DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–101657–20]

RIN 1545–BP70

Guidance Related to the Foreign Tax Credit; Clarification of Foreign-Derived Intangible Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the foreign tax credit, including guidance on the disallowance of a credit or deduction for foreign income taxes with respect to dividends eligible for a dividends-received deduction; the allocation and apportionment of interest expense, foreign income tax expense, and certain deductions of life insurance companies; the definition of a foreign income tax and a tax in lieu of an income tax; transition rules relating to the impact on loss accounts of net operating loss carrybacks allowed by reason of the Coronavirus Aid, Relief, and Economic Security Act; the definition of foreign branch category and financial services income; and the time at which foreign taxes accrue and can be claimed as a credit. This document also contains proposed regulations clarifying rules relating to foreign-derived intangible income. The proposed regulations affect taxpayers that claim credits or deductions for foreign income taxes, or that claim a deduction for foreign-derived intangible income.

DATES: Written or electronic comments and requests for a public hearing must be received by February 10, 2021.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–101657–20) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. The Department of the Treasury (the ''Treasury Department'') and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket. Send paper submissions to: CC:PA:LPD:PR (REG–101657–20), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under §§ 1.245A(d)–1, 1.336–2, 1.338–9, 1.861–3, 1.861–20, 1.904–6, 1.960–1, and 1.960–2, Suzanne M. Walsh, (202) 317–4908; concerning §§ 1.250(b)–1, 1.861–8, 1.861–9, and 1.861–14, Jeffrey P. Cowan, (202) 317–4924; concerning § 1.250(b)–5, Brad McCormack, (202) 317–6911; concerning §§ 1.164–2, 1.901–1, 1.901–2, 1.903–1, 1.905–1, and 1.905–3, Tianlin (Laura) Shi, (202) 317–6987; concerning §§ 1.367(b)–3, 1.367(b)–4, and 1.367(b)–10, Logan Kincheloe, (202) 317–6075; concerning §§ 1.367(b)–7, 1.861–10, 1.904–2, 1.904–4, 1.904–5, and 1.904(f)–12, Jeffrey L. Parry, (202) 317–4916; concerning submissions of comments and requests for a public hearing, Regina Johnson, (202) 317–5177 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On December 7, 2018, the Treasury Department and the IRS published proposed regulations (REG–105600–18) relating to foreign tax credits in the **Federal Register** (83 FR 63200) (the ''2018 FTC proposed regulations''). Those regulations addressed several significant changes that the Tax Cuts and Jobs Act (Pub. L. 115–97, 131 Stat. 2054, 2208 (2017)) (the ''TCJA'') made with respect to the foreign tax credit rules and related rules for allocating and apportioning deductions in determining the foreign tax credit limitation. On December 17, 2019, portions of the 2018 FTC proposed regulations were finalized in TD 9882, published in the **Federal Register** (84 FR 69022) (the ''2019 FTC final regulations''). On the same date, new proposed regulations were issued addressing changes made by the TCJA as well as other related foreign tax credit rules (the ''2019 FTC proposed regulations''). Correcting amendments to the 2019 FTC final regulations and the 2019 FTC proposed regulations were published in the **Federal Register** on May 15, 2020, see 85 FR 29323 (2019 FTC final regulations) and 85 FR 29368 (2019 FTC proposed regulations). The 2019 FTC proposed regulations are finalized in the Rules and Regulations section of this issue of the **Federal Register** (the ''2020 FTC final regulations'').

On July 15, 2020, the Treasury Department and the IRS finalized regulations under section 250 (the ''section 250 regulations'') in TD 9901, published in the **Federal Register** (85 FR 43042).

This document contains proposed regulations (the ''proposed regulations'') addressing: (1) The determination of foreign income taxes subject to the credit and deduction disallowance provision of section 245A(d); (2) the determination of oil and gas extraction income from domestic and foreign sources and of electronically supplied services under the section 250 regulations; (3) the impact of the repeal of section 902 on certain regulations issued under section 367(b); (4) the sourcing of inclusions under sections 951, 951A, and 1293; (5) the allocation and apportionment of interest deductions, including rules for allocating interest expense of foreign bank branches and certain regulated utility companies, an election to capitalize research and experimental expenditures and advertising expenses for purposes of calculating tax basis, and a revision to the controlled foreign corporation (''CFC'') netting rule; (6) the allocation and apportionment of section 818(f) expenses of life insurance companies that are members of consolidated groups; (7) the allocation and apportionment of foreign income taxes, including taxes imposed with respect to disregarded payments; (8) the definitions of a foreign income tax and a tax in lieu of an income tax, including the addition of a jurisdictional nexus requirement and changes to the net gain requirement, the treatment of certain tax credits, the treatment of foreign tax law elections for purposes of the noncompulsory payment rules, and the substitution requirement under section 903; (9) the allocation of the liability for foreign income taxes in connection with certain mid-year transfers or reorganizations; (10) transition rules to account for the effect on loss accounts of net operating loss carrybacks to pre-2018 taxable years that are allowed under the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116–136, 134 Stat. 281 (2020); (11) the foreign branch category rules in § 1.904–4(f) and the definition of a financial services entity for purposes of section 904; and (12) the time at which credits for foreign income taxes can be claimed pursuant to sections 901(a) and 905(a).

Explanation of Provisions

I. Foreign Income Taxes With Respect to Dividends for Purposes of Section 245A(d)

Section 245A(d)(1) provides that no credit is allowed under section 901 for any taxes paid or accrued (or treated as paid or accrued) with respect to any dividend for which a deduction is allowed under that section. Section 245A(d)(2) disallows a deduction under chapter 1 for any tax for which a credit is not allowable under section 901 by reason of section 245A(d)(1). Section 245A(e)(3) also provides that no credit or deduction is allowed for foreign income taxes paid or accrued with respect to a hybrid dividend or a tiered hybrid dividend.

Proposed § 1.245A(d)–1(a) generally provides that neither a foreign tax credit under section 901 nor a deduction is allowed for foreign income taxes (as defined in § 1.901–2(a)) that are ''attributable to'' certain amounts. For this purpose, the proposed regulations rely on the rules in § 1.861–20, contained in the 2020 FTC final regulations and proposed to be modified in these proposed regulations, that allocate and apportion foreign income taxes to income for purposes of various operative sections, including sections 904, 960, and 965(g). Specifically, proposed § 1.245A(d)–1 provides that § 1.861–20 (which includes portions contained in these proposed regulations as well as in the 2020 FTC final regulations) applies for purposes of determining foreign income taxes paid or accrued that are attributable to any dividend for which a deduction is allowed under section 245A(a), to a hybrid dividend or tiered hybrid dividend, or to previously taxed earnings and profits that arose as a result of a sale or exchange that by reason of section 964(e)(4) or 1248 gave rise to a deduction under section 245A(a) or as a result of a tiered hybrid dividend that by reason of section 245A(e)(2) gave rise to an inclusion in the gross income of a United States shareholder (collectively, such previously taxed earnings and profits are referred to as ''section 245A(d) PTEP'').

In addition, the rules apply to foreign income taxes that are imposed with respect to certain foreign taxable events, such as a deemed distribution under foreign law or an inclusion under a foreign law CFC inclusion regime, even though such event does not give rise to a distribution or inclusion for Federal income tax purposes. Proposed § 1.245A(d)–1(a) provides that foreign income taxes that are attributable to ''specified earnings and profits'' are also subject to the disallowance under section 245A(d). Under proposed § 1.245A(d)–1(b), § 1.861–20 applies to determine whether foreign income taxes are attributable to specified earnings and profits. Under § 1.861–20, foreign income taxes may be allocated and apportioned by reference to specified earnings and profits, even though the person paying or accruing the foreign income tax does not have a corresponding U.S. item in the form of a distribution of, or income inclusion with respect to, such earnings and profits. See, for example, § 1.861–20(d)(2)(ii)(B), (C), or (D) (foreign law distribution or foreign law disposition and certain foreign law transfers between taxable units), (d)(3)(i)(C) (income from a reverse hybrid), (d)(3)(iii) (foreign law inclusion regime), and proposed § 1.861–20(d)(3)(v)(C)(*1*)(*i*) (disregarded payment treated as a remittance). Specified earnings and profits means earnings and profits that would give rise to a section 245A deduction (without regard to the holding period requirement under section 246 or the rules under § 1.245A–5 that disallow a deduction under section 245A(a) for certain dividends), a hybrid dividend, or a tiered hybrid dividend, or a distribution sourced from section 245A(d) PTEP if an amount of money equal to all of the foreign corporation's earnings and profits were distributed. Therefore, for example, a credit or deduction for foreign income taxes paid or accrued by a domestic corporation that is a United States shareholder (''U.S. shareholder'') with respect to a distribution that is not recognized for Federal income tax purposes (for example, in the case of a consent dividend under foreign tax law that is not regarded for Federal income tax purposes, or a distribution of stock that is excluded from gross income under section 305(a) but is treated as a taxable dividend under foreign tax law) is not allowed under section 245A(d) to the extent those foreign income taxes are attributable to specified earnings and profits.

An anti-avoidance rule is included in proposed § 1.245A(d)–1 to address situations in which taxpayers engage in transactions with a principal purpose of avoiding the purposes of section 245A(d), which is to disallow a foreign tax credit or deduction with respect to foreign income taxes imposed on income that is effectively exempt from tax (due to the availability of a deduction under section 245A(a)) or with respect to foreign income taxes imposed on a hybrid dividend or tiered hybrid dividend. Such transactions may include transactions to separate foreign income taxes from the income to which they relate in situations that are not explicitly covered under § 1.861–20 (including, for example, loss sharing transactions under group relief regimes). Such transactions may also include successive distributions (under foreign law) out of earnings and profits that, under the rules in § 1.861–20, are treated as distributed out of previously taxed earnings and profits (and therefore foreign income taxes attributable to such amounts are not generally subject to the disallowance under section 245A(d)), when there is no reduction of such previously taxed earnings and profits due to the absence of a distribution under Federal income tax law. See proposed § 1.245A(d)–1(e)(4) (*Example 3*). The Treasury Department and the IRS are concerned that because the rules in § 1.861–20(d) addressing foreign law distributions and dispositions do not currently make adjustments to a foreign corporation's earnings and profits to reflect distributions that are not recognized for Federal income tax purposes, such foreign law transactions could be used to circumvent the purposes of section 245A(d). Comments are requested on potential revisions to § 1.861–20(d) that could address these concerns, including the possibility of maintaining separate earnings and profits accounts, characterized with reference to the relevant statutory and residual groupings, for each taxable unit whereby the accounts would be adjusted annually to reflect transactions that occurred under foreign law but not under Federal income tax law.

II. Clarifications to Regulations Under Section 250

A. Definition of Domestic and Foreign Oil and Gas Extraction Income

Section 250 provides a domestic corporation a deduction (''section 250 deduction'') for its foreign-derived intangible income (''FDII'') as well as its global intangible low-taxed income (''GILTI'') inclusion amount and the amount treated as a dividend under section 78 that is attributable to its GILTI inclusion. The section 250 deduction attributable to FDII is calculated in part by determining the foreign-derived portion of a corporation's deduction eligible income (''DEI''). DEI is defined as the excess of gross DEI over the deductions (including taxes) properly allocable to such gross income. See section 250(b)(3)(A) and § 1.250(b)–1(c)(2). Gross DEI is determined without regard to domestic oil and gas extraction income (''DOGEI''), which is defined as income described in section 907(c)(1) determined by substituting ''within the United States'' for ''without the United States.'' See section 250(b)(3)(B) and § 1.250(b)–1(c)(7). Similarly, foreign oil and gas extraction income (''FOGEI'') as defined in section 907(c)(1) is excluded from the computation of gross tested income which is used to determine a U.S. shareholder's GILTI inclusion amount. See § 1.951A–2(c)(1)(v).

The Treasury Department and the IRS have determined that it would be inappropriate for taxpayers to use inconsistent methods to determine the amounts of DOGEI and FOGEI from the sale of oil or gas that has been transported or processed. Taxpayers with both types of income may have an incentive to minimize their DOGEI in order to maximize their potential section 250 deduction attributable to FDII, while in contrast maximizing their FOGEI in order to minimize their gross tested income, even though this would also decrease the amount of the section 250 deduction attributable to their GILTI inclusion amount. Accordingly, the proposed regulations provide that taxpayers must use a consistent method for purposes of determining both DOGEI and FOGEI. See proposed § 1.250(b)–1(c)(7). Similarly, for purposes of allocating and apportioning deductions, taxpayers are already required under existing regulations to use the same method of allocation and the same principles of apportionment where more than one operative section, for example sections 250 and 904, apply. See § 1.861–8(f)(2)(i).

B. Definition of Electronically Supplied Service

Section 1.250(b)–5(c)(5) defines the term ''electronically supplied service'' to mean a general service (other than an advertising service) that is delivered primarily over the internet or an electronic network, and provides that such services include, by way of examples, cloud computing and digital streaming services.

Since the publication of the section 250 regulations, the Treasury Department and the IRS have determined that the definition of electronically supplied services could be interpreted in a manner that includes services that were not primarily electronic and automated in nature but rather where the renderer applies human effort or judgment, such as professional services that are provided through the internet or an electronic network. Therefore, these proposed regulations clarify that the value of the service to the end user must be derived primarily from the service's automation or electronic delivery in order to be an electronically supplied service. The regulations further provide that services that primarily involve the application of human effort by the renderer to provide the service (not including the effort involved in developing or maintaining the technology to enable the electronic service) are not electronically supplied services. For example, certain services for which automation or electronic delivery is not a primary driver of value, such as legal, accounting, medical, or teaching services delivered electronically and synchronously, are not electronically supplied services.

III. Carryover of Earnings and Profits and Taxes When One Foreign Corporation Acquires Assets of Another Foreign Corporation in a Section 381 Transaction

Section 1.367(b)–7 provides rules regarding the manner and the extent to which earnings and profits and foreign income taxes of a foreign corporation carry over when one foreign corporation (''foreign acquiring corporation'') acquires the assets of another foreign corporation (''foreign target corporation'') in a transaction described in section 381 (the combined corporation, the ''foreign surviving corporation''). See § 1.367(b)–7(a). Before the repeal of section 902 in the TCJA, these rules were primarily relevant for determining the foreign income taxes of the foreign surviving corporation that were considered deemed paid by its U.S. shareholder with respect to a distribution or inclusion under section 902 or 960, respectively.

Section 1.367(b)–7 applies differently with respect to ''pooling corporations'' and ''nonpooling corporations.'' A pooling corporation is a foreign corporation with respect to which certain ownership requirements were satisfied in pre-2018 taxable years and that, as a result, maintained ''pools'' of post-1986 undistributed earnings and related post-1986 foreign income taxes. See § 1.367(b)–2(l)(9). In general, if the foreign surviving corporation was a pooling corporation, the post-1986 undistributed earnings and post-1986 foreign income taxes of the foreign acquiring corporation and the foreign target corporation were combined on a separate category-by-separate category basis. See § 1.367(b)–7(d)(1). However, the regulations required the foreign surviving corporation to combine the taxes related to a deficit in a separate category of post-1986 undistributed earnings of one or both of the foreign acquiring corporation or foreign target corporation (a ''hovering deficit'') with other post-1986 foreign income taxes in that separate category only on a pro rata basis as the hovering deficit was absorbed by post-transaction earnings in the same separate category. See § 1.367(b)–7(d)(2)(iii). Similarly, a hovering deficit in a separate category of post-1986 undistributed earnings could offset only earnings and profits accumulated by the foreign surviving corporation after the section 381 transaction. Under § 1.367(b)–7(d)(2)(ii), the reduction or offset was generally deemed to occur as of the first day of the foreign surviving corporation's first taxable year following the year in which the post-transaction earnings accumulated.

A nonpooling corporation is a foreign corporation that is not a pooling corporation and, as a result, maintains ''annual layers'' of pre-1987 accumulated profits and pre-1987 foreign income taxes. See § 1.367(b)–2(l)(10). In general, a foreign surviving corporation maintains the annual layers of pre-1987 accumulated profits and pre-1987 foreign income taxes, and the taxes related to a deficit in an annual layer cannot be associated with post-section 381 transaction earnings of the foreign surviving corporation.

As a result of the repeal of section 902 in the TCJA, post-1986 foreign income taxes and pre-1987 foreign income taxes of foreign corporations are generally no longer relevant for taxable years beginning on or after January 1, 2018. In addition, consistent with the TCJA, the Treasury Department and the IRS issued regulations under section 960 clarifying that only current year taxes are taken into account in determining taxes deemed paid under section 960. See § 1.960–1(c)(2). Current year tax means certain foreign income tax paid or accrued by a controlled foreign corporation in a current taxable year. See § 1.960–1(b)(4).

In light of the changes made by the TCJA and subsequent implementing regulations, the proposed regulations provide rules to clarify the treatment of foreign income taxes of a foreign surviving corporation in taxable years of foreign corporations beginning on or after January 1, 2018, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end (''post-2017 taxable years''). The proposed regulations provide that all foreign target corporations, foreign acquiring corporations, and foreign surviving corporations are treated as nonpooling corporations in post-2017 taxable years and that any amounts remaining in the post-1986 undistributed earnings and post-1986 foreign income taxes of any such corporation as of the end of the foreign corporation's last taxable year beginning before January 1, 2018, are treated as earnings and taxes in a single pre-pooling annual layer in the foreign corporation's post-2017 taxable years.

The proposed regulations also clarify that foreign income taxes that are related to non-previously taxed earnings of a foreign acquiring corporation and a foreign target corporation that were accumulated in taxable years before the current taxable year of the foreign corporation, or in a foreign target corporation's taxable year that ends on the date of the section 381 transaction, are not treated as current year taxes (as defined in § 1.960–1(b)(4)) of a foreign surviving corporation in any post-2017 taxable year. Furthermore, the proposed regulations clarify that foreign income taxes related to hovering deficits are not current year taxes in the year that the hovering deficit is absorbed, in part because the hovering deficit is not considered to offset post-1986 undistributed earnings until the first day of the foreign surviving corporation's first taxable year following the year in which the post-transaction earnings accumulated. In addition, because such taxes were paid or accrued by a foreign corporation in a prior taxable year, they are not considered paid or accrued by the foreign corporation in the current taxable year and therefore are not current year taxes under § 1.960–1(b)(4). Finally, foreign income taxes related to a hovering deficit in pre-1987 accumulated profits generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c); therefore, such foreign income taxes are never included in current year taxes.

In addition to the proposed changes to § 1.367(b)–7, the proposed regulations remove some references to section 902 in other regulations issued under section 367(b) that are no longer relevant as a result of the repeal of section 902. For example, pursuant to § 1.367(b)–4(b)(2), a deemed dividend inclusion is required in certain cases upon the receipt of preferred stock by an exchanging shareholder, in order to prevent the excessive potential shifting of earnings and profits, notwithstanding that the exchanging shareholder's status as a section 1248 shareholder is preserved. One of the conditions for application of the rule requires a domestic corporation to meet the ownership threshold of section 902(a) or (b) and, thus, be eligible for a deemed paid credit on distributions from the transferee foreign corporation. § 1.367(b)–4(b)(2)(i)(B). These proposed rules generally retain the substantive ownership threshold of this requirement, but without reference to section 902 and by modifying the ownership threshold requirement to consider not only voting power but value as well. Specifically, § 1.367(b)–4(b)(2)(i)(B) is revised to require that a domestic corporation owns at least 10 percent of the transferee foreign corporation by vote or value.

Comments are requested as to whether further changes to § 1.367(b)–4 or 1.367(b)–7, or any changes to other regulations issued under section 367, are appropriate in order to clarify their application after the repeal of section 902. In addition, the Treasury Department and the IRS are studying the interaction of § 1.367(b)–4(b)(2) with section 245A and other Code provisions and considering whether additional revisions to the regulation are appropriate in light of TCJA generally. Comments are specifically requested with respect to the proposed revisions to § 1.367(b)–4(b)(2), including whether there is a continuing need to prevent excessive potential shifting of earnings and profits through the use of preferred stock in light of the TCJA generally. For example, the Treasury Department and the IRS are considering, and request comments on, the extent to which, in certain transactions described in § 1.367(b)–4(b)(2), (1) an exchanging shareholder who would not qualify for a deduction under section 245A could potentially shift earnings and profits of a foreign acquired corporation to a transferee foreign corporation with a domestic corporate shareholder that would qualify for a deduction under section 245A, or (2) a domestic corporate exchanging shareholder of a foreign acquired corporation with no earnings and profits could access the earnings and profits of a transferee foreign corporation.

IV. Source of Inclusions Under Sections 951, 951A, 1293, and Associated Section 78 Dividend

Sections 861(a) and 862(a) contain rules to determine the source of certain items of gross income. Section 863(a) provides that the source of items of gross income not specified in sections 861(a) and 862(a) will be determined under regulations prescribed by the Secretary. As a result of changes to section 960 made by the TCJA, the Treasury Department and the IRS revised the regulations under section 960. As part of that revision, the Treasury Department and the IRS removed former § 1.960–1(h)(1), which contained a source rule for the amount included in gross income under section 951 and the associated section 78 dividend. Section 1.960–1(h)(1) provided that, for purposes of section 904, the amount included in gross income of a domestic corporation under section 951 with respect to a foreign corporation, plus any section 78 dividend to which such section 951 inclusion gave rise by reason of taxes deemed paid by such domestic corporation, was derived from sources within the foreign country or possession of the United States under the laws of which such foreign corporation, or the first-tier corporation in the same chain of ownership as such foreign corporation, was created or organized.

Although section 904(h)(1) treats as from sources within the United States certain amounts included in gross income under section 951(a) that otherwise would be treated as derived from sources without the United States, absent former § 1.960–1(h)(1), no rule specifies the source of inclusions under section 951 before the application of section 904(h)(1). In addition, the rule in former § 1.960–1(h)(1) only provided for the source of a domestic corporation's section 951 inclusions for purposes of section 904. A similar lack of guidance exists with respect to the source of inclusions under section 951A. See section 951A(f)(1)(A) (requiring the application of section 904(h)(1) with respect to amounts included in gross income under section 951A(a) in the same manner as amounts included under section 951(a)(1)(A)). The removal of former § 1.960–1(h)(1) also left uncertain the source of amounts included in gross income as a result of an election under section 1293(a), because under section 1293(f)(1), such amounts are treated for purposes of section 960 as amounts included in gross income under section 951(a).

To clarify the source of income inclusions after the removal of former § 1.960–1(h)(1), the proposed regulations include a new rule in § 1.861–3(d), which provides that for purposes of the sourcing provisions an amount included in the gross income of a United States person under section 951 is treated as a dividend received by the United States person directly from the foreign corporation that generated the inclusion.

This proposed rule differs from former § 1.960–1(h)(1) in two respects. First, former § 1.960–1(h)(1) provided that if the foreign corporation that generated the income included under section 951 was held indirectly through other foreign corporations, the amount included was treated as if it had been paid through such intermediate corporations and as received from the first-tier foreign corporation. The Treasury Department and the IRS have determined that, in light of the repeal of section 902, and because a section 951 inclusion with respect to a lower-tier CFC is not treated as a deemed distribution through the first-tier CFC, the source of the inclusion should be determined by reference to the lower-tier CFC.

Second, former § 1.960–1(h)(1) treated the entire amount of the inclusion under section 951 as derived from sources without the United States. However, the Treasury Department and the IRS have determined that because dividends and inclusions of the same earnings and profits should be sourced in the same manner, the general rule for inclusions under section 951 should be consistent with the rule in section 861(a)(2)(B) and § 1.861–3(a)(3) that treats dividends as derived from sources within the United States to the extent that the dividend is from a foreign corporation with significant income effectively connected with the conduct of a trade or business in the United States. This is particularly appropriate in circumstances in which effectively connected income is not excluded from subpart F income under section 952(b) (which could arise as a result of a treaty obligation of the United States precluding the effectively connected income from being taxed by the United States in the hands of the CFC). In addition, the Treasury Department and the IRS have determined that the source of a taxpayer's gross income from an inclusion of CFC earnings that are subject to a high rate of foreign tax should be the same, regardless of whether the taxpayer includes the income under subpart F or elects the high-taxed exception of section 954(b)(4) and repatriates the earnings as a dividend. Therefore, the proposed regulations provide that the source of an inclusion under section 951 is determined under the same rules as those for dividends. However, the resourcing rules in section 904(h) and § 1.904–5(m) independently operate to ensure that dividends and inclusions under section 951(a) that are attributable to U.S. source income of the CFC retain that U.S. source in the hands of the United States shareholder.

The proposed regulations also clarify that the source of section 78 dividends associated with inclusions under section 951 follows the rules for sourcing dividends. See also § 1.78–1(a).

Finally, and consistent with sections 951A(f)(1)(A) and 1293(f)(1), the proposed regulations apply the same rules with respect to inclusions under sections 951A and 1293 and the associated section 78 dividend.

V. Allocation and Apportionment of Expenses Under Section 861 Regulations

A. Election To Capitalize R&E and Advertising Expenditures

A taxpayer determines its foreign tax credit limitation under section 904, in part, based on the taxpayer's taxable income from sources without the United States. Taxable income from sources without the United States is determined by deducting from the items of gross income from sources without the United States the expenses, losses, and other deductions properly allocated and apportioned to that income, and a ratable part of any expenses, losses, or other deductions that cannot definitely be allocated to some item or class of gross income. See section 862(b). Section 864(e)(2) generally requires taxpayers to allocate and apportion interest expense on the basis of assets, rather than income. Under the asset method, a taxpayer apportions interest expense to the various statutory or residual groupings based on the average total value of assets within each grouping for the taxable year as determined under the asset valuation rules of § 1.861–9T(g).

The preamble to the 2019 FTC proposed regulations stated that the Treasury Department and the IRS continue to study the rules for allocating and apportioning interest deductions, and requested comments on a potential proposal to provide for the capitalization and amortization of certain expenses solely for purposes of § 1.861–9 to better reflect asset values under the tax book value method. One comment supported the adoption of such a rule.

The Treasury Department and the IRS recognize that internally-developed intangible assets (including intangible assets such as goodwill that are created as a result of advertising) that have no tax book value because the costs of generating them have been currently deducted may nevertheless have continuing economic value, and that debt financing may support the generation and maintenance of that value. Accordingly, proposed § 1.861–9(k) provides an election for taxpayers to capitalize and amortize their research and experimental (''R&E'') and advertising expenditures incurred in a taxable year. This election is analogous to the election under § 1.861–9(i) to determine asset values based on the alternative tax book value method, since both elections allow taxpayers to determine the tax book value of an asset in a manner that is different from the general rules that apply under Federal income tax law, but solely for purposes of allocating and apportioning interest expense under § 1.861–9, and not for any other Federal income tax purpose (such as determining the amount of any deduction actually allowed for depreciation or amortization).

Proposed § 1.861–9(k)(1) and (2) generally provides that for purposes of allocating and apportioning interest expense under § 1.861–9, an electing taxpayer capitalizes and amortizes its R&E expenditures under the rules in section 174 as contained in Public Law 115–97, title I, § 13206(a), which generally requires that beginning in taxable years beginning in 2022, R&E expenditures must be capitalized and then amortized.

Similarly, proposed § 1.861–9(k)(1) and (3) generally requires an electing taxpayer to capitalize and amortize its advertising expenditures. The definition of advertising expenditures and the method of cost recovery contained in proposed § 1.861–9(k)(3) is based on prior legislative proposals (which have not been enacted) proposing that certain advertising expenditures be capitalized. See, for example, H.R.1, 113th Cong. Section 3110 (2014). Comments are requested on whether a different definition of advertising expenditures or a different method of cost recovery should be adopted for purposes of the election in proposed § 1.861–9(k).

B. Nonrecourse Debt of Certain Utility Companies

Section 1.861–10T provides certain exceptions to the general asset-based apportionment of interest expense requirement under section 864(e)(2), including rules that directly allocate interest expense to the income generated by certain assets that are subject to ''qualified nonrecourse indebtedness.'' See § 1.861–10T(b).

A comment to the 2019 FTC proposed regulations asserted that interest expense incurred on certain debt of regulated utility companies should be directly allocated to income from assets of the utility business because the debt must be approved by a regulatory agency and relates directly to the underlying needs of the utility business. The comment suggested that the existing rules for qualified nonrecourse indebtedness were insufficient because utility indebtedness is often subject to guarantees and cross collateralizations that permit the lender to seek recovery beyond any identified property, and because the cash flows of a regulated utility company used to support utility indebtedness are broader than the permitted cash flows described in § 1.861–10T(b).

In response to this comment, the proposed regulations provide that certain interest expense of regulated utility companies is directly allocated to assets of the utility business. See proposed § 1.861–10(f). The type of utility companies that qualify for the rule, and the rules for tracing debt to assets, are modeled on similar rules provided in regulations under section 163(j). See §§ 1.163(j)–1(b)(15) and 1.163(j)–10(d)(2). Consistent with the approach taken in § 1.163(j)–10(d)(2), the proposed regulations expand the scope of permitted cash flows under § 1.861–10T(b) but do not modify the requirement that the creditor look to particular assets as security for payment on the loan because unsecured debt generally is supported by all of the assets of the borrower. See also Part XI.L.2 of the Summary of Comments and Explanation of Revisions to TD 9905 (85 FR 56686).

C. Revision to CFC Netting Rule Relating to CFC-to-CFC Loans

Section 1.861–10(e)(8)(v) provides that for purposes of applying the CFC netting rule of § 1.861–10(e), certain loans made by one CFC to another CFC are treated as loans made by a U.S. shareholder to the borrower CFC, to the extent the U.S. shareholder makes capital contributions directly or indirectly to the lender CFC, and are treated as related group indebtedness. No income derived from the U.S. shareholder's ownership of the lender CFC stock is treated as interest income derived from related group indebtedness, including subpart F inclusions related to the interest income earned by the lender CFC. As a result, no interest expense is generally allocated to income related to the CFC-to-CFC debt, but the debt may nevertheless increase the amount of allocable related group indebtedness for which a reduction in assets is required under § 1.861–10(e)(7).

The Treasury Department and the IRS have determined that the failure to account for income related to the CFC-to-CFC debt can distort the general allocation and apportionment of other interest expense under § 1.861–9. Therefore, the proposed regulations revise § 1.861–10(e)(8)(v) to provide that CFC-to-CFC debt is not treated as related group indebtedness for purposes of the CFC netting rule. Proposed § 1.861–10(e)(8)(v) also provides that CFC-to-CFC debt is not treated as related group indebtedness for purposes of determining the foreign base period ratio, which is based on the average of related group debt-to-asset ratios in the five prior taxable years, even if the CFC-to-CFC debt was otherwise properly treated as related group indebtedness in a prior year. This is necessary to prevent distortions that would otherwise arise in comparing the ratio in a year in which CFC-to-CFC debt was treated as related group indebtedness to the ratio in a year in which the CFC-to-CFC debt is not treated as related group indebtedness.

D. Direct Allocation of Interest Expense for Foreign Bank Branches

Under §§ 1.861–8 through 1.861–13, the combined interest expense of a domestic corporation and its foreign branches is allocated and apportioned to income categories on the basis of the tax book value of their combined assets. Comments received with respect to the 2018 and 2019 FTC proposed regulations asserted that special rules were needed for financial institutions for allocating and apportioning interest expense to foreign branch category income. The comments asserted that the general approach under §§ 1.861–8 through 1.861–13 fails to take into account the fact that foreign branches of financial institutions have assets and liabilities that reflect interest rates that differ from interest rates related to assets and liabilities of the home office held in the United States. As a result, the general approach results in over- or under-allocation of interest expense to the foreign branch category income.

In response to this comment, the proposed regulations provide that interest expense reflected on a foreign banking branch's books and records is directly allocated against the foreign branch category income of that foreign branch, to the extent it has foreign branch category income. The proposed regulations also provide for a corresponding reduction in the value of the assets of the foreign branch for purposes of allocating other interest expense of the foreign branch owner. See proposed § 1.861–10(g).

Comments are requested as to whether additional rules are needed to account for disregarded interest payments between foreign branches and between a foreign branch and a foreign branch owner. Comments are also requested as to whether adjustments to the amount of foreign branch liabilities subject to this rule are necessary to account for differing asset-to-liability ratios in a foreign branch and a foreign branch owner.

E. Treatment of Section 818(f) Expenses for Consolidated Groups

Section 818(f)(1) provides that a life insurance company's deduction for life insurance reserves and certain other deductions (''section 818(f) expenses'') are treated as items which cannot definitely be allocated to an item or class of gross income. Proposed § 1.861–14(h) in the 2019 FTC proposed regulations provided that section 818(f) expenses are allocated and apportioned on a separate company basis instead of on a life subgroup basis. In the 2020 FTC final regulations, this rule was withdrawn in response to comments. As discussed in Part I.C of the Summary of Comments and Explanation of Revisions to the 2020 FTC final regulations, the Treasury Department and the IRS have determined that there are merits and drawbacks to both the separate company and the life subgroup approaches.

These proposed regulations provide that section 818(f) expenses must be allocated and apportioned on a life subgroup basis, but that a one-time election is allowed for consolidated groups to choose instead to apply a separate company approach. A consolidated group's use of the separate entity method constitutes a binding choice to use the method chosen for that year for all members of the group and all taxable years thereafter.

F. Allocation and Apportionment of Foreign Income Taxes

1. Background

These proposed regulations repropose certain of the 2019 FTC proposed regulations in order to provide more detailed and comprehensive guidance regarding the assignment of foreign gross income, and the allocation and apportionment of the associated foreign income tax expense, to the statutory and residual groupings in certain cases. Comments to the 2019 FTC proposed regulations had requested more detailed guidance regarding the assignment to the statutory and residual groupings of foreign gross income arising from transactions that are dispositions of stock under Federal income tax law. In response to these comments, the Treasury Department and IRS have determined that it is appropriate to propose a comprehensive set of rules for dispositions of both stock and partnership interests, as well as rules that, similar to rules in the 2020 FTC final regulations for distributions with respect to stock, provide detailed rules for transactions that are distributions with respect to a partnership interest under Federal income tax law. The proposed regulations also address comments requesting that the rules for the assignment to the statutory and residual groupings of foreign gross income arising from disregarded payments distinguish between disregarded payments that would be deductible if regarded under Federal income tax law and disregarded payments that would, if the payor (or recipient) were a corporation under Federal income tax law, be distributions with respect to stock or contributions to capital. See also Part IV.B of the Summary of Comments and Explanation of Revisions in the 2020 FTC final regulations.

2. Dispositions of Stock

Proposed § 1.861–20(d)(3)(i)(D) contains rules assigning to statutory and residual groupings the foreign gross income and associated foreign tax that arise from a transaction that is treated for Federal income tax purposes as a sale or other disposition of stock. These rules assign the foreign gross income first to the statutory and residual groupings to which any U.S. dividend amount, a term that applies in the disposition context when there is an amount of gain to which section 1248(a) or 964(e) applies, is assigned, to the extent thereof. Foreign gross income is next assigned to the grouping to which the U.S. capital gain amount is assigned, to the extent thereof.

Any excess of the foreign gross income recognized by reason of the transaction over the sum of the U.S. dividend amount and the U.S. capital gain amount is assigned to the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the stock is (or would be if the taxpayer were a United States person) assigned to the groupings under the rules of § 1.861–9(g) in the U.S. taxable year in which the disposition occurs. This rule, which uses the asset apportionment percentages of the tax book value of the stock as a surrogate for earnings of the corporation that are not recognized for U.S. tax purposes, associates foreign tax on a U.S. return of capital amount (that is, foreign tax on foreign gain in excess of the amount of gain recognized for U.S. tax purposes) with the same groupings to which the tax would be assigned under § 1.861–20(d)(3)(i)(B)(*2*) of the 2020 FTC final regulations if the item of foreign gross income arose from a distribution made by the corporation, rather than a sale or other disposition of the stock.

As discussed in Part III.B of the Summary of Comments and Explanation of Revisions to the 2020 FTC final regulations, the Treasury Department and the IRS have determined that it is appropriate to treat foreign tax on a U.S. return of capital amount resulting from a distribution as a timing difference in the recognition of corporate earnings. The proposed regulations adopt the same rule in the case of a foreign tax on a U.S. return of capital amount resulting from a disposition of stock. The Treasury Department and the IRS have determined that this result is appropriate because a foreign country generally recognizes more gain on a disposition of stock than is recognized for U.S. tax purposes when the shareholder's tax basis in the stock is greater for U.S. tax purposes than for foreign tax purposes, and this disparity typically occurs when the shareholder's U.S. tax basis in the stock has been increased under section 961 to reflect subpart F or GILTI inclusions of earnings attributable to the stock. Comments are requested on whether other situations more commonly result in this disparity, such that different rules might be appropriate for distributions and sales in order to better match foreign tax on income included in the foreign tax base with income included in the U.S. tax base.

3. Partnership Transactions

The proposed regulations contain new rules on the treatment of distributions from partnerships and sales of partnership interests, including partnerships that are treated as corporations for foreign law purposes. In general, these rules follow similar principles as the rules for distributions from corporations and sales of stock.

The rule in proposed § 1.861–20(d)(3)(ii)(B), like the rule for assigning foreign tax on a return of capital with respect to stock, uses the asset apportionment percentages of the tax book value of the partner's distributive share of the partnership's assets (or, in the case of a limited partner with less than a 10 percent interest, the tax book value of the partnership interest) as a surrogate for the partner's distributive share of earnings of the partnership that are not recognized in the year in which the distribution is made for U.S. tax purposes. Proposed § 1.861–20(d)(3)(ii)(C) similarly associates foreign tax on a U.S. return of capital amount in connection with the sale or other disposition of a partnership interest with a hypothetical distributive share. The Treasury Department and the IRS have determined that this rule is appropriate because foreign tax on a return of capital distribution from a partnership most commonly occurs in the case of hybrid partnerships (that is, entities that are treated as partnerships for U.S. tax purposes but as corporations for foreign tax purposes). In this case, earnings that have been recognized and capitalized into basis by the partner for U.S. tax purposes as a distributive share of income in prior years are not subject to foreign tax until the earnings are distributed. Similarly, the higher U.S. tax basis in an interest in a hybrid partnership accounts for the most common cases where the amount of foreign gross income that results from a sale of a partnership interest exceeds the amount of taxable gain for U.S. tax purposes. Comments are requested on whether a different ordering rule or matching convention may better match foreign tax on income included in the foreign tax base with income included in the U.S. tax base. Comments are also requested on whether special rules are needed to associate foreign gross income and the associated foreign tax on distributions from partnerships and sales of partnership interests with items that are subject to special treatment for U.S. tax purposes (such as gain recharacterized as ordinary income under section 751).

4. Disregarded Payments

i. Background

The proposed regulations contain a new comprehensive set of rules addressing the allocation and apportionment of foreign income taxes relating to disregarded payments. In general, the 2019 FTC proposed regulations assigned foreign gross income included by reason of a disregarded payment by a branch owner to the residual grouping and assigned foreign gross income included by reason of a disregarded payment by a branch to its owner by reference to the asset apportionment percentages of the tax book value of the branch assets in the statutory and residual groupings. Comments noted that this rule, in the context of section 960, could lead to the assignment of foreign income taxes to the residual grouping rather than a grouping to which an inclusion under section 951 or 951A is attributable, resulting in the disallowance of foreign tax credits. Comments requested that, for purposes of assigning foreign gross income included by reason of a disregarded payment to a statutory or residual grouping, the rule should identify disregarded payments that should be treated as made out of current earnings, and distinguish those payments from other types of disregarded payments.

ii. Reattribution Payments

Proposed § 1.861–20(d)(3)(v) contains new rules that generally assign foreign gross income arising from the receipt of disregarded payments and the associated foreign tax to the recipient's statutory and residual groupings based on the current or accumulated income of the payor (as computed for U.S. tax purposes) out of which the disregarded payment is considered to be made. For this purpose, the regulations refer to disregarded payments made to or by a taxable unit. In the case of a taxpayer that is an individual or a domestic corporation, a taxable unit means a foreign branch, a foreign branch owner, or a non-branch taxable unit, as defined in proposed § 1.904–4(f)(3). In the case of a taxpayer that is a foreign corporation, a taxable unit means a tested unit as such term is defined in proposed § 1.954–1(d)(2), as contained in proposed regulations (REG–127732–19) addressing the high-tax exception under section 954(b)(4), published in the **Federal Register** (85 FR 44650) on July 23, 2020 (the ''2020 HTE proposed regulations''). See proposed § 1.861–20(d)(3)(v)(A) and (d)(3)(v)(E)(*10*).

Proposed § 1.861–20(d)(3)(v)(B)(*1*) addresses the assignment of foreign gross income that arises from the portion of a disregarded payment that results in a reattribution of U.S. gross income from the payor taxable unit to the recipient taxable unit. Under proposed § 1.861–20(d)(3)(v)(B)(*1*), the foreign gross income is assigned to the statutory and residual groupings to which the amount of U.S. gross income that is reattributed (a ''reattribution amount'') is initially assigned upon receipt of the disregarded payment by a taxable unit, before taking into account reattribution payments made by the recipient taxable unit. For this purpose, under proposed § 1.861–20(d)(3)(v)(B)(*2*), in the case of a taxpayer that is an individual or a domestic corporation, the attribution rules in § 1.904–4(f)(2) apply to determine the section 904 separate categories of reattribution amounts received by foreign branches, foreign branch owners, and non-branch taxable units. In the case of a taxpayer that is a foreign corporation, the attribution rules in proposed § 1.954–1(d)(1)(iii) (as contained in the 2020 HTE proposed regulations) [1] apply to determine the reattribution amounts received by a tested unit in the tested income and subpart F income groupings of its tested units for purposes of the applying the high-tax exception of section 954(b)(4). Under proposed § 1.861–20(d)(3)(v)(B)(*2*), the rules in the 2020 HTE proposed regulations for attributing U.S. gross income to tested units also apply to attribute items of foreign gross income to tested units for purposes of allocating and apportioning the associated foreign income taxes in computing the amount of an inclusion and deemed-paid taxes under sections 951, 951A, and 960.

For purposes of applying all other operative sections, the U.S. gross income that is attributable to a taxable unit is determined under the principles of the foreign branch category rules (for U.S. taxpayers) or the high-tax exception rules (for foreign corporations). The foreign branch category rules of § 1.904–4(f)(2) generally attribute U.S. gross income to taxable units on the basis of books and records, as modified to reflect Federal income tax principles, and reattribute U.S. gross income between the general category and the foreign branch category by reason of certain disregarded payments between a foreign branch and its owner, or another foreign branch, that would be deductible if regarded for Federal income tax purposes. The reattribution is made by reference to the statutory and residual groupings of the payor to which the disregarded payment would be allocated and apportioned if it were regarded for Federal income tax purposes.

Proposed § 1.954–1(d)(1)(iii), as contained in the 2020 HTE proposed regulations, generally adopts the principles of § 1.904–4(f)(2) for purposes of assigning U.S. gross income to tested units of a controlled foreign corporation for purposes of the high-tax exception. However, although § 1.904–4(f)(2)(vi) does not treat disregarded interest payments as a disregarded reallocation transaction, under proposed § 1.954–1(d)(1)(iii)(B) of the 2020 HTE proposed regulations, disregarded interest payments are treated as reattribution payments to the extent they are deductible for foreign law purposes in the country where the payor taxable unit is a tax resident. Proposed § 1.954–1(d)(1)(iii)(B)(*4*) provides that these disregarded interest payments are treated as made ratably out of the payor's current year U.S. gross income to the extent thereof, and provides ordering rules when the same taxable unit both makes and receives disregarded interest payments. Comments are requested on additional ordering rules that should be included in the final regulations, including rules that apply when multiple taxable units both make and receive disregarded payments, such as rules for determining the starting point for assigning reattribution payments received by taxable units, and the order in which particular types of disregarded payments made by taxable units are allocated and apportioned to U.S. gross income (including income attributable to reattribution payments received by the payor taxable unit) of the payor taxable unit. In addition, because proposed § 1.861–20(d)(3)(v) more clearly coordinates with the provisions in proposed § 1.954–1(d)(1), the proposed regulations propose to update proposed § 1.954–1(d)(1)(iv)(A) (as contained in the 2020 HTE proposed regulations) to clarify that the rules in § 1.861–20 (rather than the principles of § 1.904–6(b)(2)) apply in the case of disregarded payments. In order to achieve consistency with the new tested unit rules in proposed § 1.954–1(d) and taxable unit rules in § 1.861–20(d)(3)(v), the proposed regulations also contain a modification to the high-tax kickout rules in § 1.904–4(c)(4) to provide that the grouping rules at the CFC level are applied on a tested unit (instead of foreign QBU) basis.

Proposed § 1.861–20(d)(3)(v)(B)(*3*) provides that the statutory or residual grouping to which foreign gross income of a taxable unit (including foreign gross income that arises from the receipt of a disregarded payment) is assigned is determined without regard to reattribution payments made by the taxable unit, and that no item of foreign gross income is reassigned to another taxable unit by reason of a reattribution payment that reattributes U.S. gross income of the payor taxable unit to another taxable unit by reason of such reattribution payments. Under this rule, if foreign gross income is associated under § 1.861–20(d)(1) with a corresponding U.S. item initially attributed to a payor taxable unit, that foreign gross income is always assigned to the grouping that includes the U.S. gross income of that payor taxable unit. The effect of this rule and proposed § 1.861–20(d)(3)(v)(B)(*1*) is to allocate and apportion foreign tax imposed on foreign gross income that is associated either with a corresponding U.S. item that is initially attributed to a payor taxable unit or with a reattribution amount that is attributed to a recipient taxable unit (before taking into account reattribution payments made by the recipient taxable unit) to the grouping that includes the U.S. gross income of the taxable unit that paid the foreign tax; no portion of the foreign tax is associated with U.S. gross income that is reattributed to another taxable unit by reason of a reattribution payment.

In the case of foreign income tax imposed on the basis of foreign taxable income for a taxable period (that is, net basis taxes), this rule will generally produce appropriate results because foreign gross income of a taxable unit will generally be reduced by foreign law deductions for disregarded payments

[1] References to § 1.954–1(d) in these proposed regulations are to proposed § 1.954–1(d) as contained in the 2020 HTE proposed regulations.

made by that taxable unit, so that the amount of the payor's foreign taxable income will approximate the amount of U.S. taxable income attributed to the taxable unit after accounting for reattribution payments made and received by that taxable unit. Foreign gross basis taxes (such as withholding taxes) imposed on foreign gross income of a taxable unit, if not reassigned along with the associated U.S. gross income that is reattributed to another taxable unit as the result of a reattribution payment, however, may in some cases distort the effective foreign tax rate of the payor taxable unit. The Treasury Department and the IRS have determined that rules reattributing foreign gross basis taxes among taxable units by reason of reattribution payments would require complex ordering rules that would be unduly burdensome for taxpayers to apply and for the IRS to administer. Comments are requested on whether the final regulations should include different rules, including anti-abuse rules, to account for the assignment of foreign gross basis taxes paid by taxable units that make disregarded payments.

iii. Remittances and Contributions

Similar to the rules in the 2019 FTC proposed regulations, proposed § 1.861–20(d)(3)(v)(C)(*1*)(*i*) assigns foreign gross income that arises from a disregarded payment that is treated as a remittance for U.S. tax purposes by reference to the statutory and residual groupings to which the assets of the payor taxable unit are assigned (or would be assigned if the taxable unit were a United States person) under the rules of § 1.861–9 for purposes of apportioning interest expense. This rule uses the payor's asset apportionment percentages as a proxy for the accumulated earnings of the payor taxable unit from which the remittance is made. Proposed § 1.861–20(d)(3)(v)(C)(*1*)(*ii*) provides that for this purpose the assets of the taxable unit making the remittance are determined in accordance with the rules of § 1.987–6(b) that apply in determining the source and separate category of exchange gain or loss on a section 987 remittance, as modified in two respects.

First, for purposes of § 1.860–20(d)(3)(v)(C)(*1*)(*i*) the assets of the remitting taxable unit include stock owned by the taxable unit, even though for purposes of section 987 such stock may be treated as owned directly by the owner of the taxable unit. This rule helps to ensure that foreign tax on remittances are properly associated with earnings of corporations that may be distributed through the taxable unit.

Second, proposed § 1.861–20(d)(3)(v)(C)(*1*)(*ii*) modifies the determination of assets under § 1.987–6(b)(2) to provide that the assets of a taxable unit that give rise to U.S. gross income that is assigned to another taxable unit by reason of a reattribution payment are treated as assets of the recipient taxable unit. The Treasury Department and the IRS have determined that reassigning the tax book value of assets among taxable units in proportion to the U.S. gross income attributed to a taxable unit, after taking into account all reattribution payments made and received by the taxable unit, for purposes of determining the statutory and residual groupings to which foreign tax on a remittance is assigned is appropriate to properly match the foreign tax with the accumulated earnings out of which the remittance is made. In addition, because it uses asset values that are already required to be computed and maintained for other Federal income tax purposes, this reattribution rule is less complicated to apply than a rule that would treat disregarded assets and liabilities as if they were regarded for U.S. tax purposes in applying this rule.

However, the Treasury Department and the IRS acknowledge that any asset method for associating foreign gross income included by the remittance recipient with the payor's accumulated earnings may lead to inexact determinations of the groupings of the accumulated earnings out of which a remittance is paid, particularly when a taxable unit makes a remittance in conjunction with reattribution payments. The potential for distortions exist to the extent the tax book value of assets does not reflect their income-producing value, as in the case of self-developed intangibles the costs of which are currently expensed, as well as to the extent the characterization of the tax book value of an asset based on the income generated by the asset in the current taxable year does not reflect the characterization of the income generated by the asset over time. Comments are requested on whether a different method of determining the statutory and residual groupings to which a remittance is assigned, such as the maintenance of historical accounts of accumulated earnings of taxable units, including adjustments to reflect disregarded payments among taxable units, could produce more accurate results without unduly increasing administrative burdens.

Similar to the rule in the 2019 FTC proposed regulations, proposed § 1.861–20(d)(3)(v)(C)(*2*) provides that foreign gross income and the associated foreign tax that arise from the receipt of a contribution are assigned to the residual category, except as provided under the rules for an operative section (such as under proposed § 1.904–6(b)(2)(ii), which assigns foreign tax on contributions to a foreign branch to the foreign branch category). Proposed § 1.861–20(d)(3)(v)(E)(*2*) defines a contribution as a disregarded transfer of property that would be treated as a transaction described in section 118 or 351 if the recipient taxable unit were treated as a corporation for Federal income tax purposes, or the excess amount of a disregarded payment made to a taxable unit that the payor unit owns over the amount that is treated as a reattribution payment.

Foreign tax paid by a foreign corporation that is allocated and apportioned to the residual category is not eligible to be deemed paid under section 960. See § 1.960–1(e). However, because proposed § 1.861–20(d)(3)(v) treats most disregarded payments as reattribution payments or remittances, and contributions (as characterized for corporate law purposes) are rarely subject to foreign tax, the Treasury Department and the IRS expect this rule will have limited application.

Proposed § 1.861–20(d)(3)(v)(C)(*3*) provides an ordering rule attributing the amount of foreign gross income that arises from the receipt of a disregarded payment that includes both a reattribution payment and a remittance or contribution first to the portion of the disregarded payment that is a reattribution payment. Any excess amount of the foreign gross income item is attributed to the portion of the disregarded payment that is a remittance or contribution.

In addition, proposed § 1.861–20(d)(2)(ii)(D) provides that if an item of foreign gross income arises from an event that for foreign law purposes is treated as a distribution, contribution, accrual, or payment between taxable units, but that is not treated as a disregarded payment for Federal income tax purposes (for example, a consent dividend from a disregarded entity), the foreign gross income and associated foreign tax are assigned in the same way as if a transfer of property in the amount of the foreign gross income item resulted in a disregarded payment in the year the foreign tax is paid or accrued.

Finally, in light of the heightened importance of the rules in § 1.904–4(f), which are being applied in connection with § 1.861–20 as well as the high-tax exception rules in § 1.951A–2(c)(7), the proposed regulations include some technical changes to the rules in § 1.904–4(f) that will facilitate this interaction. See Part XI.A of this Explanation of Provisions.

iv. Disregarded Payments With Respect to Disregarded Sales of Property

Proposed § 1.861–20(d)(3)(v)(D) clarifies that an item of foreign gross income attributable to gain recognized under foreign law by reason of a disregarded payment received in exchange for property is characterized and assigned under § 1.861–20(d)(2)(ii)(A) of the 2020 FTC final regulations, that is, as a timing difference in the taxation of the property's built-in gain. Proposed § 1.861–20(d)(3)(v)(D) further provides that if a taxpayer recognizes U.S. gross income as a result of a disposition of property that was previously received in exchange for a disregarded payment, any item of foreign gross income that the taxpayer recognizes as a result of that same disposition is assigned to a statutory or residual grouping under the U.S. corresponding item rules in § 1.861–20(d)(1) of the 2020 FTC final regulations. Because in this situation the seller's basis in the property initially acquired in a disregarded sale is not adjusted for U.S. tax purposes, but is assumed to reflect the purchase price for foreign tax purposes, the assignment of the foreign gross income resulting from the regarded sale of the property is made without regard to any reattribution of the gain that is recognized for U.S. tax purposes under § 1.904–4(f)(2)(vi)(A) or (D), which apply to attribute U.S. gross income in the amount of the property's built-in gain at the time of the initial acquisition to the foreign branch or foreign branch owner that originally transferred the property in the disregarded sale. The same result obtains with respect to all taxable units under proposed § 1.861–20(d)(3)(v)(B)(*3*).

5. Group-Relief Regimes

The Treasury Department and the IRS are concerned about the use of certain foreign law group-relief regimes (that is, regimes that allow for the sharing of losses of one member of a group with another member) to create a mismatch in how foreign income taxes are characterized under § 1.861–20 for purposes of various operative sections, including sections 245A(d), 904, and 960. Comments are requested on the appropriate treatment of foreign income taxes paid or accrued in connection with the sharing of losses.

VI. Creditability of Foreign Taxes Under Sections 901 and 903

A. Definition of Foreign Income Tax

1. Background and Overview

Section 901 allows a credit for foreign income, war profits, and excess profits taxes, and section 903 provides that such taxes include a tax in lieu of a generally-imposed foreign income, war profits, or excess profits tax.[2] Section 1.901–2, which was originally promulgated in 1983 in TD 7918 (the ''1983 final regulations''), sets forth conditions for determining when a foreign levy is a foreign income, war profits, and excess profits tax (collectively, an ''income tax'') that is creditable under section 901. Under the existing regulations, a foreign levy is an income tax if and only if (1) it is a tax, and (2) the predominant character of that tax is that of an income tax in the U.S. sense. See § 1.901–2(a)(1). Under § 1.901–2(a)(3), the predominant character of a foreign tax is that of an income tax in the U.S. sense if it meets two requirements: (1) The foreign tax is likely to reach net gain in the normal circumstances in which it applies (the ''net gain requirement''), and (2) it is not a ''soak-up'' tax. To satisfy the net gain requirement, a tax must meet the realization, gross receipts, and net income requirements in § 1.901–2(b)(2), (3), and (4), respectively. Under § 1.901–2(a)(1), a foreign tax either is or is not a foreign income tax, in its entirety, for all persons subject to the foreign tax. This all-or-nothing rule ensures consistent outcomes for taxpayers and minimizes the administrative burdens on the IRS that would result if the creditability of a foreign tax instead varied depending on each taxpayer's particular facts.

The Treasury Department and the IRS have determined that it is necessary and appropriate to require that a foreign tax conform to traditional international norms of taxing jurisdiction as reflected in the Internal Revenue Code in order to qualify as an income tax in the U.S. sense, or as a tax in lieu of an income tax. As discussed in more detail in Part VI.A.2 of this Explanation of Provisions, this requirement will ensure that the foreign tax credit operates in accordance with its purpose to mitigate double taxation of income that is attributable to a taxpayer's activities or investment in a foreign country.

In addition, the Treasury Department and the IRS have determined that it is necessary and appropriate to revise the net gain requirement in order to better align the regulatory tests with norms reflected in the Internal Revenue Code that define an income tax in the U.S. sense, as well as to simplify and clarify the application of the rules. In particular, the existing regulations provide that the net gain requirement is met if a foreign tax reaches net gain in the ''normal circumstances'' in which it applies. However, this rule leads to inappropriate results and presupposes an empirical analysis requiring access to information that is difficult for taxpayers and the IRS to obtain. Therefore, the proposed regulations narrow the situations in which an empirical analysis is relevant in analyzing the nature of a foreign tax. See Part VI.A.3 of this Explanation of Provisions.

The proposed regulations make other changes to improve or clarify the rules, and to address issues that have arisen since the 1983 final regulations were issued. In particular, the proposed regulations introduce the term ''net income tax'' to describe foreign levies described in section 901 and the term ''foreign income tax'' to describe foreign levies described in section 901 or 903. See also Part X.F of this Explanation of Provisions (describing conforming changes made to §§ 1.960–1 and 1.960–2). Conforming changes to the terms and definitions cross-referenced in other regulations will be made when the proposed regulations are finalized.

