that applies to taxes attributable to distributions of section 965 PTEP.

- **Applicability date:** Tax years ending on or after December 16, 2019.

GILTI prepayment rule

- The 2020 Final Regulations also finalize without substantive change a rule that effectively disallows as a reduction to tested income or subpart F income certain deductions with respect to payments (primarily prepayments) made to a related CFC after the related CFC's earnings and profits measurement date under section 965 and before the applicability of GILTI.

- **Applicability date:** The rule applies to foreign corporation tax years ending after April 7, 2020.

Additional proposed regulations

Initial impressions of the 2020 Proposed Regulations are as follows:

Foreign income taxes with respect to dividends for purposes of section 245A(d)

- A corporate U.S. shareholder is generally allowed a deduction equal to the amount of the foreign-source portion of a dividend received from a specified 10% owned foreign corporation (a "section 245A DRD," and a dividend for which a section 245A DRD is allowed, a "section 245A DRD-eligible dividend"). The section 245A DRD, however, is not allowed for any portion of a hybrid dividend received from a CFC or the subpart F income that results from a tiered hybrid dividend received by a CFC. Section 245A(d) disallows credits and deductions for foreign income taxes with respect to section 245A DRD-eligible dividends, and section 245A(e) disallows credits and deductions for foreign income taxes with respect to hybrid dividends and the subpart F income that results from tiered hybrid dividends.

- The 2020 Proposed Regulations provide rules under section 245A(d) for attributing foreign income taxes to "specified distributions" from, and specified earnings and profits ("E&P" and "specified E&P") of, foreign corporations that apply the principles of Reg. § 1.861-20, as well as broad successor rules, to ensure that no section 901 or section 960 credits and no deductions are allowable with respect to such taxes. Very generally, the specified distribution and specified E&P concepts are intended to measure the amount of a foreign corporation's E&P that gives rise (or would give rise if distributed) to section 245A-DRD eligible dividends, hybrid dividends, tiered hybrid dividends, or section 245A(d) PTEP (i.e., PTEP attributable to section 1248 or section 964(e) dividends or subpart F income from a tiered hybrid dividend).

- The section 245A(d) proposed regulation also includes an anti-avoidance rule providing that foreign income taxes are treated as attributable to a specified distribution from, or the specified E&P of, a foreign corporation if a transaction, series of related transactions, or arrangement is undertaken with a principal purpose of avoiding the purposes of section 245A(d) (e.g., transactions that separate foreign income taxes from the related foreign income or the related E&P).

- **Proposed applicability date:** This rule is proposed to apply to tax years of foreign corporations that begin after December 31, 2019, and end on or after the date the regulation is finalized, and with respect to U.S. persons, tax years in which or with which such tax years of foreign corporations end.

Expense allocation and apportionment

Interest expense

CFC netting

- The current CFC netting regulations treat as "related group indebtedness" certain debt between CFCs of the taxpayer. The 2020 Proposed Regulations would eliminate this rule.

- **Proposed applicability date:** This change proposed to apply to tax years ending on or after the date the 2020 Proposed Regulations are filed with the Federal Register.

Direct allocation of interest expense of foreign banking branches

- Under the 2020 Proposed Regulations, the interest expense recorded on the separate books and records of a foreign banking branch would be directly allocated to the gross income of the foreign branch (to the extent thereof) rather than apportioned under the general asset method. For purposes of applying the asset method to apportion other interest expense of the affiliated group, the value of the foreign banking branch's assets would be reduced by the amount of the branch's liabilities that gave rise to directly allocated interest expense. A "foreign banking branch" includes only "true" branches of banks and not disregarded entities owned by a bank. Significantly, the proposed regulations do not change the treatment of amounts recorded as interest income or expense on the books of a foreign banking branch as a result of inter-branch transactions that are disregarded for federal income tax purposes.

- **Proposed applicability date:** This rule is proposed to apply prospectively to tax years beginning on or after the rule is finalized.

