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Global Tax Alert

US: Additional final regulations provide foreign tax credit guidance

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In another set of final regulations (T.D. 9922, released 29 September 2020), the United States (US) Treasury Department provided guidance for determining the foreign tax credit allowed under Internal Revenue Code[1] Section 901. The final regulations (2020 final regulations) adopt proposed regulations that were issued on 2 December 2019 (2019 proposed regulations), with some modifications.[2] In particular, the 2020 final regulations provide rules on the following:

- Foreign tax redeterminations under Section 905(c), including a new election to allow taxpayers to account for certain foreign tax redeterminations affecting tax years preceding the *Tax Cuts and Jobs Act* (TCJA) during their last tax year beginning before 31 December 2017
- The allocation and apportionment of research and experimentation (R&E) expenditures solely to gross intangible income (which does not include global intangible low-taxed income (GILTI), subpart F income, and dividends) and on the basis of gross receipts
- Allocating and apportioning stewardship expenses
- Adjustments to hybrid dividend accounts, an expanded definition of conduit financing arrangements, and the treatment of certain "GILTI gap period" transactions[3]

This Tax Alert discusses the 2020 final regulations, with an emphasis on those provisions that deviate from the 2019 proposed regulations.

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Foreign tax redeterminations under Section 905(c)

General rules

Historically, a foreign tax redetermination consisted only of events, including a change to a foreign tax liability, that affected a taxpayer's foreign tax credit. The 2020 final regulations expand the definition of a foreign tax redetermination to include a change in foreign tax liability that affects a taxpayer's US tax liability (even if the foreign tax credit claimed by the taxpayer does not change), including:

- The amount of a distribution or inclusion under subpart F, Global Intangible Low-Taxed Income (GILTI) and Section 1293
- The application of the subpart F income high-tax exception and GILTI high-tax exclusion
- Certain amounts determined under Section 1291

Accordingly, the 2020 final regulations generally require taxpayers to redetermine their US tax liability to account for a foreign tax redetermination of foreign income taxes paid or accrued by a foreign corporation as follows:

- First, taxpayers treat the amount of redetermined foreign income taxes as paid or accrued by the foreign corporation in the year to which those taxes relate (the relation-back year), and adjust the foreign corporation's taxable income, earnings and profits, and current-year taxes for that year by the redetermined amount.
- Second, taxpayers redetermine their US tax liability to account for the impact of these adjustments. For example, these adjustments could affect the characterization and amount of distributions, subpart F and GILTI inclusions, the application of the subpart F and GILTI high-tax exceptions, and the amount of deemed paid credits under Section 960 for that year and any affected subsequent year.

The 2020 final regulations also require a redetermination of US tax liability for a foreign tax redetermination in this manner regardless of whether the taxpayer chooses to deduct or credit its foreign income taxes in any tax year. In contrast, taxpayers that pay foreign taxes directly are generally required to redetermine their US tax liability only for a tax year in which a credit was claimed, including by reason of Section 904(c) (permitting certain foreign tax credits exceeding the Section 904 limitation to be claimed as a credit in other years).

Transition rule for post-2017 foreign tax redeterminations for pre-2018 foreign income taxes

Before the TCJA, with certain exceptions, a foreign tax redetermination was not required for changes that did not impact a claimed foreign tax credit. Instead, prospective "pooling" adjustments to the foreign corporation's Section 902 earnings and profits and tax pools were allowed in most instances. With the repeal of Section 902 by the TCJA, prospective "pooling" adjustments are no longer available. Accordingly, a taxpayer must redetermine its US tax liability for a pre-2018 year (and other affected years) to which a post-2017 foreign tax redetermination relates, taking into account the effects of the foreign tax redetermination on the foreign corporation's taxable income, earnings and profits, foreign income taxes, the amount of taxes deemed paid, the character and amount of distributions and inclusions, and the subpart F high-tax exception in those years.

