KPMG report: Analysis of final and proposed foreign tax credit regulations

November 24, 2020

Introduction

The U.S. Treasury Department and IRS (collectively, "Treasury") on September 29, 2020, released an unofficial advance copy of final regulations (T.D. 9922, and the "2020 Final Regulations") and proposed regulations (REG-101657-20, and the "2020 Proposed Regulations") related to the determination of the foreign tax credit ("FTC"). The 2020 Final Regulations and the 2020 Proposed Regulations were published in the Federal Register on November 12, 2020.

This package marks the third significant revision of FTC regulations since the enactment of the 2017 U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017, and often referred to as the "Tax Cuts and Jobs Act" or "TCJA") implementing changes to the FTC enacted by the TCJA. (The prior major revisions were published in the Federal Register on December 7, 2018, and December 17, 2019).

- The 2020 Final Regulations finalize aspects of the proposed regulations published on December 17, 2019 (the "2019 Proposed Regulations") generally without significant substantive changes (with limited exceptions noted herein). Read the **final regulations**, [PDF 582 KB] (78 pages as published in the Federal Register on November 12, 2020).

- The 2020 Proposed Regulations contain newly proposed guidance, as well as re-proposed portions of the 2019 Proposed Regulations where Treasury materially revised their approach and sought to afford taxpayers additional opportunity to comment. Read the **proposed regulations**, [PDF 615 KB] (79 pages as published in the Federal Register on November 12, 2020).

This publication supplements **KPMG's initial impressions** of the 2020 Final Regulations and the 2020 Proposed Regulations dated October 5, 2020.

The 2020 Final Regulations provide guidance related to the allocation and apportionment of foreign taxes and other expenses for purposes of determining a taxpayer's FTC limitation. Expenses addressed include stewardship, research and experimental ("R&E") expenditures, interest, damages and other payments arising from litigation. As well, detailed rules are provided for associating foreign income taxes with related income.

The 2020 Final Regulations also finalize guidance related to foreign tax redeterminations that was proposed in the 2019 Proposed Regulations (in connection with finalizing other aspects of these rules), which generally require the filing of amended returns upon a foreign tax redetermination. Other issues related to the FTC addressed by the 2020 Final Regulations include the disallowance of a portion of a taxpayer's FTCs attributable to distributions of earnings and profits ("E&P") previously taxed (such previously taxed E&P, "PTEP") under section 965 and the application of the FTC limitation to consolidated groups.

Finally, the 2020 Final Regulations finalize guidance regarding hybrid instruments and entities that was included in proposed regulations released in April, as well as guidance in respect of the treatment of certain deductions attributable to prepayments that were not included in income by the recipient under the global intangible low-taxed income ("GILTI") provisions.

The 2020 Proposed Regulations re-propose certain rules relating to the allocation and apportionment of foreign income taxes, including with respect to foreign income taxes that arise in connection with disregarded payments. Rules related to the allocation and apportionment of interest expense are also contained in the 2020 Proposed Regulations.

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In addition, the 2020 Proposed Regulations would introduce a substantial overhaul of the existing section 901 and 903 regulations that address the creditability of foreign taxes as foreign income taxes or "in lieu of" taxes.

Notably, the 2020 Proposed Regulations would introduce a new jurisdictional nexus requirement in respect of foreign taxes, reflecting a concern by Treasury that an increasing number of taxes are being adopted worldwide that diverge from traditional international norms of income taxation.

The 2020 Proposed Regulations also contain guidance on a number of miscellaneous aspects of the FTC, including the sourcing of shareholder inclusions, the application of the technical taxpayer rules to mid-year transactions, the definition of financial services income, the disallowance of a credit or deduction for foreign taxes related to earnings eligible for the dividends-received deduction afforded by section 245A, the carryover of E&P and taxes in connection with non-recognition transactions under section 367(b) and transition rules necessary to coordinate the carryback of NOLs allowed by the CARES Act[1] with the determination of a taxpayer's FTC limitation.

Finally, clarifying guidance related to the treatment of electronically provided services under the FDII regime is included.

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[1] "Coronavirus Aid, Relief, and Economic Security Act" (CARES Act) (Pub. L. No. 116-136, enacted March 27, 2020).

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Allocation and apportionment of expenses other than foreign taxes

R&E expenditures—2020 Final Regulations

The 2020 Final Regulations finalize most of the changes introduced in the 2019 Proposed Regulations. Accordingly, the deductions subject to Reg. § 1.861-17 now include both amounts deducted under section 174 and the amortization deductions of amounts capitalized under section 59(e) ("R&E expenditures"). Also consistent with the 2019 Proposed Regulations, R&E expenditures must be allocated to "gross intangible income" ("GII") that is reasonably connected to the relevant three-digit standard industrial classification ("SIC") code.

KPMG observation

Reg. § 1.861-17 is premised on the notion that R&E is inherently speculative and that there could be a significant time lag between when R&E expenditures are incurred and when the resulting income is produced (if the R&E ever produces income at all). Under this view, it is generally impossible to create a direct, reliable connection between R&E expenditures incurred in a particular year and the income the taxpayer earns during that year. Accordingly, the regulations use the taxpayer's current year GII and gross receipts as a proxy for what current expenditures are reasonably expected to produce in the future and allocate and apportion R&E on the basis of those amounts.

Allocation

The 2020 Final Regulations generally retain the 2019 Proposed Regulation's definition of GII. Thus, GII includes all of a taxpayer's directly earned gross income that is attributable to a sale or license of intangible property ("IP"), including from direct transfers of IP rights (e.g., through a sale or license). GII also includes all gross income from the taxpayer's sales or leases of products or services that are derived directly or indirectly in whole or in part from IP, without any bifurcation to distinguish between the IP-

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related gross income and returns to functions such as manufacturing and distribution (i.e., the entire item of gross income is included in GII).

KPMG observation

Under the 2020 Final Regulations, entity classification can have a significant impact on the scope of GII. For example, if a U.S. taxpayer licenses IP to a CFC, only the royalty income received with respect to the license will be included in GII. However, when a U.S. taxpayer "licenses" IP to a foreign branch, all of the gross income from the branch's sales will be included in GII, even though arguably the intangible related portion of the gross income is solely in the general category as a result of the reallocation of part of the branch's gross income on account of the disregarded royalty it pays to its owner.

KPMG observation

Treasury received a comment requesting that GII exclude income from acquired IP, such as IP acquired from a prior participant in a cost sharing arrangement ("CSA"), because a taxpayer's R&E expenditures do not relate to IP developed by a different taxpayer. In rejecting the comment, Treasury reiterates that the R&E allocation rules are not premised on a factual connection between the expenses and GII that is earned in a particular tax year.

When R&E expenditures relate to more than one three-digit SIC code, taxpayers may aggregate SIC codes within a major group (i.e., the two-digit SIC code category for a group of three digit SIC Codes). However, in a rule that was not included in the 2019 Proposed Regulations, taxpayers are no longer permitted to aggregate three-digit SIC codes that fall within separate Major Groups.

KPMG observation

In explaining its decision not to allow the aggregation of SIC codes in different Major Groups, Treasury asserts that it is not reasonable to expect R&E expenditures related to one business line to benefit another business line falling within a different Major Group. When a taxpayer incurs R&E expenditures that are intended and expected to benefit SIC codes falling within different Major Groups, it is not clear how the taxpayer should allocate that R&E expenditure if the expenditure cannot be easily bifurcated into amounts that benefit each of the SIC codes.

Taxpayers are required to be consistent from year to year in their use of SIC codes (including with respect to aggregation) unless the taxpayer establishes to the satisfaction of the Commissioner justification for a change.

Sales-related R&E expenditures will continue to be assigned to a SIC code within the wholesale trade or retail trade groups only when the taxpayer does not perform material non-sales-related activities with respect to the particular category of products. For taxpayers that conduct other activities with respect to a particular category of products, all R&E expenditures related to sales of the products must be allocated and apportioned as if the expenditures were reasonably connected to the most closely related (non-retail or wholesale) SIC code.

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Apportionment

Exclusive apportionment

The 2020 Final Regulations retain "exclusive apportionment," but limit its application to the allocation and apportionment of R&E expenditures for purposes of section 904 (i.e., for purposes of determining a taxpayer's foreign tax credit limitation in each separate category). When applicable, 50% of the taxpayer's R&E expenditures related to a SIC code must be exclusively apportioned, either (i) to U.S. source GII within the SIC code if at least 50% of such R&E expenditures were generated by R&E activities in the United States, or, alternatively (ii) ratably to foreign source GII within the section 904 separate limitation categories, if more than 50% of the taxpayer's R&E expenditures relate to R&E activities that occurred outside the United States.

KPMG observation

The 2020 Final Regulations make clear that all R&E activities conducted during the year are taken into account in determining the application of exclusive apportionment regardless of whether the associated expenditures are capitalized and therefore not actually deducted until amortized in future years. This focus on current year activities seems more administrable than a requirement to trace amortization deductions to prior year activities, while still accommodating the policy of encouraging taxpayers to locate their R&E activities domestically without penalizing them for choosing to capitalize the associated expenditures under section 59(e). However, taxpayers should bear in mind that the future amortization deductions will be allocated and apportioned based on the apportionment factors in the future year, including whether exclusive apportionment applies with respect to U.S. or foreign source income in the future year. This may present a planning opportunity for taxpayers to limit the effect of applying exclusive apportionment to foreign sources by capitalizing R&E expenditures in years when more than 50% of its R&E expenditures in the relevant SIC code relate to R&E activities conducted outside of the United States.

ODLs and exclusive apportionment

Although exclusive apportionment is generally regarded as a taxpayer favorable rule, a comment asked for regulatory relief when exclusive apportionment to U.S. source income reduces a taxpayer's foreign tax credit limitation in the section 951A or foreign branch category in the current year. Such a result can occur when exclusive apportionment to U.S. source income results in a taxpayer having an overall U.S. source loss (an overall domestic loss, or "ODL"). In such case, the taxpayer's ODL is allocated to each of its foreign source categories, including its section 951A category, on a proportionate basis, thereby reducing its foreign tax credit limitation with respect to each category in the given year. Treasury declined to provide relief, noting that reductions in income in the section 951A category in an ODL year would be reversed in later years as a result of ODL recapture.

KPMG observation

While the ODL will be recaptured into GILTI in subsequent years, excess GILTI credits do not carry over to future years, with the result that the loss of creditable GILTI taxes in an ODL year may represent a permanent cost, in particular to a taxpayer that generally has excess limitation in the GILTI basket.

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The sales method

Consistent with the 2019 Proposed Regulations, the 2020 Final Regulations make the sales method the exclusive method for apportioning a taxpayer's R&E expenditures that are not accounted for under exclusive apportionment, thereby eliminating the gross income method. Though generally referred to as "the sales method", apportionment is made on the basis of gross receipts received in connection with a broad range of transactions, including sales, leases, licenses, and services that are related to GII. In applying this method, taxpayers are required to take into account certain gross receipts of controlled and uncontrolled corporations if the taxpayer can reasonably be expected to license, sell, or transfer IP that would arise from the taxpayer's R&E expenditures to such persons.

Under the 2019 Proposed Regulations, if the taxpayer had previously transferred IP related to a SIC code category to a controlled or uncontrolled party, the taxpayer was presumed to reasonably expect to transfer rights to all future IP related to the same SIC code category to the same party. The 2020 Final Regulations retain this presumption but clarify that it is rebuttable.

In addition, the 2020 Final Regulations significantly expand the scope of the sales of related and unrelated parties that are included in the apportionment formula. In addition to including the sales of entities that are expected to directly acquire rights to any resulting 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 of such products, or (2) receive services that directly or indirectly benefit from the IP. Thus, a taxpayer would have to take into account gross receipts of a related or unrelated limited risk distributor or retailer 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, even if there is no sale or license of IP from the taxpayer.

KPMG observation

The 2020 Final Regulation's inclusion of sales and services with embedded IP ensures that gross receipts taken into account for apportionment generally will reflect the sales of related and unrelated parties made to end users. The focus in the 2020 Final Regulations on sales and services to end users echoes the rules in the Final FDII Regulations regarding sales or licenses of IP, which generally provide that IP embedded or used to sell products is exploited where products are sold to end users, and IP used to provide a service is exploited at the location of the service recipients. The need to gather information regarding sales or services to the ultimate end user may be challenging to apply when uncontrolled parties, rather than the taxpayer or controlled entities, are selling or providing services to end users. Both the 2020 Final Regulations under Reg. § 1.861-17 and the Final FDII Regulations allow taxpayers to make reasonable estimates regarding third party sales, but the speculative nature of these estimates may create uncertainty for both taxpayers and the IRS.

Treatment of CSAs

Under the 2020 Final Regulations, consistent with the 2019 Proposed Regulations, the sales method does not include sales of a controlled party that has entered a CSA with the taxpayer for purposes of apportioning the taxpayer's R&E expenditures that are intangible development costs under the CSA. Under Reg. § 1.482-7, the controlled party is required to bear its proportionate share of R&E expenditures and is treated as an owner of its share the resulting intangible property. Accordingly, a taxpayer that is a party to a CSA would not expect to transfer its share of the IP developed under the CSA to any other participants in the future.

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KPMG observation

The exclusion of the sales of a party to a CSA only applies with respect to the taxpayer's R&E expenditures that are intangible development costs under the CSA. Accordingly, if a taxpayer incurs R&E expenditures that are not shared under the CSA, the sales of the party to the CSA would be taken into account if the party is reasonably expected to benefit from those expenses. The rule in the 2020 Final Regulations modifies the prior rules, which appeared to exclude all of the controlled party's sales for purposes of apportioning all of the taxpayer's R&E expenditures, including those that were unrelated to the CSA.

Comments suggested that special rules are needed when a CSA terminates because, for a period of time after the termination, the controlled party will continue to benefit primarily from its share of the IP developed under the CSA rather than the IP that the taxpayer develops and may transfer to the controlled participant in the future. The comments suggested that, following the termination of a CSA, special adjustments would be needed either with respect to exclusive apportionment (i.e., allowing an increased exclusive apportionment based on facts and circumstances) or the sales included in the apportionment formula (i.e., a reduction in the sales of the controlled party that would be taken into account). In rejecting these comments, Treasury again disavows any implication that Reg. § 1.861-17 is intended to directly match R&E expenditures with the income that the expenditures generate. Treasury emphasizes that current year sales serve as a proxy for the income that R&E expenditures are expected to produce in future years. However, in the preamble, Treasury signals that it intends to further study whether special rules are necessary to address the tax consequences of terminating a CSA.

Partnership rules

The 2020 Final Regulations include specific provisions relating to partnerships. First, a taxpayer's R&E expenditures include its distributive share of R&E expenditures of a partnership in which it is a partner. Also, R&E activities of the partnership are taken into account for purposes of applying exclusive apportionment to the R&E expenditures of the partner. Further, if the partnership is reasonably expected to benefit from the taxpayer's IP in the future, the sales of the partnership are taken into account under the general rules that apply to sales of controlled and uncontrolled parties that are expected to benefit from the taxpayer's IP.

Foreign branch category income

The 2020 Final Regulations clarify that if a branch licenses IP from its regarded owner, the disregarded royalty payment will generally result in gross income being reallocated from the foreign branch category to the general category pursuant to the disregarded reallocation transaction rules ("DRT rules") provided in Reg. § 1.904-4(f). The 2020 Final Regulations provide that the gross receipts relating to branch sales are also assigned to the general category in the same proportion as the reallocated income bears to the total income in respect of such gross receipts initially assigned to the foreign branch category.

KPMG observation

If a branch licenses IP from the branch owner, the amount of the disregarded royalty payment must be determined under section 482 principles to reflect the arm's length return associated with the IP for purposes of the applying the DRT rules. As such, on account of the disregarded royalty,

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all of the IP return would be expected to be reallocated to the general category under the DRT rules. This raises the question as to whether any of the branch's sales should be treated as remaining in the foreign branch category given all of the income associated with the IP return is in the general category. Nonetheless, the 2020 Final Regulations reattribute only a proportion of the gross receipts initially attributed to the foreign branch category to the general category where the gross income from the branch sales exceeds the disregarded royalty, resulting in arguably an over-apportionment of R&E expenditures to the foreign branch category. By contrast, if a taxpayer licenses IP to a CFC, all of the CFC's gross receipts will be attributed to the general category. Treasury described this marked difference in the manner in which R&E expenditures burden the foreign branch versus general categories as unavoidable due to the inability of a disregarded royalty paid to the branch owner by the branch to change the character of its income from sales of products with embedded IP or to bifurcate a single sale into part-GII and part non-GII.

Contract research arrangements

Comments requested clarification as to whether expenditures incurred in performing contract research ("contracted expenditures") on behalf of another taxpayer (including an affiliate) are properly within the scope of section 174 and therefore are governed by Reg. § 1.861-17. The uncertainty with respect to these expenditures stems from a lack of clarity as to whether section 174 governs expenditures for which a taxpayer does not bear ultimate risk of success or failure because such taxpayer is fully reimbursed for its expenses. Treasury responded that whether contracted expenditures are within the scope of section 174 is outside the scope of the 2020 Final Regulations. While it remains clear that the payment by the contracting taxpayer to the taxpayer performing the services is subject to section 174, it remains unclear as to whether the expenses of the taxpayer performing these services are governed by Reg. § 1.861-17.

KPMG observation

While not directly relevant to Reg. § 1.861-17, or any other provision of the 2020 Final Regulations, starting in 2022, R&E expenditures become subject to capitalization under section 174. It is hard to understand why a contract research provider should be subject to those capitalization rules on amounts that it incurs simply to provide a service to another party that will own all of the IP created from the services.

KPMG observation

If a branch performs research services for the branch owner and receives disregarded services payments from the branch owner, such payment will generally result in the reallocation of general category income to the foreign branch category pursuant to the Foreign Branch DRT Rules (defined below). Because the Foreign Branch DRT Rules do not change the category of the underlying regarded gross income, the gross income reallocated to the branch on account of the disregarded services payment will continue to be treated as GII in the branch's hands and a portion of the sales of the branch owner treated initially as general category sales will be similarly reassigned to the foreign branch category. Such reassigned sales will result in a portion of regarded R&E expense (including that incurred by the branch itself in providing services to the IP owner) to the foreign branch category even though the branch does not have an ownership interest in the IP.

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Applicability date

The 2020 Final Regulations in Reg. § 1.861-17 are applicable to tax years beginning after December 31, 2019. For tax years beginning in 2018 or 2019, taxpayers have three choices: (1) apply the prior version of final Reg. § 1.861-17, (2) rely on the version of Reg. § 1.861-17 that was proposed in the 2019 Proposed Regulations, or (3) early adopt Reg. § 1.861-17 as revised in the 2020 Final Regulations (see Reg. § 1.861-17(h)). To rely on the second or third options, taxpayers must apply that version of the regulation in its entirety and for any subsequent year beginning before January 1, 2020. The preamble to the 2020 Final Regulations explains that the requirement to apply either regulation "in its entirety" means that the taxpayer must apply it with respect to all operative sections, specifically referencing sections 250 and 904.

KPMG observation

While the 2019 Proposed FDII Regulations stated that exclusive apportionment does not apply for FDII purposes, the Final FDII Regulations published on July 15, 2020 (T.D. 9901) ("Final FDII Regulations") are silent on the issue, deferring instead to the regulations under Reg. § 1.861-17. While the Final FDII Regulations apply to tax years beginning on or after January 1, 2021, a taxpayer may choose to apply the Final FDII Regulations for earlier tax years. Taxpayers have the option of applying the prior version of final Reg. § 1.861-17 for tax years beginning in 2018, 2019, and 2020. Accordingly, an early adopter of the Final FDII Regulations is not explicitly prohibited from applying exclusive apportionment for FDII purposes for tax years beginning in 2018, 2019 and 2020. However, the prior version of Reg. § 1.861-17(b)(1) provides that exclusive apportionment applies only "where an apportionment based upon geographic source of income of a deduction for research and experimentation is necessary."

For FDII purposes, the geographic "source" of income, within the commonly understood meaning of that term, is irrelevant. Moreover, the Tax Court in *St. Jude Medical, Inc. v. Commissioner*, 97 T.C. 457 (1991), *aff'd in part, rev'd in part*, 34 F.3d 1394 (8th Cir. 1994), held that exclusive apportionment was not applicable in the analogous context of section 994 and the DISC regime.

Stewardship expenses—2020 Final Regulations

The 2019 Proposed Regulations provided a revised methodology for the allocation and apportionment of stewardship deductions. The 2020 Final Regulations finalized those rules with notable changes and clarifications.

Stewardship deductions remain defined as deductions from "duplicative activities" (as defined in Reg. § 1.482-9(l)(3)(iii)) or "shareholder activities" (as defined in Reg. § 1.482-9(l)(3)(iv)) under the 2020 Final Regulations. The 2020 Final Regulations expand the types of entities that may be "stewarded" to include any business entity, including a disregarded entity. Treasury specifically rejected comments recommending the definition include expenses incurred to oversee a "true" branch because branch income is directly earned income of the taxpayer itself.

The 2020 Final Regulations also provide that the affiliated group rules in Reg. § 1.861-14 and the "tax exempt asset rule" in Reg. § 1.861-8(d)(2) do not apply for purposes of allocating and apportioning stewardship expense. Therefore, stewardship incurred by each member of an affiliated group to oversee the activities of a subsidiary is allocated and apportioned on a separate entity basis.