Capitalization of expenses for purposes of computing tax basis

- The 2020 Proposed Regulations would allow a taxpayer to elect, solely for purposes of apportioning interest expense under Reg. § 1.861-9, to capitalize and amortize R&E expenditures and advertising expenditures in order to better reflect asset values under the tax book value method. Under the election, R&E expenditures would be capitalized and amortized over a 15-year period, and 50% of advertising expenditures would be capitalized and amortized over a 10-year period. The election would apply for the current and all subsequent tax years, unless revoked by the taxpayer with the Commissioner's consent, except that the election with respect to R&E expenditures would cease to apply when the general requirement to capitalize R&E expenditures becomes effective in 2022. Comments are requested concerning the definition of advertising expenditures and the method of cost recovery.

- **Proposed applicability date:** This rule is proposed to apply to tax years beginning on or after the rule is finalized.

Life insurance company deductions

- The 2019 Proposed Regulations would have required life insurance companies that are members of a consolidated group to allocate and apportion deductions for reserves and certain other expenses ("section 818(f) expenses") on a separate company basis. Some comments supported the separate company approach, while others asserted that a single entity approach should apply for businesses operated on a group basis (a "life subgroup" approach), and yet others argued for electivity. In lieu of finalizing the 2019 proposed rule, Treasury proposed a new rule that would apply a life subgroup approach, subject to a one-time election for the separate company approach. The election would be made by applying the separate entity method on a group's return for its first applicable tax year and would apply for all tax years thereafter, unless the Commissioner consents to its revocation.

- **Proposed applicability date:** This rule is proposed to apply to tax years beginning on or after the rule is finalized.

Allocation and apportionment of foreign income taxes

- The 2020 Proposed Regulations would provide specific guidance under Reg. § 1.861-20 for assigning to groupings foreign gross income arising from dispositions of stock, as well as rules reserved in the 2020 Final Regulations for assigning foreign gross income with respect to an interest in a partnership or a disregarded payment. The 2020 Proposed Regulations also would provide a rule for allocating and apportioning in lieu of taxes under section 903; specifically (and not surprisingly), such taxes (other than withholding taxes) would be allocated and apportioned to groupings in the same proportions as the foreign taxable income to which the base of the in lieu of tax relates.

Dispositions of stock

- With respect to a transaction treated as a sale or other disposition of stock for federal income tax purposes, the proposed rules generally would assign the foreign gross income attributable to a U.S. dividend amount, U.S. capital gain amount, and return of capital amount similar to the final rule for those components of a foreign dividend amount. In particular, the deemed basis recovery – the excess of the foreign gross income over the U.S. dividend amount (i.e., the section 1248 or section 964(e) amount) and the U.S. capital gain amount – is assigned to groupings based on the proportions in which the tax book value of the stock of the transferred corporation is assigned to the groupings under the asset method in Reg. § 1.861-9 in the tax year in which the transfer occurs.

- **Proposed applicability date:** This rule is proposed to apply to tax years that begin after December 31, 2019, and that end on or after the date the 2020 Proposed Regulations are published in the Federal Register.

Partnership transactions

- Similarly, with respect to foreign gross income arising from a transaction treated as a partnership distribution or as a sale, exchange, or other disposition of an interest in a partnership for federal income tax purposes, the 2020 Proposed Regulations would assign foreign gross income to the extent of the U.S. capital gain amount to the statutory or residual group to which the U.S. capital gain is assigned. Any excess of the foreign gross income amount over the U.S. capital gain amount is assigned based on the proportions in which the tax book value 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) are assigned to the groupings for purposes of apportioning the partner's interest expense under Reg. § 1.861-9(e).

- **Proposed applicability date:** This rule is proposed to apply to tax years that begin after December 31, 2019, and that end on or after the date the 2020 Proposed Regulations are published in the Federal Register.

Disregarded payments

- The 2019 Proposed Regulations provided specific rules to allocate and apportion foreign income taxes related to disregarded payments between a foreign branch and its owner. Treasury reserved on these rules in the 2020 Final Regulations and re-proposed revised rules to allow taxpayers additional time for comment.