The proposed regulations specifically address the treatment of surtaxes and the circumstances in which a source-based withholding tax on cross-border income can qualify as a foreign income tax. The proposed regulations also reorganize the existing regulations to address soak-up taxes as part of the determination of the amount of tax paid, rather than as part of the definition of a foreign income tax, and clarify the rules for determining when a foreign tax is a separate levy. The proposed regulations addressing the amount of tax paid also modify the treatment of refundable credits, clarify the interaction between the rules addressing refundable amounts and multiple levies, and clarify the application of the noncompulsory payment rules with respect to foreign tax law elections. Finally, the proposed regulations revise the definition of a tax in lieu of an income tax. These rules are described in more detail in Parts VI.A.3.v, VI.A.4, VI.A.5, VI.B, and VI.C of this Explanation of Provisions.

The proposed regulations do not include proposed amendments to the rules in § 1.901–2A addressing dual

[2] Taxpayers may generally claim a deduction instead of a credit for these foreign taxes, as well as for certain other foreign taxes that do not qualify for the foreign tax credit. See section 164(a).

capacity taxpayers. However, certain proposed changes to §§ 1.901–2 and 1.903–1 may impact § 1.901–2A. For example, when the proposed regulations are finalized, certain terms that are defined in § 1.901–2 and cross-referenced in § 1.901–2A will need to be updated. Comments are requested on whether additional changes to § 1.901–2A are appropriate in light of the proposed revisions to §§ 1.901–2 and 1.903–1.

2. Jurisdictional Nexus Requirement

As a dollar-for-dollar credit against U.S. income tax, the foreign tax credit is intended to mitigate double taxation of foreign source income. This fundamental purpose is served most appropriately if there is substantial conformity in the principles used to calculate the base of the foreign tax and the base of the U.S. income tax. This conformity extends not just to ascertaining whether the foreign tax base approximates U.S. taxable income determined on the basis of realized gross receipts reduced by allocable expenses, but also to whether there is a sufficient nexus between the income that is subject to tax and the foreign jurisdiction imposing the tax. Although prior regulations under section 901 did contain jurisdictional limitations on the definition of an income tax, see § 4.901–2(a)(1)(iii) (1980) (requiring that a foreign tax follow ''reasonable rules regarding source of income, residence, or other bases for taxing jurisdiction''), the existing regulations do not contain such a rule.

In recent years, several foreign countries have adopted or are considering adopting a variety of novel extraterritorial taxes that diverge in significant respects from traditional norms of international taxing jurisdiction as reflected in the Internal Revenue Code. In addition, the Treasury Department and the IRS have received requests for guidance on whether the definition of foreign income tax includes a jurisdictional limitation, and recommending that the regulations adopt a rule requiring that income subject to foreign tax bear an appropriate connection to a foreign country for a foreign tax to be eligible for the foreign tax credit. In light of these developments, the Treasury Department and the IRS have determined that it is appropriate to revisit the regulatory definition of a foreign income tax to ensure that to be creditable, foreign taxes in fact have a predominant character of ''an income tax in the U.S. sense.''

The Treasury Department and the IRS have determined that in order to qualify as a creditable income tax, the foreign tax law must require a sufficient nexus between the foreign country and the taxpayer's activities or investment of capital or other assets that give rise to the income being taxed. For example, a tax imposed by a foreign country on a taxpayer's income that lacks a sufficient nexus to such country (such as the lack of operations, employees, factors of production, or management in that foreign country) is not an income tax in the U.S. sense and should not be eligible for a foreign tax credit if paid or accrued by U.S. taxpayers. Such a nexus is required in order for persons and income to be subject to U.S. income tax, and so a similar nexus reflecting the foreign country's exercise of taxing jurisdiction consistent with Federal income tax principles should be required in order for foreign taxes to be eligible for a dollar-for-dollar credit against U.S. income tax.

The proposed regulations therefore require that for a foreign tax to qualify as an income tax, the tax must conform with established international norms, reflected in the Internal Revenue Code and related guidance, for allocating profit between associated enterprises, for allocating business profits of nonresidents to a taxable presence in the foreign country, and for taxing cross-border income based on source or the situs of property (together, the ''jurisdictional nexus requirement''). Proposed § 1.901–2(c)(1)(i) generally provides that in the case of a foreign country imposing tax on nonresidents, the foreign tax law must determine the amount of income subject to tax based on the nonresident's activities located in the foreign country (including its functions, assets, and risks located in the foreign country). Thus, for example, rules that are consistent with the rules under section 864(c) for taxing income effectively connected with a U.S. trade or business, or with Articles 5 and 7 of the U.S. Model Income Tax Convention for taxing profits attributable to a permanent establishment, will meet this requirement. However, foreign countries that, for example, impose tax by using as a significant factor the location of customers, users, or any other similar destination-based criterion to allocate profit (for example, by deeming a taxable presence based on the existence of customers) will not satisfy the jurisdictional nexus requirement.

If the foreign tax law imposes tax on a nonresident's income based on the income arising from sources in the foreign country (for example, tax imposed on interest, rents, or royalties sourced in the foreign country and paid to a nonresident), proposed § 1.901–2(c)(1)(ii) requires the sourcing rules of the foreign tax law to be reasonably similar to the sourcing rules that apply for Federal income tax purposes. For the avoidance of doubt, the proposed regulations provide that in the case of income from services, the income must be sourced based on the place of performance of the services, not the location of the services recipient.

The jurisdictional nexus requirement for taxing gains from sales or other dispositions of property is separately addressed in proposed § 1.901–2(c)(1)(iii), which provides that income from sales or other dispositions of property by nonresidents that do not meet the activities requirement in proposed § 1.901–2(c)(1)(i) satisfy the jurisdictional nexus requirement only with respect to gains on the disposition of real property in the foreign country or movable property forming part of the business property of a taxable presence in the foreign country (or from interests in certain entities holding such property). This rule is consistent with the fact that Federal income tax law generally does not tax gains of nonresidents that do not have a trade or business in the United States. See, for example, section 865(a)(2) and (e)(2); § 1.871–7(a)(1); see also U.S. Model Income Tax Convention (2016), Art. 13.

A similar rule applies under proposed § 1.901–2(c)(2) with respect to determining the income of a resident taxpayer in cases where income of a related entity may be allocated under transfer pricing rules to the resident taxpayer. For the jurisdictional nexus requirement to be satisfied in such a case, the foreign tax law's transfer pricing rules must be determined under arm's length principles. Thus, for example, foreign tax laws that contain transfer pricing rules that are consistent with the arm's length standard under the section 482 regulations, or with the arm's length principle under the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, will satisfy this requirement. However, foreign transfer pricing rules that allocate profits by taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion will not satisfy the jurisdictional nexus requirement. Comments are requested on whether special rules are needed to address foreign transfer pricing rules that allocate profits to a resident on a formulary basis (rather than on the basis of arm's length prices), such as through the use of fixed margins in a manner that is not consistent with arm's length principles. The jurisdictional nexus requirement is not violated when a foreign country imposes tax on the worldwide income of a resident taxpayer, including under controlled foreign corporation regimes that deem income to be included (or distributed) to a resident shareholder (as opposed to allocated directly to the resident under a transfer pricing adjustment). For this purpose, the terms resident and nonresident are defined in proposed § 1.901–2(g)(6) and in the case of an entity, the classification is generally based on the entity's place of incorporation or management.

As part of its response to the extraterritorial tax measures referred to in this Part VI.A.2 of the Explanation of Provisions, the Treasury Department has been actively engaged in negotiations with other countries, as part of the OECD/G20 Inclusive Framework on BEPS, to explore the possibility of a new international framework for allocating taxing rights.[3] If an agreement is reached that includes the United States, the Treasury Department recognizes that changes to the foreign tax credit system may be required at that time.

No inference is intended as to the application of existing §§ 1.901–2 and 1.903–1 to the treatment of novel extraterritorial foreign taxes such as digital services taxes, diverted profits taxes, or equalization levies. In addition, the proposed regulations, when finalized, would not affect the application of existing income tax treaties to which the United States is a party with respect to covered taxes (including any specifically identified taxes) that are creditable under the treaty. Comments are requested on the extent to which the new jurisdictional nexus requirement may impact the treatment of other types of foreign taxes, and on alternative approaches the Treasury Department and the IRS may consider to modify the rules to achieve the policy objectives described in this Part VI.A.2 of the Explanation of Provisions.

3. Net Gain Requirement

i. Use of Empirical Analysis

The existing regulations provide that the net gain requirement is met if a foreign tax reaches net gain in the ''normal circumstances'' in which it applies. See § 1.901–2(a)(1). As noted in the preamble to the 1983 final regulations, this rule is based on the standard set forth in *Inland Steel Company* v. *United States,* 677 F.2d 72 (Ct. Cl. 1982), *Bank of America Nat'l Trust and Savings Ass'n* v. *United States,* 459 F.2d 513 (Ct. Cl. 1972) (''*Bank of America I*''), and *Bank of America Nat'l Trust and Savings Ass'n* v. *Comm'r,* 61 T.C. 752 (1974), *aff'd,* 538 F.2d 334 (9th Cir.1976) (''*Bank of America II*''). See TD 7918, 48 FR 46272–01 (1983).

The Treasury Department and the IRS have determined that, in some respects, the empirical analysis contemplated by the existing regulations is unnecessary to identify the essential elements of an income tax in the U.S. sense. In addition, in the absence of specific rules and thresholds in the regulations on how to evaluate empirical data (if even available), both taxpayers and the IRS have had difficulties in applying the existing regulations to foreign taxes in a consistent and predictable manner. In some cases, the reliance on empirical data to determine whether the requirements of the existing regulations are met creates uncertainty and undue burdens for taxpayers and the IRS, considering challenges in obtaining the necessary information. Therefore, the proposed regulations limit the relevance of the ''normal circumstances'' in which the tax applies, as well as the role of the predominant character analysis, in determining whether a tax meets the various components of the net gain requirement. These changes will lead to more accurate and consistent outcomes and reduce the compliance and administrative burdens of the existing law requirement that taxpayers and the IRS obtain from the foreign government empirical information, such as tax return information for persons subject to the tax, to determine the normal circumstances in which the tax applies.

Instead, proposed § 1.901–2(b)(1) generally provides that whether a tax is a foreign income tax is determined under the terms of the foreign tax law, taking into account statutes, regulations, case law, and administrative rulings or other official pronouncements, as modified by treaties. Accordingly, whether a tax satisfies the net gain requirement is generally based on whether the terms of the foreign tax law governing the computation of the tax base meet the realization, gross receipts, and cost recovery requirements that make up the net gain requirement under § 1.901–2(a)(3). This approach will better allow taxpayers and the IRS to evaluate the nature of the foreign tax based on objective and readily available information (that is, based on the terms of the foreign tax law, rather than how it is applied in practice), to achieve more consistent and predictable outcomes. Evaluation of the normal circumstances in which the tax applies is still a factor in determining whether specific elements of the net gain requirement are satisfied, but the proposed regulations specifically identify the elements of the requirement for which this type of empirical evidence is relevant.

ii. Realization Requirement

Under the existing regulations, a foreign tax generally satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed upon or after the occurrence of events (''realization events'') that would result in the realization of income under the Code, or in certain cases, it is imposed on the occurrence of a pre-realization event, such as in the case of a foreign law mark-to-market regime. See § 1.901–2(b)(2)(i).

As discussed in Part VI.A.3.i of this Explanation of Provisions, due to the burdens resulting from the requirement to perform an empirical analysis to ascertain the nature of a tax, the proposed regulations provide more specific rules regarding the elements of the requirement for which this type of empirical evidence is relevant. In particular, the Treasury Department and the IRS have determined that the inclusion in the foreign tax base of insignificant amounts of gross receipts that do not meet the realization requirement should not prevent an otherwise-qualifying foreign tax from qualifying as an income tax. Accordingly, proposed § 1.901–2(b)(2) provides that if a foreign tax generally meets the various realization requirements described in proposed § 1.901–2(b)(2)(i)(A) through (C), except with respect to one or more specific and defined classes of nonrealization events, the tax may still be treated as meeting the realization requirement if the incidence and amounts of gross receipts attributable to the nonrealization events are minimal relative to the incidence and amounts of gross receipts attributable to events covered by the foreign tax that do meet the realization requirement. This determination is made based on the application of the foreign tax to all taxpayers subject to the foreign tax (rather than on a taxpayer-by-taxpayer basis). Therefore, for example, if a foreign tax contains all of the same realization requirements as the Code, but also imposes tax on imputed rent with respect to owner-occupied housing, the foreign tax may still qualify as a foreign income tax if, relative to all of the income of all taxpayers that are subject to the tax, imputed rental

[3] See Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy (January 2020), available at *https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf.*

income comprises a relatively small amount (even if for some taxpayers, all of their income may constitute imputed rent). Comments are requested on whether the regulations could substitute a more objective standard for identifying acceptable deviations from the realization requirement that would avoid the need for empirical analysis.

Proposed § 1.901–2(b)(2)(i)(C) consolidates the rules relating to pre-realization timing differences, including the rule currently in § 1.901–2(b)(2)(ii) that foreign taxes imposed on a shareholder on deemed distributions or inclusions (such as inclusions similar to those imposed by U.S. law under subpart F) of income realized by the distributing entity satisfy the realization requirement, so long as a second tax is not imposed on the shareholder on the same income upon the occurrence of a later event (such as an actual distribution). Under proposed § 1.901–2(b)(2)(i)(C), because a shareholder-level tax on a distribution from a corporation is imposed on a different taxpayer, the shareholder-level tax is not treated as a second tax on the corporation's income (including income arising from a pre-realization event). For this purpose, proposed § 1.901–2(b)(2)(i)(C) provides that a disregarded entity is treated as a taxpayer separate from its owner. Comments are requested on whether there are additional categories of pre-realization timing differences that should be included in the final regulations.

Finally, the Treasury Department and the IRS expect to update the examples illustrating the realization requirement that are contained in § 1.901–2(b)(2)(iv) and include them in the regulations when proposed § 1.901–2(b)(2) is finalized.

iii. Gross Receipts Requirement

Under existing § 1.901–2(b)(3), a foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of (1) gross receipts; or (2) gross receipts computed under a method that is likely to produce an amount that is not greater than the fair market value of actual arm's length gross receipts (''the alternative gross receipts test''). See § 1.901–2(b)(3)(ii) *Examples 1* and *2.*

The proposed regulations modify the alternative gross receipts test to provide that it is satisfied in the case of tax imposed on deemed gross receipts arising from pre-realization timing difference events described in proposed § 1.901–2(b)(2)(i)(C) (that is, a mark-to-market regime, tax on the physical transfer, processing, or export of readily marketable property, or a deemed distribution or inclusion), or on the basis of gross receipts from a non-realization event that is insignificant and therefore does not cause the foreign tax to fail the realization requirement in proposed § 1.901–2(b)(2). Therefore, taxes on insignificant non-realization events or pre-realization timing difference events that satisfy the realization requirement in proposed § 1.901–2(b)(2)(i)(C) also satisfy the gross receipts test.

However, the proposed regulations remove the provision referring to gross receipts computed under a method that is ''likely'' to produce an amount not greater than gross receipts. This rule purports to allow for foreign taxes to be imposed on an amount greater than the amount of income actually realized, or the value of the property being taxed, and the Treasury Department and the IRS have determined that such a tax should not be considered to be a tax on income, since it can be imposed on amounts in excess of actual gross receipts. In addition, the Treasury Department and the IRS have determined that the test is vague, unduly burdensome, and has given rise to controversies requiring taxpayers and the IRS to conduct an empirical evaluation to determine whether a nonconforming statutory method of determining alternative gross receipts is likely not to exceed the fair market value of actual gross receipts. See, for example, *Phillips Petroleum* v. *Comm'r,* 104 T.C. 256 (1995) (applying the former § 1.901–2T (1980) TD 7739). The Treasury Department and the IRS have determined that, other than in the case of insignificant non-realization events, only a tax base determined with reference to realized gross receipts or, in the case of a pre-realization timing difference event, the value or amount of a deemed inclusion or accrual (and not an approximation of gross receipts), should qualify as an income tax in the U.S. sense. In contrast, a tax based on alternative measurements of gross receipts, such as a foreign tax that requires gross receipts to be calculated by applying a markup to costs, fundamentally diverges from the measurement of realized gross receipts under the Internal Revenue Code, and could result in a taxable base that exceeds the amount of income properly attributable to the taxpayer's activities or investment in the foreign country. The revised rule will also minimize the need for empirical analyses, making it simpler for both taxpayers and the IRS to determine whether a tax satisfies the net gain requirement.

This rule is not intended to implicate the allocation of gross income under transfer pricing or branch profit attribution rules, which are instead addressed under proposed § 1.901–2(c). Proposed § 1.901–2(b)(3)(i) provides that in determining a taxpayer's actual gross receipts, amounts that are properly allocated to such taxpayer under the jurisdictional nexus rules in proposed § 1.901–2(c), such as pursuant to transfer pricing rules that properly allocate income to a taxpayer on the basis of costs incurred by that entity, are treated as the taxpayer's actual gross receipts.

iv. Cost Recovery Requirement

Under the net income requirement in the existing regulations, foreign tax law must permit the recovery of the significant costs and expenses attributable, under reasonable principles, to gross receipts included in the taxable base. A foreign tax law permits the recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be under the Code, unless the time of recovery is such that under the circumstances there is effectively a denial of recovery. Under the ''nonconfiscatory gross basis tax'' rule in § 1.901–2(b)(4) of the existing regulations, which reflects the standard described in *Bank of America I,* a foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the ''rare situation'' when the tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement in the existing regulations if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax).

The Treasury Department and the IRS have determined that to constitute an income tax for U.S. tax purposes, that is, a tax on net gain, the base of a foreign tax should conform in essential respects to the determination of taxable income for Federal income tax purposes. See, for example, *Keasbey & Mattison Co.* v. *Rothensies,* 133 F.2d 894, 895 (3d Cir. 1943) (holding that the criteria prescribed by U.S. revenue laws are determinative of the meaning of the term ''income taxes'' in applying the former version of section 901); and *Comm'r* v. *American Metal Co.,* 221

F.2d 134, 137 (2d Cir. 1955) (providing that ''the determinative question is 'whether the foreign tax is the substantial equivalent of an 'income tax' as that term is understood in the United States' ''). The Treasury Department and the IRS have determined that any foreign tax imposed on a gross basis is by definition not an income tax in the U.S. sense, regardless of the rate at which it is imposed or the extent of the associated costs.

In addition, the Treasury Department and the IRS have determined that the empirical standards contained in *Bank of America I* and that are contemplated by the nonconfiscatory gross basis tax rule in the existing regulations create substantial compliance and administrative burdens for taxpayers and the IRS when evaluating whether a foreign tax is an income tax in the U.S. sense. For example, the IRS and taxpayers must obtain foreign tax return information with respect to all persons subject to the tax to determine if persons subject to the tax are almost certain never to incur an after-tax loss. See, for example, *PPL Corp.* v. *Comm'r,* 135 T.C. 304 (2010), *rev'd,* 665 F.3d 60 (3d Cir. 2011), *rev'd,* 569 U.S. 329 (2013); *Texasgulf, Inc.* v. *Comm'r,* 107 T.C. 51 (1996), *aff'd,* 172 F.3d 209 (2d Cir. 1999); and *Exxon Corp.* v. *Comm'r,* 113 T.C. 338 (1999) (applying the empirical analysis required by the regulations).

Therefore, the proposed regulations remove the nonconfiscatory gross basis tax rule. Instead, the proposed regulations provide that whether a tax meets the net gain requirement is made solely on the basis of the terms of the foreign tax law that define the foreign taxable base, without any consideration of the rate of tax imposed on that base. See proposed § 1.901–2(b)(1). In addition, the cost recovery requirement in proposed § 1.901–2(b)(4) requires the deductions allowed under the foreign tax law to approximate the cost recovery provisions of the Internal Revenue Code in order for the foreign tax to qualify as an income tax in the U.S. sense. Under proposed § 1.901–2(b)(4)(i)(A), a tax that is imposed on gross receipts or gross income, without reduction for any costs or expenses attributable to earning that income, cannot qualify as a net income tax, without regard to whether the empirical impact of the tax is confiscatory, and even if in practice there are no or few costs and expenses attributable to all or particular types of gross receipts included in the foreign tax base. Under this rule, the cost recovery requirement is not satisfied for taxes such as payroll taxes on gross income from wages, but may be satisfied in the case of a personal income tax similar to that imposed under section 1 of the Code on all gross income (including wages), if the foreign country allows taxpayers to reduce such gross income by the substantial costs and expenses that are reasonably attributable to such gross income (taking into account any reasonable deduction disallowance provisions).

Under the ''alternative allowance rule'' in § 1.901–2(b)(4) of the existing regulations, a foreign tax that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. The Treasury Department and IRS have determined, however, that the alternative allowance rule fundamentally diverges from the approach to cost recovery in the Internal Revenue Code, and so is inconsistent with an essential element of an income tax in the U.S. sense. Moreover, it is unduly burdensome, and may be impossible as a practical matter, for taxpayers and the IRS to determine whether an alternative allowance under foreign tax law effectively compensates for the nonrecovery of significant costs or expenses attributable to realized gross receipts under that foreign law. The alternative allowance rule in the existing regulations has given rise to controversies between taxpayers and the IRS, and different interpretations by the courts, over whether the rule requires taxpayers to demonstrate that the alternative allowance exceeds disallowed expense deductions for a majority of persons potentially subject to the tax, a majority of persons that actually pay the tax, or for taxpayers in the aggregate, determined by comparing the aggregate amounts of disallowed deductions and alternative allowances reported on the foreign tax returns of all persons subject to the tax. See, for example, *Texasgulf, Inc.* v. *Comm'r,* 107 T.C. 51 (1996), *aff'd,* 172 F3d 209 (2d Cir. 1999); and *Exxon Corp.* v. *Comm'r,* 113 T.C. 338 (1999). Therefore, the proposed regulations at § 1.901–2(b)(4)(i)(A) modify the alternative allowance rule to treat alternative allowances as meeting the cost recovery requirement only if the foreign tax law expressly guarantees that the alternative allowance will equal or exceed actual costs (for example, under a provision identical to percentage depletion allowed under section 613).

The proposed regulations at § 1.901–2(b)(4)(i)(B)(*1*) retain the existing rule that foreign tax law is considered to permit the recovery of significant costs and expenses even if the costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied, unless the time of recovery is so much later (for example, after the property becomes worthless or is disposed of) as effectively to constitute a denial of such recovery. The regulations clarify that the different time can be either earlier or later than it would be if the Code applied, and that time value of money considerations relating to the economic cost (or value) of accelerating (or deferring) a foreign tax liability are not relevant in determining the amount of recovered costs and expenses.

The proposed regulations also add a new rule to allow a tax to satisfy the cost recovery requirement even if recovery of all or a portion of certain costs or expenses is disallowed, if such disallowance is consistent with the types of disallowances required under the Internal Revenue Code. See proposed § 1.901–2(b)(4)(i)(B)(*2*). For example, foreign tax law is considered to permit the recovery of significant costs and expenses even if such law disallows interest deductions equal to a certain percentage of adjusted taxable income similar to the limitation under section 163(j) or disallows interest and royalty deductions in connection with hybrid transactions similar to those subject to section 267A. This new provision is consistent with the rule that principles of U.S. law apply to determine whether a tax is a creditable income tax. See § 1.901–2(a)(1)(ii); see also, for example, *Keasbey,* 133 F.2d at 897; and *American Metal,* 221 F.2d at 137.

Finally, proposed § 1.901–2(b)(4)(i)(B)(*2*) provides that an empirical analysis of a foreign tax is still pertinent, in part, in determining whether a cost or expense is significant for purposes of the cost recovery requirement. In particular, the significance of a cost or expense is determined based on whether, for all taxpayers to which the foreign tax applies, the item of cost or expense constitutes a significant portion of the total costs or expenses. However, proposed § 1.901–2(b)(4)(i)(B)(*2*) adds certainty by providing that costs or expenses related to capital expenditures, interest, rents, royalties, services, and research and experimentation are always treated as significant costs or expenses. The Treasury Department and the IRS have determined that these types of costs represent a substantial portion of expenses typically deducted in computing taxable income for U.S. tax purposes. Requiring a foreign tax law to allow recovery of these costs will increase assurances that the income subject to U.S. and foreign tax is actually subject to double taxation. Because interest expense in particular is a significant cost that under section 864(e)(2) is allocable to all of a taxpayer's worldwide income-producing activities regardless of where it is incurred, a foreign levy that allows, for example, no deduction for interest expense is not an income tax in the U.S. sense, even if U.S. taxpayers record minimal interest expense in foreign countries that restrict its deductibility.

v. Qualifying Surtax

The Treasury Department and the IRS have received questions on the appropriate treatment of certain foreign taxes that are computed as a percentage of the tax due under a separate levy that is itself an income tax. To address the treatment of these taxes, proposed § 1.901–2(b)(5) adds a rule providing that a foreign tax satisfies the net gain requirement if the base of the foreign tax is the amount of a foreign income tax.

4. Soak-Up Taxes

The proposed regulations move the soak-up tax rule from the rules that define a creditable levy to the rules for determining the amount of creditable tax that is considered paid. See proposed § 1.901–2(e)(6). Because the rules at existing §§ 1.901–2(a)(3)(ii) and 1.903–1(b)(2) treat an otherwise creditable levy as a soak-up tax only to the extent it would not be imposed but for the availability of a credit, this change is more consistent with the general structure of the regulations that determine whether a separate levy as a whole qualifies as a creditable tax, and then identifies the amount of a particular taxpayer's foreign tax liability that is paid or accrued and can be claimed as a foreign tax credit.

In addition, the proposed regulations omit the special rule in § 1.903–1(b)(2) that limits the portion of a tax in lieu of an income tax that is a soak-up tax to the amount by which the foreign tax exceeds the income tax that would have been paid if the taxpayer had instead been subject to the generally-imposed income tax. The Treasury Department and the IRS have determined that this rule is inconsistent with the rationale for making soak-up taxes not creditable, which is to ensure that the foreign country does not impose a soak-up tax liability that under the existing regulations could be allowed as a foreign tax credit to reduce the taxpayer's U.S. tax liability.

Finally, the Treasury Department and the IRS are reconsidering the examples illustrating the soak-up tax rules that are contained in §§ 1.901–2(c)(2) and 1.903–1(b)(3) (*Examples 6* and *7*) and expect to include updated examples in the regulations when proposed § 1.901–2(e)(6) is finalized. Comments are requested on whether additional issues are presented by currently applicable soak-up taxes that should be addressed in the final regulations.

5. Separate Levy Determination

Whether a foreign levy is an income tax is determined independently for each separate foreign levy. For purposes of sections 901 and 903, whether a single levy or separate levies are imposed by a foreign country depends on U.S. principles and not on whether foreign law imposes the levy or levies in a single or separate statutes. Section § 1.901–2(d)(1) of the existing regulations provides that, where the base of a levy is different in kind, and not merely in degree, for different classes of persons subject to the levy, the levy is considered for purposes of sections 901 and 903 to impose separate levies for such classes of persons.

The proposed regulations revise § 1.901–2(d)(1) to clarify the determination of whether a foreign levy is separate from another foreign levy for purposes of determining if a levy meets the requirements of section 901 or 903. The Treasury Department and the IRS have determined that the standards under the existing regulations for making this determination are unclear. In one place the existing regulations state that the only differentiating factor is if the base of the levy is different in kind, as opposed to degree. See, for example, § 1.901–2(d)(1) (''foreign levies identical to the taxes imposed by sections 11, 541, 881, 882, 1491, and 3111 of the Internal Revenue Code are each separate levies, because the base of each of those levies differs in kind, and not merely in degree''). However, in the same sentence, the regulations suggest that one levy may be separate from another levy if a different class of taxpayers is subject to each levy, regardless of whether the base of the two levies is different in kind. See, for example, id. (''a foreign levy identical to the tax imposed by section 871(b) of the Internal Revenue Code is a separate levy from a foreign levy identical to the tax imposed by section 1 of the Internal Revenue Code *as it applies to persons other than those described in section 871(b)*'' (emphasis added)).

The proposed regulations modify the rules for determining whether a foreign levy is a separate levy to clarify how U.S. principles are relevant in determining whether one foreign levy is separate from another foreign levy. In general, the proposed regulations identify separate levies as those that include different items of income and expense in determining the base of the tax, but in certain circumstances separate levies may result even if the taxable base of each levy is the same. In particular, proposed § 1.901–2(d)(1)(i) provides that a foreign levy is always separate from another foreign levy if the levy is imposed by a different foreign tax authority, even if the base of the tax is the same. Proposed § 1.901–2(d)(1)(ii) provides the general rule that separate levies are imposed on particular classes of taxpayers if the taxable base is different for those taxpayers. For example, the proposed regulations provide that a foreign levy identical to the tax imposed by section 3101 (employee tax on wage income) is a separate levy from the foreign levy identical to the tax imposed by section 3111 (employer tax on wages paid). Proposed § 1.901–2(d)(1)(ii) also provides that income included in the taxable base of a separate levy may also be included in the taxable base of another levy (which may or may not also include other items of income); and separate levies are considered to be imposed if the taxable bases are not combined as a single taxable base. Therefore, a foreign levy identical to the tax imposed by section 1411 is a separate levy from a foreign levy identical to the tax imposed by section 1 because tax is separately imposed on the income included in each taxable base.

Additionally, the proposed regulations at § 1.901–2(d)(1)(iii) provide that a foreign levy imposed on nonresidents is treated as a separate levy from that imposed on residents of the taxing jurisdiction, even if the base is the same for both levies, and even if the levies are treated as a single levy under foreign tax law. These changes are intended to ensure that, in general, if a generally-imposed income tax on residents is also imposed on an extraterritorial basis on some nonresidents, in violation of the jurisdictional nexus requirement, only the portion of the levy that applies to nonresidents will not be treated as a foreign income tax. Otherwise, a foreign country's general income tax regime could fail to qualify as a net income tax if the tax was also imposed on an extraterritorial basis on some nonresidents.

Finally, proposed § 1.901–2(d)(1)(iii) provides that a withholding tax on gross income of nonresidents is treated as a separate levy with respect to each class of gross income (as listed in section 61) to which it applies. This special rule is provided in order to allow withholding taxes that are imposed on several classes of income, based on sourcing rules that meet the jurisdictional nexus requirement with respect to only some of the classes of income, to be analyzed as separate levies under the covered withholding tax rule in § 1.903–1(c)(2). See Part VI.C.3 of this Explanation of Provisions.

B. Amount of Tax That is Considered Paid

1. Background

As discussed in more detail in Part X of this Explanation of Provisions, section 901 allows a credit for foreign income taxes in either the year the taxes are paid or the year the taxes accrue, according to the taxpayer's method of accounting for such taxes. See section 905(a). Regardless of the year in which the credit is allowed, the taxpayer must both owe and actually remit the foreign income tax to be entitled to a foreign tax credit for such tax. See section 905(b); *Chrysler* v. *Comm'r,* 116 T.C. 465, 469 n.2 (2001), *aff'd,* 436 F.3d. 644 (6th Cir. 2006). The taxpayer's liability for the tax may become fixed and determinable in a different taxable year than that in which the tax is remitted, so that the taxpayer's entitlement to the credit may be perfected in a taxable year after the taxable year in which the credit is allowed.

Section 1.901–2(e) of the existing regulations provides rules for determining the amount of foreign tax that is considered paid and eligible for credit under section 901. The existing regulations at § 1.901–2(g)(1) and proposed § 1.901–2(g)(5) clarify that the word ''paid'' as used in § 1.901–2(e) means ''paid'' or ''accrued,'' depending on whether the taxpayer claims the foreign tax credit for taxes paid (that is, remitted) or accrued (that is, for which the liability becomes fixed) during the taxable year. The proposed regulations clarify in several respects the amount of tax that is considered paid (or accrued, as the case may be) and eligible for credit. These clarifications are explained in Parts VI.B.2 and 3 of this Explanation of Provisions.

2. Refundable Amounts, Credits, and Multiple Levies

Under § 1.901–2(e)(2)(i) of the existing 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, abated, or forgiven. That regulation further provides that it is not reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of the final tax liability to the foreign country.

Current law is unclear whether an amount that is not treated as an amount of tax paid under § 1.901–2(e)(5)(i) because it is reasonably certain to be credited against a taxpayer's tentative liability for a second foreign tax should be treated as a constructive refund of the credited amount from the foreign country, followed by a constructive payment by the taxpayer of the second foreign tax. The law is similarly unclear as to whether credits allowed under foreign tax law that are computed with reference to amounts other than foreign tax payments (such as, for example, investment tax credits) may be treated as a constructive receipt of cash by the taxpayer from the foreign country, followed by a constructive payment by the taxpayer of foreign income tax. The results have sometimes differed depending on whether the credit is refundable under foreign law, that is, whether taxpayers are entitled to receive a cash payment from the foreign country to the extent the credit exceeds the taxpayer's foreign income tax liability. See, for example, Rev. Rul. 86–134, 1986–2 C.B. 104 (investment incentives reduced tentative Dutch income tax liability during period in which such incentives could only be claimed as an offset against the income tax liability, rather than as a refundable credit).

The Treasury Department and the IRS have determined that the current uncertainty as to how to properly account for tax credits leads to varying and inconsistent interpretations and that a single, clear rule regarding the treatment of tax credits would improve the consistency in outcomes for taxpayers. In addition, the Treasury Department and the IRS are concerned that if the use of tax credits can be treated as a means of payment of a foreign income tax for foreign tax credit purposes, then foreign countries, rather than reducing their tax rates, could instead offer tax credits that would have the same economic effect without reducing the amount of foreign income tax that is treated as paid by taxpayers for purposes of the foreign tax credit. The Treasury Department and the IRS have also determined it is too administratively challenging to determine whether a foreign country whose law provides for nominally refundable credits in practice actually issues cash payments to taxpayers that do not have income tax liabilities equal to the credit. In addition, the Treasury Department and the IRS have determined that the rule in § 1.901–2(e)(2)(i) with respect to amounts that will be ''credited'' is ambiguous. Section 1.901–2(e)(4)(i) of the existing regulations provides that if, under foreign law, a taxpayer's tentative liability for one levy (the ''first levy'') is or can be reduced by the amount of the taxpayer's liability for a different levy (the ''second levy''), then the amount considered paid by the taxpayer to the foreign country pursuant to the second levy is an amount equal to its entire liability for that levy, and the remainder of the amount paid is considered paid pursuant to the first levy. However, § 1.901–2(e)(2)(i) suggests that the credited amount of the second levy is not considered paid.

Therefore, proposed § 1.901–2(e)(2)(i) provides certainty on the treatment of credited amounts by eliminating the provision that suggests that an amount of tax is not treated as paid if it is allowed as a credit. Instead, proposed § 1.901–2(e)(2)(ii) provides that foreign income tax is not considered paid if it is reduced by a tax credit, regardless of whether the amount of the tax credit is refundable in cash. Therefore, an amount allowed as a credit (including, but not limited to, an amount paid under one levy that is credited against an amount due under another levy) is not treated as a constructive payment of cash from the foreign country (or a constructive refund of the levy that is paid) followed by a constructive payment of the levy that is reduced by the credit, even if the creditable amount is refundable in cash to the extent it exceeds the taxpayer's liability for the levy that is reduced by the credit. However, proposed § 1.901–2(e)(2)(iii) provides that overpayments of tax (which exceed the taxpayer's liability and so are not treated as an amount of tax paid) that are refundable in cash at the taxpayer's option and that are applied in satisfaction of the taxpayer's liability for foreign income tax may qualify as an amount of such foreign income tax paid.

Comments are requested on whether additional rules should be provided for government grants that are provided outside of the foreign tax system, and the circumstances in which such grants should also be treated as a reduction in the amount of tax paid.

Finally, as noted in this Part VI.B.2, the multiple levy rule in § 1.901–2(e)(4) of the existing regulations provides that when an amount of a second levy is applied as a credit to reduce the taxpayer's liability for a first levy, the full amount of the second levy (and not the amount of the first levy that is offset by the credit) is considered paid. The proposed regulations clarify the multiple levy rule by referring to the first levy as the ''reduced levy'' and to the second levy as the ''applied levy.'' The proposed regulations also modify an existing example and add a new example to illustrate the application of proposed § 1.901–2(e)(2) and (4). See proposed § 1.901–2(e)(4)(ii).

3. Noncompulsory Payments

i. Background

Section 1.901–2(e)(5) provides that an amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of the taxpayer's liability under foreign law for tax (the ''noncompulsory payment rule''). Section 1.901–2(e)(5) further provides that if foreign tax law includes options or elections whereby a taxpayer's liability may be shifted, in whole or part, to a different year, the taxpayer's use or failure to use such options or elections does not result in a noncompulsory payment, and that a settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory amount. In addition, it provides that a taxpayer is not required to alter its form of doing business, its business conduct, or the form of any transaction in order to reduce its liability for tax under foreign law.

On March 30, 2007, proposed regulations (REG–156779–06) were published in the **Federal Register** at 72 FR 15081 that, in part, would amend § 1.901–2(e)(5) to treat as a single taxpayer all foreign entities in which the same United States person has a direct or indirect interest of 80 percent or more (a ''U.S.-owned foreign group''). The proposed rule (the ''2007 proposed regulations'') would apply for purposes of determining whether amounts paid are compulsory payments of foreign tax, for example, when one member of a U.S.-owned foreign group surrenders a loss to another member of the group that reduces the foreign tax due from the second member in that year but increases the amount of foreign tax owed by the loss member in a subsequent year. In Notice 2007–95, 2007–2 C.B. 1091, the Treasury Department and the IRS announced that, in reviewing comments received, it was determined that the proposed change may lead to inappropriate results in certain cases and that the proposed change would be effective for taxable years beginning after the publication of final regulations, but that taxpayers may rely on that portion of the proposed regulations for taxable years ending on or after March 29, 2007, and beginning on or before the date on which final regulations are published.

Section 1.909–2 provides an exclusive list of foreign tax credit splitter arrangements, including a loss-sharing splitter arrangement, which exists under a foreign group relief or other loss-sharing regime to the extent a ''usable shared loss'' of a ''U.S. combined income group'' (that is, an individual or corporation and all the entities with which it combines income and expense under Federal income tax law) is used to offset foreign taxable income of another U.S. combined income group. See § 1.909–1(b)(2).

ii. Treatment of Elections and Other Clarifications

Section 1.901–2(e)(5) currently applies on a taxpayer-by-taxpayer basis, obligating each taxpayer to minimize its liability for foreign taxes over time. The 2007 proposed regulations were intended to create a limited exception to the taxpayer-by-taxpayer approach, recognizing that the net effect of a loss surrender in the case of a group relief regime may be to minimize the amount of foreign taxes paid in the aggregate by the group over time. However, the 2007 proposed regulations were both overinclusive and underinclusive. Comments criticized the approach taken, including how the U.S.-owned foreign group was defined, and noted that the proposal had created uncertainty over the extent to which noncompulsory payment issues arise in situations not addressed by the proposed regulations. In addition, as noted in Notice 2007–95, the Treasury Department and the IRS have determined that the 2007 proposed regulations would lead to inappropriate results in certain cases. Furthermore, a comment received in connection with 2012 temporary regulations issued under section 909 (TD 9597, 77 FR 8127) recommended that the 2007 proposed regulations be withdrawn in light of the coverage of loss-sharing splitter arrangements under the section 909 regulations.

The Treasury Department and the IRS agree that the 2007 proposed regulations should be withdrawn. However, withdrawing the 2007 proposed regulations (which taxpayers were permitted to rely on under Notice 2007–95) without providing additional guidance could result in a disallowance of all foreign tax credits related to loss-sharing arrangements because under § 1.901–2(e)(5) the requirement to minimize foreign income tax liability applies on a taxpayer-by-taxpayer basis. To address this issue, proposed § 1.901–2(e)(5)(ii)(B)(*2*) provides that when foreign law permits one foreign entity to join a consolidated group, or to surrender its loss to offset the income of another foreign entity pursuant to a foreign group relief or other loss-sharing regime, a taxpayer's decision to file as a consolidated group, to surrender or not to surrender a loss, or to use or not to use a surrendered loss, will not give rise to a noncompulsory payment.

Although the proposed regulations will generally exempt loss surrender under group relief or other loss-sharing regimes from the noncompulsory payment regulations, the Treasury Department and the IRS remain concerned that in certain cases loss sharing arrangements, particularly when combined with hybrid arrangements, may be used to separate foreign taxes from the related income. For example, if passive category income of a CFC is offset for U.S. tax purposes by a loss recognized by a disregarded entity owned by that CFC, but that loss is surrendered to reduce general category tested income of an affiliated CFC for foreign tax purposes, under § 1.909–3(a) the split taxes of the loss CFC may be eligible to be deemed paid if the affiliated CFC's related income is included in the U.S. shareholder's income in the same taxable year, but such taxes may not be properly associated with the related income. Therefore, the Treasury Department and the IRS are considering whether additional guidance on loss sharing arrangements, including for example under § 1.861–20, is needed. Comments are requested on this and other aspects of the treatment of loss sharing arrangements.

The existing regulations at § 1.901–2(e)(5) provide that where foreign tax law includes options or elections whereby a taxpayer's foreign income tax liability may be shifted to a different year, the taxpayer's use or failure to use such options or elections does not result in a noncompulsory payment. However, the regulations are not clear as to whether the use or failure to use options or elections that result in an overall change in foreign income tax liability over time would result in a noncompulsory payment. For example, a taxpayer's choice to capitalize and amortize capital expenditures over time, rather than to claim a current expense deduction, does not result in a noncompulsory payment; in contrast, a taxpayer's election to compute its tax liability under one of two alternative regimes, one of which qualifies as an income tax and one of which qualifies as a tax in lieu of an income tax, may result in a noncompulsory payment if the taxpayer does not choose the option that is reasonably calculated to minimize its liability for creditable foreign tax over time. Accordingly, proposed § 1.901–2(e)(5)(ii) provides that the use or failure to use such an option or election is relevant to whether a taxpayer has minimized its liability for foreign income taxes. However, an exception is provided for elections to surrender losses under a foreign consolidation, group relief or other loss-surrender regime, as well as for an option or election to treat an entity as fiscally transparent or non-fiscally transparent for foreign tax purposes. Because these elections and options generally have the effect of shifting to another entity, rather than reducing in the aggregate, a taxpayer group's foreign income tax liability, the Treasury Department and the IRS have determined that foreign tax credit concerns related to the use or failure to use such an election or option are more appropriately addressed under other rules. The Treasury Department and IRS request comments on whether there are other foreign options or elections that should be excepted from the general rule.

The Treasury Department and IRS are aware that some taxpayers have taken the position that because § 1.901–2(e)(5) refers to payments of ''foreign taxes,'' rather than ''foreign income taxes,'' the noncompulsory payment regulations only require taxpayers to minimize their total liability for all foreign taxes in the aggregate (including non-income taxes such as excise taxes), as opposed to minimizing foreign income tax. The Treasury Department and IRS disagree with this interpretation, since § 1.901–2(e) defines the amount of ''taxes paid'' for purposes of section 901, which only applies to creditable foreign income taxes. Accordingly, proposed § 1.901–2(e)(5)(i) clarifies that taxpayers are obligated to minimize their foreign income tax liabilities. For example, if a taxpayer may choose to apply a tax credit to reduce either the amount of a creditable income tax or the amount of a non-creditable excise tax, then the proposed regulations require that the taxpayer choose to minimize its liability for the creditable income tax; if instead the taxpayer chooses to apply the credit against the excise tax, income tax in the amount of the applied credit is considered a noncompulsory payment.

Finally, proposed § 1.901–2(e)(5)(i) clarifies that the time value of money is not relevant in determining whether a taxpayer has met its obligation to minimize the amount of its foreign income tax liabilities over time. This rule is consistent with the rule in § 1.901–2(b)(4), providing that the amount of costs that are treated as recovered in computing the base of a foreign tax is the same, regardless of whether a taxpayer chooses to deduct currently, or to capitalize and amortize, a particular expense. Therefore, for example, if a taxpayer subject to foreign income tax at a rate of 20 percent chooses to capitalize a $100x cost and deduct it ratably over five years rather than to deduct the entire $100x cost in the first year, the full $100x cost is considered recovered under either option, and is not affected by the fact that as an economic matter the present value of the $20x reduction in tax liability by reason of the $100x deduction in the first year exceeds the discounted present value of the same $20x reduction in tax spread over five years. Similarly, under proposed § 1.901–2(e)(5)(i), the taxpayer will be treated as paying the same amount of foreign income tax regardless of whether it chooses to pay that amount in the current tax year or in a later year.

Although the Treasury Department and the IRS understand that time value of money considerations have economic effects, for Federal income tax purposes income and expenses (including taxes) generally are neither discounted nor indexed by reference to time value of money considerations. A regime that required taxpayers to minimize the discounted present value, rather than the nominal amount, of foreign income tax liabilities would be complex, requiring assumptions about future tax rates and appropriate discount rates. Similarly, a regime that required taxpayers to compare the discounted present value of a foreign tax credit for a foreign income tax to the discounted present value of a deduction for an alternative payment of non-creditable tax that would be incurred in a different year and select the option that minimized the cost to the U.S. fisc would be comparably complex and burdensome for taxpayers to apply and for the IRS to administer. Accordingly, the proposed regulations provide that economic considerations related to the discounted present value of U.S. and foreign tax benefits are not taken into account for purposes of determining the amount of cost recovery or the amount of foreign income tax that is, or would be under foreign tax law options available to the taxpayer, paid or accrued over time.

C. Tax in Lieu of Income Tax

1. In General

Section 903 provides that, for purposes of the foreign tax credit, the term ''income, war profits, and excess profits taxes'' includes a tax paid in lieu of an income tax otherwise generally imposed by any foreign country or by any possession of the United States (an ''in lieu of tax''). The existing regulations clarify that the foreign country's purpose in imposing the foreign tax (for example, whether it imposes the foreign tax because of administrative difficulty in determining the base of the income tax otherwise generally imposed) is immaterial. See § 1.903–1(a). The existing regulations further provide that it is immaterial whether the base of the foreign tax bears any relation to realized net income and that the base may, for example, be gross income, gross receipts or sales, or the number of units produced or sold. See § 1.903–1(b)(1). The existing regulations also require that the foreign tax meet a substitution requirement, which is satisfied if the tax in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed. See id.

The proposed regulations revise the substitution requirement by more specifically defining the circumstances in which a foreign tax is considered ''in lieu of'' a generally-imposed income tax, consistent with the interpretation of the substitution requirement in prior judicial decisions. See, for example, *Metro. Life Ins. Co.* v. *United States,* 375 F.2d 835, 838–40 (Ct. Cl. 1967). In addition, the proposed regulations provide that an in lieu of tax under section 903, by virtue of the substitution requirement, must also satisfy the jurisdictional nexus requirement described in proposed § 1.901–2(c). Although prior regulations under section 903 did contain a jurisdictional limitation with respect to in lieu of taxes, see § 4.903–1(a)(4) (1980) (requiring that an in lieu of tax follow ''reasonable rules of taxing jurisdiction within the meaning of § 4.901–2(a)(1)(iii)''), the existing regulations do not contain such a rule. The reasons for adopting a jurisdictional nexus requirement under § 1.901–2, as described in Part VI.A.2 of this Explanation of Provisions, apply equally to in lieu of taxes described in section 903. In addition, this rule is necessary to ensure that a foreign tax that is imposed on net gain but that fails the jurisdictional nexus requirement in § 1.901–2 cannot be converted into a creditable tax under section 903 simply by being imposed on a taxable base other than income (such as a tax on gross receipts).

Furthermore, the proposed regulations include a special rule for certain cross-border source-based withholding taxes in order to clarify the application of the substitution requirement to such taxes. The rules in proposed § 1.903–1 apply independently to each separate levy. Therefore, if a separate levy is an in lieu of tax, and a second levy is later enacted by the same foreign country, such second levy may also qualify as an in lieu of tax if the requirements in proposed § 1.903–1 are met.

2. Substitution Requirement

The foreign tax that is being analyzed under section 903 (the ''tested foreign tax'') satisfies the substitution requirement only if, based on the foreign tax law, four tests are met. First, as under the existing regulations, a separate levy that is a foreign income tax described in § 1.901–2(a)(3) (a ''foreign net income tax'') must be generally imposed by the same foreign country (a ''generally-imposed net income tax''). See proposed § 1.903–1(c)(1)(i).

Second, proposed § 1.903–1(c)(1)(ii) requires that neither the generally-imposed net income tax nor any other separate levy that is a foreign net income tax imposed by the same foreign country that imposes the tested foreign tax is imposed with respect to any portion of the income to which the amounts (such as sales or units of production) that form the base of the tested foreign tax relate (the ''excluded income''). For example, if a tonnage tax regime applies with respect to a taxpayer engaged in shipping, income from shipping must be excluded from the foreign country's regular net income tax for the tonnage tax to qualify as an in lieu of tax. This requirement is not met if, under the foreign tax law, a net income tax imposed by the same foreign country applies to the excluded income of any persons that are subject to the tested foreign tax, even if not all of the persons subject to the tested foreign tax are subject to the net income tax.

Third, proposed § 1.903–1(c)(1)(iii) requires that, but for the existence of the tested foreign tax, the generally-imposed net income tax would be imposed on the excluded income. For example, if a tonnage tax regime applies with respect to a taxpayer engaged in shipping, it must be shown that, but for the existence of such regime, the regular income tax would apply to income from shipping. This ''but for'' requirement is met only if the imposition of the tested foreign tax bears a ''close connection'' to the failure to impose the generally-imposed net income tax on the excluded income. See *Metro. Life Ins. Co,* 375 F.2d at 840.

The proposed regulations provide that the close connection requirement is satisfied if the generally-imposed net income tax would apply by its terms to the excluded income but for the fact that it is expressly excluded. For example, if a corporate income tax regime would, by its terms, apply to all corporations, but income of insurance companies is expressly excluded by law under such regime and taxed under a separate regime, then the close connection requirement is met.

Otherwise, a close connection must be established with proof that the foreign country made a ''cognizant and deliberate choice'' to impose the tested foreign tax instead of the generally-imposed net income tax. Id. Such proof may take into account the legislative history of either the tested foreign tax or the generally-imposed net income tax for purposes of ascertaining the intent and purpose of the two taxes in order to determine the relationship between them.

Not all income derived by persons subject to the tested foreign tax need be excluded income, as long as the tested foreign tax applies only to amounts that relate to the excluded income. For example, if a taxpayer that earns income from operating restaurants and hotels is subject to a generally-imposed net income tax except that, pursuant to an agreement with the foreign country, the taxpayer's income from restaurants is subject to a tax based on number of tables and not to the income tax, the table tax can meet the substitution requirement notwithstanding that the hotel income is subject to the generally-imposed net income tax.

Fourth, proposed § 1.903–1(c)(1)(iv) requires that, if the generally-imposed net income tax were applied to the excluded income, the generally-imposed net income tax would either continue to qualify as a foreign net income tax, or would itself constitute a separate levy that is a foreign net income tax. This rule is intended to ensure that a foreign tax can qualify as an in lieu of tax only if the foreign country imposing the tax could instead have subjected the excluded income to a tax on net gain that would satisfy the jurisdictional nexus requirement in § 1.901–2(c).

Finally, proposed § 1.861–20(h) provides a rule for allocating and apportioning foreign taxes described in section 903 (other than withholding taxes) to statutory and residual groupings. In general, the rule provides that the in lieu of tax is allocated and apportioned in the same proportions as the excluded income.

3. Covered Withholding Tax

Gross-basis taxes, such as withholding taxes, do not satisfy the net gain requirement under proposed § 1.901–2(b). While such withholding taxes may be treated as in lieu of taxes under section 903, the analysis under section 903 and existing § 1.903–1 is unclear. Therefore, proposed § 1.903–1(c)(2) provides a special rule for applying the substitution requirement to certain ''covered withholding taxes'' imposed by a foreign country that also has a generally-imposed net income tax.

First, the tax must be a withholding tax (as defined in section 901(k)(1)(B)) that is imposed on gross income of persons who are nonresidents of the foreign country imposing the tax. See proposed § 1.903–1(c)(2)(i).

Second, the tax cannot be in addition to a net income tax that is imposed by the foreign country on any portion of the income subject to the withholding tax. See proposed § 1.903–1(c)(2)(ii). Thus, for example, if a withholding tax applies by its terms to certain gross income of nonresidents that is also subject to the generally-imposed net income tax if it is attributable to a taxable presence of the nonresident in the foreign country imposing the tax, the withholding tax cannot meet the substitution requirement, including as to nonresidents that do not have a taxable presence in that country.

Third, the withholding tax must meet the source-based jurisdictional nexus requirement in proposed § 1.901–2(c)(1)(ii), requiring that rules for sourcing income to the foreign country are reasonably similar to the sourcing rules that apply for Federal income tax purposes (including that services income is sourced to the place of performance). Similar to the rule in proposed § 1.903–1(c)(1)(iv) requiring that the generally-imposed net income tax, if expanded to cover the excluded income, would continue to qualify as a net income tax under § 1.901–2, proposed § 1.903–1(c)(2)(iii) requires that the income subject to the withholding tax satisfies the source requirement described in § 1.901–2(c)(1)(ii).

VII. Rules for Allocating Taxes After Certain Ownership and Entity Classification Changes

A. Background

On February 14, 2012, the **Federal Register** published final regulations (77 FR 8124, TD 9576) under section 901 concerning the determination of the person who pays a tax for foreign tax credit purposes (the ''2012 final regulations''). The 2012 final regulations address the inappropriate separation of foreign income taxes from the income on which the tax was imposed in certain circumstances. The 2012 final regulations provide rules for allocating foreign tax imposed on the combined income of multiple persons, as well as rules for allocating entity-level foreign tax imposed on partnerships and disregarded entities that undergo ownership or certain entity classification changes that do not cause the foreign taxable year of the partnership or disregarded entity (the ''continuing foreign taxable year'') to close.

Section 1.901–2(f)(4)(i) of the 2012 final regulations addresses partnership terminations under section 708(b)(1) that do not cause the foreign taxable year to close. Under this provision, foreign tax paid or accrued with respect to the continuing foreign taxable year (for example, in the case of a section 708(b)(1) termination, foreign tax paid or accrued by a successor corporation or owner of a disregarded entity) is allocated between each terminating partnership and successor entity (or, in the case of a partnership that becomes a disregarded entity, the owner of the disregarded entity). The allocation is based upon the respective portions of the foreign tax base that are attributable under the principles of § 1.1502–76(b) to the period of existence of the terminating partnership and successor entity or the period of ownership by a disregarded entity owner during the continuing foreign taxable year. Section 1.901–2(f)(4)(i) also provides similar rules for allocating foreign tax paid or accrued by a partnership among the respective portions of the partnership's U.S. taxable year that end with, and begin after, a change in a partner's interest in the partnership that does not result in a partnership termination (a variance).

Section 1.901–2(f)(4)(ii) of the 2012 final regulations addresses a change in the ownership of a disregarded entity that does not cause the foreign taxable year of the entity to close. Under this rule, foreign tax paid or accrued with respect to the foreign taxable year is allocated between the transferor and transferee of the disregarded entity. The allocation is made based on the respective portions of the foreign tax base that are attributable under the principles of § 1.1502–76(b) to the period of ownership of each transferor and transferee.

B. Covered Events

The proposed regulations move the § 1.901–2(f)(4) allocation rules that apply in the case of partnership terminations and variances and other ownership and entity classification changes to new § 1.901–2(f)(5), and modify those rules to ensure that they cover any entity classification change under U.S. tax law that does not cause the entity's foreign taxable year to close. The proposed regulations also clarify certain aspects of the 2012 final regulations. The general legal liability rules for taxes imposed on partnerships and disregarded entities are now contained in proposed § 1.901–2(f)(4) and are generally unchanged from the 2012 final regulations.

Proposed § 1.901–2(f)(5)(i) provides a single allocation rule that applies to a partnership, disregarded entity, or corporation that undergoes one or more ''covered events'' during its foreign taxable year that do not result in a closing of the foreign taxable year. Under proposed § 1.901–2(f)(5)(ii), a covered event is 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. These proposed regulations therefore apply to allocate foreign tax paid or accrued with respect to the continuing foreign taxable year of a partnership that terminates under section 708(b)(1), a disregarded entity that becomes a partnership or a corporation, and a corporation that becomes a partnership or a disregarded entity. In addition, proposed § 1.901–2(f)(5)(iv) allocates foreign tax paid or accrued with respect to certain changes in a partner's interest in a partnership (a ''variance'') by treating the variance as a covered event.

These proposed regulations also ensure that the allocation rules apply not just in the case of one or more covered events of the same type within a continuing foreign taxable year, but also in the case of any combination of covered events. For example, proposed § 1.901–2(f)(5) applies to foreign tax that is paid or accrued with respect to a continuing foreign taxable year in which a corporation elects to be treated as a disregarded entity and the disregarded entity subsequently becomes a partnership. A portion of foreign tax is allocated among all persons that were predecessor entities (namely, a terminating partnership or corporation undergoing an entity classification change) or prior owners (namely, the owner of a disregarded entity that is transferred or undergoes an entity classification change) during the continuing foreign taxable year. Like the rules provided in the 2012 final regulations, the allocation is made based on the respective portions of the foreign tax base for the continuing foreign taxable year that are attributable under the principles of § 1.1502–76(b) to the period of existence or ownership of each predecessor entity or prior owner during such year.