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Allocation

Under the prior final regulations, stewardship expenses were allocated to "dividends received, or to be received from" the corporation's subsidiaries. Like the 2019 Proposed Regulations, the 2020 Final Regulations provide that stewardship expenses are allocated to a class of gross income that includes not only dividends from a subsidiary (including the section 78 gross-up), but also inclusions with respect to the subsidiary under section 951, section 951A, or the PFIC regime. The 2020 Final Regulations state that stewardship expenses are allocated to the gross income from a given entity if the expense is definitely related to the oversight of that entity under all the facts and circumstances; a position that is consistent with an interpretation of prior versions of the stewardship allocation and apportionment regulations.

Apportionment

Stewardship expenses must be apportioned between the statutory and residual groupings using only the relative values in each grouping of the entity or entities to which the expenses relate as such amounts are or would be characterized for purposes of allocating and apportioning interest expense.

KPMG observation

Stewardship expenses are apportioned in a manner similar to interest expense, but without regard to the tax-exempt asset rules. Therefore, the relative value of assets in the statutory and residual groupings for purposes of the apportionment of stewardship expense will likely differ from the value in such groupings for purposes of the apportionment of interest expense. With respect to a stewardship expense incurred to oversee a directly owned CFC, the non-application of the exempt asset rules may cause more expense to be apportioned to section 951A category income because the full value of stock assigned to the section 951A category under Reg. § 1.861-13 remains in such category without reduction to take into account the section 250 deduction.

KPMG observation

The reference to apportionment based on the rules for interest expense fails to provide clear guidance as to the treatment of stewardship with respect to an affiliated group member, because interest expense of an affiliated group is allocated and apportioned as if the affiliated group were a single corporation pursuant to Reg. § 1.861-11. Under the asset method, the value of an asset is based on the average of its adjusted tax basis as of the beginning and ending of the tax year. In the case of a 10% owned corporation, additional adjustments are made under Reg. § 1.861-12 (e.g., adjustments for the E&P of the corporation). However, a 10% owned corporation does not include an affiliated group member. In the absence of specific guidance, the value of the stock in a consolidated group member appears to be based on the generally applicable basis rules under Reg. § 1.1502-32 because no modification was made to include an affiliated group member within the definition of 10%-owned corporation for purposes of apportionment of stewardship expense.

If stewardship is incurred to oversee a lower-tier entity, the expenses must be apportioned based on the relative values of the entity or entities that directly or indirectly own the lower-tier entity and that are directly owned by the entity that incurs the expense.

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KPMG observation

The rule for apportioning stewardship expenses incurred to oversee an indirectly owned entity may lead to curious results. For example, assume a U.S. parent corporation incurs stewardship expenses to oversee a CFC it indirectly owns through a U.S. subsidiary. The rules require the U.S. parent to apportion such expenses based on how the U.S. subsidiary's assets (inclusive of the CFC stock) are characterized for purposes of apportioning interest expense despite that U.S. parent's stewardship expenses would be allocated only to the gross income of the CFC. If the U.S. subsidiary owns assets used to generate U.S. source income, it appears that a portion of the stewardship expenses in respect of the CFC would be apportioned to the residual grouping (i.e., against U.S. source income) for purposes of section 904.

Alternatively, if the U.S. subsidiary incurs stewardship expenses with respect to its directly owned CFC, the subsidiary would apportion the expenses based solely on the value and characterization of the CFC stock. Similarly, if the U.S. parent corporation incurs stewardship expenses with respect to a lower-tier U.S. subsidiary held through a chain that includes CFCs, the stewardship expenses may be apportioned to, for instance, section 951A category income based, in part, on CFC stock owned through a different part of the chain even if the U.S. subsidiary for which the stewardship expenses were incurred has no CFCs of its own. These results appear to conflict with the rule that provides for a direct allocation of stewardship expenses to the class of gross income from a particular entity to the extent the expenses factually relate to the oversight of that entity.

Stewardship expenses incurred to oversee a partnership are apportioned based on the value and characterization of the partnership under the asset method in Reg. § 1.861-9. Stewardship expenses incurred to oversee a disregarded entity are apportioned based on the value and characterization of the disregarded entity under the principles of the Reg. § 1.861-9 asset method as if the disregarded entity were treated as a corporation for U.S. federal income tax purposes.

KPMG observation

The rules for apportioning stewardship expenses related to a disregarded entity do not appear to be based on the gross value of the disregarded entity's assets. Instead, the preamble to the 2020 Final Regulations suggests that apportionment rules are applied as if the disregarded entity were regarded as a corporation and based on the value and characterization of the deemed stock in the entity. Assuming that the deemed stock basis reflects either a hypothetical contribution of assets subject to liabilities each year, or alternatively reflects actual history of contributions to the disregarded entity, the deemed stock basis would generally be lower than asset basis by the amount of the disregarded entity's liabilities. This netting effect is consistent with the treatment of wholly-owned corporations (whether CFC stock measured under Reg. § 1.861-12 or affiliate stock measured—which as noted above appears to be required—under Reg. § 1.1502-32), but stands in contrast to the treatment of 10%-owned partnerships under Reg. § 1.861-9(e).

Applicability date

The changes to the allocation and apportionment of stewardship deductions made by the 2020 Final Regulations are applicable to tax years beginning after December 31, 2019.

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Litigation damages—2020 Final Regulations

The 2020 Final Regulations retain and clarify the new rules for allocating and apportioning damages, prejudgment interest, and settlement payments (collectively, "damages") that were introduced in the 2019 Proposed Regulations. Treasury determined that new rules were needed because, while such costs are often substantial, they were not specifically addressed in the prior rules for allocating legal and accounting fees. The new guidance provides three distinct rules to address claims relating to (i) sales, licenses, or leases of products or the provision of services, (ii) events incident to the production or sale of goods or services, and (iii) shareholder suits.

Claims relating to sales, licenses, or leases of products or the provision of services

While the 2019 Proposed Regulations referred to this first type of claim as a "product liability and similar or related claims," the 2020 Final Regulations revised that description to refer instead to claims "relating to sales, licenses, or leases of products or the provision of services." The preamble explains that the change is intended to clarify that the category is not limited to damages arising from product liability claims, and the regulations explicitly provide as an example that the rule may apply to patent infringement claims.

Expenses in this first category must be allocated to the class of gross income "of the type" produced by the specific sales or leases of the products or provision of services that gave rise to the claims for damages. Although the proposed rules did not include a rule for how to apportion this first category of expenses, the 2020 Final Regulations provide that the deductions are apportioned among the statutory and residual groupings based on the relative amounts of gross income in the relevant class in each grouping in the year in which the deductions are allowed.

KPMG observation

The 2020 Final Regulations allocate product liability expenses to the class of gross income "of the type" produced by the specific sales that gave rise to the liability. Although the specific sales may have been made in a prior year, the reference to "of a type" and the fact that the apportionment rule refers specifically to the gross income earned in the year the deduction accrued suggests that Treasury intended for taxpayers to determine whether the relevant class includes multiple groupings, such that apportionment is necessary, by reference to the groupings in which income from the current year sales is classified. An example (Example 15) reinforces this interpretation.

The example deals with damages paid in 2020 arising from harm a product caused to a customer in Country X in 2018. The taxpayer's sales in Country X resulted in foreign source gross income in both the general and foreign branch category in 2018 through 2020. Accordingly, the example concludes that the deductible settlement payment is definitely related and allocable to the class of gross income of the type produced by the specific sales of the product in Country X, such that U.S. sales are irrelevant. The example further concludes that, "because **in 2020** that class of gross income consists of both foreign source foreign branch category income and foreign source general category income, the settlement payment of $60x must be apportioned between gross income in the two categories in proportion to the relative amounts of gross income in each category in 2020" [emphasis added].

Thus, for example, if sales of Product A produce both foreign branch income and foreign general

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source income in the current year, a settlement payment in the current year relating to a liability arising from a sale of Product A that occurred before the enactment of the TCJA would be apportioned to foreign branch income and foreign general source income in the same proportion that the sale of Product A generates foreign branch category income and foreign general source income in the current year.

Claims arising from events incident to the production or sale of goods or services

The second rule applies to claims that arise from an event incident to the production or sale of products or the provision of services, such as an industrial accident. Payments for these types of claims are allocable to the class of gross income ordinarily produced by the assets that are involved in the event, and apportioned based on the relative values of the assets involved in the event or the assets that were used to produce or sell products or services in the relevant class in the year the deductions are allowed.

KPMG observation

Under the 2019 Proposed Regulations, it was unclear whether, in the allocation stage in respect of damages relating to a "process liability", the expense was to be considered narrowly related to gross income produced by the actual assets involved in the event (as suggested by the preamble) or, more broadly, to the gross income produced by all "assets used to produce the products or services" involved in the event.

Under the broader interpretation, in the case of an accident caused by a machine that is used to manufacture Product A for sale to customers in Country X, the expense would be allocated to the gross income produced by all the assets used to manufacture and sell Product A in Country X. The 2020 Final Regulations clarify that the expense is allocated only to gross income ordinarily produced by the specific assets involved in the event—in this example, the gross income from customers in Country X. However, with respect to the apportionment phase, the 2020 Final Regulations appear to give taxpayers the flexibility to apportion expenses among statutory and residual groupings based either on the value of the specific assets involved in the event or the value of all the assets used to produce the product ordinarily produced by the assets involved in the event.

Thus, if a machine is used to manufacture Product B for sale to customers in Country Y and in the United States, a litigation expense that arises by reason of such machine could be apportioned between foreign-source income and U.S-source income based either on the value of the machine or on the relative values of all assets used to manufacture and sell Product B.

Damages arising from shareholder suits

The third rule addresses investor lawsuits. As under the proposed regulations, damages and settlement payments arising from claims by investors for corporate negligence, fraud, or other malfeasance of the corporation (or its representatives) are allocable to all the gross income of the corporation and apportioned based on relative asset values (as determined under the asset method in Reg. §1.861-9) in the year the deductions are allowed. In finalizing this rule, Treasury rejected several comments requesting flexibility to take into account the location of the underlying events or the jurisdiction of the lawsuit, noting that a geographical limitation is inappropriate because investor lawsuits generally serve to compensate an investor for damages to the investment in the company as a whole.

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KPMG observation

The final regulations do not purport to cover the allocation and apportionment of all deductible damages. Moreover, the methodologies do not make sense for certain categories of claims, such as claims for damages by employees, because no "asset" would generally be involved in the event that gives rise to the liability. Accordingly, it appears that certain categories of claims will continue to be governed by the general allocation and apportionment rules of Reg. § 1.861-8.

Applicability date

The allocation and apportionment rules for litigation damages added by the 2020 Final Regulations apply to tax years that begin after December 31, 2019.

Allocation and apportionment of interest expense—2020 Final Regulations and 2020 Proposed Regulations

Interest equivalents, upstream partnership loans, and guaranteed payments—2020 Final Regulations

The 2020 Final Regulations finalize without change the rule in the 2019 Proposed Regulations applying the allocation and apportionment rules of Reg. §§1.861-9 and -9T(b) to an expense or loss substantially incurred in consideration of the time value of money pursuant to a transaction in which the taxpayer secures the use of funds for a period of time, i.e. an interest equivalent. Furthermore, under the 2020 Final Regulations, like the 2019 Proposed Regulations, guaranteed payments under section 707(c) are allocated and apportioned like interest expense, preventing a taxpayer from avoiding the consequences of the partnership loan rules discussed below by converting a partnership loan to an equity interest with a guaranteed payment. Treasury rejected comment suggestions that the regulations treat guaranteed payments like interest expense only in abusive cases.

The 2020 Final Regulations also finalize with only minor non-substantive changes the rules in the 2019 Proposed Regulations providing rules for upstream partnership loans similar to those previously provided for downstream partnership loans. The rules match a partner's distributive shares of interest income or interest expense in order to net the amounts against each other in order to prevent any overall impact on the partner's foreign tax credit capacity.

Applicability date

The foregoing rules contained in the 2020 Final Regulations with respect to the allocation and apportionment of interest expense apply to tax years ending on or after December 16, 2019.

Capitalized interest—2020 Final Regulations

Section 864(e) generally provides that all allocations and apportionments of a taxpayer's interest expense must be made on the basis of assets (the "Asset Method"). Under the Asset Method, the taxpayer apportions its interest expense among the various statutory groupings and the residual grouping based on the average adjusted U.S. tax bases of the assets within each group for the tax year. Reg. § 1.861-12T(f) provided that if debt proceeds are used to acquire or produce an asset (i.e., acquisition indebtedness) and interest on the debt is required to be capitalized, deferred, or disallowed under a

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provision of the Code by reason of this fact, the value of the asset for interest allocation and apportionment purposes is reduced by the principal amount of such indebtedness. The 2019 Proposed Regulations proposed to finalize this rule with additional language (described as a clarification) to the effect that the rule only applies where capitalization is a result of debt proceeds being used acquire or produce the asset, and added examples, including an example to illustrate that a taxpayer could not affirmatively use the interest disallowance rule of section 163(l) to cause a reduction in the basis of its CFC stock for purposes of the Asset Method. The 2020 Final Regulations adopt this portion of the 2019 Proposed Regulations without change.

Applicability date

The new capitalized interest expense apportionment rule applies to tax years that end on or after December 16, 2019.

Election to capitalize certain expenditures for purposes of the Asset Method–2020 Proposed Regulations

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. This rule is proposed to apply to tax years beginning on or after the rule is finalized.

KPMG observation

It is not clear why the 2020 Proposed Regulations would limit the capitalization election to application for purposes of only of apportioning interest expense, given that other expenses (particularly litigation-related expenses and stewardship expenses) are also allocated and apportioned on the basis of tax book value.

Applicability date

The 2020 Proposed Regulation relating to the capitalization of certain expenditures for purposes of applying the Asset Method is proposed to apply to tax years beginning on or after the date final regulations are filed with the Federal Register.

Interest netting—2020 Proposed Regulations

Under current CFC netting rules, if a U.S. shareholder makes capital contributions to a CFC which then lends to other CFCs owned by the U.S. shareholder, such CFC-to-CFC loans may be treated as related group indebtedness. While no interest expense is generally allocated to income inclusions from the lender CFC, the debt may nevertheless increase the amount of allocable related group indebtedness for which a reduction in assets is required under Reg. § 1.861-10(e)(7). The 2020 Proposed Regulations would revise current Reg. § 1.861-10(e)(8)(v) to provide that CFC-to-CFC loans would not be treated as related group indebtedness for purposes of applying the CFC netting rules, and thus would no longer

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result in a reduction in assets under Reg. § 1.861-10(e)(7).

KPMG observation

The 2019 Final Regulations contained a similar revision to Reg. § 1.861-10(e)(8)(vi) which provided that related party hybrid debt would not be treated as related group indebtedness for purposes of applying the CFC netting rules. In both situations (i.e., CFC-to-CFC loans and related party hybrid debt), the government appears to be targeting a perceived incentive to affirmatively cause the CFC netting rules to apply in order to reduce certain assets as required under Reg. § 1.861-10(e)(7), while avoiding direct allocation of interest expense under Reg. § 1.861-10(e)(4).

Applicability date

This change to the interest netting rules issued in the 2020 Proposed Regulations are proposed to apply to tax years ending on or after November 2, 2020.

Foreign banking branches—2020 Proposed Regulations

The 2020 Proposed Regulations provide for a new rule that would allow a "direct" allocation and apportionment of foreign banking branch interest expense of a foreign banking branch to income of the foreign banking branch (to the extent thereof). The value of the assets of the foreign banking branch are adjusted downward (but not below zero) for purposes of allocating and apportioning non-directly allocated and apportioned interest expense by the amount of the foreign banking branch's liabilities the interest expense of which was directly allocated and apportioned. In adopting this rule, the government explicitly stopped short of providing an exception to the rule that disregarded interest payments have no impact for purposes of the amount of income allocated to the section 904 foreign branch category, although the preamble does request further comments on the issue.

KPMG observation

The direct allocation of foreign banking branch liabilities and associated interest expense against branch assets should generally reflect a better matching of interest rates and spreads than would result from global allocations.

KPMG observation

It is curious that the preamble explains neither why this rule is limited to banks nor why it is limited to true branches of a bank but not disregarded entities. One is left to infer that the government is concerned that the rule could otherwise be manipulable and that the existence of regulatory constraints on where a bank books its liabilities may help limit such manipulation in the context where this rule is allowed to apply.

Applicability date

The rule allowing for direct allocation and apportionment of foreign banking branch interest expense is proposed to be applicable to tax years beginning on or after the date final regulations are filed with the Federal Register.

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Allocation and apportionment of certain other expenses

Section 904(b)(4) and NOLs—2020 Final Regulations

The 2020 Final Regulations clarify that for purposes of applying section 904(b)(4) and the section 861 regulations to the deductions of a U.S. shareholder, the only gross income included in a section 245A subgroup is dividend income for which a section 245A deduction is allowed. This rule applies to tax years beginning after December 31, 2017.

The 2020 Final Regulations also provide that for purposes of a given operative section, an NOL is divided into component parts based on the amounts of the deductions that are assigned to the relevant statutory and residual groupings and that are not absorbed in the tax year in which the loss is incurred under the rules of that operative section.

In order to implement the foregoing rule where section 904 is the operative section, the 2020 Final Regulations provide that for purposes of determining the source and separate category of an NOL, the SLL, OFL, and ODL rules are applied without taking into account section 904(b). This rule applies to tax years ending on or after December 16, 2019.

Applicability date

Except as provided above, the rules pertaining to the allocation and apportionment of NOLs apply to tax years that begin after December 31, 2019.

Controlled service transactions—2020 Proposed Regulations

The 2020 Proposed Regulations propose minor changes to the rule in Reg. § 1.861-8(e)(4) concerning the allocation of deductions to amounts paid or allocated with respect to controlled services transactions for clarity and to reflect the fact that such transactions may be between entities that are not corporations.

Applicability date

The changes to the controlled services definition are proposed to apply to tax years ending on or after November 2, 2020.

Insurance companies and the exempt income and asset rules—2020 Final Regulations

The 2020 Final Regulations finalize guidance contained in the 2019 Proposed Regulations related to the application of the exempt income and asset rules to certain dividends and tax-exempt interest received by 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); similarly, an asset that gave rise to exempt income was an exempt asset without regard to the proration rules. In finalizing these rules, Treasury rejected a comment asserting that an adjustment should be allowed to the amount of exempt income for insurance companies. Minor modifications were made to make clear that the amount of stock treated as exempt is based on the DRDs with respect to dividends that the stock generates, has generated, or can reasonably be expected to generate.

Read a separate KPMG report on the provisions of the 2020 Final Regulations and 2020 Proposed Regulations that specifically focus on insurance companies: **KPMG report: Treasury responds to**

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insurance comments in proposed and final regulations on foreign tax credit [PDF 113.6 KB].

Applicability date

The rules above related to insurance companies contained in the 2020 Final Regulations apply to tax years beginning after December 31, 2019.

Insurance companies and section 818(f) expenses—2020 Proposed Regulations

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.

Applicability date

The section 818(f) expenses rule is proposed to apply to tax years beginning on or after the date final regulations are filed with the Federal Register.

Affiliated group apportionment—2020 Final Regulations

The 2020 Final Regulations finalize the rules in the 2019 Proposed Regulations concerning the allocation and apportionment of expenses of an affiliated group that are not directly allocable to specific income-producing activities or property solely of the member of the affiliated group that incurred the expense. The 2020 Final Regulations deviate from the 2019 Proposed Regulations in excluding stewardship expenses from the application of Reg. § 1.861-14, as discussed in more detail above. They also provide that although the section 250 deduction is generally allocated and apportioned on a separate entity basis, a section 250 deduction of a consolidated group is allocated and apportioned as if all members of the consolidated group are treated as a single corporation.

Applicability date

The rules related to the apportionment of certain deductions of affiliated group members apply to tax years beginning after December 31, 2019.

Allocation and apportionment of foreign income taxes—2020 Final Regulations and 2020 Proposed Regulations

Consistent with the 2019 Proposed Regulations, the rules for allocating and apportioning foreign taxes were finalized in new Reg. § 1.861-20 and apply for a number of operative sections, including the allocation of creditable foreign tax expenditures under section 704, the allocation and apportionment of foreign income taxes among the foreign tax credit categories under section 904, and the deemed paid foreign tax credit with respect to subpart F and GILTI inclusions (or distributions of related PTEP) under

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section 960. Reg. § 1.904-6 contains additional guidance on the allocation and apportionment of foreign income taxes where section 904 is the relevant operative section and is discussed below after discussion of the general rules contained in Reg. § 1.861-20.

Significantly, the 2020 Final Regulations do not adopt the rules contained in the 2019 Proposed Regulations regarding the allocation and apportionment of foreign tax on "disregarded payments" (defined below and referred to herein as "DRPs"). Instead, these rules are re-proposed in the 2020 Proposed Regulations. In this regard, the 2020 Proposed Regulations would supplement the framework laid out in Reg. § 1.861-20 by providing rules to allocate and apportion foreign gross income (and thereby, foreign income taxes) that arises on account of a DRP.