- There was uncertainty regarding whether the 2019 Proposed Regulations with respect to disregarded payments applied when the disregarded entity was not a qualified business unit ("QBU") or did not have any assets, because the 2019 Proposed Regulations defined a foreign branch for this purpose by cross reference to that term in Reg. § 1.904-4(f). The 2020 Proposed Regulations would provide instead that the allocation and apportionment rules apply to a broader range of disregarded payments made to or by a "taxable unit." If the taxpayer is an individual or a U.S. corporation, a taxable unit includes a foreign branch, a foreign branch owner, and a non-branch taxable unit. If the taxpayer is a foreign corporation, a taxable unit is a tested unit, as defined in Prop. Reg. § 1.954-1(d)(2) of the proposed elective high-tax exception regulations (REG-127732-19, 85 FR 44650). The definition of taxable unit was added to clarify that the rules for disregarded payments in Reg. §§ 1.861-20, 1.904-4(f), and 1.904-6 can apply to disregarded payments to or from a disregarded entity or branch even if the disregarded entity or branch is not a "foreign branch" (i.e., a QBU that engages in a trade or business outside the U.S.) so that foreign income taxes paid may be properly characterized as within the separate categories and among the income groups of a CFC.

- The 2020 Proposed Regulations coordinate the interaction of the rules for allocating foreign income taxes with the rules that reattribute income from a foreign branch and its foreign branch owner for purposes of the section 904 limitation or from one tested unit to another tested unit for purposes of the GILTI high-tax exception. In either case, the reattribution of an item of income for U.S. federal income tax purposes ("U.S. gross income") from one taxable unit to another taxable unit applies for purposes of assigning that income to a statutory or residual grouping. The allocation and apportionment of taxes paid on that income by the payor (or on receipt of the disregarded payment by the payee), are then governed by the same rules that more generally associate foreign taxes with items of U.S. gross income. The rules generally recognize that while an item of U.S. gross income may be reattributed from one taxable unit to another taxable unit, the payor taxable unit's foreign gross income would not be reattributed to the payee taxable unit for purposes of assigning the payor's foreign taxes to groupings because, in the case of a net basis tax, the disregarded payment generally would be deductible for foreign purposes.

- The 2020 Proposed Regulations would revise the 2019 Proposed Regulations related to disregarded payments from a branch to its tax owner (a remittance) and from a tax owner to a branch (a contribution).

    - Comments recommending that tracing rules similar to those in Reg. § 1.904-4 should apply were generally adopted. As applied in this context, those similar rules generally would trace the disregarded payment to the income of the payor that makes the disregarded payment for purposes of determining the grouping to which the foreign income taxes on the disregarded payment are allocated and apportioned.

    - Similar to the 2019 Proposed Regulations, the 2020 Proposed Regulations would allocate foreign income taxes paid in connection with a remittance based on the payor's asset apportionment percentages as calculated under Reg. § 1.987-6(b) as a proxy for the accumulated earnings of the payor. The rule in the 2020 Proposed Regulations specifically reiterates that stock owned by the taxable unit is treated as an asset of the taxable unit and a rule providing for the reattribution of assets between taxable units for this limited purpose to the extent U.S. gross income is reattributed between such taxable units.

    - The 2020 Proposed Regulations, like the 2019 Proposed Regulations, would assign foreign taxes paid with respect to a contribution to the residual category. While foreign taxes paid or accrued by a CFC that are allocated to the residual are not creditable for U.S. federal income tax purposes, the preamble to the 2020 Proposed Regulations explains that the instances in which foreign taxes will be paid in connection with a contribution will be a rare occurrence in practice and even less common with the addition of the reattribution rules as well as an ordering rule that prioritizes treating a disregarded payment as a reattribution payment before treating it as a contribution.

- **Proposed applicability date:** This rule is proposed to apply to tax years that begin after December 31, 2019, and that end on or after the date the 2020 Proposed Regulations are published in the Federal Register.

Creditability of foreign taxes under sections 901 and 903

Definition of foreign income tax

- In the preamble to the 2020 Proposed Regulations, Treasury expresses a concern that the purpose of the FTC to mitigate double taxation of income is undercut by the recent adoption by jurisdictions of taxes on bases that do not approximate the base of the U.S. income tax, including by lacking nexus to the taxing jurisdiction under historic international norms, as is the case for digital service taxes. In response, the 2020 Proposed Regulations would modify the rules under sections 901 and 903 for determining whether a foreign tax is a creditable tax.

