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INTERNATIONAL TAX ISSUES AND DEVELOPMENTS

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I. TRANSFER PRICING.

A. Coca-Cola: § 482.

1. The Tax Court ruled in favor of the IRS in *Coca-Cola Company v. Commissioner*, 155 T.C. No. 10 (2020), upholding nearly $10 billion in transfer pricing adjustments for the tax years 2007-2009.

2. The parent Coca-Cola company (”P”) owned the relevant intellectual property (“IP”) including trademarks, product names, logos, patents, secret formulas, and proprietary manufacturing processes. P licensed these rights to its wholly owned foreign manufacturing affiliates, called supply points (“Supply-Point Subsidiaries”). The Supply-Point Subsidiaries[1] used the licensed IP to produce concentrate that they sold to hundreds of

[1] P owned seven supply points, including its Mexican branch. The Brazilian and Chilean supply points were CFCs. The Costa Rican, Egyptian, Irish and Swazi supply points were branches or disregarded entities of a Cayman Islands CFC. The Irish supply point was by far the largest, selling concentrate to Bottlers in more than 90 countries.

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bottlers ("Bottlers") that produced finished product for sale to distributors and retailers. Most of the Bottlers were unrelated to P.

3. The Supply-Point Subsidiaries' manufacturing activities consisted of procuring raw materials and using P's guidelines and production technologies to mix and convert the raw materials into concentrate. The procurement activities were limited: many ingredients could be obtained only through company-owned flavor plants, and other ingredient purchases were negotiated by bulk procurement specialists employed by P or the related-party service companies discussed below ("Service Companies"). The concentrate manufacturing steps were governed by a detailed manufacturing protocol dictated by P. The Court stated that Supply-Point Subsidiaries engaged almost exclusively in manufacturing, and that P's experts agreed that this was a routine activity that could be benchmarked to the activities of contract manufacturers.[2]

4. P also owned over 60 foreign Service Companies that were responsible for local advertising and in-country consumer marketing that they carried out with assistance from third-party media companies and creative design firms. They were also responsible for liaison with local Bottlers, a function called "franchise leadership," and acted in a day-to-day advisory role to Bottlers, facilitating Bottlers' access to statistical data, consumer insights, advertising plans, and marketing strategies. The Service Companies shared with Bottlers the responsibility for creating coordinated annual business plans that fulfilled global strategy and the needs of the local market. Some had research and development ("R&D") centers. The Supply-Point Subsidiaries had little or no direct ownership interest in the Service Companies.

5. The Service Companies employed non-manufacturing personnel, including leadership personnel. During the years in issue, the Service Companies employed all of the regional operating group leadership (for territories) and 90% of the 200 officers who made up the business units leadership that had responsibility for one or more national markets.

6. The vast bulk of the Coca-Cola beverages were produced and distributed by about 300 independent Bottlers that produced most of the beverages using concentrate manufactured by the Supply-Point Subsidiaries. The Bottlers mixed the concentrate with purified water, carbon dioxide, sweeteners, and/or flavorings; injected the finished beverages into bottles and cans of various serving sizes; packaged and warehoused these items pending distribution; and delivered the beverages to about 20 million retail

[2] The Court also stated that "much of the Coca-Cola System's value rested on familiar, consistently flavored drinks delivered by well-established production processes." This would seem to suggest there was substantial value in the manufacturing function.

establishments that included supermarkets, small retail stores, bars, and restaurants.

7. P's personnel performed most of the quality control functions including regular quality control audits of Supply-Point Subsidiaries, flavoring plants, and other manufacturing facilities, including plants owned by Bottlers.

8. The "Coca-Cola System" is a flexible management structure that permitted local adaptation and encouraged close coordination with Bottlers in a governance model called "Freedom within a Framework." P was chiefly responsible for supply chain management regarding concentrate. The Bottlers were responsible for supply chain management regarding finished products.

9. P set detailed guidelines for brand identity, visual identity of products, quality assurance, business goals, and marketing strategies. But it permitted local units to adapt these rules (within limits) to the cultural, religious, linguistic, and culinary traditions of their particular foreign markets. Any major deviation from the global brand marketing standards required explicit review and approval by P. Global marketing campaigns were designed by P with input from the Service Company personnel in various markets. P had an Integrated Marketing Communications ("IMC") unit that provided tools and frameworks for training local Service Company marketers in the field, called Coca-Cola University.

10. P and the Bottlers conducted aggressive advertising and marketing campaigns to keep their products fresh and at the top of consumers' minds. During the tax years at issue the Coca-Cola System expended billions of dollars annually for marketing, split about evenly between P and its Bottlers. P and the Bottlers implemented an informal "true up" strategy to ensure that marketing expenses were split roughly 50-50 between them.

11. P took principal responsibility for consumer marketing. Global campaigns were designed at P's home office in Atlanta with input from Service Company personnel. The Bottlers took principal responsibility for trade marketing directed toward the retail establishments (supermarkets, mom-and-pop stores, bars, and restaurants). Bottlers were responsible for securing advantageous product placement in stores, arranging point-of-sale promotions (such as floor decals and end-of-aisle displays), and offering in-store samples of new products. The Bottlers also had to manage inventory and ensure timely delivery.

12. P contracted with the Service Companies and paid them a cost-plus fee for their services. The Supply-Point Subsidiaries were charged allocated shares of the Service Company "fees and commissions" (marked-up costs)

plus allocated shares of the Service Companies' third-party marketing expenses. During the years in issue, the Supply-Point Subsidiaries were charged approximately $3 billion for the Service Companies fees and commissions and direct marketing expenses. The Court stated that "most [Service Company] charges eventually found their way onto the books of one or more [Supply-Point Subsidiaries]."

13. The Supply-Point Subsidiaries received only a limited right to use the trademarks in connection with their production and sales activities. No Supply-Point Subsidiary was granted exclusive territorial rights. No Supply-Point Subsidiary limited its concentrate sales to the geographical territory in which its manufacturing facility was located. Supply-Point Subsidiaries regularly sold concentrate to Bottlers in other Supply-Point Subsidiaries' domestic markets. No Supply-Point Subsidiary was granted any right to guaranteed production of Coca-Cola products and production shifts were common.

14. In virtually all of the Bottler agreements P was the legal counterparty. Unlike the agreements with the Supply-Point Subsidiaries, Bottler contracts explicitly granted long-term and generally exclusive rights to produce and sell within their respective territories. Like the Supply-Point Subsidiaries, Bottlers were required to buy ingredients from approved suppliers and enjoyed no right to purchase these inputs at any predetermined price. Whereas the Supply-Point Subsidiaries were permitted to sell concentrate only to approved Bottlers, Bottlers had complete freedom to sell finished beverages to any wholesaler or retailer within their respective territories. Bottlers also had limited trademark rights.

15. The Bottlers remunerated P through the price they paid for concentrate. That price in effect bundled all of the valuable inputs into a single bill for the concentrate. By paying this bill, Bottlers secured not only the physical beverage base, but the entire package of rights and privileges they needed to operate efficiently as Bottlers. This package included the right to use trademarks, access to approved suppliers, access to critical databases and marketing materials, and the expectation of ongoing consumer marketing support. P reserved the unilateral right to set the concentrate price, which in theory enabled it to determine the Bottler's profitability.

16. P and its Supply-Point Subsidiaries used the same "10-50-50" transfer pricing methodology that they had used for the previous 11 years based on a 1996 closing agreement with the IRS. The closing agreement covered the years 1987-1995. This method permitted the Supply-Point Subsidiaries to retain profit equal to 10% of their gross sales, with the remaining profit being split 50%-50% with P. The 1996 closing agreement permitted the Supply-Point Subsidiaries to satisfy their royalty obligations by repatriating funds to P as dividends. The 1996 closing

agreement did not address what transfer pricing methodology would be used for years after 1995, but did state that use of the 10-50-50 methodology would protect P from penalties in future years.

17. The IRS asserted that for 2007-2009 the 10-50-50 method did not reflect arm's-length pricing because it overcompensated the Supply-Point Subsidiaries and undercompensated P for the use of its IP. The IRS reallocated income to P under a comparable profits method ("CPM") that used the unrelated Bottlers as comparable parties. The IRS regarded the Bottlers as comparable to the Supply-Point Subsidiaries because they operated in the same industry, faced similar economic risks, had similar contractual relationships with P, employed many of the same intangible assets (P's brand names, trademarks, and logos), and ultimately shared the same income stream from sales of Coca-Cola beverages.

18. P argued that the reallocation was arbitrary and capricious, and that the IRS acted arbitrarily by abandoning the 10-50-50 method. P also argued that the IRS erred in employing the Bottler CPM to reallocate income. It argued that the independent Bottlers were not comparable to the Supply-Point Subsidiaries because the Supply-Point Subsidiaries owned immensely valuable marketing intangible assets. As alternatives to the CPM, P offered a comparable uncontrolled transaction ("CUT") model, a residual profit split method ("RPSM") and an unspecified method.

19. The IRS's expert, Dr. Newlon, said that P, as the legal owner of virtually all the trademarks and intangible property, owned the vast bulk of its brand value. Dr. Newlon rejected the comparable uncontrolled transaction ("CUT") method and the "profit split" method, since he believed that the supply points owned virtually no IP. He applied a CPM using the independent Bottlers as parties comparable to the Supply-Point Subsidiaries.

20. The Court rejected P's reliance on the 1996 closing agreement and stated that "the closing agreement says nothing whatever about the transfer pricing methodology that was to apply for years after 1995."