KPMG observation

A major theme of the 2020 Final Regulations and the 2020 Proposed Regulations is a reduction of the amount of foreign taxes that are assigned to the residual category. These changes reduce the likelihood that foreign taxes will be non-creditable when section 960 is the operative section. In contrast, the 2019 Proposed Regulations would have generally assigned foreign gross income (that is, the gross income that the relevant foreign jurisdiction is taxing) arising from a DRP from a foreign branch owner to a foreign branch to the residual grouping, rendering the associated taxes ineligible to be deemed paid under section 960(a) or (d).

Framework for the allocation and apportionment of foreign income taxes under the 2020 Final Regulations

The 2020 Final Regulations generally finalize the framework contained in the 2019 Proposed Regulations and maintain the three-step process for allocating and apportioning foreign income taxes:

- First, items of foreign gross income are assigned to the relevant statutory or residual groupings;
- Second, deductions allowed under foreign law are allocated and apportioned using the relevant rules or principles under foreign law or, if there are none, U.S. expense allocation and apportionment principles; and
- Third, the foreign income tax is allocated to the groupings to which the foreign gross income was assigned and, if necessary, apportioned ratably among the statutory and residual groupings in proportion to the foreign taxable income in each.

Step 1: Assigning foreign gross income to statutory and residual groupings—2020 Final Regulations

The first step requires identifying the items of foreign gross income included in the foreign tax base under foreign law and applying U.S. federal income tax principles to assign the foreign gross income to statutory or residual groupings based on the relevant operative Code section (e.g., section 904(d) for purposes of allocating and apportioning income and deductions to FTC separate limitation categories). 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.

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Consistent with the 2019 Proposed Regulations, the 2020 Final Regulations replace the generally principle-based standard of prior law with more mechanical rules for assigning foreign gross income to groupings. Specifically, the 2020 Final Regulations provide a series of general rules that apply to assign foreign gross income to a grouping. These include rules for identifying a foreign gross income item with a “corresponding U.S. item," a definition narrowing the exclusive list of “base differences,” and special rules for circumstances where a foreign income item has no corresponding U.S. item, including because the recognition event occurs in different U.S. and foreign tax years. In addition, the 2020 Final Regulations contain special rules that apply to specific types of foreign gross income (and which have priority over the general rules where applicable). The 2020 Proposed Regulations would expand upon the 2020 Final Regulations by providing additional special rules in respect of certain other items of foreign gross income, including foreign gross income arising with respect to a DRP.

Corresponding U.S. item

Generally, if an item of foreign gross income is included in the foreign taxable income on which a foreign income tax is imposed and the taxpayer also realizes, recognizes or takes into account a “corresponding U.S. item,” the taxpayer assigns the foreign gross income to the same grouping as the corresponding U.S. item. If the corresponding U.S. item is a loss (or zero), the foreign gross income is assigned to the same grouping that a hypothetical gain would be assigned if recognized for U.S. federal income tax purposes. A “corresponding U.S. item” is generally defined as the item of U.S. gross income recognized for U.S. federal income tax purposes 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, even if the item of foreign gross income and corresponding U.S. item are different amounts. A “corresponding U.S. item” also exists if the U.S. and foreign tax years end on different dates and the transaction giving rise to both the U.S gross income and foreign gross income occurs in the last U.S. tax year ending before the foreign tax year.

No corresponding U.S. item—U.S. nonrecognition events and “timing differences”

If there is no corresponding U.S. item or if an item of foreign gross income arises from a transaction that is treated as a nonrecognition event for U.S. tax purposes (for example, in cases generally referred to as “timing differences” under prior Reg. § 1.904-6(a)(1)(iv)), the foreign gross income is assigned to a grouping based on a hypothetical determination of how the U.S. gross income would have been assigned had it been recognized in the U.S. tax year in which the foreign tax was paid or accrued.

KPMG observation

The 2020 Final Regulations somewhat simplify the process of characterizing taxes for corporations with mismatched U.S. and foreign tax years (e.g., CFCs with November 30 year ends) by expanding the definition of corresponding U.S. item in such cases to include an item of gross income recognized in the immediately preceding U.S. tax year where the event giving rise to the foreign gross income occurs in such preceding 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 in the year the foreign income tax is paid or accrued.

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Foreign gross income arising from foreign law distributions or foreign law dispositions without a corresponding U.S. Item

The 2020 Final Regulations include specific rules implementing this timing principle in respect of "foreign law distributions" and "foreign law dispositions" (both terms referring to distributions or dispositions under foreign tax law that are not also so treated for U.S. federal income tax purposes).

Foreign gain or loss recognized as a result of a foreign law distribution or a foreign law disposition may not have a corresponding U.S. item because the transaction may be treated differently for foreign law purposes than for U.S. tax purposes (i.e., treated as a distribution or disposition for foreign law purposes but not for U.S. federal income tax purposes) or because the recognition transaction occurs in a different U.S. tax year. Generally, in the case of a foreign law distribution or a foreign law disposition, foreign gross income is assigned to the same grouping as a hypothetical gross income item would be assigned if it were recognized for U.S. federal income tax purposes on the date of the distribution or in the U.S. tax year in which the taxpayer paid or accrued the foreign income tax with respect to the foreign law distribution or disposition.

If a corporate distribution is treated as a distribution for foreign law purposes, but not for U.S. federal income tax purposes (a "foreign law distribution"), foreign gross income is assigned to the same groupings that a distribution would be assigned if recognized for U.S. federal income tax purposes on the same date as the foreign law distribution in accordance with the special rule for such distributions described below.

For a foreign law disposition of property, the hypothetical U.S. gain or loss is determined for U.S. tax purposes as if the property were disposed of in a taxable exchange for an amount equal to the gross receipts or other value used to calculate the foreign gross income under foreign law.

Foreign gross income excluded from U.S. gross income and base differences

The 2020 Final Regulations contain an exclusive list of base differences, consistent with the 2019 Proposed Regulations. The 2020 Final Regulations also finalized the narrow rule providing that foreign gross income that is of a type recognized by the U.S. but that is excluded from U.S. gross income (and is also not a base difference) is assigned to the grouping to which the income would be assigned for U.S. federal income tax purposes if it were not so excluded. The application of this rule is generally limited and applies to items such as municipal bond interest.

In response to comments to the 2019 Proposed Regulations, the 2020 Final Regulations remove two items that had previously 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 (i.e., nontaxable returns of capital). Instead, these distributions are described in the preamble as more appropriately attributable to timing differences and foreign income taxes associated with such distributions are now apportioned to the relevant groupings based on how the related foreign gross income would be assigned under the rules for foreign law distributions described below. As a result, only five items now comprise the exclusive list of base differences: (i) capital contributions under section 118, (ii) money or other property received for the issuance of shares under section 1032, (iii) money or other property received in exchange for a partnership interest under section 721, (iv) death benefits, and (v) gifts and inheritances. Foreign gross income that is attributable to a base difference is assigned to the residual grouping.

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KPMG observation

In applying section 960 as an operative section for which Reg. § 1.861-20 applies to determine which foreign taxes may be deemed paid by a U.S. corporation in connection with a subpart F or GILTI inclusion, foreign income tax assigned to the residual grouping is never eligible to be deemed paid under section 960. As such, narrowing the list of base differences is taxpayer favorable at least where the technical taxpayer is a CFC.

KPMG observation

While it is clearly the case that return of basis distributions will often represent timing differences rather than base differences, as the preamble acknowledges, there are other situations where the opposite may be true. Presumably, although left unstated, the government views a facts and circumstances determination of base differences as unadministrable.

Special rules

The 2020 Final Regulations contain a set of special rules that assign foreign gross income from certain events or assets to particular statutory or residual groupings. As discussed further below, the 2020 Proposed Regulations would provide additional special rules for certain types of foreign gross income not explicitly provided for in the 2020 Final Regulations. When one of these special rules applies, it takes priority over the general rules discussed above.

Foreign gross income arising from a corporate distribution

The 2020 Final Regulations add rules for assigning foreign gross income related to distributions with respect to corporate stock (rules for assigning foreign gross income related to dispositions of corporate stock and partnership interests are contained in the 2020 Proposed Regulations and discussed below).

If a distribution is treated as a distribution of property for both foreign law and U.S. federal income tax purposes, the foreign gross income arising from the distribution is assigned based on amounts that are essentially treated as corresponding U.S. items and generally based on the U.S. dividend ordering rules.

First, the taxpayer must determine the "foreign dividend amount," defined as the amount of the distribution that is treated as a dividend under foreign law. The foreign dividend amount is assigned to the same grouping as the "U.S. dividend amount" up to the amount of the U.S. dividend amount. The U.S. dividend amount is defined as the portion of a distribution that is made of out E&P under U.S. federal income tax law, including distributions of PTEP and amounts included in gross income as a deemed dividend under the rules for dispositions of foreign corporation stock provided by sections 1248 and 964(e).

Any excess of the foreign dividend amount over the U.S. dividend amount is then assigned to the same grouping that a distribution equal to any "U.S. return of capital amount" would be assigned if it were recognized for U.S. federal income tax purposes. For this purpose, U.S. return of capital amount is defined as the portion of a distribution that would be treated as a return of capital under section 301(c)(2). These earnings are deemed to arise in groupings in the same proportion that the tax book value of stock of the distributing corporation would be assigned under the asset method in Reg. § 1.861-9 for allocating and apportioning interest expense.

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Any remaining excess of the foreign dividend amount over the sum of the U.S. dividend amount and U.S. return of capital amount is assigned to the same grouping as the "U.S. capital gain amount," defined as the portion of the distribution treated as capital gain under section 301(c)(3).

A similar, but reversed, allocation rule applies to the "foreign capital gain amount". The foreign capital gain amount is assigned first to the same groupings as the U.S. capital gain amount, to the extent thereof; second to the same groupings as any U.S. return of capital amount; and finally any excess ratably to the same groupings to which the U.S. dividend amount is assigned.

As noted above, where a foreign law distribution does not have a corresponding U.S. item, foreign gross income in respect of such distribution is assigned to a grouping based on these rules by treating such distribution as if it resulted in U.S. gross income on the same date as the foreign law distribution.

Foreign gross income arising from the sale of a disregarded entity

The 2020 Final Regulations also provide a rule for assigning foreign gross income arising from the sale of a disregarded entity that is treated as a sale of stock for foreign law purposes but a sale of assets for U.S. federal income tax purposes. In such a case, the 2020 Final Regulations assign the foreign gross income proportionately to the same grouping or groupings that foreign gross income would be assigned if the transaction were treated as a disposition of assets under foreign law.

Foreign gross income arising from income of a reverse hybrid

A new rule in the 2020 Final Regulations provides guidance on assigning foreign gross income arising on account of a direct or indirect interest in a reverse hybrid that, for foreign law purposes, would be treated as income from a pass-through entity. Such income is assigned by treating the foreign gross income as foreign gross income of the reverse hybrid and applying the general rules for allocating and apportioning foreign gross income as if the reverse hybrid were the taxpayer. Reg. § 1.904-6 provides additional guidance on reverse hybrids where section 904 is the operative section (discussed below).

Foreign gross income arising under a foreign law inclusion regime

The 2020 Final Regulations also provide similar rules for assigning foreign gross income that a taxpayer includes in income in its capacity as a shareholder of a foreign law CFC under a foreign law inclusion regime (e.g., foreign tax laws similar to those that apply to subpart F income inclusions under U.S. tax law). These rules assign the foreign gross income based on how the foreign law CFC's foreign gross income giving rise to the foreign law inclusion would be assigned if the foreign law CFC were the taxpayer.

The 2020 Proposed Regulations also contain additional special rules for assigning foreign gross income to groupings and are discussed below.

Step 2: Allocating and apportioning foreign law deductions to foreign gross income

Once items of foreign gross income are assigned to the various groupings, the deductions allowed under foreign law must be allocated and apportioned among the foreign gross income in order to arrive at foreign taxable income in each grouping. If foreign law specifically allocates deductions to items of foreign gross income, the allocation follows foreign law. To the extent that foreign law does not specifically allocate deductions to foreign income groupings, the deductions are allocated and apportioned under the principles of the applicable foreign law or, in the absence of foreign law providing rules for the allocation and apportionment of deductions, pursuant to principles of the section 861

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regulations. For this purpose, the apportionment of expenses may be made on a separate company basis. A taxpayer's application of the principles of the section 861 regulations for foreign tax credit purposes must be consistent with the taxpayer's application of the principles for determining the income and E&P of the entity, branch, or CFC in question. Reg. § 1.904-6 again provides additional guidance on the allocation and apportionment of foreign law deductions where section 904 is the operative section.

Step 3: Allocating and apportioning foreign income taxes

Finally, foreign income tax is allocated to the statutory or residual groupings to which the items of foreign gross income are assigned. If an item of foreign gross income is assigned to more than one grouping, then the associated foreign taxes are apportioned between or among the groupings based upon the relative amount of foreign taxable income in each grouping. No foreign taxes are allocated or apportioned to any foreign income that is exempt from foreign tax or to any grouping that is reduced to or below zero by foreign tax deductions. Foreign withholding taxes are allocated and apportioned to the foreign gross income from which the tax is withheld. Finally, if any items of income are subject to a special rate of tax under foreign law, including any treaty, the allocation of taxes must take into account such treatment.

Applicability date

The 2020 Final Regulations related to the allocation and apportionment of foreign income taxes apply to tax years beginning after December 31, 2019.

Proposed special rules for the assignment of foreign gross income to statutory and residual groupings—2020 Proposed Regulations

The 2020 Proposed Regulations respond to taxpayer requests for additional guidance on the allocation and apportionment of foreign income tax by providing additional special rules that apply for assigning foreign gross income to a grouping. These rules pertain to, dispositions of stock and partnership interests, distributions with respect to a partnership interest, and DRPs (including foreign law transfers that are not treated as DRPs for U.S. federal income tax purposes in the U.S. tax year in which foreign income tax is paid or accrued).

The 2020 Proposed Regulations introduce several new defined terms that are used to implement these additional special rules.

For example, the 2020 Proposed Regulations introduce the concept of a "taxable unit" to address the uncertainty regarding whether the rules addressing DRPs in the 2019 Proposed Regulations applied when the disregarded entity was not a qualified business unit ("QBU") or did not have any assets. Instead of focusing on payments to or from a "foreign branch," the 2020 Proposed Regulations would provide instead that the allocation and apportionment rules apply to a broader range of DRPs 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" (as defined below in the discussion of proposed changes to the foreign branch category income). If the taxpayer is a foreign corporation, a taxable unit is a "tested unit," as defined in the proposed subpart F and GILTI high-tax exception regulations issued in July of 2020 (REG-127732-19, 85 FR 44650).

Second, the 2019 Proposed Regulations defined "disregarded payment" by reference to the definition in the foreign branch regulations provided by Reg. § 1.904-4(f). To account for the application of the proposed disregarded payment rules to taxable units, the 2020 Proposed Regulations would instead provide a new, although generally similar, definition of "disregarded payment" (or, DRP). Under this new

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definition, disregarded payments would include the transfer of an amount of property (within the meaning of section 317(a)) to or from a taxable unit. These payments would include not just amounts that result in the reallocation of U.S. gross income from one taxable unit to another, but more broadly include any payment made in exchange for property or in satisfaction of an account payable, or a remittance or contribution, in connection with a transaction that is disregarded for U.S. federal income tax purposes and that is reflected on the taxable unit's separate set of books and records. A DRP would also include any other amount that is reflected on the taxable unit's separate set of books and records in connection with a transaction that is disregarded for U.S. federal income tax purposes and that would constitute an item of accrued income, gain, deduction, or loss if the transaction to which the amount is attributable were regarded for U.S. federal income tax purposes.

KPMG observation

Under section 317(a), "property" is defined broadly to include an amount of money, securities, and any other property other than stock of a distributing corporation. Outside of the definition of DRP, the definition of property contained in section 317 is generally used in the context of sections 301, 302 and 304 that prescribe the U.S. federal income tax consequences of amounts paid by, or distributed by, a corporation in exchange for, or in respect of, its stock. However, the DRP rules apply to disregarded contributions as well as distributions, making it is unclear how the reference to stock of "a distributing corporation" in section 317(a) should be interpreted. For example, if Corp X owns DEY, we are not told whether the exception to the DRP rule is for transactions involving stock of Corp X or of DEY.

Dispositions of stock

The 2020 Proposed Regulations would provide a special rule for assigning foreign gross income to groupings with respect to a transaction treated as a sale, exchange, or other disposition of stock for U.S. federal income tax purposes similar to the rule provided in the 2020 Final Regulations with respect to distributions on stock. First, the foreign gross income would be assigned to the groupings to which any U.S. dividend amount (i.e., gain recharacterized as a dividend under section 1248(a) or 964(e)) is assigned. Second, any foreign gross income that exceeds the U.S. dividend amount would be assigned to the grouping to which the U.S. capital gain amount is assigned. For this purpose, the U.S. capital gain amount includes the amount of any distribution that would be treated as gain under section 301(c)(3)(A). Lastly, the deemed basis recovery—the excess of the foreign gross income over the sum of the U.S. dividend amount and the U.S. capital gain amount—is assigned to groupings based on the proportions in which the tax book value of the stock of the transferred corporation is assigned under the asset method in Reg. § 1.861-9 in the tax year in which the disposition occurs.

KPMG observation

The assignment of foreign gross income (and related foreign income taxes) to the same statutory or residual groupings as the U.S. capital gain amount may result in a mismatch of groupings to which foreign income taxes and foreign gross income are assigned. For instance, consider USP owning a CFC with E&P entirely consisting of $100 in a section 951(a)(1)(A) PTEP group within the general category. For U.S. tax purposes, USP's only basis in its CFC stock is section 961(a) basis of $100 from subpart F inclusions that gave rise to the PTEP. For foreign law purposes, USP has zero basis in its CFC stock. If USP sells the stock of CFC for $100, USP would recognize no gain for U.S. federal income tax purposes but $100 of gain for foreign law purposes and subject to foreign

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income tax. Under the 2020 Proposed Regulations, there is no U.S. dividend amount or U.S. capital gain amount, so the $100 foreign gross income is assigned to the same grouping as a hypothetical U.S. return of capital amount based on a deemed recognition of CFC's earnings for U.S. tax purposes. Although the CFC's earnings consist entirely of PTEP, the 2020 Proposed Regulations would deem the CFC's earnings as arising in the same groupings as the tax book value of the CFC stock would be assigned under the asset method in Reg. § 1.861-9. Therefore, foreign gross income (and related foreign income taxes) would potentially be assigned to statutory and residual groupings other than the section 951(a)(1)(A) PTEP group within the general category (i.e., the category to which a distribution of the PTEP would be assigned).

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 grouping to which the U.S. capital gain amount is assigned. For this purpose, the 2020 Proposed Regulations define a U.S. capital gain amount, in relevant part, to include gain recognized on the sale, exchange, or other disposition of an interest in a partnership, or the portion of a partnership distribution that exceeds the partner's outside basis in the partnership under section 731(a). Any excess of the foreign gross income amount over the U.S. capital gain amount is assigned to the groupings 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 for purposes of apportioning the partner's interest expense under Reg. § 1.861-9(e).

Disregarded payments

The 2019 Proposed Regulations provided specific rules to assign foreign gross income that a taxpayer includes on account of a DRP to a grouping. In response to comments criticizing the assignment of foreign branch owner to branch payments to the residual category, Treasury reserved on these rules in the 2020 Final Regulations and re-proposed revised rules to allow taxpayers additional time for comment. The DRP rules in the 2020 Proposed Regulations would provide rules for assigning foreign gross income that arises from a DRP that results in a reattribution of U.S. gross income from one taxable unit to another (such reattributed amount, a "reattribution amount") pursuant to the disregarded reattribution transaction rules contained in the foreign branch regulations finalized in 2019 (the "Foreign Branch DRT Rules") or the disregarded payment rules provided by the 2020 proposed GILTI and subpart F high-tax exception regulations (the "Proposed HTE DRP Rules"), as applicable. In addition, these regulations would provide additional rules for the assignment of foreign gross income that arises from DRPs that do not result in the reallocation of U.S. gross income, which are generally classified as either contributions or remittances. For this purpose, the 2020 Proposed Regulations introduce several defined terms that generally incorporate the principles of similar terms used in the Foreign Branch DRT Rules and the Proposed HTE DRP Rules but differ slightly to account for their application to the broader class of taxable units.

KPMG observation

These rules apply to assign the foreign gross income arising from a DRP to a grouping. After all foreign gross income has been assigned to a grouping, the general rules contained in the 2020

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> Final Regulations for reducing foreign gross income by applicable deductions allowed under foreign law would apply to determine foreign taxable income and foreign income taxes would then be apportioned among groupings based on the proportionate amount of foreign taxable income in each grouping in accordance with the 2020 Final Regulations.

Reattribution payments

The 2020 Proposed Regulations would provide that the sum of all reattribution amounts attributed to the recipient of a DRP on account of that DRP is a "reattribution payment."