- The concern regarding extraterritorial taxes would be addressed by a new jurisdictional nexus requirement for a tax to be creditable.

  - Under this new requirement, for a tax on nonresidents to be creditable, the foreign tax base must be determined by reference to the nonresident's activities (including its functions, assets, and risks) located in the foreign country, so that a tax based on the location of customers or users would not be creditable. Alternatively, for a tax based on the source of income (rather than on activities) to be creditable, the foreign tax law's sourcing rules, including for dispositions of property, must be similar to U.S. sourcing rules. In particular, a foreign tax on income from services must be sourced based on where the services are performed, not on the location of the service recipient.

  - Similarly, for taxes imposed on residents of the jurisdiction, the profits subject to the tax must be based on transfer pricing rules determined under the arm's length principle.

  - The preamble states that no inference is intended concerning the current creditability of digital service taxes and other extraterritorial taxes. In addition, the preamble acknowledges that if an agreement on a new international framework for allocating taxing rights is reached as part of the work of the OECD/G20 Inclusive Framework on BEPS, changes to the U.S. FTC system may be required.

- The 2020 Proposed Regulations also propose a number of other changes to the rules under section 901 to address ongoing points of controversy, particularly with respect to the existing requirement that a tax must be imposed on **net** income to be an income tax in the U.S. sense. The 2020 Proposed Regulations generally would eliminate any empirical analysis of whether a foreign tax satisfies the net gain requirement in the "normal circumstances" in which it applies (as provided under the existing regulations); instead, whether a foreign tax meets the net gain requirement would be based on the terms of the foreign law itself, with certain exceptions. Accordingly, Treasury proposes to remove the nonconfiscatory gross basis tax rule, so that a gross basis tax could not qualify as a net income tax regardless of effect. The 2020 Proposed Regulations also specify certain significant costs and expenses that must be allowed as a deduction for a tax to be creditable, such as deductions for interest expense.

- The 2020 Proposed Regulations also would remove the limitation on the portion of an "in lieu of" tax under section 903 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. As a result, no FTC would be allowed for an in lieu of tax that is a soak-up tax.

- The 2020 Proposed Regulations also would modify the rules for determining whether a tax is a separate levy. In general, the 2020 Proposed Regulations would treat levies as separate levies if they have separate bases or are imposed by different tax authorities. In addition, a foreign levy imposed on nonresidents would always be treated as a separate levy from that imposed on residents of the taxing jurisdiction (even if the base is the same for both), to ensure that if a generally imposed income tax on residents is also imposed on an extraterritorial basis to nonresidents, only the portion of the levy that applies to nonresidents will fail to qualify as a foreign income tax. For similar reasons, a withholding tax on the gross income of nonresidents would be treated as a separate levy with respect to each class of gross income (as listed in section 61) to which it applies.

- The 2020 Proposed Regulations under section 903 also would require that an in lieu of tax meet the new jurisdictional nexus requirement. Specifically, a tax (the "tested tax") would qualify as an in lieu of tax under section 903 only if the generally imposed income tax would qualify as a net income tax if applied to the income on which the tested tax is imposed. In addition, the existing requirement that the tax act as a substitution for a generally imposed income tax would be revised to reflect case law concerning substitution by adding several additional requirements, including a requirement of a close connection between the imposition of the tested tax and the failure to impose the generally imposed tax. Rules would also be added to address the qualification of certain source-based withholding taxes as "in lieu of" taxes, including a requirement that such a tax not be imposed in addition to a net income tax imposed on the same income, and that the rules for sourcing income subject to the withholding tax are similar to the U.S. federal income tax sourcing rules.

- **Proposed applicability date:** The foregoing rules are proposed to apply to foreign taxes paid or accrued in tax years beginning on or after finalization.

Amount of tax that is considered paid

- The 2020 Proposed Regulations would also modify the rules under section 901 concerning the amount of tax that is considered paid and eligible for credit.