C. Timing of the Payment or Accrual of an Allocated Tax

These proposed regulations also provide consistent rules for when allocated tax is treated as paid or accrued. Proposed § 1.901–2(f)(5)(i) provides that tax allocated to a predecessor entity is treated as paid or accrued as of the close of the last day of its last U.S. taxable year, and that tax allocated to the prior owner of a disregarded entity is treated as paid or accrued as of the close of the last day of its U.S. taxable year in which the change in ownership occurs.

D. Treatment of Withholding Taxes

The 2012 final regulations do not clearly state whether foreign withholding taxes are subject to the allocation rules. As explained in Part VI.A of this Explanation of Provisions, foreign taxes are allocated based on the portion of the foreign tax base that is attributed to the period of existence or ownership of each predecessor or prior owner during the foreign taxable year, applying the principles of § 1.1502–76(b). The principles of § 1.1502–76(b) allow taxpayers to use either a closing of the books method or a ratable allocation method in attributing the foreign tax base to these periods.

If the ratable allocation method is used, foreign tax is generally allocated to a predecessor entity or prior owner based on its ratable share of the foreign tax base for the continuing foreign taxable year. In the case of net basis foreign tax paid or accrued by a new owner or successor entity with respect to a continuing foreign taxable year, the resulting allocation of a portion of the tax to a predecessor entity or prior owner is appropriate because the predecessor entity or prior owner generally took into account for U.S. tax purposes a portion of the related income on which the net basis tax was imposed. However, in the case of withholding tax that is imposed on an amount that accrues for U.S. tax purposes when it is paid, such as a dividend, an allocation of a portion of the withholding tax based on ratably allocating the dividend income over the foreign taxable year to a predecessor entity or prior owner is not appropriate because the predecessor entity or prior owner will not have taken any of the related dividend income into account for U.S. tax purposes. Even if withholding tax is imposed on income, such as interest, that accrues for U.S. tax purposes ratably over a period, an allocation of a portion of the withholding tax to a predecessor entity or prior owner based on ratably allocating the interest income over the foreign taxable year may not be appropriate if the foreign taxable year is not the same period as the accrual period under the terms of the instrument that generated the interest.

Because applying the ratable allocation method under proposed § 1.901–2(f)(5) to allocate withholding taxes to a predecessor entity or prior owner may separate withholding taxes from income that accrues when paid, and may not achieve appropriate matching of withholding taxes and related income in the case of withholding tax imposed on income that accrues over a period, these proposed regulations provide that withholding taxes paid in the foreign taxable year of a covered event are not subject to allocation under proposed § 1.901–2(f)(5).

E. Elections Under Sections 336(e) and 338

Sections 1.336–2(g)(3)(ii) and 1.338–9(d) provide rules for allocating foreign tax between old target and new target where a section 336(e) election or 338 election, respectively, is in effect with respect to the sale, exchange, or distribution of the target and the transaction does not cause old target's foreign taxable year to close. The proposed regulations clarify that, in the case of a section 338 election, the allocation is made with respect to the portions of the foreign tax base that are attributable under § 1.1502–76(b) principles to old target and new target, and clarify how the allocation is made if there are multiple transfers of the stock of target that are each subject to a separate section 338 election during the foreign taxable year. The proposed regulations also provide that if a section 338 election is made for target and target holds an interest in a disregarded entity or partnership, the rules of § 1.901–2(f)(4) and (5) apply to determine the person who is considered for Federal income tax purposes to pay foreign income tax imposed at the entity level on the income of the disregarded entity or partnership. In addition, the proposed regulations clarify that withholding tax is not subject to allocation. Finally, the proposed regulations make a conforming change to the allocation rules that apply where a section 336(e) election is in effect by providing that withholding taxes are not subject to allocation.

VIII. Transition Rules Accounting for NOL Carrybacks

A. Background

The 2019 FTC final regulations provide transition rules for assigning any separate limitation loss (''SLL'') or overall foreign loss (''OFL'') accounts in a pre-2018 separate category to a post-2017 separate category. The regulations also provide transition rules for how an SLL or OFL that reduced pre-2018 general category income is recaptured in post-2017 years, and for how to treat foreign losses that are part of general category net operating losses (''NOLs'') incurred in pre-2018 taxable years that are carried forward to post-2017 taxable years. See § 1.904(f)–12(j).

The transition rules included in the 2019 FTC final regulations did not address post-2017 NOL carrybacks to pre-2018 taxable years because section 172 generally did not allow for NOL carrybacks when the 2019 FTC final regulations were issued. However, on March 27, 2020, Congress enacted the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. 116–136, 134 Stat. 281 (2020) (the ''CARES Act''), which revised section 172(b) to allow taxpayers to carry back, for five years, NOLs incurred in 2018 through 2020.

B. Rule for Post-2017 NOL Carrybacks

The proposed regulations provide rules analogous to the existing transition rules in § 1.904(f)–12(j) to situations involving an NOL arising in a post-2017 taxable year that is carried back to a pre-2018 taxable year. In particular, proposed § 1.904(f)–12(j)(5)(i) confirms that the rules of § 1.904(g)–3(b) apply to the NOL carryback, and provides that income in a pre-2018 separate category in the taxable year to which the NOL is carried back is generally treated as if it included only income that would be assigned to the same separate category in post-2017 taxable years. Therefore, any SLL created by reason of a passive category component of a post-2017 NOL that is carried back to offset pre-2018 general category income will be recaptured in post-2017 taxable years as general category income, and not as a combination of post-2017 general, foreign branch, or section 951A category income.

However, in order to reduce the potential for creating SLLs by reason of the carryback of a post-2017 NOL component in the foreign branch category or section 951A category to a pre-2018 taxable year, the proposed regulations provide that such losses will first ratably offset a taxpayer's general category income in the carryback year, to the extent thereof, and that no SLL account will be created as a result of that offset. The amount of income in the general category available to be offset under this rule is determined after first offsetting the general category income in the carryback year by a post-2017 NOL component in the general category that is carried back to the same year.

IX. Foreign Tax Credit Limitation Under Section 904

A. Revisions to Definition of Foreign Branch Category Income

The proposed regulations revise certain aspects of the foreign branch category income rules in § 1.904–4(f) to account for a broader range of disregarded payments, as well as to better coordinate with the rules in § 1.861–20 and the elective high-tax exception rules in proposed § 1.954–1(d) of the 2020 HTE proposed regulations (85 FR 44650).

Section 904(d)(2)(J)(i) defines foreign branch category income as business profits of a United States person that are attributable to qualified business units in foreign countries. Section 1.904–4(f)(2)(ii) and (iii) of the 2019 FTC final regulations provide that income attributable to a foreign branch does not include income arising from activities carried out in the United States or income arising from stock that is not dealer property. Section 1.904–4(f)(1)(ii) of the 2019 FTC final regulations, reflecting section 904(d)(2)(J)(ii), provides that passive category income is excluded from foreign branch category income. These rules exclude from foreign branch category income for purposes of section 904 income generated by assets that may be owned through the foreign branch and reflected on its books and records, but that is not properly characterized as business profits attributable to foreign branch activities.

In contrast, in the different context of applying the disregarded payment rules in proposed § 1.861–20(d)(3)(v) or proposed § 1.954–1(d), which rely on the rules in § 1.904–4(f), such income is properly attributed to a taxable unit or a tested unit, respectively, for purposes of those provisions. In order to facilitate the incorporation by cross-reference of the rules and principles in § 1.904–4(f) for attributing income to taxable units for purposes of other provisions, the proposed regulations move the exclusions for income arising from U.S. activities and stock to § 1.904–4(f)(1)(iii) and (iv), respectively, and modify the language to provide that such income may be attributable to a foreign branch but is always excluded from foreign branch category income. See also Part

V.F.4 of this Explanation of Provisions (discussing the rules in proposed § 1.861–20(d)(3)(v)(B)(*2*) for attributing income to taxable units). This technical change does not reflect any reconsideration by the Treasury Department and the IRS of the determination in the 2019 FTC final regulations that income arising from U.S. activities and stock do not constitute business profits that are attributable to foreign branches within the meaning of section 904(d)(2)(J).

Proposed § 1.904–4(f)(2)(vi)(G) provides that the disregarded reallocation payment rules generally apply in the case of disregarded payments made to and from a ''non-branch taxable unit'' (as defined in proposed §§ 1.904–4(f)(3) and 1.904–6(b)(2)(i)(B)), which includes certain persons and interests that do not meet the definition of a foreign branch or foreign branch owner. This change accounts for the fact that disregarded payments may occur among, for example, foreign branches, foreign branch owners, and disregarded entities that have no trade or business (and are therefore not foreign branches). In order to attribute gross income to a foreign branch or a foreign branch owner, disregarded payments to and from non-branch taxable units must cause the reattribution of current gross income to the same extent as disregarded payments to and from foreign branches and foreign branch owners. The gross income attributed to a non-branch taxable unit after taking into account all the disregarded payments that it makes and receives must then be further attributed to a foreign branch (if it is part of a ''foreign branch group''), or foreign branch owner (if it is part of a ''foreign branch owner group''), to the extent of its ownership of the non-branch taxable unit. For this purpose, a non-branch taxable unit is part of either a foreign branch group or a foreign branch owner group to the extent it is owned, including indirectly through other non-branch taxable units, by a foreign branch or a foreign branch owner, respectively. The gross income that is attributed to the members of a foreign branch group is attributed to the foreign branch that owns the group, and the gross income that is attributed to the members of a foreign branch owner group is attributed to the foreign branch owner that owns the group.

The proposed regulations also clarify that the reattribution of gross income by reason of disregarded payments is capped at the amount of current gross income in the payor foreign branch or foreign branch owner. See proposed § 1.904–4(f)(2)(vi)(A).

Finally, the proposed regulations include more detailed rules on the treatment of payments between foreign branches, and provide an example illustrating the application of the matching rule in § 1.1502–13 to the rules in § 1.904–4(f)(2)(vi) in response to a comment received with respect to the 2019 FTC proposed regulations. See proposed § 1.904–4(f)(4)(xiii) through (xv) (*Examples 13* through *15*).

B. Financial Services Entities

Section 904(d)(2)(D)(i) provides that financial services income can only be received or accrued by a person ''predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.'' The 2019 FTC proposed regulations modified the definition of a financial services entity (''FSE'') by adopting a definition of ''predominantly engaged in the active conduct of a banking, insurance, financing, or similar business'' and ''income derived in the active conduct of a banking, insurance, financing, or similar business.'' As discussed in the preamble to the 2020 FTC final regulations, in response to comments made in response to the 2019 FTC proposed regulations, the Treasury Department and the IRS determined that these provisions of the 2019 FTC proposed regulations should be revised and reproposed to provide an additional opportunity for comment.

The proposed regulations retain the general approach of the existing § 1.904–4(e) final regulations by providing a numerical test whereby an entity is a financial services entity if more than a threshold percentage of its gross income is derived directly from active financing income, and the regulations continue to contain a list of income that qualifies as active financing income. However, the proposed regulations lower the threshold from 80 percent to 70 percent, and further provide that active financing income must generally be earned from customers or other counterparties that are not related parties. These changes will 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. The modified rule also makes clear that internal financing companies do not qualify as financial services entities if 70 percent or less of their gross income meets the unrelated customer requirement. In addition, the proposed regulations modify § 1.904–5(b)(2) to provide that the look-through rules in § 1.904–5 apply in all cases to assign related party payments attributable to passive category income to the passive category, including in the case of related party payments made to a financial services entity. Comments are requested on the treatment of related party payments in the numerator and denominator of the 70-percent gross income test, and whether related party payments should in some cases constitute active financing income.

In the case of an insurance company's income from investments, the Treasury Department and the IRS recognize that an insurance company must hold passive investment assets to support its insurance obligations, including capital and surplus in addition to insurance reserves, to ensure the company's ability to satisfy insurance liabilities if claims are greater than anticipated or investment returns are less than anticipated. However, the Treasury Department and the IRS have determined that limits on the amount of an insurance company's investment income that may be treated as active financing income are appropriate in cases where an insurance company holds substantially more investment assets and earns substantially more passive investment income than necessary to support its insurance business. Thus, proposed § 1.904–4(e)(2)(ii) imposes a cap on the amount of an insurance company's income from investments that may be treated as active financing income. The cap is determined based on an applicable percentage of the insurance company's total insurance liabilities. If investment income exceeds the insurance company's investment income limitation, investment income in excess of the limitation is not considered ordinary and necessary to the proper conduct of the company's insurance business and will not qualify as active financing income.

The Treasury Department and the IRS request comments on the investment income limitation rule and in particular on whether the applicable percentages selected for life and nonlife insurance companies are reasonable.

X. Sections 901(a) and 905(a)—Rules Regarding When the Foreign Tax Credit Can Be Claimed

A. Background

Section 901(a) provides that a taxpayer has the option, for each taxable year, to claim a credit for foreign income taxes paid or accrued to a foreign country in such taxable year, subject to the limitations under section 904. Alternatively, a taxpayer may deduct the foreign income taxes under section 164(a)(3). The deduction and credit for foreign income taxes are mutually exclusive; section 275(a)(4) provides that no deduction shall be allowed for foreign income taxes if the taxpayer chooses to take to any extent the benefits of section 901. Section 1.901–1(c) of the existing regulations, which clarifies the application of section 275(a)(4), provides that if a taxpayer chooses with respect to any taxable year to claim a credit for taxes to any extent, such choice will be considered to apply to all taxes paid or accrued in such taxable year to all foreign countries, and no portion shall be allowed as a deduction in such taxable year or any succeeding taxable year.

Section 901(a) further provides that the choice to claim the foreign tax credit for any taxable year ''may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year.'' Section 6511 prescribes the periods for making a claim for credit or refund of U.S. tax. The default period under section 6511(a) is three years from the time the taxpayer filed the relevant return or two years from when the tax is paid, whichever is later. Section 6511(d) sets forth special periods of limitation for making a claim of credit or refund of U.S. tax that is attributable to particular attributes. Under section 6511(d)(3), if the refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country for which credit is allowed under section 901, the taxpayer has 10 years from the un-extended due date of the return for the taxable year in which the foreign taxes are paid or accrued to file the claim. See § 301.6511(d)–3. Section 6511(d)(2) sets out a special limitations period for refund claims ''attributable to a net operating loss carryback'' of three years from the due date of the return for the year in which the net operating loss originated. The existing regulations at § 1.901–1(d) provide that a taxpayer can claim the benefits of section 901 (or claim a deduction in lieu of a foreign tax credit) at any time before the expiration of the period prescribed by section 6511(d)(3)(A).

Section 905(a) and § 1.905–1(a) of the existing regulations provide that a taxpayer may claim a credit for foreign income taxes either in the year the taxes accrue or in the year the taxes are paid, depending on the taxpayer's method of accounting. Sections 1.446–1(c) and 1.461–1 provide rules for when income and liabilities are taken into account for taxpayers using the cash receipts and disbursement method of accounting (cash method) and for taxpayers using the accrual method of accounting. Under § 1.461–1(a)(1), cash method taxpayers generally take into account allowable deductions in the taxable year in which paid. For accrual method taxpayers, § 1.461–1(a)(2) provides that liabilities are taken into account in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. If the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax. See § 1.461–4(g)(6)(i). However, in the case of foreign income taxes, economic performance occurs when the requirements of the all events test, other than economic performance, are met, whether or not the taxpayer elects to credit such taxes under section 901. See § 1.461–4(g)(6)(iii)(B). In the case of foreign income taxes imposed on the basis of a taxable period, because all of the events that fix the fact and amount of liability for the foreign tax with reasonable accuracy do not occur until the end of the foreign taxable year, such foreign income taxes accrue and are creditable in the U.S. tax year within which the taxpayer's foreign taxable year ends. See § 1.960–1(b)(4); Revenue Ruling 61–93, 1961–1 C.B. 390.

Section 905(a) also provides that, regardless of the taxpayer's method of accounting, a taxpayer can elect to claim the foreign tax credit in the year in which the taxes accrue. Once made, this election is irrevocable and must be followed in all subsequent years. In addition, courts have held that the election to claim the foreign tax credit on the accrual basis cannot be made on an amended return. See *Strong* v. *Willcuts,* 17 AFTR 1027 (D. Minn.) (1935) (holding that taxpayer may not change to accrual basis on an amended return because when the taxpayer made an election that the Government has accepted, the rights of the parties became fixed); see also Rev. Rul. 59–101, 1959–1 C.B. 189 (holding that a taxpayer who elected on his original return to claim credit for foreign income tax accrued may not change this election and file amended returns to claim credit for foreign taxes in the year paid). However, for the year the election is made, a taxpayer can claim a credit both for taxes that accrue in that year as well as taxes paid in such year that had accrued in prior years. See *Ferrer* v. *Comm'r,* 35 T.C. 617 (1961) (holding that a cash method taxpayer is entitled, in the year he elects pursuant to section 905(a) to claim foreign tax credits on the accrual basis, to claim a credit for prior years' foreign income taxes paid as well as foreign income taxes accrued in that year), *rev'd on other grounds,* 304 F.2d 125 (2d Cir. 1962).

With respect to the accrual of a contested tax, the Supreme Court held in *Dixie Pine Products Co.* v. *Comm'r,* 320 U.S. 516 (1944), that a state income tax that is contested is not fixed, and so does not accrue, until the contest is resolved. See also section 461(f) (rule permitting taxpayers to deduct contested taxes in the year in which they are paid does not apply to foreign income taxes). The contested tax doctrine, however, does not apply in determining when foreign taxes accrue for purposes of the foreign tax credit. See *Cuba Railroad Co.* v. *United States,* 124 F. Supp. 182, 185 (S.D.N.Y. 1954) (holding that taxes with respect to taxpayer's 1943 income accrued for purposes of the foreign tax credit in 1943 even though the tax was contested and paid in a later year). In Revenue Ruling 58–55, 1958–1 C.B. 266, the IRS examined *Dixie Pine* and *Cuba Railroad,* as well as the legislative history and purpose of the foreign tax credit provisions, and concluded that a contested foreign tax does not accrue until the contest is resolved and the liability becomes finally determined, but for foreign tax credit purposes, the foreign tax, once finally determined, is considered to accrue in the taxable year to which it relates. The revenue ruling further clarified that this ''relation back'' rule does not apply for purposes of determining the taxable year in which foreign taxes may be deducted under section 164, which is governed by the contested tax doctrine.

The relation back rule has since been consistently applied by courts. See, for example, *United States* v. *Campbell,* 351 F.2d 336, 338 (2d Cir. 1965) (explaining that if a taxpayer contests his liability for a foreign tax imposed on income in 1960, and the liability is finally adjudicated in 1965, the taxpayer may not claim the credit until 1965, but at that time the credit relates back to offset U.S. tax imposed on taxpayer's 1960 income); *Albemarle Corp. & Subsidiaries* v. *United States,* 797 F.3d 1011, 1019 (Fed. Cir. 2015) (holding that in the context of determining in what year a taxpayer is eligible to claim a foreign tax credit, the relation back doctrine applies, and thus the 10-year limitations period for filing a refund claim started to run from the un-extended due date for the return for the year to which the tax relates, not the later year in which the contest was resolved). In Revenue Ruling 70–290, 1970–1 C.B. 160, the IRS held that contested taxes that have been paid to the foreign country may be provisionally accrued and claimed as a foreign tax credit, even if the liability has not actually accrued because the taxpayer continues to contest its liability for the tax in the foreign country. The revenue ruling reasons that this is permissible because section 905(c) would require a redetermination of U.S. tax liability if the taxpayer's contest is successful, and the foreign tax is refunded to the taxpayer by the foreign government. Revenue Ruling 84–125, 1984–2 C.B. 125, similarly held that a taxpayer is eligible to claim a credit for the portion of contested taxes that have actually been paid for the taxable year in which the contested liability relates because such taxes are accruable at the time of payment, even though the amount of the liability is not finally determined.

The Treasury Department and the IRS received comments in response to the 2019 FTC proposed regulations asking for clarification on when contested taxes accrue for purposes of the foreign tax credit and for clarification regarding whether the special period of limitations in section 6511(d)(3)(A) applies in the case of a refund claim relating to foreign income taxes that a taxpayer chose to deduct. Questions have also arisen regarding whether taxpayers can make an election to claim the foreign tax credit or revoke such an election (in order to deduct the foreign taxes) on an amended return when making or revoking such election results in a time-barred U.S. tax deficiency in one or more intervening years because the assessment statute under section 6501 does not align with the time for making or changing the election under § 1.901–1(d).

These proposed regulations provide rules clarifying when a foreign tax credit may be taken for both cash method taxpayers and for accrual method taxpayers, and in the case of accrual method taxpayers, clarify the application of the relation-back doctrine. The proposed regulations also modify the period during which a taxpayer can change the choice to claim a credit or a deduction for foreign income taxes on an amended return to align with the different refund periods under section 6511. The proposed regulations also clarify that a change from claiming a deduction to claiming a credit, or vice versa, for foreign income taxes results in a foreign tax redetermination under section 905(c). In addition, the proposed regulations address mismatch and time-barred deficiency issues resulting from the application of the relation-back doctrine for the accrual of foreign income taxes for purposes of the foreign tax credit, and the application of the contested tax doctrine for purposes of determining when foreign income taxes can be deducted.

B. Rules for Choosing To Deduct or Credit Foreign Income Taxes

1. Application of Section 275(a)(4)

Section 1.901–1(c) of the existing regulations, interpreting section 275(a)(4), provides that if a taxpayer chooses to claim a foreign tax credit to any extent with respect to the taxable year, such choice applies to all creditable taxes and no deduction for any such taxes is allowed in such taxable year or in any succeeding taxable year. Questions have arisen as to whether this rule prevents taxpayers from claiming either the benefit of a credit or a deduction with respect to additional taxes that are paid in a taxable year in which a taxpayer claims a foreign tax credit if those additional taxes relate (under the relation-back doctrine) to an earlier year in which taxpayer claimed a deduction. As described in Part X.A of this Explanation of Provisions, additional tax paid by an accrual method taxpayer (or a cash method taxpayer that has elected to claim foreign tax credits using the accrual method) as a result of a foreign tax audit or at the end of a contest relate back and are considered to accrue in the taxable year to which the taxes relate. Thus, the additional taxes are not creditable in the year they are paid and would only be creditable in the relation-back year. However, if a taxpayer deducted foreign income taxes in the relation-back year, the taxpayer cannot claim an additional deduction in the earlier year because the additional taxes accrue for deduction purposes in the year the additional taxes are paid.

The Treasury Department and the IRS have determined that this result is not intended by section 275(a)(4), the purpose of which is to prevent taxpayers from claiming the benefits of both a credit and a deduction with respect to the same taxes. Thus, the proposed regulations provide an exception which allows a taxpayer that is claiming credits on an accrual basis to claim, in a year in which it has elected to claim a credit for foreign income taxes that accrue in that year, also to deduct additional taxes paid in that year that, for foreign tax credit purposes, relate back and are considered to accrue in a prior year in which the taxpayer deducted foreign income taxes. See proposed § 1.901–1(c)(3).

2. Period Within Which an Election To Claim a Foreign Tax Credit Can Be Made or Changed

The proposed regulations also modify § 1.901–1(d), which sets forth the period during which a taxpayer can make or change its election to claim a foreign tax credit. Existing § 1.901–1(d), which was amended in 1987 under TD 8160 (52 FR 33930–02), provides that a taxpayer can, for a particular taxable year, claim the benefits of section 901 or claim a deduction in lieu of a foreign tax credit at any time before the expiration of the period prescribed by section 6511(d)(3)(A) (or section 6511(c) if the period is extended by agreement). The 1987 amendment was preceded by cases in which courts determined that the applicable period of limitations for making an initial election to claim a foreign tax credit under section 901 is the special 10-year period in section 6511(d)(3)(A). See *Woodmansee* v. *United States,* 578 F.2d 1302 (9th Cir. 1978); *Hart* v. *United States,* 585 F.2d 1025 (Ct. Cl. 1978) (also holding that prior regulations, which required taxpayers to make the election to claim a foreign tax credit within the three-year period prescribed by 6511(a), were invalid).

However, as recent court decisions have made clear, the 10-year statute of limitations in section 6511(d)(3)(A) applies only to claims for credit or refund of U.S. taxes attributable to foreign income taxes for which the taxpayer was allowed a credit; it does not apply in the case of a claim for credit or refund of U.S. taxes attributable to foreign income taxes for which a taxpayer claimed a deduction under section 164(a)(3). See, for example, *Trusted Media Brands, Inc.* v. *United States,* 899 F.3d 175 (2d Cir. 2018). In addition, the reason for the special period of limitations provided by section 6511(d)(3) is to allow taxpayers to seek a refund of U.S. tax if foreign taxes were assessed or increased after the regular three-year statute of limitations period has run, and to better align with the IRS' ability to assess additional U.S. tax under section 905(c) when a taxpayer receives a refund of the foreign income tax claimed as a credit. The special period of limitations is not needed when a taxpayer instead claims a deduction, because accrued foreign income taxes do not relate back for deduction purposes, and the additional tax paid as a result of the foreign assessment can be claimed as a deduction in the year the contest is resolved.

Therefore, the Treasury Department and the IRS have determined that the better interpretation of section 901(a) is that the period for choosing or changing the election to claim a credit or a deduction is based on the applicable refund period, depending on the choice made. Thus, an election to claim a credit, or to change from claiming a deduction to claiming a credit, for taxes paid or accrued in a particular year must be made before the expiration of the 10-year period prescribed by section 6511(d)(3)(A) within which a claim for refund attributable to foreign tax credits may be made, but a choice to claim a deduction, or to change from claiming a credit to claiming a deduction, for taxes paid or accrued in a particular year must be made before the expiration of the three-year period prescribed by section 6511(a) within which a claim for refund attributable to a section 164 deduction may be made. See proposed § 1.901–1(d). This proposed rule eliminates the mismatch between the election and refund periods that exists under the existing regulations, whereby a taxpayer who makes a timely election to change from claiming a credit to claiming a deduction within a 10-year period may in some cases be time-barred from obtaining a refund of U.S. taxes attributable to the resulting decrease in taxable income for the deduction year. In addition, the proposed rule is consistent with the court's decision in each of *Hart* and *Woodmansee,* since it allows taxpayers to elect to claim a credit within the 10-year period provided by section 6511(d)(3)(A).

3. Change in Election Treated as a Foreign Tax Redetermination Under Section 905(c)

As part of the 2019 FTC final regulations, the Treasury Department and the IRS issued final regulations under § 1.905–3 to provide guidance on when foreign tax redeterminations occur. Section 1.905–3(a) provides that a foreign tax redetermination means a change in the liability for a foreign income tax or certain other changes that affect a taxpayer's foreign tax credit. Consistent with section 905(c), this includes when foreign income taxes for which a taxpayer claimed a credit are refunded, foreign income taxes when paid or later adjusted differ from amounts a taxpayer claimed as a credit or added to PTEP group taxes, and when accrued taxes are not paid within 24 months of the close of the taxable year to which the taxes relate. The 2020 FTC final regulations further modify the definition of foreign tax redetermination to include changes to foreign income tax liability that affect a taxpayer's U.S. tax liability even when there is no change to the amount of foreign tax credits claimed, such as when a change to foreign taxes affects subpart F and GILTI inclusion amounts or affects whether or not a CFC's subpart F income and tested income is eligible for the high-tax exception under section 954(b)(4) in the year to which the redetermined foreign tax relates.

These proposed regulations further amend § 1.905–3 to provide that a foreign tax redetermination includes a change by a taxpayer in its decision to claim a credit or a deduction for foreign income taxes that may affect a taxpayer's U.S. tax liability. Section 905(c)(1)(A) provides that a foreign tax redetermination is required ''if accrued taxes when paid differ from the amounts claimed as credits by the taxpayer.'' When a taxpayer changes its election from claiming a credit to claiming a deduction, or vice versa, with respect to foreign income taxes paid or accrued in a particular year, the amount of tax that was accrued and paid differs from the amount that has been claimed as a credit by the taxpayer. Accordingly, a change in a taxpayer's election to claim a credit or a deduction for foreign income taxes is described in section 905(c)(1)(A) even if the foreign income tax liability remains unchanged.

This interpretation is consistent with the purpose of section 905(c) and within the constraints courts have placed in interpreting the provision. As noted by the court in *Texas Co. (Caribbean) Ltd.* v. *Comm'r,* 12 T.C. 925 (1949), section 905(c) addresses problems for which the relevant information might not be available within the general period of limitations or ones where the taxpayer has exclusive control of the information, which justify removing these situations from the generally-applicable period of limitations on assessment. The court in *Texas Co.* held that a U.S. tax deficiency that results from a computational error, which was discoverable by the IRS within the normal assessment period, is not within the scope of section 905(c). A taxpayer's decision to change its election can occur outside the normal assessment period under section 6501(a) and is information that is under the exclusive control of the taxpayer. Thus, the Treasury Department and the IRS have determined that it is appropriate to treat a change in election as a foreign tax redetermination that requires a redetermination of U.S. tax liability for the affected years and notification of the IRS to the extent required under § 1.905–4.

The effect of treating a change in a taxpayer's decision to claim a credit or a deduction for foreign income taxes as a foreign tax redetermination is that the IRS may assess and collect any U.S. tax deficiencies in intervening years that result from the taxpayer's change in election, even if the generally-applicable three-year assessment period under section 6501(a) has expired. See section 6501(c)(5). This can occur, for example, if a timely change to switch from deductions originally claimed in a loss year (to increase a net operating loss) to credits (in order to claim a carryforward of excess foreign taxes in a later year) would result in a time-barred deficiency in a year to which the net operating loss that was increased by the deductions for foreign taxes was originally carried. Currently, the law is unclear how section 274(a)(4), equitable doctrines such as the duty of consistency, or the mitigation provisions under sections 1311 through 1314 operate to prevent taxpayers from obtaining a double benefit (through both a deduction and a credit) for a single amount of foreign income tax paid. These uncertainties have led taxpayers to request guidance from the IRS to clarify the effect of a timely change in election on their U.S. tax liabilities. The proposed regulations provide a clear and efficient process by which taxpayers can eliminate uncertainty with respect to the tax consequences of changing from claiming a credit to claiming a deduction, or vice versa, for foreign income taxes, within the time period allowed.

C. Rules for When a Cash Method Taxpayer Can Claim the Foreign Tax Credit

Proposed § 1.905–1(c) provides rules on when foreign income taxes are creditable for taxpayers using the cash method of accounting. Consistent with § 1.461–1(a)(1), which provides that for taxpayers using the cash method, amounts representing allowable deductions are taken into account in the taxable year in which they are paid, proposed § 1.905–1(c)(1) provides that foreign income taxes are creditable in the taxable year in which they are paid. Foreign income taxes are generally considered paid in the year the taxes are remitted to the foreign country. However, foreign income taxes that are withheld from gross income by the payor are considered paid in the year withheld. See proposed § 1.905–1(c)(1). As discussed in Part VI.B of this Explanation of Provisions, taxes that are not paid within the meaning of § 1.901–2(e) because they exceed a reasonable approximation of the taxpayer's final foreign income tax liability are not eligible for a foreign tax credit.

The regulations at § 1.905–3(a) further provide that a refund of foreign income taxes that have been claimed as a credit in the year paid, or a subsequent determination that the amount paid exceeds the taxpayer's liability for foreign income tax, is a foreign tax redetermination under section 905(c), and the taxpayer must file an amended return and redetermine its U.S. tax liability for the affected years. However, additional taxes that are paid by a cash method taxpayer in a later year with respect to a prior year do not relate back to the prior year, nor do they result in a redetermination of foreign income taxes paid and U.S. tax lability under section 905(c) for the prior year; instead, those additional taxes are creditable in the year in which they are paid.

Proposed 1.905–1(e) sets forth rules for cash method taxpayers electing to claim foreign tax credits on an accrual basis. As provided by section 905(a), this election is irrevocable, and once made, must be followed in all subsequent years, and consistent with the holding in *Strong* v. *Willcuts,* the election generally cannot be made on an amended return. See proposed § 1.905–1(e)(1). However, the proposed regulations provide exceptions to these general rules in order to ensure that a taxpayer who makes this election to switch from claiming credits on a cash basis to an accrual basis is not double taxed in certain situations. First, proposed § 1.905–1(e)(2) provides that a taxpayer who has previously never claimed a foreign tax credit may make the election to claim the foreign tax credit on an accrual basis when the taxpayer claims the credit, even if such initial claim for credit is made on an amended return. In addition, following the decision in *Ferrer* v. *CIR,* proposed § 1.905–1(e)(3) provides that, for the taxable year in which the accrual election is made and for the subsequent years in which a taxpayer claims a foreign tax credit on an accrual basis, that taxpayer can claim a foreign tax credit for taxes paid in the year, if pursuant to the rules for accrual method taxpayers that are described in Part X.D of this Explanation of Provisions, those taxes paid relate to a taxable year before the taxpayer elected to claim credits on an accrual basis. The Treasury Department and the IRS have determined that this result is appropriate because otherwise taxpayers that make the accrual election would, in effect, have to forego a credit for prior year taxes, unless the election is made for the very first year in which a credit is claimed.

D. Rules for Accrual Method Taxpayers

1. In General

Proposed § 1.905–1(d)(1) provides general rules for when taxpayers using the accrual method of accounting can claim a foreign tax credit. This determination requires applying the all events test contained in § 1.461–1. In accordance with § 1.461–1(a)(2)(i), foreign income taxes accrue in the taxable year in which all the events have occurred that establish the fact of liability, and the amount of the liability can be determined with reasonable accuracy. See also § 1.461–4(g)(6)(iii)(B) (economic performance with respect to foreign income taxes occurs when the requirements of the all events test, other than the payment prong of the economic performance requirement, are met). The proposed regulations confirm that where the all events test has not been met with respect to a foreign income tax liability, such as in the case where the tax liability is contingent upon a distribution of earnings, such taxes have not accrued and may not be claimed as a credit. See proposed § 1.905–1(d)(1)(i).

Proposed § 1.905–1(d)(1)(ii) incorporates the relation-back doctrine, and provides that, for foreign tax credit purposes, once the all events test is met, the foreign income taxes relate back and are considered to accrue in the year to which the taxes relate, the ''relation-back year.'' For example, additional taxes paid as a result of a foreign adjustment relate back and are considered to accrue at the end of the foreign taxable year(s) with respect to which the taxes were adjusted. Thus, the additional taxes paid in the later year are creditable in the relation-back year, not in the year in which the additional taxes are paid. See proposed § 1.905–1(d)(6)(iii) (*Example 3*); see also § 1.905–3(b)(1)(ii)(A) (*Example 1*). Moreover, in the case of foreign income taxes which are treated as refunded pursuant to § 1.905–3(a) because they were not paid within 24 months of the close of the taxable year in which they first accrued, proposed § 1.905–1(d)(1)(ii) provides that when payment is later made, the taxes are considered to accrue in the relation-back year.

2. Special Rule for 52–53 Week Taxable Years

Consistent with Revenue Ruling 61–93, the proposed regulations provide that the liability for a foreign tax becomes fixed on the last day of the taxpayer's foreign taxable year; thus, foreign income taxes generally accrue and are creditable in the taxpayer's U.S. taxable year with or within which its foreign taxable year ends. However, the Treasury Department and the IRS have determined that it is appropriate to provide a limited exception to this rule in order to address mismatches that occur for taxpayers that elect to use a 52–53 week taxable year for U.S. tax purposes under § 1.441–2. Section 1.441–2 permits certain eligible taxpayers to elect to use a fiscal year that (i) varies from 52 to 53 weeks in length, (ii) always ends on the same day of the week, and (iii) ends either on the same day of the week that last occurs in a calendar month or on whatever date the same day of the week falls that is nearest to the last day of the calendar month.

A taxpayer that adopts a 52–53 week year, or that changes from a 52–53 week year to another fiscal year, without changing its foreign taxable year, will often have a short taxable year that does not include the foreign year-end. That short U.S. taxable year would include substantially all of the foreign income but none of the related foreign taxes. Similarly, a taxpayer that uses a 52–53 week year for U.S. tax purposes but that uses a foreign tax year that ends on a fixed month-end will in some years have a U.S. taxable year that does not include a foreign year-end and in other years have a U.S. taxable year that includes two foreign year-ends. For example, a taxpayer who uses a 52–53 week year that ends on the last Friday of December for U.S. tax purposes would have a tax year that begins Saturday, December 26, 2020, and that ends Friday, December 31, 2021, which includes two calendar year-ends. The following taxable year, which begins on Saturday, January 1, 2022, and ends on Friday, December 30, 2022, would not include a calendar year-end.

Proposed § 1.905–1(d)(2) addresses these mismatches by providing that where a U.S. taxpayer uses a 52–53 week taxable year that ends by reference to the same calendar month as its foreign taxable year, and the U.S taxable year closes within 6 days of the close of the foreign taxable year, then for purposes of determining the amount of foreign income tax that accrues during the U.S. taxable year, the U.S. taxable year will be deemed to end on the last day of its foreign taxable year.

3. Accrual of Contested Foreign Income Taxes

The Treasury Department and IRS have determined that the administrative rulings that allow an accrual method taxpayer to claim a foreign tax credit for a contested tax that has been remitted to a foreign country, notwithstanding the fact that the contest is ongoing, are inconsistent with the all events test (specifically, the test's requirement that all the events must have occurred that establish the fact and amount of the liability with reasonable accuracy).[4] In addition, permitting taxpayers to claim a credit for contested taxes before the contest is resolved reduces the incentive for taxpayers to continue to pursue the contest and exhaust all effective and practical remedies, as required under § 1.901–2(e)(5)(i), if the period of assessment for the year to which the taxes relate has closed and the IRS would be time-barred from disallowing the foreign tax credit claimed with respect to the contested tax paid on noncompulsory payment grounds. The Treasury Department and the IRS have determined that this is an inappropriate result that undermines the longstanding policy for requiring an amount of foreign income tax to be a compulsory payment in order to be creditable.

Therefore, the proposed regulations provide new rules for when a credit for contested foreign income taxes can be claimed. Following the Supreme Court's holding in *Dixie Pine,* and consistent with the exception to section 461(f) and § 1.461–2(a)(2)(i) for foreign income taxes, proposed § 1.905–1(d)(3) provides that contested foreign income taxes do not accrue until the contest is resolved, because only then is the amount of the foreign income tax liability finally determined. Thus, contested foreign income taxes accrue and are creditable only when resolution of the contest establishes the fact and the amount of a liability with reasonable accuracy, even if the taxpayer remits the contested taxes to the foreign country in an earlier year. When the contest is resolved, the liability accrues and, for foreign tax credit purposes, relates back and is considered to accrue in the earlier year to which the liability relates. Once the finally determined liability has been paid, as required by section 905(c)(2)(B) and § 1.905–3(a), the taxpayer can claim a foreign tax credit in the relation-back year.

However, the Treasury Department and the IRS recognize that a taxpayer may be placed in a difficult position if it pays the contested tax to the foreign country (which it may do, for example, to toll the accrual of interest owed to the foreign country) but cannot be made whole until the contest is resolved, possibly years later. Thus, the proposed regulations provide that a taxpayer may elect to claim a provisional credit for the portion of the taxes paid, even though the contest is not resolved and the amount of the liability is not yet fixed. See proposed § 1.905–1(d)(4). As a condition for making this election, a taxpayer must agree to give the IRS an opportunity to examine whether the taxpayer exhausted all effective and practical remedies when the contest is concluded by agreeing to notify the IRS when the contest concludes and by agreeing to not assert the statute of limitations as a defense to the assessment of additional taxes and interest if the IRS determines that the tax was not a compulsory payment. The proposed regulations require taxpayers making this election to file with their amended return (for the year in which the credit is claimed) a provisional foreign tax credit agreement meeting the conditions under proposed § 1.905–1(d)(4)(ii) through (iv) and to file annual certifications notifying the IRS of the status of the contest.

The Treasury Department and the IRS intend to withdraw Revenue Ruling 70–290 and Revenue Ruling 84–125 when the proposed regulations are finalized. Taxpayers can make the election under proposed § 1.905–1(d)(4) for contested taxes remitted in taxable years beginning on or after the date the proposed regulations are finalized but that relate to an earlier taxable year. See proposed § 1.905–1(h).

4. Correction of Improper Accruals

The proposed regulations address issues that arise when an accrual method taxpayer, including a foreign corporation or a partnership or other pass-through entity, has established an improper method of accounting for accruing foreign income taxes. A taxpayer generally establishes an improper method of accounting for an item once it has treated the item consistently in two consecutive tax years (see Rev. Rul. 90–38, 1990–1 CB 57). Proposed § 1.905–1(d)(5)(i) provides that the time at which a taxpayer accrues a foreign income tax expense generally is treated as a method of accounting, regardless of whether the taxpayer or the owners of the foreign corporation, partnership or other pass-through entity claim credits or deductions for those taxes. Therefore, taxpayers must comply with the procedures set forth in Revenue Procedure 2015–13, 2015–5 I.R.B. 419, or successor administrative procedures, to obtain the Commissioner's consent before changing from an improper method to a proper method of accruing foreign income taxes.

The proposed regulations provide specific rules, under a ''modified cut-off'' approach, for adjusting the amount of foreign income taxes that can be claimed as a credit or deduction in the year that a taxpayer changes from an improper to a proper method of accruing foreign income taxes (and in subsequent years, if applicable) in order to prevent a duplication or omission of any amount of foreign income tax paid. Proposed § 1.905–1(d)(5)(ii) requires taxpayers to adjust the amount of foreign income tax that is assigned under § 1.861–20 to each statutory or residual grouping (such as separate categories) and that properly accrues in the year of change, accounted for in the currency in which the foreign tax liability is denominated, (1) downward by the amount of foreign income tax in the same grouping that was improperly accrued and claimed as a credit or a deduction in a taxable year before the year of change (''pre-change year'') and that did not properly accrue in any pre-change year, and (2) upward by the amount of foreign income tax in the same grouping that properly accrued in a pre-change year but which the taxpayer, under its improper method of accounting, failed to accrue and claim as either a credit or a deduction in any pre-change year. To the extent that the required amount of the downward adjustment exceeds the amount of properly-accrued foreign income tax in the year of change, the balance carries forward to offset properly-accrued taxes in subsequent years.

Proposed § 1.905–1(d)(5)(iii) provides rules coordinating the application of the rules under section 905(c) with the rules in proposed § 1.905–1(d)(5). Under proposed § 1.905–1(d)(5)(iii), the determination of whether an improperly-accrued foreign income tax was paid within 24 months of the close of the taxable year to which the taxes relate for purposes of section 905(c)(2) will be measured from the close of the taxable year(s) in which the taxpayer accrued the tax. Any payment of properly-accrued tax in and after the year of change that is offset by the downward adjustment required by proposed § 1.905–1(d)(5)(ii) and so not allowed as a foreign tax credit or deduction in that year is treated as a payment of the foreign income tax improperly accrued in pre-change years, in order, based on the most recently-accrued amounts.

Finally, proposed § 1.905–1(d)(5)(iv) provides that when a foreign corporation, partnership, or other pass-through entity changes from an improper method of accruing foreign income taxes, the rules in § 1.905–1(d)(5) apply as if the foreign corporation, partnership or other pass-through entity were eligible to, and did, claim foreign tax credits. Comments are

[4] See Rev. Rul. 70–290, 1970–1 C.B. 160, and Rev. Rul. 84–125, 1984–2 C.B. 125, discussed in Part X.A of this Explanation of Provisions.

requested on additional adjustments that may be required to prevent an omission or duplication of a tax benefit for foreign income taxes that have been improperly accrued (or which the taxpayer has improperly failed to accrue) under the taxpayer's improper method of accounting. Comments are also requested on alternative methods for implementing a method change involving the improper accrual of foreign income taxes.

E. Creditable Foreign Tax Expenditures of Partnerships and Other Pass-Through Entities

The proposed regulations provide rules that clarify when foreign income taxes paid or accrued by a partnership or other pass-through entity (that is, foreign income taxes for which the pass-through entity is considered to be legally liable under § 1.901–2(f)) can be claimed as a credit or deduction by such entity's partners, shareholders, or beneficiaries. Consistent with the rules in §§ 1.702–1(a)(6) and 1.703–1(b)(2), proposed § 1.905–1(f) provides that a partner that elects to claim a foreign tax credit in a taxable year may claim its distributive share of foreign income taxes that the partnership paid or accrued (as determined under the partnership's method of accounting) during the partnership's taxable year that ends with or within the partner's taxable year. Thus, the pass-through entity's method of accounting for foreign income taxes generally controls for purposes of determining the taxable year in which a partner is considered to pay or accrue its distributive share of those taxes. Therefore, a cash method taxpayer may claim a credit for its distributive share of an accrual method partnership's foreign income taxes even if the partnership has not paid (that is, remitted) the taxes to the foreign country during the partner's taxable year with or within which the partnership's tax expense accrued, so long as those taxes otherwise qualify for the credit, and subject to the rules of section 905(c)(2)(A) (treating accrued foreign taxes as refunded if not paid within 24 months). The rules in proposed § 1.905–1(f) also apply in the case of shareholders of a S corporation, beneficiaries of an estate or trust, or other owners of a pass-through entity with respect to foreign income taxes paid or accrued by such entities.

With respect to a contested foreign tax liability of a pass-through entity, the proposed regulations provide that the entity takes into account and reports a contested foreign income tax to its partners, shareholders, beneficiaries, or other owners only when the contest concludes and the finally determined amount of the liability has been paid by the entity. This rule takes into account the requirement in section 905(c)(2)(B) and § 1.905–3(a) that a foreign tax that first accrues more than 24 months after the close of the taxable year to which the tax relates can only be claimed as a credit once the tax has been paid. See proposed § 1.905–1(f)(1). However, proposed § 1.905–1(f)(2) allows a partner or other owner of a pass-through entity to claim a provisional foreign tax credit for its share of a contested foreign income tax liability that the entity has paid to the foreign country pursuant to the procedures in proposed § 1.905–1(d)(4). As required by §§ 1.905–3(a) and 1.905–4(b), a pass-through entity is required to notify the IRS and its partners, shareholders, or beneficiaries if there is a foreign tax redetermination with respect to foreign income tax previously reported to its partners, shareholders, or beneficiaries.

F. Conforming Changes to Regulations Under Section 960

Existing regulations under section 960 provide a definition of a current year tax that includes language regarding the timing of accrual of a foreign income tax, including the timing of accrual of additional payments of foreign income tax resulting from a foreign tax redetermination. These proposed regulations revise this definition to cross-reference the proposed rules in § 1.905–1 regarding when foreign income taxes are considered to be paid or accrued for foreign tax credit purposes.

In addition, existing rules exclude from the definition of a foreign income tax a levy for which a credit is disallowed at the level of a controlled foreign corporation. The proposed regulations revise the definition of a foreign income tax in § 1.960–1(b) to include a levy that is a foreign income tax within the meaning of proposed § 1.901–2(a), including a levy for which a credit is disallowed at the level of the controlled foreign corporation. These changes are necessary to clarify that a foreign income tax for which a credit is disallowed is nonetheless an item of expense that must be allocated and apportioned to an income group under the rules of § 1.960–1(d) in order to determine the amount of net income in each income group.

Finally, proposed § 1.960–1(b)(5) introduces a new defined term, ''eligible current year taxes,'' that refers to current year taxes for which a foreign tax credit may be allowed. This change is necessary to ensure that the current year taxes that are deemed paid under sections 960(a) and (d) comprise only current year taxes that are eligible for a foreign tax credit. Conforming changes to § 1.960–2 are proposed to provide that deemed paid computations are made only with respect to eligible current year taxes. Additional conforming changes will be proposed to § 1.960–3 to address the computation of deemed paid taxes under section 960(b) as part of future proposed regulations under section 959.

XI. Applicability Dates

The rules in §§ 1.164–2(d), 1.336–2(g)(3)(ii) and (iii), 1.338–9(d), 1.368(b)–10(c)(1), 1.861–9(k), 1.861–10(f) and (g), 1.861–14(h), 1.861–20(h), 1.901–1, 1.901–2, 1.903–1, 1.904–4(e)(1)(ii) and (e)(2) and (3), 1.904–5(b)(2), 1.905–1, 1.905–3(a) and (b)(4), 1.960–1(b)(4) through (6), and 1.960–1(c)(1)(ii) through (iv) and (d)(3)(ii)(B) generally apply to taxable years beginning on or after the date final regulations adopting these rules are filed with the **Federal Register**.

Consistent with the prospective applicability date in the section 250 regulations, the revisions to §§ 1.250(b)–1(c)(7) and 1.250(b)–5(c)(5) apply to taxable years beginning on or after January 1, 2021. See § 1.250–1(b).

The rules in proposed §§ 1.367(b)–4(b)(2)(i)(B), 1.367(b)–7(g), 1.367(b)–10(c)(1), 1.861–3(d), 1.861–8(e)(4)(i), and 1.861–10(e)(8)(v) generally apply to taxable years ending on or after November 2, 2020.

Proposed §§ 1.245A(d)–1, 1.861–20 (other than proposed § 1.861–20(h)), 1.904–4(f), and 1.904–6(b)(2) apply to taxable years that begin after December 31, 2019, and end on or after November 2, 2020.

Finally, proposed § 1.904(f)–12(j)(5) applies to carrybacks of net operating losses incurred in taxable years beginning after December 31, 2017, which is consistent with the applicability date in the CARES Act with respect to net operating loss carrybacks. See Public Law 116–136, 134 Stat. 355, section 2303(d), (2020); see also section 7805(b)(2).

Special Analyses

I. Regulatory Planning and Review

Executive Orders 13771, 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility. The Executive Order 13771 designation for any final rule resulting from these proposed regulations will be informed by comments received.

The proposed regulations have been designated by the Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these regulations as economically significant under section 1(c) of the MOA. Accordingly, the OMB has reviewed these regulations.

A. Background and Need for the Proposed Regulations

The U.S. foreign tax credit (FTC) regime alleviates potential double taxation by allowing a non-refundable credit for foreign income taxes paid or accrued that could be applied to reduce the U.S. tax on foreign source income. Although the Tax Cuts and Jobs Act (TCJA) eliminated the U.S. tax on some foreign source income by enacting a dividends received deduction, the United States continues to tax other foreign source income, and to provide foreign tax credits against this U.S. tax. The calculation of how foreign taxes can be credited against U.S. tax operates by defining different categories of foreign source income (a ''separate category'') based on the type of income.[5] Foreign taxes paid or accrued, as well as deductions for expenses borne by U.S. parents and domestic affiliates that support foreign operations, are allocated to the separate categories based on the income to which such taxes or deductions relate. These allocations of deductions reduce foreign source taxable income and therefore reduce the allowable FTCs for the separate category, since FTCs are limited to the U.S. income tax on the foreign source taxable income (that is, foreign source gross income less allocated expenses) in that separate category. Therefore, these expense allocations help to determine how much foreign tax credit is allowable, and the taxpayer can then use allowable foreign tax credits allocated to each separate category against the U.S. tax owed on income in that category.

The Code and existing regulations further provide definitions of the foreign taxes that constitute creditable foreign taxes. Section 901 allows a credit for foreign income taxes, war profits taxes, and excess profits taxes. The existing regulations under section 901 define these ''foreign income taxes'' such that a foreign levy is an income tax if it is a tax whose predominant character is that of an income tax in the U.S. sense. Under the existing regulations, this requires that the foreign tax is likely to reach net gain in the normal circumstances in which it applies (the ''net gain requirement''), and that it is not a so-called soak-up tax.

The ''net gain requirement'' is made up of the realization, gross receipts, and net income requirements, and the existing regulations define in detail their meaning. Generally, the creditability of the foreign tax under the existing regulations relies on the definition of an income tax under U.S. principles, and on several aggregate empirical tests designed to determine if in practice the tax base upon which the tax is levied is an income tax base. However, compliance and administrative challenges faced by taxpayers and the IRS in implementing the existing definition of an income tax under these regulations necessitate changes to the existing structure. These proposed regulations set forth such changes.

Additionally, as a dollar-for-dollar credit against United States income tax, the foreign tax credit is intended to mitigate double taxation of foreign source income. This fundamental purpose is most appropriately served if there is substantial conformity in the principles used to calculate the base of the foreign tax and the base of the U.S. income tax, not only with respect to the definition of the income tax base, but also with respect to the jurisdictional nexus upon which the tax is levied. The Treasury Department and the IRS have received requests for guidance with respect to a jurisdictional limitation, and recommending that the regulations adopt a rule necessitating some form of nexus rule for creditable taxes. Further, countries, including the United States, have traditionally adhered to consensus-based norms governing jurisdictional nexus for the imposition of tax. However, the adoption or potential adoption by foreign countries of novel extraterritorial foreign taxes that diverge in significant respects from these norms of taxing jurisdiction now suggests that further guidance is appropriate to ensure that creditable foreign taxes in fact have a predominant character of ''an income tax in the U.S. sense.''

Finally, these regulations are necessary in order to respond to outstanding comments raised with respect to other regulations and in order to address a variety of issues arising from the interaction of provisions in other regulations.

The Treasury Department and the IRS issued final regulations in 2019 (84 FR 69022) (2019 FTC final regulations) and proposed regulations (84 FR 69124) (2019 FTC proposed regulations), which are being finalized in this issue of the **Federal Register** as part of the 2020 FTC final regulations. The Treasury Department and the IRS received comments with respect to the 2019 FTC proposed regulations, some of which are addressed in these proposed regulations (instead of the 2020 FTC final regulations) in order to allow further opportunity for notice and comment.

The following analysis provides an overview of the regulations, discussion of the costs and benefits of these regulations as compared with the baseline, and a discussion of alternative policy choices that were considered.

B. Overview of the Structure of and Need for Proposed Regulations

These proposed regulations address a variety of outstanding issues, most importantly with respect to the existing definition of an income tax. Section 901 allows a credit for foreign income taxes, and the existing regulations define the conditions under which foreign taxes will be considered income taxes. These proposed regulations revise aspects of this definition in light of challenges that taxpayers and the IRS have faced in applying the rules. In particular, the requirements in the existing regulations presuppose conclusions based on country-level or other aggregated data that can be difficult for taxpayers and the IRS to analyze for purposes of determining net gain, causing both administrative and compliance burdens and difficulties resolving disputes. Therefore, the proposed regulations revise the net gain requirements such that, in cases where data-driven conclusions have been difficult to establish historically, the requirements rely less on data of the effects of the foreign tax, and instead rely more on the terms of the foreign tax law (See Part VI.A.3 of the Explanation of Provisions for additional detail, and Part I.C.3.i. of this Special Analyses for alternatives considered and affected taxpayers). For example, a foreign tax, to be creditable, must generally be levied on gross receipts (and certain deemed gross receipts) net of deductions. Under these

[5] Before the TCJA, these categories were primarily the passive income and general income categories. The TCJA added new separate categories for global intangible low-taxed income (the section 951A category) and foreign branch income.

proposed regulations, the use of data to demonstrate that an alternative receipts base upon which the tax is levied is in practice a gross receipts equivalent cannot be used to satisfy the gross receipts portion of the net gain requirement.

In addition to these changes, the proposed regulations introduce a jurisdictional limitation for purposes of determining whether a foreign tax is an income tax in the U.S. sense; that is, the foreign tax law must require a sufficient nexus between the foreign country and the taxpayer's activities or investment of capital or other assets that give rise to the income being taxed. Therefore, a tax imposed by a foreign country on income that lacks sufficient nexus to activity in the foreign country (such as operations, employees, factors of production) in a country is not creditable. This limitation is designed to ensure that the foreign tax is an income tax in the U.S. sense by requiring that there is an appropriate nexus between the taxable amount and the taxing foreign jurisdiction (see Part VI.A.2 of the Explanation of Provisions for additional detail, and Part I.C.3.ii of this Special Analyses for discussion of alternatives considered and taxpayers affected). Together, the clarifications and changes introduced in the net gain requirement and the jurisdictional nexus requirement will tighten the rules governing the creditability of foreign taxes and will likely restrict creditability of foreign taxes to some extent relative to the existing regulations.

Finally, these proposed regulations address other issues raised in comments or resulting from other legislation. For example, comments asked for clarification of uncertainty regarding the appropriate level of aggregation (affiliated group versus subgroup) at which expenses of life insurance companies should be allocated to foreign source income, and comments asked for clarification on when contested taxes (that is, taxes owed to a foreign government which a taxpayer disputes) accrue for purposes of the foreign tax credit. With respect to the life insurance issue, the 2019 FTC proposed regulations specified an allocation method, but requested comments regarding whether another method might be superior. Subsequent comments supported both methods for different reasons, and the Treasury Department and the IRS found both methods to have merit. Therefore, the proposed regulations allow taxpayers to choose the most appropriate method for their circumstances. (See Part V.E of the Explanation of Provisions for additional detail, and Part I.C.3.iii of this Special Analyses for alternatives considered and affected taxpayers).