21. P's argument that foreign marketing and sales activities performed by the Service Companies and P could be attributed to the Supply-Point Subsidiaries was rejected by the Court.

22. The Court also rejected P's argument that the Supply-Point Subsidiaries owned valuable intangible assets in the form of franchise rights. It stated that P's "central submission in this case [is] that the [Supply-Point Subsidiaries] owned immensely valuable off-book intangible assets that justified the extraordinarily high profits they enjoyed." Once the Court rejected P's argument that the Supply-Point Subsidiaries owned valuable IP, it concluded that CPM was the best method. The Court rejected the

CUT method and the profit split method stating that P owns virtually all of the relevant intangibles.

23. P argued that the trademarks are wasting assets and that without the billions of dollars invested in marketing the trademarks would have lost substantial value over time. The Court stated that consumer marketing in foreign markets was undertaken by the Service Companies and that the Supply-Point Subsidiaries played no role in arranging consumer marketing and had no voice in selecting or evaluating the services.

24. The Court held that "To the extent the Service Companies' consumer advertising expenditures added value, those expenditures did not create new intangible assets owned by the Supply-Point Subsidiaries. Rather, the advertising enhanced the value of the trademarks and other intangible assets that were legally owned by [P]." The Court stated that P "is attempting to create, retroactively, something resembling a 'cost sharing arrangement.'"[3]

25. In terms of legal ownership of IP, the Court found that the Supply-Point Subsidiaries did not hold any IP rights pursuant to the parties' contractual terms and other legal provisions. The Supply-Point Subsidiaries received only a limited right to use intangibles in connection with their production and sales activities.

26. The Court said that P was arguing against its own agreements when it contended that the Supply-Point Subsidiaries owned valuable marketing intangibles. Disregarding a taxpayer's agreements based on economic substance in generally a prerogative of the IRS, not the taxpayer. Further, an appeal would lie to the Eleventh Circuit, which is a *Danielson* circuit. *Danielson* makes it especially difficult for a taxpayer to argue against its agreements.

27. The Court also rejected application of developer-assister rules of the 1968 § 482 regulations although it did so specifically in the context of the Brazilian Supply-Point Subsidiary. Among other reasons, the property was already in existence.

28. The Court said that P had cited no authority for the proposition that spending money on consumer advertising, without more, gives rise to freestanding intangible assets as a matter of economic substance."[4]

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[3] The Court was clear in stating "But [P and its Supply-Point Subsidiaries] did not enter into a 'qualified cost sharing arrangement.' [citation omitted.] And this is simply not a cost sharing case." In fact, Judge Lauber also was the judge in *Amazon.com v. Commissioner*, 148 T.C. 108 (2017), *aff'd*, ___ F.3d ___ (9th Cir. 2019), a cost sharing case resolved in favor of the taxpayer.

[4] We would think that, dealing at arm's length, the Supply-Point Subsidiaries should be entitled to a return for incurring the cost and risk of $3 billion of advertising and marketing costs that relate directly to and are

29. P put forth an alternative argument "that the [Supply-Point Subsidiaries'] contracts with [P] endowed them with intangible assets in the form of 'long-term licenses.'" The Court found "no factual support for that argument." The agreements were terminable at will, had no territorial exclusivity, and had no guaranteed production right. The Court stated that production repeatedly shifted from one supply point to another.

30. In analyzing the independent Bottlers as comparable parties to the Supply-Point Subsidiaries for purposes of CPM, the Court held they were reasonably treated as comparable. CPM is keyed to operating profit, which makes it particularly dependent on resources employed and risks assumed. They operated in the same industry, faced similar economic risks, had similar (but more favorable) contractual and economic relationships with P, employed in the manner many of the same intangible assets, and ultimately shared the same income stream from sales of P's beverages. The Court said the "functions performed" by the Bottlers resembled those of the Supply-Point Subsidiaries, except that the Bottlers performed those functions at a greater scale, and quality control was important to both sets of companies. The Court held that the "contractual terms," "economic conditions" and "risks assumed" also were comparable.

31. P argued that Supply-Point Subsidiaries bore marketing risk because they funded consumer advertising in foreign markets. The Court said they had no operational responsibility for consumer marketing, and thus bore no risk of "mission failure." P also argued that the Bottlers were "marketing-light businesses" and that the Supply-Point Subsidiaries had "marketing-intensive operations," but the Court disagreed, stating that the Bottlers in the aggregate paid as much for trade marketing annually as P and its affiliates paid for consumer marketing. In addition, the Supply-Point Subsidiaries engaged in no marketing operations.

32. The Court also said that even if the Supply-Point Subsidiaries had intangibles they would still be comparable to the Bottlers.

33. One of P's experts, Dr. Unni, used the CUT method using a master franchising agreement with McDonald's and Domino's. Dr. Unni began with the premise that the Supply-Point Subsidiaries are responsible for the foreign businesses, including managing and overseeing the franchise bottlers and that the Supply-Point Subsidiaries are responsible for consumer marketing activities and expenditures to exploit and develop the intangibles. The Court disagreed with this premise. The Court stated that the Bottlers' contracts invariably ran with P, not with the Supply-Point Subsidiaries and that the Bottlers received direction and marketing

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important in their customers' businesses. That return, one would think, should be substantially more than a routine return on the manufacturing function.

assistance from the Service Companies, not from the Supply-Point Subsidiaries.

34. Another one of P's experts, Dr. Cragg used the residual profit split method that allocated income between P and "the Field." The Court rejected Dr. Cragg's "Field" construct. The Court stated that "the [Supply Point Subsidiaries]--the relevant 'controlled parties' for § 482 purposes – did not actually perform the economic functions that Dr. Cragg regarded as valuable, e.g., "implementing consumer advertising and engaging in 'franchise leadership' with bottlers."

35. Another one of P's experts, Mr. Reams, used an unspecified method based on an asset management model. He asserted that the Field drives the success and profitability of the foreign business and that P primarily focuses on governance and high level strategy similar to an asset manager. The Court rejected this argument and stated that even Mr. Reams acknowledged that a services-pricing model would not normally be used to price an intangible license.

36. At bottom, the Court held that P failed to establish that the IRS's allocations were "arbitrary, capricious and unreasonable." Under § 482, the Service's determination must be sustained absent a showing that the Service abused its discretion in making the adjustment. The Court stated the review focuses on the reasonableness of the Service's result and not the details of its methodology. The Court further stated that in cases such as this, involving unique, extremely valuable intangible property, comparable uncontrolled transaction might not exist. Thus, the taxpayer typically will need to establish that the IRS employed an unreasonable methodology to reach its result, including by showing that the methodology implicated a significant legal error or was implemented in an unreasonable manner.

37. If the taxpayer demonstrates that the Service's allocation is arbitrary, capricious, or unreasonable but fails to prove an alternative allocation that meets the arm's-length standard, the Court, using its best judgment, must determine from the record the proper allocation of income. But here, as noted, the Court found that the Service did not abuse its discretion.

38. Other important issues in the case included the Court's permitting P to treat $1.8 billion of the royalties as paid in the form of dividends from its subsidiaries (thereby reducing the IRS's adjustment by this amount). A Brazilian blocked income issue was deferred until *3M Co v. Comm.*, T.C. Dkt. No. 5816-13 (2013), is decided. In that case, the taxpayer has challenged the validity of Treas. Reg. § 1.482-1(h)(2). The taxpayer submitted a motion to decide the case under Rule 122, and the case is still pending. Finally, the Court also addressed certain § 987 issues regarding P's Mexican branch supply point.

B. Coca-Cola: Motion for Reconsideration.

1. Coca-Cola filed a motion for reconsideration supported by a 75-page brief that was filed with the Tax Court on June 2, 2021.

2. The brief states that the IRS acted unlawfully in imposing Dr. Newlon's CPM after leading Coca-Cola to reasonably rely on the 10-50-10 method to calculate the company's taxes.

3. It also states that the IRS's "bait and switch" violates the United States Constitution.

4. It further states that the Court contravened the Treasury Regulations by failing to account for the Supply Points' licenses to use Coca-Cola's trademarks, or to compensate them even if all they did was add value to Coca-Cola's trademarks. (See our footnote 4 above.)

C. DEMPE Functions.

1. A report by Ryan Finley in Tax Notes International is entitled "After Coca-Cola, Practitioners see DEMPE as Part of U.S. Tax Law." 102 Tax Notes Int'l 113 (May 24, 2021). Finley quotes certain practitioners as believing that "the Coca-Cola opinion suggests that the Tax Court might now interpret U.S. law in a way that incorporates OECD guidance on control over risk and intangible development, enhancement, maintenance, protection and exploitation (DEMPE) functions."

2. This addresses, of course, whether a traditional analysis of transfer pricing functions for U.S. tax purposes now incorporates the OECD's DEMPE functions even though the U.S. does not adhere to, and specifically did not adopt, the changes in the OECD's transfer pricing guidelines as a result of the BEPS project.

3. Two practitioners specifically referred to the court's statements that "the Supply Points did not perform or control the activities associated with" the marketing expenditures that they incurred and that they were "passive recipients of charges." *See* Nos. 23 and 31 above.

4. The brief in support Coca-Cola's Motion for Reconsideration cites Finley's report.

5. The issue could involve Treas. Reg. § 1.482-1(d)(3)(iii)(B) regarding risk. In considering the parties' allocation of risk, that allocation will be respected if it is consistent with the economic substance of the transaction. In considering economic substance, one of the facts to be considered is the extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized.