- Under the current 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, or forgiven. In connection with the multiple levy rules of current law, this means that if one levy is creditable against a second levy it is the second levy that was treated as paid. Under the 2020 Proposed Regulations, the rule is changed so that the application of a credit (other than a credit of cash overpayments) is not treated as the payment or accrual of a tax. Thus in the multiple levy scenario described above, the first levy will be the one which is treated as paid. Further, and in a change that Treasury also seems to acknowledge as a departure from a fair reading of current law, the 2020 Proposed Regulations would provide that a tax will not be considered paid or accrued if it is satisfied via the application of a tax credit even if that credit is potentially fully refundable in cash. Cf., Rev. Rul. 86-134 1986-2 C.B. 104. Comments are requested as to the appropriate treatment of government grants that are not administered through the tax system, including the circumstances in which such grants should be treated as a reduction in the amount of tax paid.

- The 2020 Proposed Regulations also address the treatment of payments as noncompulsory payments that would not constitute an amount of tax paid. The existing final regulations determine noncompulsory payments on a taxpayer-by-taxpayer basis, but 2007 proposed regulations would have allowed certain commonly controlled foreign entities to be treated as a single taxpayer for this purpose. In response to comments criticizing the 2007 proposed regulations, Treasury intends to withdraw them. However, a reversion to a taxpayer-by-taxpayer determination of noncompulsory payments, under which each taxpayer would be required to minimize its tax liability, could prevent crediting certain taxes imposed under a loss-sharing regime. Accordingly, the 2020 Proposed Regulations include rules that would provide that a decision to surrender (or not surrender) a loss or to join in a consolidation regime would not give rise to a noncompulsory payment. However, the preamble notes that Treasury is concerned about potentially inappropriate results under loss surrender regimes, in particular the potential to shift income between FTC limitation baskets.

- The 2020 Proposed Regulations would clarify that the noncompulsory payment rules require the minimization of foreign income taxes, and not foreign taxes (including non-income taxes such as excise taxes) as an aggregate.

- The 2020 Proposed Regulations also would clarify that the time value of money is not taken into account for purposes of the noncompulsory payment rules (for example, in the context of an election to capitalize and amortize certain expenses rather than deduct them currently).

- **Proposed applicability date:** The foregoing rules are proposed to apply to foreign taxes paid or accrued in tax years beginning on or after finalization.

Rules for allocating foreign taxes after certain ownership and entity classification changes

- The 2020 Proposed Regulations would modify the rules in Reg. § 1.901-2(f)(4) addressing the allocation of foreign income taxes paid or accrued by a partnership or disregarded entity upon the occurrence of certain transfers or reorganizations of the partnership or disregarded entity that do not result in the closing of the entity's foreign tax year (e.g., a termination of the partnership or the transfer of the interests in a disregarded entity). Upon the occurrence of such events, the existing regulations allocate entity-level foreign taxes between the relevant taxpayers based on the principles in the consolidated return regulations in Reg. § 1.1502-76(b). The 2020 Proposed Regulations would modify the rules for allocating foreign taxes by:

    - Expanding the categories of transactions subject to these rules by defining a category of "covered events," which would include mid-year changes in the U.S. tax classification of a corporation or disregarded entity

    - Addressing the allocation of foreign taxes where multiple covered events occur during the same tax year

    - Excluding withholding taxes from the application of the allocation rules

- The 2020 Proposed Regulations would make similar modifications to the rules in existing Reg. § 1.901-2(f)(5) addressing the allocation of foreign taxes between the "old target" and "new target" in connection with an election under section 336(e) or section 338.

- By narrowly limiting its definition of "covered events" this rule potentially leaves room for other situations where U.S. tax rules will see a transfer between taxpayers and the close of a U.S. tax year while foreign law sees no event whatsoever, such in the continuation of a foreign entity into the United States without relinquishing its foreign corporate charter.

- **Proposed applicability date:** The rules in Prop. Reg. § 1.901-2 are proposed to apply prospectively to foreign taxes paid or accrued in tax years beginning on or after finalization.