With respect to the contested tax issue, the proposed regulations establish that contested taxes do not accrue (and therefore cannot be claimed as a credit) until the contest is resolved; however, the proposed regulations will allow taxpayers to claim a provisional credit for the portion of taxes already paid to the foreign government, if the taxpayer agrees to notify the IRS when the contest concludes and agrees not to assert the statute of limitations as a defense to assessment of U.S. tax if the IRS determines that the taxpayer failed to take appropriate steps to secure a refund of the foreign tax. (See Part X.D of the Explanation of Provisions for additional detail, and Part I.C.3.iv of this Special Analyses for alternatives considered and affected taxpayers). In this way, the proposed regulations alleviate taxpayer cash flow constraints that could result from temporary double taxation during the period of dispute resolution, while still providing the taxpayer with the incentive to resolve the tax dispute and providing the IRS with the ability to ensure that appropriate action was taken regarding dispute resolution.

The guidance and specificity provided by these regulations clarify which foreign taxes are creditable as income taxes, and (with respect to contested taxes) when they are creditable. The guidance also helps to resolve uncertainty and more generally to address issues raised in comments.

C. Economic Analysis

1. Baseline

In this analysis, the Treasury Department and the IRS assess the benefits and costs of these proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these regulations.

2. Summary of Economic Effects

The proposed regulations provide certainty and clarity to taxpayers regarding the creditability of foreign taxes. In the absence of the enhanced specificity provided by these regulations, similarly situated taxpayers might interpret the creditability of taxes differently, particularly with respect to new extraterritorial taxes, potentially resulting in inefficient patterns of economic activity. For example, some taxpayers may forego specific economic projects, foreign or domestic, that other taxpayers deem worthwhile based on different interpretations of the tax consequences alone. The guidance provided in these regulations helps to ensure that taxpayers face more uniform incentives when making economic decisions. In general, economic performance is enhanced when businesses face more uniform signals about tax treatment.

In addition, these regulations generally reduce the compliance and administrative burdens associated with information collection and analysis required to claim foreign tax credits, relative to the no-action baseline. The regulations achieve this reduction because they rely to a significantly lesser extent on data-driven conclusions than the regulatory approach provided in the existing regulations and instead rely more on the terms and structure of the foreign tax law.

To the extent that taxpayers, in the absence of further guidance, would generally interpret the existing foreign tax credit rules as being more favorable to the taxpayer than the proposed regulations provide, the proposed regulations may result in reduced international activity relative to the no-action baseline. This reduced activity may have included both activities that could have been beneficial to the U.S. economy (perhaps because the activities would have represented enhanced international opportunities for businesses with U.S. owners) and activities that may not have been beneficial (perhaps because the activities would have been accompanied by reduced activity in the United States). Thus, the Treasury Department and the IRS recognize that foreign economic activity by U.S. taxpayers may be a complement or substitute to activity within the United States and that to the extent these regulations lead to a reduction in foreign economic activity relative to the no-action baseline, a mix of results may occur. To the extent that foreign governments, in response to these proposed regulations, alter their tax regimes to reduce their reliance on taxes that are not income taxes in the U.S. sense, any such reduction in foreign economic activity by U.S. taxpayers as a result of these proposed regulations, relative to the no-action baseline, will be mitigated.

The Treasury Department and the IRS project that the regulations will have economic effects greater than $100 million per year ($2020) relative to the no-action baseline. This determination is based on the substantial size of many of the businesses potentially affected by these regulations and the general responsiveness of business activity to effective tax rates,[6] one component of which is the creditability of foreign taxes. Based on these two magnitudes, even modest changes in the treatment of foreign taxes, relative to the no-action baseline, can be expected to have annual effects greater than $100 million ($2020).

The Treasury Department and the IRS have not undertaken quantitative estimates of the economic effects of these regulations. The Treasury Department and the IRS do not have readily available data or models to estimate with reasonable precision (i) the tax stances that taxpayers would likely take in the absence of the proposed regulations or under alternative regulatory approaches; (ii) the difference in business decisions that taxpayers might make between the proposed regulations and the no-action baseline or alternative regulatory approaches; or (iii) how this difference in those business decisions will affect measures of U.S. economic performance.

In the absence of such quantitative estimates, the Treasury Department and the IRS have undertaken a qualitative analysis of the economic effects of the proposed regulations relative to the no-action baseline and relative to alternative regulatory approaches. This analysis is presented in Part I.C.3 of this Special Analyses.

The Treasury Department and the IRS solicit comments on this economic analysis and particularly solicit data, models, or other evidence that may be used to enhance the rigor with which the final regulations might be developed.

3. Options Considered and Number of Affected Taxpayers, by Specific Provisions

i. ''Net Gain Requirement'' for Determining a Creditable Foreign Tax

a. Summary

Under existing rules, a foreign tax is creditable if it reaches ''net gain,'' which is determined based in part on data-driven analysis. Therefore, under the existing rules, a gross basis tax can in certain cases be creditable if it can be shown that the tax as applied does not result in taxing more than the taxpayer's profit. In certain cases, in order to determine creditability, the IRS requests country-level or other aggregate data to analyze whether the tax reaches net gain. The creditability determination is made based on data with respect to a foreign tax in its entirety, as it is applied for all taxpayers. In other words, the tax is creditable or not creditable based on its application to all taxpayers rather than on a taxpayer-by-taxpayer basis. However, different taxpayers can and do take different positions with respect to what the language of the existing regulations and the empirical tests imply about creditability.

b. Options Considered for the Proposed Regulations

The Treasury Department and the IRS considered three options to address concerns with the ''net gain'' test. The first option is not to implement any changes and to continue to determine the definition of a foreign income tax based in part on conclusions based on country-level or other aggregate data. This option would mean that the determination of whether a tax satisfies the definition of foreign income tax would continue to be administratively difficult for taxpayers and the IRS, in part because it requires the IRS and the taxpayer to obtain information from the foreign country to determine how the tax applies in practice to taxpayers subject to the tax. The existing regulations apply a ''predominant character'' analysis such that deviations from the net gain requirement do not cause a tax to fail this requirement if the predominant character of the tax is that of an income tax in the U.S. sense. For example, the existing regulations allow a credit for a foreign tax whose base, judged on its predominant character, is computed by reducing gross receipts by significant costs and expenses, even if gross receipts are not reduced by all allocable costs and expenses. This requires some judgment in determining whether the exclusion of some costs and expenses causes the tax to fail the net gain requirement.

The second option considered is not to use data-driven conclusions for any portion of the net gain requirement and rely only on foreign tax law to make the determination. This rule would be easier to apply compared with the first option because it requires looking only at foreign law, regulations, and rulings. However, this option could result in an overly harsh outcome, to the extent the rules determine whether a levy is an income tax in its entirety (that is, not on a taxpayer-by-taxpayer basis). For example, if a country had a personal income tax that satisfied all the requirements, except that the country also included imputed rental income in the tax base, the Treasury Department and the IRS would not necessarily want to disallow as a credit the entire personal income tax system of that country due to the one deviation from U.S. tax law definitions of income tax. As part of this option, the Treasury Department and the IRS therefore considered also allowing a parsing of each tax for conforming and non-conforming parts. For example, in the prior example, only a portion of the income tax could be disallowed (that is, the portion attributable to imputed rental income). However, this approach would be extremely complicated to administer since there would need to be special rules for determining which portion of the tax relates to the non-conforming parts and which do not. It would also imply that taxpayers could not know from the outset whether a particular levy is an income tax but would instead have to analyze the tax in each fact and circumstances in which it applied to a particular taxpayer.

The third option considered is to use data-driven conclusions only for portions of the net gain requirement. The net gain requirement consists of three requirements: The realization requirement, the gross receipts requirement, and the cost recovery requirement. The Treasury Department and the IRS considered retaining data-based conclusions in portions of the realization requirement and the cost-recovery requirement but removing them in the gross receipts requirement. This is the approach taken in these regulations. In these regulations, the cost recovery requirement retains the rule that the tax base must allow for recovery of significant costs and expenses. Data are still used in the cost recovery analysis to determine whether a cost or expense is significant with respect to all taxpayers.

Because these options differ in terms of the creditability of foreign taxes, they may increase or decrease foreign activity by U.S. taxpayers. The Treasury Department and the IRS have not projected the differences in economic activity across the three alternatives because they do not have readily available data or models that capture these effects. It is anticipated that the proposed regulations will reduce taxpayer compliance costs relative to the baseline by significantly reducing the circumstances in which taxpayers must incur costs to obtain data (which may or may not be readily available) in order to evaluate the creditability of a tax.

The Treasury Department and the IRS do not have data or models that would allow them to quantify the reduced administrative burden resulting from these final regulations relative to alternative regulatory approaches. The Treasury Department and the IRS expect

[6] See E. Zwick and J. Mahon, ''Tax Policy and Heterogeneous Investment Behavior,'' at *American Economic Review* 2017, 107(1): 217–48 and articles cited therein.

that the regulations will reduce administrative burden and compliance burdens because the collection and analysis of empirical data is time consuming for taxpayers and the IRS, and the existing regulations have resulted in a variety of disputes. Hence a reduction in required data collection should reduce burdens. Further, greater reliance on legal definitions rather than empirical review of available data has the potential to reduce the number of disputes, which also should reduce burdens.

c. Number of Affected Taxpayers

The Treasury Department and the IRS have determined that the population of taxpayers potentially affected by the net gain provisions of the proposed regulations includes any taxpayer with foreign operations claiming foreign tax credits (or with the potential to claim foreign tax credits). Based on currently available tax filings for tax year 2018, there were about 9.3 million Form 1116s filed by U.S. individuals to claim foreign tax credits with respect to foreign taxes paid on individual, partnership, or S corporation income. There were 17,500 Form 1118s filed by C corporations to claim foreign tax credits with respect to foreign taxes paid. In addition, there were about 16,500 C corporations with CFCs that filed at least one Form 5471 with their Form 1120 return, indicating a potential to claim a foreign tax credit even if no credit was claimed in 2018. Similarly, in these data there were about 41,000 individuals with CFCs that e-filed at least one Form 5471 with their Form 1040 return. In 2018, there were about 3,250 S corporations with CFCs that filed at least one Form 5471 with their Form 1120S return. The identified S corporations had an estimated 23,000 shareholders. Finally, the Treasury Department and the IRS estimate that there were approximately 7,500 U.S. partnerships with CFCs that e-filed at least one Form 5741 in 2018. The identified partnerships had approximately 1.7 million partners, as indicated by the number of Schedules K–1 filed by the partnerships; however, this number includes both domestic and foreign partners. Furthermore, there is, likely to be some overlap between the Form 5471 and the Form 1116 and/or 1118 filers.

These numbers suggest that between 9.3 million (under the assumption that all Form 5471 filers or shareholders of filers also filed Form 1116 or 1118) and 11 million (under the assumption that filers or shareholders of filers of Form 5471 are a separate pool from Form 1116 and 1118 filers) taxpayers will potentially be affected by these regulations. Based on Treasury tabulations of Statistics of Income data, the total volume of foreign tax credits reported on Form 1118 in 2016 was about 90 billion dollars. Data do not exist that would allow the Treasury Department or the IRS to identify how this total volume might change as a result of these regulations; however, the Treasury Department and the IRS anticipate that only a small fraction of existing FTCs would be impacted by these regulations.

ii. Jurisdictional Nexus

a. Summary

Rules under existing § 1.901–2 do not explicitly require, for purposes of determining whether a foreign tax is a creditable foreign income tax, the tax to be imposed only on income that has a jurisdictional nexus (or adequate connection) to the country imposing the tax. In order ensure that creditable taxes under section 901 conform to traditional international norms of taxing jurisdiction and therefore are income taxes in the U.S. sense, these regulations add a jurisdictional nexus requirement.

b. Options Considered for the Proposed Regulations

The Treasury Department and the IRS considered the following three options for designing a nexus requirement. The first option considered is to create a jurisdictional nexus requirement based on Articles 5 (Permanent Establishment) and 7 (Business Profits) in the U.S. Model Income Tax Convention (the ''U.S. Convention''). The U.S. Convention includes widely accepted and understood standards with respect to a country's right to tax a nonresident's income. The relevant articles of the U.S. Convention generally require a certain presence or level of activity before the country can impose tax on business income, and the tax can only be imposed on income that is attributable to the business activity. This option was rejected due to concerns that this standard would be too rigid and prescriptive, and such a rigid standard is not necessary; there are numerous departures from the U.S. Convention in both domestic laws and bilateral treaties, which are not considered problematic because they are not considered significant deviations from international norms.

The second option considered was to create a jurisdictional nexus requirement based on Code section 864, which contains a standard for income effectively connected with the conduct of a U.S. trade or business (ECI). The Code does not provide a definition of U.S. trade or business; it is instead defined in case law, and the definition is therefore not strictly delineated. This option was therefore rejected as potentially being too broad, and not necessarily targeting the primary concern with respect to the new extraterritorial taxes, which is that, in contrast to traditional international income tax norms governing the creditability of taxes, they are imposed based on the location of customers or users, or other destination-based criteria.

The third option considered was to require that foreign tax imposed on a nonresident must be based on the nonresident's activities located in the foreign country (including its functions, assets, and risks located in the foreign country) without taking into account as a significant factor the location of customers, users, or similar destination-based criteria. This more narrowly tailored approach better addresses the concern that extraterritorial taxes that are imposed on the basis of location of customers, users, or similar criteria should not be creditable under traditional norms reflected in the Internal Revenue Code that govern nexus and taxing rights and therefore should be excluded from creditable income taxes. Taxes imposed on nonresidents that would meet the Code-based ECI requirement could qualify, as well as taxes that would meet the permanent establishment and business profit standard under the U.S. Convention. This is the option adopted by the Treasury Department and the IRS.

This approach is consistent with the fact that under traditional norms reflected in the Internal Revenue Code, income tax is generally imposed taking into account the location of the operations, employees, factors of production, residence, or management of the taxpayer. In contrast, consumption taxes such as sales taxes, value-added taxes, or so-called destination based income taxes are generally imposed on the basis of location of customers, users, or similar destination-based criteria. Although the tax incidence of these two groups of taxes may vary, tax incidence does not play a role in the definition of an income tax in general, or an income tax in the U.S. sense. Therefore, the choice among regulatory options was based on which option most closely aligned the definition of foreign income taxes to taxes that are income taxes in the U.S. sense.

The Treasury Department and the IRS have not attempted to estimate the differences in economic activity that might result under each of these regulatory options because they do not have readily available data or models that capture (i) the jurisdictional nexus of taxpayers' activities under the different regulatory approaches and (ii) the economic activities that taxpayers might undertake under different jurisdictional nexus criteria. The Treasury Department and the IRS further have not attempted to estimate the difference in compliance costs under each of these regulatory options.

c. Number of Affected Taxpayers

The Treasury Department and the IRS have determined that the population of taxpayers potentially affected by the jurisdictional nexus provisions of the proposed regulations includes any taxpayer with foreign operations claiming foreign tax credits (or with the potential to claim foreign tax credits). Based on currently available tax filings for tax year 2018, there were about 9.3 million Form 1116s filed by U.S. individuals to claim foreign tax credits with respect to foreign taxes paid on individual, partnership, or S corporation income. There were 17,500 Form 1118s filed by C corporations to claim foreign tax credits with respect to foreign taxes paid. In addition, there were about 16,500 C corporations with CFCs that filed at least one Form 5471 with their Form 1120 return, indicating a potential to claim a foreign tax credit, even if no credit was claimed in these years. Similarly, for the same period, there were about 41,000 individuals with CFCs that e-filed at least one Form 5471 with their Form 1040 return. In 2018, there were about 3,250 S corporations with CFCs that filed at least one Form 5471 with their Form 1120S return. The identified S corporations had an estimated 23,000 shareholders. Finally, the Treasury Department and the IRS estimate that there were approximately 7,500 U.S. partnerships with CFCs that e-filed at least one Form 5471 in 2018. The identified partnerships had approximately 1.7 million partners, as indicated by the number of Schedules K–1 filed by the partnerships; however, this number includes both domestic and foreign partners. Furthermore, there is likely to be overlap between the Form 5471 and the Form 1116 and/or 1118 filers.

These numbers suggest that between 9.3 million (under the assumption that all Form 5471 filers or shareholders of filers also filed Form 1116 or 1118) and 11 million (under the assumption that filers or shareholders of filers of Form 5471 are a separate pool from Form 1116 and 1118 filers) taxpayers will potentially be affected by these regulations. Based on Treasury Department tabulations of Statistics of Income data, the total volume of foreign tax credits reported on Form 1118 in 2016 was about 90 billion dollars. Data do not exist that would allow us to identify how this total volume might change as a result of these regulations; however, the Treasury Department and the IRS anticipate that only a small fraction of existing FTCs would be impacted by these regulations.

iii. Allocation and Apportionment of Expenses for Insurance Companies

a. Summary

Section 818(f) provides that for purposes of applying the expense allocation rules to a life insurance company, the deduction for policyholder dividends, reserve adjustments, death benefits, and certain other amounts (''section 818(f) expenses'') are treated as items that cannot be definitely allocated to an item or class of gross income. That means, in general, that the expenses are apportioned ratably across all of the life insurance company's gross income.

Under the expense allocation rules, for most purposes, affiliated groups are treated as a single entity, although there are exceptions for certain expenses. The statute is unclear, however, about how affiliated groups are to be treated with respect to the allocation of section 818(f) expenses of life insurance companies. Depending on how section 818(f) expenses are allocated across an affiliated group, the results could be different because the gross income categories across the affiliated group could be calculated in multiple ways. The Treasury Department and the IRS received comments and are aware that in the absence of further guidance taxpayers are taking differing positions on this treatment. Some taxpayers argue that the expenses described in section 818(f) should be apportioned based on the gross income of the entire affiliated group, while others argue that expenses should be apportioned on a separate company or life subgroup basis taking into account only the gross income of life insurance companies.

b. Options Considered for the Proposed Regulations

The Treasury Department and the IRS are aware of at least five potential methods for allocating section 818(f) expenses in a life-nonlife consolidated group. First, the expenses might be allocated solely among items of the life insurance company that has the reserves (''separate entity method''). Second, to the extent the life insurance company has engaged in a reinsurance arrangement that constitutes an intercompany transaction (as defined in § 1.1502–13(b)(1)), the expenses might be allocated in a manner that achieves single entity treatment between the ceding member and the assuming member (''limited single entity method''). Third, the expenses might be allocated among items of all life insurance members (''life subgroup method''). Fourth, the expenses might be allocated among items of all members of the consolidated group (including both life and non-life members) (''single entity method''). Fifth, the expenses might be allocated based on a facts and circumstances analysis (''facts and circumstances method'').

The 2019 FTC proposed regulations proposed adopting the separate entity method because it is consistent with section 818(f) and with the separate entity treatment of reserves under § 1.1502–13(e)(2). The Treasury Department and the IRS recognized, however, that this method may create opportunities for consolidated groups to use intercompany transactions to shift their section 818(f) expenses and achieve a more advantageous foreign tax credit result. Accordingly, the Treasury Department and the IRS requested comments on whether a life subgroup method more accurately reflects the relationship between section 818(f) expenses and the income producing activities of the life subgroup as a whole, and whether the life subgroup method is less susceptible to abuse because it might prevent a consolidated group from inflating its foreign tax credit limitation through intercompany transfers of assets, reinsurance transactions, or transfers of section 818(f) expenses. Comments received supported both methods and the Treasury Department and the IRS have concluded that the life subgroup method should generally be used, because it minimizes opportunities for abuse and is more consistent with the general rules allocating expenses among affiliated group members. However, recognizing that the single entity method also has merit, the proposed regulations permit a taxpayer to make a one-time election to use the separate entity method for all life insurance members in the affiliated group. This election is binding for all future years and may not be revoked without the consent of the Commissioner. Because the election is binding and applies to all members of the group, taxpayers will not be able to change allocation methods from year to year depending on which is most advantageous. The Treasury Department and the IRS may consider future proposed regulations to address any additional anti-abuse concerns (such as under section 845), if needed.

The Treasury Department and the IRS have not attempted to assess the differences in economic activity that might result under each of these regulatory options because they do not have readily available data or models that capture activities at this level of specificity. The Treasury Department and the IRS further have not estimated the difference in compliance costs under each of these regulatory options because they lack adequate data.

c. Number of Affected Taxpayers

The Treasury Department and the IRS have determined that the population of taxpayers potentially affected by these insurance expense allocation rules consists of life insurance companies that are members of an affiliated group. The Treasury Department and the IRS have established that there are approximately 60 such taxpayers.

iv. Creditability of Contested Foreign Income Taxes

a. Summary

Section 901 allows a taxpayer to claim a foreign tax credit for foreign income taxes paid or accrued (depending on the taxpayer's method of accounting) in a taxable year. Foreign income taxes accrue in the taxable year in which all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy (''all events test''). When a taxpayer disputes or contests a foreign tax liability with a foreign country, that contested tax does not accrue until the contest concludes because only then can the amount of the liability be finally determined. However, under two IRS revenue rulings (Rev. Ruls. 70–290 and 84–125), a taxpayer is allowed to claim a credit for the portion of a contested tax that the taxpayer has actually paid to the foreign country, even though the taxpayer continues to dispute the liability. While this alleviates taxpayer cash flow constraints associated with temporary double taxation, it is not fully consistent with the all events test. In addition, it potentially disincentivizes the taxpayer from continuing to contest the foreign tax, since the tax is already credited and the dispute could be time-consuming and costly, which could result in U.S. tax being reduced by foreign tax in excess of amounts properly due.

b. Options Considered for the Proposed Regulations

The Treasury Department and the IRS considered three options for the treatment of contested foreign taxes. The first option considered is to not make any changes to the existing rule and to continue to allow taxpayers to claim a credit for a foreign tax that is contested but that has been paid to the foreign country. The Treasury Department and the IRS determined that this option is inconsistent with the all events test. It would also result in a taxpayer potentially having two foreign tax redeterminations (FTRs) with respect to one contested liability: One FTR at the time the taxpayer pays the contested tax to the foreign country, and a second FTR when the contest concludes (if the finally determined liability differs from the amount that was paid and claimed as a credit). Furthermore, this option impinges on the IRS's ability to enforce the requirement in existing § 1.902–1(e) that a tax has to be a compulsory payment in order to be creditable—if a taxpayer claims a credit for a contested tax, then surrenders the contest once the assessment statute closes, the IRS would be time-barred from challenging that the tax was not creditable on the grounds that the taxpayer failed to exhaust all practical remedies.

The second option considered is to only allow taxpayers to claim a credit when the contest concludes. In some cases, the taxpayer must pay the tax to the foreign country in order to contest the tax or in order to stop the running of interest in the foreign country. This option would leave the taxpayer out of pocket to two countries (potentially giving rise to cash flow issues for the taxpayer) while the contest is pending, which could take several years. The Treasury Department and the IRS determined that this outcome is unduly harsh.

The third option considered is to allow taxpayers the option to claim a provisional credit for an amount of contested tax that is actually paid, even though in general, taxpayers can only claim a credit when the contest resolves. This is the option adopted in proposed § 1.905–1(d)(3) and (4). As a condition for making this election, the taxpayer must enter into a provisional foreign tax credit agreement in which it agrees to notify the IRS when the contest concludes and agrees to not assert the expiration of the assessment statute (for a period of three years from the time the contest resolves) as a defense to assessment, so that the IRS is able to challenge the foreign tax credit claimed with respect to the contested tax if the IRS determines that the taxpayer failed to exhaust all practical remedies.

The Treasury Department and the IRS have not attempted to assess the differences in economic activity that might result under each of these regulatory options because they do not have readily available data or models that capture taxpayers' activities under the different treatments of contested taxes. The Treasury Department and the IRS further have not attempted to estimate the difference in compliance costs under each of these regulatory options.

c. Number of Affected Taxpayers

The Treasury Department and the IRS have determined that the proposed regulations potentially affect U.S. taxpayers that claim foreign tax credits on an accrual basis and that contest a foreign income tax liability with a foreign country. Although data reporting the number of taxpayers that claim a credit for contested foreign income tax in a given year are not readily available, the potentially affected population of taxpayers would, under existing § 1.905–3, have a foreign tax redetermination for the year to which the contested tax relates. Data reporting the number of taxpayers subject to a foreign tax redetermination in a given year are not readily available, however some taxpayers currently subject to such redetermination will file amended returns. Based on currently available tax filings for tax year 2018, the Treasury Department and the IRS have determined that approximately 1,500 filers would be affected by these proposed regulations. This estimate is based on the number of U.S. corporations that filed an amended return that had a Form 1118 attached to the Form 1120; S corporations that filed an amended return with a Form 5471 attached to the Form 1120S or that reported an amount of foreign tax accrued on the Form 1120S, Schedule K; partnerships that filed an amended return with a Form 5471 attached to Form 1065 or that reported an amount of foreign tax accrued on Schedule K; U.S. individuals that filed an amended return and had a Form 1116 attached to the Form 1040. Because only taxpayers that claim foreign tax credits on an accrual basis could potentially be subject to the proposed regulations, only taxpayers that checked the accrual box on the Form 1116 or Form 1118, or that indicated on Schedule K that an amount of foreign income tax accrued, were taken into account for the estimate.

II. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520) (''Paperwork Reduction Act'') requires that a federal agency obtain the approval of the OMB before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit.

A. Overview

The proposed regulations include new collection of information requirements in proposed §§ 1.905–1(d)(4) and (5), 1.901–1(d)(2), and 1.905–3. The collections of information in proposed § 1.905–1(d)(4) apply to taxpayers that elect to claim a provisional credit for contested foreign income taxes before the contest resolves. Taxpayers making this election are required to file an agreement described in proposed § 1.905–1(d)(4)(ii) as well as an annual certification described in proposed § 1.905–1(d)(4)(iii). The collection of information in § 1.905–1(d)(5) requires taxpayers that are correcting an improper method of accruing foreign income tax expense to file a Form 3115, Application for Change in Accounting Method, with their return. Proposed §§ 1.901–1(d)(2) and 1.905–3 require taxpayers that make a change between claiming a credit and a deduction for foreign income taxes to comply with the notification and reporting requirements in § 1.905–4, which is being finalized in a Treasury Decision published concurrently with this notice of proposed rulemaking. The collection of information in § 1.905–4 generally requires taxpayers to file an amended return for the year or years affected by a foreign tax redetermination (FTR), along with an updated Form 1116 or Form 1118, and a written statement providing specific information relating to the FTR. The burdens associated with collections of information in proposed §§ 1.905–1(d)(4)(iii) and (d)(5), 1.901–1(d)(2), and 1.905–3, which will be conducted through existing IRS forms, is described in Part II.B of this Special Analyses. The burden for a new collection of information in proposed § 1.905–1(d)(4)(ii), which will be conducted on a new IRS form, is described in Part II.C of this Special Analyses.

B. Collections of Information—Proposed §§ 1.905–1(d)(4)(iii), 1.905–1(d)(5), 1.901–1(d)(2), and 1.905–3

The Treasury Department and the IRS intend that the information collection requirements described in this Part II.B will be set forth in the forms and instructions identified in Table 1.

TABLE 1—TABLE OF TAX FORMS IMPACTED

Tax forms impacted		
Collection of information	Number of respondents (estimated)	Forms to which the information may be attached
§ 1.905–1(d)(4)(iii)	1,500	Form 1116, Form 1118.
§ 1.905–1(d)(5)	465,500–514,500	Form 3115.
§ 1.901–1(d)(2), § 1.905–3	10,400–13,500	Form 1065 series, Form 1040 series, Form 1041 series, and Form 1120 series.

Source: [MeF, DCS, and IRS's Compliance Data Warehouse].

As indicated in Table 1, the Treasury Department and the IRS intend the annual certification requirement in proposed § 1.905–1(d)(4)(iii), which applies to taxpayers that elect to claim a provisional credit for contested taxes, will be conducted through amendment of existing Form 1116, Foreign Tax Credit (Individual, Estate, or Trust) (covered under OMB control numbers 1545–0074 for individuals, and 1545–0121 for estates and trusts) and existing Form 1118, Foreign Tax Credit (Corporations) (covered under OMB control number 1545–0123). The collection of information in proposed § 1.905–1(d)(4)(iii) will be reflected in the Paperwork Reduction Act submission that the Treasury Department and the IRS will submit to OMB for these forms. The current status of the Paperwork Reduction Act submissions related to these forms is summarized in Table 2. The estimate for the number of impacted filers with respect to the collection of information in proposed § 1.905–1(d)(4)(iii), as well as with respect to the collection of information in proposed § 1.905–1(d)(4)(ii) (described in Part II.C), is based on the number of U.S. corporations that filed an amended return that had a Form 1118 attached to the Form 1120; S corporations that filed an amended return with a Form 5471 attached to the Form 1120S or that reported an amount of foreign tax accrued on the Form 1120S, Schedule K; partnerships that filed an amended return with a Form 5471 attached to Form 1065 or that reported an amount of foreign tax accrued on Schedule K; and U.S. individuals that filed an amended return and had a Form 1116 attached to the Form 1040.

The Treasury Department and the IRS expect that the collection of information in proposed § 1.905–1(d)(5) will be reflected in the Paperwork Reduction Act submission that the Treasury Department and the IRS will submit to OMB for Form 3115 (covered under OMB control numbers 1545–0123 and 1545–0074). See Table 2 for current status of the Paperwork Reduction Act submission for Form 3115. Exact data is not available to estimate the number of taxpayers that have used an incorrect method of accounting for accruing foreign income taxes, and that are potentially subject to the collection of information in proposed § 1.905–1(d)(5). The estimate in Table 1 of number of taxpayers potentially affected by this collection of information is based on the total number of filers in the Form 1040, Form 1041, Form 1120, Form 1120S, and Form 1065 series that indicated on their return that they use an accrual method of accounting, and that either claimed a foreign tax credit or claimed a deduction for taxes (which could include foreign income taxes). This represents an upper bound of potentially affected taxpayers. The Treasury Department and the IRS expect that only a small percentage of this population of taxpayers will be subject to the collection of information in proposed § 1.905–1(d)(5), because only taxpayers that have used an improper method of accounting are subject to proposed § 1.905–1(d)(5).

The collection of information resulting from proposed §§ 1.901–1(d)(2) and 1.905–3, which is contained in § 1.905–4, will be reflected in the Paperwork Reduction Act submission that the Treasury Department and the IRS will submit for OMB control numbers 1545–0123, 1545–0074 (which cover the reporting burden for filing an amended return and amended Form

1116 and Form 1118 for individual and business filers), OMB control number 1545–0092 (which covers the reporting burden for filing an amended return for estate and trust filers), OMB control number 1545–0121 (which covers the reporting burden for filing a Form 1116 for estate and trust filers), and OMB control number 1545–1056 (which covers the reporting burden for the written statement for FTRs). Exact data are not available to estimate the additional burden imposed by proposed §§ 1.901–1(d)(2) and 1.905–3, which propose to amend the definition of foreign tax redetermination in § 1.905–3 to include a taxpayer's change from claiming a deduction to claiming a credit, or vice versa, for foreign income taxes. Taxpayers making or changing their election to claim a foreign tax credit, under existing regulations, must already file amended returns and, if applicable, a Form 1116 or Form 1118, for the affected years. The Treasury Department and the IRS do not anticipate that proposed regulations, which would require taxpayers making this change to comply with the collection of information and reporting burden in § 1.905–4, will substantially change the reporting requirement. Exact data are not available to estimate the number of taxpayers potentially subject to proposed §§ 1.901–1(d)(2) and 1.905–3. The estimate in Table 1 is based upon the total number of filers in the Form 1040, Form 1041, and Form 1120 series that either claimed a foreign tax credit or claimed a deduction for taxes (which could include foreign income taxes), and filed an amended return. This estimate represents an upper bound of potentially affected taxpayers.

OMB control number 1545–0123 represents a total estimated burden time for all forms and schedules for corporations of 3.344 billion hours and total estimated monetized costs of $61.558 billion ($2019). OMB control number 1545–0074 represents a total estimated burden time, including all other related forms and schedules for individuals, of 1.717 billion hours and total estimated monetized costs of $33.267 billion ($2019). OMB control number 1545–0092 represents a total estimated burden time, including related forms and schedules, but not including Form 1116, for trusts and estates, of 307,844,800 hours and total estimated monetized costs of $14.077 billion ($2018). OMB control number 1545–0121 represents a total estimated burden time for all estate and trust filers of Form 1116, of 25,066,693 hours and total estimated monetized costs of $1.744 billion ($2018). OMB control number 1545–1056 has an estimated number of respondents in a range from 8,900 to 13,500 and total estimated burden time of 56,000 hours and total estimated monetized costs of $2,583,840 ($2017).

The overall burden estimates provided for OMB control numbers 1545–0123, 1545–0074, and 1545–0092 are aggregate amounts that relate to the entire package of forms associated with these OMB control numbers and will in the future include but not isolate the estimated burden of the tax forms that will be revised as a result of the information collections in the proposed regulations. The difference between the burden estimates reported here and those future burden estimates will therefore not provide an estimate of the burden imposed by the proposed regulations. The burden estimates reported here have been reported for other regulations related to the taxation of cross-border income. The Treasury Department and IRS urge readers to recognize that many of the burden estimates reported for regulations related to taxation of cross-border income are duplicates and to guard against overcounting the burden that international tax provisions impose. The Treasury Department and the IRS have not identified the estimated burdens for the collections of information in proposed §§ 1.905–1(d)(4)(iii) and (d)(5), 1.901–1(d)(2), and 1.905–3 because no burden estimates specific to proposed §§ 1.905–1(d)(4)(iii) and (d)(5), 1.901–1(d)(2), and 1.905–3 are currently available. The Treasury Department and the IRS estimate burdens on a taxpayer-type basis rather than a provision-specific basis.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. Any proposed revisions to these forms that reflect the information collections contained in proposed §§ 1.905–1(d)(4)(iii) and (d)(5), 1.901–1(d)(2), and 1.905–3 will be made available for public comment at *https://apps.irs.gov/app/picklist/list/draftTaxForms.html* and will not be finalized until after these forms have been approved by OMB under the Paperwork Reduction Act.

TABLE 2—STATUS OF CURRENT PAPERWORK REDUCTION SUBMISSIONS

Form	Type of filer	OMB No.(s)	Status
Form 1116	Trusts & estates (NEW Model)	1545–0121	Approved by OMB through 10/31/2020.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201704-1545-023		
	Individual (NEW Model)	1545–0074	Approved by OMB through 1/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021		
Form 1118	Business (NEW Model)	1545–0123	Approved by OMB through 1/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001		
Form 3115	Business (NEW Model)	1545–0123	Approved by OMB through 1/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001		
	Individual (NEW Model)	1545–0074	Approved by OMB through 1/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021		
Notification of FTRs		1545–1056	Approved by OMB through 12/31/2020.

TABLE 2—STATUS OF CURRENT PAPERWORK REDUCTION SUBMISSIONS—Continued

Form	Type of filer	OMB No.(s)	Status
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201703-1545-008		
Amended returns	Business (NEW Model)	1545–0123	Approved by OMB through 1/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001		
	Individual (NEW Model)	1545–0074	Approved by OMB through 1/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021		
	Trusts & estates	1545–0092	Approved by OMB through 5/31/2022.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201806-1545-014		

C. Collections of Information—Proposed § 1.905–1(d)(4)(ii)

The collection of information contained in § 1.905–1(d)(4)(ii) have been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act. Commenters are strongly encouraged to submit public comments electronically. Comments and recommendations for the proposed information collection should be sent to *http://www.reginfo.gov/public/do/PRAMain*, with electronic copies emailed to the IRS at *omb.unit@irs.gov* (indicate REG–101657–20 on the subject line). This particular information collection can be found by selecting ''Currently under Review—Open for Public Comments'' then by using the search function. Comments can also be mailed to OMB, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies mailed to the IRS, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collections of information should be received by January 11, 2021.

The likely respondents are: U.S. persons who pay or accrue foreign income taxes:

Estimated total annual reporting burden: 3,000 hours.

Estimated average annual burden per respondent: 2 hours.

Estimated number of respondents: 1,500.

Estimated frequency of responses: Annually.

III. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that the proposed regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act.

The proposed regulations provide guidance needed to comply with statutory changes and affect individuals and corporations claiming foreign tax credits. The domestic small business entities that are subject to the foreign tax credit rules in the Code and in the proposed regulations are generally those domestic small business entities that are at least 10 percent corporate shareholders of foreign corporations, and so are eligible to claim dividends received deductions or compute foreign taxes deemed paid under section 960 with respect to inclusions under subpart F and section 951A from CFCs. Other provisions of these proposed regulations might also affect domestic small business entities that operate in foreign jurisdictions or that have income from sources outside of the United States.

Based on 2018 Statistics of Income data, the Treasury Department and the IRS computed the fraction of taxpayers owning a CFC by gross receipts size class. The smaller size classes have a relatively small fraction of taxpayers that own CFCs, which suggests that many domestic small business entities would be unaffected by these regulations. Many of the important aspects of the proposed regulations, including the rules in proposed §§ 1.245A(d)–1(a), 1.367(b)–4, 1.367(b)–7, 1.367(b)–10, 1.861–3, and 1.960–1 apply only to U.S. persons that operate a foreign business in corporate form, and, in most cases, only if the foreign corporation is a CFC.

Other provisions in the proposed regulations, specifically the rules in proposed §§ 1.861–14 and 1.904–4, generally apply only to members of an affiliated group and insurance companies or other members of the financial services industry earning income from sources outside of the United States. It is infrequent for domestic small entities to operate as part of an affiliated group, to be taxed as an insurance company, or to constitute a financial services entity, and also earn income from sources outside of the United States. Consequently, the Treasury Department and the IRS expect that the proposed regulations are unlikely to affect a substantial number of domestic small business entities. However, adequate data are not available at this time to certify that a substantial number of small entities would be unaffected.

The Treasury Department and the IRS have determined that the proposed regulations will not have a significant economic impact on domestic small business entities. Based on information from the Statistics of Income 2017 Corporate File, foreign tax credits as a percentage of three different tax-related measures of annual receipts (see Table for variables) by corporations are substantially less than the 3 to 5 percent threshold for significant economic impact.

Size (by business receipts)	Under $500,000	$500,000 under $1,000,000	$1,000,000 under $5,000,000	$5,000,000 under $10,000,000	$10,000,000 under $50,000,000	$50,000,000 under $100,000,000	$100,000,000 under $250,000,000	$250,000,000 or more
FTC/Total Receipts	0.12%	0.00%	0.00%	0.00%	0.01%	0.01%	0.02%	0.28%
FTC/(Total Receipts-Total Deductions)	0.61%	0.03%	0.09%	0.05%	0.35%	0.71%	1.38%	9.89%

Size (by business receipts)	Under $500,000	$500,000 under $1,000,000	$1,000,000 under $5,000,000	$5,000,000 under $10,000,000	$10,000,000 under $50,000,000	$50,000,000 under $100,000,000	$100,000,000 under $250,000,000	$250,000,000 or more
FTC/Business Receipts ...	0.84%	0.00%	0.00%	0.00%	0.01%	0.01%	0.02%	0.05%

Source: Statistics of Income (2017) Form 1120.

Although proposed §§ 1.905–1(d)(4) and (5), 1.901–1(d)(2), and 1.905–3 contain a collection of information requirement, the small businesses that are subject to these requirements are domestic small entities with significant foreign operations. The data to assess precise counts of small entities affected by proposed §§ 1.905–1(d)(4) and (5), 1.901–1(d)(2), and 1.905–3 are not readily available. As demonstrated in the table in this Part III of the Special Analyses, foreign tax credits do not have a significant economic impact for any gross-receipts class of business entities.[7] Therefore, the proposed regulations do not have a significant economic impact on small business entities. Accordingly, it is hereby certified that the requirements of proposed §§ 1.905–1(d)(4) and (5), 1.901–1(d)(2), and 1.905–3 will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses. The Treasury Department and the IRS also request comments from the public on the certifications in this Part III of the Special Analyses.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This proposed rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

[7] Although proposed §§ 1.905–1(d)(5), 1.901–1(d)(2), and 1.905–3 also impact taxpayers that claim a deduction, instead of a credit, for foreign income taxes, the Treasury Department and the IRS expect that the vast majority of taxpayers that have creditable foreign income taxes would choose a dollar-for-dollar credit instead of a deduction; thus, the data in this table measuring foreign tax credit against various variables is a reasonable estimate of the economic impact of these proposed regulations.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled ''Federalism'') prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive order.

Comments and Request for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** section. The Treasury Department and the IRS request comments on all aspects of the proposed rules. See also the specific requests for comments in the following Parts of the Explanation of Provisions: I (on potential revisions to § 1.861–20(d) to address concerns regarding foreign law transactions that may circumvent the purpose of section 245A(d)), III (on the proposed revisions to § 1.367(b)–4(b)(2) and on whether further changes to regulations issued under section 367 are appropriate in order to clarify their application after the repeal of section 902), V.A (on the definition of advertising expenditures and the method of cost recovery for purposes of the election in proposed § 1.861–9(k)), V.D (regarding the rules on direct allocation of interest expense incurred by foreign banking branches), V.F.2 (regarding the assignment of foreign tax on a U.S. return of capital amount resulting from a disposition of stock), V.F.3 (regarding the assignment of foreign tax on partnership distributions and sales of partnership interests), V.F.4.ii (regarding ordering rules for assignment of foreign taxes with respect to multiple disregarded payments and regarding the assignment of foreign gross basis taxes paid by taxable units that make disregarded payments), V.F.4.iii (regarding the method of determining the statutory and residual groupings to which a remittance is assigned), V.F.5 (regarding the appropriate treatment of foreign income taxes paid or accrued in connection with the sharing of losses and foreign law group-relief regimes), VI.A.1 (on whether additional revisions to § 1.901–2A are needed in light of the proposed revisions to §§ 1.901–2 and 1.903–1), VI.A.2 (regarding the jurisdictional nexus requirement in proposed § 1.901–2(c), including whether special rules are needed to address foreign transfer pricing rules that allocate profits to a resident on a formulary basis), VI.A.3.ii (on whether a more objective standard for identifying acceptable deviations from the realization requirement should be adopted in the final regulations and on whether additional categories of pre-realization timing differences are needed), VI.A.4 (regarding additional issues related to soak-up taxes), VI.B.2 (regarding additional rules for government grants that are provided outside the foreign tax system), VI.B.3.ii (on the treatment of loss sharing arrangements and on other foreign options and elections that should be excepted from the general rule in § 1.901–2(e)(5)(ii)), IX.B (on the treatment of related party payments in the 70-percent gross income test, on whether related party payments should in some cases constitute active financing income, and on the investment income limitation rule), and X.D.4 (on alternative methods and additional adjustments for implementing a method change involving the improper accrual of foreign income taxes).

Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at *www.regulations.gov* or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020–4, 2020–17 IRB 1, provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

Drafting Information

The principal authors of the proposed regulations are Corina Braun, Karen J. Cate, Jeffrey P. Cowan, Logan M. Kincheloe, Brad McCormack, Jeffrey L. Parry, Tianlin (Laura) Shi, and Suzanne M. Walsh of the Office of Associate Chief Counsel (International), as well as Sarah K. Hoyt and Brian R. Loss of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

■ **Paragraph 1.** The authority citation for part 1 is amended by adding an entry for § 1.245A(d)–1 in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805.

* * * * *

Section 1.245A(d)–1 also issued under 26 U.S.C. 245A(g).

* * * * *

■ **Par. 2.** Section 1.164–2 is amended by revising paragraph (d) and adding paragraph (i) to read as follows:

§ 1.164–2 Deduction denied in case of certain taxes.

* * * * *

(d) *Foreign income taxes.* Except as provided in § 1.901–1(c)(2) and (3), all foreign income taxes as defined in § 1.901–2(a) paid or accrued (as the case may be, depending on the taxpayer's method of accounting for such taxes) in such taxable year, if the taxpayer chooses to take to any extent the benefits of section 901, relating to the credit for taxes of foreign countries and possessions of the United States, for taxes that are paid or accrued (according to the taxpayer's method of accounting for such taxes) in such taxable year.

* * * * *

(i) *Applicability dates.* Paragraph (d) of this section applies to foreign taxes paid or accrued in taxable years beginning on or after [date final regulations are filed with the **Federal Register**].

■ **Par. 3.** Section 1.245A(d)–1 is added to read as follows:

§ 1.245A(d)–1 Disallowance of foreign tax credit or deduction.

(a) *In general.* With respect to a domestic corporation for which a deduction under section 245A(a) is allowable, neither a foreign tax credit under section 901 nor a deduction is allowed for foreign income taxes that are attributable to a specified distribution or specified earnings and profits of a foreign corporation. In addition, if a domestic corporation is a United States shareholder of a foreign corporation (''upper-tier foreign corporation'') that itself owns (including indirectly through a pass-through entity) stock of another foreign corporation (''lower-tier foreign corporation''), no foreign tax credit under section 901 (including by reason of section 960) is allowed to the domestic corporation, and no deduction is allowed to the upper-tier foreign corporation, for foreign income taxes paid or accrued by the upper-tier foreign corporation that are attributable to a specified distribution or specified earnings and profits of the lower-tier foreign corporation. Moreover, neither a foreign tax credit under section 901 nor a deduction is allowed to a successor (including an individual who is a citizen or resident of the United States) of a corporation described in this paragraph (a) for foreign income taxes that are attributable to the portion of a foreign corporation's specified earnings and profits that constitute section 245A(d) PTEP.

(b) *Attribution of foreign income taxes to specified distributions and specified earnings and profits*—(1) *In general.* Foreign income taxes are attributable to a specified distribution from a foreign corporation to the extent such taxes are allocated and apportioned under § 1.861–20 to foreign taxable income arising from the specified distribution. Foreign income taxes are attributable to specified earnings and profits of a foreign corporation to the extent such taxes are allocated and apportioned under § 1.860–20 to foreign taxable income arising from a distribution or inclusion under foreign law of specified earnings and profits if the event giving rise to such distribution or inclusion does not give rise to a specified distribution. See, for example, §§ 1.861–20(d)(2)(ii)(B), (C), or (D) (foreign law distribution or disposition and certain foreign law transfers between taxable units), 1.861–20(d)(3)(i)(C) (income from a reverse hybrid), 1.861–20(d)(3)(iii) (foreign law inclusion regime), and 1.861–20(d)(3)(v)(C)(*1*)(*i*) (disregarded payment treated as a remittance). For purposes of this paragraph (b), § 1.861–20 is applied by treating foreign gross income in an amount equal to the amount of a distribution (under Federal income tax law) that is a specified distribution, or the amount of a distribution or inclusion under foreign law that would if recognized for Federal income tax purposes be a distribution out of, or inclusion with respect to, specified earnings and profits, as a statutory grouping, and any remaining portion of the foreign gross income arising from the distribution or inclusion under foreign law as the residual grouping. See also § 1.960–1(e) (foreign income tax paid or accrued by a controlled foreign corporation that is assigned to the residual grouping cannot be deemed paid under section 960).

(2) *Anti-avoidance rule.* Foreign income taxes are treated as attributable to a specified distribution from, or the specified earnings and profits 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) and this section, including, for example, by separating foreign income taxes from the income, or earnings and profits, to which such foreign income taxes relate or by making distributions (or causing inclusions) under foreign law in multiple years that give rise to foreign income taxes that are allocated and apportioned with reference to the same previously taxed earnings and profits. See paragraph (e)(4) of this section (*Example 3*).

(c) *Definitions.* The following definitions apply for purposes of this section.

(1) *Foreign income tax.* The term *foreign income tax* has the meaning set forth in § 1.901–2(a).

(2) *Hybrid dividend.* The term *hybrid dividend* has the meaning set forth in § 1.245A(e)–1(b)(2).

(3) *Pass-through entity.* The term *pass-through entity* has the meaning set forth in § 1.904–5(a)(4).

(4) *Section 245A(d) PTEP.* The term *section 245A(d) PTEP* means previously taxed earnings and profits described in § 1.960–3(c)(2)(v) or (ix) to the extent such previously taxed earnings and profits arose as a result of a sale or exchange that by reason of section 964(e)(4) or 1248 gave rise to a deduction under section 245A(a) or as a result of a tiered hybrid dividend that by reason of section 245A(e)(2) and § 1.245A(e)–1(c)(1) gave rise to an inclusion in the gross income of a United States shareholder.

(5) *Specified distribution.* With respect to a domestic corporation, the term *specified distribution* means, in the case of a distribution to the domestic corporation (including indirectly through a pass-through entity), the portion of the distribution that is a

dividend for which a deduction under section 245A(a) is allowed or that is a hybrid dividend or that is attributable to section 245A(d) PTEP. In addition, the term specified distribution means, in the case of a distribution from a foreign corporation to another foreign corporation (including indirectly through a pass-through entity), the portion of the distribution that is attributable to section 245A(d) PTEP or that is a tiered hybrid dividend that gives rise to an inclusion in the gross income of a United States shareholder of the second foreign corporation by reason of section 245A(e)(2) and § 1.245A(e)–1(c)(1).

(6) *Specified earnings and profits.* With respect to a domestic corporation, the term *specified earnings and profits* means the portion of earnings and profits of the foreign corporation that would give rise to a specified distribution (determined without regard to section 246 or § 1.245A–5) if an amount of money equal to all of the foreign corporation's earnings and profits were distributed with respect to the stock of the foreign corporation owned by all the shareholders on any date on which the domestic corporation has an item of foreign gross income as the result of a distribution from or inclusion with respect to the foreign corporation under foreign law. In addition, for purposes of applying § 1.861–20(d)(3)(i)(B) or (D) to assign foreign gross income arising from a distribution with respect to, or a disposition of, stock of the foreign corporation, earnings and profits in the amount of the U.S. return of capital amount (as defined in § 1.861–20(b)) that are deemed to arise in a section 245A subgroup (after applying the asset method in § 1.861–9) are also treated as specified earnings and profits.

(7) *Tiered hybrid dividend.* The term *tiered hybrid dividend* has the meaning set forth in § 1.245A(e)–1(c)(2).

(d) *Effect on earnings and profits.* The disallowance of a credit or deduction for foreign income taxes under paragraph (a) of this section does not affect whether the foreign income taxes reduce earnings and profits of a corporation.

(e) *Examples.* The following examples illustrate the application of this section.

(1) *Presumed facts.* Except as otherwise provided, the following facts are presumed for purposes of the examples:

(i) USP is a domestic corporation;

(ii) CFC is a controlled foreign corporation organized in Country A, and is not a reverse hybrid (as defined in § 1.861–20(b));

(iii) USP would be allowed a deduction under section 245A(a) to the extent of dividends received from CFC;

(iv) All parties have a U.S. dollar functional currency and a U.S. taxable year and foreign taxable year that correspond to the calendar year;

(v) No party has deductions for Country A tax purposes or deductions for Federal income tax purposes (other than foreign income tax expense); and

(vi) Section 245A(d) is the operative section.

(2) *Example 1: Distribution for foreign and Federal income tax purposes*—(i) *Facts.* USP owns all of the outstanding stock of CFC. As of December 31, Year 1, CFC has $800x of section 951A PTEP (as defined in § 1.960–3(c)(2)(viii)) in a single annual PTEP account (as defined in § 1.960–3(c)(1)), and $500x of earnings and profits described in section 959(c)(3). On December 31, Year 1, CFC distributes $1,000x of cash to USP. For Country A tax purposes, the distribution is treated entirely as a dividend to USP, and Country A imposes a withholding tax on USP of $150x with respect to the $1,000x of foreign gross income. For Federal income tax purposes, $800x of the distribution is excluded from USP's gross income and not treated as a dividend under section 959(a) and (d), respectively; the remaining $200x of the distribution gives rise to a dividend to USP.

(ii) *Analysis*—(A) *Identification of specified distribution.* With respect to USP, $200x of the distribution gives rise to a dividend for which a deduction under section 245A(a) is allowed. Accordingly, the distribution results in a $200x specified distribution. See paragraph (c)(5) of this section.

(B) *Foreign income taxes attributable to specified distribution.* For purposes of allocating and apportioning the $150x of Country A foreign income tax, § 1.861–20 is applied by first assigning the $1,000x of Country A gross income to the relevant statutory and residual groupings for purposes of applying section 245A(d) as the operative section. Under paragraph (b)(1) of this section, the statutory grouping is foreign gross income in the amount of the specified distribution and the residual grouping is the remaining amount of foreign gross income. Under § 1.861–20(d)(3)(i)(B)(*2*), the foreign dividend amount ($1,000x) is, to the extent of the U.S. dividend amount ($1,000x), assigned to the same statutory or residual groupings to which the distribution of the U.S. dividend amount is assigned under Federal income tax law. Thus, $200x of the foreign dividend amount is assigned to the statutory grouping, and the remaining $800x is assigned to the residual grouping. Under § 1.861–20(f), $30x ($150x × $200x/$1,000x) of the Country A foreign income tax is apportioned to the statutory grouping, and $120x ($150x × $800x/$1,000x) of the Country A foreign income tax is apportioned to the residual grouping.

(C) *Disallowance.* USP is allowed neither a foreign tax credit nor a deduction for the $30x of Country A foreign income tax that is allocated and apportioned to, and therefore attributable to, the $200x specified distribution. See paragraphs (a) and (b) of this section.

(3) *Example 2: Distribution for foreign law purposes*—(i) *Facts.* USP owns all of the outstanding stock of CFC. On December 31, Year 1, CFC distributes $1,000x of its stock to USP. For Country A tax purposes, the stock distribution is treated entirely as a dividend to USP, and Country A imposes a withholding tax on USP of $150x with respect to the $1,000x of foreign gross income. For Federal income tax purposes, USP recognizes no U.S. gross income as a result of the stock distribution pursuant to section 305(a). As of December 31, Year 1, the date of the stock distribution, CFC has $800x of section 951A PTEP (as defined in § 1.960–3(c)(2)(viii)) in a single annual PTEP account (as defined in § 1.960–3(c)(1)), and $500x of earnings and profits described in section 959(c)(3).

(ii) *Analysis*—(A) *Identification of specified earnings and profits.* With respect to USP, CFC has $500x of specified earnings and profits because if, on December 31, Year 1, CFC were to distribute $1,300x of money (an amount equal to all of CFC's earnings and profits) with respect to its stock to USP, $500x of the distribution would be a dividend for which USP would be allowed a deduction under section 245A(a) and, therefore, would give rise to a specified distribution. See paragraphs (c)(5) and (6) of this section. The remaining $800x of the distribution would not be included in USP's gross income or treated as a dividend and, thus, would not give rise to a deduction under section 245A(a). See section 959(a) and (d), respectively.

(B) *Foreign income taxes attributable to specified earnings and profits.* For purposes of allocating and apportioning the $150x of Country A foreign income tax, § 1.861–20 is applied by first assigning the $1,000x of Country A gross income to the relevant statutory and residual groupings for purposes of applying section 245A(d) as the operative section. Under paragraph (b)(1) of this section, the statutory grouping is the amount of foreign gross income arising from the foreign law distribution that would if recognized for Federal income tax purposes be a distribution out of CFC's specified earnings and profits, and the residual grouping is the remaining amount of the foreign gross income. There is no corresponding U.S. item because under section 305(a) USP recognizes no U.S. gross income with respect to the stock distribution. Under § 1.861–20(d)(2)(ii)(B), the item of foreign gross income (the $1,000x dividend) is assigned under the rules of § 1.861–20(d)(3)(i)(B) to the same statutory or residual groupings to which the foreign gross income would be assigned if a distribution of the same amount were made for Federal income tax purposes on December 31, Year 1, the date the stock distribution occurs for Country A tax purposes. If recognized for Federal income tax purposes, a $1,000x distribution on December 31, Year 1, would result in a U.S. dividend amount (which as defined in § 1.861–20(b) includes distributions of previously taxed earnings and profits) of $1,000x. Under § 1.861–20(d)(3)(i)(B)(*2*), the foreign dividend amount ($1,000x) is, to the extent of the U.S. dividend amount ($1,000x), assigned to the same statutory or residual groupings from which a distribution of the U.S. dividend amount would be made under Federal income tax law. Thus, $200x of foreign gross income related to the foreign dividend amount is assigned to the statutory grouping for the gross income that would arise from a distribution of CFC's specified earnings and profits, and $800x is assigned to the residual grouping. Under § 1.861–20(f), $30x ($150x × $200x/$1,000x) of the Country A foreign income tax is apportioned to the statutory grouping, and $120x ($150x × $800x/$1,000x) of the Country A foreign income tax is apportioned to the residual grouping.

(C) *Disallowance.* USP is allowed neither a foreign tax credit nor a deduction for the $30x of Country A foreign income tax that is allocated and apportioned to, and therefore attributable to, the $500x of specified earnings and profits of CFC. See paragraphs (a) and (b) of this section.