Whether all or any portion of a DRP constitutes a reattribution amount depends on the application of the Foreign Branch DRT Rules or the Proposed HTE DRT Rules, as relevant. The Foreign Branch DRT Rules generally treat U.S. gross income as attributable to a foreign branch or a foreign branch owner based on the foreign branch's or the foreign branch owner's separate books and records, as modified to reflect U.S. federal income tax principles. In order to accurately reflect gross income attributable to a foreign branch or a foreign branch owner, the Foreign Branch DRT Rules generally provide that gross income attributable to a foreign branch must be adjusted for DRPs between a foreign branch and its owner or between foreign branches owned by the same owner (i.e., reattributed from the payor to the payee) if the payment would be deductible or capitalized if it were regarded for U.S. federal income tax purposes, subject to exceptions for certain payments including interest. These rules also have application where property is transferred in a disregarded transaction. Similarly, the Proposed HTE DRP Rules generally adopt the principles of the foreign branch DRP rules (with some modifications (including that interest is a DRP for this purpose to the extent deductible under the law of the relevant foreign jurisdiction)) and apply those principles to attribute and, if necessary, reattribute, U.S. gross income to "tested units" of a CFC for purposes of the subpart F and GILTI high-tax exceptions. Importantly, both sets of rules provide that the underlying source and character of the U.S. gross income that is attributed to a recipient taxable unit remains unchanged despite reattribution (e.g., U.S. gross income earned by a payor taxable unit that is tested income remains tested income in the hands of the recipient taxable unit irrespective of the type of DRP that results in the reattribution of this income).

The 2020 Proposed Regulations would clarify that the amount of a DRP that is a reattribution payment is limited to the payor taxable unit's U.S. gross income.

In connection with a DRP that consists in whole or in part of a reattribution payment, once the statutory and residual groupings of such payment have been determined pursuant to the Foreign Branch DRT Rules or the Proposed HTE DRP Rules, as applicable, the 2020 Proposed Regulations would assign foreign gross income arising from such DRP to the same statutory or residual groupings to which the reattribution amount (or amounts) that make up the reattribution payment are assigned when received by the taxable unit. Each item of U.S. gross income remaining with a taxable unit after taking into account all reattribution payments made and received by the unit is referred to as an "attribution item."

The rules would provide that no foreign gross income of a payor taxable unit is treated as foreign gross income of a payee taxable unit on account of a DRP (i.e., foreign gross income of a payor taxable unit is assigned to groupings of the payor taxable unit without regard to any reattribution payments it makes).

> ## KPMG observation
>
> Under this rule, even if a foreign jurisdiction taxes a payor taxable unit on foreign gross income that is related to U.S. gross income that is reattributed to a payee taxable unit, the foreign income tax

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remains assigned to groupings of the payor taxable unit. Because foreign gross income of the payor is reduced by foreign law deductions (including those relating to DRPs), this rule generally produces appropriate results. However, where the amount deductible under foreign law differs from the amount of the reattribution payments, this rule can result in a foreign tax being allocated and apportioned to the payor taxable unit even if no U.S. gross income remains at the payor unit as a result of reattribution payments.

KPMG observation

In the case of a gross basis withholding tax, this rule can lead to a mismatch between the foreign taxes and related U.S. gross income. For example, if a taxable unit (TU1) receives a $100 payment from an unrelated third party that is subject to a 10% net basis withholding tax, and also makes a $100 payment to another taxable unit (TU2), TU1 will have no foreign gross income (and no net foreign income tax) assuming that the $100 payment to TU2 is deductible in TU1's country of organization. Although the $100 of U.S. gross income from the disregarded payment to TU2 would be reattributed to TU2, the foreign gross income that gave rise to the disregarded payment (i.e., the $100 unrelated party payment to TU1) would not also be reattributed to USP. Therefore, a mismatch arises because the reattribution payment does not move TU1's foreign gross income and TU1 is left with a gross basis withholding tax but no foreign gross income.

A similar result may obtain for disregarded sales or transfers of property. The Foreign Branch DRT Rules require (and the Proposed HTE DRP Rules incorporate) adjustments to gross income attributable to a foreign branch or a foreign branch owner (or tested unit, as applicable) for disregarded payments made in exchange for property that the recipient later disposes of in a regarded sale or exchange. In such case, a portion of the U.S. gross income from the regarded sale may be reattributed from the taxable unit that is the seller in the regarded transaction to the taxable unit that is the seller in the initial disregarded transaction, and no reattribution is made at the time of the initial transfer.

The 2020 Proposed Regulations would clarify that if a taxpayer receives property in exchange for a DRP, any foreign gross income attributable to the exchange would be assigned to the selling taxable unit's statutory or residual groupings under the general rules in the 2020 Final Regulations that apply when there is no corresponding U.S. item. The 2020 Proposed Regulations also would provide that, if the payor of the DRP in the initial disregarded transaction subsequently disposes of the property in a regarded transaction, and recognizes U.S. gross income as a result, the foreign gross income attributable to the regarded sale would be assigned to the selling taxable unit's statutory or residual groupings without regard to any reattribution of U.S. gross income as a result of the initial DRP. The preamble provides that ignoring the reattribution of U.S. gross income from the initial disregarded payment is appropriate with respect to the regarded disposition because it is assumed that the subsequent seller's basis in the property reflects the initial purchase price for foreign law purposes.

KPMG observation

In certain cases, this may result in the reattribution of U.S. gross income to a statutory or residual grouping while the related foreign income taxes are assigned to a different grouping. For example, if USP sells non-depreciable, non-inventory Asset A (with zero basis) used in its active trade or business to its foreign disregarded entity (FDE) for $500 in Year 1, and FDE subsequently sells Asset A to an unrelated third party in Year 2 for $500, $500 of U.S. gross income initially attributable to income of FDE in the foreign branch category would be reattributed to USP as

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general category income under the Foreign Branch DRT Rules for purposes of section 904.

Assuming that FDE's country of residence imposes $100 of foreign income tax on the $500 of foreign gross income attributable to the Year 2 regarded sale of Asset A, the 2020 Proposed Regulations would assign the $500 of foreign gross income and the related $100 of foreign income taxes to the same grouping as the corresponding U.S. item ($500 in the foreign branch category), without regard to the reattribution of gain under the Foreign Branch DRT Rules. Consequently, the foreign income taxes would not end up in the same category as (and would not be available as a credit with respect to) the reattributed income.

This result would be extended to cover multiple disregarded payments. The 2020 Proposed Regulations provide that if a taxable unit that receives a disregarded payment (the "recipient taxable unit") also makes a disregarded payment to another taxable unit, its U.S. gross income from the reattribution amount received may no longer be an attribution item of the recipient taxable unit (due to the recipient taxable unit's disregarded payment to another taxable unit and the resulting reattribution of the item of U.S. gross income away from the recipient taxable unit). In these circumstances, the 2020 Proposed Regulations similarly would provide that foreign gross income related to the reattribution amount received by the recipient taxable unit is still assigned to the same statutory or residual grouping as the item of U.S. gross income attributed to the recipient taxable unit by reason of the receipt of the gross reattribution amount, regardless of whether the recipient taxable unit still has the corresponding attribution item.

Finally, if the amount of foreign gross income related to a reattribution payment differs from the amount of the reattribution payment, and the reattribution payment includes multiple reattribution amounts that have been assigned to multiple groupings, the proposed rules would assign foreign gross income to those same groupings on a pro rata basis. For example, if Foreign Branch 1 (FB1) earns $800 of U.S. gross income and makes a $1,000 disregarded payment to Foreign Branch 2 (FB2) that results in $800 of U.S. gross income being reattributed from FB1 to FB2 (i.e., the portion of the disregarded payment that is a reattribution payment) as $600 of foreign branch category income and $200 of passive category income (each a reattribution amount), and foreign gross income included by reason the reattribution payment is $1,200, $900 of the foreign gross income would be assigned to the foreign branch category and $300 of the foreign gross income would be assigned to the passive category.

Remittances and contributions

The 2020 proposed regulations introduce broad definitions of "remittance" and "contribution" to assign to a grouping foreign gross income arising from a DRP that does not result in a reallocation of U.S. gross income under the foreign branch DRT rules or the proposed HTE DRP rules. A remittance is generally defined as a transfer of section 317(a) property that would be treated as a distribution by a corporation to its shareholder if the taxable unit were treated as a corporation for U.S. federal income tax purposes, or the excess of a disregarded payment made by a taxable unit to another taxable unit over the portion of the disregarded payment that is a reattribution payment and not treated as a contribution. Similarly, a contribution is generally defined as a disregarded transfer of section 317(a) property that, if regarded for U.S. federal income tax purposes, would be treated as a contribution to capital under section 118 or a section 351 contribution if the recipient taxable unit were a corporation, or the excess of a disregarded payment made by a taxable unit to its taxable unit-owner over the portion of the disregarded payment that is a reattribution payment. Thus, any payment that would not be subject to reallocation under the applicable branch or HTE rules is included as either a contribution or remittance (e.g., in the context of the foreign branch DRT rules, this would include DRPs of interest).

Similar to the 2019 Proposed Regulations, the 2020 Proposed Regulations would assign foreign gross

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income that arises from a remittance to the same groupings out of which the remittance is made. For this purpose, a remittance is deemed to be made ratably out of the payor taxable unit's "accumulated after-tax income." Accumulated after-tax income is deemed to have arisen in statutory and residual groupings based on how the payor's assets would be assigned under the asset method in Reg. § 1.861-9 in the year in which the remittance is made. The payor's assets are determined under the rules for determining the character and source of a section 987 QBU owner's section 987 gain or loss under the section 987 regulations by treating the taxable unit as the section 987 QBU.

KPMG observation

Despite the reference to the payor taxable unit's "accumulated after-tax income," the determination of the groupings to which foreign gross income arising on account of a remittance is assigned depends entirely on the assets held by the taxable unit at the time of the remittance. If a remittance is made in connection with a taxable unit winding up its operations, its assets in the tax year in which the remittance is made may consist solely of cash or other liquid assets received in connection with the disposition of its operating assets and therefore may not reflect the character of the income earned by the taxable unit over the course of its operating history.

For section 987 purposes, a QBU owner uses the asset method under the interest expense allocation and apportionment regulations to determine the character and source of a section 987 gain or loss and only takes into account directly owned assets of each QBU (i.e., not including interests in other QBUs held by the QBU). However, for this limited purpose, the proposed rule specifically reiterates that stock owned by a taxable unit is treated as an asset of the taxable unit and provides that the taxable unit's assets also include the portion of the tax book value of a "reattribution asset" that is assigned to the taxable unit.

The 2020 Proposed Regulations generally define a reattribution asset as an asset that produces one or more items of U.S. gross income to which a disregarded payment is allocated when applying the foreign branch DRT rules or the proposed HTE rules. If the payor taxable unit has no assets, foreign gross income attributable to the remittance is assigned to the residual grouping.

The portion of the tax book value of a reattribution asset that is assigned to the taxable unit that receives a disregarded payment is generally based on the percentage of total gross income produced by the reattribution asset that is reattributed to the recipient taxable unit as a result of the disregarded payment (i.e., a reattribution percentage). The portion of the tax book value of the reattribution asset that is reassigned generally is determined as the total tax book value of the reattribution asset multiplied by the reattribution percentage. The 2020 Proposed Regulations also provide that the reassigned portion of the tax book value of the reattribution asset would not be treated as an asset of the payor taxable unit.

KPMG observation

Although the 2020 Proposed Regulations deem a remitting taxable unit to include stock it holds as an asset of the taxable unit, the regulations would not provide that an interest in or the assets of lower-tier taxable unit, such as a DRE, legally owned by a remitting taxable unit are treated as an asset of the latter unit. Furthermore, because remittances do not result in the reallocation of gross income from the payor to the recipient under either the foreign branch DRT rules or the proposed HTE DRP rules, no amount of a lower-tier unit's assets would be a reattribution asset of an upper-tier taxable unit on account of a remittance.

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Thus, where a DRE functions as a pure holding company with no assets other than a lower-tier operating DRE a remittance from the lower-tier DRE to the upper-tier DRE would sensibly be assigned to groupings based on the tax book value of the lower-tier's operating assets. However, if the upper-tier DRE in turn remits this amount to its owner, it would appear that the upper-tier DRE has no assets and therefore any foreign gross income of the upper-tier DRE's owner would be assigned to the residual grouping (as would the related foreign income taxes). Where the upper-tier DRE is a CFC, this would result in any foreign taxes being ineligible for a section 960 deemed paid tax credit because the remittance and foreign taxes are assigned to the residual grouping.

The 2020 Proposed Regulations, like the 2019 Proposed Regulations, would assign foreign gross income with respect to a contribution to the residual grouping. While foreign taxes paid or accrued by a CFC with respect to its foreign gross income that are allocated to the residual grouping 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. The proposed rule also provides that foreign gross income arising from a contribution by one taxable unit to another may be assigned to the foreign branch category under the "foreign branch group contribution" rule contained in Prop. Reg. § 1.904-6 where section 904 is the operative section, as discussed below.

KPMG observation

The broad definition of contribution introduced by the 2020 Proposed Regulations would include DRPs that do not result in the reattribution of U.S. gross income from the payor to the payee under the Foreign Branch DRT Rules or Proposed HTE DRP Rules, as applicable. As a result, more foreign gross income can be assigned to the residual grouping (or foreign branch categories where section 904 is the operative section pursuant to Prop. Reg. § 1.904-6) than one might otherwise expect. For example, if a foreign branch owner makes a disregarded interest payment to its foreign branch, the interest DRP would not cause the reattribution of income from the foreign branch owner to its foreign branch because interest and interest equivalents are generally excluded from application of the Foreign Branch DRT Rules. Therefore, the interest payment would fall within the broad definition of contribution under the 2020 Proposed Regulations and the related foreign gross income would be assigned to the residual grouping (or foreign branch category pursuant to Prop. Reg. § 1.904-6).

Foreign law transfers between taxable units that are not DRPs

The 2020 Proposed Regulations would apply timing principles for assigning foreign gross income arising from a foreign law transfer between taxable units that is not treated as a disregarded payment for U.S. federal income tax purposes in the same year in which foreign income tax is paid or accrued. The proposed rules would address, for instance, a consent dividend or a stock dividend from one taxable unit to another taxable unit of a CFC treated as a distribution for foreign law purposes and giving rise to foreign gross income of the CFC and corresponding foreign income taxes but not as a disregarded payment for U.S. federal income tax purposes.

In such a case, the 2020 Proposed Regulations would assign the foreign gross income to the same grouping as gross income from a hypothetical DRP in the amount of the foreign gross income would be assigned (under the proposed disregarded payment rules discussed above) for U.S. federal income tax purposes in the U.S. tax year in which the foreign income tax is paid or accrued.

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Applicability dates

The rules relating to the allocation and apportionment of foreign income taxes contained in the 2020 Proposed Regulations are generally proposed to apply to tax years that begin after December 31, 2019, and end on or after November 2, 2020. However, the proposed rules for the allocation and apportionment of certain foreign in lieu of taxes are proposed to apply to tax years beginning after the date final regulations are filed with the Federal Register.

Section 904 as the operative section—2020 Final Regulations and 2020 Proposed Regulations

As noted above, the 2020 Final Regulations, in line with the 2019 Proposed Regulations, moved much of the infrastructure for the allocation and apportionment of foreign income taxes to Reg. § 1.861-20. Accordingly, the rules finalized in Reg. § 1.904-6 apply solely to extend and in certain circumstances modify the application of Reg. § 1.861-20 when section 904 is the operative section (i.e., to assign foreign income taxes to particular section 904 categories). The 2020 Final Regulations provide special rules for base differences, allocating and apportioning deductions, allocating foreign taxes to the section 951A category, and apportioning taxes for the high-taxed income tests. In addition, the 2020 Proposed Regulations would provide additional rules in respect of foreign gross income arising from DRPs.

In respect of base differences, the 2020 Final Regulations provide that any item of foreign gross income that is attributable to a base difference is assigned to "the separate category described in 904(d)(2)(H)(i)," which is the foreign branch category.

KPMG observation

Treasury explained in the preamble to the 2019 Proposed Regulations that income relating to base differences is assigned to the foreign branch category because of the statutory base difference rule in section 904(d)(2)(H)(i). The 2020 Final Regulations follow the formulation for the base difference rule from the 2019 Proposed Regulations, cross-referencing the "separate category described in section 904(d)(2)(H)(i)" rather than specifically stating that the appropriate place for the income is the foreign branch category.

This presumably preserves the possibility of arguing that the cross-reference in section 904(d)(2)(H)(i) to the foreign branch category is a scrivener's error, and that the amount attributable to a base difference should be assigned to the general category.

The 2020 Final Regulations also finalize unchanged the rules for allocating and apportioning foreign law deductions for purposes of allocating and apportioning foreign income taxes to the foreign tax credit categories. In particular, for purposes of allocating and apportioning deductions allowed under foreign law to foreign gross income in the separate categories, foreign gross income assigned to the passive category is first reduced by any related person interest expense allocated to that income under the principles of section 954(b)(5) and Reg. § 1.904-5(c). This modifies the approach of Reg. § 1.861-20 which generally gives primacy to foreign laws for the allocation and apportionment of foreign law deductions. Further, in allocating and apportioning expenses that are *not* specifically allocated under foreign law, principles of the foreign law are applied only after taking into account this reduction of passive income by related person interest expense. If foreign law does not provide rules for the allocation or apportionment of expenses, losses, or other deductions to particular items of foreign gross income, the principles of section 861 apply to allocate and apportion the expenses, losses, or other foreign law deductions to

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foreign gross income, again, only after first reducing the passive income by related person interest expense under the principles of section 954(b)(5).

For purposes of applying section 904 when a reverse hybrid is owned directly by a U.S. shareholder, like the 2019 Proposed Regulations, the 2020 Final Regulations assign the foreign gross income that the taxpayer recognizes from the reverse hybrid to the section 951A income category to the extent the foreign gross income would be tested income of the reverse hybrid and to the extent of the owner's inclusion percentage. For example, if a U.S. shareholder has an inclusion percentage of 60%, then 60% of the foreign gross income of the U.S. shareholder that would be assigned (under the general rule in Reg. § 1.861-20) to the tested income group within the general category income of a reverse hybrid to which section 951A is attributable is assigned to the section 951A category (assuming no treaty resourcing) and not to the general category. The same rule also applies to U.S. shareholders that own foreign law CFCs subject to a foreign law inclusion regime (e.g. if a U.S. shareholder owns a disregarded entity that owns a CFC subject to a foreign law inclusion regime at the jurisdiction of the disregarded entity).

KPMG observation

Under the 2020 Final Regulations, the foreign income taxes attributable to the foreign income of a reverse hybrid that are treated as paid or accrued by a U.S. shareholder owner of the reverse hybrid under the technical taxpayer rule would be assigned to the section 951A income category (assuming the taxes relate to gross income earned by the reverse hybrid that results in a section 951A inclusion) rather than the general income category. The preamble to the 2019 Proposed Regulations requested comments on the interaction of this rule with sections 245A(g) and 909 (pertaining to split taxes, of which foreign taxes imposed on reverse hybrids is one category). It appears that no comments on this issue were submitted, however, given that the preamble to the 2020 Final Regulations contains no discussion of the decision to finalize the rule in substantially the same form as it was proposed.

KPMG observation

As was the case under the 2019 Proposed Regulations, the 2020 Final Regulations do not subject foreign income taxes assigned to the section 951A income category to a 20% reduction, even though taxes attributable to GILTI inclusions are subject to a haircut.

The 2020 Final Regulations also provide special rules for allocating and apportioning foreign income taxes to passive income for purposes of applying the high-tax kickout. As discussed in more detail below, the high-tax kickout generally applies to recharacterize passive category high-taxed income as general category income, foreign branch category income, section 951A category income, or income in a specified separate category, depending on how such income would have been characterized had it not otherwise been passive income.

The 2020 Final Regulations require that taxes that have been allocated and apportioned to passive income under the general rules under Reg. § 1.861-20 must further be apportioned to the high-tax kickout income groups (e.g. amounts received or accrued by U.S. persons, dividends and inclusions from CFCs, etc.) for purposes of determining if the income is high taxed.

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KPMG observation

Under certain circumstances, this rule appears to lead to unintended results for owners of reverse hybrids. Assume U.S. shareholder (USSH) wholly owns a CFC reverse hybrid (RH), which owns portfolio stock. RH sells the portfolio stock for $100 gain and USSH is taxed at a 15% rate on the flow through income. USSH also includes as subpart F income the $100 gain. Section 909 says there is a foreign tax credit splitting event, but the related income is picked up as subpart F so the foreign tax is unsuspended. The general Reg. § 1.861-20 rules assign the tax incurred by USSH to groupings by treating the foreign gross income (the $100 gain) recognized by USSH under foreign law as income of RH, as the taxpayer. This should mean the tax is assigned to passive income. The high-tax kickout rule in Reg. § 1.904-6 provides that next the tax must be apportioned to the relevant high-tax kickout groups.

However, it is unclear under these facts which is the appropriate group for the $15 tax. If the tax is in the group for amounts received or accrued by a U.S. person (the Reg. § 1.904-(c)(3) group), because the tax is a direct liability of USSH, the $100 gain is in a different group (i.e., that for dividends and inclusions from CFCs (the Reg. § 1.904-(c)(4) group)). As a result, because there is no other income in the Reg. § 1.904-(c)(3) group, the $15 tax is kicked out of passive category income to general category income. By contrast, the $100 subpart F inclusion remains in the passive category without the associated tax. This result is unclear, however, because the associated income on which the tax is imposed is not technically "an amount received or accrued by a U.S. person" for U.S. federal income tax purposes (i.e. it is received by a CFC) but is, nonetheless, also not a dividend or inclusion from a CFC.