Proper time for claiming foreign income taxes as a credit or as a deduction

- The 2020 Proposed Regulations would significantly revise Reg. § 1.905-1, which currently provides rules for determining the proper time for claiming a foreign tax credit. The revised rules would provide more detailed guidance to accrual method and cash method taxpayers alike with respect to when to take into account foreign income taxes for purposes of the foreign tax credit (if elected) or for purposes of claiming a deduction (if the foreign tax credit is not elected). This guidance appears generally consistent with current law.

- The 2020 Proposed Regulations would revise the time period in which a taxpayer may change an election to credit or deduct foreign income taxes. Under current law, a taxpayer is allowed 10 years from the due date a tax return is filed to amend and change the taxpayer's election to deduct or credit foreign income taxes. Recent case law, however, indicates that the 10-year statute does not apply to refund claims for foreign income taxes for which a taxpayer claimed a deduction. Accordingly, the 2020 Proposed Regulations would allow a taxpayer to change its election to deduct foreign income taxes to an election to credit foreign income taxes within the ten-year period, but would limit the taxpayer's election to the three-year statute of limitation with respect to refund claims in the case of a change from credit to deduction.

- The 2020 Proposed Regulations also address many issues taxpayers have encountered in this area:

  - An exception to the prohibition in the current regulations on deducting foreign income taxes in the same tax year in which a foreign tax credit is elected was added to explicitly allow a deduction for foreign income taxes that accrue in a tax year in which the taxpayer elects to claim foreign tax credits but which relate back for foreign tax credit purposes to a tax year in which the taxpayer had elected to deduct foreign income taxes. Absent this exception, a taxpayer could be precluded from being able to credit or deduct such foreign income taxes.

  - The 2020 Proposed Regulations reiterate that foreign income taxes accrue for U.S. federal income tax purposes on the last day of the foreign tax year because that is when the all-events test is met with respect to foreign income taxes. A taxpayer that made an election to use a 52-53 week tax year for U.S. federal income tax purposes but which has, for example, a regular calendar year for foreign law purposes, could have a mismatch between the end of the taxpayer's U.S. federal income tax year and the taxpayer's foreign tax year that, absent an exception, could be viewed as resulting in tax years in which the taxpayer accrues no foreign income taxes and tax years in which the taxpayer accrues foreign income taxes with respect to two foreign tax years. The 2020 Proposed Regulations would treat the taxpayer's U.S. federal income tax year as ending on the same date as the taxpayer's foreign tax year when such year ends within six days of the taxpayer's U.S. federal income tax year for purposes of determining which U.S. federal income tax year of the taxpayer such taxes accrue.

  - Current law would allow an accrual method taxpayer to accrue contested foreign income taxes to the extent the taxpayer has made an actual payment of all or a portion of the contested foreign income taxes. Such accrued tax may then be claimed as a credit in the tax year to which it relates. Treasury noted in the preamble to the 2020 Proposed Regulations that such result is inconsistent with the principles of the all events test. As a result, the 2020 Proposed Regulations would not generally allow a taxpayer to accrue and claim a foreign tax credit for any portion of a contested foreign income tax until the contest is resolved. The 2020 Proposed Regulations provide an exception, however, that would allow accrual and a foreign tax credit to the extent a taxpayer pays a contested tax if the taxpayer enters into an agreement with the IRS to allow the

IRS to audit such claim when the contest is resolved and to not raise the statute of limitations as a defense to any assessment with respect to such claim.

- o The 2020 Proposed Regulations clarify that a partnership takes foreign income taxes into account based upon its method of accounting and that the partners in such partnership may claim a foreign tax credit (to the extent they are otherwise allowed) for their distributive share of those foreign income taxes even if the partner uses a different method of accounting than the partnership. For example, a cash method taxpayer may claim its distributive share of a foreign income tax accrued by an accrual method partnership as a credit to the extent otherwise allowed even if the partnership had not yet paid the foreign income tax.

- **Proposed applicability dates:** The rules in Prop. Reg. §§ 1.901-1 and 1.905-1 are proposed to apply prospectively to foreign taxes paid or accrued in tax years beginning on or after finalization.