(4) *Example 3: Successive foreign law distributions subject to anti-abuse rule*—(i) *Facts.* During Year 1, CFC generates $500x of subpart F income that is included in USP's income under section 951(a), and $500x of foreign oil and gas extraction income (as defined in section 907(c)(1)) in Country A. As of December 31, Year 1, CFC has $500x of earnings and profits described in section 959(c)(3) and $500x of section 951(a)(1)(A) PTEP (as defined in § 1.960–3(c)(2)(x)). CFC generates no income in Years 2 through 4. In each of Years 2 and 3, USP makes a consent dividend election under Country A law that, for Country A tax purposes, deems CFC to distribute to USP, and USP immediately to contribute to CFC, $500x on December 31 of each year. For Country A tax purposes, each deemed distribution and contribution is treated as a dividend of $500x to USP, followed immediately by a contribution to CFC of $500x, and Country A imposes a withholding tax on USP of $150x with respect to $500x of foreign gross income in each of Years 2 and 3. For Federal income tax purposes, the Country A consent dividend is disregarded, and USP recognizes no U.S. gross income. In Year 4, CFC distributes $1,000x to USP, which for Country A tax purposes is treated as a return of contributed capital on which no withholding tax is imposed. For Federal income tax purposes, $500x of the $1,000x distribution is excluded from USP's gross income and not treated as a dividend under section 959(a) and (d), respectively; the remaining $500x of the distribution gives rise to a dividend to USP for which USP is allowed a deduction under section 245A(a). The Country A consent dividend elections in Years 2 and 3 are made with a principal purpose of avoiding the application of section 245A(d) and this section to disallow a credit or deduction for Country X withholding tax incurred with respect to CFC's specified earnings and profits.

(ii) *Analysis*—(A) *Identification of specified earnings and profits.* With respect to USP, CFC has $500x of specified earnings and profits in Years 2 and 3 because if, on the date of each foreign law distribution, CFC were to distribute $1,000x of money (an amount equal to all of CFC's earnings and profits) with respect to its stock owned by USP, $500x of the distribution would be a dividend for which USP would be allowed a deduction under section 245A(a) and, therefore, would give rise to a specified distribution. See paragraphs (c)(5) and (6) of this section.

(B) *Foreign income taxes attributable to specified earnings and profits.* For purposes of allocating and apportioning the $150x of Country A foreign income tax incurred by USP in each of Years 2 and 3, § 1.861–20 is applied by first assigning the $500x of Country A gross income to the relevant statutory and residual groupings for purposes of applying section 245A(d) as the operative section. Under paragraph (b)(1) of this section, the statutory grouping is the amount of foreign gross income arising from the foreign law distribution that would if recognized for Federal income tax purposes be a distribution out of CFC's specified earnings and profits, and the residual grouping is the remaining amount of the foreign gross income. The $500x of foreign gross income is not included in the U.S. gross income of USP, and thus, there is no corresponding U.S. item. The Country A consent dividends in Years 2 and 3 meet the definition of a foreign law distribution in § 1.861–20(b) because Country A treats them as a taxable distribution but Federal income tax law does not. Under § 1.861–20(d)(2)(ii)(B), the $500x item of foreign law dividend income is assigned to a statutory or residual grouping by treating CFC as making an actual distribution (for Federal income tax purposes) of $500x on December 31 of each of Years 2 and 3. Accordingly, in each of Years 2 and 3, the $500x of foreign gross income arising from the foreign law distribution is assigned to the residual grouping because the hypothetical distribution is treated as distributed out of section 951(a)(1)(A) PTEP, which are not characterized as specified earnings and profits. Under § 1.861–20(f), none of the $150x of Country A foreign income tax incurred by USP in each of Years 2 and 3 is apportioned to the statutory grouping relating to specified earnings and profits.

(C) *Disallowance pursuant to anti-avoidance rule.* By electing to make two successive foreign law distributions in Years 2 and 3 that were subject to Country A withholding tax and that did not individually exceed, but in the aggregate did exceed, the section 951(a)(1)(A) PTEP of CFC, and then making an actual distribution of property equal to all of the earnings and profits of CFC in Year 4 that was not subject to Country A withholding tax (because the previous consent dividends converted CFC's earnings and profits to capital for Country A tax purposes), USP would have avoided the disallowance under section 245A(d) (but for the application of the anti-avoidance rule in paragraph (b)(2) of this section) despite having received a $500x dividend that gave rise to a deduction under section 245A(a), and incurring withholding tax related to the earnings and profits that gave rise to that dividend. However, the Country A consent dividend elections in Years 2 and 3 were made with a principal purpose of avoiding the purposes of section 245A(d) and this section. Therefore, USP is allowed neither a foreign tax credit nor a deduction for $150x of Country A foreign income tax, which is treated as being attributable to the $500x of specified earnings and profits of CFC. See paragraphs (a) and (b)(2) of this section.

(f) *Applicability date.* This section applies to taxable years of a foreign corporation that begin after December 31, 2019, and end on or after November 2, 2020, and with respect to a United States person, taxable years in which or with which such taxable years of the foreign corporation end.

§ 1.245A(e)–1 [Amended]

■ **Par. 4.** Section 1.245A(e)–1 is amended by adding the language ''and § 1.245A(d)–1'' after the language ''rules of section 245A(d)'' in paragraphs (b)(1)(ii), (c)(1)(iii), (g)(1)(ii) introductory text, (g)(1)(iii) introductory text, and (g)(2)(ii) introductory text.

■ **Par. 5.** Section 1.250(b)–1 is amended by adding two sentences to the end of paragraph (c)(7) to read as follows:

§ 1.250(b)–1 Computation of foreign-derived intangible income (FDII).

* * * * *

(c) * * *

(7) * * * A taxpayer must use a consistent method to determine the amount of its domestic oil and gas extraction income (''DOGEI'') and its foreign oil and gas extraction income (''FOGEI'') from the sale of oil or gas that has been transported or processed. For example, a taxpayer must use a consistent method to determine the amount of FOGEI from the sale of gasoline from foreign crude oil sources in computing the exclusion from gross tested income under § 1.951A–2(c)(1)(v) and the amount of DOGEI from the sale of gasoline from domestic crude oil sources in computing its section 250 deduction.

* * * * *

■ **Par. 6.** Section 1.250(b)–5 is amended by revising paragraph (c)(5) to read as follows:

§ 1.250(b)–5 Foreign-derived deduction eligible income (FDDEI) services.

* * * * *

(c) * * *

(5) *Electronically supplied service.* The term *electronically supplied service* means, with respect to a general service other than an advertising service, a service that is delivered primarily over the internet or an electronic network and for which value of the service to the end user is derived primarily from automation or electronic delivery. Electronically supplied services include the provision of access to digital content (as defined in § 1.250(b)–3), such as streaming content; on-demand network access to computing resources, such as networks, servers, storage, and software; the provision or support of a business or personal presence on a network, such as a website or a web page; online intermediation platform services; services automatically generated from a computer via the internet or other network in response to data input by the recipient; and similar services. Electronically supplied services do not include services that primarily involve the application of human effort by the renderer (not considering the human effort involved in the development or maintenance of the technology enabling the electronically supplied services). Accordingly, electronically supplied services do not include, for example certain services (such as legal, accounting, medical, or teaching services) provided electronically and synchronously.

* * * * *

■ **Par. 7.** Section 1.336–2 is amended:

■ 1. By revising the heading of paragraph (g)(3)(ii).

■ 2. In paragraph (g)(3)(ii)(A), by revising the first sentence and removing the language ''foreign tax'' and adding in its place the language ''foreign income tax'' in the second sentence.

■ 3. By revising paragraphs (g)(3)(ii)(B) and (g)(3)(iii).

■ 4. By removing both occurrences of paragraph (h) at the end of the section.

The revisions read as follows:

§ 1.336–2 Availability, mechanics, and consequences of section 336(e) election.

* * * * *

(g) * * *

(3) * * *

(ii) *Allocation of foreign income taxes*—(A) * * * Except as provided in paragraph (g)(3)(ii)(B) of this section, if a section 336(e) election is made for target and target's taxable year under foreign law (if any) does not close at the end of the disposition date, foreign income tax as defined in § 1.960–1(b)(5) (other than a withholding tax as defined in section 901(k)(1)(B)) paid or accrued by new target with respect to such foreign taxable year is allocated between old target and new target. * * *

(B) *Foreign income taxes imposed on partnerships and disregarded entities.* If a section 336(e) election is made for target and target holds an interest in a disregarded entity (as described in § 301.7701–2(c)(2)(i) of this chapter) or partnership, the rules of § 1.901–2(f)(4) and (5) apply to determine the person who is considered for Federal income tax purposes to pay foreign income tax imposed at the entity level on the income of the disregarded entity or partnership.

(iii) *Disallowance of foreign tax credits under section 901(m).* For rules that may apply to disallow foreign tax credits by reason of a section 336(e) election, see section 901(m) and §§ 1.901(m)–1 through 1.901(m)–8.

* * * * *

■ **Par. 8.** Section 1.336–5 is revised to read as follows:

§ 1.336–5 Applicability dates.

Except as otherwise provided in this section, the provisions of §§ 1.336–1 through 1.336–4 apply to any qualified stock disposition for which the disposition date is on or after May 15, 2013. The provisions of § 1.336–1(b)(5)(i)(A) relating to section 1022 apply on and after January 19, 2017. The provisions of § 1.336–2(g)(3)(ii) and (iii) apply to foreign income taxes paid or accrued in taxable years beginning on or after [date final regulations are filed with the **Federal Register**].

■ **Par. 9.** Section 1.338–9 is amended by revising paragraph (d) to read as follows:

§ 1.338–9 International aspects of section 338.

* * * * *

(d) *Allocation of foreign income taxes*—(1) *In general.* Except as provided in paragraph (d)(3) of this section, if a section 338 election is made for target (whether foreign or domestic), and target's taxable year under foreign law (if any) does not close at the end of the acquisition date, foreign income tax as defined in § 1.901–2(a)(1)) (other than a withholding tax as defined in section 901(k)(1)(B)) paid or accrued by new target with respect to such foreign taxable year is allocated between old target and new target. If there is more than one section 338 election with respect to target during target's foreign taxable year, foreign income tax paid or accrued with respect to that foreign taxable year is allocated among all old targets and new targets. The allocation is made based on the respective portions of the taxable income (as determined under foreign law) for the foreign taxable year that are attributable under the principles of § 1.1502–76(b) to the period of existence of each old target and new target during the foreign taxable year.

(2) *Foreign income taxes imposed on partnerships and disregarded entities.* If a section 338 election is made for target and target holds an interest in a disregarded entity (as described in § 301.7701–2(c)(2)(i) of this chapter) or partnership, the rules of § 1.901–2(f)(4) and (5) apply to determine the person who is considered for Federal income tax purposes to pay foreign income tax imposed at the entity level on the

income of the disregarded entity or partnership.

(3) *Disallowance of foreign tax credits under section 901(m).* For rules that may apply to disallow foreign tax credits by reason of a section 338 election, see section 901(m) and §§ 1.901(m)–1 through 1.901(m)–8.

(4) *Applicability date.* This paragraph (d) applies to foreign income taxes paid or accrued in taxable years beginning on or after [date final regulations are filed with the **Federal Register**].

* * * * *

§ 1.367(b)–2 [Amended]

■ **Par. 10.** Section 1.367(b)–2 is amended by removing the last sentence of paragraph (e)(4), *Example 1.*

§ 1.367(b)–3 [Amended]

■ **Par. 11.** Section 1.367(b)–3 is amended:

■ 1. In paragraph (b)(3)(ii):

■ i. By removing the last sentence of *Example 1.*(ii).

■ ii. By removing the last sentence of *Example 2.*(ii).

■ 2. By removing the last sentence of paragraph (c)(5), *Example 1.*(iii).

■ **Par. 12.** Section 1.367(b)–4 is amended:

■ 1. By revising paragraph (b)(2)(i)(B).

■ 2. By adding a sentence to the end of paragraph (h).

The revision and addition read as follows:

§ 1.367(b)–4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.

* * * * *

(b) * * *

(2) * * *

(i) * * *

(B) Immediately after the exchange, a domestic corporation directly or indirectly owns 10 percent or more of the voting power or value of the transferee foreign corporation; and

* * * * *

(h) * * * Paragraph (b)(2)(i)(B) of this section applies to exchanges completed in taxable years of exchanging shareholders ending on or after November 2, 2020, and to taxable years of exchanging shareholders ending before November 2, 2020 resulting from an entity classification election made under § 301.7701–3 of this chapter that was effective on or before November 2, 2020 but was filed on or after November 2, 2020.

■ **Par. 13.** Section 1.367(b)–7 is amended:

■ 1. By adding a sentence to the end of paragraph (b)(1).

■ 2. By revising paragraph (g).

■ 3. By adding paragraph (h).

The revisions and additions read as follows:

§ 1.367(b)–7 Carryover of earnings and profits and foreign income taxes in certain foreign-to-foreign nonrecognition transactions.

* * * * *

(b) * * *

(1) * * * See paragraph (g) of this section for rules applicable to taxable years of foreign corporations beginning on or after January 1, 2018, and taxable years of United States shareholders in which or with which such taxable years of foreign corporations end (''post-2017 taxable years'').

* * * * *

(g) *Post-2017 taxable years.* As a result of the repeal of section 902 effective for taxable years of foreign corporations beginning on or after January 1, 2018, all foreign target corporations, foreign acquiring corporations, and foreign surviving corporations are treated as nonpooling corporations in post-2017 taxable years. Any amounts remaining in post-1986 undistributed earnings and post-1986 foreign income taxes of any such corporation in any separate category as of the end of the foreign corporation's last taxable year beginning before January 1, 2018, are treated as earnings and taxes in a single pre-pooling annual layer in the foreign corporation's post-2017 taxable years for purposes of this section. Foreign income taxes that are related to non-previously taxed earnings of a foreign acquiring corporation and a foreign target corporation that were accumulated in taxable years before the current taxable year of the foreign corporation, or in a foreign target's taxable year that ends on the date of the section 381 transaction, are not treated as current year taxes (as defined in § 1.960–1(b)(4)) of a foreign surviving corporation in any post-2017 taxable year. In addition, foreign income taxes that are related to a hovering deficit are not treated as current year taxes of the foreign surviving corporation in any post-2017 taxable year, regardless of whether the hovering deficit is absorbed.

(h) *Applicability dates.* Except as otherwise provided in this paragraph (h), this section applies to foreign section 381 transactions that occur on or after November 6, 2006. Paragraph (g) of this section applies to taxable years of foreign corporations ending on or after November 2, 2020, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

■ **Par. 14.** Section 1.367(b)–10 is amended:

■ 1. In paragraph (c)(1), by removing the language ''sections 902 or'' and adding in its place the language ''section''.

■ 2. By revising the heading and adding a sentence to the end of paragraph (e).

The revision and addition read as follows:

§ 1.367(b)–10 Acquisition of parent stock or securities for property in triangular reorganizations.

* * * * *

(e) *Applicability dates.* * * * Paragraph (c)(1) of this section applies to deemed distributions that occur in taxable years ending on or after November 2, 2020.

§ 1.461–1 [Amended]

■ **Par. 15.** Section 1.461–1 is amended by removing the language ''paragraph (b)'' and adding in its place the language ''paragraph (g)'' in the last sentence of paragraph (a)(4).

■ **Par. 16.** Section 1.861–3 is amended:

■ 1. By revising the section heading.

■ 2. By redesignating paragraph (d) as paragraph (e).

■ 3. By adding a new paragraph (d).

■ 4. In newly redesignated paragraph (e):

■ i. By revising the heading.

■ ii. By removing ''this paragraph'' and adding ''this paragraph (e),'' in its place.

■ iii. By adding a sentence to the end of the paragraph.

The revisions and additions read as follows:

§ 1.861–3 Dividends and income inclusions under sections 951, 951A, and 1293 and associated section 78 dividends.

* * * * *

(d) *Source of income inclusions under sections 951, 951A, and 1293 and associated section 78 dividends.* For purposes of sections 861 and 862 and §§ 1.861–1 and 1.862–1, and for purposes of applying this section, the amount included in gross income of a United States person under sections 951, 951A, and 1293 and the associated section 78 dividend for the taxable year with respect to a foreign corporation are treated as dividends received directly by the United States person from the foreign corporation that generated the inclusion. See section 904(h) and § 1.904–5(m) for rules concerning the resourcing of inclusions under sections 951, 951A, and 1293.

(e) *Applicability dates.* * * * Paragraph (d) of this section applies to taxable years ending on or after November 2, 2020.

■ **Par. 17.** Section 1.861–8, as amended in FR Doc. 2020–21819, published elsewhere in this issue of the **Federal**

Register, is further amended by revising paragraph (e)(4)(i) and adding paragraph (h)(4) to read as follows:

§ 1.861–8 Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(e) * * *

(4) * * *

(i) *Expenses attributable to controlled services.* If a taxpayer performs a controlled services transaction (as defined in § 1.482–9(l)(1)), which includes any activity by one member of a group of controlled taxpayers (the renderer) that results in a benefit to a controlled taxpayer (the recipient), and the renderer charges the recipient for such services, section 482 and § 1.482–1 provide for an allocation where the charge is not consistent with an arm's length result. The deductions for expenses of the taxpayer attributable to the controlled services transaction are considered definitely related to the amounts so charged and are to be allocated to such amounts.

* * * * *

(h) * * *

(4) Paragraph (e)(4)(i) of this section applies to taxable years ending on or after November 2, 2020.

■ **Par. 18.** Section 1.861–9, as amended in FR Doc. 2020–21819, published elsewhere in this issue of the **Federal Register**, is further amended:

■ 1. By adding a sentence to the end of paragraph (g)(3).

■ 2. By redesignating paragraph (k) as paragraph (l).

■ 3. By adding a new paragraph (k).

■ 4. By revising newly redesignated paragraph (l).

The additions and revision read as follows:

§ 1.861–9 Allocation and apportionment of interest expense and rules for asset-based apportionment.

* * * * *

(g) * * *

(3) * * * For purposes of applying section 904 as the operative section, the statutory or residual grouping of income that assets generate, have generated, or may reasonably be expected to generate is determined after taking into account any reallocation of income required under § 1.904–4(f)(2)(vi).

* * * * *

(k) *Election to capitalize certain expenses in determining tax book value of assets*—(1) *In general.* Solely for purposes of apportioning interest expenses under the asset method described in paragraph (g) of this section, a taxpayer may elect to determine the tax book value of its assets by capitalizing and amortizing its research and experimental and advertising expenditures incurred in each taxable year under the rules described in paragraphs (k)(2) and (3) of this section. Any election made pursuant to this paragraph (k)(1) by a taxpayer must also be made by or on behalf of all members of an affiliated group of corporations as defined in §§ 1.861–11(d) and 1.861–11T(d) that includes the taxpayer. A taxpayer that makes an election under this paragraph (k)(1) for a taxable year must determine the tax book value of its assets for the taxable year as if it had capitalized its research and experimental and advertising expenditures under paragraphs (k)(2) and (3) of this section in every prior taxable year. Any election made pursuant to this paragraph (k)(1) applies to all subsequent taxable years of the taxpayer unless revoked by the taxpayer. Revocation of such an election requires the consent of the Commissioner.

(2) *Research and experimental expenditures*—(i) *In general.* A taxpayer making an election under paragraph (k)(1) of this section must capitalize its specified research or experimental expenditures paid or incurred during the taxable year (for purposes of apportioning interest expense under the asset method described in paragraph (g) of this section) under the rules in section 174, as contained in Pub. L. 115–97, title I, section 13206(a), except that the 15-year amortization period that applies to foreign research applies to all research whether conducted within or outside the United States.

(ii) *Character of asset.* The tax book value of the asset created as a result of capitalizing and amortizing specified research or experimental expenditures is apportioned to statutory and residual groupings by first assigning the asset to SIC code categories based on the SIC code categories of the specified research or experimental expenditures used to generate the asset, and then apportioning the tax book value of the asset in proportion to the taxpayer's sales in each statutory and residual grouping in the SIC code group for the taxable year in which the expenditures are or were incurred. The rules in § 1.861–17 (without regard to the exclusive apportionment rule in § 1.861–17(c)) apply for purposes of the preceding sentence.

(iii) *Effect of section 13206(a) of Public Law 115–97, title I.* Beginning with the first taxable year in which the rules in section 13206(a) of Public Law 115–97, title I, for capitalizing specified research or experimental expenditures for Federal income tax purposes become effective, the election in paragraph (k)(1) of this section will no longer apply to research and experimental expenditures incurred in that taxable year and subsequent taxable years, and the general rules for capitalizing and amortizing specified research or experimental expenditures under section 174 will apply instead in determining the tax book value of assets attributable to such expenditures for purposes of apportioning expenses under the asset method.

(3) *Advertising expenditures*—(i) *In general.* A taxpayer making an election under paragraph (k)(1) of this section must capitalize and amortize fifty percent of its specified advertising expenses in each taxable year for purposes of apportioning expenses under the asset method described in paragraph (g) of this section. The share of specified advertising expenses that are charged to the capital account is treated as being amortized ratably over the 10-year period beginning with the midpoint of the taxable year in which such expenses are paid or incurred. The tax book value of the asset created as a result of capitalizing specified advertising expenses is apportioned once, in the taxable year that the expenses are incurred, to the statutory and residual groupings based on the character of the gross income that would be generated by selling products to, or performing services for, the persons to whom the specified advertising expenses are directed, and ratably apportioning the tax book value of the asset based on a reasonable estimate of the number of such persons with respect to each such grouping in such taxable year. Therefore, for example, if 80 percent of specified advertising expenses incurred in Year 1 for promoting Product X relate to advertising viewed by persons within the United States and 20 percent relate to advertising viewed by persons outside the United States, and sales of Product X to persons within the United States would be U.S. source general category income and sales of Product X to persons outside the United States would be foreign source general category income, then for purposes of section 904 as the operative section, 80 percent of the asset is treated as a U.S. source general category asset and 20 percent of the asset is treated as a foreign source general category asset (regardless of the actual amount of sales or gross income generated from product sales in the taxable year). In subsequent years, the amortizable portion of the asset created from specified advertising expenses is treated as being amortized

ratably among the statutory and residual groupings to which the tax book value of the asset was assigned in the taxable year that it was created.

(ii) *Specified advertising expenses.* The term *specified advertising expenses* means any amount paid or incurred in a taxable year (but only to the extent otherwise deductible in such taxable year), for the development, production, or placement (including any form of transmission, broadcast, publication, display, or distribution) of any communication to the general public (or portions thereof) which is intended to promote the taxpayer (or any related person under § 1.861–8(c)(4)) or a trade or business of the taxpayer (or any related person), or any service, facility, or product provided pursuant to such trade or business.

(l) *Applicability dates.* (1) Except as provided in paragraphs (l)(2) and (3) of this section, this section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

(2) Paragraphs (b)(1)(i), (b)(8), and (e)(9) of this section apply to taxable years that end on or after December 16, 2019. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and also end before December 16, 2019, see § 1.861–9T(b)(1)(i) as contained in 26 CFR part 1 revised as of April 1, 2019.

(3) Paragraph (k) of this section applies to taxable years beginning on or after [date final regulations are filed with the **Federal Register**].

■ **Par. 19.** Section 1.861–10 is amended:

■ 1. By adding paragraph (a).

■ 2. By revising paragraphs (e)(8)(v) and (f).

■ 3. By adding paragraphs (g) and (h).

The additions and revisions read as follows:

§ 1.861–10 Special allocations of interest expense.

(a) *In general.* This section applies to all taxpayers and provides exceptions to the rules of § 1.861–9 that require the allocation and apportionment of interest expense on the basis of all assets of all members of the affiliated group. Section 1.861–10T(b) describes the direct allocation of interest expense to the income generated by certain assets that are subject to qualified nonrecourse indebtedness. Section 1.861–10T(c) describes the direct allocation of interest expense to income generated by certain assets that are acquired in an integrated financial transaction. Section 1.861–10T(d) provides special rules that apply to all transactions described in § 1.861–10T(b) and (c). Paragraph (e) of this section requires the direct allocation of third-party interest expense of an affiliated group to such group's investment in related controlled foreign corporations in cases involving excess related person indebtedness (as defined therein). See also § 1.861–9T(b)(5), which requires the direct allocation of amortizable bond premium. Paragraph (f) of this section provides a special rule for certain regulated utility companies. Paragraph (g) of this section requires the direct allocation of interest expense in the case of certain foreign banking branches. Paragraph (h) of this section sets forth applicability dates.

* * * * *

(e) * * *

(8) * * *

(v) *Classification of loans between controlled foreign corporations.* In determining the amount of related group indebtedness for any taxable year, loans outstanding from one controlled foreign corporation to a related controlled foreign corporation are not treated as related group indebtedness. For purposes of determining the foreign base period ratio under paragraph (e)(2)(iv) of this section for a taxable year that ends on or after November 2, 2020, the rules of this paragraph (e)(8)(v) apply to determine the related group debt-to-asset ratio in each taxable year included in the foreign base period, including in taxable years that end before November 2, 2020.

* * * * *

(f) *Indebtedness of certain regulated utilities.* If an automatically excepted regulated utility trade or business (as defined in § 1.163(j)–1(b)(15)(i)(A)) has qualified nonrecourse indebtedness within the meaning of the second sentence in § 1.163(j)–10(d)(2), interest expense from the indebtedness is directly allocated to the taxpayer's assets in the manner and to the extent provided in § 1.861–10T(b).

(g) *Direct allocation of interest expense incurred by foreign banking branches*—(1) *In general.* The foreign banking branch interest expense of a foreign banking branch is directly allocated to the foreign banking branch income of that foreign banking branch, to the extent of the foreign banking branch income. For rules that may apply to foreign banking branch interest expense in excess of amounts allocated under this paragraph (g), see § 1.861–9.

(2) *Adjustments to asset value.* For purposes of applying § 1.861–9 to apportion interest expense in excess of the interest expense directly allocated under paragraph (g)(1) of this section, the value of the assets of the foreign banking branch for the year (as determined under § 1.861–9T(g)(3)) is reduced (but not below zero) by an amount equal to the liabilities of that branch with respect to which the interest expense was directly allocated under paragraph (g)(1) of this section. For purposes of this paragraph (g), the amount of a liability with respect to a foreign currency hedge described in § 1.861–9T(b)(2) or derivative financial product described in § 1.861–9T(b)(6) is zero.

(3) *Definitions.* The following definitions apply for purposes of this paragraph (g).

(i) *Bank.* The term *bank* means a bank, as defined by section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)) without regard to 12 U.S.C. 1841(c)(2)(C) and (G)), that is licensed or otherwise authorized to accept deposits, and accepts deposits in the ordinary course of business.

(ii) *Foreign banking branch.* The term *foreign banking branch* means a foreign branch as defined in § 1.904–4(f)(3), other than a disregarded entity (as defined in § 1.904–4(f)(3)), that is owned by a bank and gives rise to a taxable presence in a foreign country.

(iii) *Foreign banking branch income.* The term *foreign banking branch income* means gross income assigned to foreign branch category income (within the meaning of § 1.904–4(f)(1)) that is attributable to a foreign banking branch. Foreign banking branch income also includes gross income attributable to a foreign banking branch that would be assigned to the foreign branch category but is assigned to a separate category for foreign branch category income that is resourced under an income tax treaty. See § 1.904–4(k).

(iv) *Foreign banking branch interest expense.* The term *foreign banking branch interest expense* means the interest expense that is regarded for Federal income tax purposes and that is recorded on the separate books and records (as defined in § 1.989(a)–1(d)(1) and (2)) of a foreign banking branch.

(v) *Liability.* The term *liability* means a deposit or other debt obligation, transaction, or series of transactions resulting in expense or loss described in § 1.861–9T(b)(1)(i).

(h) *Applicability dates.* Except as provided in this paragraph (h), this section applies to taxable years ending on or after December 4, 2018. Paragraph (e)(8)(v) of this section applies to taxable years ending on or after November 2, 2020, and paragraphs (f) and (g) of this section apply to taxable years beginning on or after [date final regulations are filed with the **Federal Register**].

■ **Par. 20.** Section 1.861–14, as amended in FR Doc. 2020–21819, published elsewhere in this issue of the **Federal**

Register, is further amended by revising paragraphs (h) and (k) to read as follows:

§ 1.861–14 Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations.

* * * * *

(h) *Special rule for the allocation and apportionment of section 818(f)(1) items of a life insurance company*—(1) *In general.* Except as provided in paragraph (h)(2) of this section, life insurance company items specified in section 818(f)(1) (''section 818(f)(1) items'') are allocated and apportioned as if all members of the life subgroup were a single corporation (''life subgroup method''). See also § 1.861–8(e)(16) for rules on the allocation of reserve expenses with respect to dividends received by a life insurance company.

(2) *Alternative separate entity treatment.* A consolidated group may choose not to apply the life subgroup method and may instead allocate and apportion section 818(f)(1) items solely among items of the life insurance company that generated the section 818(f)(1) items (''separate entity method''). A consolidated group indicates its choice to apply the separate entity method by applying this paragraph (h)(2) for purposes of the allocation and apportionment of section 818(f)(1) items on its Federal income tax return filed for its first taxable year to which this section applies. A consolidated group's use of the separate entity method constitutes a binding choice to use the method chosen for that year for all members of the consolidated group and all taxable years of such members thereafter. The taxpayer's choice of a method may not be revoked without the prior consent of the Commissioner.

* * * * *

(k) *Applicability date.* Except as provided in this paragraph (k), this section applies to taxable years beginning after December 31, 2019. Paragraph (h) of this section applies to taxable years beginning on or after [date final regulations are filed with the **Federal Register**].

■ **Par. 21.** Section 1.861–20, as added in FR Doc. 2020–21819, published elsewhere in this issue of the **Federal Register**, is amended:

■ 1. In paragraph (b)(4), by removing the language ''301(c)(3)(A)'' and adding in its place the language ''301(c)(3)(A) or section 731(a)''.

■ 2. By revising paragraphs (b)(7), (19), and (23).

■ 3. By revising the first and second sentences in paragraph (c) introductory text.

■ 4. In paragraph (d)(2)(ii)(B), by adding the text '', and paragraph (d)(3)(ii)(B) of this section for rules regarding the assignment of foreign gross income arising from a distribution by a partnership'' at the end of the paragraph.

■ 5. By adding paragraph (d)(2)(ii)(D).

■ 6. In paragraph (d)(3)(i)(A), by removing the text ''or an inclusion of foreign law pass-through income'' and adding the language '', an inclusion of foreign law pass-through income, or gain from a disposition under both foreign and Federal income tax law'' in its place.

■ 7. By adding paragraphs (d)(3)(i)(D), (d)(3)(ii) and (v), (g)(10) through (13), and (h).

■ 8. By revising paragraph (i).

The additions and revisions read as follows:

§ 1.861–20 Allocation and apportionment of foreign income taxes.

* * * * *

(b) * * *

(7) *Foreign income tax.* The term *foreign income tax* has the meaning provided in § 1.901–2(a).

* * * * *

(19) *U.S. capital gain amount.* The term *U.S. capital gain amount* means gain recognized by a taxpayer on the sale, exchange, or other disposition of stock or an interest in a partnership or, in the case of a distribution with respect to stock or a partnership interest, the portion of the distribution to which section 301(c)(3)(A) or 731(a)(1), respectively, applies. A U.S. capital gain amount includes gain that is subject to section 751 and § 1.751–1, but does not include any portion of the gain recognized by a taxpayer that is included in gross income as a dividend under section 964(e) or 1248.

* * * * *

(23) *U.S. return of capital amount.* The term *U.S. return of capital amount* means, in the case of the sale, exchange, or other disposition of either stock or an interest in a partnership, the taxpayer's adjusted basis of the stock or partnership interest, or in the case of a distribution with respect to stock or a partnership interest, the portion of the distribution to which section 301(c)(2) or 733, respectively, applies.

* * * * *

(c) * * * A foreign income tax (other than certain in lieu of taxes described in paragraph (h) of this section) is allocated and apportioned to the statutory and residual groupings that include the items of foreign gross income included in the base on which the tax is imposed. Each such foreign income tax (that is, each separate levy) is allocated and apportioned separately under the rules in paragraphs (c) through (f) of this section. * * *

* * * * *

(d) * * *

(2) * * *

(ii) * * *

(D) *Foreign law transfers between taxable units.* An item of foreign gross income arising from an event that foreign law treats as a transfer of property, or as giving rise to an item of accrued income, gain, deduction, or loss with respect to a transaction, between taxable units (as defined in paragraph (d)(3)(v)(E) of this section) of the same taxpayer, but that is not treated as a disregarded payment (as defined in paragraph (d)(3)(v)(E) of this section) for Federal income tax purposes in the same U.S. taxable year in which the foreign income tax is paid or accrued, is characterized and assigned to the grouping to which a disregarded payment in the amount of the item of foreign gross income (or the gross receipts giving rise to the item of foreign gross income) would be assigned under the rules of paragraph (d)(3)(v) of this section if the event giving rise to the foreign gross income resulted in a disregarded payment in the U.S. taxable year in which the foreign income tax is paid or accrued. For example, an item of foreign gross income that a taxpayer recognizes by reason of a foreign law distribution (such as a stock dividend or a consent dividend) from a disregarded entity is assigned to the same statutory or residual groupings to which the foreign gross income would be assigned if a distribution of property in the amount of the taxable distribution under foreign law were made for Federal income tax purposes on the date on which the foreign law distribution occurred.

* * * * *

(3) * * *

(i) * * *

(D) *Foreign gross income items arising from a disposition of stock.* An item of foreign gross income that arises from a transaction that is treated as a sale, exchange, or other disposition of stock in a corporation for Federal income tax purposes is assigned first, to the extent of any U.S. dividend amount that results from the disposition, to the same statutory or residual grouping (or ratably to the groupings) to which the U.S. dividend amount is assigned under Federal income tax law. If the foreign gross income item exceeds the U.S.

dividend amount, the foreign gross income item is next assigned, to the extent of the U.S. capital gain amount, to the statutory or residual grouping (or ratably to the groupings) to which the U.S. capital gain amount is assigned under Federal income tax law. Any excess of the foreign gross income item over the sum of the U.S. dividend amount and the U.S. capital gain amount is assigned to the same statutory or residual grouping (or ratably to the groupings) to which earnings equal to such excess amount would be assigned if they were recognized for Federal income tax purposes in the U.S. taxable year in which the disposition occurred. These earnings are deemed to arise in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the stock is (or would be if the taxpayer were a United States person) assigned to the groupings under the asset method in § 1.861–9 in the U.S. taxable year in which the disposition occurs. See paragraph (g)(10) of this section (*Example 9*).

(ii) *Items of foreign gross income included by a taxpayer by reason of its ownership of an interest in a partnership*—(A) *Scope.* The rules of this paragraph (d)(3)(ii) apply to assign to a statutory or residual grouping certain items of foreign gross income that a taxpayer includes in foreign taxable income by reason of its ownership of an interest in a partnership. See paragraphs (d)(1) and (2) of this section for rules that apply in characterizing items of foreign gross income that are attributable to a partner's distributive share of income of a partnership. See paragraph (d)(3)(iii) of this section for rules that apply in characterizing items of foreign gross income that are attributable to an inclusion under a foreign law inclusion regime.

(B) *Foreign gross income items arising from a distribution with respect to an interest in a partnership.* If a partnership makes a distribution that is treated as a distribution of property for both foreign law and Federal income tax purposes, the foreign gross income arising from the distribution (including foreign gross income attributable to a distribution from a partnership that foreign law classifies as a dividend from a corporation) is, to the extent of the U.S. capital gain amount, assigned to the statutory and residual groupings to which the U.S. capital gain amount is assigned under Federal income tax law. If the foreign gross income arising from the distribution exceeds the U.S. capital gain amount, such excess amount is assigned to the statutory and residual groupings to which earnings equal to such excess amount would be assigned if they were recognized in the U.S. taxable year in which the distribution is made. These earnings are deemed to arise in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the partnership interest or the partner's pro rata share of the partnership assets, as applicable, is assigned (or would be assigned if the partner were a United States person) for purposes of apportioning the partner's interest expense under § 1.861–9(e) in the U.S. taxable year in which the distribution is made.

(C) *Foreign gross income items arising from the disposition of an interest in a partnership.* An item of foreign gross income arising from the sale, exchange, or other disposition of an interest in a partnership for Federal income tax purposes is assigned first, to the extent of the U.S. capital gain amount, to the statutory or residual grouping (or ratably to the groupings) to which the U.S. capital gain amount is assigned. Any excess of the foreign gross income item over the U.S. capital gain amount is assigned to the statutory and residual grouping (or ratably to the groupings) to which a distributive share of income of the partnership in the amount of such excess would be assigned if such income was recognized for Federal income tax purposes in the U.S. taxable year in which the disposition occurred. The items constituting this distributive share of income are deemed to arise in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the partnership interest, or the partner's pro rata share of the partnership assets, as applicable, is assigned (or would be assigned if the partner were a United States person) for purposes of apportioning the partner's interest expense under § 1.861–9(e) in the U.S. taxable year in which the disposition occurred.

* * * * *

(v) *Disregarded payments*—(A) *In general.* This paragraph (d)(3)(v) applies to assign to a statutory or residual grouping a foreign gross income item that a taxpayer includes by reason of the receipt of a disregarded payment. In the case of a taxpayer that is an individual or a domestic corporation, this paragraph (d)(3)(v) applies to a disregarded payment made between a taxable unit that is a foreign branch, a foreign branch owner, or a non-branch taxable unit, and another such taxable unit of the same taxpayer. In the case of a taxpayer that is a foreign corporation, this paragraph (d)(3)(v) applies to a disregarded payment made between taxable units that are tested units of the same taxpayer. For purposes of this paragraph (d)(3)(v), an individual or corporation is treated as the taxpayer with respect to its distributive share of foreign income taxes paid or accrued by a partnership, estate, trust or other pass-through entity. The rules of paragraph (d)(3)(v)(B) of this section apply to attribute U.S. gross income comprising the portion of a disregarded payment that is a reattribution payment to a taxable unit, and to associate the foreign gross income item arising from the receipt of the reattribution payment with the statutory and residual groupings to which that U.S. gross income is assigned. The rules of paragraph (d)(3)(v)(C) of this section apply to assign to statutory and residual groupings items of foreign gross income arising from the receipt of the portion of a disregarded payment that is a remittance or a contribution. The rules of paragraph (d)(3)(v)(D) of this section apply to assign to statutory and residual groupings items of foreign gross income arising from disregarded payments in connection with disregarded sales or exchanges of property. Paragraph (d)(3)(v)(E) of this section provides definitions that apply for purposes of this paragraph (d)(3)(v) and paragraph (g) of this section.

(B) *Reattribution payments*—(*1*) *In general.* This paragraph (d)(3)(v)(B) assigns to a statutory or residual grouping a foreign gross income item that a taxpayer includes by reason of the receipt by a taxable unit of the portion of a disregarded payment that is a reattribution payment. The foreign gross income item is assigned to the statutory or residual groupings to which one or more reattribution amounts that constitute the reattribution payment are assigned upon receipt by the taxable unit. If a reattribution payment comprises multiple reattribution amounts and the amount of the foreign gross income item that is attributable to the reattribution payment differs from the amount of the reattribution payment, foreign gross income is apportioned among the statutory and residual groupings in proportion to the reattribution amounts in each statutory and residual grouping. The statutory or residual grouping of a reattribution amount received by a taxable unit is the grouping that includes the U.S. gross income attributed to the taxable unit by reason of its receipt of the gross reattribution amount, regardless of whether, after taking into account disregarded payments made by the taxable unit, the taxable unit has an attribution item as a result of its receipt of the reattribution amount. See paragraph (g)(13) of this section (*Example 12*).

(*2*) *Attribution of U.S. gross income to a taxable unit.* This paragraph (d)(3)(v)(B)(*2*) provides attribution rules to determine the reattribution amounts received by a taxable unit in the statutory and residual groupings in order to apply paragraph (d)(3)(v)(B)(*1*) of this section to assign foreign gross income items arising from a reattribution payment to the groupings. In the case of a taxpayer that is an individual or a domestic corporation, the attribution rules in § 1.904–4(f)(2) apply to determine the reattribution amounts received by a taxable unit in the separate categories (as defined in § 1.904–5(a)(4)(v)) in order to apply paragraph (d)(3)(v)(B)(*1*) of this section for purposes of § 1.904–6(b)(2)(i). In the case of a taxpayer that is a foreign corporation, the attribution rules in § 1.954–1(d)(1)(iii) apply to determine the reattribution amounts received by a taxable unit in the statutory and residual groupings in order to apply paragraph (d)(3)(v)(B)(*1*) of this section for purposes of §§ 1.951A–2(c)(3), 1.954–1(c)(1)(i) and (d)(1)(iv), and 1.960–1(d)(3)(ii). For purposes of other operative sections (as described in § 1.861–8(f)(1)), the principles of § 1.904–4(f)(2)(vi) or § 1.954–1(d)(1)(iii), as applicable, apply to determine the reattribution amounts received by a taxable unit in the statutory and residual groupings. The rules and principles of § 1.904–4(f)(2)(vi) or § 1.954–1(d)(1)(iii), as applicable, apply to determine the extent to which a disregarded payment made by the taxable unit is a reattribution payment and the reattribution amounts that constitute a reattribution payment, and to adjust the U.S. gross income initially attributed to each taxable unit to reflect the reattribution payments that the taxable unit makes and receives. The rules in this paragraph (d)(3)(v)(B)(*2*) limit the amount of a disregarded payment that is a reattribution payment to the U.S. gross income of the payor taxable unit that is recognized in the U.S. taxable year in which the disregarded payment is made.

(*3*) *Effect of reattribution payment on foreign gross income items of payor taxable unit.* The statutory or residual grouping to which an item of foreign gross income of a taxable unit is assigned is determined without regard to reattribution payments made by the taxable unit, and without regard to whether the taxable unit has one or more attribution items after taking into account such reattribution payments. No portion of the foreign gross income of the payor taxable unit is treated as foreign gross income of the payee taxable unit by reason of the reattribution payment, notwithstanding that U.S. gross income of the payor taxable unit that is used to assign foreign gross income of the payor taxable unit to statutory and residual groupings is reattributed to the payee taxable unit under paragraph (d)(3)(v)(B)(*1*) of this section by reason of the reattribution payment. See paragraph (e) of this section for rules reducing the amount of a foreign gross income item of a taxable unit by deductions allowed under foreign law, including deductions by reason of disregarded payments made by a taxable unit that are included in the foreign gross income of the payee taxable unit.

(C) *Remittances and contributions*—(*1*) *Remittances*—(*i*) *In general.* An item of foreign gross income that a taxpayer includes by reason of the receipt of a remittance by a taxable unit is assigned to the statutory or residual groupings of the recipient taxable unit that correspond to the groupings out of which the payor taxable unit made the remittance under the rules of this paragraph (d)(3)(v)(C)(*1*)(*i*). A remittance paid by a taxable unit is considered to be made ratably out of all of the accumulated after-tax income of the taxable unit. The accumulated after-tax income of the taxable unit that pays the remittance is deemed to have arisen in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the assets of the taxable unit are (or would be if the owner of the taxable unit were a United States person) assigned for purposes of apportioning interest expense under the asset method in § 1.861–9 in the taxable year in which the remittance is made. See paragraph (g)(11) and (12) of this section (*Example 10* and *11*). If the payor taxable unit is determined to have no assets under paragraph (d)(3)(v)(C)(*1*)(*ii*) of this section, then the foreign gross income that is included by reason of the receipt of the remittance is assigned to the residual grouping.

(*ii*) *Assets of a taxable unit.* The assets of a taxable unit are determined in accordance with § 1.987–6(b), except that for purposes of applying § 1.987–6(b)(2) under this paragraph (d)(3)(v)(C)(*1*)(*ii*), a taxable unit is deemed to be a section 987 QBU (within the meaning of § 1.987–1(b)(2)) and assets of the taxable unit include stock held by the taxable unit and the portion of the tax book value of a reattribution asset that is assigned to the taxable unit. The portion of the tax book value of a reattribution asset that is assigned to a taxable unit is an amount that bears the same ratio to the total tax book value of the reattribution asset as the sum of the attribution items of that taxable unit arising from gross income produced by the reattribution asset bears to the total gross income produced by the reattribution asset. The portion of a reattribution asset that is assigned to a taxable unit under this paragraph (d)(3)(v)(C)(*1*)(*ii*) is not treated as an asset of the taxable unit making the reattribution payment for purposes of applying paragraph (d)(3)(v)(C)(*1*)(*i*) of this section.

(*2*) *Contributions.* An item of foreign gross income that a taxpayer includes by reason of the receipt of a contribution by a taxable unit is assigned to the residual grouping. See, however, § 1.904–6(b)(2)(ii) (assigning certain items of foreign gross income to the foreign branch category for purposes of applying section 904 as the operative section).

(*3*) *Disregarded payment that comprises both a reattribution payment and a remittance or contribution.* If both a reattribution payment and either a remittance or a contribution result from a single disregarded payment, the foreign gross income is first attributed to the portion of the disregarded payment that is a reattribution payment to the extent of the amount of the reattribution payment, and any excess of the foreign gross income item over the amount of the reattribution payment is then to attributed to the portion of the disregarded payment that is a remittance or contribution.

(D) *Disregarded payments in connection with disregarded sales or exchanges of property.* An item of foreign gross income attributable to gain recognized under foreign law by reason of a disregarded payment received in exchange for property is characterized and assigned under the rules of paragraph (d)(2) of this section. If a taxpayer recognizes U.S. gross income as a result of a disposition of property that was previously received in exchange for a disregarded payment, any item of foreign gross income that the taxpayer recognizes as a result of that same disposition is assigned to a statutory or residual grouping under paragraph (d)(1) of this section, without regard to any reattribution of the U.S. gross income under § 1.904–4(f)(2)(vi)(A) (or the principles of § 1.904–4(f)(2)(vi)(A)) by reason of a disregarded payment described in § 1.904–4(f)(2)(vi)(B)(*2*) (or by reason of § 1.904–4(f)(2)(vi)(D)). See paragraph (d)(3)(v)(B)(*3*) of this section.

(E) *Definitions.* The following definitions apply for purposes of this paragraph (d)(3)(v) and paragraph (g) of this section.

(*1*) *Attribution item.* The term *attribution item* means the portion of an item of gross income, computed under Federal income tax law, that is attributed to a taxable unit after taking into account all reattribution payments made and received by the taxable unit.

(*2*) *Contribution.* The term *contribution* means:

(*i*) A transfer of property (within the meaning of section 317(a)) to a taxable unit that is disregarded for Federal income tax purposes and that would be treated as a contribution to capital described in section 118 or a transfer described in section 351 if the taxable unit were a corporation under Federal income tax law; or

(*ii*) The excess of a disregarded payment made by a taxable unit to another taxable unit that the first taxable unit owns over the portion of the disregarded payment that is a reattribution payment.

(*3*) *Disregarded entity.* The term *disregarded entity* means an entity described in § 301.7701–2(c)(2) of this chapter that is disregarded as an entity separate from its owner for Federal income tax purposes.

(*4*) *Disregarded payment.* The term *disregarded payment* means an amount of property (within the meaning of section 317(a)) that is transferred to or from a taxable unit, including a payment 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 Federal income tax purposes and that is reflected on the separate set of books and records of the taxable unit. A disregarded payment also includes any other amount that is reflected on the separate set of books and records of a taxable unit in connection with a transaction that is disregarded for Federal income tax purposes and that would constitute an item of accrued income, gain, deduction, or loss of the taxable unit if the transaction to which the amount is attributable were regarded for Federal income tax purposes.

(*5*) *Reattribution amount.* The term *reattribution amount* means an amount of gross income, computed under Federal income tax law, that is initially assigned to a single statutory or residual grouping that includes gross income of a taxable unit but that is, by reason of a disregarded payment made by that taxable unit, attributed to another taxable unit under paragraph (d)(3)(v)(B)(*2*) of this section.

(*6*) *Reattribution asset.* The term *reattribution asset* means an asset that produces one or more items of gross income, computed under Federal income tax law, to which a disregarded payment is allocated under the rules of paragraph (d)(3)(v)(B)(*2*) of this section.

(*7*) *Reattribution payment.* The term *reattribution payment* means the portion of a disregarded payment equal to the sum of all reattribution amounts that are attributed to the recipient of the disregarded payment.

(*8*) *Remittance.* The term *remittance* means:

(*i*) A transfer of property (within the meaning of section 317(a)) by a taxable unit that would be treated as a distribution by a corporation to a shareholder with respect to its stock if the taxable unit were a corporation under Federal income tax law; or

(*ii*) The excess of a disregarded payment made by a taxable unit to a second taxable unit (including a second taxable unit that shares the same owner as the payor taxable unit) over the portion of the disregarded payment that is a reattribution payment, other than an amount that is treated as a contribution under paragraph (d)(3)(v)(E)(*2*)(*i*) of this section.

(*9*) *Taxable unit.* In the case of a taxpayer that is an individual or a domestic corporation, the term *taxable unit* means a foreign branch, a foreign branch owner, or a non-branch taxable unit, as defined in § 1.904–6(b)(2)(i)(B). In the case of a taxpayer that is a foreign corporation, the term *taxable unit* means a tested unit, as defined in § 1.954–1(d)(2).

* * * * *

(g) * * *

(10) *Example 9: Gain on disposition of stock*—(i) *Facts.* USP owns all of the outstanding stock of CFC, which conducts business in Country A. In Year 1, USP sells all of the stock of CFC to US2 for $1,000x. For Country A tax purposes, USP's basis in the stock of CFC is $200x. Accordingly, USP recognizes $800x of gain on which Country A imposes $80x of foreign income tax based on its rules for taxing capital gains of nonresidents. For Federal income tax purposes, USP's basis in the stock of CFC is $400x. Accordingly, USP recognizes $600x of gain on the sale of the stock of CFC, of which $150x is included in the gross income of USP as a dividend under section 1248(a) that, as provided in section 1248(j), is treated as a dividend eligible for the deduction under section 245A(a). Under paragraphs (b)(20) and (19) of this section, respectively, the sale of CFC stock by USP gives rise to a $150x U.S. dividend amount and a $450x U.S. capital gain amount. Under §§ 1.904–4(d) and 1.904–5(c)(4), the $150x U.S. dividend amount is general category section 245A subgroup income, and the $450x U.S. capital gain amount is passive category income to USP. For purposes of allocating and apportioning its interest expense under §§ 1.861–9(g)(2)(i)(B) and 1.861–13, USP's stock in CFC is characterized as general category stock in the section 245A subgroup.

(ii) *Analysis.* For purposes of allocating and apportioning the $80x of Country A foreign income tax, the $800x of Country A gross income from the sale of the stock of CFC is first assigned to separate categories. Under paragraph (d)(3)(i)(D) of this section, the $800x of Country A gross income is first assigned to the separate category to which the $150x U.S. dividend amount is assigned, to the extent thereof, and is next assigned to the separate category to which the $450x U.S. capital gain amount is assigned, to the extent thereof. Accordingly, $150x of Country A gross income is assigned to the general category in the section 245A subgroup, and $450x of Country A gross income is assigned to the passive category. Under paragraph (d)(3)(i)(D) of this section, the remaining $200x of Country A gross income is assigned to the statutory and residual groupings to which earnings of CFC in that amount would be assigned if they were recognized for Federal income tax purposes in the U.S. taxable year in which the disposition occurred. These earnings are all deemed to arise in the section 245A subgroup of the general category, based on USP's characterization of its stock in CFC. Thus, under paragraph (d)(3)(i)(D) of this section the $800x of foreign gross income, and therefore the foreign taxable income, is characterized as $350x ($150x + $200x) of income in the general category section 245A subgroup and $450x of income in the passive category. This is the result even though for Country A tax purposes all $800x of Country A gross income is characterized as gain from the sale of stock, which would be passive category income under section 904(d)(2)(B)(i), because the income is assigned to a separate category based on the characterization of the gain under Federal income tax law. Under paragraph (f) of this section, the $80x of Country A tax is ratably apportioned between the general category section 245A subgroup and the passive category based on the relative amounts of foreign taxable income in each grouping. Accordingly, $35x ($80x

× $350x / $800x) of the Country A tax is apportioned to the general category section 245A subgroup, and $45x ($80x × $450x / $800x) of the Country A tax is apportioned to the passive category. See also § 1.245A(d)–1 for rules that may disallow a foreign tax credit or deduction for the $35x of Country A tax apportioned to the general category section 245A subgroup.

(11) *Example 10: Disregarded transfer of built-in gain property*—(i) *Facts.* USP owns FDE, a disregarded entity that is treated for Federal income tax purposes as a foreign branch operating in Country A. FDE transfers Asset F, equipment used in FDE's trade or business in Country A, for no consideration to USP in a transaction that is a remittance described in paragraph (d)(3)(v)(E)(*8*)(*i*) of this section for Federal income tax purposes but is treated as a distribution of Asset F from a corporation to its shareholder, USP, for Country A tax purposes. At the time of the transfer, Asset F has a fair market value of $250x and an adjusted basis of $100x for both Federal and Country A income tax purposes. Country A imposes $30x of tax on FDE with respect to the $150x of built-in gain on a deemed sale of Asset F, which is recognized for Country A tax purposes by reason of the transfer to USP. If FDE had sold Asset F for $250x in a transaction that was regarded for Federal income tax purposes, FDE would also have recognized gain of $150x for Federal income tax purposes, and that gain would have been characterized as foreign branch category income as defined in § 1.904–4(f). Country A also imposes $25x of withholding tax, a separate levy, on USP by reason of the distribution of Asset F, valued at $250x, to USP.

(ii) *Analysis*—(A) *Net income tax on built-in gain.* For purposes of allocating and apportioning the $30x of Country A foreign income tax imposed on FDE by reason of the deemed sale of Asset F for Country A tax purposes, under paragraph (c)(1) of this section the $150x of Country A gross income from the deemed sale of Asset F is first assigned to a separate category. Because the transaction is disregarded for Federal income tax purposes, there is no corresponding U.S. item. However, FDE would have recognized gain of $150x, which would have been a corresponding U.S. item, if the deemed sale had been recognized for Federal income tax purposes. Therefore, under paragraph (d)(2)(i) of this section, the item of foreign gross income is characterized and assigned to the grouping to which such corresponding U.S. item would have been assigned if the deemed sale were recognized under Federal income tax law. Because the sale of Asset F in a regarded transaction would have resulted in foreign branch category income, the foreign gross income is characterized as foreign branch category income. Under paragraph (f) of this section, the $30x of Country A tax is also allocated to the foreign branch category, the statutory grouping to which the $150x of Country A gross income is assigned. No apportionment of the $30x is necessary because the class of gross income to which the foreign gross income is allocated consists entirely of a single statutory grouping, foreign branch category income.

(B) *Withholding tax on distribution.* For purposes of allocating and apportioning the $25x of Country A withholding tax imposed on USP by reason of the transfer of Asset F, under paragraph (c)(1) of this section the $250x of Country A gross income from the distribution of Asset F is first assigned to a separate category. The transfer of Asset F is a remittance from FDE to USP, and thus there is no corresponding U.S. item. Under paragraph (d)(3)(v)(C)(*1*)(*i*) of this section, the item of foreign gross income is assigned to the groupings to which the income out of which the payment is made is assigned; the payment is considered to be made ratably out of all of the accumulated after-tax income of FDE, as computed for Federal income tax purposes; and the accumulated after-tax income of FDE is deemed to have arisen in the statutory and residual groupings in the same proportions as those in which the tax book value of FDE's assets in the groupings, determined in accordance with paragraph (d)(3)(v)(C)(*1*)(*ii*) of this section, are assigned for purposes of apportioning USP's interest expense. Because all of FDE's assets produce foreign branch category income, under paragraph (d)(3)(v)(C)(*1*) of this section the foreign gross income is characterized as foreign branch category income. Under paragraph (f) of this section, the $25x of Country A withholding tax is also allocated entirely to the foreign branch category, the statutory grouping to which the $250x of Country A gross income is assigned. No apportionment of the $25x is necessary because the class of gross income to which the foreign gross income is allocated consists entirely of a single statutory grouping, foreign branch category income.

(12) *Example 11: Disregarded payment that is a remittance*—(i) *Facts.* USP owns all of the outstanding stock of CFC1. CFC1, a tested unit within the meaning of § 1.954–1(d)(2) (the ''CFC1 tested unit''), owns all of the interests in FDE, a disregarded entity that is organized in Country B. CFC1's interests in FDE are also a tested unit within the meaning of § 1.954–1(d)(2) (the ''FDE tested unit''). The sole assets of FDE (determined in accordance with paragraph (d)(3)(v)(C)(*1*)(*ii*) of this section) consist of all of the outstanding stock of CFC3, a controlled foreign corporation organized in Country B. In Year 1, CFC3 pays a $400x dividend to FDE that is excluded from CFC1's foreign personal holding company income (''FPHCI'') by reason of section 954(c)(6). FDE makes no payments to CFC1 and pays no Country B tax in Year 1. In Year 2, FDE makes a $400x payment to CFC1 that is a remittance (as defined in paragraph (d)(3)(v)(E) of this section). Under the laws of Country B, the remittance gives rise to a $400x dividend. Country B imposes a 5% ($20x) withholding tax (which is an eligible current year tax as defined in § 1.960–1(b)) on CFC1 on the dividend. In Year 2, CFC3 pays no dividends to FDE, and FDE earns no income. For Federal income tax purposes, the $400x payment from FDE to CFC1 is a disregarded payment and results in no income to CFC1. For purposes of this paragraph (g)(12) (*Example 11*), section 960(a) is the operative section and the income groups described in § 1.960–1(d)(2) are the statutory and residual groupings. See § 1.960–1(d)(3)(ii)(A) (applying § 1.960–1 to allocate and apportion current year taxes to income groups). For Federal income tax purposes, in Year 2 the stock of CFC3 owned by FDE has a tax book value of $1,000x, $750x of which is assigned under the asset method in § 1.861–9 (as applied by treating CFC1 as a United States person) to the general category tested income group described in § 1.960–1(d)(2)(ii)(C), and $250x of which is assigned to a passive category FPHCI group described in § 1.960–1(d)(2)(ii)(B)(*2*)(*i*).