In response to comments, the 2020 final regulations allow taxpayers to make an irrevocable election to treat all post-2017 foreign tax redeterminations that related to pre-2018 tax years as occurring in the foreign corporation's last tax year beginning before 1 January 2018 (last pooling year). For most controlled foreign corporations (CFCs) (or any other Section 965 specified foreign corporation), the last pooling year is the inclusion year for purposes of Section 965.

The last-pooling-year election applies the terms of the temporary Section 905(c) regulations, which expired in 2007, to determine whether to account for the foreign tax redetermination in the last pooling year or the pre-2018 year to which the foreign taxes relate. Unless an exception applies, the election will result in adjustments to the foreign corporation's earnings and profits, post-1986 undistributed earnings and post-1986 foreign income taxes in the last pooling year. These may be taken into account in determining the foreign corporation's Section 965(a) inclusion and the foreign income taxes deemed paid with respect to the inclusion. While the election may offer administrative benefits, any foreign income taxes deemed paid for a Section 965 inclusion are reduced under Section 965(g). Furthermore, any reduction in liability under Section 965 may not result in an immediate refund in tax payment liability if the US shareholder has deferred its tax payment liability under Section 965(h).

The last-pooling-year election is made for a foreign corporation's first tax year ending with or within its US shareholder's tax year ending on or after publication of the regulations (e.g., 2020 for a calendar-year taxpayer) and in which a foreign tax redetermination occurs (the first redetermination year). The election is made by the controlling domestic shareholders of the foreign corporation and is irrevocable and binding on all persons that are (or were in a prior year to which the election applies) US shareholders of the foreign corporation.

The election applies to all foreign tax redeterminations in the first redetermination year and all subsequent tax years of the foreign corporation. It is also subject to a CFC group conformity requirement modelled on the GILTI high-tax exception rules. Thus, the election also applies to all CFCs that are members of the same CFC group and is irrevocably binding on all persons that are (or were in a year prior to which election applies) US shareholders of any member of the CFC group.

Notification requirements

The 2020 final regulations adopt notification requirements and penalty provisions for foreign tax redeterminations. Specifically, taxpayers generally must notify the Internal Revenue Service (IRS) of a foreign tax redetermination by filing an amended return, Form 1116 or Form 1118 (as applicable), and a statement for the affected year(s). If the redetermination increases US tax liability, the amended return must be filed by the due date (including extensions) of the original return for the taxpayer's tax year in which the foreign tax redetermination occurs. If the redetermination decreases US tax liability, the amended return must be filed within the period specified by Section 6511 (generally within 10 years of the affected year). Special rules apply when the taxpayer has multiple foreign tax redeterminations within the same year or within two consecutive years (relief from filing an amended return for all years). If the amount of US tax due for any tax year does not change, the taxpayer may attach a statement to the tax return for the tax year in which the redetermination occurs in lieu of filing an amended return. Taxpayers that have a foreign tax redetermination that increases the US tax liability and are under a current examination by LB&I may notify the IRS by giving a statement to their examiner.

The 2020 final regulations do not provide any other exception to using an amended return to notify the IRS of a foreign tax redetermination. A transition rule, however, allows taxpayers an additional year to file the required notifications for foreign tax redeterminations that occur in tax years ending on or after 16 December 2019, and before the date on which the final regulations are published in the Federal Register. Failure to comply with the notification requirements risks penalties under Section 6689, which may be up to 25% of the US tax liability attributable to the redetermination.

Successor rules

If a foreign tax redetermination occurs and the person that is treated, for purposes of Section 901, as paying the foreign income tax (the successor) is not the same as the person that was liable for the foreign income tax in the relation-back year (the original taxpayer), the original taxpayer must account for the redetermination. Federal income tax principles apply to determine the consequences if the successor paid the tax or received the refund (including, for example, by deeming certain transactions to have occurred between the successor and the original taxpayer).