Definition of foreign branch category income

- The 2020 Proposed Regulations would modify the rules defining foreign branch category income, largely to streamline the cross-references to the rules introduced in the proposed revisions to Reg. § 1.861-20. In addition, as for Reg. § 1.861-20, rules are added to account for transactions with foreign disregarded entities that do not conduct a trade or business and other "non-branch taxable units." The proposed regulations also clarify that the reattribution of gross income by reason of disregarded payments is capped at the amount of current branch category or general category gross income in the payor foreign branch or foreign branch owner, respectively. New examples are also added, including an example illustrating the interaction of the rules for foreign branch category income with the rules of Reg. § 1.1502-13 for transactions between members of a consolidated group.

- **Proposed applicability dates:** These rules are proposed to apply to tax years that begin after December 31, 2019, and that end on or after the date the 2020 Proposed Regulations are filed in the Federal Register.

Definition of financial services income

- The 2019 Proposed Regulations proposed significant changes to the rules for determining "financial services income" under section 904(d) that would have limited the situations in which a taxpayer was treated as a financial services entity and income was treated as financial services income for purposes of the foreign tax credit limitation rules. The 2020 Proposed Regulations substantially revise and re-propose the rules defining financial services income. The re-proposed rules largely retain the structure and content of the existing final regulations with minor modifications. Notably, the re-proposed rules would lower the threshold of active financing income that a person must derive to be a financial services entity from 80% to 70% and generally would consider for this purpose only income from customers that are not related persons. The regulations would retain for purposes of the 70% gross income test a detailed list of categories of active financing income that is similar, but not identical, to the current final regulations.

- **Proposed applicability dates:** The rules in Prop. Reg. § 1.904-4(e)(1)(ii), (e)(2), and (e)(3) would apply prospectively to tax years beginning on or after finalization.

Deemed inclusion source rule

- The 2020 Proposed Regulations would add a rule in Prop. Reg. § 1.861-3(d) to govern the sourcing of: (1) subpart F and GILTI inclusions along with the associated section 78 gross up, and (2) PFIC inclusions under section 1293(f)(1). Under this rule, deemed inclusions from a CFC or PFIC and the section 78 gross up would be sourced in the same manner as a dividend paid directly by the CFC or PFIC regardless of whether the CFC or PFIC is directly held by the relevant U.S. taxpayer. As a result, deemed inclusions from a CFC or PFIC and the section 78 gross up generally would be treated as foreign source income unless the foreign corporation earns a significant amount of effectively connected income or the income is resourced under section 904(h). This rule was needed to fill the gap Treasury left when they removed the prior sourcing rule in Reg. § 1.960-1(h) to align the section 960 regulations with the TCJA.

- **Proposed applicability date:** Prop. Reg. § 1.861-3(d) is proposed to apply to tax years ending on or after the date the 2020 Proposed Regulations are filed with the Federal Register.

Transition rules for accounting for NOL carrybacks

- Prior to the enactment of the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (2020) (the "CARES Act"), NOLs generated in a post-TCJA year were not eligible to be carried back to a pre-TCJA year. Therefore, no transition rules were necessary to coordinate the carry back of any component of a post-TCJA year NOL in the branch or GILTI category to a pre-TCJA year with the separate limitation loss ("SLL") and overall foreign loss ("OFL") rules. To address that gap, the 2020 Proposed Regulations would provide transition rules for post-TCJA NOL carrybacks. The 2020 Proposed Regulations provide that the NOL carryback rules of Reg. § 1.904(g)-3(b) apply for purposes of assigning post-TCJA NOLs in a separate category to the separate categories in the pre-TCJA tax year. For this purpose, however, a passive SLL created by an NOL carryback will generate an SLL account only in the general limitation category (and not a combination of the general, foreign branch, and GILTI category income) even if the income in the carryback year that absorbs the NOL would be foreign branch or GILTI category income if such income were earned in the post-TCJA year. Additionally, any component of an NOL in the branch or GILTI category carried back to a pre-TCJA year is to be carried back to the general basket without creating an SLL to the extent such NOL component offsets income in the general basket, but after any general limitation component of the NOL is first used to offset income in the general limitation category.