(ii) *Analysis.* (A) The $20x Country B withholding tax on the remittance from FDE is imposed on a $400x item of foreign gross income that CFC1 includes in income by reason of its receipt of a disregarded payment. In order to allocate and apportion the $20x of Country B withholding tax under paragraph (c) of this section for purposes of § 1.960–1(d)(3)(ii)(A), paragraph (d)(3)(v) of this section applies to assign the $400x item of foreign gross dividend income to a statutory or residual grouping. Under paragraph (d)(3)(v)(C)(*1*) of this section, the $400x item of foreign gross income is assigned to the statutory or residual groupings that include the U.S. gross income that is attributable to the CFC1 tested unit under the attribution rules in § 1.954–1(d)(1)(iii) and that correspond to the statutory and residual groupings out of which FDE made the remittance.

(B) Under paragraph (d)(3)(v)(C)(*1*)(*i*) of this section, FDE is considered to pay the remittance ratably out of all of its accumulated after-tax income, which is deemed to have arisen in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of FDE's assets would be assigned (if CFC1 were a United States person) for purposes of apportioning interest expense under the asset method in Year 2, the taxable year in which FDE made the remittance. Accordingly, $300x ($400x × $750x / $1,000x) of the remittance is deemed to be made out of the general category tested income of the FDE tested unit, and $100x ($400x × $250x / $1,000x) of the remittance is deemed to be made out of the passive category FPHCI of the FDE tested unit.

(C) Under paragraph (d)(3)(v)(C)(*1*)(*i*) of this section, $300x of the $400x item of foreign gross income from the remittance, and therefore an equal amount of foreign taxable income, is assigned to the income group that includes general category tested income attributable to the CFC1 tested unit, and $100x of this foreign gross income item, and therefore an equal amount of foreign taxable income, is assigned to the income group that includes passive category FPHCI attributable to the CFC1 tested unit. Under paragraph (f) of this section, the $20x of Country B withholding tax is ratably apportioned between the income groups based on the relative amounts of foreign taxable income in each grouping. Accordingly, $15x ($20x × $300x / $400x) of the Country B withholding tax is apportioned to the income group that includes general category tested income attributable to the CFC1 tested unit, and $5x ($20x × $100x / $400x) of the Country B withholding tax is apportioned to the income group that includes passive category FPHCI attributable to the CFC1 tested unit. See § 1.960–2 for rules on determining the amount of such taxes that may be deemed paid under section 960(a) and (d).

(13) *Example 12: Disregarded payment that is a reattribution payment*—(i) *Facts.* (A) USP owns all of the outstanding stock of CFC1, a tested unit within the meaning of § 1.954–1(d)(2) (the ''CFC1 tested unit''). CFC1 owns all of the interests in FDE1, a disregarded entity organized in Country B. CFC1's interests in FDE1 are also a tested unit within the meaning of § 1.954–1(d)(2) (the ''FDE1 tested unit''). Country B imposes a 20 percent net income tax on its residents. CFC1 also owns all of the interests in FDE2, a disregarded entity organized in Country C. CFC1's interests in FDE2 are also a tested unit within the meaning of § 1.954–1(d)(2) (the ''FDE2 tested unit''). Country C imposes a 15 percent net income tax on its residents. Each of the taxes imposed by Countries B and C is a foreign income tax within the meaning of § 1.901–2(a) and a separate levy within the meaning of § 1.901–2(d). For purposes of this paragraph (g)(13) (*Example 12*), the operative section is the high-tax exception of § 1.954–1(d), and the statutory groupings are the general gross item groupings of each tested unit, as defined in § 1.954–1(d)(1)(ii)(A).

(B) FDE2 owns Asset A, which is intangible property that has a tax book value of $10,000x and is properly reflected on the separate set of books and records of FDE2. In Year 1, pursuant to a license agreement between FDE1 and FDE2 for the use of Asset A, FDE1 makes a disregarded royalty payment to FDE2 of $1,000x that would be a deductible royalty payment if regarded for Federal income tax purposes. Because it is disregarded for Federal income tax purposes, the $1,000x disregarded royalty payment by FDE1 to FDE2 results in no income to CFC1 for Federal income tax purposes. Also in Year 1, pursuant to a sub-license agreement between FDE1 and a third party for the use of Asset A, FDE1 earns $1,000x of royalty income for Federal income tax purposes (the ''U.S. gross royalty'') that is gross tested income (as defined in § 1.951A–2(c)(1)) and properly reflected on the separate set of books and records of FDE1.

(C) Under the laws of Country B, the transaction that gives rise to the $1,000x item of U.S. gross royalty income causes FDE1 to include a $1,200x item of gross royalty income in its Country B taxable income (the ''Country B gross royalty''). In addition, FDE1 deducts its $1,000x disregarded royalty payment to FDE2 for Country B tax purposes. For Country B tax purposes, FDE1 therefore has $200x ($1,200x − $1,000x) of taxable income on which Country B imposes $40x (20% × $200x) of net income tax.

(D) Under the laws of Country C, the $1,000x disregarded royalty payment from FDE1 to FDE2 causes FDE2 to include a $1,000x item of gross royalty income in its Country C taxable income (the ''Country C gross royalty''). FDE2 makes no deductible payments under the laws of Country C. For Country C tax purposes, FDE2 therefore has $1,000x of taxable income on which Country C imposes $150x (15% × $1,000x) of net income tax.

(ii) *Analysis*—(A) *Country B net income tax.* (*1*) The Country B net income tax is imposed on foreign taxable income of FDE1 that consists of a $1,200x item of Country B gross royalty income and a $1,000x item of royalty expense. For Federal income tax purposes, the FDE1 tested unit has a $1,000x item of U.S. gross royalty income that is initially attributable to it under paragraph (d)(3)(v)(B)(*2*) of this section and § 1.954–1(d)(1)(iii). The transaction that produced the $1,000x item of U.S. gross royalty income also produced the $1,200x item of Country B gross royalty income. Under paragraph (b)(2) of this section, the $1,000x item of U.S. gross royalty income is therefore the corresponding U.S. item for the $1,200x item of Country B gross royalty income of FDE1.

(*2*) The $1,000x disregarded royalty payment from FDE1 to FDE2 is allocated under paragraph (d)(3)(v)(B)(*2*) of this section and § 1.954–1(d)(1)(iii) to the $1,000x of U.S. gross income of the FDE1 tested unit to the extent of that gross income. As a result, the $1,000x disregarded royalty payment causes the $1,000x item of U.S. gross royalty income to be reattributed from the FDE1 tested unit to the FDE2 tested unit, and results in a $1,000x reattribution amount that is also a reattribution payment.

(*3*) The $1,200x Country B gross royalty item that is included in the Country B taxable income of FDE1 is assigned under paragraph (d)(1) of this section to the statutory or residual grouping to which the $1,000x corresponding U.S. item is initially assigned under § 1.954–1(d)(1)(iii), namely, the general gross item grouping of the FDE1 tested unit. This assignment is made without regard to the $1,000x reattribution payment from the FDE1 tested unit to the FDE2 tested unit or to the fact that the FDE1 tested unit has no attribution item arising from its $1,000x item of U.S. gross royalty income, which is all reattributed to the FDE2 tested unit; none of the FDE1 tested unit's $1,200x Country B gross royalty income is reattributed to the FDE2 tested unit for this purpose. See paragraph (d)(3)(v)(B)(*3*) of this section. Under paragraph (f) of this section, all of the $40x of Country B net income tax is allocated to the general gross item group of the FDE1 tested unit, the statutory grouping to which the $1,200x item of Country B gross royalty income of FDE1 is assigned. No apportionment of the $40x is necessary because the class of gross income to which the foreign gross income is allocated consists entirely of a single statutory grouping.

(B) *Country C net income tax.* The Country C net income tax is imposed on foreign taxable income of FDE2 that consists of a $1,000x item of Country C gross royalty income. For Federal income tax purposes, under paragraph (d)(3)(v)(B)(*2*) of this section and § 1.954–1(d)(1)(iii), the FDE2 tested unit has a reattribution amount of $1,000x of U.S. gross royalty income by reason of its receipt of the $1,000x reattribution payment from FDE1. The $1,000x item of U.S. gross royalty income that is included in the taxable income of the FDE2 tested unit by reason of the $1,000x reattribution payment is assigned under paragraph (d)(3)(v)(B)(*1*) of this section to the statutory or residual grouping to which the $1,000x reattribution amount of U.S. gross royalty income that constitutes the reattribution payment is assigned upon receipt by the FDE2 tested unit under § 1.954–1(d)(1)(iii), namely, the general gross item group of the FDE2 tested unit. Under paragraph (d)(3)(v)(B)(*1*) of this section, the $1,000x item of Country C gross royalty income is assigned to the statutory grouping to which the $1,000x corresponding U.S. item is assigned. Accordingly, under paragraph (f) of this section, all of the $150x of Country C net income tax is allocated to the general gross item group of the FDE2 tested unit, the statutory grouping to which the $1,000x item of Country C gross royalty income of FDE2 is assigned. No apportionment of the $150x is necessary because the class of gross income to which the foreign gross income is allocated consists entirely of a single statutory grouping.

(h) *Allocation and apportionment of certain foreign in lieu of taxes described in section 903.* A tax that is a foreign income tax by reason of § 1.903–1(c)(1) is allocated and apportioned to statutory and residual groupings in the same proportions as the foreign taxable income that comprises the excluded income (as defined in § 1.903–1(c)(1)). See paragraph (f) of this section for rules on allocating and apportioning certain withholding taxes described in § 1.903–1(c)(2).

(i) *Applicability date.* Except as provided in this paragraph (i), this section applies to taxable years beginning after December 31, 2019. Paragraphs (b)(19) and (23) and (d)(3)(i), (ii), and (v) of this section apply to taxable years that begin after December 31, 2019, and end on or after November 2, 2020. Paragraph (h) of this section applies to taxable years beginning after [date final regulations are filed with the **Federal Register**].

■ **Par. 22.** Section 1.901–1 is amended:

■ 1. By revising the section heading and paragraphs (a) through (d).

■ 2. In paragraph (e), by removing the language ''a husband and wife'' and adding the language ''spouses'' in its place.

■ 3. By revising paragraphs (f) and (h)(1).

■ 4. By removing paragraph (h)(2).

■ 5. By redesignating paragraph (h)(3) as paragraph (h)(2).

■ 6. By revising the heading and second sentence in paragraph (j).

The revisions and additions read as follows:

§ 1.901–1 Allowance of credit for foreign income taxes.

(a) *In general.* Citizens of the United States, domestic corporations, certain aliens resident in the United States or Puerto Rico, and certain estates and trusts may choose to claim a credit, as provided in section 901, against the tax imposed by chapter 1 of the Internal Revenue Code (Code) for certain taxes paid or accrued to foreign countries and possessions of the United States, subject to the conditions prescribed in this section.

(1) *Citizen of the United States.* An individual who is a citizen of the United States, whether resident or nonresident, may claim a credit for—

(i) The amount of any foreign income taxes, as defined in § 1.901–2(a), paid or accrued (as the case may be, depending on the individual's method of accounting for such taxes) during the taxable year;

(ii) The individual's share of any such taxes of a partnership of which the individual is a member, or of an estate or trust of which the individual is a beneficiary; and

(iii) In the case of an individual who has made an election under section 962, the taxes deemed to have been paid under section 960 (see § 1.962–1(b)(2)).

(2) *Domestic corporation.* A domestic corporation may claim a credit for—

(i) The amount of any foreign income taxes, as defined in § 1.901–2(a), paid or accrued (as the case may be, depending on the corporation's method of accounting for such taxes) during the taxable year;

(ii) The corporation's share of any such taxes of a partnership of which the corporation is a member, or of an estate or trust of which the corporation is a beneficiary; and

(iii) The taxes deemed to have been paid under section 960.

(3) *Alien resident of the United States or Puerto Rico.* Except as provided in a Presidential proclamation described in section 901(c), an individual who is a resident alien of the United States (as defined in section 7701(b)), or an individual who is a bona fide resident of Puerto Rico (as defined in section 937(a)) during the entire taxable year, may claim a credit for—

(i) The amount of any foreign income taxes, as defined in § 1.901–2(a), paid or accrued (as the case may be, depending on the individual's method of accounting for such taxes) during the taxable year;

(ii) The individual's share of any such taxes of a partnership of which the individual is a member, or of an estate or trust of which the individual is a beneficiary; and

(iii) In the case of an individual who has made an election under section 962, the taxes deemed to have been paid under section 960 (see § 1.962–1(b)(2)).

(4) *Estates and trusts.* An estate or trust may claim a credit for:

(i) The amount of any foreign income taxes, as defined in § 1.901–2(a), paid or accrued (as the case may be, depending on the estate or trust's method of accounting for such taxes) during the taxable year to the extent not allocable to and taken into account by its beneficiaries under paragraph (a)(1)(ii), (a)(2)(ii), or (a)(3)(ii) of this section (see section 642(a)); and

(ii) In the case of an estate or trust that has made an election under section 962, the taxes deemed to have been paid under section 960 (see § 1.962–1(b)(2)).

(b) *Limitations.* Certain Code sections, including sections 245A(d) and (e)(3), 814, 901(e) through (m), 904, 906, 907, 908, 909, 911, 965(g), 999, and 6038, reduce, defer, or otherwise limit the credit against the tax imposed by chapter 1 of the Code for certain amounts of foreign income taxes.

(c) *Deduction denied if credit claimed*—(1) *In general.* Except as provided in paragraphs (c)(2) and (3) of this section, if a taxpayer chooses with respect to any taxable year to claim a foreign tax credit to any extent, such choice will be considered to apply to all of the foreign income taxes paid or accrued (as the case may be, depending on the taxpayer's method of accounting for such taxes) in such taxable year, and no portion of any such taxes is allowed as a deduction from gross income in any taxable year. See section 275(a)(4).

(2) *Exception for taxes not subject to section 275.* Foreign income taxes for which a credit is disallowed and to which section 275 does not apply may be allowed as a deduction under section 164(a)(3). See, for example, sections 901(f), 901(j)(3), 901(k)(7), 901(l)(4), 901(m)(6), and 908(b). For rules on the year in which a deduction for foreign income taxes is allowed under section

164(a)(3), see §§ 1.446–1(c)(1)(ii), 1.461–2(a)(2), and 1.461–4(g)(6)(iii)(B).

(3) *Exception for additional taxes paid by an accrual basis taxpayer that relate to a prior year for which the taxpayer deducted foreign income taxes.* In a taxable year in which a taxpayer chooses to claim a credit for foreign income taxes accrued in that year (including a cash method taxpayer who has made an election under section 905(a) to claim credits in the year the taxes accrue), additional foreign income taxes that are finally determined and paid as a result of a foreign tax redetermination in that taxable year may be claimed as a deduction in such taxable year, if the additional foreign income taxes relate to a prior taxable year in which the taxpayer chose to claim a deduction, rather than a credit, for foreign income taxes paid or accrued (as the case may be, depending on the taxpayer's overall method of accounting) in that prior year.

(4) *Example.* The following example illustrates the application of paragraph (c)(3) of this section.

(i) *Facts.* USC is a domestic corporation that is engaged in a trade or business in Country X through a branch. USC uses an accrual method of accounting and uses the calendar year as its taxable year for U.S. and Country X tax purposes. For taxable years 1 through 3, USC chooses to deduct foreign income taxes, including Country X income taxes, for Federal income tax purposes in the U.S. taxable year in which the taxes accrue. In years 4 through 6, USC chooses to claim a credit under section 901 for foreign income taxes that accrued in those years. In year 6, USC pays an additional $50x in tax to Country X with respect to year 1 as a result of a Country X tax audit.

(ii) *Analysis.* The additional $50x of Country X tax for year 1 that is paid by USC in year 6 cannot be claimed as a deduction on an amended return for year 1, because those taxes did not accrue until year 6. See section 461(f) (flush language); §§ 1.461–1(a)(2)(i) and 1.461–2(a)(2). In addition, because the additional $50x of Country X tax liability relates to and is considered to accrue in year 1 for foreign tax credit purposes, USC cannot claim a credit for the $50x on its Federal income tax return for year 6. See § 1.905–1(d)(1). However, pursuant to paragraph (c)(3) of this section, USC can claim a deduction for the additional $50x of year 1 Country X tax on its Federal income tax return for year 6, in addition to claiming a credit for foreign income taxes that accrued in year 6.

(d) *Period during which election can be made or changed*—(1) *In general.* The taxpayer may, for a particular taxable year, elect to claim the benefits of section 901 (or claim a deduction in lieu of electing a foreign tax credit) at any time before the expiration of the period within which a claim for credit or refund of Federal income tax for such taxable year that is attributable to such credit or deduction, as the case may be, may be made or, if longer, the period prescribed by section 6511(c) if the refund period for that taxable year is extended by an agreement to extend the assessment period under section 6501(c)(4). Thus, an election to claim a credit for foreign income taxes paid or accrued (as the case may be, depending on the taxpayer's method of accounting for such taxes) in a particular taxable year can be made within the period prescribed by section 6511(d)(3)(A) for claiming a credit or refund of Federal income tax for that taxable year that is attributable to a credit for the foreign income taxes paid or accrued in that particular taxable year or, if longer, the period prescribed by section 6511(c) with respect to that particular taxable year. A choice to claim a deduction under section 164(a)(3), rather than a credit, for foreign income taxes paid or accrued in a particular taxable year can be made within the period prescribed by section 6511(a) or 6511(c), as applicable, for claiming a credit or refund of Federal income tax for that particular taxable year.

(2) *Manner in which election is made or changed.* A taxpayer claims a deduction or elects to claim a credit for foreign income taxes paid or accrued in a particular taxable year by filing an original or amended return for that taxable year within the relevant period specified in paragraph (d)(1) of this section. A claim for credit shall be accompanied by Form 1116 in the case of an individual, estate or trust, and by Form 1118 in the case of a corporation (and an individual, estate or trust making an election under section 962). See §§ 1.905–3 and 1.905–4 for rules requiring the filing of amended returns for all affected years when a timely change in the taxpayer's election results in U.S. tax deficiencies.

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(f) *Taxes against which credit not allowed.* The credit for foreign income taxes is allowed only against the tax imposed by chapter 1 of the Code, except that it is not allowed against tax that, under section 26(b)(2), is treated as a tax not imposed under such chapter.

* * * * *

(h) * * *

(1) Except as provided in paragraphs (c)(2) and (3) of this section, a taxpayer who deducts foreign income taxes paid or accrued (as the case may be, depending on the taxpayer's method of accounting for such taxes) for that taxable year (see sections 164 and 275); and

* * * * *

(j) *Applicability date.* * * * This section applies to foreign taxes paid or accrued in taxable years beginning on or after [date final regulations are filed with the **Federal Register**].

■ **Par. 23.** Section 1.901–2 is amended:

■ 1. By revising paragraphs (a) heading and (a)(1).

■ 2. By removing the undesignated paragraph following paragraph (a)(1).

■ 3. By revising paragraphs (a)(3), (b) heading, (b)(1), (b)(2) heading, and (b)(2)(i).

■ 4. By removing the undesignated paragraph following paragraph (b)(2)(i) and paragraph (b)(2)(ii).

■ 5. By redesignating paragraphs (b)(2)(iii) and (iv) as paragraphs (b)(2)(ii) and (iii), respectively.

■ 6. By revising paragraphs (b)(3), (b)(4) heading, and (b)(4)(i).

■ 7. By removing the undesignated paragraph following paragraph (b)(4)(i).

■ 8. By revising paragraph (b)(4)(iv).

■ 9. By adding paragraph (b)(5).

■ 10. By revising paragraphs (c) and (d)(1).

■ 11. By removing the last sentence of paragraph (d)(2).

■ 12. By revising paragraphs (e) heading, (e)(1), and (e)(2)(i).

■ 13. By redesignating paragraph (e)(2)(ii) as paragraph (e)(2)(iv).

■ 14. By adding a new paragraph (e)(2)(ii) and paragraph (e)(2)(iii).

■ 15. By removing the undesignated sentence after paragraph (e)(3)(iii)(C) and paragraph (e)(3)(v).

■ 16. By revising paragraphs (e)(4) and (e)(5)(i).

■ 17. By redesignating paragraph (e)(5)(ii) as paragraph (e)(5)(iii).

■ 18. By adding a new paragraph (e)(5)(ii) and paragraph (e)(6).

■ 19. In paragraph (f)(3)(ii)(A), by removing the language "§ 1.909–2T(b)(2)(vi)" and adding the language "§ 1.909–2(b)(2)(vi)" in its place.

■ 20. In paragraph (f)(3)(iii)(B)(*2*), by removing the language "§ 1.909–2T(b)(3)(i)" and adding the language "§ 1.909–2(b)(3)(i)" in its place.

■ 21. By revising paragraph (f)(4).

■ 22. By redesignating paragraphs (f)(5) and (6) as paragraphs (f)(6) and (7), respectively.

■ 23. By adding a new paragraph (f)(5).

■ 24. By revising newly redesignated paragraph (f)(6).

■ 25. In newly redesignated paragraph (f)(7) introductory text, by removing the language ''paragraphs (f)(3) and (f)(4)'' and adding the language ''paragraphs (f)(3) through (6)'' in its place.

■ 26. In newly redesignated paragraph (f)(7), by removing *Example 3.*

■ 27. By revising paragraphs (g) and (h).

The revisions and additions read as follows:

§ 1.901–2 Income, war profits, or excess profits tax paid or accrued.

(a) *Definition of foreign income tax*—(1) *Overview and scope.* Paragraphs (a), (b), and (c) of this section define a foreign income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate levy. Paragraph (e) of this section provides rules for determining the amount of foreign income tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign income tax is paid. Paragraph (g) of this section defines the terms used in this section. Paragraph (h) of this section provides the applicability date for this section.

(i) *In general.* Section 901 allows a credit for the amount of income, war profits, and excess profits taxes paid during the taxable year to any foreign country, and section 903 provides that for purposes of Part III of subchapter N of the Code and sections 164(a) and 275(a), such taxes include a tax paid in lieu of a tax on income, war profits or excess profits that is otherwise generally imposed by a foreign country (collectively, for purposes of this section, a ''foreign income tax''). Whether a foreign levy is a foreign income tax is determined independently for each separate levy. A foreign tax either is or is not a foreign income tax, in its entirety, for all persons subject to the foreign tax.

(ii) *Requirements.* A foreign levy is a foreign income tax only if—

(A) It is a foreign tax; and

(B) Either:

(*1*) The foreign tax is a net income tax, as defined in paragraph (a)(3) of this section; or

(*2*) The foreign tax is a tax in lieu of an income tax, as defined in § 1.903–1(b).

* * * * *

(3) *Net income tax.* A foreign tax is a net income tax only if the foreign tax meets the net gain and jurisdictional nexus requirements in paragraphs (b) and (c) of this section.

(b) *Net gain requirement*—(1) *In general.* A foreign tax satisfies the net gain requirement only if the tax satisfies the realization, gross receipts, and cost recovery requirements in paragraphs (b)(2), (3), and (4) of this section, respectively, or if the foreign tax is a surtax described in paragraph (b)(5) of this section. Paragraphs (b)(2) through (5) of this section are applied with respect to a foreign tax solely on the basis of the foreign tax law governing the calculation of the foreign taxable base, unless otherwise provided, and without any consideration of the rate of tax imposed on the foreign taxable base.

(2) *Realization requirement*—(i) *In general.* A foreign tax satisfies the realization requirement if it is imposed upon one or more of the events described in paragraphs (b)(2)(i)(A) through (C) of this section. If a foreign tax meets the realization requirements in paragraphs (b)(2)(i)(A) through (C) of this section except with respect to one or more specific and defined classes of nonrealization events (such as, for example, imputed rental income from a personal residence used by the owner), and as judged based on the application of the foreign tax to all taxpayers subject to the foreign tax, the incidence and amounts of gross receipts attributable to such nonrealization events is insignificant relative to the incidence and amounts of gross receipts attributable to events covered by the foreign tax that do meet the realization requirement, then the foreign tax is treated as meeting the realization requirement in paragraph (b)(2) of this section (despite the fact that the foreign tax is also imposed on the basis of some nonrealization events, and that some persons subject to the foreign tax may only be taxed on nonrealization events).

(A) *Realization events.* The foreign tax is imposed upon or after the occurrence of events (''realization events'') that result in the realization of income under the income tax provisions of the Internal Revenue Code.

(B) *Pre-realization recapture events.* The foreign tax is imposed upon the occurrence of an event before a realization event (a ''pre-realization event'') that results in the recapture (in whole or part) of a tax deduction, tax credit, or other tax allowance previously accorded to the taxpayer (for example, the recapture of an incentive tax credit if required investments are not completed within a specified period).

(C) *Pre-realization timing difference events.* The foreign tax is imposed upon the occurrence of a pre-realization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event, impose tax under the same or a separate levy (a ''second tax'') on the same taxpayer (for purposes of this paragraph (b)(2)(i)(C), treating a disregarded entity as defined in § 301.7701–3(b)(2)(i)(C) of this chapter as a taxpayer separate from its owner), with respect to the income on which tax is imposed by reason of such pre-realization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the pre-realization event) and—

(*1*) The imposition of the tax upon such pre-realization event is based on the difference in the fair market value of property at the beginning and end of a period;

(*2*) The pre-realization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(ii) of this section) and the imposition of the tax upon the pre-realization event is based on the fair market value of such property; or

(*3*) The pre-realization event relates to a deemed distribution (for example, by a corporation to a shareholder) or inclusion (for example, under a controlled foreign corporation inclusion regime) of amounts (such as earnings and profits) that meet the realization requirement in paragraph (b)(2) of this section in the hands of the person that, under foreign tax law, is deemed to distribute such amounts.

* * * * *

(3) *Gross receipts requirement*—(i) *Rule.* A foreign tax satisfies the gross receipts requirement if it is imposed on the basis of actual gross receipts, on the basis of the amount of deemed gross receipts arising from pre-realization timing difference events described in paragraph (b)(2)(i)(C) of this section, or on the basis of gross receipts from an insignificant non-realization event that is described in the second sentence of paragraph (b)(2) of this section. A taxpayer's actual gross receipts are determined taking into account the gross receipts that are properly allocated to such taxpayer under a foreign tax meeting the jurisdictional nexus requirements of paragraph (c)(1)(i) or (c)(2) of this section.

(ii) *Examples.* The following examples illustrate the rules of paragraph (b)(3)(i) of this section.

(A) *Example 1: Cost-plus tax*—(*1*) *Facts.* Country X imposes a ''cost-plus tax'' on country X corporations that serve as regional headquarters for affiliated nonresident corporations, and this tax is a separate levy (within the meaning of paragraph (d) of this section). A headquarters company for purposes of this tax is a corporation that performs administrative, management or coordination functions solely for nonresident affiliated entities. Due to the difficulty of determining on a case-by-case basis the arm's length gross receipts that headquarters companies would charge affiliates for such services, gross receipts of a headquarters company are deemed, for purposes of this tax, to equal 110 percent of the business expenses incurred by the headquarters company.

(*2*) *Analysis.* Because the cost-plus tax is based on costs and not on gross receipts, under paragraph (b)(3)(i) of this section the cost-plus tax does not satisfy the gross receipts requirement.

(B) *Example 2: Petroleum taxed on extraction*—(*1*) *Facts.* Country X imposes a tax that is a separate levy (within the meaning of paragraph (d) of this section) on income from the extraction of petroleum. Under the terms of that tax, gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted.

(*2*) *Analysis.* Because it is imposed on deemed gross receipts that exceed the fair market value of the petroleum extracted, the tax on extraction income does not satisfy the gross receipts requirement of paragraph (b)(3)(i) of this section.

(4) *Cost recovery requirement*—(i) *In general*—(A) *Requirement.* A foreign tax satisfies the cost recovery requirement if the base of the tax is computed by reducing gross receipts (as described in paragraph (b)(3) of this section) to permit recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts. In addition, a foreign tax satisfies the cost recovery requirement if the foreign tax law permits recovery of an amount that by its terms may be greater, but can never be less, than the actual amounts of such significant costs and expenses (for example, under a provision identical to percentage depletion allowed under section 613). A foreign tax whose base is gross receipts or gross income for which no reduction is allowed under foreign tax law for costs and expenses does not satisfy the cost recovery requirement, even if in practice there are few costs and expenses attributable to all or particular types of gross receipts included in the foreign tax base. See paragraph (b)(4)(iv) of this section (*Example 3*).

(B) *Significant costs and expenses*—(*1*) *Timing of recovery.* A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered earlier or later than they are recovered under the Internal Revenue Code, unless the time of recovery is so much later (for example, after the property becomes worthless or is disposed of) as effectively to constitute a denial of such recovery. The amount of costs and expenses that are considered to be recovered under the foreign tax law is neither discounted nor augmented by taking into account the time value of money attributable to any acceleration or deferral of a tax benefit resulting from the foreign law cost recovery method compared to when tax would be paid under the Internal Revenue Code. Therefore, the cost recovery requirement is satisfied where items deductible under the Internal Revenue Code are capitalized under the foreign tax law and recovered either immediately, on a recurring basis over time, or upon the occurrence of some future event, or where the recovery of items capitalized under the Internal Revenue Code occurs more or less rapidly than under the foreign tax law.

(*2*) *Amounts that must be recovered.* Whether a cost or expense is significant for purposes of this paragraph (b)(4)(i) is determined based on whether, for all taxpayers in the aggregate to which the foreign tax applies, the item of cost or expense constitutes a significant portion of the taxpayers' total costs and expenses. However, costs and expenses related to capital expenditures, interest, rents, royalties, services, or research and experimentation are always treated as significant costs or expenses for purposes of this paragraph (b)(4)(i). Foreign tax law is considered to permit recovery of significant costs and expenses even if recovery of all or a portion of certain costs or expenses is disallowed, if such disallowance is consistent with the types of disallowances required under the Internal Revenue Code. For example, foreign tax law is considered to permit recovery of significant costs and expenses if such law disallows interest deductions equal to a certain percentage of adjusted taxable income similar to the limitation under section 163(j), disallows interest and royalty deductions in connection with hybrid transactions similar to those described in section 267A, or disallows certain expenses based on public policy considerations similar to those disallowances contained in section 162. A foreign tax law that does not permit recovery of one or more significant costs or expenses does not meet the cost recovery requirement, even if it provides alternative allowances that in practice equal or exceed the amount of nonrecovered costs or expenses. However, in determining whether a foreign tax (the ''tested foreign tax'') meets the cost recovery requirement, it is immaterial whether the tested foreign tax allows a deduction for other taxes that would qualify as foreign income taxes (determined without regard to whether such other tax allows a deduction for the tested foreign tax). See paragraph (b)(4)(iv) of this section (*Example 5*).

(*3*) *Attribution of costs and expenses to gross receipts.* Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code (for example, principles that apply under section 265, 465 or 861(b) of the Internal Revenue Code).

* * * * *

(iv) *Examples.* The following examples illustrate the rules of this paragraph (b)(4).

(A) *Example 1: Tax on gross interest income of certain residents; no deductions allowed*—(*1*) *Facts.* Country X imposes a net income tax on corporations resident in Country X; however, that income tax is not applicable to banks. Country X also imposes a tax (the ''bank tax'') of 1 percent on the gross amount of interest income derived by banks resident in Country X; no deductions are allowed. Banks resident in Country X incur substantial costs and expenses (for example, interest expense) attributable to their interest income.

(*2*) *Analysis.* Because the terms of the bank tax do not permit recovery of significant costs and expenses attributable to the gross receipts included in the tax base, under paragraph (b)(4)(i) of this section the bank tax does not satisfy the cost recovery requirement.

(B) *Example 2: Tax on gross interest income of nonresidents; no deductions allowed*—(*1*) *Facts.* Country X imposes a net income tax on nonresident persons engaged in a trade or business in Country X. Country X also imposes a tax (the ''bank tax'') of 1 percent on the gross amount of interest income earned by nonresident banks from loans to residents of Country X if such banks are not engaged in a trade or business in Country X or if such interest income is not considered attributable to a trade or business conducted in Country X. Under Country X tax law, no deductions are allowed in determining the base of the bank tax. Banks incur substantial costs and expenses (for example, interest expense) attributable to their interest income.

(*2*) *Analysis.* Because no deductions are allowed in determining the base of the bank tax, under paragraph (b)(4)(i) of this section the bank tax does not satisfy the cost recovery requirement.

(C) *Example 3: Payroll tax*—(*1*) *Facts.* A foreign country imposes payroll tax at the rate of 10 percent on the amount of gross wages realized by resident employees; no deductions are allowed in computing the base of the payroll tax.

(*2*) *Analysis.* Because the foreign tax law does not allow for the recovery of any costs and expenses attributable to gross receipts included in the taxable base, under paragraph (b)(4)(i) of this section the payroll tax does not satisfy the cost recovery requirement.

(D) *Example 4: Tax on gross wages reduced by allowable deductions*–(*1*) *Facts.* A foreign country imposes a tax at the rate of 40 percent on the realized gross receipts of its residents, including gross income from wages, reduced by deductions for significant costs and expenses attributable to the gross receipts included in the taxable base.

(*2*) *Analysis.* Because foreign tax law allows for the recovery of significant costs and expenses attributable to gross receipts included in the taxable base, under paragraph (b)(4)(i) of this section the tax satisfies the cost recovery requirement.

(E) *Example 5: No deduction for another net income tax*—(*1*) *Facts.* Each of Country X and Province Y (a political subdivision of Country X) imposes a tax on resident corporations, called the ''Country X income tax'' and the ''Province Y income tax,'' respectively. Each tax has an identical base, which is computed by reducing a corporation's realized gross receipts by deductions that, based on the laws of Country X and Province Y, generally permit recovery of the significant costs and expenses (including significant capital expenditures) that are attributable under reasonable principles to such gross receipts. However, the Country X income tax does not allow a deduction for the Province Y income tax for which a taxpayer is liable, nor does the Province Y income tax allow a deduction for the Country X income tax for which a taxpayer is liable.

(*2*) *Analysis.* Under paragraph (d)(1)(i) of this section, each of the Country X income tax and the Province Y income tax is a separate levy. Without regard to whether the Province Y income tax may allow a deduction for the Country X income tax, and without regard to whether the Country X income tax may allow a deduction for the Province Y income tax, both taxes would qualify as net income taxes under paragraph (a)(3) of this section. Therefore, under paragraph (b)(4)(i)(B)(*2*) of this section the fact that neither levy's base allows a deduction for the other levy is immaterial, and both levies satisfy the cost recovery requirement.

(5) *Surtax on net income tax.* A foreign tax satisfies the net gain requirement in this paragraph (b) if the base of the foreign tax is the amount of a net income tax. For example, if a tax (surtax) is computed as a percentage of a separate levy that is itself a net income tax, then such surtax is considered to satisfy the net gain requirement.

(c) *Jurisdictional nexus requirement.* A foreign tax meets the jurisdictional nexus requirement only if the tax satisfies the requirements of paragraph (c)(1) of this section (with respect to a separate levy imposed on nonresidents of the foreign country) or paragraph (c)(2) of this section (with respect to a separate levy imposed on residents of the foreign country).

(1) *Tax on nonresidents.* Each of the items of income of nonresidents of a foreign country that is subject to the foreign tax must satisfy the requirements of paragraph (c)(1)(i), (ii), or (iii) of this section.

(i) *Income attribution based on activities nexus.* The income that is taxable in the foreign country is limited to income that is attributable, under reasonable principles, to the nonresident's activities within the foreign country (including the nonresident's functions, assets, and risks located in the foreign country), without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion. For purposes of the preceding sentence, attribution of income under reasonable principles includes rules similar to those for determining effectively connected income under section 864(c).

(ii) *Nexus based on source of income.* The amount of income (other than income from sales or other dispositions of property) that is taxable in the foreign country on the basis of source (instead of on the basis of activities as described in paragraph (c)(1)(i) of this section) is based on income arising from sources within the foreign country that imposes the tax, but only if the sourcing rules of the foreign tax law are reasonably similar to the sourcing rules that apply for Federal income tax purposes. In particular, a foreign tax on income from services must be sourced based on where the services are performed, and not based on the location of the service recipient.

(iii) *Nexus based on situs of property.* The amount of income from sales or dispositions of property that is taxable in the foreign country on the basis of the situs of real or movable property (instead of on the basis of activities as described in paragraph (c)(1)(i) of this section) includes only gains that are attributable to the disposition of real property situated in the foreign country or movable property forming part of the business property of a taxable presence in the foreign country (including, for purposes of this paragraph (c)(1)(iii), interests in a company or other entity to the extent attributable to such real property or business property).

(2) *Tax on residents.* A foreign tax imposed on residents of the foreign country imposing the foreign tax may be imposed on the worldwide income of the resident, but must provide that any allocation to or from the resident of income, gain, deduction, or loss with respect to transactions between such resident and organizations, trades, or businesses owned or controlled directly or indirectly by the same interests (that is, any allocation made pursuant to the foreign country's transfer pricing rules) is determined under arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.

(3) *Example.* The following example illustrates the rules of this paragraph (c).

(i) *Facts.* Country X imposes a separate levy on nonresident companies that furnish specified types of electronically supplied services to users located in Country X (the ''ESS tax''). The base of the ESS tax is computed by taking the nonresident company's overall net income (determined under rules consistent with paragraph (b) of this section) related to supplying electronically supplied services, and deeming a portion of such net income to be attributable to a deemed permanent establishment of the nonresident company in Country X. The amount of the nonresident company's net income attributable to the deemed permanent establishment is determined on a formulary basis based on the percentage of the nonresident company's total users that are located in Country X.

(ii) *Analysis.* The taxable base of the ESS tax is not computed based on a nonresident company's activities located in Country X, but instead takes into account the location of the nonresident company's users. Therefore, the ESS tax does not meet the requirement in paragraph (c)(1)(i) of this section. The ESS tax also does not meet the requirement in paragraph (c)(1)(ii) of this section because it is not imposed on the basis of source, and it does not meet the requirement in paragraph (c)(1)(iii) of this section because it is not imposed on the sale or other disposition of property.

(iii) *Alternative facts.* Instead of imposing the ESS tax by deeming nonresident companies to have a permanent establishment in Country X, Country X treats gross income from electronically supplied services provided to users located in Country X as sourced in Country X. The gross income sourced to Country X is reduced by costs that are reasonably attributed to such gross income, to arrive at the taxable base of the ESS tax. The amount of the nonresident's gross income that is sourced to Country X is determined by multiplying the nonresident's total gross income by the percentage of its total users that are located in Country X.

(iv) *Analysis.* Country X tax law's rule for sourcing electronically supplied services is not based on where the services are performed, but is based on the location of the service recipient. Therefore, the ESS tax, which is imposed on the basis of source, does not meet the requirement in paragraph (c)(1)(ii) of this section. The ESS tax also does not meet the requirement in paragraph (c)(1)(i) of this section because it is not imposed on the basis of a nonresident's activities located in Country X, and it does not meet the requirement in paragraph (c)(1)(iii) of this section because it is not imposed on the sale or other disposition of property.

(d) * * *

(1) *In general.* Each foreign levy must be analyzed separately to determine whether it is a net income tax within the meaning of paragraph (a)(3) of this section and whether it is a tax in lieu of an income tax within the meaning of § 1.903–1(b)(2). Whether a single levy or separate levies are imposed by a foreign country depends on U.S. principles and not on whether foreign tax law imposes the levy or levies pursuant to a single or separate statutes. A foreign levy is a separate levy described in this paragraph (d)(1) if it is described in paragraph (d)(1)(i), (ii), or (iii) of this section. In the case of levies that apply to dual capacity taxpayers, see also § 1.901–2A(a).

(i) *Taxing authority.* A levy imposed by one taxing authority (for example, the national government of a foreign country) is always separate from a levy imposed by another taxing authority (for example, a political subdivision of that foreign country), even if the base of the levy is the same.

(ii) *Different taxable base.* Where the base of a foreign levy is computed differently for different classes of persons subject to the levy, the levy is considered to impose separate levies with respect to each such class of persons. For example, foreign levies identical to the taxes imposed by sections 1, 11, 541, 871(a), 871(b), 881, 882, 3101 and 3111 of the Internal Revenue Code are each separate levies, because the levies are imposed on different classes of taxpayers, and the base of each of those levies contains different items than the base of each of the others. A taxable base of a separate levy may consist of a particular type of income (for example, wage income, investment income, or income from self-employment). The taxable base of a separate levy may also consist of an amount unrelated to income (for example, wage expense or assets). A separate levy may provide that items included in the base of the tax are computed separately merely for purposes of a preliminary computation and are then combined as a single taxable base. Income included in the taxable base of a separate levy may also be included in the taxable base of another levy (which may or may not also include other items of income); separate levies are considered to be imposed if the taxable bases are not combined as a single taxable base. For example, a foreign levy identical to the tax imposed by section 1 is a separate levy from a foreign levy identical to the tax imposed by section 1411, because tax is imposed under each levy on a separate taxable base that is not combined with the other as a single taxable base. Where foreign tax law imposes a levy that is the sum of two or more separately computed amounts of tax, and each such amount is computed by reference to a different base, separate levies are considered to be imposed. Levies are not separate merely because different rates apply to different classes of taxpayers that are subject to the same provisions in computing the base of the tax. For example, a foreign levy identical to the tax imposed on U.S. citizens and resident alien individuals by section 1 of the Internal Revenue Code is a single levy notwithstanding that the levy has graduated rates and applies different rate schedules to unmarried individuals, married individuals who file separate returns, and married individuals who file joint returns. In addition, in general, levies are not separate merely because some provisions determining the base of the levy apply, by their terms or in practice, to some, but not all, persons subject to the levy. For example, a foreign levy identical to the tax imposed by section 11 of the Internal Revenue Code is a single levy even though some provisions apply by their terms to some but not all corporations subject to the section 11 tax (for example, section 465 is by its terms applicable to corporations described in sections 465(a)(1)(B), but not to other corporations), and even though some provisions apply in practice to some but not all corporations subject to the section 11 tax (for example, section 611 does not, in practice, apply to any corporation that does not have a qualifying interest in the type of property described in section 611(a)).

(iii) *Tax imposed on nonresidents.* A foreign levy imposed on nonresidents is always treated as a separate levy from that imposed on residents, even if the base of the tax as applied to residents and nonresidents is the same, and even if the levies are treated as a single levy under foreign tax law. In addition, a withholding tax (as defined in section 901(k)(1)(B)) that is imposed on gross income of nonresidents is treated as a separate levy as to each separate class of income described in section 61 (for example, interest, dividends, rents, or royalties) subject to the withholding tax.

* * * * *

(e) *Amount of foreign income tax that is creditable*—(1) *In general.* Credit is allowed under section 901 for the amount of foreign income tax that is paid by the taxpayer. The amount of foreign income tax paid by the taxpayer is determined separately for each taxpayer.

(2) * * *

(i) *Refundable amounts.* An amount remitted to a foreign country is not an amount of foreign income tax paid to the extent that it is reasonably certain that the amount will be refunded, rebated, abated, or forgiven. It is reasonably certain that an amount will be refunded, rebated, abated, or forgiven to the extent the amount exceeds a reasonable approximation of final foreign income tax liability to the foreign country. See section 905(c) and § 1.905–3 for the required redeterminations if amounts claimed as a credit (on either the cash or accrual basis) exceed the amount of the final foreign income tax liability.

(ii) *Credits.* Except as provided in paragraph (e)(2)(iii) of this section, an amount of foreign income tax liability is not an amount of foreign income tax paid to the extent the foreign income tax is reduced, satisfied or otherwise offset by a tax credit, regardless of whether the amount of the tax credit is refundable in cash to the extent it exceeds the taxpayer's liability for foreign income tax.

(iii) *Overpayments of tax applied as a credit.* An amount of foreign income tax paid is not reduced (or treated as constructively refunded) solely by reason of the fact that the amount paid is allowed (or may be allowed) as a credit to reduce the amount of a different separate levy owed by the taxpayer. See paragraphs (e)(2)(ii) and (e)(4) of this section. However, under paragraph (e)(2)(i) of this section (and taking into account any redetermination required under section 905(c) and § 1.905–3), an amount remitted with respect to a separate levy for a foreign taxable period that constitutes an overpayment of the taxpayer's final liability for that levy for that period, and that is refundable in cash at the taxpayer's option, is not an amount of tax paid. Therefore, if such an overpayment of one tax is applied as a credit against a different foreign income tax liability owed by the taxpayer for the same or a different taxable period, the credited amount may qualify as an amount of that different foreign income tax paid, if it does not exceed a reasonable approximation of the taxpayer's final foreign income tax liability for the taxable period to which the overpayment is applied.

* * * * *

(4) *Multiple levies*—(i) *In general.* If, under foreign law, a taxpayer's tentative liability for one levy (the ''reduced levy'') is or can be reduced by the amount of the taxpayer's liability for a different levy (the ''applied levy''), then the amount considered paid by the taxpayer to the foreign country pursuant to the applied levy is an amount equal to its entire liability for that applied levy (not limited to the amount applied to reduce the reduced levy), and the remainder of the total amount paid is considered paid pursuant to the reduced levy. See also paragraphs (e)(2)(ii) and (iii) of this section.

(ii) *Examples.* The following examples illustrate the rules of paragraphs (e)(2)(ii) and (iii) and (e)(4)(i) of this section.

(A) *Example 1: Tax reduced by credits*—(*1*) *Facts.* A's tentative liability for foreign income tax imposed by Country X is 100u (units of Country X currency). However, under Country X tax law, in determining A's final foreign income tax liability its tentative liability is reduced by a 15u credit for a separate Country X levy that does not qualify as a foreign income tax and that A accrued and paid on its gross services income, and is also reduced by a 5u credit for charitable contributions. Under Country X tax law, the amount of the charitable contributions credit is refundable in cash to the extent the credit exceeds the taxpayer's Country X income tax liability after applying the credit for the tax on gross services income. A timely remits the 80u due to Country X.

(*2*) *Analysis.* Under paragraphs (e)(2)(ii) and (e)(4) of this section, the amount of Country X income tax paid by A is 80u (100u tentative liability − 20u tax credits), and the amount of Country X tax on gross services income paid by A is 15u.

(B) *Example 2: Tax paid by credit for overpayment*—(*1*) *Facts.* The facts are the same as in paragraph (e)(4)(ii)(A)(*1*) of this section (the facts in *Example 1*), except that A's final Country X income tax liability of 80u is satisfied by applying a credit for an otherwise refundable 60u overpayment from the previous taxable year of A's liability for a separate levy imposed by Country X that is also a foreign income tax and remitting the balance due of 20u.

(*2*) *Analysis.* The result is the same as in paragraph (e)(4)(ii)(A)(*2*) of this section (the analysis in *Example 1).* Under paragraph (e)(2)(iii) of this section, the portion of A's Country X income tax liability that was satisfied by applying the 60u overpayment of A's different foreign income tax liability for the previous taxable year qualifies as an amount of Country X income tax paid, because that refundable overpayment exceeded (and so is not treated as a payment of) A's different foreign income tax liability for the previous taxable year.

(5) * * *

(i) *In general.* An amount remitted to a foreign country (a ''foreign payment'') is not a compulsory payment, and thus is not an amount of foreign income tax paid, to the extent that the foreign payment exceeds the amount of liability for foreign income tax under the foreign tax law (as defined in paragraph (g) of this section). A foreign payment does not exceed the amount of such liability if the foreign payment is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign tax law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for foreign income tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign income tax (including liability pursuant to a foreign tax audit adjustment). See paragraph (e)(5)(ii) of this section for the effect of options and elections under foreign tax law. An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (for example, a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. Whether a taxpayer has satisfied its obligation to minimize the aggregate amount of its liability for foreign income taxes over time is determined without regard to the present value of a deferred tax liability or other time value of money considerations. In determining whether a taxpayer has exhausted all effective and practical remedies, a remedy is effective and practical only if the cost of pursuing it (including the risk of incurring an offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success. An available remedy is considered effective and practical if an economically rational taxpayer would pursue it whether or not a compulsory payment of the amount at issue would be eligible for a U.S. foreign tax credit. A settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory payment. A taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for foreign income tax.

(ii) *Effect of foreign tax law elections*—(A) *In general.* Where foreign tax law includes options or elections whereby a taxpayer's foreign income tax liability may be shifted, in whole or part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in a foreign payment in excess of the taxpayer's liability for foreign income tax. Except as provided in paragraph (e)(5)(ii)(B) of this section, where foreign tax law provides for options or elections whereby a taxpayer's foreign income tax liability may be permanently decreased in the aggregate over time, the taxpayer's failure to use such options or elections results in a foreign payment in excess of the taxpayer's liability for foreign income tax.

(B) *Exception for certain options or elections*—(*1*) *Entity classification elections.* If foreign tax law provides an option or election to treat an entity as fiscally transparent or non-fiscally transparent, a taxpayer's decision to use or not use such option or election is not considered to increase the taxpayer's liability for foreign income tax over time for purposes of this paragraph (e)(5).

(*2*) *Foreign consolidation, group relief, or other loss sharing regime.* If foreign tax law provides an option or election for one foreign entity to join in the filing of a consolidated return with another foreign entity, or to surrender its loss in order to offset the income of another foreign entity pursuant to a foreign group relief or other loss-sharing regime, a taxpayer's decision whether to file a consolidated return, whether to surrender a loss, or whether to use a surrendered loss, is not considered to increase the taxpayer's liability for foreign income tax over time for purposes of this paragraph (e)(5).

* * * * *

(6) *Soak-up taxes*—(i) *In general.* An amount remitted to a foreign country is not an amount of foreign income tax paid to the extent that liability for the foreign income tax is dependent (by its terms or otherwise) on the availability of a credit for the tax against income tax liability to another country. Liability for foreign income tax is dependent on the availability of a credit for the foreign income tax against income tax liability to another country only if and to the extent that the foreign income tax would not be imposed on the taxpayer but for the availability of such a credit.

(ii) [Reserved]

(f) * * *

(4) *Taxes imposed on partnerships and disregarded entities*—(i) *Partnerships.* If foreign law imposes tax at the entity level on the income of a partnership, the partnership is considered to be legally liable for such tax under foreign law and therefore is considered to pay the tax for Federal income tax purposes. The rules of this paragraph (f)(4)(i) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid. See §§ 1.702–1(a)(6) and 1.704–1(b)(4)(viii) for rules relating to the determination of a partner's distributive share of such tax.

(ii) *Disregarded entities.* If foreign law imposes tax at the entity level on the income of an entity described in § 301.7701–2(c)(2)(i) of this chapter (a *disregarded entity*), the person (as defined in section 7701(a)(1)) who is treated as owning the assets of the disregarded entity for Federal income tax purposes is considered to be legally liable for such tax under foreign law. Such person is considered to pay the tax for Federal income tax purposes. The rules of this paragraph (f)(4)(ii) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid.

(5) *Allocation of taxes in the case of certain ownership changes*—(i) *In general.* If a partnership, disregarded entity, or corporation undergoes one or more covered events during its foreign taxable year that do not result in a closing of the foreign taxable year, then a portion of the foreign income tax (other than a withholding tax described in section 901(k)(1)(B)) paid or accrued by a person under paragraphs (f)(1) through (4) of this section with respect to the continuing foreign taxable year in which such change or changes occur is allocated to and among all persons that were predecessor entities or prior owners during such foreign taxable year. The allocation is made based on the respective portions of the taxable income (as determined under foreign law) for the continuing foreign taxable year that are attributable under the principles of § 1.1502–76(b) to the period of existence or ownership of each predecessor entity or prior owner during the continuing foreign taxable year. Foreign income tax allocated to a person that is a predecessor entity is treated (other than for purposes of section 986) as paid or accrued by the person as of the close of the last day of its last U.S. taxable year. Foreign income tax allocated to a person that is a prior owner, for example a transferor of a disregarded entity, is treated (other than for purposes of section 986) as paid or accrued by the person as of the close of the last day of its U.S. taxable year in which the covered event occurred.

(ii) *Covered event.* For purposes of this paragraph (f)(5), a covered event is 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.

(iii) *Predecessor entity and prior owner.* For purposes of this paragraph (f)(5), a predecessor entity is a partnership or a corporation that undergoes a covered event as described in paragraph (f)(5)(ii) of this section. A prior owner is a person that either transfers a disregarded entity or owns a disregarded entity immediately before a change in the entity classification of the disregarded entity as described in paragraph (f)(5)(ii) of this section.

(iv) *Partnership variances.* In the case of a change in any partner's interest in the partnership (a variance), except as otherwise provided in section 706(d)(2) (relating to certain cash basis items) or 706(d)(3) (relating to tiered partnerships), foreign tax paid or accrued by the partnership during its U.S. taxable year in which the variance occurs is allocated between the portion of the U.S. taxable year ending on, and the portion of the U.S. taxable year beginning on the day after, the day of the variance. The allocation is made under the principles of this paragraph (f)(5) as if the variance were a covered event.

(6) *Allocation of foreign taxes in connection with elections under section 336(e) or 338 or § 1.245A–5(e).* For rules relating to the allocation of foreign taxes in connection with elections made pursuant to section 336(e), see § 1.336–2(g)(3)(ii). For rules relating to the allocation of foreign taxes in connection with elections made pursuant to section 338, see § 1.338–9(d). For rules relating to the allocation of foreign taxes in connection with elections made pursuant to § 1.245A–5(e)(3)(i), see § 1.245A–5(e)(3)(i)(B).

* * * * *

(g) *Definitions.* For purposes of this section and §§ 1.901–2A and 1.903–1, the following definitions apply.

(1) *Foreign country and possession (territory) of the United States.* The term *foreign country* means any foreign state, any possession (territory) of the United States, and any political subdivision of any foreign state or of any possession (territory) of the United States. The term *possession* (or *territory*) *of the United States* includes American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, and the U.S. Virgin Islands.

(2) *Foreign levy.* The term *foreign levy* means a levy imposed by a foreign country.

(3) *Foreign tax.* The term *foreign tax* means a foreign levy that is a tax as defined in paragraph (a)(2) of this section.

(4) *Foreign tax law.* The term *foreign tax law* means the laws of the foreign country imposing a foreign tax, as modified by applicable tax treaties. The foreign tax law is construed on the basis of the foreign country's statutes, regulations, case law, and administrative rulings or other official pronouncements, as modified by applicable income tax treaties.

(5) *Paid, payment, and paid by.* The term *paid* means ''paid'' or ''accrued''; the term *payment* means ''payment'' or ''accrual''; and the term *paid by* means ''paid by'' or ''accrued by or on behalf of,'' depending on whether the taxpayer claims the foreign tax credit for taxes paid (that is, remitted) or taxes accrued (as determined under § 1.905–1(d)) during the taxable year.

(6) *Resident and nonresident.* The terms *resident* and *nonresident,* when used in the context of the foreign tax law of a foreign country, have the meaning provided in paragraphs (g)(6)(i) and (ii) of this section.

(i) *Resident.* An individual is a resident of a foreign country if the individual is liable to income tax in such country by reason of the individual's residence, domicile, citizenship, or similar criterion under such country's foreign tax law. An entity (including a corporation, partnership, trust, estate, or an entity that is disregarded as an entity separate from its owner for Federal income tax purposes) is a resident of a foreign country if the entity is liable to tax on its income (regardless of whether tax is actually imposed) under the laws of the foreign country by reason of the entity's place of incorporation or place of management in that country (or in a political subdivision or local authority thereof), or by reason of a criterion of similar nature, or if the entity is of a type that is specifically identified as a resident in an income tax treaty with the United States to which the foreign country is a party. If an individual or entity is a resident of more than one country, a single country of residence will be determined based upon applicable rules for resolving dual residency under the foreign tax law of the foreign country or countries; if no resolution is reached, the individual or entity is treated as a resident of each country.

(ii) *Nonresident.* A nonresident with respect to a foreign country is any individual or entity that is not a resident of such foreign country.

(h) *Applicability date.* This section applies to foreign taxes paid or accrued in taxable years beginning on or after [date final regulations are filed with the **Federal Register**].

* * * * *

■ **Par. 24.** Section 1.903–1 is revised to read as follows:

§ 1.903–1 Taxes in lieu of income taxes.

(a) *Overview.* Section 903 provides that the term ''income, war profits, and excess profits taxes'' includes a tax paid in lieu of a tax on income, war profits, or excess profits that is otherwise generally imposed by any foreign country. Paragraphs (b) and (c) of this section define a tax described in section 903. Paragraph (d) of this section provides examples illustrating the application of this section. Paragraph (e) of this section sets forth the applicability date of this section. For purposes of this section and §§ 1.901–2 and 1.901–2A, a tax described in section 903 is referred to as a ''tax in lieu of an income tax'' or an ''in lieu of tax''; and the definitions in § 1.901–2(g) apply for purposes of this section. Determinations of the amount of a tax in lieu of an income tax that is paid by a person and determinations of the person by whom such tax is paid are made under § 1.901–2(e) and (f), respectively. Section 1.901–2A contains additional rules applicable to dual capacity taxpayers (as defined in § 1.901–2(a)(2)(ii)(A)).