6. However, in a different report by Ryan Finley, he discussed this issue and quoted former Treasury and IRS officials who represented the U.S. in the relevant OECD negotiations. Those former government officials said the OECD and U.S. rules arguably might appear somewhat similar but they are much different. Under the U.S. rules, the extent of control might be a factor, but it's not a decisive factor, i.e., it might go to "how it's priced in" but it's not something that's a "must." *See* Finley, TNI May 4, 2021.

7. What did the Tax Court do in *Coca Cola*? Has the Tax Court created new law? Might it be reversible error? *See* Nos. 23 and 31 above. While IRS personnel presumably are pleased with the Service's victory, has the playing field now been tilted in favor of DEMPE functions, something the U.S. fought and specifically has not included in the § 482 regulations?

D. Medtronic.

1. The Eighth Circuit vacated the Tax Court's decision in *Medtronic v. Commissioner*, 900 F.3d 610 (8th Cir. 2018), and remanded the case back to the Tax Court for a comparability assessment.

2. Medtronic used the comparable uncontrolled transactions ("CUT") transfer pricing method to determine the royalty rates paid on its intercompany licenses. To resolve a 2002 audit, Medtronic and the IRS entered into a Memorandum of Understanding ("MOU") on the royalty rates and agreed to apply the royalty rates in future years "as long as there [were] no significant changes in any underlying facts."

3. In 2005 and 2006, the IRS asserted that the comparable profits method – not the CUT method – was the best way to determine an arm's length price for Medtronic's intercompany licensing agreements for those two years resulting in tax deficiencies.

4. Medtronic filed in Tax Court, arguing that the CUT method, not the comparable profits method, was the best method for determining an arm's length price for the intercompany licenses. The Tax Court found that the comparable profits method downplayed Medtronic Puerto Rico's role in ensuring the quality that it did not reasonably attribute a royalty rate to Medtronic's profits, that it used an incorrect return on assets approach, that it improperly aggregated the transactions, and that it ignored the value of licensed intangibles. Similarly, the Tax Court concluded that Medtronic's CUT method did not produce an accurate arm's length adjustment because it did not distinguish between devices and leads and therefore produced a result that was unconvincing and overly broad.

5. The Tax Court then engaged in its own valuation analysis. It ultimately decided that Medtronic's CUT method was the best way to determine an

arm's length royalty rate for intercompany agreements, but made a number of adjustments.

6. The Eighth Circuit reviewed the Tax Court's de novo for legal conclusions and mixed questions of law and fact and reviewed factual findings under the clear error standard.

7. The Tax Court applied the Pacesetter agreement as the best CUT to calculate the arm's length result for intangible property. The Pacesetter agreement was entered into by Pacesetter's parent company and Medtronic US in 1992 in an effort to settle several lawsuits regarding patent and license use. As part of the agreement, the parties cross-licensed their pacemaker and patent portfolios.

8. The Tax Court determined that the Pacesetter agreement was an appropriate CUT because it involved similar intangible property and had similar circumstances regarding licensing. The Eight Circuit concluded that the Tax Court's factual findings are insufficient to enable the Eighth Circuit to conduct an evaluation of that determination.

9. The Eighth Circuit stated that the Tax Court did not address in sufficient detail whether the circumstances of the settlement were comparable to the licensing agreement.

10. Additionally, the Eighth Circuit stated that the Tax Court did not analyze the degree of comparability of the contractual terms.

11. The Eighth Circuit stated that the Tax Court also did not evaluate how the different treatment of intangibles affected the comparability. The Pacesetter agreement was limited to patents and excluded all other intangibles, including "any technical know-how or design information, manufacturing, marketing, and/or processing information or know-how, designs, drawings, specifications, software source code or other documents directly or indirectly pertinent to the use of the Licensed patents." The Medtronic Puerto Rico licensing agreement on the other hand, did not exclude such intangibles.

12. The Tax Court made a 7% adjustment of the "know how" that Medtronic Puerto Rico received from Medtronic, as well as a 2.5% adjustment to account for the differences in licensed products, however, the Eighth Circuit stated it could not determine that appropriateness of using the Pacesetter agreement as a CUT without additional findings regarding the comparability of the remaining intangibles.

13. Finally, the Eighth Circuit stated that the Tax Court did not decide the amount of risk and product liability expense that should be allocated between Medtronic US and Medtronic Puerto Rico.

14. The remand resulted in the need for a second trial that started on June 14, 2021. Tax Court Dkt. 6944-11. Note also that Medtronic suffered an IRS change in position just as did Coca-Cola.

15. Medtronic stated at the opening of the trial that the CUT method was the best way to price an intercompany technology license, and that the Pacesetter license addressed in the prior trial provided the best benchmark. As was the case at the first trial, the IRS position is that CPM should be used because the manufacturing function was a routine function.[5]

16. As reported by Ryan Finley in Tax Notes Today of June 15, 2021, the court seemed interested in learning about what further adjustments could be made to the CUT than those previously made, and when there are too many adjustments for the CUT method to be the best method. The judge stated that the court also will consider whether CPM is the better method and, if so, whether any adjustments to the profit level indicators of the comparables are necessary.

17. *See* A.3. and fn. 2 above regarding Coca-Cola.

E. Other Transfer Pricing Development.

1. Cameco Corp.

(a) In *Canada v. Cameco Corp*, the taxpayer won a major Canadian transfer pricing case that was affirmed on appeal following which, on February 18, 2021, the Canadian Supreme Court declined to consider the case.

(b) It's a case of significant importance as it involved an interpretation of the Canadian transfer pricing "recharacterization rules." Those rules apply in situations in which non-arm's length transactions (i) would not have been entered into between parties dealing at arm's length and (ii) it can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.

(c) The appeals court specifically stated that the profit that was proposed to be reallocated resulted from a change in the market prices of the product involved that the parties could not have forecast. Thus, the adjustment was the result of an inappropriate use of hindsight.

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[5] We note that the product involved in Medtronic, pacemakers, is much different from the one involved in Coca-Cola. Pacemakers would seem to be a "life and death product." The IRS analogized Medtronic's Puerto Rican subsidiary to Coca-Cola's Supply Points in arguing Medtronic's subsidiary conducted a routine manufacturing activity.

2. Glencore.

(a) In *Glencore Investment Pty Ltd. v. Commissioner of Taxation* [2019] FCA 1432, appeal dismissed, the taxpayer won a landmark Australian transfer pricing case, with the court citing certain testimony given in *Cameco*, the Canadian case discussed above.

(b) The taxpayer had proven the pricing under its agreements was arm's length.

(c) The co-called "reconstruction exceptions" in the OECD commentary were said to be "very highly generalized and frustratingly opaque." These are the exceptions that can apply where substance differs from form, and where the arrangements differ from those that independent enterprises would have adopted. A clear preference was expressed in the domestic statute, with an observation that the OECD Guidelines "may not be of much assistance."

3. Impresa Pizzarotti & C SpA.

(a) The European Court of Justice held the Romanian tax authorities could apply domestic law to adjust the understated profits of the Romanian branch of a non-resident (Italian company) in respect of transactions between the branch and the Italian head office (regarding funds lent interest free to the head office) (Decision in case C-588/19 October 8, 2020).

F. Annual IRS APA Report.

1. The IRS released its annual report on Advanced Pricing Agreements ("APAs") for calendar year 2020 in Announcement 2021-6.

2. Despite the Coronavirus Pandemic, APA applications filed (121) were generally consistent with last year. Most APA applications received during 2020 were bilateral: 103 were bilateral; 15 were unilateral; and 3 were multilateral. This was generally consistent with 2019. In 2020, 41% of the bilateral APA requests involved Japan, 11% India and 10% Canada.

3. The number of APAs executed also remained generally consistent with prior years which is a credit to the APA office's personnel for their efforts given the Pandemic environment in which they had to work. The total number of APAs executed in 2020 increased slightly to 127 from 120 in 2019. Most (108) were bilateral or multilateral with 52% involving Japan, 11% India and 8% Canada. Of the 127, 75 were renewals and 52 were new APAs.

4. Similar to prior years, the majority of APAs executed during 2020 were inbound APAs. The category "Non-US Parent and US Subsidiary" represented 61% of the executed APAs. The category "US Parent and Non-US Subsidiary" represented 27%, and 11% were in the category "Sister Companies."

5. The average completion time for a new bilateral APA was 50.8 months. This indicates that it took slightly longer in 2020 to finalize new bilateral APAs than it did in 2019 which should not be surprising given the environment. Bilateral renewals, however, were completed in an average time of 34.1 months, a significant reduction in time compared to 2019's average time of 38.5 months. Most APAs issued in 2020 were bilateral as indicated above. While it takes a lengthy time to obtain a bilateral APA, it underscores the seriousness and substantiality of the process involved in having the two (or more) countries agree in advance regarding a taxpayer's transfer pricing.

6. An interesting part of the report involves the term of these 2020 executed APAs. Approximately half have a 5-year term, and nearly half have a term in excess of 5 years. The report states that a substantial number of those APAs with terms of greater than 5 years were submitted as a request for a 5-year term and the additional years were agreed to between the taxpayer and the IRS (or, in the case of a bilateral APA, between the IRS and the foreign government upon the taxpayer's request) to ensure a reasonable amount of prospectivity in the APA term. It also states that of the APAs executed in 2020, 11% included rollback years.