The final regulations under Section 905(c) generally apply for tax years ending on or after 16 December 2019, and to foreign tax redeterminations occurring in tax years ending with or within a US shareholder's tax year ending on or after 16 December 2019. The election for redeterminations that occur in post-2017 tax years and relate to pre-2018 tax years generally applies to a foreign corporation's foreign tax redeterminations occurring in tax years ending with or within a US shareholder's tax years ending on or after the date the 2020 final regulations are filed with the Federal Register for public inspection.

The final rules under Section 905(c) regulations generally apply for tax years ending on or after 16 December 2019, and to foreign tax redeterminations occurring in tax years ending with or within a US shareholder's tax year ending on or after 16 December 2019. The transition rules for foreign tax redeterminations that occur in post-2017 tax years and relate to pre-2018 tax years generally apply to foreign tax redeterminations occurring in tax years ending with or within a US shareholder's tax years ending on or after publication of the 2020 final regulations.

Modifications to the expense allocation and apportionment provisions

R&E expenses

New Treas. Reg. Section 1.861-17 (the Final R&E Regulations) provides additional clarity for allocating and apportioning R&E expense. In particular, the Final R&E

Regulations generally maintain a formulaic approach to the allocation and apportionment of R&E expenses, with an emphasis on administrability over the factual relationship between intangible assets and the associated income.

Consistent with Prop. Reg. Section 1.861-17 (the Proposed R&E Regulations), the Final R&E Regulations first allocate R&E expenditures to a taxpayer's "gross intangible income" (GII) under the relevant Standard Industrial Classification (SIC) code category. Next, R&E expenditures are apportioned to statutory and residual groupings within that class of gross income. The apportionment of R&E expenditures includes (i) 50% exclusive apportionment based on geographical source solely for purposes of Section 904 (e.g., if research is primarily in the US, 50% of R&E expenditures are apportioned to US-source income) and (ii) apportionment to the statutory and residual groupings based on gross receipts related to GII.

The Final R&E Regulations include the full amount of a taxpayer's gross income from sales or leases of products or services in GII if the income derives directly or indirectly (in whole or in part) from intangible property. As such, GII includes all income from sales or leases of products or services that are only partially derived from intangible property. It does not, however, include GILTI, subpart F income inclusions or dividends.

The Final R&E Regulations clarify that a taxpayer may aggregate SIC codes only if the 3-digit SIC code categories are in the same "Major Group," as determined by the 2-digit SIC codes in the SIC manual. Aggregation of SIC codes outside of the same Major Group is not permitted. For taxpayers engaged in both wholesaling/retailing in one Major Group and other activities (e.g., manufacturing activity) that fall into a different Major Group for a category of products, the wholesale/retailing activity must be included in the 3-digit SIC code category for the other activities. The ability to aggregate SIC code categories within a Major Group provides additional flexibility to taxpayers; the same aggregation, however, generally must be used for future tax years.

The Final R&E Regulations removed the gross-income method of apportionment, the special rules for legally-mandated R&E and the potential for increased exclusive apportionment based on facts and circumstances. The Final R&E Regulations also provide that exclusive apportionment applies only for Section 904 purposes (and not, for example, for Section 250 purposes).

Foreign branch income

For purposes of apportioning R&E to the foreign branch basket, foreign branch gross income is determined after accounting for any disregarded reattribution payments to or from a foreign branch under Treas. Reg. Section 1.904-4(f)(2)(vi). For example, for a disregarded reattribution payment from a foreign branch to its US owner, the branch's gross receipts are reduced by the amount of gross receipts associated with the payment and the branch owner's gross receipts are increased by the same amount. The adjustment to gross receipts is determined by how the disregarded payment, if regarded, would be allocated to the branch's gross income. R&E expenses are apportioned only after accounting for the reattribution of gross receipts. In the following example (based on Example 6 in Treas. Reg. Section 1.861-17(g)(6)), the adjustment results in less R&E expense apportioned to foreign branch income and more R&E expense apportioned to general category income.

