KPMG report: Correcting amendments to foreign tax credit regulations

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Introduction

The U.S. Treasury Department and IRS released two sets of technical corrections that make changes to final regulations relating primarily to the determination of the foreign tax credit (FTC) and the allocation and apportionment of deductions (including foreign income taxes). The technical corrections were published in the Federal Register today, July 27, 2022. Read the **final regulations** [PDF 1.2 MB] (T.D. 9959, and the "2021 Final Regulations") released December 28, 2021, and published in the Federal Register on January 4, 2022.

- The **first set of correcting amendments** [PDF 252 KB] was issued under sections 245A, 338, 367, 861, 901, 904, 905, 951A, and 960 of the Internal Revenue Code. The correcting amendments are effective upon publication in the Federal Register and applicable to tax years as provided for in the 2021 Final Regulations. Read a **January 2022 report** [PDF 1.5 MB] prepared by KPMG LLP that provides a discussion and initial analysis of the 2021 Final Regulations.

- The changes in the **second set of correcting amendments** [PDF 225 KB] reflect revisions to the language of the preamble to the 2021 Final Regulations.

Creditability of foreign taxes

The 2021 Final Regulations provided revised rules for determining whether a foreign levy is a creditable foreign income tax. Under those rules, the cost recovery requirement is satisfied if the foreign tax base allows the recovery of significant costs and expenses attributable to the gross receipts included in the foreign tax base. The 2021 Final Regulations identified certain costs and expenses that are always treated as significant costs and expenses. A disallowance of a deduction for all or a portion of such "per se" significant costs and expenses would cause the cost recovery requirement to be failed unless the foreign law disallowance is consistent with the principles underlying the disallowances required under the Code, including disallowances intended to limit base erosion or profit shifting (the "disallowance rule").

As corrected, the cost recovery requirement is satisfied if a disallowance of a deduction for a significant expense is consistent with ***any*** principle underlying the disallowances required under the Code, including the principles of limiting base erosion or profit shifting and public policy concerns. The correction also modified the in-line example demonstrating the application of the disallowance rule by removing certain details of a hypothetical foreign tax law relating to a permissible interest disallowance (i.e., by striking a reference to a 10% cap on interest deductions), as well as language providing that the permissible disallowance under the hypothetical foreign tax law is "based on principles similar to those underlying" section 163(j).

KPMG observation

Many taxpayers viewed the cost recovery requirement in the 2021 Final Regulations as overly restrictive. Treasury had publicly stated its intention to provide clarifications with respect to the disallowance rule to avoid narrow interpretations of such rule.

In general, the correction does not appear to eliminate the "cliff effect" whereby a foreign income tax would not be creditable in whole if the foreign tax law does not permit the recovery of a single significant cost or expense. However, when recovery of all or a portion of certain costs or expenses is disallowed under the applicable foreign tax law, the correction expressly permits taxpayers to consider "any" principle under the

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Code, including the principles of preventing base erosion and profit shifting and—more broadly—public policy concerns, to determine whether the cost recovery requirement is nevertheless satisfied. In this manner, the correction clarifies that taxpayers need not rely on, or identify, a specific provision of the Code (or a principle more specific than the general prevention of base erosion or profit shifting) that is directly analogous to the specific disallowance under foreign tax law (e.g., section 163(j) in the case of an interest disallowance or section 267A in the case of a deduction disallowed in connection with a hybrid transaction).

Taken to a logical extreme, any disallowance of cost recovery could be framed through the lens of preventing base erosion. Yet, the retention of a "per se" rule subject to an exception for disallowances that are "consistent with … the principles of preventing base erosion or profit shifting" suggests that a reading that expansive cannot be intended. One potential resolution of that tension would be to look to the legislative history of the foreign provision to see if it was subjectively intended to prevent base erosion or profit shifting. However, the 2021 Final Regulation as corrected arguably weakens the inference that such an inquiry is relevant by removing any mention of comparing the principles underlying a foreign disallowance to a principle underlying any disallowance in the Code. Thus, taxpayers may continue to struggle in their application of the 2021 Final Regulation due to the lack of any clarity as to the intended scope of the exception related to the prevention of base erosion.

Allocation and apportionment of foreign taxes

The 2021 Final Regulations provided disregarded payment (DRP) 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 basket regulations finalized in 2019 (the "Foreign Branch DRT Rules") or the disregarded payment rules provided by the GILTI high-tax exception regulations (the "HTE DRP Rules").

The 2021 Final Regulations also provided that foreign gross income with respect to a DRP received in exchange for property (including inventory) was assigned to the relevant groupings using the rules applicable to timing differences. The correction modifies the operative rule for DRPs received in exchange for disregarded sales of property to provide that it does not apply to the portion of a DRP that is a reattribution payment. Consequently, foreign gross income arising from a DRP received in exchange for property and that meets the definition of a reattribution payment generally will be subject to the rule for reattribution payments.

KPMG observation

In addition to characterizing foreign gross income with respect to a disregarded sale of property pursuant to the reattribution rules, the change to the 2021 Final Regulation could also affect the application of the 2021 Final Regulations' remittance rule. The remittance rule characterizes foreign gross income with respect to a remittance using the asset method. Reattribution payments can result in the reattribution of assets from one taxable unit to another. Prior to correction, the 2021 Final Regulations would not have treated a disregarded payment made in exchange for property as a reattribution payment and there would have been no reattribution of assets as a result of such payments. The correction would cause a reattribution of assets to the extent that the DRP made in exchange for property resulted in a reattribution payment.

Assume controlled foreign corporation (CFC) owns DRE1 and DRE2. In Year 1, DRE1 incurs $80 cost of goods sold (COGS) to produce inventory and sells such inventory to DRE2 for $100. Also in Year 1, DRE2 sells the inventory to an unrelated party for $110. For U.S. tax purposes, there is $30 regarded gain ("U.S. Gross

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Income") on the inventory sales which is recorded on DRE2's separate books and records (as adjusted to conform to U.S. tax principles). On these facts, it is expected that $20 of DRE2's U.S. Gross Income would be reattributed to DRE1, and thus treated as a reattribution payment and could result in a reattribution of assets for purposes of applying the remittance rule.

Foreign branch category income

The 2021 Final Regulations provided 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 2021 Final Regulations added the terms "foreign branch contribution," "foreign branch group," and "foreign branch owner group." However, the definitions of foreign branch group and foreign branch owner group arguably required the group to include at least one non-branch taxable unit. The correction revises the definitions of a foreign branch group and foreign branch owner group to require the inclusion of a non-branch taxable unit in the relevant group only if a non-branch taxable unit is actually owned by the foreign branch or the foreign branch owner, as the case may be.

KPMG observation

The correction modifies the definition of a foreign branch group and foreign branch owner group to clarify that foreign gross income related to a foreign branch contribution will be characterized as foreign branch basket income to the extent that the contribution is made to a foreign branch.

GILTI tested income

The 2021 Final Regulations modified the definition of a "current year tax" and added a new defined term, "eligible current year tax," in regulations under section 960. The correction makes a corresponding modification to a cross-reference within the global intangible low taxed income (GILTI) regulations dealing with the effective rate test for the GILTI high-tax exception to now refer to an "eligible current year tax" (instead of a "current year tax") as defined in the section 960 regulations.

KPMG observation

The term "eligible current year tax" excludes taxes for which a credit is disallowed at the level of a controlled foreign corporation—for example, a tax disallowed under section 901(m). The modification to the cross-reference within the GILTI regulations ensures that certain disallowed taxes will not be attributed to tentative tested income for purposes of applying the GILTI high-tax exception.

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