G. 2021 Priority Guidance Plan.

1. The 2021 Priority Guidance Plan released on September 9, 2021 is discussed further elsewhere in this outline. *See* Section VIII.

2. However, of note here is that it contains 4 new projects under § 482 (it says "5," but one is the annual report on the APA program discussed in F above).

3. One project addresses the §§ 367(d) and 482 regulations that were published on September 16, 2015 and that expired in 2018.

4. A second project is to clarify the effects of group membership on the arm's length pricing, including specifically for financial transactions.

5. The third project is to clarify certain aspects of the arm's length standard including (a) coordination of the best method rule with guidance on specified methods from different categories of transactions, (b) discretion to determine allocation of risk based on the facts and circumstances of transactions and arrangements, and (c) periodic adjustments.

6. The fourth project involves updating the APA guidelines.

H. Stock-Compensation. The recently released IRS AM regarding stock compensation and *Altera* is discussed in Section IX, below.

II. GILTI AND FDII.

A. Final Regulations. Under new final regulations, the 20-year ADS recovery period for Qualified Improvement Property ("QIP") applies to determine Qualified Business Asset Investment ("QBAI") for purposes of the Global Intangible Low-Tax Income ("GILTI") and Foreign-Derived Intangible Income ("FDII") rules.

1. Section 951A(a) requires a U.S. shareholder (as defined in § 951(b)) ("U.S. shareholder") of any controlled foreign corporation ("CFC") for any taxable year to include in gross income the U.S. shareholder's GILTI for that taxable year ("GILTI inclusion amount"). The U.S. shareholder's GILTI inclusion amount is calculated based on its pro rata share of certain items – such as tested income, tested loss, and QBAI – of each CFC owned by the U.S. shareholder. Treas. Reg. § 1.951A-1(c). Section 951A(d)(3) requires a taxpayer to calculate QBAI by determining the adjusted basis of property using the ADS under § 168(g) "notwithstanding any provision of his title (or any other provision of law) which is enacted after the date of the enactment of [section 951A]."

2. Treas. Reg. § 1.951A-3(e)(2) states that "[t]he adjusted basis in specified tangible property is determined without regard to any provision of law enacted after December 22, 2017, unless such later enacted law specifically and directly amends the definition of qualified business asset investment under section 951A." The GILTI provisions in § 951A apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. § 14201(d) of the TCJA.

3. The definition of QBAI in § 951A(d) also applies for purposes of determining deemed tangible income return under § 250. § 250(b)(2)(B) and Treas. Reg. § 1.250(b)-2(b). Section 250 generally allows a domestic corporation a deduction equal to 37.5% (21.875% for taxable years after 2025) of its FDII (as defined in § 250(b)(1) and Treas. Reg. § 1.250(b)-1(b)). For purposes of FDII, QBAI is used to determine the deemed tangible income return of a corporation, which in turn reduces the amount of FDII of a corporation. §§ 250(b)(1) and (2).

4. Section 250(b)(2)(B) and Treas. Reg. § 1.250(b)-2 incorporate the definition of QBAI in § 951A(d)(3), with some modifications. Similar to the GILTI rule provided in Treas. Reg. § 1.951A-3(e)(2), Treas. Reg. § 1.250(b)-2(e)(2) provides that "[t]he adjusted basis in specified tangible property is determined without regard to any provision of law enacted

after December 22, 2017, unless such later enacted law specifically and directly amends the definition of QBAI under section 250 or section 951A." The FDII provisions in § 250 apply to taxable years beginning after December 31, 2017. § 14202(a) of the TCJA.

5. ADS ("Alternative Depreciation System") depreciation under § 168(g) is determined by using the straight-line method (without regard to salvage value), the applicable convention determined under § 168(d), and the applicable recovery period as determined under § 168(g)(2)(C).[6] On December 22, 2017, the date the TCJA was enacted, § 168(g)(2)(C)(iv) provided that the recovery period for purposes of ADS depreciation for nonresidential real property under § 168(e)(2)(B) was 40 years. Nonresidential real property is defined under § 168(e)(2)(B) as § 1250 property (that is, real property not described in § 1245) that is not residential rental property or property with a class life of less than 27.5 years.

6. Section 168(g)(2)(C)(i) provided that the recovery period for property not described in § 168(g)(2)(C)(ii) or (III)[7] is the property's class life. Class life is generally determined under § 168 or Rev. Proc. 87-56; 1987-42 I.R.B. 4; however, § 168(g)(3) specifies class lives for certain types of property for ADS purposes.

7. TCJA. Effective for property placed in service after December 31, 2017, § 13204 of the TCJA amended § 168(e) by removing references to qualified leasehold improvement property, qualified restaurant improvement property, and qualified retail improvement property, and instead referring only to QIP. Under § 168(e)(6), QIP includes certain improvements made by a taxpayer[8] to the interior of a nonresidential building that are placed in service after the building was first placed in service. The conference report under the TCJA states that Congress intended QIP to be classified as 15-year property under the general depreciation system and be assigned a 20-year ADS recovery period. *See* Conference Report to Accompany H.R. 1 at 366-367.

8. The Coronavirus Aid, Relief, and Economic Security Act, P.L. 116-136 (the "CARES Act") was enacted on March 27, 2020. According to the Description of the Tax Provisions of Public Law 116-136, the CARES Act, prepared by the Staff of the Joint Committee on Taxation, when

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[6] Although the applicable convention for nonresidential real property under § 168(d)(2)(A) is the mid-month convention, Treas. Reg. § 1.951A-3(e)(1) provides that for the purpose of determining QBAI, the period in the CFC inclusion year to which such depreciation relates is determined without regard to the applicable convention under § 168(d).

[7] Sections 168(g)(2)(C)(ii) and (iii) refer to personal property with no class life and residential rental property, respectively.

[8] The phrase "made by a taxpayer" was added by § 2307(a)(2) of P.L. 116-136, discussed below.

Congress added the definition of QIP in § 168(e)(6) of the Code, it intended for QIP to be classified as 15-year property under § 168(e)(3)(E) of the Code, with a 15-year recovery period under the general depreciation system in § 168(a) of the Code and a 20-year ADS recovery period but inadvertently omitted from the statute such language. *See* Joint Committee on Taxation, Description of the Tax Provisions of Public Law 116-136, CARES Act (JCX-12R-20) at 69-70 (Apr. 23, 2020) ("JCT CARES Act Report").

9. Section 2307(a)(2) of the CARES Act amended § 168(e) by adding clause (vii) to paragraph (E)(3) providing that QIP is classified as 15-year property, and amending the taxable in § 168(g)(3)(B) to provide a recovery period of 20 years for QIP for purposes of the ADS (the "technical amendment"). The technical amendment is effective as if it had been included in the TCJA.[9]

10. Notice 2020-69. Notice 2020-69, 2020-30 I.R.B. 604, announced that Treasury and the IRS intended to issue regulations addressing the treatment of QIP under the ADS depreciation provision in § 168(g) for purposes of calculating QBAI under the FDII and GILTI provisions. The notice provided that Treasury and the IRS expected the regulations under §§ 250 and 951A to clarify that the technical amendment to § 168 enacted in § 2307(a) of the CARES Act applies to determine the adjusted basis of property under § 951A(d)(3) as if it had originally been part of § 13204 of the TCJA.

11. The Final Regulations. The final regulations contain the rules announced in Notice 2020-69. Final Treas. Reg. §§ 1.250(b)-2(e)(2) and 1.951A-3(e)(2) clarify that the technical amendment to § 168 enacted in § 2307(a) of the CARES Act applies to determine the adjusted basis of property under § 951A(d)(3) as if it had originally been part of § 13204 of the TCJA. Treasury and the IRS believe that this clarification is consistent with congressional intent. JCT CARES Act Report at 69-70.

12. Consistent with § 2307(b) of the CARES Act, the regulations apply retroactively. The modification to Treas. Reg. § 1.951A-3(e)(2) applies to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. The modification to Prop. Treas. Reg. § 1.250(b)-2(e)(2) applies to taxable years beginning after December 31, 2017.

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[9] Rev. Proc. 2020-25, 2020-19 I.R.B. 785, generally allows a taxpayer to change its depreciation method under § 168 for QIP placed in service by the taxpayer after December 31, 2017, by amended the applicable tax returns or requesting an accounting method change. The determination of a taxpayer's adjusted basis for purposes of determining QBAI is not addressed in the revenue procedure and is not treated as a method of accounting. T.D. 9866, 84 FR 29288, 29304 (2019).

B. CFC Accounting Method Change.

1. The IRS published Rev. Proc. 2021-26 to permit certain foreign corporations to utilize the automatic consent procedures to change their methods of accounting for depreciation to the alternative depreciation system under § 168(g) ("ADS"). The revenue procedure also updated and revised Rev. Proc. 2015-13, 2015-5 I.R.B. 419, to provide additional terms and conditions applicable regarding § 481(a) adjustments arising from accounting method changes by certain foreign corporations. Lastly, the revenue procedure also modified Rev. Proc. 2015-13 to change an existing rule that limits audit protection regarding certain foreign corporations.

2. Section 951A(d)(3) provides that the adjusted basis of any property for purposes of calculating qualified business asset investment ("QBAI") is determined by using ADS. ADS generally applies for purposes of determining QBAI irrespective of when the property was placed in service or whether the basis of the property is determined using another method for computing depreciation for other purposes of the Code.