Example

Facts. X corporation owns FDE, an entity disregarded as separate from its owner for Federal income tax purposes (disregarded entity). FDE operates in Country Y and is a foreign branch under Treas. Reg. Section 1.904-4(f)(3)(vii). X has gross receipts of $500,000 and FDE has gross receipts of $300,000, all from sales of products within one SIC code. X has incurred R&E expenses of $60,000 and performs 100% of its R&E activity the US. FDE compensates X for the use of its intangibles with an arm's-length royalty payment of $10,00, which is disregarded for federal income tax purposes. FDE has gross income of $100,000.

Allocation. The R&E expenses are definitely related to the items of GII that are related to the relevant SIC code category, namely the gross income from sales in both the US and Country Y.

Apportionment. Because X performs at least 50% of its R&E activity in the US, 50% of its R&E expenses, or $30,000 ($60,000 x 50%), is apportioned exclusively to the residual grouping of US-source GII solely for purposes of Section 904. Before apportioning the remaining R&E expenses on the basis of gross receipts, X adjusts the gross receipts under the principles of Treas. Reg. Section 1.904-4(f)(2)(vi). In particular, under Treas. Reg. Section 1.904-4(f)(2)(vi), foreign-source gross income equal to the royalty paid by FDI to X ($10,000) is reattributed from the foreign branch category to the general category of income. This represents 10% of FDE's initial gross income ($100,000). Accordingly,

10% of FDE's initial gross receipts of $300,000 (i.e., $30,000) is assigned to the grouping of foreign-source general category income. The R&E expenses are then apportioned as follows: (i) $1,125 (i.e., $30,000 x $30,000 / ($500,000 + $270,000 + $30,000)) to foreign-source general category income, (ii) $10,125 (i.e., $30,000 x $270,000 / ($500,000 + $270,000 + $30,000)) to foreign-source foreign branch category income, and (iii) $18,750 ($30,000 x $500,000 / ($500,000 + $270,000 + $30,000)) to US-source income (not including the $30,000 exclusively apportioned to US-source income).

The Final R&E Regulations clarify that a controlled or uncontrolled party is reasonably expected to benefit from a license, sale or transfer of intangible property if there is a transfer of an intangible, a transfer of a product with an embedded intangible, or the performance of a service incorporating an intangible. If a taxpayer has previously licensed, sold or transferred intangible property to a controlled or uncontrolled party, the final regulations presume the taxpayer licensed, sold, or transferred to that party future intangible property related to the same SIC code category. Taxpayers may, however, rebut this presumption.

The Final R&E Regulations are effective for tax years beginning after 31 December 2019. Taxpayers may choose to rely on the Final R&E regulations or the Proposed R&E Regulations for tax years beginning after 31 December 2017 and before 1 January 2020, provided they apply the Final or Proposed R&E Regulations in their entirety. Taxpayers applying the Final or Proposed R&E Regulations to the tax year beginning in 2018 must also apply the final or Proposed R&E Regulations for the subsequent tax year beginning in 2019.

Stewardship expenses

Treas. Reg. Section 1.861-8(e)(4) (the Final Stewardship Regulations) retains the definition of stewardship as a duplicative activity or a shareholder activity related to overseeing an investment in a related entity, which includes a corporation, partnership or disregarded entity. If stewardship expenses are definitely related to oversight of a particular entity (or entities), the Final Stewardship Regulations allocate the stewardship expenses to the income from that entity (or entities).

For corporations, stewardship expenses are allocable to dividends received or amounts included, or to be received or included, from the related corporation. Thus, stewardship expenses for corporations would be allocated to dividends, or to subpart F income, GILTI inclusions, or PFIC inclusions, and Section 78 gross-up amounts. For partnerships, stewardship expenses are allocable to a partner's distributive share of partnership income. For disregarded entities, stewardship expenses are allocable to all gross income attributable to the disregarded entity.