Accordingly, the tax does not comfortably fit into any of the high-tax kickout groups. Note that, under the rule for reverse hybrids above, if instead the $100 was a GILTI inclusion, the $15 tax would be allocated to the section 951A category to the extent of the inclusion.

Further guidance when section 904 is the operative section is included in the 2020 Proposed Regulations. As noted above, Prop. Reg. § 1.861-20 would generally assign foreign gross income arising from a DRP received by a taxable unit, as well as the associated foreign taxes, to statutory and residual groupings based on the current or accumulated income of the payor (for U.S. federal income tax purposes) depending on the nature of the DRP. Prop. Reg. § 1.904-6 specifically would provide that these rules apply to all foreign gross income arising from DRPs made or received by a taxable unit owned a U.S. taxpayer, including a non-branch taxable unit.

Additionally, the 2020 Proposed Regulations would modify the treatment of contributions under Prop. Reg. § 1.861-20 where section 904 is the operative section and the taxpayer owning the taxable unit is an individual or domestic corporation. Whereas under the general rule foreign gross income and the associated foreign taxes arising from a contribution would be assigned to the residual category, when section 904 is the operative section, foreign taxes on contributions to a foreign branch (including a non-branch taxable unit owned by a foreign branch) would be assigned to the foreign branch category.

KPMG observation

Note, however, that if the contribution is from a CFC, the associated foreign gross income and associated foreign income taxes would continue to be assigned to the residual grouping and would not be deemed paid under section 960.

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Applicability date

Final Reg. § 1.904-6 applies to tax years that begin after December 31, 2019. Proposed Reg. § 1.904-6 is proposed to apply to tax years that begin after December 31, 2019 and that end on or after November 2, 2020.

Section 960 as the operative section—2020 Final Regulations and 2020 Proposed Regulations

The 2020 Final Regulations revise certain rules that determine taxes deemed paid under section 960, largely to conform with other revisions made in the 2020 Final Regulations. In order to compute deemed paid taxes, a CFC's foreign income taxes must be allocated and apportioned to its current year income, which is fist assigned to a section 904 category, and then further segregated into different subcategories of income and PTEP groups. Under the 2020 Final Regulations, current year taxes are allocated and apportioned under the rules in Reg. §§ 1.861-20 and 1.904-6. Any taxes attributable to a "base difference" (as determined under Reg. § 1.861-20(d)(2)(iii)(B)) are assigned to the residual income group and cannot be claimed as a deemed paid credit under section 960.

The 2020 Final Regulations also finalize without change a rule in the 2019 Proposed Regulations under which E&P of a CFC that is recharacterized as subpart F income under the section 952(c) recapture rule are not treated as items of income for purposes of computing deemed paid foreign tax credits.

The 2020 Proposed Regulations would make minor changes to the section 960 regulations, including changes to conform the definition of "current year taxes" to take into account foreign tax redeterminations required under the section 905 rules included in the 2020 Proposed Regulations, as well as changes to certain other terminology.

KPMG observation

The application of the rules allocating and apportioning foreign taxes in Reg. § 1.861-20 for section 960 purposes can be more complex than for other provisions. For example, taxes are only apportioned across the separate limitation categories when applying Reg. § 1.861-20 for section 904 purposes. For purposes of applying the rules for section 960, foreign taxes must be allocated and apportioned first to the separate limitation category, and then further allocated and apportioned across the various groupings of CFC income and PTEP, including multiple groupings for subpart F income and multiple groupings for different types of PTEP.

KPMG observation

Under the 2020 Final Regulations, an increase in a CFC's subpart F income under the section 952(c)(2) recapture rules does not increase the CFC's income for purposes of determining deemed paid foreign tax credits. This rule is consistent with existing rules for determining foreign income taxes attributable to subpart F income groups in the earlier year when the CFC's subpart F income was reduced under the E&P limitation rules in section 952(c)(1)(A) or (C). Under existing rules, the full benefit of foreign taxes attributable to income excluded from subpart F income under the E&P limitation rules is allowed in the E&P limitation year. An adjustment to the CFC's income for deemed paid foreign credit purposes in the recapture year therefore is not permitted.

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Applicability date

The section 960 rules finalized in the 2020 Final Regulations apply to tax years of a foreign corporation beginning after December 31, 2019, and to each tax year of a domestic corporation that is a U.S. shareholder of the foreign corporation in which or with which such tax year of such foreign corporation ends. The section 960 rules contained in the 2020 Proposed Regulations are proposed to apply to tax years of foreign corporations beginning on or after the date final regulations are filed with the Federal Register, and to each tax year of a domestic corporation that is a U.S. shareholder of the foreign corporation in which or with which such tax year of such foreign corporation ends.

Section 965(g) as the operative section—2020 Final Regulations

Section 965(g) disallows a portion of FTCs (the "applicable percentage" as defined in section 965(g)) paid or accrued with respect to income included under section 965, including taxes paid or accrued with respect to section 965 PTEP. 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 regardless of whether a distribution is actually made for U.S. federal income tax purposes. 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

The section 965(g) rules finalized in the 2020 Final Regulations apply to tax years of foreign corporations ending on or after December 16, 2019 and, with respect to a U.S. person, tax years in which or with which such tax years of such foreign corporations end.

Section 245A(d) as the operative section—2020 Proposed Regulations

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 paid or deemed paid with respect to hybrid dividends and the subpart F income that results from tiered hybrid dividends.

The 2020 Proposed Regulations would provide rules for attributing foreign income taxes to "specified distributions" from, and "specified E&P" of, foreign corporations. The result of that attribution of foreign income taxes would be that no credit or deduction would be allowed for any such foreign income 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 gave rise (or would give rise if distributed) to section 245A DRD-eligible dividends, hybrid dividends, tiered hybrid dividends, or distributions of section 245A(d) PTEP (i.e., PTEP attributable to section 1248 or section 964(e)(4) dividends that gave rise to a section 245A deduction or PTEP attributable to subpart F income resulting from a tiered hybrid dividend). The 2020 Proposed Regulations would apply the rules in Reg. § 1.861-20 to attribute foreign income taxes to specified distributions and specified E&P by treating foreign gross income in an amount equal to the amount of the distribution (for U.S. federal income tax purposes) that is a specified distribution or that

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would be a distribution out of, or an inclusion with respect to, specified E&P (if recognized for U.S. federal income tax purposes) as a statutory grouping, with all other foreign gross income arising from the distribution or inclusion under foreign law treated as the residual grouping. Note that no foreign income taxes arising with respect to foreign gross income assigned to the residual grouping are eligible for the deemed paid credit under section 960, as discussed above.

The 2020 Proposed Regulations also include 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).

Treasury stated that the anti-avoidance rule is intended to address concerns around perceived gaps in the rules in Reg. § 1.861-20(d) pertaining to foreign income taxes resulting from foreign law distributions and dispositions that are not recognized for U.S. federal income tax purposes, which taxpayers may exploit to circumvent the purposes of section 245A(d). Treasury requested comments on potential changes to Reg. § 1.861-20(d) that could address these concerns, including the maintenance of separate E&P accounts that are characterized with reference to the relevant statutory and residual groupings for each taxable unit, taking into account foreign law transactions that are disregarded for U.S. federal income tax purposes.

Applicability date

The section 245A(d) rules contained in the 2020 Proposed Regulations are proposed to tax years of foreign corporations beginning after December 31, 2019 and ending on or after November 2, 2020 and, with respect to a U.S. person, tax years in which or with which such tax years of foreign corporations end.

Section 905(c) foreign tax redeterminations—2020 Final Regulations

General

The 2020 Final Regulations under section 905(c) contain detailed rules for when a “foreign tax redetermination” occurs and address when a U.S. tax redetermination may be required as the result of a foreign tax redetermination. The 2020 Proposed Regulations further amend Reg. § 1.905-3 to provide that a foreign tax redetermination also includes a taxpayer’s change in its decision to claim a credit or deduction for foreign income taxes.

A taxpayer is required under section 905(c) to notify the IRS of certain changes in its foreign income tax liability (a “foreign tax redetermination”). Section 905(c) defines a foreign tax redetermination as the occurrence of any of the following events:

- Accrued foreign taxes when paid differ from the amounts claimed as credits,
- Accrued foreign taxes are not paid within two years after the close of the tax year to which they relate, or
- Any foreign tax paid is fully or partially refunded.

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The Treasury and IRS finalized guidance in the 2019 Final Regulations that is applicable to U.S. tax redeterminations resulting from foreign tax redeterminations related to foreign income taxes that are paid or accrued by a U.S. taxpayer (i.e., when the U.S. taxpayer is the technical taxpayer under Reg. § 1.901-2(f)). In conjunction with the 2019 Final Regulations, Treasury also issued the 2019 Proposed Regulations to address U.S. tax redeterminations resulting from foreign tax redeterminations of foreign corporations.

Under pre-TCJA law, because the E&P and foreign income taxes of a foreign corporation were maintained and tracked by the U.S. taxpayer under the section 902 pooling regime, many changes in the foreign corporation's foreign income taxes paid or accrued could be made prospectively by adjusting the amount of E&P and the amount of foreign taxes within the relevant pools subject to certain exceptions in prior Reg. § 1.905-3T(d)(3). With the TCJA's repeal of the section 902 pooling regime and the revocation of the Treasury's authority in 905(c) to issue regulations allowing for prospective pooling adjustments, additional guidance was required to determine when a change in a foreign corporation's foreign income taxes paid or accrued would result in a foreign tax redetermination and when a foreign tax redetermination would require a U.S. tax redetermination.

The 2020 Final Regulations adopt with only minor changes the section 905(c) guidance related to adjustments to foreign income taxes paid or accrued by a foreign corporation as set forth in the 2019 Proposed Regulations. In particular, the 2020 Final Regulations provide that a foreign tax redetermination includes a change in the liability for foreign income taxes, as defined in Reg. § 1.960-1(b)(5), that may affect a taxpayer's U.S. tax liability, including by reason of a change in the amount of its foreign tax credit; the amount of its distributions or inclusions under sections 951, 951A, or 1293; the application of the subpart F or GILTI HTE; or the amount of tax determined under sections 1291(c)(2) and 1291(g)(1)(C)(ii). If a foreign tax redetermination occurs, then the 2020 Final Regulations require a U.S. tax redetermination to account for changes to the amount of foreign taxes deemed paid, the related section 78 gross-up, and an adjustment to the taxable income and E&P of the foreign corporation for the year to which such foreign tax redetermination relates. The 2020 Final Regulations also finalize without change the conforming modifications proposed to be made under section 904 concerning foreign tax redeterminations, which relate to the potential impact of a foreign tax redetermination on U.S. tax liability as a result of a high-tax exception election.

KPMG observation

The repeal of section 902 and the changes made to section 905(c) by the TCJA will dramatically increase the frequency with which a U.S. shareholder will have a U.S. tax redetermination resulting from a foreign tax redetermination with respect to its foreign subsidiary corporations. Significantly, a U.S. tax redetermination may be required to account for the effect of a foreign tax redetermination even in situations in which the foreign tax credit is not changed. For example, a U.S. shareholder that chose to apply the high-tax exception described in section 954(b)(4) may be required to redetermine whether it qualified for the high-tax exception as a result of a foreign tax redetermination, even if the U.S. shareholder chose to deduct foreign income taxes rather than to claim a foreign tax credit.

KPMG observation

As mentioned above, a foreign tax redetermination may require a U.S. shareholder to redetermine whether its tested income qualifies for the GILTI HTE. Under the GILTI HTE regulations, taxpayers may make the GILTI HTE election on an annual basis and may do so on an amended return filed

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within twenty-four months of the unextended due date of the original income tax return. Because a foreign tax redetermination may occur long after the prescribed period for making or revoking the GILTI HTE election, at least one taxpayer requested that the time period for making the GILTI HTE be extended such that a taxpayer would be entitled to make the election on an amended return following a foreign tax redetermination. Treasury declined to extend the 24-month period prescribed by the GILTI HTE regulations.

The 2020 Proposed Regulations further expand the definition of foreign tax redetermination to include a change by a taxpayer of its decision to claim a credit or a deduction for foreign income taxes that may affect a taxpayer's U.S. tax liability.

KPMG observation

The expansion of the instances in which a foreign tax redetermination is required is meant to provide certainty to both taxpayers and the IRS as to when a taxpayer's change in its election to credit or deduct foreign income taxes has collateral consequences in years outside of the year of the foreign tax redetermination that are outside of the normal period for assessments. For example, a taxpayer may initially choose to deduct foreign taxes in a year in which it has a NOL to increase its NOL that will carry forward and benefit the taxpayer in subsequent tax years. However, in a later year, the taxpayer may choose instead to elect to credit foreign income taxes in that prior year to increase foreign tax credit carryforwards.

Without the protection of section 905(c), the IRS may be unable to assess additional U.S. tax for the decrease in the NOL related to the previously deducted foreign income taxes to the extent those years to which the NOL was carried are outside of the normal period for assessments. The expansion of the instances in which foreign tax redeterminations are required to include changes in the election to deduct or credit foreign income taxes would provide additional certainty for both taxpayers and the IRS in such instances.

The 2020 Final Regulations also finalize without modification the "successor rule" that was included in the 2019 Proposed Regulations. Pursuant to this rule, when the person that is legally liable for a foreign tax redetermination is not the same person that had legal liability for the tax in the relation-back year as determined under U.S. tax principles (e.g., a disregarded entity that elects to be treated as a corporation for U.S. federal income tax purposes), the required U.S. tax redetermination is made as if the redetermination occurred in the hands of the original taxpayer. The successor rule will frequently apply in the case of disregarded entities whose regarded owner changes before a foreign tax redetermination of an earlier tax year occurs and in the case of reorganizations and liquidations.

While the successor rules provide that it is the original taxpayer that is the party with the liability for, or a right to a refund of, this redetermined foreign tax, it may be the case that the difference in foreign tax is paid by, or received as a refund by, the successor. In such cases, the successor rule provides that general U.S. tax principles apply to determine the U.S. federal income tax consequences of this mismatch (such as constructive distributions or contributions). For example, USP is a domestic corporation that owns FDE, a Country X entity disregarded from USP. FDE elects to be treated as a corporation for U.S. tax purposes and following the conversion of FDE, Country X imposes an additional foreign tax on FDE that is paid by FDE. Under the successor rule, USP (the original taxpayer) is treated as the party liable for the additional tax; however, FDE (now treated as a corporation for U.S. tax purposes) actually pays the additional foreign income tax. In this example, general U.S. tax principles would apply to

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determine the U.S. federal income tax consequences of FDE's payment of the redetermined foreign taxes.

KPMG observation

Treasury included a similar example in the preamble of the 2019 Proposed Regulations, but specifically concluded that the mismatch would be treated as a distribution from FDE to FDE's tax owner in an amount equal to the foreign income taxes paid. In response to a taxpayer comment, Treasury noted that there may be multiple ways to characterize the mismatch for U.S. federal income tax purposes under these circumstances.

Notification requirements

A foreign tax redetermination requires a taxpayer to provide notification to the IRS pursuant to section 905(c) and Reg. § 1.905-3 of the 2020 Final Regulations. Reg. §§ 1.905-4 and 1.905-5 of the 2020 Final Regulations provide the relevant rules for determining the timing and contents of that notification.

Generally, a taxpayer's notification must take the form of an amended return with a revised Form 1118 (corporations) or Form 1116 (individuals, estates, and trusts) and a statement containing the information outlined in the regulations for the taxpayer's U.S. federal income tax year to which the foreign tax redetermination relates. If the foreign tax redetermination results in an increase to U.S. federal income tax in the relevant year, then the taxpayer must file its notification by the due date (including extension) of the original return for the taxpayer's tax year in which the foreign tax redetermination occurs. A taxpayer has until the expiration of the 10-year statute of limitation period described in section 6511(d)(3)(A) to file its notification if the foreign tax redetermination results in a reduction of the taxpayer's U.S. federal income tax in the relevant year.

The statement that must accompany a taxpayer's amended return (if required) or be filed in other cases described below must generally contain sufficient detail for the IRS to verify and compare the original computation of the taxpayer's U.S. federal income tax liability, the taxpayer's revised U.S. federal income tax liability computation resulting from the foreign tax redetermination, and the net changes between those two amounts. Reg. § 1.905-4(c) also specifies specific information that must be included on such statement.

KPMG observation

Like original U.S. federal income tax returns, amended U.S. federal income tax returns are filed under penalties of perjury that the signer believes everything on the return is true, correct, and complete to the best of the signer's knowledge and belief. If a taxpayer must amend a tax return for a tax year because of a foreign tax redetermination, then such taxpayer would be required to revise its computations to take into account changes made by any regulations issued after such return was originally filed and that apply to such tax year.

Special notification rules apply to pass-through entities (i.e., partnerships, trusts, or S corporations). Generally, these entities must notify both the IRS and its partners, beneficiaries, or shareholders of the foreign tax redetermination by providing the statement described below. Because such pass-through entities are technical taxpayers but do not claim foreign tax credits themselves, the 2020 Final Regulations provide that such entities must determine whether there has been a foreign tax

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redetermination by treating themselves as a domestic corporation that had elected and claimed foreign tax credits in the amount reported by the entity for the U.S. federal income tax year to which such foreign taxes relate.

KPMG observation

While a pass-through entity must treat itself as a domestic corporation that claimed foreign tax credits for purposes of determining whether a foreign tax redetermination has occurred, the 2020 Final Regulations do not provide specific rules for determining which owners must receive the required notification: the current owners at the time of the foreign tax redetermination or those who owned an interest in the pass-through entity in the year in which such foreign tax redetermination relates.

However, the purpose of the 2020 Final Regulations is to provide both those owners that are entitled to claim foreign tax credits and the IRS with the information necessary to adjust the U.S. federal income tax liability of the owners in the year to which the foreign tax redetermination relates. Thus, an accrual method pass-through entity should notify its owners for its U.S. federal income tax year to which the foreign tax redetermination relates. It appears that a cash method pass-through entity should also notify its owners in the relation-back year in the case of a refund but would notify its current owners in the case of additional payments of foreign income tax.

These results derive from the fact that the accounting method of a pass-through entity controls the time in which its owners take into account foreign income taxes for purposes of the foreign tax credit, even if such owners use an account method different than the pass-through entity, as discussed further below.

A different notification regime applies to partnerships that are subject to chapter 63, subchapter C of the Code (the “BBA”). Such partnerships must file an administrative adjustment request (an “AAR”) pursuant to the rules of that subchapter when there is a foreign tax redetermination with respect to foreign income tax paid or accrued by the partnership. Generally, every partnership that is required to or does file a Form 1065 is a BBA partnership except certain “small” partnerships that are able to and do elect out of the BBA. A partnership qualifies as a small partnership if it has 100 or fewer partners, all of which are individuals, C corporations, “eligible foreign entities,” estates, or S corporations (counting the S corporation shareholders as partners for this purpose). The AAR process is similar to an amended return; however, such amendment is made pursuant to the specific administrative procedures outlined in the BBA.

KPMG observation

A penalty of up to 25% applies to any deficiency in U.S. federal income tax caused by a foreign tax redetermination if the taxpayer fails to timely notify the IRS. This penalty is meant to incentivize compliance with the notification timing described above. No penalty would be assessable in the case of a foreign tax redetermination that reduces the taxpayer’s U.S. federal income tax because such redetermination would not result in a U.S. federal income tax deficiency. The Treasury and IRS reasoned that no penalty was required in that latter case because a taxpayer would be incentivized to comply with their notification requirements to claim a refund of U.S. federal income tax to which it would be entitled.

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Exceptions

Exceptions to the filing requirements described above are limited. First, the 2020 Final Regulations provide that an amended return is not required if the foreign tax redetermination does not result in a change in U.S. federal income tax due for any tax year. In this case, the taxpayer must still notify the IRS; however, it may do so by providing the notification statement described above with its original return for the taxpayer's U.S. federal income tax year when the foreign tax redetermination occurs by the due date (with extensions) for that return.

A taxpayer under examination by the IRS Large Business and International (LB&I) division (or its successor) may notify the IRS by providing a statement to its examiner within the time frames described in the 2020 Final Regulations if certain other specific requirements are met (the "audit exception"). These requirements include that the foreign tax redetermination increase the taxpayer's U.S. federal income tax liability (e.g., because of a refund of foreign income tax) and the timeframe prescribed by the 2020 Final Regulations for providing notice is not before the later of the opening conference or the hand-delivery or postmark date of the examination opening letter. These two requirements significantly narrow the types of foreign tax redeterminations that qualify for this exception. However, the IRS may accept a statement in lieu of an amended return if the foreign tax redetermination results in a refund of U.S. federal income tax at its discretion when all of the other requirements of the exception are met.

KPMG observation

The 2020 Final Regulations do not describe when a taxpayer is "under examination by the Large Business and International Division."

An example in the 2020 Final Regulations addresses whether the audit exception could apply. In that example, a calendar year taxpayer is "within the jurisdiction of the Large Business and International Division" and receives a refund of foreign income taxes on November 15, Year 2 that relate to the taxpayer's Year 1 tax year. As a result of the foreign tax refund, a foreign tax redetermination occurs on November 15, Year 2 and the taxpayer must notify the IRS of such redetermination no later than October 15, Year 3. After October 15, Year 3, the taxpayer receives an opening letter concerning an IRS examination of the taxpayer's Year 1 tax year and the opening conference is scheduled for January 15, Year 4. The example concludes that the taxpayer may not use the audit exception and must instead file an amended return for Year 1 to consider the Year 2 foreign tax redetermination. The example does so, however, because the taxpayer was required to file its notification on a date that occurred prior to the date of the opening conference and does not mention whether the fact that the foreign tax redetermination occurred prior to the beginning of the examination would also cause the taxpayer to be unable to apply the audit exception.