3. Pursuant to prior revenue procedures addressing the automatic consent rules for accounting method changes, a CFC on a permissible non-ADS method of accounting is ineligible for an automatic change to use ADS. Treasury and the IRS announced their intention to expand the availability of automatic consent for depreciation changes in Treasury Decision 9866 (June 21, 2019).

4. Accordingly, the new revenue procedure provides procedures, for a limited period, for a CFC on an impermissible non-ADS method as well as a CFC on a permissible non-ADS method to obtain the automatic consent of the IRS to change its method of accounting for depreciation of property described in § 168(g)(1)(A) to ADS in determining the CFC's gross and taxable income under Treas. Reg. § 1.952-2 as well as its E&P under §§ 964 and 986(b).

5. When there is a change in a CFC's method of accounting, to prevent amounts from being duplicated or omitted, the difference between the CFC's income and E&P pursuant to the old and the new methods must generally be taken into account as a § 481 adjustment. Section 7.07 of Rev. Proc. 2015-13, which predates the enactment of § 951A, sets forth the applicable terms and conditions for a change in method of accounting for a CFC. It generally requires a § 481 adjustment (or a component thereof) to take, or be allocated to the class of gross income that has, the same source, separate limitation classification, character, and treatment for Subpart F purposes as the CFC's income to which the adjustment or component relates had or would have had in the prior year or years.

6. In Treasury Decision 9866, Treasury and the IRS also stated their intention to update the terms and conditions in § 7.07 of Rev. Proc. 2015-13 to take § 951A into account. The new revenue procedure implements this intention regarding § 951A.

7. Section 8.01 of Rev. Proc. 2015-13 provides that, with certain exceptions, a taxpayer generally will receive audit protection regarding an item that is subject to an accounting method change. For an accounting method change made for a CFC or a 10/50 corporation, however, those rules deny audit protection for a taxable year before the requested year of change in which one or more of the CFC's domestic corporate shareholders computes an amount of foreign taxes deemed paid under §§ 902 and 960 regarding the CFC that exceeds 150% of the average amount of foreign taxes deemed paid by the shareholder regarding the CFC in the shareholder's three prior taxable years.

8. The purpose of the 150% threshold is to deny audit protection for an improper method of accounting that may improperly inflate the amount of foreign taxes deemed paid regarding an income inclusion from that corporation. The new revenue procedure modifies that rule so that the 150% threshold is computed with respect to the amount of the foreign corporation's foreign taxes deemed paid, regardless of the extent to which a foreign tax credit is allowed.

9. The AICPA submitted comments on Rev. Proc. 2021-26 recommending that foreign corporations be permitted to report a net § 481(a) adjustment for entire groups of property for which the depreciation expense from the assets have the same source, separate limitation character, or treatment for purposes of Subpart F or tested income.

III. HIGH TAX EXCEPTION.

INTRODUCTION

A. Regulations adopting the GILTI High-Tax exception were finalized. They retain the basic approach and structure of the proposed elective GILTI high-tax exclusion regulations under § 951A(c)(2)(A)(i)(III), with important revisions.

B. A separate notice of proposed rulemaking was published that proposes to generally conform the rules implementing the Subpart F high-tax exception to the rules implementing the GILTI high-tax exclusion, and provides for a single election under § 954(b)(4) for purposes of both Subpart F income and tested income. This regulation, when finalized, will be a big change.

C. We also note that the real, unstated issue under these regulations for most taxpayers likely will involve foreign tax credits.

FINAL GILTI REGULATIONS

A. Summary. The final regulations provide rules to determine the effective rate of tax on foreign items of income for the purposes of applying the GILTI high-tax exclusion. Unfortunately, the final regulations retain the high tax threshold of 90% of the top corporate rate which is 18.9%. The effective foreign tax rate is determined on a tested unit basis. They also provide rules to determine the net amount of income and the foreign taxes paid or accrued to compute the effective rate of tax. In addition, they indicate how to make the GILTI high-tax exclusion election. The election, if made, must be made for the entire "CFC Group." The final regulations also provide that taxpayers can make the election annually.

B. Calculation of Effective Foreign Tax Rate.

1. QBU-by-QBU Determination.

(a) The 2019 proposed regulations applied based on the effective foreign tax rate imposed on the aggregate of all items of tentative net tested income of a CFC attributable to a single qualified business unit (as defined in § 989(a)) ("QBU") of the CFC that would be in a single tested income group. They applied on a QBU-by-QBU basis to minimize the "blending" of income subject to different foreign tax rates and, as a result, were intended to more accurately identify income subject to a high rate of foreign tax.

(b) Treasury and the IRS received several comments regarding the determination of the effective foreign tax rate on a QBU-by-QBU basis. Some comments requested that the effective foreign tax rate test apply on a CFC-by-CFC basis and asserted that this approach would better align the GILTI high-tax exclusion with the Subpart F high-tax exception.

(c) The final regulations replace the QBU-by-QBU approach with a "tested unit" approach.

2. CFC-level Determination of Foreign Taxes.

(a) One comment requested that the effective foreign tax rate test be based on the shareholder's deemed paid credit for taxes properly attributable to tested income, as defined in § 960(d), over the shareholder's net CFC tested income, as defined in § 951A(c).

(b) Treasury and the IRS believe that this approach would be inconsistent with § 954(b)(4). Unlike a GILTI inclusion, which is based on the aggregate amounts of a U.S. shareholder's pro rata shares of items from all the CFCs, § 954(b)(4) applies by its terms to items of income of a single CFC. The preamble states that nothing in § 954(b)(4), or § 951A(c)(2)(A)(i)(III), suggests that the

aggregate approach of the GILTI regime should or could apply for purposes of determining whether an item of income received by a CFC is subject to a sufficiently high level of foreign tax under § 954(b)(4). Thus, the final regulations do not adopt this comment.

3. Effective Foreign Tax Rate.

(a) Threshold Rate of Tax.

i. The 2019 proposed regulations applied the GILTI high-tax exclusion by comparing the effective foreign tax rate with 90% of the rate that would apply if the income were subject to the maximum rate of tax specified in § 11 (currently 18.9%, based on a maximum rate of 21%).

ii. Several comments requested that the GILTI high-tax exclusion instead be applied if the effective foreign tax rate is at least 13.125%. The final regulations did not adopt these comments.

(b) Safe Harbors.

i. One comment said that the "mechanical snapshot" rule for determining the effective foreign tax rate can produce results that are unreasonable given timing differences between the U.S. and foreign tax bases. To address these timing differences, the comment suggested that the final regulations include two new methods, for calculating the effective foreign tax rate, each of which could be safe harbors applied at the discretion of the taxpayer.

ii. The final regulations did not adopt these safe harbors. Treasury and the IRS believe that the tested unit combination rule should ameliorate some of the expressed concerns.

4. Base and Timing Differences.

(a) In General. The 2019 proposed regulations generally provided that the effective rate at which taxes are imposed for a taxable year is the U.S. dollar amount of foreign income taxes paid or accrued regarding a tentative net tested income item, over the sum of the U.S. dollar amount of the tentative net tested income item and the amount of foreign income taxes paid or accrued regarding the tentative net tested income item. A tentative net tested income item was generally determined by taking into account items of gross income (determined under federal income tax principles) attributable to a QBU, less deductions (also determined under

federal income tax principles) allocated and apportioned to such gross income. Thus, the effective foreign tax rate was based on the amount of foreign income taxes paid or accrued on income attributable to the QBU as determined for federal income tax purposes, without regard to how the income is determined for foreign income tax purposes

(b) Disregarded Payments.

i. The proposed regulations generally provided that gross income was attributable to a QBU if it was properly reflected on the books and records of the QBU, determined under federal income tax principles, except that the income was adjusted to account for some disregarded payments.

ii. One comment suggested that a disregarded payment should not result in the reallocation of income between QBUs for purposes of computing the GILTI high-tax exclusion. Treasury and the IRS believe the comment's concern to be the potential inability to claim the GILTI high-tax exclusion in scenarios where a disregarded payment was made from a high-taxed CFC to a disregarded entity that paid no tax.

iii. They believe that, if a tested unit makes a disregarded payment to another tested unit, gross income should be reallocated among the tested units to appropriately associate the income with the tested unit in which it is subject to tax. This reallocation would promote conformity between the income attributed to a tested unit and the income of that tested unit that is subject to tax in the foreign country, and, therefore, this rule will result in a more accurate grouping of items of income that are generally subject to the same or similar rates of foreign tax. In addition, treating disregarded payments in this manner is consistent with the treatment of regarded payments. For these reasons, the comment was not adopted.

iv. The final regulations, however, provide additional rules addressing disregarded payments, including providing additional detail on how the principles of Treas. Reg. § 1.904-4(f)(2)(vi) should be applied. For example, the final regulations provide that a disregarded payment of interest is allocated and apportioned ratably to all of the gross income attributable to the tested unit that is making the disregarded payment. The final regulations also

provide special ordering rules for reallocations regarding multiple disregarded payments.

(c) Foreign NOLs and Other Timing Differences.

i. Some comments requested that the final regulations allow taxpayers to elect to adjust either the numerator or denominator of the effective foreign tax rate fraction to take into account foreign net operating loss ("NOL") carryforwards and other similar items.

ii. Treasury and the IRS believe that adjusting the numerator or denominator of the effective foreign tax rate fraction for foreign NOL carryforwards or other timing differences would result in considerable complexity and would impose a significant burden on both taxpayers and the government. It would require the application of foreign tax accounting rules, and complex coordination rules to reconcile their application with U.S. tax accounting rules, both in the current taxable year and other taxable years, to prevent an item of income, gain, deduction, loss, or credit from being duplicated or omitted. Accordingly, this comment was not adopted.