Stewardship expenses are apportioned between the statutory and residual groupings based on the relative values of the entity (or entities) in each grouping owned by the taxpayer. The taxpayer's value in a related entity is determined and characterized under the rules that apply for interest expense apportionment purposes under Treas. Reg. Sections 1.861-9, 1.861-12, and 1.861-13. For disregarded entities, the entity's character and value are determined as if the entity were a corporation for Federal income tax purposes.

Unlike the interest expense apportionment rules, the Final Stewardship Regulations do not treat assets as exempt assets for stewardship apportionment purposes. Thus, assets that give rise to a Foreign-Derived Intangible Income or GILTI deduction, or a dividends-received deduction, and are exempt for interest expense apportionment purposes are not exempt for stewardship apportionment purposes.

In addition, the Final Stewardship Regulations provide that the affiliated group rules in Treas. Reg. Section 1.861-14(e)(1)(i), which apply for interest expense apportionment purposes, do not apply for stewardship apportionment purposes. As such, a taxpayer's value in a subsidiary, which is normally eliminated for interest expense apportionment purposes, is not eliminated for stewardship apportionment purposes. Accordingly, if stewardship is allocable to a taxpayer's domestic corporate subsidiary, the value of that subsidiary is not eliminated for stewardship apportionment purposes. Taxpayer will likely welcome this clarification of the treatment of stewardship expenses related to a domestic affiliated corporation, as it will reduce stewardship expenses allocated to foreign-source income.

Example

Facts. USP directly owns 100% of the stock of USSub, a domestic corporation, and of a group of CFCs. USP and USSub file separate returns for US Federal income tax purposes but are members of the same affiliated group. USP incurs $540 of stewardship expense with respect to USSub and the CFCs. The value and character of USP's investment in the stock in these entities for interest expense apportionment purposes is as follows:

- USSub
  - US Source – $15,000 (33.33% of total)
- CFCs
  - Passive Category – $9,000 (20% of total)
  - GILTI Category – $15,000 (33.33% of total)
  - General Category Section 245A subgroup - $6,000 (13.33% of total)
- Total – $45,000

Analysis. USP performs stewardship with respect to USSub and the CFCs. Accordingly, USP's stewardship expense is allocable to dividend income and, with respect to the CFCs, GILTI and subpart F income, and apportioned to statutory and residual groupings based on the value and character of those entities as determined for interest expense apportionment purposes. Because a portion of USP's stewardship relates to USSub, USP's value in USSub is taken into account for stewardship apportionment purposes even though this amount is eliminated for interest expense apportionment purposes under the affiliated group rules of Treas. Reg. Section 1.861-14(e)(1)(i). Furthermore, no portion of USP's stock in the CFCs is treated as exempt for stewardship apportionment purposes even though a portion generating GILTI is treated as exempt for interest expense apportionment purposes. As a result, USP's stewardship expense is allocated and apportioned as follows:

- USSub – $180
  - US source – $180 (33.33% of $540)
- CFCs - $360
  - Passive category – $108 (20% of $540)
  - GILTI category – $180 (33.33% of $540)
  - General category Section 245A subgroup – $72 (13.33% of $540)
- Total – $540

See Treas. Reg. Section 1.861-8(g)(18), Example 18.

The treatment of stewardship expenses under the Final Stewardship Regulations applies to tax years beginning after 31 December 2019. For tax years that both begin after 31 December 2017, and end on or after 2 December 2018, and tax years that begin on or before 31 December 2019 (e.g., 2018 and 2019 calendar-year taxpayers), the Final Stewardship Regulations state that the regulations in effect on 17 December 2019, apply. This is a welcome change from the 2019 proposed regulations under Treas. Reg. Section 1.861-8(e)(4), which would have applied to tax years ending on or after 16 December 2019. The Preamble to the 2020 final regulations explains that significant changes were made to the stewardship rules (and to other rules under Treas. Reg. Section 1.861-8) compared to those in the 2019 proposed regulations; therefore, the rules' applicability date should be modified to allow taxpayers more time to comply with the revisions made in the Final Stewardship Regulations.