That lack of conclusion coupled with the stated fact that the taxpayer is "within the jurisdiction of the Large Business and International Division" raises the question of whether a taxpayer could be excluded from using the audit exception if all of the requirements for applying the exception were met except for the foreign tax redetermination not occurring while the taxpayer is "under examination."

Finally, the 2020 Final Regulations allow the IRS to provide for alternative notification requirements by forms, instructions, publications, or other guidance. These alternative notification requirements would alleviate the need to file an amended return. The IRS has not yet issued any alternative notification requirements; however, the Treasury and IRS stated in the preamble to the 2020 Final Regulations that they are considering whether "new processes or forms can be developed to streamline the filing

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requirements while ensuring that the IRS receives the necessary information to verify that taxpayers have made the required adjustments to their U.S. tax liability." Other IRS and Treasury statements in the preamble suggest though that the amended return requirement is unlikely to be fully eliminated in most cases.

Transition rules

The 2020 Final Regulations contain two transition rules. One of the transition rules provides taxpayers additional time to file amended returns for foreign tax redeterminations that occur during the first applicable year of the 2020 Final Regulations (i.e., tax years that end on or after December 16, 2019). Under this provision, taxpayers that had a foreign tax redetermination that occurred in a tax year ending on or after December 16, 2019 and before November 12, 2020 may file any required amended returns with respect to that foreign tax redetermination with their original tax return (including extensions) for their first tax year ending on or after November 12, 2020. This transition rule helps taxpayers avoid missing any required notifications of a foreign tax redetermination that occurred in a tax year to which the 2020 Final Regulations would apply and that would require an amended return because the 2020 Final Regulations were issued close in time to the filing deadlines for such tax years.

The other transition rule addresses foreign tax redeterminations of a foreign corporation that would relate back to a pre-TCJA tax year. Prior to the TCJA, a taxpayer was generally allowed to adjust a foreign corporation's pools of E&P and taxes in the year the foreign tax redetermination occurs rather than filing amended returns for the year to which such foreign tax redetermination relates. Treasury's authority to issue regulations allowing for prospective pooling adjustments was withdrawn as a result of the TCJA and, as a result, all foreign tax redeterminations relate back. The transition rule in Reg. § 1.905-5 provides a general rule and an election.

Under the general rule, Reg. § 1.905-5 provides that a taxpayer may not make prospective adjustments for foreign tax redeterminations that occur after January 1, 2018, and that relate to tax years of a foreign corporation that begin before January 1, 2018. Instead, a taxpayer must amend its tax returns for such relation-back years under the general rule and adjust the foreign corporation's E&P and foreign tax pools in the year to which the foreign tax redetermination relates. Second, the regulation provides a one-time irrevocable election that, if made, would allow a taxpayer to take account for all foreign tax redeterminations that could be made prospectively under the prior foreign tax redetermination regulations by amending the taxpayer's return for its last tax year ending before January 1, 2018 ("last pooling year"). The election must be made by the controlling domestic shareholders by filing the statement described in Reg. § 1.964-1(c)(3)(ii), any required notifications, and any amended returns with the U.S. federal income tax returns of the controlling domestic shareholders of the foreign corporation that ends with or within the foreign corporation's "first redetermination year." The first redetermination year is the foreign corporation's first tax year in which a foreign tax redetermination occurs that ends with or within its United States shareholder's tax year ending on or after November 2, 2020. The election is a binding on all persons who are or were in a prior year to which the election applies, U.S. shareholders of the foreign corporation and to all foreign tax redeterminations in the first redetermination year and all subsequent tax years of such foreign corporation.

KPMG observation

The election to take most foreign tax redeterminations that occur after the election is made and that relate to pre-reform tax years into account by amending the taxpayer's U.S. federal income tax return for the last pooling year may provide some administrative relief to taxpayers. However, such election will not fully alleviate the need to file amended returns. Because the election is a one-time

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> irrevocable election, taxpayers should carefully consider whether the potential administrative relief provided by the election is or is not outweighed by the potential for the loss of U.S. federal income tax benefits, e.g., a foreign tax redetermination that results in a reduction of the taxpayers mandatory repatriation net tax liability but could have, absent an election, resulted in a tax refund with respect to an earlier tax year.

Applicability date

The rules contained in Reg. § 1.905-3 that were finalized by the 2020 Final Regulations apply to foreign tax redeterminations occurring 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 that relate to tax years of foreign corporations beginning after December 31, 2017. The rules contained in Reg. § 1.905-4 that were finalized by the 2020 Final Regulations apply to foreign tax redeterminations occurring 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. The transition rules of Reg. § 1.905-5 apply to foreign tax redeterminations of foreign corporations and successor entities that occur in tax years that end with or within tax years of a U.S. shareholder or other U.S. persons ending on or after November 2, 2020, and that relate to tax years of such foreign corporations beginning before January 1, 2018.

Creditability of foreign taxes under sections 901 and 903—2020 Proposed Regulations

Definition of foreign income tax

In the preamble to the 2020 Proposed Regulations, Treasury expressed a concern that the recent adoption of novel extraterritorial taxes (such as digital services taxes) by certain jurisdictions undermines the purpose of the FTC to mitigate double taxation of income that is attributable to a taxpayer's activities or investment in a foreign country (i.e., income over which the foreign country would have the primary taxing right under traditional international tax principles). 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. In particular, the proposed regulations would address extraterritorial taxes by imposing a jurisdictional nexus requirement and would revise the "net gain" requirement to ensure that purported income taxes are imposed on net income.

Jurisdictional nexus requirement

The new jurisdictional nexus requirement would provide separate rules to determine whether a foreign tax is creditable based on whether the tax is imposed on residents or nonresidents of that foreign country. For a tax on nonresidents to be creditable, it must meet one of three jurisdictional nexus requirements. Under the first requirement, 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. Section 864(c) is the sole example cited of reasonable principles for attributing income to activities. Alternatively, for a tax based on

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the source of income (rather than on activities) to meet the jurisdictional nexus requirement, the foreign tax law's sourcing rules must be similar to U.S. sourcing rules. In particular, a foreign tax imposed on income from services must be sourced based on where the services are performed, not on the location of the service recipient. Finally, if the tax is imposed on income from dispositions of property located in the foreign country, the property must either be real property or movable property that is part of a business with a taxable presence in the country (including interests in a company or other entity to the extent attributable to such real property or business property).

KPMG observation

The rule regarding nexus based on the situs of property suggests that a foreign tax imposed on the disposition of an interest in a company would meet the jurisdictional nexus requirement to the extent that the interest is attributable to property that is used by such company in a business in the taxing jurisdiction. Such a rule would not be consistent with the U.S. sourcing rules for gain from the sale of corporate stock (which does not look through to the corporation's underlying assets except for section 897 purposes) though it would be consistent with the rule under section 864(c)(8) treating certain gain from the sale of a partnership interest as income effectively connected with the conduct of a trade or business in the United States.

KPMG observation

While the jurisdictional nexus requirement would make clear that digital services taxes are not creditable, many other types of taxes may fail the jurisdictional nexus requirement. For example, many jurisdictions impose tax on gain from the sale of shares of corporations that are resident in the jurisdiction, even if the shares do not constitute a real property interest and are not attributable to a trade or business in the jurisdiction. Those taxes appear not to be creditable under the 2020 Proposed Regulations.

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

The 2020 Proposed Regulations under section 903 also would be revised to require that a foreign tax that is being analyzed as an "in lieu of" tax under section 903 meet the new jurisdictional nexus requirement by cross-referencing the section 901 proposed regulations. This and other changes to the section 903 regulations are discussed in detail below.

KPMG observation

The jurisdictional nexus requirement for in lieu of taxes (including withholding taxes) under section 903 generally would make withholding taxes on services non-creditable, because those taxes often would apply to fees for services performed outside of the taxing jurisdiction. As discussed below, a withholding tax is treated as a separate levy as to each separate class of gross income described in section 61. Thus, even if the withholding tax does not meet the jurisdictional nexus requirement with respect to a services fee, it may meet the jurisdictional nexus requirement with respect to royalties. In some cases, it may be possible to restructure a value chain to provide for a royalty rather than a service fee, though treatment as a royalty may or may not be beneficial depending on

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many factors, including the foreign tax treatment of services and royalties.

KPMG observation

In Notice 2011-29, 2011-16 I.R.B. 663, Treasury announced that it would not challenge a taxpayer's assertion of creditability with respect to the Puerto Rico excise tax on a controlled group member's acquisition from another group member of certain personal property manufactured in Puerto Rico and certain services performed in Puerto Rico. The 2020 Proposed Regulations do not discuss their potential impact on Notice 2011-29.

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 (the "Inclusive Framework"), changes to the U.S. FTC system may be required.

KPMG observation

As suggested by the preamble, the 2020 Proposed Regulations would call into question the creditability of the taxes contemplated under Pillar 1 and—to a lesser extent—Pillar 2, as proposed in the "Blueprints" recently released by the Inclusive Framework. Read KPMG's reports on **Pillar 1** and **Pillar 2**. The 2020 Proposed Regulations may be intended to increase pressure to reach a deal within the OECD/G20 Inclusive Framework.

Changes to net gain requirement

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 an income tax in the U.S. sense must be imposed on net gain. In that regard, the 2020 Proposed Regulations would re-label section 901 taxes as "net income taxes," while section 903 taxes would be "in lieu of income taxes," and the two together would be referred to as "foreign income taxes." The 2020 Proposed Regulations generally would retain the net gain requirement, but would eliminate 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); requiring instead for a foreign tax to meet the net gain requirement 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 net gain requirement would continue to comprise a realization requirement, a gross receipts requirement, and a requirement for the allowance of significant cost recovery (referred to in the existing final regulations as a net income requirement). The 2020 Proposed Regulations would modify the realization requirement by providing that inclusion in the tax base of a minimal amount of income (measured based on the application of the tax to all taxpayers) that is not tied to a realization or pre-realization event (and, therefore, that does not meet the realization requirement) does not prevent qualification of the tax as a net income tax. Treasury requested comments concerning a more objective standard that would completely eliminate the need for empirical analysis.

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Consistent with the general goal of minimizing empirical analysis, the 2020 Proposed Regulations would remove the rule in the gross receipts requirement that allowed computation under a method that is "likely" to produce an amount not greater than gross receipts. However, the 2020 Proposed Regulations clarify that amounts properly allocated according to the transfer pricing principles incorporated under the jurisdictional nexus requirement are treated as gross receipts.

With respect to the cost recovery requirement, in addition to removing the nonconfiscatory gross basis tax rule, the 2020 Proposed Regulations also specify certain significant costs and expenses that must be allowed as a deduction for the cost recovery requirement to be satisfied and a tax to be creditable, which are capital expenditures, interest, rents, royalties, services, and research and experimentation. Otherwise, empirical analysis is still required for determining whether a cost or expense is significant. Alternative allowances that may approximate the deductions for such amounts would no longer satisfy the cost recovery requirement under the 2020 Proposed Regulations (by contrast to the existing final regulation), but the imposition of disallowances under foreign law consistent with the rules under U.S. tax law (e.g., section 163(j), section 267A, or section 162) would not prevent satisfaction of the requirement. The 2020 Proposed Regulations also clarify that differences in timing of a cost recovery deduction, whether allowed before or after an amount would be allowed under U.S. tax law, generally would not prevent satisfaction of the cost recovery requirement, and that the time value of money is not taken into account in determining the amount recovered. The availability of a deduction for foreign income tax is irrelevant to the satisfaction of the cost recovery requirement.

KPMG observation

The 2020 Proposed Regulations would require that a foreign tax allow deductions for interest expense in order to qualify as a potentially creditable net income tax, subject to deduction limitations that are consistent with the limitations in the Code. From an economic standpoint, however, if a foreign tax allows full expensing (or, to a lesser extent, accelerated depreciation) for capital investments, also allowing interest deductions on debt that finances the investment would provide an inconsistent double benefit and would cause the tax rate on debt-financed investment to be significantly negative.

Applicability date

The foregoing rules in respect of the qualification of a tax as a foreign income tax are proposed to apply to foreign taxes paid or accrued in tax years beginning on or after the date final regulations are filed with the Federal Register.

"In lieu of" taxes under section 903

The 2020 Proposed Regulations would completely replace the existing regulations under section 903. The 2020 Proposed Regulations would retain the basic requirement of the existing regulations that to qualify as an in lieu of tax under section 903 a foreign levy must: (i) be a tax (as determined under Reg. § 1.901-2(a)(2)); and (ii) satisfy a substitution requirement. However, the 2020 Proposed Regulations would substantially modify the substitution requirement to include four prongs.

Under the first prong, the foreign jurisdiction must generally impose a net income tax as defined under Prop. Reg. § 1.901-2(a)(3) (the "generally imposed net income tax"). Under the second ("non-duplication") prong, neither the generally imposed net income tax nor any other net income tax may be imposed by the foreign country on income (the "excluded income") to which the base of the tested tax

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relates.

Under the third ("close connection") prong, the imposition of the tested tax must bear a close connection to the failure to impose the generally imposed net income tax on the excluded income. For purposes of this test, a close connection exists if the generally imposed net income tax would apply by its terms to the excluded income, but for the fact that the excluded income is expressly excluded. Otherwise, a close connection must be established with proof that the foreign country made a cognizant and deliberate choice to impose the tested tax instead of the generally imposed net income tax. There is a rebuttable presumption that there is not a close connection for a later-enacted tested tax that applies to the same base and persons as an earlier-enacted tested tax.

The fourth prong requires that, if the generally imposed net income tax were applied to the excluded income, the generally imposed net income tax would continue to qualify as a net income tax described in Prop. Reg. § 1.901-2(a)(3) (or would qualify as a net income tax if it constituted a separate levy).

KPMG observation

The cross-reference to Prop. Reg. § 1.901-2(a)(3) includes both the net gain requirement and the jurisdictional nexus requirement. The preamble states that the requirement is intended to incorporate the jurisdictional nexus requirement but appears to assume that the net gain requirement is met. Perhaps the reference to the "excluded income" (which is not the base of the tested tax, but rather appears to be the net income related to the base of the tested tax) could be interpreted to mean that the test applies to a base that meets the net gain requirement, but that conclusion is far from clear.

The 2020 Proposed Regulations also would add rules to address the qualification of certain source-based withholding taxes as "in lieu of" taxes. For a withholding tax to qualify, the foreign jurisdiction must also generally impose a net income tax, the tested tax must be imposed on nonresidents, the tested tax must not be imposed in addition to a net income tax imposed on the same income, and (as discussed above) the rules for sourcing income subject to the withholding tax must be similar to the U.S. federal income tax sourcing rules.

Applicability date

The foregoing rules are proposed to apply to foreign taxes paid or accrued in tax years beginning on or after the date final regulations are filed in the Federal Register.

Separate levy rules

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. However, 2020 Proposed Regulations would no longer allow contractual arrangements between a person and a foreign jurisdiction modifying a tax to be

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treated as resulting in a separate levy from the tax unmodified by the contractual arrangements.

Applicability date

The foregoing rules are proposed to apply to foreign taxes paid or accrued in tax years beginning on or after the date final regulations are filed with the Federal Register.

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 is treated as paid. Under the 2020 Proposed Regulations, the rule is changed so that the application of a credit is not treated as the payment or accrual of a tax. Thus, in the multiple levy scenario described above, the first levy will be treated as paid, and the amount of the second levy treated as paid will be reduced by the credit. 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.

KPMG observation

Although the preamble to the 2020 Proposed Regulations generally describes the change in law concerning the satisfaction of a tax with a credit as intended to improve certainty and administrability, Treasury also expresses concern that foreign countries may design tax credits that have the same economic effect as reducing tax rates without reducing the amount of tax that is treated as paid for U.S. FTC purposes. This concern, along with the request for comments about the treatment of government grants outside of the tax system, suggests that Treasury is considering guidance that would treat certain government grants as a reduction in tax payments.

The 2020 Proposed Regulations also address the treatment of payments as noncompulsory payments that would not constitute an amount of tax paid. 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.

KPMG observation

The rule requiring that a taxpayer minimize foreign income taxes appears intended to forestall foreign countries from implementing regimes under which a taxpayer could elect into a foreign net income tax to avoid being subject to, for example, an excise tax.

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

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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 taxes between FTC limitation categories. Furthermore, the 2020 Proposed Regulations would clarify that a decision to make (or not make) an entity classification election would not give rise to a noncompulsory payment. 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).

The 2020 Proposed Regulations also would remove the provision under current law that limits 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 net income tax. As a result, no FTC would be allowed for an in lieu of tax to the extent it is a soak-up tax. Treasury requested comments as to whether other issues related to currently applicable soak-up taxes should be addressed.

Applicability date

The foregoing rules are proposed to apply to foreign taxes paid or accrued in tax years beginning on or after the date final regulations are filed with the Federal Register.

Mid-year transactions and the "technical taxpayer" rule—2020 Proposed Regulations

Existing Reg. § 1.901-2(f)(4) provides rules for allocating foreign income taxes paid or accrued by a partnership or a disregarded entity between relevant taxpayers upon the occurrence of a transaction that results in a change to the technical taxpayer with respect to the foreign taxes paid or accrued by the entity, but does not result in the closing of the entity's foreign tax year (e.g., a technical termination of the partnership or the transfer of the interests in a disregarded entity) (the "foreign tax allocation rules"). The existing regulations allocate entity-level foreign taxes between the relevant taxpayers based on the respective portions of the foreign tax base that are attributable under the principles of Reg. § 1.1502-76(b) to the period of ownership of each taxpayer. Under the principles of Reg. § 1.1502-76(b), taxpayers are permitted to allocate the foreign tax base between relevant taxpayers based either on a "closing of the books" method or a "ratable allocation" method. Absent the foreign tax allocation rules, a taxpayer that acquires a disregarded entity, for instance, and holds such entity until the close of the entity's foreign tax year would accrue for U.S. federal income tax purposes all the foreign taxes paid by the disregarded entity, notwithstanding that the taxes relate, in part, to income taken into account by the disregarded entity's previous owner.

The 2020 Proposed Regulations would provide that the foreign tax allocation rules apply only upon the occurrence of any "covered event," which is defined as a partnership termination under section 708(b)(1), a transfer of a disregarded entity, or a change in the entity classification of a disregarded entity or a corporation, as well as certain "variances" in a partner's interest in a partnership. The proposed rules would also clarify that the rules can apply to allocate foreign taxes among multiple prior owners if multiple covered events occur during the same tax year. Finally, the proposed rules would also exclude withholding taxes from the application of the foreign tax allocation rules, on the grounds that withholding taxes, in contrast to net basis foreign taxes, generally accrue contemporaneously with the income with

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which they relate.

KPMG observation

The proposed rules are intended to expand the application of the foreign tax allocation rules to, for instance, a change in the U.S. tax classification of a disregarded entity to a corporation. However, by limiting the application to certain "covered events," the proposed rule potentially leaves room for other situations where U.S. tax rules may see a transfer between taxpayers and the close of a U.S. tax year while foreign law sees no event whatsoever, such as the continuation of a foreign entity into the United States without relinquishing its foreign corporate charter.

The preamble to the 2020 Proposed Regulations acknowledges that, in certain situations, an income item, such as interest, on which a withholding tax is imposed could be of the type that accrues ratably for U.S. tax purposes during the foreign tax year of a predecessor entity or a prior owner. In this situation, the preamble notes that allocating withholding taxes ratably over the foreign tax year may not be appropriate if the foreign tax year is not the same period as the accrual period under the terms of the instrument that generated the interest.

However, it appears that the foreign tax allocation rules would not apply to withholding taxes on interest even if the accrual period and the foreign tax year are the same for the interest, resulting in a predecessor entity or prior owner recognizing interest income with no allocation of any of the related foreign withholding taxes imposed on such income.

The 2020 Proposed Regulations also modify the rules for allocating foreign income taxes in the case of a section 338 election to conform to the existing rules that apply in the case of a section 336(e) election as well as the proposed foreign tax allocation rules. Specifically, the 2020 Proposed Regulations clarify that, similar to existing foreign income tax allocation rules for section 336(e) elections, the allocation is made with respect to the portion of the foreign tax base that is attributable under Reg. § 1.1502-76(b) principles. Additionally, the proposed regulations clarify that when there are multiple section 338 elections with respect to the target during target’s foreign tax year, foreign income tax paid or accrued with respect to that foreign tax year is allocated among all old targets and new targets. The proposed rules also provide that if a section 338 election is made for target and target holds an interest in a disregarded entity or partnership, the foreign tax allocation rules apply with respect to foreign income taxes paid by the disregarded entity or partnership. Finally, the proposed rules clarify that withholding taxes are not subject to allocation in the case of either a section 336(e) or 338 election.

Applicability date

The foregoing rules are proposed to apply to foreign taxes paid or accrued in tax years beginning on or after the date final regulations are filed with the Federal Register.