C. Adoption of Tested Unit Standard.

1. In General.

(a) In lieu of the QBU standard in the 2019 proposed regulations, the final regulations apply the GILTI high-tax exclusion based on the gross tested income of a CFC that is attributable to a "tested unit." Unlike the QBU standard that served as a proxy for being subject to foreign tax, the tested unit approach generally applies to the extent an entity, or the activities of an entity, are actually subject to tax, as either a tax resident or a permanent establishment (or similar taxable presence), under the tax law of a foreign country.

(b) This obviously is an important change, and can give rise to definitional issues.

(c) The final regulations provide three categories of a tested unit. First, and consistent with the 2019 proposed regulations, a tested unit includes a CFC. Thus, if a CFC, which itself is a tested unit, has no other tested units, the GILTI high-tax exclusion is applied for all the tentative gross tested income items (determined under Treas. Reg. § 1.951A-2(c)(7)(ii)) of the CFC.

(d) Second, and also consistent with the 2019 proposed regulations, a tested unit generally includes an interest in a pass-through entity held, directly or indirectly, by a CFC. For this purpose, a pass-through entity is defined to include, for example, a partnership or a disregarded entity.

(e) More specifically, a CFC's interest in a pass-through entity is a tested unit if the pass-through entity meets one of two tests. First, the CFC's interest in the pass-through entity is a tested unit if the pass-through entity is a tax resident of a foreign country because, in these cases, income earned by the CFC indirectly through the pass-through entity may be subject to tax at a rate different from the rate at which income earned by the CFC directly is subject to tax. Second, the CFC's interest in the pass-through entity is a tested unit if the pass-through entity is not subject to tax as a resident, but is treated as a corporation (or as another entity that is not fiscally transparent) for purposes of the CFC's country's tax law, because in these cases income earned by the CFC indirectly through the pass-through entity may not be subject to tax in the foreign country of which the CFC is a tax resident; thus, for example, an interest in a domestic limited liability company that is a partnership for federal income tax purposes would typically be a tested unit. A CFC's interest in a pass-through entity (or the activities of a branch) that is not a tested unit is a "transparent interest."

(f) Treasury and the IRS believe this treatment of interests in pass-through entities in the final regulations is consistent with a comment suggesting that a pass-through entity should be treated as a tested unit if the entity is treated as a separate entity for purposes of a foreign tax law, but not if the entity is fiscally transparent (and thus not a tax resident) for purposes of the tax law of a foreign country.

(g) An interest in an entity, rather than the entity itself, is treated as a tested unit (or a transparent interest) because the entity may have multiple owners and the characterization of the interest as a tested unit may depend on each holder's tax treatment regarding the interest. As a result, less than the entire entity may be characterized as a tested unit or a transparent interest. In addition, different interests in an entity held directly or indirectly by the same CFC may be characterized differently. The final regulations include an example that illustrates the application of this rule. Treas. Reg. § 1.951A-2(c)(8)(iii)(D) (Example 4).

(h) Finally, a tested unit includes a branch, or a portion of a branch, the activities of which are carried on directly or indirectly by a

CFC, provided that either (i) the branch gives rise to a taxable presence in the country in which the branch is located, or (ii) the branch gives rise to a taxable presence under the owner's tax law, and the owner's tax law provides an exclusion, exemption, or other similar relief (such as a preferential rate) for income attributable to the branch.

(i) In these cases, the income indirectly earned by the owner through the branch is likely subject to tax at a rate different than the rate at which income directly earned by the owner is subject to tax. Treasury and the IRS believe that this branch tested unit rule addresses blending concerns related to an owner's taxable presence in another country in a more targeted manner than the "activities" QBU standard from the 2019 proposed regulations. They also believe that the branch tested unit rule will likely reduce compliance burdens, as compared to the QBU standard, because the tested unit rule depends on how activities are treated under foreign tax law, an analysis of which in most cases would be conducted independently of the final regulations (for example, to determine whether a tax return must be filed because activities in that country give rise to a taxable presence).

(j) For purposes of the tested unit rules, references to the tax law of a foreign country include statutes, regulations, administrative or judicial rulings, and treaties of the country.

(k) The final regulations make clear that tested units are determined independently of one another. For example, even though a CFC is itself a tested unit, the CFC may have other tested units, such as a permanent establishment or an interest in a disregarded entity that, subject to the application of the combination rule, must be treated separately for purposes of the GILTI high-tax exclusion.

(l) The final regulations also provide a rule that addresses cases where the same item is attributable to more than one tested unit in a tier of tested units. This may occur, for example, if an item is properly reflected both on the separate set of books and records of one tested unit, and on the separate set of books and records of a lower-tier tested that is owned (directly or indirectly) by the first tested unit, because the books and records of the two tested units were prepared under different accounting standards. In such a case, the final regulations provide that the item is considered to be attributable only to the lowest-tier tested unit.

2. Combined Tested Units.

(a) The 2019 proposed regulations applied separately to each QBU of a CFC.

(b) Several comments recommended combining "same-country" QBUs, on an elective basis, noting it would reduce complexity and compliance burdens. Another comment recommended allowing taxpayers to take into account a fiscal unity or similar grouping in determining the effective foreign tax rate.

(c) Treasury and the IRS generally agree that a combination rule would reduce compliance burdens and would be consistent with the policies underlying the GILTI high-tax exclusion. A combination rule also could minimize the effect of timing and other differences between the U.S. and foreign tax bases. Accordingly, the final regulations provide that tested units of a CFC (including the CFC tested unit), other than certain nontaxed branch tested units, will be treated as a single tested unit if the tested units are tax residents of, or located in, the same foreign country.

(d) A nontaxed branch tested unit is a branch tested unit that does not give rise to a taxable presence under the tax law of the foreign country where the branch is located, but gives rise to a taxable presence under the tax law of the foreign country where the home office of the branch is a tax resident and such tax law provides an exclusion, exemption, or similar relief for purposes of taxing income attributable to the branch. The tested unit combination rule does not apply to a nontaxed branch tested unit because such a unit typically would not be subject to tax (or to any meaningful level of tax) in any foreign country. Thus, combining it with other tested units (the income of which may be subject to a meaningful level of tax) could give rise to inappropriate blending.

(e) The combination rule applies without regard to whether the tested units are subject to the same foreign tax rate because it would be inconsistent with the purpose of the combination rule to require taxpayers to determine the effective foreign tax rate imposed on the tested units separately, and simply comparing the statutory foreign tax rates may not be meaningful.

(f) The combination rule also is not conditioned on the tested units having the same functional currency because the effective foreign tax rate is calculated in U.S. dollars and any differences in functional currency are unlikely to have a material effect on whether income qualifies for the GILTI high-tax exclusion.

Finally, the combination rule is mandatory, not elective, because providing an election would give rise to additional complexity, and related administrative and compliance burdens.

3. Books and Records.

(a) In General.

i. Under the 2019 proposed regulations, gross income was attributable to a QBU if it was properly reflected on the books and records of the QBU. For this purpose, gross income was determined under federal income tax principles with certain adjustments to reflect disregarded payments.

ii. The final regulations adopt a tested unit standard, rather than a QBU standard, for purposes of determining a tentative gross tested income item. Nevertheless, the final regulations retained the general approach of relying on a separate set of books and records (as modified to apply to tested units, rather than QBUs) as the starting point for determining gross income attributable to a tested unit.

iii. Treasury and the IRS believe that applying a books-and-records approach for tested units is appropriate because it serves as a reasonable proxy for determining the amount of gross income that the tested unit's foreign country is likely to subject to tax. They also believe that relying on a separate set of books and records is consistent with the approach taken under other provisions and, therefore, that doing so should promote administrability for both taxpayers and the Service.

iv. The final regulations provide that items of gross income of a CFC are attributable to a tested unit of the CFC to the extent they are properly reflected on the separate set of books and records of the tested unit, or of the entity an interest in which is a tested unit (for example, in the case of certain partnerships). The provision starts with the items of gross income of the CFC for federal income tax purposes and then attributes those items to the CFC's tested units to the extent the items are properly reflected on the separate set of books and records of the tested units (with certain adjustments, such as to account for disregarded payments).

v. For example, if a CFC owns a partnership interest that is a tested unit, the items of gross income that the CFC derives through the partnership interest are attributed to the CFC's

interest in the partnership to the extent that the items are properly reflected on the separate set of books and records of the partnership. Thus, this approach first gives effect to the rules that determine the items of gross income of the CFC, such as the rules under § 704 for purposes of determining a CFC partner's distributive share of items of a partnership, and then attributes those items to the tested units of the CFC depending on whether the items are properly reflected on the separate set of books and records.

(b) Separate Set of Books and Records.

i. Treasury and the IRS believe that a tested unit, or an entity an interest in which is a tested unit, generally will maintain a separate set of books and records that would be readily available for purposes of the final regulations. This is expected to be the case for a branch tested unit under Treas. Reg. § 1.951A-2(c)(7)(iv)(A)(3) (involving a taxable presence), for example, because a separate set of books and records would ordinarily be required to compute the foreign tax liability arising in the taxing country (or for not taking into account items attributable to the taxable presence if determined only under the owner's tax law). Accordingly, the final regulations retain the general approach taken in the 2019 proposed regulations by defining a "separate set of books and records" by reference to Treas. Reg. § 1.989(a)-1(d).

ii. The 2020 proposed regulations (discussed below), however, would replace the reference to "books and records" with a more specific standard based on items properly reflected on an "applicable financial statement."