(b) *Definition of tax in lieu of an income tax*—(1) *In general.* Paragraphs (b)(2) and (c) of this section provide the requirements for a foreign levy to qualify as a tax in lieu of an income tax. The rules of this section are applied independently to each separate levy (within the meaning of §§ 1.901–2(d) and 1.901–2A(a)). A foreign tax either is or is not a tax in lieu of an income tax in its entirety for all persons subject to the tax. It is immaterial whether the base of the in lieu of tax bears any relation to realized net gain. The base of the foreign tax may, for example, be gross income, gross receipts or sales, or the number of units produced or exported. The foreign country's reason for imposing a foreign tax on a base other than net income (for example, because of administrative difficulty in determining the amount of income that would otherwise be subject to a net income tax) is immaterial, although paragraph (c)(1) of this section generally requires a showing that the foreign country made a deliberate and cognizant choice to impose the in lieu of tax instead of a net income tax (see paragraph (c)(1)(iii) of this section).

(2) *Requirements.* A foreign levy is a tax in lieu of an income tax only if—

(i) It is a foreign tax; and

(ii) It satisfies the substitution requirement of paragraph (c) of this section.

(c) *Substitution requirement*—(1) *In general.* A foreign tax (the ''tested foreign tax'') satisfies the substitution requirement if, based on the foreign tax law, the requirements in paragraphs (c)(1)(i) through (iv) of this section are satisfied with respect to the tested foreign tax, or the tested foreign tax is a covered withholding tax described in paragraph (c)(2) of this section.

(i) *Existence of generally-imposed net income tax.* A separate levy that is a net income tax (as described in § 1.901–2(a)(3)) is generally imposed by the same foreign country (the ''generally-imposed net income tax'') that imposes the tested foreign tax.

(ii) *Non-duplication.* Neither the generally-imposed net income tax nor any other separate levy that is a net income tax is also imposed, in addition to the tested foreign tax, by the same foreign country on any persons with respect to any portion of the income to which the amounts (such as sales or units of production) that form the base of the tested foreign tax relate (the ''excluded income''). Therefore, a tested foreign tax does not meet the requirement of this paragraph (c)(1)(ii) if a net income tax imposed by the same foreign country applies to the excluded income of any persons that are subject to the tested foreign tax, even if not all of the persons subject to the tested foreign tax are subject to the net income tax.

(iii) *Close connection to excluded income.* But for the existence of the tested foreign tax, the generally-imposed net income tax would otherwise have been imposed on the excluded income. The requirement in the preceding sentence is met only if the imposition of such tested foreign tax bears a close connection to the failure to impose the generally-imposed net income tax on the excluded income; the relationship cannot be merely incidental, tangential, or minor. A close connection exists if the generally-imposed net income tax would apply by its terms to the 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 foreign tax instead of the generally-imposed net income tax. Such proof must be based on foreign tax law, or the legislative history of either the tested foreign tax or the generally-imposed net income tax that describes the provisions excluding taxpayers subject to the tested foreign tax from the generally-imposed net income tax. If one tested foreign tax meets the requirements in this paragraph (c)(1), and another tested foreign tax that applies to the same class of taxpayers and relates to the same excluded income as the first tested foreign tax is enacted later in time (and not contemporaneously with the first tested foreign tax), there is a rebuttable presumption that such second tested foreign tax does not meet the close connection requirement in this paragraph (c)(1)(iii). Not all income derived by persons subject to the tested foreign tax need be excluded income, as long as the tested foreign tax applies only to amounts that relate to the excluded income.

(iv) *Jurisdiction to tax excluded income.* If the generally-imposed net income tax were applied to the excluded income, the generally-imposed net income tax would either continue to qualify as a net income tax described in § 1.901–2(a)(3), or would constitute a separate levy from the generally-imposed net income tax that would itself be a net income tax described in § 1.901–2(a)(3).

(2) *Covered withholding tax.* A tested foreign tax is a covered withholding tax if, based on the foreign tax law, the requirements in paragraphs (c)(1)(i) and (c)(2)(i) through (iii) of this section are met with respect to the tested foreign tax. See also § 1.901–2(d)(1)(iii) for rules treating withholding taxes as separate levies with respect to each class of income subject to the tax.

(i) *Withholding tax on nonresidents.* The tested foreign tax is a withholding tax (as defined in section 901(k)(1)(B)) that is imposed on gross income of persons who are nonresidents of the foreign country imposing the tested foreign tax. It is immaterial whether the tested foreign tax is withheld by the payor or is imposed directly on the nonresident taxpayer.

(ii) *Non-duplication.* The tested foreign tax is not in addition to any net income tax that is imposed by the foreign country on any portion of the net income attributable to the gross income that is subject to the tested foreign tax. Therefore, a tested foreign tax does not meet the requirement of this paragraph (c)(2)(ii) if by its terms it applies to gross income of nonresidents that are also subject to a net income tax imposed by the same foreign country on the same income, even if not all nonresidents subject to the tested foreign tax are also subject to the net income tax.

(iii) *Source-based jurisdictional nexus.* The income subject to the tested foreign tax satisfies the source requirement described in § 1.901–2(c)(1)(ii).

(d) *Examples.* The following examples illustrate the rules of this section.

(1) *Example 1: Tax on gross income from services; non-duplication requirement*—(i) *Facts.* Country X imposes a tax at the rate of 3 percent on the gross receipts of companies, wherever resident, from furnishing specified types of electronically supplied services to customers located in Country X (the ''ESS tax''). No deductions are allowed in determining the taxable base of the ESS tax. In addition to the ESS tax, Country X imposes a net income tax within the meaning of § 1.901–2(a)(3) on resident companies (the ''net income tax'') and also imposes a net income tax within the meaning of § 1.901–2(a)(3) on the income of nonresident companies that is attributable, under reasonable principles, to the nonresident's activities within Country X (the ''permanent establishment tax''). Both the net income tax and the permanent establishment tax, which are each separate levies under § 1.901–2(d)(1)(iii), qualify as generally-imposed net income taxes. The ESS tax applies to both resident and nonresident companies regardless of whether the company is also subject to the net income tax or permanent establishment tax, respectively.

(ii) *Analysis.* Under § 1.901–2(d)(1)(iii), the ESS tax comprises two separate levies, one imposed on resident companies (the ''resident ESS tax''), and one imposed on nonresident companies (the ''nonresident ESS tax''). Under paragraph (c)(1)(ii) of this section, neither the resident ESS tax nor the nonresident ESS tax satisfies the substitution requirement, because by its terms the income subject to the ESS tax is also subject to a generally-imposed net income tax imposed by Country X. Similarly, under paragraph (c)(2)(ii) of this section, the nonresident ESS tax is not a covered withholding tax because it is imposed in addition to the permanent establishment tax. It is immaterial that some nonresident taxpayers that are subject to the nonresident ESS tax are not also subject to the permanent establishment tax on the gross receipts included in the base of the nonresident ESS tax. Therefore, neither the resident ESS tax nor the nonresident ESS tax is a tax in lieu of an income tax.

(2) *Example 2: Tax on gross income from services; jurisdictional nexus*—(i) *Facts.* The facts are the same as in paragraph (d)(1)(i) of this section (the facts in *Example 1*), except that under Country X tax law, the nonresident ESS tax is imposed only if the nonresident company does not have a permanent establishment in Country X under domestic law or an applicable income tax treaty. In addition, the text of and legislative history to the nonresident ESS tax demonstrate that Country X made a cognizant and deliberate choice to impose the nonresident ESS tax instead of the permanent establishment tax with respect to the gross receipts that are subject to the nonresident ESS tax.

(ii) *Analysis*—(A) *General application of substitution requirement.* The nonresident ESS tax meets the requirements in paragraphs (c)(1)(i) and (ii) of this section because Country X has a generally-imposed net income tax, the permanent establishment tax, and neither the permanent establishment tax nor any other separate levy is imposed by Country X on a nonresident's gross income that forms the base of the nonresident ESS tax (which is the excluded income) in addition to the nonresident ESS tax. The text of and legislative history to the nonresident ESS tax demonstrate that Country X made a cognizant and deliberate choice to exclude the excluded income from the base of the generally-imposed permanent establishment tax. Therefore, the nonresident ESS tax meets the requirement in paragraph (c)(1)(iii) of this section because but for the existence of the tested foreign tax, the generally-imposed permanent establishment tax would otherwise have been imposed on the excluded income. However, if Country X had modified the permanent establishment tax to also apply to the excluded income, the modified permanent establishment tax would not qualify as a net income tax described in § 1.901–2(a)(3), because it would fail the jurisdictional nexus requirement in § 1.901–2(c)(1). First, the modified tax would not satisfy § 1.901–2(c)(1)(i) because the modified tax would not apply to income attributable under reasonable principles to the nonresident's activities within the foreign country, since the modified tax is determined by taking into account the location of customers. Second, the modified tax would not satisfy § 1.901–2(c)(1)(ii) because the excluded income is from services performed outside of Country X. Third, the modified tax would not satisfy the property nexus in § 1.901–2(c)(1)(iii) because the excluded income is not from sales of property located in Country X. Because if the Country X generally-imposed net income tax applied to excluded income it would not qualify as a net income tax described in § 1.901–2(a)(3), the nonresident ESS tax does not meet the requirement in paragraph (c)(1)(iv) of this section. Therefore, the nonresident ESS tax does not satisfy the substitution requirement in paragraph (c)(1) of this section.

(B) *Covered withholding tax analysis.* The nonresident ESS tax meets the requirement in paragraph (c)(1)(i) of this section, because there exists a generally-imposed net income tax (the permanent establishment tax), and it also meets the requirements in paragraphs (c)(2)(i) and (ii) of this section, because it is a withholding tax on gross income of nonresidents that is not also subject to the permanent establishment tax. However, the nonresident ESS tax does not meet the requirement in paragraph (c)(2)(iii) of this section because the services income subject to the nonresident ESS tax is from electronically supplied services performed outside of Country X. See § 1.901–2(c)(1)(ii). Therefore, the nonresident ESS tax is not a covered withholding tax under paragraph (c)(2) of this section. Because the nonresident ESS tax does not meet the substitution requirement of paragraph (c) of this section, it is not a tax in lieu of an income tax.

(e) *Applicability date.* This section applies to foreign taxes paid or accrued in taxable years beginning on or after [date final regulations are filed with the **Federal Register**].

§ 1.904–2 [Amended]

■ **Par. 25.** Section 1.904–2(j)(1)(iii)(D) is amended by removing the language ''§ 1.904(f)–12(j)(5)'' and adding the language ''§ 1.904(f)–12(j)(6)'' in its place.

■ **Par. 26.** Section 1.904–4, as amended in FR Doc. 2020–21819, published elsewhere in this issue of the **Federal Register**, is further amended:

■ 1. By revising paragraph (b)(2)(i)(A).

■ 2. By revising the third sentence of paragraph (c)(4).

■ 3. By revising paragraphs (e)(1)(ii) and (e)(2) and (3).

■ 4. In paragraph (f)(1)(i) introductory text, by removing the language ''paragraph (f)(1)(ii) of this section'' and adding in its place the language ''paragraph (f)(1)(ii), (iii), or (iv) of this section''.

■ 5. By adding paragraphs (f)(1)(iii) and (iv).

■ 6. By removing and reserving paragraphs (f)(2)(ii) and (iii).

■ 7. By revising paragraphs (f)(2)(vi)(A) and (f)(2)(vi)(B)(*1*)(*ii*).

■ 8. By adding paragraph (f)(2)(vi)(G).

■ 9. By revising paragraph (f)(3)(v).

■ 10. By redesignating paragraphs (f)(3)(viii) and (ix) as paragraphs (f)(3)(ix) and (xii), respectively.

■ 11. By adding a new paragraph (f)(3)(viii).

■ 12. In newly redesignated paragraph (f)(3)(ix), by removing the language ''paragraph (f)(3)(viii)'' and adding the language ''paragraph (f)(3)(ix)'' in its place.

■ 13. By redesignating paragraph (f)(3)(x) as paragraph (f)(3)(xiii).

■ 14. By adding a new paragraph (f)(3)(x) and paragraph (f)(3)(xi).

■ 15. In paragraphs (f)(4)(i)(B)(*1*) and (*2*), by removing the language ''paragraph (f)(3)(viii)'' and adding the language ''paragraph (f)(3)(ix)'' in its place.

■ 16. In paragraphs (f)(4)(iv)(B)(*1*) and (f)(4)(v)(B)(*2*), by removing the language ''paragraph (f)(3)(x)'' and adding the language ''paragraph (f)(3)(xiii)'' in its place.

■ 17. By adding paragraphs (f)(4)(xiii) through (xvi) and (q)(3).

The additions and revisions read as follows:

§ 1.904–4 Separate application of section 904 with respect to certain categories of income.

* * * * *

(b) * * *

(2) * * *

(i) * * *

(A) Income received or accrued by any person that is of a kind that would be foreign personal holding company income (as defined in section 954(c), taking into account any exceptions or exclusions to section 954(c), including, for example, section 954(c)(3), (c)(6), (h), or (i)) if the taxpayer were a controlled foreign corporation, including any amount of gain on the sale or exchange of stock in excess of the amount treated as a dividend under section 1248;

* * * * *

(c) * * *

(4) * * * The grouping rules of paragraphs (c)(3)(i) through (iv) of this section also apply separately to income attributable to each tested unit described in § 1.954–1(d)(2)(i) of a controlled foreign corporation, and to each foreign QBU of a noncontrolled 10-percent owned foreign corporation or any other look-through entity defined in § 1.904–5(i), or of any United States person.

* * * * *

(e) * * *

(1) * * *

(ii) *Definition of financial services income.* The term *financial services income* means income derived by a financial services entity, as defined in paragraph (e)(3) of this section, that is:

(A) Income derived in the active conduct of a banking, insurance, financing, or similar business (active financing income) as defined in paragraph (e)(2) of this section; or

(B) Passive income as defined in section 904(d)(2)(B) and paragraph (b) of this section as determined before the application of the exception for high-taxed income but after the application of the exception for export financing interest, but not including payments from a related person that is not a financial services entity (determined after the application of the financial services group rule of paragraph (e)(3)(ii) of this section) that are attributable to passive category income under the look-through rules of § 1.904–5.

(2) *Active financing income*—(i) *Income included.* For purposes of paragraph (e)(1) and (3) of this section, income is active financing income only if it is income from—

(A) Regularly making personal, mortgage, industrial, or other loans to customers in the ordinary course of the corporation's trade or business;

(B) Factoring evidences of indebtedness for customers;

(C) Purchasing, selling, discounting, or negotiating for customers notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness;

(D) Issuing letters of credit and negotiating drafts drawn thereunder for customers;

(E) Performing trust services, including as a fiduciary, agent, or custodian, for customers, provided such trust activities are not performed in connection with services provided by a dealer in stock, securities or similar financial instruments;

(F) Arranging foreign exchange transactions for, or engaging in foreign exchange transactions with, customers;

(G) Arranging interest rate, currency or commodities futures, forwards, options or notional principal contracts for, or entering into such transactions with, customers;

(H) Underwriting issues of stock, debt instruments or other securities under best efforts or firm commitment agreements for customers;

(I) Engaging in finance leasing (that is, is any lease that is a direct financing lease or a leveraged lease for accounting purposes and is also a lease for tax purposes) for customers;

(J) Providing charge and credit card services for customers or factoring receivables obtained in the course of providing such services;

(K) Providing traveler's check and money order services for customers;

(L) Providing correspondent bank services for customers;

(M) Providing paying agency and collection agency services for customers;

(N) Maintaining restricted reserves (including money or securities) in a segregated account in order to satisfy a capital or reserve requirement imposed by a local banking or securities regulatory authority;

(O) Engaging in hedging activities directly related to another activity described in this paragraph (e)(2)(i);

(P) Repackaging mortgages and other financial assets into securities and servicing activities with respect to such assets (including the accrual of interest incidental to such activity);

(Q) Engaging in financing activities typically provided in the ordinary course by an investment bank, such as project financing provided in connection with construction projects, structured finance (including the extension of a loan and the sale of participations or interests in the loan to other financial institutions or investors), and leasing activities to the extent incidental to such financing activities;

(R) Providing financial or investment advisory services, investment management services, fiduciary services, or custodial services to customers;

(S) Purchasing or selling stock, debt instruments, interest rate or currency futures or other securities or derivative financial products (including notional principal contracts) from or to customers and holding stock, debt instruments and other securities as inventory for sale to customers, unless the relevant securities or derivative financial products are not held in a dealer capacity;

(T) Effecting transactions in securities for customers as a securities broker;

(U) Investing funds in circumstances in which the taxpayer holds itself out as providing a financial service by the acceptance or the investment of such funds, including income from investing deposits of money and income earned investing funds received for the purchase of traveler's checks or face amount certificates;

(V) Investments by an insurance company of its unearned premiums or reserves ordinary and necessary to the proper conduct of the insurance business (as defined in paragraph (e)(2)(ii) of this section);

(W) Activities generating income of a kind that would be insurance income as defined in section 953(a)(1) (including related person insurance income as defined in section 953(c)(2) and without regard to the exception in section 953(a)(2) for income that is exempt insurance income under section 953(e)), but with respect to investment income includible in section 953(a)(1) insurance income, only to the extent ordinary and necessary to the proper conduct of the insurance business (as defined in paragraph (e)(2)(ii) of this section); or

(X) Providing services as an insurance underwriter, insurance brokerage or agency services, or loss adjuster and surveyor services.

(ii) *Ordinary and necessary investment income of an insurance company.* For purposes of paragraphs (e)(2)(i)(V) and (W) of this section, income from investments by an insurance company is not ordinary and necessary to the proper conduct of the insurance business to the extent that the investment income component of paragraphs (e)(2)(i)(V) and (W) of this section exceeds the insurance company's investment income limitation. Any item of investment income falling under both paragraphs (e)(2)(i)(V) and (W) of this section is only counted once.

(A) *Insurance company investment income limitation.* An insurance company's investment income limitation for a taxable year is equal to the company's passive category income (as defined in section 904(d)(2)(B) and paragraph (b) of this section, but including income excluded from foreign personal holding company income under section 954(i)) multiplied by the proportion that the company's investment asset limitation (as determined under paragraph (e)(2)(ii)(B) of this section) bears to the value of the company's passive category assets (as determined under § 1.861–9(g)(2)) for such taxable year. For purposes of this paragraph (e)(2)(ii), the term *passive category asset* means an asset that is characterized as a passive category asset, under the rules of §§ 1.861–9 through 1.861–13.

(B) *Insurance company investment asset limitation.* For purposes of paragraph (e)(2)(ii)(A) of this section, the investment asset limitation equals the applicable percentage of the company's total insurance liabilities. The applicable percentage is—

(*1*) 200 percent of total insurance liabilities, for a domestic corporation taxable under part I of subchapter L of the Code or a foreign corporation that would be taxable under part I of subchapter L if it were a domestic corporation.

(*2*) 400 percent of total insurance liabilities, for a domestic corporation taxable under part II of subchapter L or a foreign corporation that would be taxable under part II of subchapter L if it were a domestic corporation.

(C) *Total insurance liabilities.* For purposes of paragraph (e)(2)(ii)(B) of this section—

(*1*) *Corporations taxable under part I of subchapter L.* In the case of a corporation taxable under part I of subchapter L (including a foreign corporation that is a section 953(d) company), the term total insurance liabilities means the sum of the total reserves (as defined in section 816(c)) plus (to the extent not included in total reserves) the items referred to in paragraphs (3), (4), (5), and (6) of section 807(c).

(*2*) *Corporations taxable under part II of subchapter L.* In the case of a corporation taxable under part II of subchapter L (including a foreign corporation that is a section 953(d) company), the term *total insurance liabilities* means the sum of unearned premiums (determined under § 1.832–4(a)(8)) and unpaid losses.

(*3*) *Controlled foreign insurance corporations.* In the case of a controlled foreign corporation that would be taxable under subchapter L if it were a domestic corporation, the term *total insurance liabilities* means the reserve determined in accordance with section 953(b)(3).

(D) *Example.* The following example illustrates the application of this paragraph (e)(2)(ii).

(*1*) *Facts.* X is a domestic nonlife insurance company taxable under part II of subchapter L. X has passive category assets valued under § 1.861–9(g)(2) at $1,000x, total insurance liabilities of $200x, and passive category income of $100x.

(*2*) *Analysis—Investment income limitation.* Pursuant to paragraph (e)(2)(ii)(B) of this section, the applicable percentage for nonlife insurance companies is 400 percent, and X has an investment asset limitation of $800x, which is equal to its total insurance liabilities of $200x multiplied by 400 percent. The proportion of its investment asset limitation ($800x) to its passive category assets ($1,000x) is 80 percent. Pursuant to paragraph (e)(2)(ii)(A) of this section, X has an investment income limitation equal to its passive category income ($100x) multiplied by 80 percent, or $80x. Under paragraph (e)(2)(ii) of this section, no more than $80x of X's $100x of income from investments qualifies as ordinary and necessary to the proper conduct of X's insurance business.

(3) *Financial services entities*—(i) *Definition of financial services entity*—(A) *In general.* The term *financial services entity* means an individual or corporation that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business (active financing business) for any taxable year. Except as provided in paragraph (e)(3)(ii) of this section, a determination of whether an individual or corporation is a financial services entity is done on an individual or entity-by-entity basis. An individual or corporation is predominantly engaged in the active financing business for any year if for that year more than 70 percent of its gross income is derived directly from active financing income under paragraph (e)(2) of this section with customers, or counterparties, that are not related to such individual or corporation under section 267(b) or 707 (except in the case of paragraph (e)(2)(i)(W) of this section which permits related party insurance).

(B) *Certain gross income included and excluded.* For purposes of applying the rules in paragraph (e)(3)(i)(A) of this section (including by reason of paragraph (e)(3)(ii) of this section), gross income includes interest on State and local bonds described in section 103(a), but does not include income from a distribution of previously taxed earnings and profits described in section 959(a) or (b). In addition, total gross income (for purposes of the denominator of the 70-percent test) includes income received from related persons.

(C) *Treatment of partnerships and other pass-through entities.* For purposes of applying the rules in paragraph (e)(3)(i)(A) of this section (including by reason of paragraph (e)(3)(ii) of this section) with respect to an individual or corporation that is a direct or indirect partner in a partnership, the partner's distributive share of partnership income is characterized as if each partnership item of gross income were realized directly by the partner. For example, in applying section 954(h)(2)(B) under paragraph (e)(3)(i)(A) of this section, a customer with respect to a partnership is treated as a related person with respect to an individual or corporation that is a partner in the partnership if the customer is related to the individual or corporation under section 954(d)(3). The principles of this paragraph (e)(3)(i)(C) apply for an individual or corporation's share of income from any other pass-through entities.

(ii) *Financial services group.* A corporation that is a member of a financial services group is deemed to be a financial services entity regardless of whether it is a financial services entity under paragraph (e)(3)(i) of this section. For purposes of this paragraph (e)(3)(ii), a financial services group means an affiliated group as defined in section 1504(a) (but determined without regard to paragraphs (2) or (3) of section 1504(b)) if more than 70 percent of the affiliated group's gross income is active financing income under paragraph (e)(2) of this section. For purposes of determining whether an affiliated group is a financial services group under the previous sentence, only the income of group members that are domestic corporations, or foreign corporations that are controlled foreign corporations in which U.S. members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting power and value of the stock, is included. In addition, indirect ownership is determined under section 318, and the income of the group does not include any income from transactions with other members of the group. Passive income will not be considered to be active financing income merely because that income is earned by a member of the group that is a financial services entity without regard to the rule of this paragraph (e)(3)(ii).

* * * * *

(f) * * *

(1) * * *

(iii) *Income arising from U.S. activities excluded from foreign branch category income.* Gross income that is attributable to a foreign branch and that arises from activities carried out in the United States by any foreign branch, including income that is reflected on a foreign branch's separate books and records, is not assigned to the foreign branch category. Instead, such income is assigned to the general category or a specified separate category under the rules of this section. However, under paragraph (f)(2)(vi) of this section, gross income (including U.S. source gross income) attributable to activities carried on outside the United States by the foreign branch may be assigned to the foreign branch category by reason of a disregarded payment to a foreign branch from a foreign branch owner or another foreign branch that is allocable to income recorded on the books and records of the payor foreign branch or foreign branch owner.

(iv) *Income arising from stock excluded from foreign branch category income*—(A) *In general.* Except as provided in paragraph (f)(1)(iv)(B) of this section, gross income that is attributable to a foreign branch and that comprises items of income arising from stock of a corporation (whether foreign or domestic), including gain from the disposition of such stock or any inclusion under section 951(a), 951A(a), 1248, or 1293(a), is not assigned to the foreign branch category. Instead, such income is assigned to the general category or a specified separate category under the rules of this section.

(B) *Exception for dealer property.* Paragraph (f)(1)(iv)(A) of this section does not apply to gain recognized from dispositions of stock in a corporation, if the stock would be dealer property (as defined in § 1.954–2(a)(4)(v)) if the foreign branch were a controlled foreign corporation.

* * * * *

(2) * * *

(vi) * * *

(A) *In general.* If a foreign branch makes a disregarded payment to its foreign branch owner or a second foreign branch, and the disregarded payment is allocable to gross income that would be attributable to the foreign branch under the rules in paragraphs (f)(2)(i) through (v) of this section, the gross income attributable to the foreign branch is adjusted downward (but not below zero) to reflect the allocable amount of the disregarded payment, and the gross income attributable to the foreign branch owner or the second foreign branch is adjusted upward by the same amount as the downward adjustment, translated (if necessary) from the foreign branch's functional currency to U.S. dollars (or the second foreign branch's functional currency, as applicable) at the spot rate (as defined in § 1.988–1(d)) on the date of the disregarded payment. For rules addressing multiple disregarded payments in a taxable year, see paragraph (f)(2)(vi)(F) of this section. Similarly, if a foreign branch owner makes a disregarded payment to its foreign branch and the disregarded payment is allocable to gross income attributable to the foreign branch owner, the gross income attributable to the foreign branch owner is adjusted downward (but not below zero) to reflect the allocable amount of the disregarded payment, and the gross income attributable to the foreign branch is adjusted upward by the same amount as the downward adjustment, translated (if necessary) from U.S. dollars to the foreign branch's functional currency at the spot rate on the date of the disregarded payment. An adjustment to the attribution of gross income under this paragraph (f)(2)(vi) does not change the total amount, character, or source of the United States person's gross income; does not change the amount of a United States person's income in any separate category other than the foreign branch and general categories (or a specified separate category associated with the foreign branch and general categories); and has no bearing on the analysis of whether an item of gross income is eligible to be resourced under an income tax treaty.

(B) * * *

(*1*) * * *

(*ii*) Disregarded payments from a foreign branch to its foreign branch owner or to another foreign branch are allocable to gross income attributable to the payor foreign branch to the extent a deduction for that payment or any disregarded cost recovery deduction relating to that 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 1.861–14T and 1.861–17 (without regard to exclusive apportionment) by treating foreign source gross income and U.S. source gross income in each separate category (determined before the application of this paragraph (f)(2)(vi) to the disregarded payment at issue) each as a statutory grouping.

* * * * *

(G) *Effect of disregarded payments made and received by non-branch taxable units*—(*1*) *In general.* For purposes of determining the amount, source, and character of gross income attributable to a foreign branch and its foreign branch owner under paragraph (f)(2) of this section, the rules of paragraph (f)(2) of this section apply to a non-branch taxable unit as though the non-branch taxable unit were a foreign branch or a foreign branch owner, as appropriate, to attribute gross income to the non-branch taxable unit and to further attribute, under this paragraph (f)(2)(vi)(G), the income of a non-branch taxable unit to one or more foreign branches or to a foreign branch owner. See paragraph (f)(4)(xvi) of this section (*Example 16*).

(*2*) *Foreign branch group income.* The income of a foreign branch group is attributed to the foreign branch that owns the group. The income of a foreign branch group is the aggregate of the U.S. gross income that is attributed, under the rules of this paragraph (f)(2), to each member of the foreign branch group, determined after taking into account all disregarded payments made and received by each member.

(*3*) *Foreign branch owner group income.* The income of a foreign branch owner group is attributed to the foreign branch owner that owns the group. The income of a foreign branch owner group income is the aggregate of the U.S. gross income that is attributed, under the rules of this paragraph (f)(2), to each member of the foreign branch owner group, determined after taking into account all disregarded payments made and received by each member.

(3) * * *

(v) *Disregarded payment.* A disregarded payment includes an amount of property (within the meaning of section 317(a)) that is transferred to or from a non-branch taxable unit, foreign branch, or foreign branch owner, including a payment 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 Federal income tax purposes and that is reflected on the separate set of books and records of a non-branch taxable unit (other than an individual or domestic corporation) or a foreign branch. A disregarded payment also includes any other amount that is reflected on the separate set of books and records of a non-branch taxable unit (other than an individual or a domestic corporation) or a foreign branch in connection with a transaction that is disregarded for Federal income tax purposes and that would constitute an item of accrued income, gain, deduction, or loss of the non-branch taxable unit (other than an individual or a domestic corporation) or the foreign branch if the transaction to which the amount is attributable were regarded for Federal income tax purposes.

* * * * *

(viii) *Foreign branch group.* 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.

* * * * *

(x) *Foreign branch owner group.* 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 owner owns the non-branch taxable unit directly or indirectly through one or more other non-branch taxable units.

(xi) *Non-branch taxable unit.* The term *non-branch taxable unit* has the meaning provided in § 1.904–6(b)(2)(i)(B).

* * * * *

(4) * * *

(xiii) *Example 13: Disregarded payment from domestic corporation to foreign branch*—(A) *Facts.* P, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch. FDE's functional currency is the U.S. dollar. In Year 1, P accrues and records on its books and records for Federal income tax purposes $400x of gross income from the license of intellectual property to unrelated parties that is not passive category income, all of which is U.S. source income. P also accrues $600x of foreign source passive category interest income. P compensates FDE for services that FDE performs in a foreign country with an arm's length payment of $350x, which FDE records on its books and records; the transaction is disregarded for Federal income tax purposes. Absent the application of paragraph (f)(2)(vi) of this section, the $400x of gross income earned by P from the license would be general category income that would not be attributable to FDE. If the payment were regarded for Federal income tax purposes, the deduction for the payment of $350x from P to FDE would be allocated and apportioned entirely to P's $400x of general category gross licensing income under the principles of §§ 1.861–8 and 1.861–8T (treating U.S. source general category gross income and foreign source passive category gross income each as a statutory grouping). There are no other expenses incurred by P or FDE.

(B) *Analysis.* The disregarded payment from P, a United States person, to FDE, its foreign branch, is not recorded on FDE's separate books and records (as adjusted to conform to Federal income tax principles) under paragraph (f)(2)(i) of this section because it is disregarded for Federal income tax purposes. The disregarded payment is allocable to gross income attributable to P because a deduction for the payment, if it were regarded, would be allocated and apportioned to the $400x of P's U.S. source licensing income. Accordingly, under paragraphs (f)(2)(vi)(A) and (f)(2)(vi)(B)(*3*) of this section, the amount of gross income attributable to the FDE foreign branch (and the gross income attributable to P) is adjusted in Year 1 to take the disregarded payment into account. Accordingly, $350x of P's $400x U.S. source general category gross income from the license is attributable to the FDE foreign branch for purposes of this section. Therefore, $350x of the U.S. source gross income that P earned with respect to its license in Year 1 constitutes U.S. source gross income that is assigned to the foreign branch category and $50x remains U.S. source general category income. P's $600x of foreign source passive category interest income is unchanged.

(xiv) *Example 14: Regarded payment from non-consolidated domestic corporation to a foreign branch*—(A) *Facts.* The facts are the same as in paragraph (f)(4)(xiii)(A) of this section (the facts of *Example 13*), except P wholly owns USS, and USS (rather than P) owns FDE. P and USS do not file a consolidated return. USS has no gross income other than the $350x foreign source services income it receives from P, through FDE, for Federal income tax purposes.

(B) *Analysis.* P has $400x of U.S. source general category gross income from the license and $600x of foreign source passive category interest income. The $350x services payment from P, a United States person, to FDE, a foreign branch of USS, is not a disregarded payment because the transaction is regarded for Federal income tax purposes. Under §§ 1.861–8 and 1.861–8T, P's $350x deduction for the services payment is allocated and apportioned to its U.S. source general category gross income. The payment of $350x from P to USS is services income attributable to FDE, and foreign branch category income of USS under paragraph (f)(2)(i) of this section. Accordingly, USS has $350x of foreign source foreign branch category gross income. P has $600x of foreign source passive category income and $400x of U.S. source general category gross income and a $350x deduction for the services payment, resulting in $50x of U.S. source general category taxable income to P.

(xv) *Example 15: Regarded payment from a member of a consolidated group to a foreign branch of another member of the group*—(A) *Facts.* The facts are the same as in paragraph (f)(4)(xiv)(A) of this section (the facts of *Example 14*), except that P and USS are members of an affiliated group that files a consolidated return pursuant to section 1502 (P group).

(B) *Analysis*—(*1*) *Definitions under § 1.1502–13.* Under § 1.1502–13(b)(1), the $350x services payment from P, a United States person, to FDE, a foreign branch of USS, is an intercompany transaction between P and USS; USS is the selling member, P is the buying member, P has a corresponding deduction of $350x for the services payment, and USS has $350x of intercompany income. The payment is not a disregarded payment because the transaction is regarded for Federal income tax purposes.

(*2*) *Timing and attributes under § 1.1502–13*—(*i*) *Separate entity versus single entity analysis.* Under a separate entity analysis, the result is the same as in paragraph (f)(4)(xiv)(B) of this section (the analysis in *Example 14*), whereby P has $600x of foreign source passive category income and $50x of U.S. source general category income, and USS has $350x of foreign source foreign branch category income. In contrast, under a single entity analysis, the result is the same as in paragraph (f)(4)(xiii)(B) of this section (the analysis in *Example 13*), whereby P has $600x of foreign source passive category income, $50x of U.S. source general category income, and $350x of U.S. source foreign branch category income.

(*ii*) *Application of the matching rule.* Under the matching rule in § 1.1502–13(c), the timing, character, source, and other attributes of USS's $350x intercompany income and P's corresponding $350x deduction are redetermined to produce the effect of transactions between divisions of a single corporation, as if the services payment had been made to a foreign branch of that corporation. Accordingly, all of USS's foreign source income of $350x is redetermined to be U.S. source, rather than foreign source, income. Therefore, for purposes of § 1.1502–4(c)(1), the P group has $600x of foreign passive category income, $50x of U.S. source general category income, and $350x of U.S. source foreign branch category income.

(xvi) *Example 16: Disregarded payment made from non-branch taxable unit*—(A) *Facts.* The facts are the same as in paragraph (f)(4)(xiii)(A) of this section (the facts of *Example 13*), except that P also wholly owns FDE1, a disregarded entity that is a non-branch taxable unit. In addition, FDE1 (rather than P) is the entity that properly accrues and records on its books and records the $400x of U.S. source general category income from the license of intellectual property and the $600x of foreign source passive category interest income, and FDE1 (rather than P) is the entity that makes the $350x payment, which is disregarded for Federal income tax purposes, to FDE in compensation for services.

(B) *Analysis.* Under paragraph (f)(2)(vi)(G) of this section, the rules of paragraph (f)(2) of this section apply to attribute gross income to FDE1, a non-branch taxable unit, as though FDE1 were a foreign branch. Under these rules, the $400x of licensing income and the $600 of interest income are initially attributable to FDE1. This income is adjusted in Year 1 to take into account the $350x disregarded payment, which is allocable to the $400x of licensing income of FDE1. Accordingly, $50x of the $400x of U.S. source general category licensing income is attributable to FDE1 and $350x of this income is attributable to the FDE foreign branch. In order to determine the income that is attributable to P, the foreign branch owner, and FDE, the foreign branch, the income that is attributed to FDE1, after taking into account all of the disregarded payments that it makes and receives, must be further attributed to one or more foreign branches or a foreign branch owner under paragraph (f)(2)(vi)(G) of this section. Under paragraph (f)(2)(vi)(G) of this section, the income of FDE1 is attributed to the foreign branch group or foreign branch owner group of which it is a member. Because FDE1 is wholly owned by P, FDE is a member solely of the foreign branch owner group that is owned by P. See definition of "foreign branch owner group" in § 1.904–4(f)(3). All of the income that is attributed to FDE1 under paragraph (f)(2) of this section, namely, the $50x of U.S. source general category licensing income and the $600x of foreign source passive category interest income, is further attributed to P. See § 1.904–4(f)(2)(vi)(G)(*3*). Therefore, the result is the same as in paragraph (f)(4)(xiii)(B) of this section (the analysis in *Example 13*).

* * * * *

(q) * * *

(3) Paragraphs (e)(1)(ii) and (e)(2) and (3) of this section apply to taxable years beginning on or after [date final regulations are filed with the **Federal Register**]. Paragraph (f) of this section applies to taxable years that begin after December 31, 2019, and end on or after November 2, 2020.

■ **Par. 27.** Section 1.904–5 is amended by revising paragraphs (b)(2) and (o) as follows:

§ 1.904–5 Look-through rules as applied to controlled foreign corporations and other entities.

* * * * *

(b) * * *

(2) *Priority and ordering of look-through rules.* To the extent the look-through rules assign income to a separate category, the income is assigned to that separate category rather than the separate category to which the income would have been assigned under § 1.904–4 (not taking into account § 1.904–4(l)). See paragraph (k) of this section for ordering rules for applying the look-through rules.

* * * * *

(o) *Applicability dates.* Except as provided in this paragraph (o), this section is applicable for taxable years that both begin after December 31, 2017, and end on or after December 4, 2018. Paragraph (b)(2) of this section applies to taxable years beginning on or after [date final regulations are filed with the **Federal Register**].

■ **Par. 28.** Section 1.904–6, as amended in FR Doc. 2020–21819, published elsewhere in this issue of the **Federal Register**, is further amended by adding paragraph (b)(2) and revising paragraph (g) to read as follows:

§ 1.904–6 Allocation and apportionment of foreign income taxes.

* * * * *

(b) * * *

(2) *Disregarded payments*—(i) *In general*—(A) *Assignment of foreign gross income.* Except as provided in paragraph (b)(2)(ii) of this section, if a taxpayer that is an individual or a domestic corporation includes an item of foreign gross income by reason of the receipt of a disregarded payment by a foreign branch or foreign branch owner (as those terms are defined in § 1.904–4(f)(3)), or a non-branch taxable unit, the foreign gross income item is assigned to a separate category under § 1.861–20(d)(3)(v).

(B) *Definition of non-branch taxable unit.* The term *non-branch taxable unit* means a person or interest that is described in paragraph (b)(2)(i)(B)(*1*) or (*2*) of this section, respectively.

(*1*) *Persons.* A non-branch taxable unit described in this paragraph (b)(2)(i)(B)(*1*) means 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 (or other pass-through entity, as defined in § 1.904–5(a)(4)) an interest in which is owned, directly or indirectly through one or more other partnerships (or other pass-through entities), by a U.S. individual or a domestic corporation.

(*2*) *Interests.* A non-branch taxable unit described in this paragraph (b)(2)(i)(B)(*2*) means an interest of a foreign branch owner or an interest of a person described in paragraph (b)(2)(i)(B)(*1*) of this section that is not otherwise a foreign branch, and that is either a disregarded entity or a branch, as defined in § 1.267A–5(a)(2), including a branch described in § 1.954–1(d)(2)(i)(C) (modified by substituting the term ''person'' for ''controlled foreign corporation'').

(ii) *Foreign branch group contributions*—(A) *In general.* If a taxpayer includes an item of foreign gross income by reason of a foreign branch group contribution, the foreign gross income is assigned to the foreign branch category, or, in the case of a foreign branch owner that is a partnership, to the partnership's general category income that is attributable to the foreign branch. See, however, §§ 1.861–20(d)(3)(v)(C)(*2*) and 1.960–1(d)(3)(ii)(A) and (e) for rules providing that foreign income tax on a disregarded payment that is a contribution from a controlled foreign corporation to a taxable unit is assigned to the residual grouping and cannot be deemed paid under section 960.

(B) *Foreign branch group contribution.* A foreign branch group contribution is a contribution (as defined in § 1.861–20(d)(3)(v)(E)) made by a member of a foreign branch owner group to a member of a foreign branch group that the payor owns, made by a member of a foreign branch group to another member of that group that the payor owns, or made by a member of a foreign branch group to a member of a different foreign branch group that the payor owns. For purposes of this paragraph (b)(2)(ii)(B), the terms *foreign branch group* and *foreign branch owner group* have the meanings provided in § 1.904–4(f)(3).

* * * * *

(g) *Applicability date.* Except as otherwise provided in this paragraph (g), this section applies to taxable years that begin after December 31, 2019. Paragraph (b)(2) of this section applies to taxable years that begin after December 31, 2019, and end on or after November 2, 2020.

■ **Par. 29.** Section 1.904(f)–12 is amended by:

■ 1. Removing paragraph (j)(6).

■ 2. Redesignating paragraph (j)(5) as paragraph (j)(6).

■ 3. Adding a new paragraph (j)(5) and paragraph (j)(7).

The additions read as follows:

§ 1.904(f)–12 Transition rules.

* * * * *

(j) * * *

(5) *Treatment of net operating losses incurred in post-2017 taxable years that are carried back to pre-2018 taxable years*—(i) *In general.* Except as provided in paragraph (j)(5)(ii) of this section, a net operating loss (NOL) incurred in a taxable year beginning after December 31, 2017 (a ''post-2017 taxable year''), which is carried back, pursuant to section 172, to a taxable year beginning before January 1, 2018 (a ''pre-2018 carryback year''), will be carried back under the rules of § 1.904(g)–3(b). For purposes of applying the rules of § 1.904(g)–3(b), income in a pre-2018 separate category in the taxable year to which the net operating loss is carried back is treated as if it included only income that would be assigned to the post-2017 general category. Therefore, any separate limitation loss created by reason of a passive category component of an NOL from a post-2017 taxable year that is carried back to offset general category income in a pre-2018 carryback year will be recaptured in post-2017 taxable years as general category income, and not as a combination of general, foreign branch, and section 951A category income.

(ii) *Foreign source losses in the post-2017 separate categories for foreign branch category income and section 951A category income.* Net operating losses attributable to a foreign source loss in the post-2017 separate categories for foreign branch category income and section 951A category income are treated as first offsetting general category income in a pre-2018 carryback year to the extent available to be offset by the net operating loss carryback. If the sum of foreign source losses in the taxpayer's separate categories for foreign branch category income and section 951A category income in the year the net operating loss is incurred exceeds the amount of general category income that is available to be offset in the carryback year, then the amount of foreign source loss in each of the foreign branch and section 951A categories that is treated as offsetting general category income under this paragraph (j)(5)(ii), is determined on a proportionate basis. General category income in the pre-2018 carryback year is first offset by foreign source loss in the taxpayer's post-2017 separate category for general category income in the year the net operating loss is incurred before any foreign source loss in that year in the separate categories for foreign branch category income and section 951A category income is carried back to reduce general category income. To the extent a foreign source loss in a post-2017 separate category for foreign branch category income or section 951A category income offsets general category income in a pre-2018 taxable year under the rules of this paragraph (j)(5)(ii), no separate limitation loss account is created.

* * * * *

(7) *Applicability date.* Except as otherwise provided in this paragraph (j)(7), this paragraph (j) applies to taxable years ending on or after December 31, 2017. Paragraph (j)(5) of this section applies to carrybacks of net operating losses incurred in taxable years beginning on or after January 1, 2018.

■ **Par. 30.** Section 1.905–1 is amended by:

■ 1. Revising the section heading and paragraph (a).

■ 2. Redesignating paragraph (b) as paragraph (g).

■ 3. Adding a new paragraph (b) and paragraphs (c), (d), (e), and (f).

■ 4. Revising the heading of newly redesignated paragraph (g).

■ 5. Adding paragraph (h).

The revisions and additions read as follows:

§ 1.905–1 When credit for foreign income taxes may be taken.

(a) *Scope.* This section provides rules regarding when the credit for foreign income taxes (as defined in § 1.901–2(a)) may be taken, based on a taxpayer's method of accounting for such taxes. Paragraph (b) of this section provides the general rule. Paragraph (c) of this section sets forth rules for determining the taxable year in which taxpayers using the cash receipts and disbursement method of accounting for income (''cash method'') may claim a foreign tax credit. Paragraph (d) of this section sets forth rules for determining the taxable year in which taxpayers using the accrual method of accounting for income (''accrual method'') may claim a foreign tax credit. Paragraph (e) of this section provides rules for taxpayers using the cash method to claim foreign tax credits on the accrual basis pursuant to the election provided under section 905(a). Paragraph (f) of this section provides rules for when foreign income tax expenditures of a pass-through entity can be taken as a credit by the entity's partners, shareholders, or owners. Paragraph (g) of this section provides rules for when a foreign tax credit can be taken with respect to blocked income. Paragraph (h) provides the applicability dates for this section.

(b) *General rule.* The credit for taxes provided in subpart A, part III, subchapter N, chapter 1 of the Code (the ''foreign tax credit'') may be taken either on the return for the year in which the taxes accrued or on the return for the year in which the taxes were paid, depending on whether the taxpayer uses the accrual or the cash receipts and disbursements method of accounting for purposes of computing taxable income and filing returns. However, regardless of the year in which the credit is claimed under the taxpayer's method of accounting for foreign income taxes, the foreign tax credit is allowed only to the extent the foreign income taxes are ultimately both owed and actually remitted to the foreign country (in the case of a taxpayer claiming the foreign tax credit on the accrual basis, within the time prescribed by section 905(c)(2)). See section 905(b) and §§ 1.901–1(a) and 1.901–2(e). Because the taxpayer's liability for foreign income tax may accrue (that is, become fixed and determinable) in a different taxable year than that in which the tax is paid (that is, remitted), the taxpayer's entitlement to the credit may be perfected, or become subject to adjustment, by reason of events that occur in a taxable year after the taxable year in which the credit is allowed. See section 905(c) and § 1.905–3(a) for rules relating to changes to the taxpayer's foreign income tax liability that require a redetermination of the allowable foreign tax credit and the taxpayer's U.S. tax liability.

(c) *Rules for cash method taxpayers*—(1) *Credit allowed in year paid.* Except as provided in paragraph (e) of this section, a taxpayer who uses the cash method may claim a foreign tax credit only in the taxable year in which the foreign income taxes are paid. Generally, foreign income taxes are considered paid in the taxable year in which the taxes are remitted to the foreign country. However, foreign withholding taxes described in section 901(k)(1)(B), as well as foreign net income taxes described in § 1.901–2(a)(3)(i) that are withheld from the taxpayer's gross income by the payor, are treated as paid in the year in which they are withheld. Foreign income taxes that have been withheld or remitted but which are not considered an amount of tax paid for purposes of section 901 under the rules of § 1.901–2(e) (for example, because the amount withheld or remitted was not a compulsory payment), however, are not eligible for a foreign tax credit. See §§ 1.901–2(e) and 1.905–3(b)(1)(ii)(B) (*Example 2*).

(2) *Adjustments to taxes claimed as a credit in the year paid.* A refund of foreign income taxes for which a foreign tax credit has been claimed on the cash basis, or a subsequent determination that the amount paid exceeds the taxpayer's liability for foreign income tax, requires a redetermination of foreign income taxes paid and the taxpayer's U.S. tax liability pursuant to section 905(c) and § 1.905–3. See § 1.905–3(a) and (b)(1)(ii)(G) (*Example 7*). Additional foreign income taxes paid that relate back to a prior year in which foreign income taxes were claimed as a credit on the cash basis, including by reason of the settlement of a dispute with the foreign tax authority, may only be claimed as a credit in the year the additional taxes are paid. The payment of such additional taxes does not result in a redetermination pursuant to section 905(c) or § 1.905–3 of the foreign income taxes paid in any prior year, although a redetermination of U.S. tax liability may be required due, for example, to a carryback of unused foreign tax under section 904(c) and § 1.904–2.

(d) *Rules for accrual method taxpayers*—(1) *Credit allowed in year accrued*—(i) *In general.* A taxpayer who uses the accrual method may claim a foreign tax credit only in the taxable year in which the foreign income taxes are considered to accrue for foreign tax credit purposes under the rules of this paragraph (d). Foreign income taxes accrue in the taxable year in which all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. See §§ 1.446–1(c)(1)(ii)(A) and 1.461–4(g)(6)(iii)(B). For purposes of the preceding sentence, a foreign income tax that is contingent on a future distribution of earnings does not meet the all events test until the earnings are distributed. A foreign income tax liability determined on the basis of a foreign taxable year becomes fixed and determinable at the close of the taxpayer's foreign taxable year. Therefore, foreign income taxes that are computed based on items of income, deduction, and loss that arise in a foreign taxable year accrue in the United States taxable year with or within which the taxpayer's foreign taxable year ends. Foreign withholding taxes that are paid with respect to a foreign taxable year and that represent advance payments of a foreign net income tax liability determined on the basis of that foreign taxable year accrue at the close of the foreign taxable year. Foreign withholding taxes imposed on a payment giving rise to an item of foreign gross income accrue on the date the payment from which the tax is withheld is made (or treated as made under foreign tax law).

(ii) *Relation-back rule for adjustments to taxes claimed as a credit in year accrued.* Additional tax paid as a result of a change in the foreign tax liability, including additional taxes paid when a contest with a foreign tax authority is resolved, relate back and are considered to accrue at the end of the foreign taxable year with respect to which the taxes were imposed (the ''relation-back year''). Additional withholding tax paid as a result of a change in the amount of an item of foreign gross income (such as pursuant to a foreign transfer pricing adjustment), also relate back and are considered to accrue in the year in which the payment from which the additional tax is withheld is made (or considered to have been made under foreign tax law). Foreign income taxes that are not paid within 24 months after the close of the taxable year in which they were accrued are treated as refunded pursuant to § 1.905–3(a); when subsequently paid, the foreign income taxes are allowed as a credit in the relation-back year. See § 1.905–3(b)(1)(ii)(E) (*Example 5*). For special rules that apply to determine when foreign income tax is considered to accrue in the case of certain ownership and entity classification changes, see §§ 1.336–2(g)(3)(ii), 1.338–9(d), 1.901–2(f)(5), and 1.1502–76.

(2) *Special rule for 52–53 week U.S. taxable years.* If a taxpayer has elected pursuant to section 441(f) to use a U.S. taxable year consisting of 52–53 weeks, and such U.S. taxable year closes within six calendar days of the end of the taxpayer's foreign taxable year, the determination of when foreign income taxes accrue under paragraph (d)(1) of this section is made by deeming the taxpayer's U.S. taxable year to end on the last day of its foreign taxable year.

(3) *Accrual of contested foreign tax liability.* A contested foreign income tax liability is finally determined and accrues for purposes of paragraph (d)(1) of this section when the contest is resolved. However, pursuant to section 905(c)(2), no credit is allowed for any accrued tax that is not paid within 24 months of the close of the relation-back year until the tax is actually remitted and considered paid. Thus, except as provided in paragraph (d)(4) of this section, a foreign tax credit for a contested foreign income tax liability cannot be claimed until such time as both the contest is resolved and the tax is actually paid, even if the contested liability (or portion thereof) has

previously been remitted to the foreign country. Once the contest is resolved and the foreign income tax liability is finally determined and paid, the tax liability accrues, and is considered actually to accrue in the relation-back year for purposes of the foreign tax credit. See paragraph (d)(1) of this section; see also section 6511(d)(3) and § 301.6511(d)–3 of this chapter for a special 10-year period of limitations for claiming a credit or refund of U.S. tax that is attributable to foreign income taxes for which a credit is allowed under section 901, which runs from the unextended due date of the return for the taxable year in which the foreign income taxes are paid (within the meaning of paragraph (c) of this section, for taxpayers claiming credits on the cash basis) or accrued (within the meaning of this paragraph (d)), for taxpayers claiming credits on the accrual basis).

(4) *Election to claim a provisional credit for contested taxes remitted before accrual*—(i) *Conditions of election.* A taxpayer may, under the conditions provided in this paragraph (d)(4), elect to claim a foreign tax credit (but not a deduction) for a contested foreign income tax liability (or a portion thereof) in the relation-back year when the contested amount (or a portion thereof) is remitted to the foreign country, notwithstanding that the liability is not finally determined and so has not accrued. To make the election, a taxpayer must file an amended return for the taxable year to which the contested tax relates, together with a Form 1116 (Foreign Tax Credit (Individual, Estate, or Trust)) or Form 1118 (Foreign Tax Credit—Corporations), and the agreement described in paragraph (d)(4)(ii) of this section. In addition, the taxpayer must, for each subsequent taxable year up to and including the taxable year in which the contest is resolved, file the annual certification described in paragraph (d)(4)(iii) of this section. Any portion of a contested foreign income tax liability for which a provisional credit is claimed under this paragraph (d)(4) that is subsequently refunded by the foreign country results in a foreign tax redetermination under § 1.905–3(a).

(ii) *Contents of provisional foreign tax credit agreement.* The provisional foreign tax credit agreement must contain the following:

(A) A statement that the document is an election and an agreement under the provisions of paragraph (d)(4) of this section;

(B) A description of contested foreign income tax liability, including the name of the foreign tax or taxes being contested, the name of the country imposing the tax, the amount of the contested tax, and the U.S. taxable year(s) and the income to which the contested foreign income tax liability relates;

(C) The amount of the contested foreign income tax liability in paragraph (d)(4)(ii)(B) of this section that has been remitted to the foreign country and the date of the remittance(s);

(D) An agreement by the taxpayer, for a period of three years from the later of the filing or the due date (with extensions) of the return for the taxable year in which the taxpayer notifies the Internal Revenue Service of the resolution of the contest, not to assert the statute of limitations on assessment as a defense to the assessment of additional taxes or interest related to the contested foreign income tax liability described in paragraph (d)(4)(ii)(B) of this section that may arise from a determination that the taxpayer failed to exhaust all effective and practical remedies to minimize its foreign income tax liability, so that the amount of the contested foreign income tax is not a compulsory payment and is not considered paid within the meaning of § 1.901–2(e)(5);

(E) A statement that the taxpayer agrees to comply with all the conditions and requirements of paragraph (d)(4) of this section, including to provide notice to the Internal Revenue Service upon the resolution of the contest, and to treat the failure to comply with such requirement as a refund of the contested foreign income tax liability that requires a redetermination of the taxpayer's U.S. tax liability pursuant to § 1.905–3(b); and

(F) Any additional information as may be prescribed by the Commissioner of Internal Revenue in Internal Revenue Service forms or instructions.

(iii) *Annual certification.* For each taxable year following the year in which an election pursuant to paragraph (d)(4) of this section is made up to and including the taxable year in which the contest is resolved, the taxpayer must include with its timely-filed return a certification containing the information described in paragraphs (d)(4)(iii)(A) through (C) of this section in the form or manner prescribed by the Commissioner of Internal Revenue in Internal Revenue Service forms or instructions.

(A) A description of the contested foreign income tax liability, including the name of the foreign tax or taxes, the country imposing the tax, the amount of the contested tax, and a description of the status of the contest.

(B) With the return for the taxable year in which the contest is resolved, notification that the contest has been resolved. Such notification must include the date of final resolution and the amount of the finally determined foreign income tax liability.

(C) Any additional information, which may include a copy of the final judgment, order, settlement, or other documentation of the contest resolution, as may be prescribed by the Commissioner of Internal Revenue in Internal Revenue Service forms or instructions.

(iv) *Signatory.* The provisional foreign tax credit agreement and the annual certification must be signed under penalties of perjury by a person authorized to sign the return of the taxpayer.

(v) *Failure to comply.* A taxpayer that fails to comply with the requirements for filing a provisional foreign tax credit agreement under paragraphs (d)(4)(i) and (ii) of this section will not be allowed a provisional credit for the contested foreign income tax liability. A taxpayer that fails to comply with the annual certification requirement of paragraph (d)(4)(iii) of this section will be treated as receiving a refund of the amount of the contested foreign income tax liability on the date the annual certification is required to be filed under paragraph (d)(4)(iii) of this section, resulting in a redetermination of the taxpayer's U.S. tax liability pursuant to § 1.905–3(b).