Other proposed changes to Reg. § 1.901-1

The 2020 Proposed Regulations also contain proposed updates to the rules in Reg. § 1.901-1. Although largely non-substantive, the updates would reflect that certain taxes for which a credit is disallowed (such as under section 901(j) or (m)) may be allowed as a deduction. They would also reflect that a deduction may be allowed in a year for which a credit is otherwise taken, if the deduction is for taxes resulting from a foreign tax redetermination relating to a year in which a deduction was claimed.

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The 2020 Proposed Regulations also would shorten the period during which a taxpayer can choose or change an election to claim a credit or deduction for foreign income taxes is based on the applicable refund period, depending on the choice made (i.e., generally three years for a deduction or to change to a deduction, and 10 years for a credit or to change to a credit).

Applicability date

The foregoing rules are proposed to apply to foreign taxes paid or accrued in tax years beginning on or after the date final regulations are filed with the Federal Register.

Accrual of foreign taxes and the decision to deduct or credit—2020 Proposed Regulations

The 2020 Proposed Regulations revise and significantly expand the existing regulations addressing when a foreign tax credit can be claimed. Prop. Reg. § 1.905-1 provides detailed rules that clarify when a foreign tax credit may be claimed by either a cash method or an accrual method taxpayer and, for an accrual method taxpayer, clarify the application of the "relation-back doctrine." The proposed regulation also addresses mismatch and time-barred deficiency issues resulting from the application of the relation-back doctrine, as well as the application of the "contested tax doctrine" for purposes of determining when contested foreign income taxes can be credited. It also addresses improper accruals of foreign income taxes and treats a change from an improper method to a proper method of accruing foreign taxes as a change in method of accounting. The proposed regulation also clarifies when foreign income taxes paid or accrued by a partnership or other pass-through entity, including contested taxes, can be claimed as a credit or a deduction by such entity's partners, shareholders, or beneficiaries.

The 2020 Proposed Regulations also address certain issues relating to the deduction of foreign income taxes. Prop. Reg. § 1.901-2(d) modifies the period during which taxpayers can change the choice to claim a deduction or a credit for foreign income taxes on an amended return, and addresses the treatment of foreign income taxes that accrue in a year in which the taxpayer claims a credit for foreign taxes but relate to a year in which the taxpayer deducted foreign income taxes. Prop. Reg. § 1.905-3(b)(4) also requires a redetermination of U.S. tax to account for the effect of a change between deducting and crediting foreign income taxes.

Proper time for claiming a foreign tax credit

General rule

The timing of a taxpayer's foreign tax credit is generally governed by the taxpayer's method of accounting. Under a general rule in Prop. Reg. § 1.905-1, an accrual method taxpayer must therefore determine the amount of its foreign income taxes using the accrual method while a cash method taxpayer must use the cash method for that purpose. Regardless of the method used, however, the foreign tax credit is only allowed to the extent the foreign income taxes are ultimately owed and timely paid to the foreign country. A taxpayer's entitlement to a foreign tax credit for a tax that is accrued in one year may therefore be affected by events that occur in a later year (such as a refund of foreign income taxes) and section 905(c) and the regulations thereunder (discussed above) govern the adjustments that must be made by the taxpayer as a result of such events.

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Cash method taxpayers

Prop. Reg. § 1.905-1 provides that a cash method taxpayer must use the cash method (absent an election to use the accrual method) and, as a result, may claim a credit for foreign income taxes only in the tax year they are paid to the foreign country. Withholding taxes and certain net income taxes withheld from a taxpayer's gross income by the payor are treated as paid for this purpose when withheld. If foreign income taxes are claimed as a credit when paid and are subsequently refunded, a redetermination of foreign income tax and U.S. tax liability is required pursuant to section 905(c). Additional foreign income taxes paid that relate back to a prior year in which foreign taxes were claimed as a credit under the cash method may only be claimed as a credit in the year they are paid. The payment of such additional taxes generally does not result in a redetermination pursuant to section 905(c).

Pursuant to section 905(a) and consistent with existing regulations, a cash method taxpayer may elect under the 2020 Proposed Regulations to credit foreign income taxes in the year that they accrue. Such election must be made on a timely filed original return for the year the foreign income taxes accrue and is irrevocable. If the election is made for the first tax year for which the taxpayer claims foreign tax credits, it can also be made on an amended return. The 2020 Proposed Regulations also contain rules to prevent the loss of foreign tax credits due to a change from the cash method to the accrual method.

Accrual method taxpayers

Prop. Reg. § 1.905-1 contains very detailed rules for determining the foreign tax credit under an accrual method. The proposed regulation contains the general rule that foreign income taxes accrue in the tax year in which all the events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy and cross-reference the applicable regulations under sections 446 and 461. A foreign income tax determined on the basis of a tax year becomes fixed and determinable at the close of the taxpayer's foreign tax year, and therefore accrues in the U.S. tax year with or within which the foreign tax year ends. Foreign withholding taxes imposed on a payment giving rise to an item of foreign gross income accrue on the date the payment is made (or is treated as made under foreign law).

KPMG observation

Withholding taxes may be incurred with respect to income, such as interest, that a taxpayer accrues over time. The rule that would treat withholding taxes as accruing on the date of payment may therefore result in a mismatch between the tax year income arises and the date foreign income taxes accrue.

The 2020 Proposed Regulations address the application of the "relation-back doctrine" to additional foreign income taxes paid by an accrual method taxpayer that relate to a prior tax year. Under these rules, additional foreign income tax paid as a result of a change in foreign tax liability, including as the result of the resolution of a contest with a foreign tax authority, relate back and are considered to accrue for foreign tax credit purposes at the end of the foreign tax year with respect to which the taxes were imposed (the "relation-back year"). This rule is consistent with case law addressing the relation-back doctrine. (The relation-back doctrine generally does not apply to foreign income taxes for which the taxpayer claims a deduction.) Additional withholding taxes resulting from a change in the amount of an item of foreign gross income also relate back and are considered to accrue in the year in which the relevant payment was made (or treated as made under foreign law).

Under Reg. § 1.905-3(a), foreign income taxes that are not paid within 24 months after the close of the

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tax year in which they were accrued are treated as refunded and result in a section 905(c) foreign tax redetermination. When subsequently paid, another section 905(c) foreign tax redetermination occurs and the foreign income taxes are allowed as a credit in the relation-back year under Prop. Reg. § 1.905-1.

Taxpayers generally may elect to use a "52/53 week" U.S. tax year for determining taxable income that will typically end on a day other than the last day of a month. A CFC may also be required to use a 52/53 week U.S. tax year under section 898 if it has a majority U.S. shareholder that has a 52/53 week U.S. tax year. Often, those taxpayers will have foreign tax years ending on the last day of the corresponding month rather than on the same day as the 52/53 week year. In such cases, foreign income taxes that relate to foreign income recognized within the U.S. tax year may accrue in a different U.S. tax year, resulting in a mismatch between the year of accrual of the foreign income and the related foreign taxes.

The 2020 Proposed Regulations adopt a convention that generally would avoid this mismatch. Under the 2020 Proposed Regulations, if a taxpayer has elected pursuant to section 441(f) to use a 52/53 week U.S. tax year, and such U.S. tax year closes within six calendar days of the end of the taxpayer's foreign tax year, the determination of when foreign income taxes accrue under the general rule is made by deeming the taxpayer's U.S. tax year to end on the last day of its foreign tax year.

KPMG observation

The proposed rule for taxpayers with 52/53 week tax years applies to all taxpayers with 52/53 week years and is not elective. The proposed regulation addresses tax year mismatches narrowly as it only addresses those mismatches that arise in the case of 52/53 week year taxpayers. Similar mismatches will continue to occur in other cases where taxpayers have different U.S. and foreign tax years, for example where a taxpayer uses a fiscal year for U.S. tax purposes but is required to use a calendar year for foreign tax purposes.

Under case law and IRS rulings dealing generally with the accrual method of accounting, the liability for an income tax that is contested generally is not fixed, and therefore does not accrue, until the contest is resolved. *See, e.g., Dixie Pine Products Co. v. Comm'r*, 320 U.S. 516 (1944). Under case law and IRS rulings dealing specifically with the foreign tax credit, although a contested foreign income tax does not accrue until the contest is resolved and the liability becomes finally determined, such tax, when finally determined, relates back to and is considered to accrue in the tax year to which it relates for foreign tax credit purposes. *See, e.g., Albemarle Corp. & Subsidiaries v. U.S.*, 797 F.3d 1011, 1019 (Fed. Cir. 2015), cert. denied, 136 S. Ct. 1659 (2016).

The IRS has provided an exception to the contested tax doctrine for foreign tax credit purposes in revenue rulings. In particular, Rev. Rul. 70-290, 1970-1 C.B. 160, provides that contested foreign income taxes that have been paid to a foreign country may be provisionally accrued and claimed as a foreign tax credit, even if the liability for the contested tax has not accrued because the contest has not been resolved. *See also* Rev. Rul. 84-125, 1984-2 C.B. 125.

These rulings may allow taxpayers to avoid the expiration of the statute of limitations for claiming a foreign tax credit where it would otherwise expire before the foreign contest is resolved.

The 2020 Proposed Regulations address the application of the contested tax doctrine in a manner generally consistent with the case law. The 2020 Proposed Regulations first provide as a general rule that a foreign tax credit for a contested income tax liability cannot be claimed by an accrual method taxpayer until such time as both the contest is resolved and the tax is actually paid. Thus, an accrual method taxpayer generally cannot claim a foreign tax credit for a contested foreign tax, even if remitted

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to the foreign government, before the contest is resolved.

The 2020 Proposed Regulations provide an exception to this general rule, however, that allows a provisional foreign tax credit in the relation-back year to the extent the taxpayer remits the contested amount to the foreign country pending settlement of the dispute. As a condition to this provisional credit, the taxpayer must enter into an agreement with the IRS that describes the details regarding the contested tax and allows the IRS to audit the claim for credit when the contest is resolved. The taxpayer is also required to provide annual certifications regarding the status of the contest, and must agree for a three-year period not to assert the statute of limitations as a defense to the assessment of additional taxes relating to the contested tax that may arise from a determination that the contested tax is noncompulsory. The preamble notes that Treasury and the IRS intend to withdraw Rev. Rul. 70-290 and Rev. Rul. 84-125 when the 2020 Proposed Regulations are finalized.

Prop. Reg. § 1.905-1 also provides that a change in the timing for accruing foreign income tax expense is generally a change in method of accounting. A change from an improper method of accounting to a proper method of accrual under the 2020 Proposed Regulations is treated as a change in method of accounting without regard to whether the taxpayer deducts or credits such taxes in any tax year. An improper method for this purpose does not, however, include corrections to estimated accruals or errors in computing the amount of the foreign income tax. The 2020 Proposed Regulations provide detailed rules regarding the filing of IRS Form 3115 to obtain the Commissioner's consent to a change in method of accounting and a "modified cut-off approach" to implementing a change in method of accounting for accrued foreign income taxes to prevent the omission or duplication of any amount of foreign income tax paid.

KPMG observation

Some accrual method taxpayers may have taken foreign income taxes into account using a cash method (i.e., taking foreign income taxes into account for purposes of the foreign tax credit as such amounts are actually paid). The 2020 Proposed Regulations require taxpayers to correct this method by filing a Form 3115.

The 2020 Proposed Regulations clarify that a partnership takes foreign income taxes into account based upon its method of accounting, consistent with Reg. § 1.703-1(b)(2), and that the partners in such partnership may claim a foreign tax credit for their distributive share of those foreign income taxes even if the partner uses a different method of accounting for foreign income taxes than the partnership. Thus, for example, a cash method partner can generally claim a credit for its distributive share of foreign income taxes for a year even though they are taken into account by the partnership on an accrual basis. The 2020 Proposed Regulations also address the treatment of foreign income taxes relating to a prior tax year, as well as the treatment of contested foreign income taxes. Rules similar to those for partnerships apply to S corporations, trusts and estates, and their shareholders, grantors, and beneficiaries.

Decision to credit or deduction for foreign taxes

Under current Reg. § 1.901-1(d), a taxpayer is allowed 10 years from the due date of a return to change the taxpayer's election to deduct or credit foreign taxes. The 10-year period is based on the 10-year statute of limitations in section 6511(d)(3)(A) for claims for refund or credit attributable to foreign tax credits. Recent case law holds, however, that the 10-year statute of limitations does not apply to refund claims relating to foreign income taxes that the taxpayer claims as a deduction. *See Trusted Media Brands, Inc. v. United States,* 899 F.3d 175 (2d Cir. 2018). The 2020 Proposed Regulations amend Reg. § 1.901-1(d) to eliminate the blanket cross-reference to the 10-year period in section 6511(d)(3)(A).

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Instead, a taxpayer may, for a particular tax year, elect to claim a deduction or credit at any time before the expiration of the applicable period during which a claim for credit or refund of tax for such tax year that is attributable to such credit or deduction, as the case may be, may be made (or longer if the refund period is extended by agreement under section 6511(c)). Thus, the 10-year period prescribed by section 6511(d)(3)(A) generally applies where a foreign tax credit is claimed. The three-year period of section 6511(a) generally applies where the taxpayer claims a deduction for the relevant foreign income tax.

KPMG observation

In certain cases, it may be advantageous for taxpayers to file a return initially claiming a deduction for foreign taxes rather than a credit. The taxpayer would generally have 10 years to amend its return to claim a foreign tax credit instead. If the taxpayer claims a foreign tax credit on an initial return, it generally would have to amend its return to claim a deduction within the applicable three-year period.

Under current Reg. § 1.901-1(c), a taxpayer that elects to credit foreign income taxes for any tax year cannot also claim a deduction for foreign income taxes for such year. The 2020 Proposed Regulations restate this general rule and provide an exception to allow taxpayers that claim foreign tax credits on an accrual basis for a particular year to deduct additional taxes that are finally determined and paid during that year that relate to a prior year in which the taxpayer deducted foreign income taxes. Without this rule, it is possible the taxpayer would be allowed neither a deduction nor a credit in the year the tax accrues.

Applicability date

The foregoing rules regarding the accrual of foreign taxes and the decision to deduct or credit are proposed to apply to foreign taxes paid or accrued in tax years beginning on or after the date final regulations are filed with the Federal Register.

Source and basketing of income—2020 Final Regulations and 2020 Proposed Regulations

Fairly comprehensive rules regarding the basketing of income in each of the four main foreign tax credit categories that exist post-TCJA (i.e., GILTI, branch, general, and passive) were included in the prior FTC regulation packages released in 2019. Both the 2020 Final Regulations and the 2020 Proposed Regulations contain supplemental guidance on the basketing of income as discussed below. In addition, the 2020 Proposed Regulations would provide rules with respect to the source of shareholder inclusions.

High-tax kickout—2020 Final Regulations

The high-tax kickout generally applies to recharacterize passive category high-taxed income as general category income, foreign branch category income, section 951A category income, or income in a specified separate category, depending on how such income would have been characterized had it not otherwise been passive income. The 2020 Final Regulations finalize without material change the

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application of the high-tax kickout rules in connection with a foreign tax redetermination under section 905. Adopting a wait-and-see approach, the regulations generally provide that, even if the effective rate of foreign tax on a foreign corporation's income may be reduced upon distribution, the determination of whether the income is high-taxed is made at the time of the inclusion irrespective of the possibility of a later distribution and reduction. After a distribution occurs and the foreign tax is reduced, if a redetermination of U.S. tax is required, the taxpayer must redetermine whether the revised inclusion is still high-taxed income. If after the reduction in foreign tax the inclusion is not high-taxed income, the taxpayer must attribute the inclusion and associated taxes to the passive category in redetermining the U.S. tax liability for the affected year(s).

The regulations also provide an ordering rule that applies if the foreign law does not attribute a reduction in taxes to a particular year(s), adopting an annual last in-first out ("LIFO") method to foreign taxes depending on the related income—first for previously taxed income, then passive category subpart F or tested income subject to the GILTI or subpart F high tax exclusions, and finally for other E&P. Passive income that is excluded from subpart F and GILTI because of the high-tax exclusions is treated as passive category income until distribution and then, if after redetermination the taxpayer still elects a high-tax exclusion for the income, the high-tax kickout rules may apply to attribute the income to another category upon distribution.

And, finally, in order to achieve consistency with the new tested unit rules and the taxable unit rules in Reg. § 1.861-20, discussed above, the 2020 Proposed Regulations would modify the high-tax kickout rules to provide that grouping of income earned at the CFC level is applied on a tested unit (instead of foreign QBU) basis.

Applicability date

The high-tax kickout rules apply to tax years ending on or after December 16, 2019.

Foreign branch category income—2020 Proposed Regulations

Income from U.S. activities and stock

Section 904(d)(2)(J)(i) defines foreign branch category income as business profits of a U.S. person that are attributable to non-U.S. QBUs. The 2019 Final Regulations provide, *inter alia,* that income attributable to a foreign branch excludes income arising from (i) activities carried out in the United States or (ii) stock that is not dealer property. The DRP rules contained in Prop. Reg. § 1.861-20(d)(3)(v) generally rely on the Foreign Branch DRT Rules, but income arising from activities carried out in the United States or stock may be attributable to a taxable unit in this context. The 2020 Proposed Regulations would therefore amend the Foreign Branch DRT Rules to provide that income arising from U.S. activities or stock may be attributable to a foreign branch even though such income cannot be foreign branch category income. Notwithstanding these modifications, Treasury declares that the technical change does not reflect any reconsideration of the foreign branch category income rules as it concerns the exclusion of income from U.S. activities and income from stock.

Foreign Branch DRT rules

The existing Foreign Branch DRT Rules broadly apply to DRPs made to and from foreign branches (i.e., non-U.S. QBUs), but do not apply to DRPs to and from certain persons and interests that do not meet the definition of a foreign branch or foreign branch owner. To address this gap in the Foreign Branch DRT Rules, the 2020 Proposed Regulations would modify the Foreign Branch DRT Rules to apply in the case of DRPs made to and from a "non-branch taxable unit," as defined in Reg. § 1.904-6(b)(2)(i)(B).

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The term "non-branch taxable unit" means either (i) a person that is not otherwise a foreign branch owner and that is a U.S. individual, a domestic corporation, or a foreign or domestic partnership that is owned by a U.S. individual or U.S. corporation (a "non-branch taxable unit person") or (ii) an interest of a foreign branch owner or an interest of non-branch taxable unit person that is not otherwise a foreign branch and is either a disregarded entity or a taxable presence in another jurisdiction (a "non-branch taxable unit interest"). Prop. Reg. § 1.904-4(f)(3)(v) would also amend the definition of the term "disregarded payment" to include transfers of property in connection with transactions that are disregarded for U.S. federal income tax purposes and are properly reflected on a separate set of books and records of a non-branch taxable unit.

The proposed rules would provide that reattribution of current gross income may result from DRPs to and from non-branch taxable units. Gross income attributed to a non-branch taxable unit would then be re-attributed to a foreign branch (if the non-branch taxable unit were to belong to a "foreign branch group") or a foreign branch owner (if the non-branch taxable unit were to belong to a "foreign branch owner group"), respectively.

The term "foreign branch group" means a foreign branch and one or more non-branch taxable units (other than an individual or a domestic corporation), to the extent that the foreign branch owns the non-branch taxable unit directly or indirectly through one or more other non-branch taxable units. The term "foreign branch owner group" means a foreign branch owner and one or more non-branch taxable units (other than an individual or a domestic corporation), to the extent that the foreign branch owns the non-branch taxable unit directly or indirectly through one or more other non-branch taxable units. The income of a foreign branch group or foreign branch owner group that is re-attributed is equal to the aggregate of the U.S. gross income determined after taking into account all DRPs made and received by each group member.

The proposed rules would also clarify the application of the Foreign Branch DRT Rules by providing that the reattribution of gross income by reason of a DRP is limited to the amount of current gross income in the payor foreign branch or foreign branch owner, and such amount would be translated to or from the foreign branch's functional currency at the spot rate as determined on the date of the DRP. In addition, the 2020 Proposed Regulations would provide that a DRP made by a foreign branch to a second foreign branch is allocable to gross income of the payor foreign branch if such payment, if regarded, would be allocated and apportioned to gross income attributable to the payor foreign branch under the principles of 1.861-8 through -14T and -17 (without regard to exclusive apportionment) by treating foreign source and U.S. source gross income in each separate category as a statutory grouping.

Applicability date

These foreign branch category rules are proposed to apply to tax years that begin after December 31, 2019 and end on or after November 12, 2020.

Financial services income—2020 Proposed Regulations

Section 904(d)(2)(C) provides that financial services income is treated as general category income in the case of a member of a "financial services group" or a person "predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" (each, a "financial services entity"). Existing regulations address the potential overlap among the different foreign tax credit limitation categories post-TCJA in the case of financial services income (e.g., they provide that financial services income of a CFC that is included in income of a U.S. shareholder under section 951A is treated as section 951A category income in the U.S. shareholder's hands).

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The 2019 Proposed Regulations would have significantly revised the structure of the existing regulations, in part by revising the definition of financial services income and the rules for determining when an individual or corporation is "predominantly engaged in the active conduct of a banking, insurance, financing, or similar business". Treasury received comments on these proposed modifications suggesting that the 2019 proposed rules should be revised or withdrawn. In response to these comments, Treasury did not finalize the proposed rules in the 2020 Final Regulations. Instead, Treasury proposed new rules in the 2020 Proposed Regulations, which generally maintain the structure of the existing regulations while modifying the definitions of financial services income, active financing income, and financial service entity, each as described below.