Allocating and apportioning foreign income taxes under Treas. Reg. Section 1.861-20

General rules adopted by the 2020 final regulations

Treas. Reg. Section 1.861-20 provides detailed guidance for allocating and apportioning foreign income taxes paid or accrued in the current tax year for various purposes, including the foreign tax credit limitations, determining the amount of foreign income taxes deemed paid on GILTI and subpart F income, and the application of the GILTI and subpart F high-tax exceptions.

To allocate and apportion foreign income taxes, the 2020 final regulations adopt the following three-step process.

First, items of foreign gross income are assigned to the relevant statutory and residual groupings that include the corresponding US item. A corresponding US item is the gross income or loss under US tax law from the same event that gave rise to the foreign item. If the corresponding US item is a loss (or zero), the foreign item is assigned to the grouping to which a gain would be assigned had the transaction given rise to gain under Federal income tax law. If no corresponding US item arose in the tax year the foreign income tax was paid or accrued or if the foreign gross income is a nonrecognition event for Federal income tax purposes, a foreign item is characterized and assigned as if a corresponding US item had been recognized in that year (similar to the timing difference rule under former Treas. Reg. Section 1.904-6(a)(1)(iv)). The 2020 final regulations adopt a new special rule allowing certain US income or loss from the preceding US tax year to be a corresponding US item when the taxpayer's US and foreign tax years end on different dates.

Second, deductions allowed under foreign law (foreign law deductions) are allocated and apportioned to the foreign item based on foreign law. If foreign law does not provide rules for allocating and apportioning the foreign law deductions, the principles of the Section 861 regulations apply.

Third, the current-year foreign income taxes are allocated and apportioned to the foreign taxable income in the statutory and residual groupings (as determined after the second step). If foreign law exempts a foreign item from tax, no foreign income tax would be allocated to that item.

The 2020 final regulations include several special rules for assigning specific foreign gross income items to statutory and residual groupings (i.e., for purposes of the first step of the three-step analysis).

Distributions: When a corporation makes a distribution that is treated as a dividend under foreign law (a foreign dividend amount), the foreign dividend amount is, to the extent it is also treated as a dividend for Federal income tax purposes (a US dividend amount), assigned to the same statutory and residual grouping as the US dividend amount. To the extent that the foreign dividend amount is treated as a return of capital for US purposes, the foreign dividend amount is assigned to statutory and residual groupings based on the categories to which the tax book value of the distributing corporation's stock is assigned under the asset method in Treas. Reg. Section 1.861-9. Any remaining foreign dividend amount is assigned to the same grouping as the US capital gain amount.

For example, assume that FC, a CFC, distributed $1,000 to its US shareholder, from which $100 of foreign tax was withheld. Under Treas. Reg. Section 1.861-9, FC's stock is assigned to the Section 951A category. In addition, $500 of the distribution is treated as a dividend for Federal income tax purposes under Section 301(c)(1) and is assigned to the general category; $400 of the distribution is a return of capital described in Section 301(c)(2); and $100 of the distribution is capital gain under Section 301(c)(3). Under the 2020 final regulations, $500 of the foreign dividend amount (and $50 of the foreign income tax) is assigned to the general category; $400 of the foreign dividend amount (and $40 of the foreign income tax) is assigned to the Section 951A category; and $10 of the foreign dividend amount (and $10 of the foreign income tax) is assigned to the passive category.

Foreign law distributions without a corresponding distribution under Federal income tax law are assigned as though a distribution had occurred for Federal income tax purposes on the date the distribution occurs for foreign law purposes. For example, a foreign law consent dividend is assigned to groupings as though the corporation had, in fact, distributed an amount of property equal to the consent dividend, with the US dividend, return of capital, and capital gain amounts determined as if the property had actually been distributed.