- **Proposed applicability date:** The rules in Prop. Reg. § 1.904(f)-12(j)(5) are proposed to apply to carrybacks of NOLs incurred in tax years beginning on or after January 1, 2018.

Impact of the repeal of section 902 on certain regulations issued under section 367(b)

- Section 367(b) and the regulations thereunder generally provide rules for the carryover of E&P and foreign taxes in certain nonrecognition transactions involving a foreign corporation, in addition to requiring the recognition of income when an ownership threshold is not maintained following a reorganization. These rules provide detailed mechanisms involving hovering deficits, post-1986 E&P and foreign taxes, and pre-1987 E&P and foreign taxes to account for the fact that, prior to the TCJA, E&P and foreign tax pooling was required in order to compute the foreign income taxes deemed paid on a dividend distribution or inclusion. Given the repeal of section 902, the 2020 Proposed Regulations would remove references to section 902 in the regulations without changing the ownership requirements that dictate their application. As well, the 2020 Proposed Regulations would treat earnings in each post-TCJA year of a foreign corporation as creating a separate annual layer of E&P and provide a transition rule that treats all untaxed E&P remaining from pre-TCJA years as within a single annual layer. Additionally, the 2020 Proposed Regulations confirm that no foreign taxes that carryover under these regulations are to be treated as a current year tax that is eligible to be treated as deemed paid in the year in which the transaction occurs.

- **Proposed applicability date:** The rules in Prop. Reg. §§ 1.367(b)-4(b)(2)(i)(B), 1.367(b)-7(g), and 1.367(b)-10(c)(1) are proposed to apply to tax years ending on or after the date the 2020 Proposed Regulations are filed with the Federal Register.

Rules relating to the section 250 deduction for GILTI and FDII

Definitions of FOGEI and DOGEI

- The 2020 Proposed Regulations would require taxpayers to use a consistent method to compute domestic oil and gas extraction income ("DOGEI") and foreign oil and gas extraction income ("FOGEI"), to address a concern that otherwise taxpayers may seek to minimize the former, in order to maximize their potential section 250 deduction attributable to FDII, while maximizing the latter, in order to reduce their GILTI inclusions.

- **Proposed applicability date:** This rule is proposed to apply to tax years beginning on or after January 1, 2021, consistent with the section 250 regulations generally.

Definition of electronically supplied service under FDII

- The 2020 Proposed Regulations would modify the definition of electronically supplied services included in the **final regulations** [PDF 590 KB] (T.D. 9901) [PDF 590 KB] released in July 2020 with respect to FDII. Read **KPMG report: Analysis of final FDII regulations** [PDF 1.1 MB]. Those final regulations suggest that any service delivered online could be an electronically supplied service. In order to narrow the broad application of the final rule, the proposed rule provides that, for a service to be considered an electronically supplied service, its value must be derived primarily from the service's automation or electronic delivery. Therefore, services that primarily involve human effort, such as legal, accounting, medical, or teaching services delivered electronically, would not be electronically supplied services. The provision of access to digital content, on-demand network access to computing resources, the provision or support of a presence on a network, online intermediation platform services, and automatically generated services are all listed as examples of electronically supplied services.

- **Proposed applicability date:** This rule is proposed to apply to tax years beginning on or after January 1, 2021, consistent with the section 250 regulations generally.

Contact us

For more information, contact a tax professional with KPMG's Washington National Tax:

Seth Green
T: +1 202 533 3022
E: sethgreen@kpmg.com

Danielle Rolfes
T: +1 202 533 3378
E: drolfes@kpmg.com

Kevin Brogan
T: +1 202 533 3425
E: kevinbrogan@kpmg.com

Michael Plowgian
T: +1 202 533 5006
E: mplowgian@kpmg.com

Christopher Riccardi
T: +1 404 222 7187
E: criccardi@kpmg.com

Rose Jenkins
T: +1 202 533 3959
E: rosejenkins@kpmg.com

Brett Bloom
T: +1 202 533 4061
E: bbloom@kpmg.com

Jake Burgers
T: +1 612 305 5472
E: jburgers@kpmg.com

www.kpmg.com

kpmg.com/socialmedia