Existing regulations currently define financial services income as income earned by a financial services entity that is either (1) income derived in the active conduct of a banking, insurance, financing, or similar business (referred to as "active financing income"); (2) passive income as determined before the application of the high-tax exception in section 904(d)(2)(B)(iii)(II); or (3) incidental income. These regulations contain a list of 23 categories of income that are treated as active financing income together with a "catch-all" provision that allows taxpayers to designate "[a]ny similar item of income" as financial services income on Form 1118 or 1116. The existing regulations define "incidental income" as "income that is integrally related to active financing income of a financial services entity." The existing regulations determine whether an individual or entity "is predominantly engaged in the active financing business," and thus a financial service entity, by reference to its active financing income. Specifically, an individual or entity is a financial services entity for any year if for that year at least 80% of its gross income is active financing income, or the entity is a member of an affiliated group and at least 80% of the group's income is active financing income. The existing regulations' 80% gross income test is generally applied without regard to whether income is earned from a related or unrelated person (with certain exceptions).

The 2020 Proposed Regulations would revise the definition of financial services income by removing "incidental income" as a type of financial services income. In addition, under the 2020 Proposed Regulations, the "passive income" category of financial services income would not include payments received from a related party that is not itself a financial service entity that are attributable to the related party's passive category income under the look-through regulations (in Reg. § 1.904-5). Further, proposed modifications in the look through regulations would impact amounts treated as passive income for financial services income purposes. The 2020 Proposed Regulations would modify the existing ordering rule in the look-through regulations by removing a rule that currently allows amounts characterized as passive income under a look-through rule to be treated as financial services income (under the general rule that treats passive income of a financial services entity as financial services income). As a result of removing this rule, under the 2020 Proposed Regulations, the look through rules are given priority over the financial services rules, and amounts characterized as passive under a look-through rule cannot be characterized as financial services income.

KPMG observation

The preamble does not explain the rationale for excluding income that is passive under the look-through rules from financial services income. Moreover, the rule in the proposed financial services income regulation excludes "payments" that are attributable to passive income of a related entity that is not itself a financial services entity under the look-through rules from the definition of financial services income, while the proposed look-through regulation appears to preclude financial services income treatment for all passive income characterized under the look-through rules. Final regulations should clarify the interaction of the two proposed rules.

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Consistent with the existing regulations (and in contrast to the 2019 Proposed Regulations), the 2020 Proposed Regulations would define active financing income by providing a list of 23 items, although it would remove the catch-all category. The list of items in the 2020 Proposed Regulations is similar to the existing list but adds new items, removes certain items, and modifies certain other items, including by requiring that several items be derived from transactions with "customers". In addition, the 2020 Proposed Regulations would add new rules that are meant to limit the amount of active financing income earned by an insurance company. Specifically, the new list of items would provide that the amount of certain insurance income that is active finance income would be limited to an amount that is "ordinary and necessary" for the conduct of the insurance business. The 2020 Proposed Regulations provide objective rules for making the "ordinary and necessary" determination.

The 2020 Proposed Regulations generally would retain the existing framework for defining a financial services entity based on the amount of its gross income that is active financing income. The 2020 Proposed Regulations would revise the test by reducing the "at least 80%" of gross income threshold in the existing regulations to "more than 70%" of gross income. In addition, the 2020 Proposed Regulations generally would require financial services income to be received from a customer or counterparty that is not a related person in order to be considered active finance income. The preamble states that these two revisions "promote simplification and greater consistency between Code provisions that have complementary policy objectives, while still taking into account the differences between sections 954 and 904." For purposes of applying the "more than 70% of gross income" test, interest on state and local bonds otherwise excluded from income under section 103 would be taken into account, and income from related persons would be included in the denominator (although not the numerator). The proposed rules also would specifically provide that PTEP are not taken into account for purposes of this test.

Under the 2020 Proposed Regulations, only an individual or a corporation could be a financial services entity. If an individual or a corporation is a direct or indirect partner in a partnership, the partner's distributive share of partnership income would be treated as if each partnership item of gross income were realized directly by the partner for purposes of determining whether the individual or corporation is a financial services entity.

Finally, the rules for determining a financial services group would be modified consistent with the changes made to the financial service entity definition by providing that a financial services group is an affiliated group more than 70% of the gross income of which is active financing income. The term affiliated group is defined by reference to section 1504(a) but also includes insurance companies and foreign corporations. For purposes of applying the gross income test to an affiliated group, gross income would not include income from transactions with other members of the group.

Applicability date

The modifications to the financial services income rules are proposed to apply to tax years that begin on or after the date final regulations are filed with the Federal Register.

Source of subpart F and GILTI inclusions—2020 Proposed Regulations

The 2020 Proposed Regulations would add a rule to govern the sourcing of subpart F and GILTI inclusions, as well as PFIC inclusions under section 1293(f)(1). Under this rule, deemed inclusions from a CFC or PFIC and the related 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

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effectively connected income (or the income is resourced under section 904(h)). This rule is 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; under the prior sourcing rule, inclusions would generally have been foreign source without regard to the amount of the foreign corporation's effectively connected income.

Applicability date

The sourcing rules in respect of subpart F and GILTI inclusion are proposed to apply to tax years ending on or after November 12, 2020.

Miscellaneous guidance—FTCs

The consolidated FTC—2020 Final Regulations

The 2020 Final Regulations finalize the rules in the 2019 Proposed Regulations relating to the computation of the consolidated foreign tax credit under Section 1502. For purposes of determining the group's foreign tax credit limitation, the amount of foreign source income in each separate category is the consolidated taxable income of the group (determined under Reg. § 1.1502-11) in that category, with certain adjustments. Existing Reg. § 1.1502-4 determines the foreign tax credit limitation by reference to the aggregate separate taxable incomes from foreign sources of the members of the group.

New rules were also added for purposes of determining the source and separate category of a consolidated net operating loss ("CNOL"), which generally would be determined based on the excess separate limitation losses ("SLLs") and U.S. source loss for the tax year. The 2020 Final Regulations also provide rules for determining the source and separate category of the portion of a CNOL that is apportioned to a separate return year of a member. The 2020 Final Regulations are generally intended to categorize a CNOL that is apportioned to a separate return year in a way that is linked to the source and separate category of income that is produced by the member's assets. The 2020 Final Regulations achieve this result by apportioning a proportionate amount of the CNOL in each grouping based on a comparison of the value of the member's assets in that grouping to the value of the group's total assets in the grouping, using the methodology in existing Reg. § 1.1502-9(c)(2), then by making adjustments to ensure that the amount of the CNOL apportioned to the separate return year of the member is equal to the amount of CNOL attributable to the member. The principles applicable to CNOLs also would apply to consolidated net capital losses.

The 2020 Final Regulations also update the regulations to remove references to obsolete provisions, such as the per-country limitation.

Applicability date

These rules apply to tax years for which the original consolidated federal tax return is due (without extensions) after November 12, 2020.

Transition rules: Carryback of NOLs—2020 Proposed Regulations

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

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back of any component of a post-TCJA year NOL in the branch or GILTI category to a pre-TCJA year with the SLL and 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 first to the general category without creating an SLL to the extent such NOL component offsets income in the general category, but after any general limitation component of the NOL is first used to offset income in the general limitation category. If the components of an NOL in the branch and GILTI categories available to be carried back to a pre-TCJA year would exceed the amount of income in the general limitation category to be offset, the amounts from each of the branch and GILTI category components will be determined on a proportionate basis.

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.

Coordination of various loss recapture rules—2020 Proposed Regulations

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

This rule is proposed to apply to tax years ending on or after November 2, 2020.

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Foreign-foreign nonrecognition transactions and section 367(b)—2020 Proposed Regulations

Section 367(b) and the regulations thereunder generally provide rules for the carryover of E&P and foreign taxes under section 381 in certain nonrecognition transactions involving a foreign corporation and require the recognition of income when an ownership threshold is not maintained following a reorganization. These rules provide detailed mechanisms involving the treatment of 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 retain the substantive ownership threshold of section 902, but without reference to section 902 and by modifying the ownership threshold requirement to consider not only voting power but value as well. Thus, Reg. § 1.367(b)-4(b)(2)(i)(B), which requires an income inclusion on the receipt of preferred or other stock only if the exchanging shareholder satisfies the ownership threshold specified by section 902(a) or (b), would be revised to require that a domestic corporation owns at least 10% of the transferee foreign corporation by vote or value.

The preamble to the 2020 Proposed Regulations notes that Treasury and the IRS are studying the interaction of Reg. § 1.367(b)-4(b)(2) with section 245A and other Code provisions in light of the TCJA generally. For this purpose, Treasury and the IRS have requested comments on whether Reg. § 1.367(b)-4(b)(2) remains necessary as a tool to prevent the trafficking in section 245A eligible E&P.

KPMG observation

Existing Reg. § 1.367(b)-2(e)(2) provides that a deemed dividend by reason of the section 367(b) regulations "shall be treated as a dividend for purposes of the Internal Revenue Code." Therefore, it is assumed that, absent guidance to the contrary, a deemed dividend under Reg. 1.367(b)-4 received by an exchanging shareholder that is a U.S. person would qualify for the dividend received deduction under section 245A. Based on their request for comments, it does not appear that Treasury and the IRS intend to deny the section 245A deduction with respect to a deemed dividend under Reg. § 1.367(b)-4(b)(2), but rather are merely studying whether Reg. § 1.367(b)-4(b)(2) should be retained for the purpose of causing a deemed dividend to an exchanging shareholder, thereby reducing the amount of section 245A-eligible E&P available to another shareholder.

Additionally, the 2020 Proposed Regulations create special rules for the treatment of earnings and foreign taxes for post-2017 tax years (i.e., post-TCJA years for which the repeal of section 902 is effective). First, the 2020 Proposed Regulations would treat all foreign acquiring corporations, foreign target corporations, and foreign surviving corporations as non-pooling corporations. Therefore, earnings in each post-TCJA year create a separate annual layer of E&P. The 2020 Proposed Regulations also provide a transition rule that treats all untaxed E&P remaining from pre-TCJA years as within a single pre-pooling annual layer in post-2017 tax years. However, foreign taxes related to non-previously taxed E&P accumulated in tax years before the current year, or in a foreign target's tax year that ends on the date of a section 381 transaction, are not treated as current year taxes in any post-2017 tax year (i.e., those foreign taxes are not current year taxes for purposes of any section 960 deemed paid credit). This includes foreign taxes attributable to E&P deficits that create hovering deficits that are later absorbed in post-2017 tax years.

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KPMG observation

Treasury and the IRS reserved on addressing PTEP in the **final regulations (T.D. 9273)** [PDF 501 KB] announced in August 2006 with respect to the carryover of earnings and taxes, and the 2020 Proposed Regulations do not contain rules addressing PTEP carryovers in section 381 transactions. Treasury and the IRS have announced that rules addressing PTEP generally are being considered in a separate guidance project (See IRS **Notice 2019-01** [PDF 85 KB] and the preamble to **final and temporary regulations (T.D. 9866)** [PDF 666 KB] issued in June 2019 providing guidance related to section 951A and foreign tax credits), however it is unclear whether that project will address PTEP carryover rules in the context of foreign to foreign section 381 transactions.

Applicability date

The foregoing rules are proposed to apply to tax years ending on or after November 2, 2020.

Miscellaneous guidance—Hybrids and FDII

Rules relating to hybrids

Section 245A(e) hybrid dividends—2020 Final Regulations

Section 245A(e) generally denies a dividends-received deduction with respect to a distribution for which a deduction under section 245A(a) would otherwise be allowed where the CFC payor received a foreign law deduction or other tax benefit with respect to such amount (a "hybrid dividend"). Section 245A(e) also treats a hybrid dividend paid by a lower-tier CFC with a domestic corporation that is a U.S. Shareholder to an upper-tier CFC owned by the same domestic corporation (a "tiered hybrid dividend") as subpart F income of the upper-tier CFC.

In order to implement section 245A(e), **final regulations (T.D. 9896)** [PDF 501 KB] issued in April 2020 (the "2020 Final Hybrids Regulations") require certain shareholders to maintain a hybrid deduction account ("HDA") with respect to a CFC directly or indirectly owned by it so that the dividends-received deduction under section 245A(a) is properly disallowed when the associated E&P is distributed from the relevant CFC (or, where the recipient is an upper-tier CFC, such amount properly results in a subpart F inclusion). Under these rules, an HDA is be reduced only to the extent that an amount in the account gives rise to a hybrid dividend or a tiered hybrid dividend on account of a distribution to the CFC's shareholder.

To address taxpayer concerns regarding potential double-taxation, a separate package of **proposed rules (REG-106013-19)** [PDF 377 KB] published on the same day as the 2020 Final Hybrids Regulations (the "2020 Proposed Hybrids Regulations") contained a taxpayer-favorable rule that would allow an HDA with respect to a CFC to be reduced by the U.S. shareholder's subpart F, GILTI, and certain section 956 inclusions with respect to such CFC, but only to the extent such amounts were likely subject to U.S. tax. The amounts of the allowed reductions to a taxpayer's HDA on account of such inclusions are defined as "adjusted subpart F inclusions" or "adjusted GILTI inclusions", respectively. For purposes of determining a shareholder's adjusted subpart F inclusions or adjusted GILTI inclusions, the amount of the shareholder's subpart F and GILTI inclusions would be reduced on account of the deductions allowed under section 250(a)(1)(B) with respect to its GILTI inclusion and the foreign tax credits permitted to such

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U.S. shareholder under section 960 without any consideration of the taxpayer's inability to claim such section 250 deduction (on account of the taxable income limitation contained in section 250(a)(2)(B)) or foreign tax credits (on account of having insufficient foreign tax credit limitation).

The 2020 Final Regulations retain the general structure of the proposed regulations, with certain taxpayer-favorable refinements to the mechanical calculation of the adjusted subpart F inclusion and adjusted GILTI inclusion to achieve a result that more precisely reflects the extent that the subpart F inclusion or GILTI inclusion amount is actually taxed in the United States. The primary changes include (1) a rule that takes into account the U.S. shareholder's section 250 amount *with regard to* the section 250(a)(2)(B) taxable income limitation, (2) a rule that takes into account the limitation under section 904 with respect to section 951A category taxes because any excess credits may not be carried forward or back (but not with respect to subpart F inclusions because limited subpart F taxes can be carried forward), and (3) a modification to the formula used to calculate the taxpayer's adjusted subpart F inclusions or GILTI inclusions intended to prevent distortions that could result under the proposed rule in circumstances where the CFC had overall positive taxable income but negative taxable income in a category that is neither subpart F income nor tested income.

The preamble provides that a taxpayer may resolve any circularities that result from calculating its adjusted GILTI inclusions in any reasonable manner. The 2020 Final Regulations also clarify that a "fully taxed" inclusion cannot be negative so as to increase an HDA and that a subpart F inclusion attributable to section 964(e)(4) and offset by a section 245A deduction does not reduce an HDA.

Applicability date

The HDA reduction rules contained in the 2020 Final Regulations apply to tax years ending on or after November 12, 2020. However, taxpayers may also choose to apply this rule retroactively to any earlier tax year, provided they do so consistently for that year each subsequent year.

Conduit financing regulations—2020 Final Regulations

The "anti-conduit financing regulations" allow the IRS to disregard intermediate entities in a multiple-party financing arrangement for the purposes of determining U.S. withholding tax rates in arrangements involving back-to-back "financing transactions." Generally, the term "financing transaction" excludes instruments that are treated as equity for U.S. tax purposes absent significant redemption-type features. The 2020 Proposed Hybrids Regulations would have expanded the definition of a financing transaction to include various hybrid instruments and arrangements, such as (i) instruments that are treated as debt under the issuer's foreign tax law but equity under U.S. tax law, (ii) equity in certain entities that are tax resident in jurisdictions that employ certain imputation or integration regimes (e.g., Malta's tax credit refund regime), and (iii) equity in an entity that gives rise to notional interest deductions under its foreign tax law.

The 2020 Final Regulations retain the proposed rule to expand the definition of "financing transactions" to include an instrument that is stock or a similar interest (including an interest in a partnership) for U.S. tax purposes but debt under the tax law of the country of which the issuer is a tax resident (or, if not a tax resident of any country, then under the tax laws of the country where created, organized, or otherwise established). The 2020 Final Regulations, however, do not apply to other hybrid instruments or arrangements that had been subject to the 2020 Proposed Hybrids Regulations. Treasury announced that it intends to finalize those rules separately.

Applicability date

The new rule under the anti-conduit financing regulations applies to payments made on or after

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November 12, 2020.

Section 951A and disqualified payments—2020 Final Regulations

The 2020 Final Regulations provide that any deduction related to a "disqualified payment" made by a CFC is not allocated or apportioned to its tested income. A disqualified payment generally includes an amount that would be included in tested income of a related CFC if the payment were made to the related CFC in a U.S. tax year of the recipient CFC to which the GILTI regime is applicable (i.e., prepayments made to fiscal year CFCs prior to their first tax year beginning after December 2017) .

Applicability date

This rule applies to tax years of foreign corporations ending on or after April 7, 2020, and to tax years of U.S. shareholders in which or with which such tax years end.

FDII clarifications—2020 Proposed Regulations

Definition of electronically supplied services

The 2020 Proposed Regulations would modify the definition of electronically supplied services ("ESS") included in the **final regulations (T.D. 9901)** [PDF 590 KB] released in July 2020 with respect to FDII for tax years beginning on or after January 1, 2021 (the "2020 Final FDII Regulations"). Read **KPMG report: Analysis of final FDII regulations** [PDF 1.1MB].

The Final FDII Regulations treat ESS as a subcategory of general services and create a new standard for determining whether such service generates FDDEI services income (i.e., the location of the device accessing the service).

The regulations define an ESS as a general service (other than an advertising service) that is delivered primarily over the internet or an electronic network. The 2020 Proposed Regulations would modify this definition, providing 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. 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 ESS. In contrast, a service that primarily involves human effort (other than the human effort involved in the development or maintenance of the technology enabling the electronically supplied service) would not be an ESS. Examples of services that are not ESS are legal, accounting, medical, or teaching services, even if "provided electronically and synchronously."

KPMG observation

Under the 2020 Final FDII Regulations, whether a service is an ESS appears to be determined entirely based on the method of its delivery rather than the nature of the service. As a result, any service delivered online, including by email or VoIP (Voice over Internet Protocol), could be an ESS, even if the value of the service is not attributable to the internet or an electronic network (e.g., legal services). The 2020 Proposed Regulations would significantly limit the types of services that would qualify as an ESS, but the proposed rules would not resolve entirely the ambiguity in the definition.

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For example, it seems clear that a webcast or instructional video made available electronically that is accessed live would not be treated as ESS, since the value of that service is derived primarily from the human effort of the presenters rather than its electronic delivery (such services could just as easily be delivered in person). However, if the webcast, after the live-stream, is added to a catalogue of content of the provider from which it remains available and accessible on-demand by its customers, it is unclear whether the value of the provider's service could be viewed, at this point, as being derived primarily from the electronic and automated delivery of the service.

Definitions of FOGEI and DOGEI

Section 250 provides a domestic corporation a deduction for its foreign-derived intangible income ("FDII") and global intangible low-taxed income ("GILTI") inclusion amount (including any section 78 gross up related to the GILTI inclusion amount). In general, a corporation's FDII is determined without regard to its domestic oil and gas extraction income ("DOGEI"). Similarly, a corporation's GILTI inclusion amount is determined without regard to its CFCs' foreign oil and gas extraction income ("FOGEI"). Section 951A(c)(2)(A)(i)(V) defines FOGEI by cross-reference to section 907(c)(1) as taxable income from an active oil and gas extraction trade or business "derived from sources without the United States." The Final FDII Regulations also define DOGEI by cross-reference to section 907(c)(1), except that "within the United States" is substituted for "without the United States."

In order to address concerns that taxpayers could use different methods of determining DOGEI and FOGEI in order to maximize FDII (by minimizing DOGEI) and minimize GILTI (by maximizing FOGEI), respectively, the 2020 Proposed Regulations would require that a taxpayer use a consistent method for determining both DOGEI and FOGEI. The preamble notes that taxpayers are already required to use the same method of allocation and principles of apportionment under existing Reg. § 1.861-8(f)(2)(i) where more than one operative section apply (e.g., section 904 and section 250).

KPMG observation

While the Final FDII Regulations are effective prospectively, taxpayers may apply those regulations to any pre-2021 tax year, if they apply those regulations consistently. In contrast, the 2020 Proposed Regulations do not permit taxpayers to rely on the proposed modifications to the FDII rules, either for the current year or retroactively. Therefore, a taxpayer that applies the Final FDII Regulations to a pre-2021 tax year is not explicitly permitted to rely on the modifications in the 2020 Proposed Regulations until finalized. Taxpayers should keep this in mind in choosing whether to substantively apply the statute, the 2019 Proposed FDII Regulations, or the 2020 Final FDII Regulations for their pre-2021 tax years.

Applicability date

Consistent with the prospective applicability date in the 2020 Final FDII Regulations, the changes to the definitions of DOGEI, FOGEI, and ESS are proposed to apply to tax years beginning on or after January 1, 2021.

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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

Bob Wilkerson
T: +1 404 222 3639
E: rwilkerson@kpmg.com

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

www.kpmg.com

kpmg.com/socialmedia

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