Reverse hybrids: When a taxpayer recognizes foreign law pass-through income as a result of its ownership in a reverse hybrid (i.e., an entity that is treated as a corporation for Federal income tax purposes and a pass-through entity under foreign law), the foreign law income is assigned to groupings based on the reverse hybrid's foreign income and by treating the reverse hybrid as the taxpayer. This rule, in conjunction with Treas. Reg. Section 1.904-6(f), assigns foreign income taxes paid or accrued by a US corporation on the income of a reverse hybrid CFC to the GILTI category based on the US corporation's GILTI inclusion percentage for that year.

Foreign-law inclusion regimes. Foreign income items taken into account under a foreign law inclusion regime similar to the subpart F income or GILTI regimes are assigned to the same categories as the gross income of the foreign law CFC that gave rise to the foreign law inclusion item.

Foreign-law gain on the sale of a disregarded entity. Foreign law gain from the sale of a disregarded entity is assigned to a statutory and residual grouping as if the disregarded entity's assets — rather than an interest in the disregarded entity itself — were sold for foreign tax law purposes.

Base differences. Foreign income taxes paid by a CFC that are attributable to base differences are assigned to the "residual category," so they may not be claimed as a credit under Section 960. Foreign income taxes that are paid by a US person and attributable to a base difference are assigned to the foreign branch category, whether or not the US person owns a foreign branch or has any foreign branch category income.

The 2020 final regulations provide the following exclusive list of items that constitute base differences:

- Death benefits described in Section 101
- Gifts and inheritances described in Section 102
- Capital contributions under Section 118
- The receipt of property in exchange for stock described in Section 1032 (including by reason of a Section 351 contribution)
- The receipt of money or other property in a Section 721 contribution to a partnership

In a departure from the 2019 proposed regulations, the list of base differences in the 2020 final regulations does *not* include (i) the portion of a distribution that is a return of basis under Section 301(c)(2) (now allocated based on the tax book value of the distributor's stock, as discussed previously), or (ii) a distribution from a partnership described in Section 733.

The final regulations apply to tax years beginning after 31 December 2019.

Accounting for hybrid dividends under Section 245A(e), conduit financing transactions, and GILTI gap period rules

A US shareholder that receives a hybrid dividend may not claim a deduction under Section 245A(a), and the rules of Section 245A(d) apply to disallow foreign tax credits and deductions for foreign taxes. Similarly, hybrid dividends received by certain upper-tier CFCs are treated as subpart F income, so the rules of Section 245A(d) also apply to a US shareholder's pro rata share of that subpart F income. A US shareholder or an upper-tier CFC (each, a specified owner) that holds a share of CFC stock must maintain a hybrid deduction account for hybrid deductions allocated to that share. A dividend received by a specified owner is a hybrid dividend to the extent of the sum of the balance of all hybrid deduction accounts.

The 2020 final regulations reduce a US shareholder's hybrid deduction accounts for (1) a portion of a subpart F inclusion, (2) a portion of a GILTI inclusion, and (3) certain Section 956 inclusions. A hybrid deduction account is reduced for the entire amount of a Section 956 inclusion. The extent to which subpart F inclusions and GILTI inclusions reduce a hybrid deduction account is adjusted by permitting a reduction to the hybrid deduction account only to the extent those amounts are included in a US shareholder's income and not offset by foreign tax credits deemed paid under Section 960 or, for a GILTI inclusion, the Section 250 deduction. In determining whether a GILTI inclusion is offset by foreign tax credits, the Section 904 limitation rules are taken into account. Thus, if Section 904 limits the foreign tax credit that a US shareholder may claim for its GILTI inclusion, a greater portion of the GILTI inclusion that is attributable to a CFC reduces the hybrid deduction account for that CFC's stock.

In contrast, a subpart F inclusion amount taken into account under these rules is reduced for deemed paid foreign income taxes whether or not a credit for those foreign income taxes is limited under Section 904, because those credits may be carried to another tax year. Finally, subpart F inclusions under Section 964(e)(3) do not result in a reduction to a hybrid deduction account to the extent that they are eligible for the deduction under Section 245A.