4. Booking Rule for Transparent Interests.

(a) The final regulations provide a special booking rule that applies to a transparent interest. This rule, generally treats items properly reflected on the separate set of books and records of an entity an interest in which is a transparent interest as being properly reflected on the books and records of a tested unit that holds interests (directly or indirectly through other transparent interests) in the entity.

(b) The preamble states that this treatment is appropriate because income earned by the tested unit directly, as well as income earned by the tested unit indirectly through the transparent interest, is expected to be subject to residence-based tax in only the tested

unit's country of residence (or location) and, as a result, Treasury and the IRS believe it is unlikely that blending of income subject to different foreign tax rates would occur by reason of the tested unit's ownership of the transparent interest.

(c) Failure to Maintain Books and Records. The final regulations include a rule that applies if a separate set of books and records is not prepared for a tested unit or transparent interest. In such a case, items required to apply the GILTI high-tax exclusion that would be reflected on a separate set of books and records of the tested unit or transparent interest must be determined and treated as properly reflected on the separate set of books and records. This rule is intended to address cases where a separate set of books and records is not maintained, and to prevent the avoidance of the rules by choosing to not maintain a separate set of books and records.

(d) Items Not Taken into Account.

i. In some cases, items of gross income (determined under federal income tax principles) may not be properly reflected on a separate set of books and records because they are not taken into account for financial accounting purposes. This may occur when items are taken into account for federal income tax purposes and financial accounting purposes in different taxable years, or when items are taken into account for federal income tax purposes but are not taken into account for financial accounting purposes (for example, due to the mark-to-market method of accounting).

ii. To ensure that these items of gross income are attributable to a tested unit in a CFC inclusion year, the final regulations clarify that the items are treated as properly reflected on a separate set of books and records if they would be so reflected if they were taken into account for financial accounting purposes. No inference is to be drawn from this clarification regarding other similar rules that attribute items based on books and records, including under Treas. Reg. § 1.904-4(f), Treas. Reg. § 1.987-2(b), or Treas. Reg. § 1.1503(d)-5(c).

5. De Minimis Rules.

(a) A comment recommended that the final regulations adopt two de minimis rules to simplify the application of the QBU-by-QBU approach. First, the comment suggested that taxpayers should be permitted to elect to treat all CFCs with income below a specified

threshold as a single QBU. Treasury and the IRS believe that aggregating CFCs for this purpose would be inconsistent with § 954(b)(4), which applies regarding items of income of a single CFC. Accordingly, this recommendation was not adopted.

(b) Second, the comment suggested that taxpayers should be permitted to elect to aggregate QBUs within the same CFC that have a small amount of tested income (measured either in absolute terms or based on a percentage of the CFC's income). Treasury and the IRS believe it is uncertain whether aggregating QBUs with small amounts of tested income will result in a significant amount of simplification because, for example, gross income would still have to be attributed to each QBU (taking into account disregarded payments) to determine whether the de minimis rule applies. The final regulations did not adopt the recommendation, but a de minimis rule is included in the 2020 proposed regulations to allow an opportunity for additional notice and comment.

D. Rules Regarding the Election.

1. Consistency Requirement.

(a) The 2019 proposed regulations provided that if a CFC is a member of a controlling domestic shareholder group ("CFC group"), a GILTI high-tax exclusion election (or revocation) was either made regarding each member of the CFC group or was not made for any member of the CFC group. The final regulations adopted the shorter and more descriptive term "CFC group," instead of the term "controlling domestic shareholder group."

(b) Several comments requested that the final regulations eliminate the consistency requirement so the GILTI high-tax exclusion election can be made on a CFC-by-CFC basis, which would conform the exclusion to the Subpart F high-tax exception.

(c) Treasury and the IRS believe that the consistency requirement is necessary due to the collateral effect that the GILTI high-tax exclusion has on the allocation and apportionment of deductions. Specifically, allowing CFC-by-CFC or tested unit-by-tested unit elections would encourage the selective use of the GILTI high-tax exclusion to inappropriately manipulate the § 904 foreign tax credit limitation. In this regard, deductions allocated and apportioned to income excluded under § 954(b)(4) will be subject to § 904(b)(4), and thereby disregarded for purposes of determining a taxpayer's foreign tax credit limitation under § 904.

(d) Without a consistency requirement, taxpayers would be able to include high-taxed income in GILTI to claim foreign tax credits up to the amount of their § 904 limitation, while electing to exclude the remainder of such income under the GILTI high-tax exclusion. Consequently, the taxpayer's § 904 limitation would not take into account all the deductions attributable to investments generating high-taxed income, resulting in a distortive application of the foreign tax credit limitation under § 904.

(e) A consistency requirement prevents this result by ensuring that a taxpayer that seeks to cross-credit the foreign tax imposed on high-taxed tentative tested income against low-taxed tentative tested income must take all of its high-taxed tentative tested income into account along with all of the deductions allocated and apportioned to that category of income. This concern does not arise regarding other types of income that are excluded from tested income (for example, foreign oil and gas extraction income) because these items are always excluded (that is, there is no electivity as to whether they are included in tested income), and the foreign taxes attributable to that income can never be claimed as a credit against the U.S. tax imposed on § 951A inclusions.

(f) Treasury and the IRS agree that the GILTI high-tax exclusion election and the Subpart F high-tax exception election should apply consistently and, have determined that the Subpart F high-tax exception should be conformed to the GILTI high-tax exclusion, as discussed in the preamble to the 2020 proposed regulations discussed below. This is appropriate, in part, due to changes made by the TCJA.

(g) Before the TCJA, a consistency requirement would have had minimal effect because post-1986 earnings and profits (including income excluded from Subpart F income under § 954(b)(4)) could be distributed and would be included in income of the U.S. shareholder, and foreign taxes would be deemed paid under § 902, subject to the limitations imposed by § 904, which is a result consistent with a Subpart F inclusion.

(h) Further, before the TCJA, an amount excluded under § 954(b)(4) largely resulted only in the deferral of income and deemed paid foreign taxes, rather than an exclusion of those items from the U.S. tax base, and deductions allocated and apportioned to this income would limit a taxpayer's ability to claim foreign tax credits in the future. After the TCJA, an election under § 954(b)(4) will result in a permanent change in the treatment of high-taxed income and the associated foreign taxes and deductions, increasing the significance, from a policy perspective, of inconsistent treatment.

(i) Thus, Treasury and the IRS believe that the policy underlying § 954(b)(4) is best furthered through a single election to exclude all high-taxed income from GILTI (and, subject to finalization of the 2020 proposed regulations, Subpart F income) because that income does not pose a base erosion concern and is therefore not the type of income that Congress intended to include in tested income. However, because the application of § 954(b)(4), and the additional administrative burden associated with identifying high-taxed items of income, has always been elective, Treasury and the IRS believe that the exclusion of this income (and to the extent possible any additional burden associated with identifying this income) should continue to be limited to cases where a taxpayer elects the application of § 954(b)(4).

(j) They also believe that it would be inappropriate to allow a taxpayer to selectively exclude and include income, once it makes an election under § 954(b)(4). Section 951A generally does not permit electivity in the determination of tested income. For example, a taxpayer cannot choose to include in tested income amounts that would be Subpart F income but for the application of § 954(b)(4) (regardless of whether the election is made), nor may a taxpayer choose to include foreign oil and gas extraction income in tested income. Further, contrary to some comments, Treasury and the IRS anticipate that the additional electivity is more likely to increase, rather than reduce, compliance burden as a result of the need for more numerous calculations. As a result, they concluded that the consistency rule should be retained.

2. Definition of CFC Group.

(a) The 2019 proposed regulations defined a CFC group based on two tests. Under the first test, a CFC group meant two or more CFCs if more than 50% of the total combined voting power of the stock of each CFC was owned (within the meaning of § 958(a)) by the same controlling domestic shareholder (as defined in Treas. Reg. § 1.964-1(c)(5)).

(b) The second test applied only if no single controlling domestic shareholder satisfied the first test. Under the second test, the 2019 proposed regulations provided that a CFC group meant two or more CFCs if more than 50% of the total combined voting power of the stock of each CFC was owned (within the meaning of § 958(a)) by the same controlling domestic shareholders and each such shareholder owned (within the meaning of § 958(a)) the same percentage of stock in each CFC. For purposes of both tests, a controlling domestic corporate shareholder included a related

person (within the meaning of § 267(b) or 707(b)(1)) (the "related party rule").

(c) In response to comments, the final regulations revise the definition of a CFC group. Under the final regulations, a CFC group is an affiliated group, as defined in § 1504(a), with certain modifications that broaden the definition. First, the affiliated group rules in § 1504(a) apply without regard to § 1504(b)(1) through (6) (which exclude certain corporations, such as foreign corporations, from the definition of an "includible corporation"). Second, for purposes of determining whether a CFC is a member of a CFC group, the final regulations incorporate a "more than 50%" threshold instead of the "at least 80%" threshold in § 1504(a). Stock ownership for this purpose is determined by applying the constructive ownership rules of § 318(a), with certain modifications. These constructive ownership rules would, for example, cause two corporations owned directly by the same U.S. individual to be part of a CFC group.