(5) *Correction of improper accruals*—(i) *In general.* The accrual of a foreign income tax expense generally involves the determination of the proper timing for recognizing the expense for Federal income tax purposes. Thus, foreign income tax expense is a material item within the meaning of section 446. See § 1.446–1(e)(2)(ii). As a material item, a change in the timing of accruing a foreign income tax expense is generally a change in method of accounting. See section 446(e). A change from an improper method of accruing foreign income taxes to the proper method of accrual described in this paragraph (d) is treated as a change in a method of accounting, regardless of whether the taxpayer (or a partner or beneficiary taking into account a distributive share of foreign income taxes paid by a partnership or other pass-through entity) chooses to claim a deduction or a credit for such taxes in any taxable year. For purposes of this paragraph (d)(5), an improper method of accruing foreign income taxes includes a method under which foreign income tax is accrued in a taxable year other than the taxable year in which the requirements

of the all events test in §§ 1.446–1(c)(1)(ii)(A) and 1.461–4(g)(6)(iii)(B) are met, or which fails to apply the relation-back rule in paragraph (d)(1) of this section that applies for purposes of the foreign tax credit, but does not include corrections to estimated accruals or errors in computing the amount of foreign income tax that is allowed as a deduction or credit in any taxable year. Taxpayers must file a Form 3115, Application for Change in Accounting Method, in accordance with Revenue Procedure 2015–13 (or any successor administrative procedure prescribed by the Commissioner) to obtain the Commissioner's permission to change from an improper method of accruing foreign income taxes to the proper method described in this paragraph (d). In order to prevent a duplication or omission of a benefit for foreign income taxes that accrue in any taxable year (whether through the double allowance or double disallowance of either a deduction or a credit, the allowance of both a deduction and a credit, or the disallowance of either a deduction or a credit, for the same amount of foreign income tax), the rules in paragraphs (d)(5)(ii) through (iv) of this section, describing a modified cut-off approach, apply if the Commissioner grants permission for the taxpayer to change to the proper method of accrual. Under the modified cut-off approach, a section 481(a) adjustment is neither required nor permitted with respect to the amounts of foreign income tax that were improperly accrued (or improperly not accrued) under the taxpayer's improper method in taxable years before the taxable year of change.

(ii) *Adjustments required to implement a change in method of accounting for accruing foreign income taxes.* A change from an improper method of accruing foreign income taxes to the proper method described in this paragraph (d) is made under the modified cut-off approach described in this paragraph (d)(5)(ii). Under the modified cut-off approach, the amount of foreign income tax in a statutory or residual grouping (such as a separate category as defined in § 1.904–5(a)(4)) that properly accrues in the taxable year of change (accounted for in the currency in which the foreign tax liability is denominated) is adjusted downward (but not below zero) by the amount of foreign income tax in the same grouping that the taxpayer improperly accrued in a prior taxable year and for which the taxpayer claimed a credit or a deduction in such prior taxable year, but only if the improperly-accrued amount of foreign income tax did not properly accrue in a taxable year before the taxable year of change. Conversely, under the modified cut-off approach, the amount of foreign income tax in any statutory or residual grouping that properly accrues in the taxable year of change (accounted for in the currency in which the foreign tax liability is denominated) is adjusted upward by the amount of foreign income tax in the same grouping that properly accrued in a taxable year before the taxable year of change but which, under the taxpayer's improper method of accounting, the taxpayer failed to accrue and claim as either a credit or a deduction in any taxable year before the taxable year of change. For purposes of the foreign tax credit, the adjusted amounts of accrued foreign income taxes, including any upward adjustment, are translated into U.S. dollars under § 1.986(a)–1 as if those amounts properly accrued in the taxable year of change. To the extent that the downward adjustment in any grouping required under this modified cut-off approach exceeds the amount of foreign income tax properly accruing in that grouping in the year of change, such excess will carry forward to each subsequent taxable year and reduce properly-accrued amounts of foreign income tax in the same grouping to the extent of those properly-accrued amounts, until all improperly-accrued amounts included in the downward adjustment are accounted for. See § 1.861–20 for rules that apply to assign foreign income taxes to statutory and residual groupings.

(iii) *Application of section 905(c)*—(A) *Two-year rule.* Except as otherwise provided in this paragraph (d)(5)(iii), if the taxpayer claimed a credit for improperly-accrued amounts in a taxable year before the taxable year of change, no adjustment is required under section 905(c)(2) and § 1.905–3(a) solely by reason of the improper accrual. For purposes of applying section 905(c)(2) and § 1.905–3(a) to improperly-accrued amounts of foreign income tax that were claimed as a credit in any taxable year before the taxable year of change, the 24-month period runs from the close of the U.S. taxable year(s) in which those amounts were accrued under the taxpayer's improper method and claimed as a credit. To the extent any improperly-accrued amounts remain unpaid as of the date 24 months after the close of the taxable year in which the amounts were improperly accrued and claimed as a credit, an adjustment is required under section 905(c)(2) and § 1.905–3(a) as if the improperly-accrued amounts were refunded as of the date 24 months after the close of such taxable year. See § 1.986(a)–1(c) (a refund or other downward adjustment to foreign income taxes paid or accrued on more than one date reduces the foreign income taxes paid or accrued on a last-in, first-out basis, starting with the amounts most recently paid or accrued).

(B) *Application of payments.* Amounts of foreign income tax that a taxpayer accrued and claimed as a credit or a deduction in a taxable year before the taxable year of change under the taxpayer's improper method, but that had properly accrued either in the taxable year the credit or deduction was claimed or in a different taxable year before the taxable year of change, are not included in the downward adjustment required by paragraph (d)(5)(ii) of this section. Remittances to the foreign country of such amounts (accounted for in the currency in which the foreign tax liability is denominated) are treated first as payments of the amounts of tax that had properly accrued in the taxable year claimed as a credit or deduction to the extent thereof, and then as payments of the amounts of tax that were improperly accrued in a different taxable year, on a last-in, first-out basis, starting with the most recent improperly-accrued amounts. Remittances to the foreign country of amounts of foreign income tax that properly accrue in or after the taxable year of change (accounted for in the foreign currency in which the foreign tax liability is denominated) but that are offset by the amounts included in the downward adjustment required by paragraph (d)(5)(ii) of this section are treated as payments of the amounts of tax that were improperly accrued before the taxable year of change and included in the downward adjustment on a last-in, first-out basis, starting with the most recent improperly-accrued amounts. Additional amounts of foreign income tax that first accrue in or after the taxable year of change but that relate to a taxable year before the taxable year of change are taken into account in the earlier of the taxable year of change or the taxable year or years in which they would have been considered to accrue based upon the taxpayer's improper method. Additional amounts of foreign income tax that first accrue in or after the taxable year of change and that relate to the taxable year of change or a taxable year after the year of change are taken into account in the proper relation-back year, but may then be subject to the downward adjustment required by paragraph (d)(5)(ii) of this section.

(iv) *Foreign income tax expense improperly accrued by a foreign corporation, partnership, or other pass-*

through entity. Foreign income tax expense of a foreign corporation reduces both the corporation's taxable income and its earnings and profits, and may give rise to an amount of foreign taxes deemed paid under section 960 that may be claimed as a credit by a United States shareholder that is a domestic corporation or that is a person that makes an election under section 962. If the Commissioner grants permission for a foreign corporation to change its method of accounting for foreign income tax expense, the duplication or omission of those expenses (accounted for in the functional currency of the foreign corporation) and the associated foreign income taxes (translated into dollars in accordance with § 1.986(a)–1) are accounted for by applying the rules in paragraph (d)(5)(ii) of this section as if the foreign corporation were itself eligible to, and did, claim a credit under section 901 for such amounts. In the case of a partnership or other pass-through entity that is granted permission to change its method of accounting for accruing foreign income taxes to a proper method as described in this paragraph (d), such partnership or other pass-through entity must provide its partners or other owners with the information needed for the partners or other owners to properly account for the improperly-accrued or unaccrued amounts under the rules in paragraph (d)(5)(ii) of this section as if their proportionate shares of foreign income tax expense were directly paid or accrued by them.

(6) *Examples.* The following examples illustrate the application of paragraph (d) of this section. Unless otherwise stated, for purposes of these examples it is presumed that the local currency in each of Country X and Country Y and the functional currency of any foreign branch is the Euro (€), and at all relevant times the exchange rate is $1:€1.

(i) *Example 1: Accrual of foreign income tax*—(A) *Facts.* A, a U.S. citizen, resides and works in Country X. A uses the calendar year as the U.S. taxable year, and has made an election under paragraph (e) of this section to claim foreign tax credits on an accrual basis. Country X has a tax year that begins on April 1 and ends on March 31. A's wages are subject to net income tax, at graduated rates, under Country X tax law and are subject to withholding on a monthly basis by A's employer in Country X. In the period between April 1, Year 1, and March 31, Year 2, A earns $50,000x in Country X wages, from which A's employer withholds $10,000x in tax. On December 1, Year 1, A receives a dividend distribution from a Country Y corporation, from which the corporation withheld $500x of tax. Country Y imposes withholding tax on dividends paid to nonresidents solely based on the gross amount of the dividend payment; A is not required to file a tax return in Country Y.

(B) *Analysis.* Under paragraph (d)(1) of this section, A's liability for Country X net income tax accrues on March 31, Year 2, the last day of the Country X taxable year. The Country X net income tax withheld by A's employer from A's wages is a reasonable approximation of, and represents an advance payment of, A's final net income tax liability for the year, which becomes fixed and determinable only at the close of the Country X taxable year. Thus, A cannot claim a credit for any portion of the Country X net income tax on A's Federal income tax return for Year 1, and may claim a credit for the entire Country X net income tax that accrues on March 31, Year 2, on A's Federal income tax return for Year 2. A may claim a credit for the Country Y withholding tax on A's Federal income tax return for Year 1, because the withholding tax accrued on December 1, Year 1.

(ii) *Example 2: 52–53 week taxable year*—(A) *Facts.* U.S.C., an accrual method taxpayer, is a domestic corporation that operates in branch form in Country X. U.S.C. uses the calendar year for Country X tax purposes. For Federal income tax purposes, U.S.C. elects pursuant to § 1.441–2(a) to use a 52–53 week taxable year that ends on the last Friday of December. In Year 1, U.S.C.'s U.S. taxable year ends on Friday, December 25; in Year 2, U.S.C.'s U.S. taxable year ends Friday, December 31. For its foreign taxable year ending December 31, Year 1, U.S.C. earns $10,000x of foreign source income through its Country X branch and incurs Country X foreign income tax of $500x; for Year 2, U.S.C. earns $12,000x and incurs Country X foreign income tax of $600x.

(B) *Analysis.* Under paragraph (d)(1) of this section, the $500x of Country X foreign income tax becomes fixed and determinable at the close of U.S.C.'s foreign taxable year, on December 31, Year 1, which is after the close of its U.S. taxable year (December 25, Year 1). The $600x of Country X foreign income tax becomes fixed and determinable on December 31, Year 2. Thus, both the Year 1 and Year 2 Country X foreign income taxes accrue in U.S.C.'s U.S. taxable year ending December 31, Year 2. However, pursuant to paragraph (d)(2) of this section, for purposes of determining the amount of foreign income taxes accrued in each taxable year for foreign tax credit purposes, U.S.C.'s U.S. taxable year is deemed to end on December 31, the end of U.S.C.'s Country X taxable year. U.S.C. may therefore claim a foreign tax credit for $500x of Country X foreign income tax on its Federal income tax return for Year 1 and a credit for $600x of Country X foreign income tax on its Federal income tax return for Year 2.

(iii) *Example 3: Contested tax*—(A) *Facts.* U.S.C. is a domestic corporation that operates in branch form in Country X. U.S.C. uses an accrual method of accounting and uses the calendar year as its U.S. and Country X taxable year. In Year 1, when the average exchange rate described in § 1.986(a)–1(a)(1) is $1:€1, U.S.C. earns €20,000x = $20,000x through its Country X branch for U.S. and Country X tax purposes and accrues Country X foreign income taxes of €500x = $500x, which U.S.C. claims as a credit on its Federal income tax return for Year 1. In Year 3, when the average exchange rate is $1:€1.2, Country X asserts that U.S.C. owes additional foreign income taxes of €100x with respect to U.S.C.'s Year 1 income. U.S.C. contests the liability but remits €40x to Country X with respect to the contested liability in Year 3. U.S.C. does not make an election under paragraph (d)(4) of this section to claim a provisional credit with respect to the €40x. In Year 6, after exhausting all effective and practical remedies, it is finally determined that U.S.C. is liable for €50x of additional Country X foreign income taxes with respect to its Year 1 income. U.S.C. pays an additional €10x to Country X on September 15, Year 6, when the spot rate described in § 1.986(a)–1(a)(2)(i) is $1:€2.

(B) *Analysis.* Pursuant to paragraph (d)(3) of this section, the additional liability asserted by Country X with respect to U.S.C.'s Year 1 income does not accrue until the contest is resolved in Year 6. U.S.C.'s remittance of €40x of contested tax in Year 3 is not a payment of accrued tax, and so is not a foreign tax redetermination. Both the €40x of Country X taxes paid in Year 3 and the €10x of Country X taxes paid in Year 6 accrue in Year 6, when the contest is resolved. Once accrued and paid, the €50x relates back for foreign tax credit purposes to Year 1, and can be claimed as a credit by U.S.C. on a timely-filed amended return for Year 1. Under § 1.986(a)–1(a), for foreign tax credit purposes the €40x paid in Year 3 is translated into dollars at the average exchange rate for Year 1 (€40x × $1 / €1 = $40x), and the €10x paid in Year 6 is translated into dollars at the spot rate on the date paid (€10x × $1 / €2 = $5x). Accordingly, after the €50x of Country

X income tax is paid in Year 6 U.S.C. may claim an additional foreign tax credit of $45x for Year 1.

(iv) *Example 4: Provisional credit for contested tax*—(A) *Facts.* The facts are the same as in paragraph (d)(6)(iii)(A) of this section (the facts of *Example 3*), except that U.S.C. pays the entire contested tax liability of €100x to Country X in Year 3 and elects under paragraph (d)(4) of this section to claim a provisional foreign tax credit on an amended return for Year 1. In Year 6, upon resolution of the contest, U.S.C. receives a refund of €50x from Country X.

(B) *Analysis.* In Year 3, U.S.C. may claim a provisional foreign tax credit for $100x (€100x translated at the average exchange rate for Year 1) of contested foreign tax paid to Country X by filing an amended return for Year 1, with Form 1118 attached, and a provisional foreign tax credit agreement described in paragraph (d)(4)(ii) of this section. In each year for Years 4 through 6, U.S.C. must attach the certification described in paragraph (d)(4)(iii) of this section to its timely-filed Federal income tax return. In Year 6, as a result of the €50x refund, U.S.C. must redetermine its U.S. tax liability for Year 1 and for any other affected year pursuant to § 1.905–3, reducing the Year 1 foreign tax credit by $50x (from $600x to $550x), and comply with the notification requirements in § 1.905–4. See § 1.986(a)–1(c) (refunds of foreign income tax translated into U.S. dollars at the rate used to claim the credit).

(v) *Example 5: Improperly accelerated accrual*—(A) *Facts*—(*1*) *Foreign income tax accrued and paid.* U.S.C. is a domestic corporation that operates a foreign branch in Country X. All of U.S.C.'s gross and taxable income is foreign source foreign branch category income, and all of its foreign income taxes are properly allocated and apportioned under § 1.861–20 to the foreign branch category. U.S.C. uses the accrual method of accounting and uses the calendar year as its U.S. taxable year. For Country X tax purposes, U.S.C. uses a fiscal year that ends on March 31. U.S.C. accrued €200x = $200x of Country X net income tax (as defined in § 1.901–2(a)(3)) for its foreign taxable year ending March 31, Year 2. It timely filed its Country X tax return and paid the €200x on January 15, Year 3. U.S.C. accrued and paid with its timely filed Country X tax returns €280x and €240x of Country X net income tax for its foreign taxable years ending on March 31 of Year 3 and Year 4, respectively, on January 15 of Year 4 and Year 5, respectively.

(*2*) *Improper accrual.* On its Federal income tax return for Year 1, U.S.C. improperly pro-rated and accelerated the accrual of Country X net income tax and claimed a credit for $150x, equal to three-fourths of the Country X net income tax of $200x that relates to U.S.C.'s foreign taxable year ending March 31, Year 2. Continuing with this improper method of accruing foreign income taxes, U.S.C. claimed a foreign tax credit of $260x on its U.S. tax return for Year 2, comprising $50x (one-fourth of the $200x of net income tax relating to its foreign taxable year ending March 31, Year 2) plus $210x (three-fourths of the $280x of net income tax relating to its foreign taxable year ending March 31, Year 3). Similarly, U.S.C. improperly accrued and claimed a foreign tax credit on its U.S. tax return for Year 3 for $250x of Country X net income tax, comprising $70x (one-fourth of the $280x that properly accrued in Year 3) plus $180x (three-fourths of the $240x that properly accrued in Year 4). In Year 4, U.S.C. realizes its mistake and, as provided in paragraph (d)(5)(i) of this section, files Form 3115 with the IRS to seek permission to change from an improper method to a proper method of accruing foreign income taxes.

TABLE 1 TO PARAGRAPH (d)(6)(v)(A)(*2*)

Country X taxable year ending in U.S. calendar taxable year	Net income tax properly accrued ($1 = €1))	Net income tax accrued under improper method ($1 = €1))
3/31/Y1 ends in Year 1	0	¾ (200x) = 150x.
3/31/Y2 ends in Year 2	200x	¼ (200x) + ¾ (280x) = 260x.
3/31/Y3 ends in Year 3	280x	¼ (280x) + ¾ (240x) = 250x.
3/31/Y4 ends in Year 4	240x	[year of change].

(B) *Analysis*—(*1*) *Downward adjustment.* Under paragraph (d)(5)(ii) of this section, in Year 4, the year of change, U.S.C. must reduce (but not below zero) the amount (in Euros) of Country X net income tax in the foreign branch category that properly accrues in Year 4, €240x, by the amount of foreign income tax that was accrued and claimed as either a deduction or a credit in a year before the year of change, and that had not properly accrued in either the year in which the tax was accrued under U.S.C.'s improper method or in any other taxable year before the taxable year of change. For all taxable years before the taxable year of change, under its improper method U.S.C. had accrued and claimed as a credit a total of €660x = $660x of foreign income tax, of which only €480x = $480x had properly accrued. Therefore, the downward adjustment required by paragraph (d)(5)(ii) of this section is €180x (€660x − €480x = €180x). In Year 4, U.S.C.'s foreign tax credit in the foreign branch category is reduced by $180x (€180x downward adjustment translated into dollars at $1:€1, the average exchange rate for Year 4), from $240x to $60x.

(*2*) *Application of section 905(c)*—(*i*) *Year 1.* Under paragraph (d)(5)(iii) of this section, the €200x U.S.C. paid on January 15, Year 3, that relates to its Country X taxable year ending on March 31, Year 2, is first treated as a payment of the €50x of that Country X net income tax liability that properly accrued and was claimed as a credit by U.S.C. in Year 2, and next as a payment of the €150x of that Country X net income tax liability that U.S.C. improperly accrued and claimed as a credit in Year 1. Because all €150x of the Country X net income tax that was improperly accrued and claimed as a credit in Year 1 was paid within 24 months of December 31, Year 1, no foreign tax redetermination occurs, and no redetermination of U.S. tax liability is required, for Year 1.

(*ii*) *Year 2.* Under paragraph (d)(5)(iii) of this section, the €280x U.S.C. paid on January 15, Year 4, that relates to its Country X taxable year ending on March 31, Year 3, is first treated as a payment of the €70x = $70x of that Country X net income tax liability that properly accrued and was claimed as a credit by U.S.C. in Year 3, and next as a payment of the €210x = $210x of that Country X net income tax liability that U.S.C. improperly accrued and claimed as a credit in Year 2. Together with the €50x = $50x of U.S.C.'s Country X net income tax liability that properly accrued and was claimed as a credit in Year 2, all €260x of the Country X net income tax that was accrued and claimed as a credit in Year 2 under U.S.C.'s improper method was paid within 24 months of December 31, Year 2. Accordingly, no foreign tax redetermination occurs, and no redetermination of U.S. tax liability is required, for Year 2.

(*iii*) *Year 3.* Under paragraph (d)(5)(iii) of this section, the €240x U.S.C. paid on January 15, Year 5, that relates to its Country X taxable year ending on March 31, Year 4, is first treated as a payment of the €60x = $60x of that Country X net income tax liability that properly accrued and was claimed as a credit by U.S.C. in Year 4, and next as a payment of the €180x = $180x of that Country X net income tax liability that U.S.C. improperly accrued and claimed as a credit in Year 3. Together with the €70x = $70x of U.S.C.'s Country X net income tax liability that properly accrued and was claimed as a credit by U.S.C. in Year 3, all €250x of the Country X net income tax that was accrued and claimed as a credit in Year 3 under U.S.C.'s improper method was paid within 24 months of December 31, Year 3. Accordingly, no foreign tax redetermination occurs, and no redetermination of U.S. tax liability is required, for Year 3.

(*iv*) *Year 4.* Under paragraph (d)(5)(iii) of this section, €60x = $60x of U.S.C.'s January 15, Year 5 payment of €240x with respect to its Country X net income tax liability for Year 4 is treated as a payment of €60x = $60x of Country X net income tax that, after application of the downward adjustment required by paragraph (d)(5)(ii) of this section, was accrued and claimed as a credit in Year 4, the year of change.

(vi) *Example 6: Failure to pay improperly-accrued tax within 24 months*—(A) *Facts.* The facts the same as in paragraph (d)(6)(v) of this section (the facts in *Example 5*), except that U.S.C. does not pay its €240x tax liability for its Country X taxable year ending on March 31, Year 4, until January 15 of Year 6, when the spot rate described in § 1.986(a)–1(a)(2)(i) is $1:€1.5.

(B) *Analysis.* The results are the same as in paragraphs (d)(6)(v)(B)(*2*)(*i*) and (*ii*) of this section (the analysis in *Example 5* for Year 1 and Year 2). With respect to Year 3, because the €180x = $180x of Year 4 foreign income tax that was improperly accrued and credited in Year 3 was not paid within 24 months of the end of Year 3, under section 905(c)(2) and § 1.905–3(a) that €180x = $180x is treated as refunded on December 31, Year 5, requiring a redetermination of U.S.C.'s Federal income tax liability for Year 3 (to reverse out the credit claimed). When in Year 6 U.S.C. pays the €240x of Country X income tax liability for Year 4, however, under paragraph (d)(5)(iii) of this section that payment is first treated as a payment of the €60x = $60x that was properly accrued and claimed as a credit in Year 4, and then as a payment of the €180x that was improperly accrued and claimed as a credit in Year 3 and that was treated as refunded in Year 5. Under section 905(c)(2)(B) and § 1.905–3(a), that Year 6 payment of accrued but unpaid tax is a second foreign tax redetermination for Year 3 that also requires a redetermination of U.S.C.'s U.S. tax liability. Under § 1.986(a)–1(a)(2), the €180x of redetermined tax for Year 3 is translated into dollars at the spot rate on January 15, Year 6, when the tax is paid (€180x × $1 / €1.5 = $120x). Under § 1.905–4(b)(1)(iv), U.S.C. may file one amended return accounting for both foreign tax redeterminations (which occur in two consecutive taxable years) with respect to Year 3, which taken together result in a reduction in U.S.C.'s foreign tax credit for Year 3 from $250x to $190x ($250x originally accrued − $180x unpaid after 24 months + $120x paid in Year 6).

(vii) *Example 7: Additional payment of improperly-accrued tax*—(A) *Facts.* The facts are the same as in paragraph (d)(6)(v)(A) of this section (the facts in *Example 5*), except that in Year 6, Country X assessed additional net income tax of €100x with respect to U.S.C.'s Country X taxable year ending March 31, Year 3, and after exhausting all effective and practical remedies to reduce its liability for Country X income tax, U.S.C. pays the additional assessed tax on September 15, Year 7, when the spot rate described in § 1.986(a)–1(a)(2)(i) is $1:€0.5.

(B) *Analysis.* Under paragraph (d)(3) of this section, the additional €100x of Country X income tax U.S.C. paid in Year 7 with respect to its foreign taxable year that ended March 31, Year 3, relates back and is considered to accrue in Year 3. However, under its improper method of accounting U.S.C. had accrued and claimed foreign tax credits for Country X net income tax that related to Year 3 on its Federal income tax returns for both Year 2 and Year 3. Accordingly, under paragraph (d)(5)(iii)(B) of this section U.S.C. must redetermine its U.S. tax liability for both Year 2 and Year 3 (and any other affected years) to account for the additional €100x of Country X net income tax liability, using the improper method it used to accrue foreign income taxes before the year of change. Therefore, €75x = $150x of the €100x of additional tax is treated as if it accrued in Year 2, and €25x = $50x of the additional tax is treated as if it accrued in Year 3. Under § 1.905–4(b)(1)(iii), U.S.C. may claim a refund for any resulting overpayment of U.S. tax for Year 2 or Year 3 or any other affected year by filing an amended return within the period provided in section 6511.

(viii) *Example 8: Tax improperly accrued before year of change exceeds tax properly accrued in year of change*—(A) *Facts.* U.S.C. owns all of the stock in CFC, a controlled foreign corporation organized in Country X. Country X imposes net income tax on Country X corporations at a rate of 10% only in the year its earnings are distributed to its shareholders, rather than in the year the income is earned. Both U.S.C. and CFC use the calendar year as their taxable year for both Federal and Country X income tax purposes and CFC uses the Euro as its functional currency. In each of Years 1–3, CFC earns €1,000x for both Federal and Country X income tax purposes of general category foreign base company sales income (before reduction for foreign income taxes). CFC improperly accrues €100x of Country X net income tax with respect to €1,000x of income at the end of each of Years 1 and 2, even though no distribution is made in those years. In Year 1, for which the average exchange rate is $1:€1, U.S.C. computes and includes in income with respect to CFC $900x of subpart F income, claims a deemed paid foreign tax credit of $100x under section 960(a), and has a section 78 dividend of $100x. In Year 2, for which the average exchange rate is $1:€0.5, U.S.C. computes and includes in income with respect to CFC $1,800x of subpart F income, claims a deemed paid foreign tax credit of $200x under section 960(a), and has a section 78 dividend of $200x. In Year 2, CFC makes a distribution to U.S.C. of €400x of earnings and pays €40x of net income tax to Country X. In Year 3, for which the average exchange rate is $1:€1, CFC makes another distribution to U.S.C. of €500x of earnings and pays €50x in net income tax to Country X. In Year 3, U.S.C. realizes its mistake and seeks permission from the IRS for CFC to change to a proper method of accruing foreign income taxes. In Year 4, for which the average exchange rate is $1:€2, CFC makes a distribution of €700x of earnings and pays €70x of net income tax to Country X.

TABLE 2 TO PARAGRAPH (d)(6)(viii)(A)

Taxable year ending	Foreign income tax properly accrued	Foreign income tax accrued under improper method
12/31/Y1 ($1:€1)	0	€100x = $100x.
12/31/Y2 ($1:€0.5)	€40x = $80x	€100x = $200x.
12/31/Y3 ($1:€1)	€50x = $50x	[year of change].
12/31/Y4 ($1:€2)	€70x = $35x.	

(B) *Analysis*—(*1*) *Downward adjustment.* Under paragraph (d)(5)(iv) of this section, CFC applies the rules of paragraph (d)(5) of this section as if it claimed a foreign tax credit under section 901 for Country X taxes. Under paragraph (d)(5)(ii) of this section, in Year 3, the year of change, CFC must reduce (but not below zero) the amount (in Euros) of Country X net income tax allocated and apportioned to its general category foreign base company sales income group that properly accrues in Year 3, €50x, by the amount of foreign income tax (in Euros) that was improperly accrued in that statutory grouping in a year before the year of change, and that had not properly accrued in either the year accrued or in another taxable year before the year of change. For all taxable years before the year of change, under its improper method CFC had accrued a total of €200x of foreign income tax with respect to its general category foreign base company sales income group, of which only €40x had properly accrued. Therefore, the downward adjustment required by paragraph (d)(5)(ii) of this section is €160x (€200x − €40x = €160x). In Year 3, CFC's €50x of eligible foreign income taxes in the general category foreign base company sales income group is reduced by €50x to zero. The €110x balance of the downward adjustment carries forward to Year 4, and reduces CFC's €70x of eligible foreign income taxes in the general category foreign base company sales income group by €70x to zero. The remaining €40x balance of the downward adjustment carries forward to later years and will reduce CFC's eligible foreign income taxes in the general category foreign base company sales income group until all improperly-accrued amounts are accounted for.

(*2*) *Application of section 905(c)*—(*i*) *Year 2.* Under paragraph (d)(5)(iii) of this section, CFC's payment in Year 2 of the €40x of Country X net income tax that properly accrued in Year 2, before the year of change, is treated as a payment of €40x of foreign income tax that CFC properly accrued in Year 2. The €60x of foreign income tax that CFC improperly accrued in Year 2 that remains unpaid at the end of Year 2 is not adjusted in Year 2. Under paragraph (d)(5)(iii) of this section, CFC's payment in Year 3 of €50x of Country X net income tax that properly accrued but was offset by the downward adjustment in Year 3 is treated as a payment of €50x of the €60x of Country X net income tax most recently improperly accrued in Year 2. In addition, CFC's payment in Year 4 of €70x of Country X net income tax that properly accrued but was offset by the downward adjustment in Year 4 is treated first as a payment of the remaining €10x of Country X net income tax that was improperly accrued in Year 2. Because all €100x of foreign income tax accrued in Year 2 under CFC's improper method of accounting is treated as paid within 24 months of December 31, Year 2, no foreign tax redetermination occurs, and no redetermination of CFC's foreign base company sales income, earnings and profits, and eligible foreign income taxes, or of U.S.C.'s $1,800x subpart F inclusion, $200x deemed paid credit, and $200x section 78 dividend or its U.S. tax liability is required, for Year 2.

(*ii*) *Year 1.* Because all €100x of the tax CFC improperly accrued in Year 1 remained unpaid as of December 31, Year 3, the date 24 months after the end of Year 1, under section 905(c)(2) and § 1.905–3(a) that €100x is treated as refunded on December 31, Year 3. Under § 1.905–3(b)(2)(ii), U.S.C. must redetermine its Federal income tax liability for Year 1 to account for the foreign tax redetermination, increasing CFC's foreign base company sales income and earnings and profits by €100x, and decreasing its eligible foreign income taxes by $100x. However, under paragraph (d)(5)(iii)(B) of this section €60x = $30x of CFC's payment in Year 4 of €70x of Country X net income tax that properly accrued but was offset by the downward adjustment in Year 4 is treated as a payment of €60x of the €100x of Country X net income tax that was improperly accrued in Year 1 and treated as refunded in Year 3. Under § 1.905–4(b)(1)(iv), U.S.C. may account for the two foreign tax redeterminations that occurred in Years 3 and 4 on a single amended Federal income tax return for Year 1. CFC's foreign base company sales income (taking into account the reduction for foreign income taxes) and earnings and profits for Year 1 are recomputed as €1,000x − €100x + €100x − €60x = €940x, and its eligible foreign income taxes are recomputed as $100x − $100x + $30x = $30x. U.S.C.'s subpart F inclusion with respect to CFC for Year 1 (translated at the average exchange rate for Year 1 of $1:€1) is increased from $900x to $940x (€940x × $1/€1), and the amount of foreign taxes deemed paid under section 960(a) and the amount of the section 78 dividend are reduced from $100x to $30x.

(*iii*) *Summary.* As of the end of Year 4, CFC and U.S.C. have been allowed a $30x foreign tax credit for Year 1, and a $200x foreign tax credit for Year 2. If in a later taxable year CFC distributes additional earnings to U.S.C. and accrues €40x of additional Country X net income tax that is offset by the balance of the €40x downward adjustment, CFC's payment of that €40x Country X net income tax liability will be treated as a payment of the remaining €40x of Country X net income tax that was improperly accrued in Year 1 and treated as refunded as of the end of Year 3.

(ix) *Example 9: Improperly deferred accrual*—(A) *Facts*—(*1*) *Foreign income tax accrued and paid.* U.S.C. is a domestic corporation that operates a foreign branch in Country X. All of U.S.C.'s gross and taxable income is foreign source foreign branch category income, and all of its foreign income taxes are properly allocated and apportioned under § 1.861–20 to the foreign branch category. U.S.C. uses the accrual method of accounting and uses the calendar year as its taxable year for both Federal and Country X income tax purposes. U.S.C. accrued €160x of Country X net income tax (as defined in § 1.901–2(a)(3)) with respect to Year 1. U.S.C. filed its Country X tax return and paid the €160x on June 30, Year 2. U.S.C. accrued €180x, €240x, and €150x of Country X tax for Years 2, 3, and 4, respectively, and paid with its timely filed Country X tax returns these tax liabilities on June 30 of Years 3, 4, and 5, respectively. The average exchange rate described in § 1.986(a)–1(a)(1) is

$1:€0.5 in Year 1, $1:€1 in Year 2, $1:€1.25 in Year 3, and $1:€1.5 in Year 4.

(*2*) *Improper accrual.* On its Federal income tax return for Year 1, U.S.C. claimed no foreign tax credit. On its Federal income tax return for Year 2, U.S.C. improperly accrued and claimed a credit for $160x (€160x of Country X tax for Year 1 that it paid in Year 2, translated into dollars at the average exchange rate for Year 2). Continuing with this improper method of accounting, U.S.C. improperly accrued and claimed a credit in Year 3 for $144x (€180x of Country X tax for Year 2 that it paid in Year 3, translated into dollars at the average exchange rate for Year 3). In Year 4, U.S.C. realizes its mistake and seeks permission from the IRS to change to a proper method of accruing foreign income taxes.

TABLE 3 TO PARAGRAPH (d)(6)(ix)(A)(*2*)

Taxable year ending	Foreign income tax properly accrued	Foreign income tax accrued under improper method
12/31/Y1 ($1:€0.5)	€160x = $320x	0.
12/31/Y2 ($1:€1)	€180x = $180x	€160x = $160x.
12/31/Y3 ($1:€1.25)	€240x = $192x	€180x = $144x.
12/31/Y4 ($1:€1.5)	€150x = $100x	[year of change].

(B) *Analysis*—(*1*) *Upward adjustment.* Under paragraph (d)(5)(ii) of this section, in Year 4, the year of change, U.S.C. increases the amount of Country X net income tax allocated and apportioned to its foreign branch category that properly accrues in Year 4, €150x, by the amount of foreign income tax in that same grouping that properly accrued in a taxable year before the taxable year of change, but which, under its improper method of accounting, U.S.C. failed to accrue and claim as either a credit or deduction before the taxable year of change. For all taxable years before the taxable year of change, under a proper method, U.S.C. would have accrued a total of €580x of foreign income tax, of which it accrued and claimed a credit for only €340x under its improper method. Thus, in Year 4, U.S.C. increases its €150x of properly accrued foreign income taxes in the foreign branch category by €240x (€580x − €340x), and may claim a credit in that year for the total, €390x, or $260x (translated into dollars at the average exchange rate for Year 4, as if the total amount properly accrued in Year 4).

(*2*) *Application of section 905(c).* Under paragraph (d)(5)(iii) of this section, U.S.C.'s payment of the €160x of Year 1 tax that U.S.C. accrued and claimed as a credit in Year 2 under its improper method of accounting is first treated as a payment of the amount of that (Year 1) tax liability that properly accrued in Year 2. Since none of the €160x properly accrued in Year 2, the €160x is treated as a payment of that (Year 1) tax liability that U.S.C. improperly accrued and claimed as a credit in Year 2, €160x. Because all €160x of the Country X net income tax that was improperly accrued and claimed as a credit in Year 2 was paid within 24 months of the end of Year 2, no foreign tax redetermination occurs, and no redetermination of U.S.C.'s $160x foreign tax credit and U.S. tax liability is required, for Year 2. Similarly, because all €180x of the Year 2 Country X net income tax that was improperly accrued and claimed as a credit in Year 3 was paid within 24 months of the end of Year 3, no foreign tax redetermination occurs, and no redetermination of U.S.C.'s $144x foreign tax credit and U.S. tax liability is required, for Year 3.

(e) *Election by cash method taxpayer to take credit on the accrual basis*—(1) *In general.* A taxpayer who uses the cash method of accounting for income may elect to take the foreign tax credit in the taxable year in which the taxes accrue in accordance with the rules in paragraph (d) of this section. Except as provided in paragraph (e)(2) of this section, an election pursuant to this paragraph (e)(1) must be made on a timely-filed original return, by checking the appropriate box on Form 1116 (Foreign Tax Credit (Individual, Estate, or Trust)) or Form 1118 (Foreign Tax Credit—Corporations) indicating the cash method taxpayer's choice to claim the foreign tax credit in the year the foreign income taxes accrue. Once made, the election is irrevocable and must be followed for purposes of claiming a foreign tax credit for all subsequent years. See section 905(a).

(2) *Exception for cash method taxpayers claiming a foreign tax credit for the first time.* If the year with respect to which an election pursuant to paragraph (e)(1) of this section to claim the foreign tax credit on an accrual basis is made (the ''election year'') is the first year for which a taxpayer has ever claimed a foreign tax credit, the election to claim the foreign tax credit on an accrual basis can also be made on an amended return filed within the period permitted under § 1.901–1(d)(1). The election is binding in the election year and all subsequent taxable years in which the taxpayer claims a foreign tax credit.

(3) *Treatment of taxes that accrued in a prior year.* In the election year and subsequent taxable years, a cash method taxpayer that claimed foreign tax credits on the cash basis in a prior taxable year may claim a foreign tax credit not only for foreign income taxes that accrue in the election year, but also for foreign income taxes that accrued (or are considered to accrue) in a taxable year preceding the election year but that are paid in the election year or subsequent taxable year, as applicable. Under paragraph (c) of this section, foreign income taxes paid with respect to a taxable year that precedes the election year may be claimed as a credit only in the year the taxes are paid and do not require a redetermination under section 905(c) or § 1.905–3 of U.S. tax liability in any prior year.

(4) *Examples.* The following examples illustrate the application of paragraph (e) of this section.

(i) *Example 1*—(A) *Facts.* A, a U.S. citizen who is a resident of Country X, is a cash method taxpayer who uses the calendar year as the taxable year for both U.S. and Country X tax purposes. In Year 1 through Year 5, A claims foreign tax credits for Country X foreign income taxes on the cash method, in the year the taxes are paid. For Year 6, A makes a timely election to claim foreign tax credits on the accrual basis. In Year 6, A accrues $100x of Country X foreign income taxes with respect to Year 6. Also in Year 6, A pays $80x in foreign income taxes that had accrued in Year 5.

(B) *Analysis.* Pursuant to paragraph (e)(3) of this section, A can claim a foreign tax credit in Year 6 for the $100x of Country X taxes that accrued in Year 6 and for the $80x of Country X taxes that accrued in Year 5 but that are paid in Year 6.

(ii) *Example 2*—(A) *Facts.* The facts are the same as in paragraph (e)(4)(i)(A) of this section (the facts of *Example 1*), except that in Year 7, A is assessed an additional $10x of foreign income tax by Country X with respect to A's income in Year 3. After exhausting all effective and practical remedies, A pays the additional $10x to Country X in Year 8.

(B) *Analysis.* Pursuant to paragraph (e)(3) of this section, A can claim a foreign tax credit in Year 8 for the additional $10x of foreign income tax paid to Country X in Year 8 with respect to Year 3.

(f) *Rules for creditable foreign tax expenditures of partners, shareholders, or beneficiaries of a pass-through entity*—(1) *Effect of pass-through entity's method of accounting on when foreign tax credit or deduction can be claimed.* Each partner that elects to claim the foreign tax credit for a particular taxable year may treat its distributive share of the creditable foreign tax expenditures (as defined in § 1.704–1(b)(4)(viii)(*b*)) of the partnership that are paid or accrued by the partnership, under the partnership's method of accounting, during the partnership's taxable year ending with or within the partner's taxable year, as foreign income taxes paid or accrued (as the case may be, according to the partner's method of accounting for such taxes) by the partner in that particular taxable year. See §§ 1.702–1(a)(6) and 1.703–1(b)(2). Under §§ 1.905–3(a) and 1.905–4(b)(2), additional creditable foreign tax expenditures of the partnership that result from a change in the partnership's foreign tax liability for a prior taxable year, including additional taxes paid when a contest with a foreign tax authority is resolved, must be identified by the partnership as a prior year creditable foreign tax expenditure in the information reported to its partners for its taxable year in which the additional tax is actually paid. Subject to the rules in paragraphs (c) and (e) of this section, a partner using the cash method of accounting for foreign income taxes may claim a credit (or a deduction) for its distributive share of such additional taxes in the partner's taxable year with or within which the partnership's taxable year ends. Subject to the rules in paragraph (d) of this section, a partner using the accrual method of accounting for foreign income taxes may claim a credit for the partner's distributive share of such additional taxes in the relation-back year, or may claim a deduction in its taxable year with or within which the partnership's taxable year ends. The principles of this paragraph (f)(1) apply to determine the year in which a shareholder of a S corporation, or the grantor or beneficiary of an estate or trust, may claim a foreign tax credit (or a deduction) for its proportionate share of foreign income taxes paid or accrued by the S corporation, estate or trust. See sections 642(a), 671, 901(b)(5), and 1373(a) and §§ 1.1363–1(c)(2)(iii) and 1.1366–1(a)(2)(iv). See §§ 1.905–3 and 1.905–4 for notifications and adjustments of U.S. tax liability that are required if creditable foreign tax expenditures of a partnership or S corporation, or foreign income taxes paid or accrued by a trust or estate, are refunded or otherwise reduced.

(2) *Provisional credit for contested taxes.* Under paragraph (d)(3) of this section, a contested foreign tax liability does not accrue until the contest is resolved and the amount of the liability has been finally determined. In addition, under section 905(c)(2), a foreign income tax that is not paid within 24 months of the close of the taxable year to which the tax relates may not be claimed as a credit until the tax is actually paid. Thus, a partnership or other pass-through entity cannot take the contested tax into account as a creditable foreign tax expenditure until both the contest is resolved and the tax is actually paid. However, to the extent that a partnership or other pass-through entity remits a contested foreign tax liability to a foreign country, a partner or other owner of such pass-through entity that claims foreign tax credits on the accrual basis, may, by complying with the rules in paragraph (d)(4) of this section, elect to claim a provisional credit for its distributive share of such contested tax liability in the relation-back year.

(3) *Example.* The following example illustrates the application of paragraph (f) of this section.

(i) *Facts.* ABC is a U.S. partnership that is engaged in a trade or business in Country X. ABC has two U.S. partners, A and B. For Federal income tax purposes, ABC and partner A both use the accrual method of accounting and utilize a taxable year ending on September 30. ABC uses a taxable year ending on September 30 for Country X tax purposes. B is a calendar year taxpayer that uses the cash method of accounting. For its taxable year ending September 30, Year 1, ABC accrues $500x in foreign income tax to Country X; each partner's distributive share of the foreign income tax is $250x. In its taxable year ending September 30, Year 5, ABC settles a contest with Country X with respect to its Year 1 tax liability and, as a result of such settlement, accrues an additional $100x in foreign income tax for Year 1. ABC remits the additional tax to Country X in January of Year 6. A and B both elect to claim foreign tax credits for their respective taxable Years 1 through 6.

(ii) *Analysis.* For its taxable year ending September 30, Year 1, A can claim a credit for its $250x distributive share of foreign income taxes paid by ABC with respect to ABC's taxable year ending September 30, Year 1. Pursuant to paragraph (f)(1) of this section, B can claim its distributive share of $250x of foreign income tax for its taxable year ending December 31, Year 1, even if ABC does not remit the Year 1 taxes to Country X until Year 2. Although the additional $100x of Country X foreign income tax owed by ABC with respect to Year 1 accrued in its taxable year ending September 30, Year 5, upon conclusion of the contest, because ABC uses the accrual method of accounting, it does not take the additional tax into account until the tax is actually paid, in its taxable year ending September 30, Year 6. See section 905(c)(2)(B) and paragraph (f)(1) of this section. Pursuant to § 1.905–4(b)(2), ABC is required to notify the IRS and its partners of the foreign tax redetermination. A's distributive share of the additional tax relates back, is considered to accrue, and may be claimed as a credit for Year 1; however, A cannot claim a credit for the additional tax until Year 6, when ABC remits the tax to Country X. See § 1.905–3(a). B's distributive share of the additional tax does not relate back to Year 1 and is creditable in B's taxable year ending December 31, Year 6.

(g) *Blocked income.* * * *

(h) *Applicability dates.* This section applies to foreign income taxes paid or accrued in taxable years beginning on or after [date final regulations are filed in the **Federal Register**]. In addition, the election described in paragraph (d)(4) of this section may be made with respect to amounts of contested tax that are remitted in taxable years beginning on or after [date final regulations are filed in the **Federal Register**] and that relate to a taxable year beginning before [date final regulations are filed in the **Federal Register**].

■ **Par. 31.** Section 1.905–3, as amended in FR Doc. 2020–21819, published elsewhere in this issue of the **Federal Register**, is further amended:

■ 1. In paragraph (a), by revising the first two sentences.

■ 2. By adding paragraph (b)(4).

■ 3. By revising paragraph (d).

The revisions and addition read as follows:

§ 1.905–3 Adjustments to U.S. tax liability and to current earnings and profits as a result of a foreign tax redetermination.

(a) * * * For purposes of this section and § 1.905–4, the term *foreign tax redetermination* means a change in the liability for foreign income taxes (as defined in § 1.901–2(a)) or certain other changes described in this paragraph (a) that may affect a taxpayer's U.S. tax liability, including by reason of a change in the amount of its foreign tax credit, a change to claim a foreign tax credit for foreign income taxes that it previously deducted, a change to claim a deduction for foreign income taxes that it previously credited, a change in the amount of its distributions or inclusions under sections 951, 951A, or 1293, a change in the application of the high-tax exception described in § 1.954–1(d), or a change in the amount of tax determined under sections 1291(c)(2) and 1291(g)(1)(C)(ii). In the case of a taxpayer that claims the credit in the year the taxes are paid, a foreign tax redetermination occurs if any portion of the tax paid is subsequently refunded, or if the taxpayer's liability is subsequently determined to be less than the amount paid and claimed as a credit. * * *

(b) * * *

(4) *Change in election to claim a foreign tax credit.* A redetermination of U.S. tax liability is required to account for the effect of a timely change by the taxpayer to claim a foreign tax credit or a deduction for foreign income taxes paid or accrued in any taxable year as permitted under § 1.901–1(d).

* * * * *

(d) *Applicability dates.* Except as provided in this paragraph (d), this section applies to foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019, and to foreign tax redeterminations of foreign corporations occurring in taxable years that end with or within a taxable year of a United States shareholder ending on or after December 16, 2019 and that relate to taxable years of foreign corporations beginning after December 31, 2017. The first two sentences of paragraph (a) of this section, and paragraph (b)(4) of this section, apply to foreign tax redeterminations occurring in taxable years beginning on or after [date final regulations are filed with the **Federal Register**].

§ 1.954–1 [Amended]

■ **Par. 32.** Section 1.954–1, as proposed to be amended in 85 FR 44650 (July 23, 2020), is further amended by removing the second sentence in paragraph (d)(1)(iv)(A).

■ **Par. 33.** Section 1.960–1, as amended in FR Doc. 2020–21819, published elsewhere in this issue of the **Federal Register**, is further amended:

■ 1. By revising paragraph (b)(4).

■ 2. By redesignating paragraphs (b)(5) through (37) as paragraphs (b)(6) through (38), respectively.

■ 3. By adding a new paragraph (b)(5).

■ 4. By revising newly redesignated paragraph (b)(6) and paragraph (c)(1)(ii).

■ 5. By redesignating paragraphs (c)(1)(iii) through (vi) as paragraphs (c)(1)(iv) through (vii).

■ 6. By adding a new paragraph (c)(1)(iii).

■ 7. In newly redesignated paragraph (c)(1)(iv), by removing the language "Third, current year taxes" in the first sentence adding the language "Fourth, eligible current year taxes" in its place.

■ 8. In newly redesignated paragraph (c)(1)(v), by removing the language "Fourth," from the first sentence and adding the language "Fifth," in its place.

■ 9. In newly redesignated paragraph (c)(1)(vi), by removing the language "Fifth," from the first sentence and adding the language "Sixth," in its place.

■ 10. In newly redesignated paragraph (c)(1)(vii), by removing the language "Sixth," from the first sentence and adding the language "Seventh," in its place.

■ 11. In paragraph (d)(1), by removing the language "the U.S. dollar amount of current year taxes" from the first sentence and adding the language "the U.S. dollar amount of eligible current year taxes" in its place.

■ 12. In paragraph (d)(3)(i) introductory text, by removing the language "current year taxes" from the second sentence and adding the language "eligible current year taxes" in its place.

■ 13. In paragraph (d)(3)(ii)(A), by revising the last sentence.

■ 14. In paragraph (d)(3)(ii)(B), by removing the language "a current year tax" from the first sentence and adding the language "an eligible current year tax" in its place.

■ 15. In paragraph (f)(1)(ii), by removing the language "tax" from the fifth sentence and adding the language "eligible current year tax" in its place.

■ 16. In paragraph (f)(2)(ii)(B)(*1*), by removing the language "current year taxes" from the last sentence and adding the language "eligible current year taxes" in its place.

■ 17. In paragraph (f)(2)(ii)(B)(*2*), by removing the language "current year taxes" from the fifth sentence and adding the language "eligible current year taxes" in its place.

The additions and revisions read as follows:

§ 1.960–1 Overview, definitions, and computational rules for determining foreign income taxes deemed paid under section 960(a), (b), and (d).

* * * * *

(b) * * *

(4) *Current year tax.* The term *current year tax* means a foreign income tax that is paid or accrued by a controlled foreign corporation in a current taxable year (taking into account any adjustments resulting from a foreign tax redetermination (as defined in § 1.905–3(a)). See § 1.905–1 for rules on when foreign income taxes are considered paid or accrued for foreign tax credit purposes; see also § 1.367(b)–7(g) for rules relating to foreign income taxes associated with foreign section 381 transactions and hovering deficits.

(5) *Eligible current year tax.* The term *eligible current year tax* means a current year tax, except that an eligible current year tax does not include a current year tax paid or accrued by a controlled foreign corporation for which a credit is disallowed or suspended at the level of the controlled foreign corporation. See, for example, sections 245A(e)(3), 901(k)(1), (l), and (m), 909, and 6038(c)(1)(B). Eligible current year tax, however, includes a current year tax that may be deemed paid but for which a credit is reduced or disallowed at the level of the United States shareholder. See, for example, sections 901(e), 901(j), 901(k)(2), 908, 965(g), and 6038(c)(1)(A).

(6) *Foreign income tax.* The term *foreign income tax* has the meaning provided in § 1.901–2(a).

* * * * *

(c) * * *

(1) * * *

(ii) Second, deductions (other than for current year taxes) of the controlled foreign corporation for the current taxable year are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category. See paragraph (d)(3)(i) of this section. Deductions for current year taxes (other than eligible current year taxes) of the controlled foreign corporation for the current taxable year are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category. Additionally, the functional currency amounts of eligible current year taxes are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category, and to reduce earnings and profits in the PTEP groups that were increased as provided in paragraph (c)(1)(i) of this section. No deductions other than eligible current year taxes may be allocated and apportioned to PTEP groups. See paragraph (d)(3)(ii) of this section.

(iii) Third, for purposes of computing foreign taxes deemed paid, eligible current year taxes that were allocated and apportioned to income groups and PTEP groups in the section 904 categories are translated into U.S. dollars in accordance with section 986(a).

* * * * *

(d) * * *

(3) * * *

(ii) * * *

(A) * * * For purposes of determining foreign income taxes deemed paid under the rules in §§ 1.960–2 and 1.960–3, the U.S. dollar amount of eligible current year taxes is assigned to the section 904 categories, income groups, and PTEP groups (to the extent provided in paragraph (d)(3)(ii)(B) of this section) to which the eligible current year taxes are allocated and apportioned.

* * * * *

■ **Par. 34.** Section 1.960–2, as amended in FR Doc. 2020–21819, published elsewhere in this issue of the **Federal Register**, is further amended:

■ 1. In paragraph (b)(2), by removing the language ''current year taxes'' and adding the language ''eligible current year taxes'' in its place.

■ 2. In paragraph (b)(3)(i), by removing the language ''current year taxes'' each place it appears and adding the language ''eligible current year taxes'' in its place.

■ 3. In paragraph (b)(5)(i), by revising the seventh sentence.

■ 4. In paragraph (b)(5)(ii)(A), by revising the first and second sentences.

■ 5. In paragraph (b)(5)(ii)(B), by revising the first and second sentences.

■ 6. In paragraph (c)(4), by removing the language ''current year taxes'' and adding the language ''eligible current year taxes'' in its place.

■ 7. In paragraph (c)(5), by removing the language ''current year taxes'' each place it appears and adding the language ''eligible current year taxes'' in its place.

■ 8. In paragraph (c)(7)(i)(A), by revising the fifth sentence.

■ 9. In paragraph (c)(7)(i)(B), by revising the first and second sentences.

■ 10. In paragraph (c)(7)(ii)(A)(*1*), by revising the ninth and eleventh sentences.

■ 11. In paragraph (c)(7)(ii)(B)(*1*)(*i*), by revising the first and second sentences.

■ 12. In paragraph (c)(7)(ii)(B)(*1*)(*ii*), by removing the language ''foreign income taxes'' in the first sentence and adding the language ''eligible current year taxes'' in its place.

The additions and revisions read as follows:

§ 1.960–2 Foreign income taxes deemed paid under sections 960(a) and (d).

* * * * *

(b) * * *

(5) * * *

(i) * * * CFC has current year taxes, all of which are eligible current year taxes, translated into U.S. dollars, of $740,000x that are allocated and apportioned as follows: $50,000x to subpart F income group 1; $240,000x to subpart F income group 2; and $450,000x to subpart F income group 3. * * *

(ii) * * *

(A) * * * Under paragraphs (b)(2) and (3) of this section, the amount of CFC's foreign income taxes that are properly attributable to items of income in subpart F income group 1 to which a subpart F inclusion is attributable equals USP's proportionate share of the eligible current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to subpart F income group 1, which is $40,000x ($50,000x × 800,000u/1,000,000u). Under paragraphs (b)(2) and (3) of this section, the amount of CFC's foreign income taxes that are properly attributable to items of income in subpart F income group 2 to which a subpart F inclusion is attributable equals USP's proportionate share of the eligible current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to subpart F income group 2, which is $192,000x ($240,000x × 1,920,000u/ 2,400,000u). * * *

(B) * * * Under paragraphs (b)(2) and (3) of this section, the amount of CFC's foreign income taxes that are properly attributable to items of income in subpart F income group 3 to which a subpart F inclusion is attributable equals USP's proportionate share of the eligible current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to subpart F income group 3, which is $360,000x ($450,000x × 1,440,000u/1,800,000u). CFC has no other subpart F income groups within the general category. * * *

* * * * *

(c) * * *

(7) * * *

(i) * * *

(A) * * * CFC1 has current year taxes, all of which are eligible current year taxes, translated into U.S. dollars, of $400x that are all allocated and apportioned to the tested income group. * * *

(B) * * * Under paragraph (c)(5) of this section, USP's proportionate share of the eligible current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to CFC1's tested income group is $400x ($400x × 2,000u/ 2,000u). Therefore, under paragraph (c)(4) of this section, the amount of foreign income taxes that are properly attributable to tested income taken into account by USP under section 951A(a) and § 1.951A–1(b) is $400x. * * *

(ii) * * *

(A) * * *

(*1*) * * * CFC1 has current year taxes, all of which are eligible current year taxes, translated into U.S. dollars, of $100x that are all allocated and apportioned to CFC1's tested income group. * * * CFC2 has current year taxes, all of which are eligible current year taxes, translated into U.S. dollars, of $20x that are allocated and apportioned to CFC2's tested income group.

* * * * *

(B) * * *

(*1*) * * *

(*i*) * * * Under paragraphs (c)(5) and (6) of this section, US1's proportionate share of the eligible current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to CFC1's tested income group is $95x ($100x × 285u/300u). Therefore, under paragraph (c)(4) of this section, the amount of the foreign income taxes that are properly attributable to tested income taken into account by US1 under section 951A(a) and § 1.951A–1(b) is $95x. * * *

* * * * *

■ **Par. 35.** Section 1.960–7, as amended in FR Doc. 2020–21819, published elsewhere in this issue of the **Federal Register**, is further amended by revising paragraph (b) to read as follows:

§ 1.960–7 Applicability dates.

* * * * *

(b) Section 1.960–1(c)(2) and (d)(3)(ii) apply to taxable years of a foreign corporation beginning after December 31, 2019, and to each taxable year of a domestic corporation that is a United States shareholder of the foreign corporation in which or with which such taxable year of such foreign corporation ends. For taxable years of a foreign corporation that end on or after December 4, 2018, and also begin before January 1, 2020, see § 1.960–1(c)(2) and (d)(3)(ii) as in effect on December 17, 2019. Paragraphs (b)(4), (5), and (6), (c)(1)(ii), (iii), and (iv), and (d)(3)(ii)(A) and (B) of § 1.960–1, and paragraphs (b)(2), (b)(3)(i), (b)(5)(i), (b)(5)(iv)(A), and (c)(4), (5), and (7) of § 1.960–2, apply to taxable years of foreign corporations beginning on or after [date final regulations are filed in the **Federal Register**], and to each taxable year of a domestic corporation that is a United States shareholder of the foreign corporation in which or with which such taxable year of such foreign corporation ends. For taxable years of foreign corporations beginning before [date final regulations are filed in the **Federal Register**], with respect to the paragraphs described in the preceding sentence, see §§ 1.960–1 and 1.960–2 as in effect on November 12, 2020.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

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