These rules apply to tax years ending on or after the date the 2020 final regulations are published in the Federal Register. However, taxpayers may apply the rules to an earlier tax year, provided that the rules are applied consistently in that year and each subsequent year.

Treatment of certain stock as a financing transaction under conduit financing rules

Under Treas. Reg. Section 1.881-3, the IRS can disregard a conduit entity in a conduit "financing arrangement" so that the financing arrangement is a transaction directly between the remaining parties. Under the prior regulations, an instrument that is treated as equity for US tax purposes was generally not treated as a financing transaction, even if the instrument was treated as debt for foreign tax law purposes. The 2020 final regulations reverse this exception and treat an instrument as a financing transaction if it is stock or a similar interest (including a partnership interest) for US tax purposes but debt under the tax law of the country in which the issuer is a tax resident. If the issuer is not a tax resident of a country, the instrument is a financing transaction if the instrument is debt under the tax law of the country where the issuer is created, organized or otherwise established. These rules apply to payments made on or after the date the 2020 final regulations are published in the Federal Register.

GILTI gap period rule

The 2020 final regulations also adopt as final a provision under Section 951A that effectively denies deductions for certain payments made directly or indirectly by CFC during the period from 1 January 2018, through the effective date of the GILTI provisions for the recipient CFC (the GILTI disqualified period). This rule generally applies if: (1) a payment is made during the disqualified period (a disqualified payment) that would have given rise to tested income in the hands of the recipient CFC if the GILTI provisions had been effective for the recipient CFC; and (2) a deduction is taken in a later period when economic performance with respect to the disqualified payment occurs. The rule applies to tax years of foreign corporations ending on or after 7 April 2020.

Implications

The 2020 final regulations expand the scope of foreign tax redeterminations for a foreign corporation's foreign income taxes under Section 905(c) and will result in increased instances of US tax redeterminations. The last-pooling-year election may provide some compliance relief to limit adjustments for post-2017 foreign tax redeterminations of pre-2018 foreign income taxes of a foreign corporation to the last pooling year. Taxpayers will continue, however, to be under a significant compliance burden to reflect the impact of foreign tax redeterminations for a foreign corporation's foreign income taxes in the year to which the taxes relate, and must carefully track these matters and regularly file amended returns to avoid losing foreign tax credits or incurring penalties.

The Final R&E Regulations follow the Proposed R&E Regulations by providing a welcome change to the type of gross income to which R&E expenses are considered to be related — by excluding GILTI, subpart F income and dividends. However, the regulations provide a very broad set of rules for taking into account gross receipts of controlled and uncontrolled parties. For a license to a foreign affiliate, it will commonly be the case that all of the affiliate's gross receipts are associated with the royalty income. Moreover, a very wide range of transactions with an unrelated party (i.e., any transfer of IP, sale of products with embedded IP and performance of services incorporating IP) will require the gross receipts of the unrelated party to be taken into account. This will create substantial compliance challenges. More generally, it is unclear that the rules' broad sweep for taking into account gross receipts of controlled and uncontrolled parties produces the most appropriate result from a tax policy perspective.

The 2020 final regulations on to the allocation and apportionment of foreign income taxes under Treas. Reg. Section 1.861-20 reduce the number of cases in which foreign income taxes paid or accrued by a CFC would be denied by eliminating return-of-capital distributions from the list of "base differences." These rules, however, remain intricate and difficult to manage in certain situations when a foreign income tax is imposed on an item that is not taken into account as income for US Federal income tax purposes (e.g., because the transaction or payment that gave rise to the item is disregarded for US Federal income tax purposes).

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. See EY Global Tax Alert, *US Final and proposed regulations provide additional guidance for determining allowable foreign tax credits*, dated 10 December 2019.
3. See EY Global Tax Alert, *US Final and proposed regulations on hybrid mismatches, DCLs and conduit financing provide more certainty but some surprises*, dated 13 April 2020.

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