(d) The final regulations also provide that the determination of whether a CFC is included in a CFC group is made as of the close of the CFC inclusion year of the CFC that ends with or within the taxable years of the controlling domestic shareholders. This rule is intended to address certain changes in ownership of CFCs, such as acquisitions and dispositions. The final regulations further provide that a CFC may be a member of only one CFC group and include a special tie-breaker rule for situations in which a CFC would be a member of more than one CFC group.

(e) The final regulations also clarify that if a CFC is not a member of a CFC group, a high-tax election is made (or revoked) only regarding the CFC and the rules regarding the election apply by reference to the CFC. If, however, a CFC is a member of a CFC group, a high-tax election is made (or revoked) regarding all members of the CFC group and the rules regarding the election apply by reference to the CFC group.

3. Duration of Election.

(a) The 2019 proposed regulations generally provided that the GILTI high-tax exclusion election was effective for the CFC inclusion year for which it was made and all subsequent CFC inclusion years, unless the election was revoked. The 2019 proposed regulations further provided that, subject to a "change of control" exception, if an election was revoked, then the CFC could not make a new election for any CFC inclusion year that began within

60 months following the close of the CFC inclusion year for which the previous election was revoked ("60-month restriction").

(b) Several comments requested that the 60-month restriction be eliminated so that taxpayers would be permitted to make the GILTI high-tax exclusion election on an annual basis.

(c) Treasury and the IRS agreed with these comments and determined that, given that the final regulations adopt a tested unit-by-tested unit approach (in lieu of the QBU-by-QBU approach) and retain the consistency requirement set forth in the 2019 proposed regulations, the 60-month restriction is not necessary to prevent abuse. Accordingly, the final regulations do not include the 60-month restriction and, subject to the consistency requirement, taxpayers may elect the GILTI high-tax exclusion on an annual basis.

4. Non-Controlling U.S. Shareholders.

(a) One comment requested that the final regulations include a notice of election and revocation requirement that would require any U.S. shareholder that makes or revokes an election to notify the CFC of this action and require the CFC to notify its other U.S. shareholders of the action taken by the U.S. shareholder and its ownership percentage.

(b) Treasury and the IRS agree that U.S. shareholders that are not controlling domestic shareholders of a CFC should be informed by the controlling domestic shareholders of the CFC if they make (or revoke) a GILTI high-tax exclusion election regarding the CFC. Therefore, the final regulations provide that the controlling domestic shareholders must provide notice of elections (or revocations), as required by Treas. Reg. § 1.964-1(c)(3)(iii), to each U.S. shareholder that is not a controlling domestic shareholder.

5. Domestic Partnerships as Controlling Shareholders.

(a) The proposed regulations under § 958 provide, as a general rule, that for purposes of §§ 951 and 951A (and certain related provisions) a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of § 958(a). Under an exception to this general rule, a domestic partnership is treated as owning stock of a foreign corporation within the meaning of § 958(a) for purposes of determining whether any U.S. shareholder is a controlling domestic shareholder. Treasury and the IRS intend

to address comments received when finalizing the proposed regulations under §§ 951, 956, 958, and 1502.

(b) Under currently applicable Treas. Reg. § 1.951A-1(e)(2), a domestic partnership can be a controlling domestic shareholder—for example, for purposes of determining which party elects the GILTI high-tax exclusion under Treas. Reg. § 1.951A-7(c)(7)(viii)(A), including potentially for taxable years beginning after December 31, 2017, under Treas. Reg. § 1.951A-7(b).

6. Elections on Amended Returns.

(a) The 2019 proposed regulations allowed a taxpayer to make (or revoke) the GILTI high-tax exclusion election with an amended income tax return.

(b) One comment indicated that it was unclear how the binding effect of the election on all U.S. shareholders of a CFC operates when the controlling domestic shareholder makes (or revokes) the election on an amended return.

(c) Treasury and the IRS agreed with the comment that allowing the controlling domestic shareholders to make (or revoke) the GILTI high-tax exclusion election on an amended income tax return may change the amount of U.S. tax due regarding U.S. shareholders other than the controlling domestic shareholders. The election or revocation also could change the amount of U.S. tax due regarding all U.S. shareholders in intervening tax years. If the election were made (or revoked) on an amended return after some or all of these taxable years are no longer open for assessment under § 6501, it could result in the issuance of refunds for certain taxable years of shareholders when corresponding deficiencies could not be assessed or collected.

(d) As a result, the final regulations provide that the election may be made (or revoked) on an amended federal income tax return only if all U.S. shareholders of the CFC file amended federal income tax returns (unless an original return has not yet been filed, in which case the original federal income tax return may be filed consistently with the election (or revocation)) for the taxable year (and for any other taxable year in which their U.S. tax liabilities would be increased by reason of that election (or revocation)) within 24 months of the unextended due date of the original federal income tax return of the controlling domestic shareholder's inclusion year with or within which the CFC inclusion year, for which the election is made (or revoked), ends.

(e) For administrative purposes, the final regulations also provide that amended federal income tax returns for all U.S. shareholders of the CFC for the CFC inclusion year must be filed within a single 6-month period (within the 24-month period). The requirement that all amended federal income tax returns be filed within a 6-month period is to allow the IRS to timely evaluate refund claims or make additional assessments.

(f) The final regulations also clarify how these rules operate in the case of a U.S. shareholder that is a domestic partnership. For example, the final regulations provide that in the case of a U.S. shareholder that is a partnership, the election may be made (or revoked) with an amended Form 1065 or an administrative adjustment request (as described in § 301.6227-1), as applicable. The final regulations further provide that if a partnership files an administrative adjustment request, a partner that is a U.S. shareholder in the CFC is treated as having complied with these requirements (regarding the portion of the interest held through the partnership) if the partner and the partnership timely comply with their obligations under § 6227 regarding that administrative adjustment request.

E. Foreign Tax Credit Rules.

1. CFC Stock Deductions.

(a) One comment requested that the final regulations confirm that U.S. shareholder deductions properly allocated and apportioned to income excluded under the GILTI high-tax exclusion should not be taken into account for purposes of § 904 per the application of § 904(b)(4)(B). Treasury and the IRS believe that the regulations are clear regarding the interaction of U.S. shareholder deductions allocated and apportioned to income excluded under the GILTI high-tax exclusion and § 904(b)(4), and that further rules were not necessary.

(b) Another comment suggested that the final regulations turn off the application of § 904(b)(4) for deductions allocated and apportioned to income or stock that relates to earnings and profits arising from CFC income that is excluded by reason of the GILTI high-tax exclusion. The comment was not adopted.

2. Determination of Taxes Paid or Accrued.

(a) A comment asserted that the 2019 proposed regulations are unclear as to the determination of the foreign taxes paid or accrued and requested that the final regulations clarify that foreign income

taxes include taxes imposed by a country (or countries) on the net item, as provided under current Treas. Reg. § 1.954-1(d)(3)(i).

(b) The rules provided in Treas. Reg. § 1.951A-2(c)(7)(iii) and (vii) are comparable to those provided in current Treas. Reg. § 1.954-1(d)(3)(i); both sets of rules generally apply Treas. Reg. § 1.904-6 to allocate and apportion foreign taxes to income. Although the GILTI high-tax exclusion requires that foreign taxes be associated with income on a narrower basis -- the tested unit rather than the CFC -- taxes imposed on the CFC that relate to income of the tested unit will generally be associated with the appropriate income under the rules in Treas. Reg. § 1.904-6, regardless of whether such tax is imposed by one or more countries. The 2020 proposed regulations proposed further conformity of the rules applicable for the computation of the effective foreign tax rate for both Subpart F income and tested income.

(c) Further, in response to this comment, as well as similar comments received in response to the 2019 proposed regulations, the 2019 Final FTC Regulations (T.D. 9882) and these final regulations clarify the rules for associating foreign taxes with income. In particular, these final regulations clarify that the amount of foreign income taxes paid or accrued by a CFC regarding a tentative tested income item is the U.S. dollar amount of the controlled foreign corporation's current year taxes that are allocated and apportioned to the related tentative gross tested income.

(d) The final regulations also provide that the deductions for current year taxes are allocated and apportioned to a tentative gross tested income item under the principles of Treas. Reg. § 1.960-1(d)(3), by treating each tentative gross tested income item as assigned to a separate tested income group. As a result, the principles of Treas. Reg. § 1.904-6(a)(1) generally apply to allocate and apportion foreign income taxes to a tentative gross tested income item. However, the principles of Treas. Reg. § 1.904-6(a)(2) are applied, in lieu of the principles of Treas. Reg. § 1.904-6(a)(1), to associate foreign taxes with income in the case of disregarded payments between tested units.

(e) The final regulations provide additional rules for applying the principles of Treas. Reg. § 1.904-6(a)(2) for purposes of the high-tax exception. A new example also illustrates how foreign income taxes are associated with income in the case of disregarded payments. Treas. Reg. § 1.951A-2(c)(8)(iii)(B) (Example 2).

(f) Treasury and the IRS also published proposed regulations (REG-105495-19) relating to foreign tax credits that contain more

detailed rules for associating foreign taxes with income, including in the case of disregarded payments.

3. <u>Accounting Periods and Foreign Tax Accruals</u>.

(a) The proposed regulations generally provided that the amount of foreign income taxes paid or accrued regarding a tentative net tested income item were the CFC's current year taxes (as defined in Treas. Reg. § 1.960-1(b)(4)) that would be allocated and apportioned under the principles of Treas. Reg. § 1.960-1(d)(3)(ii) to the tentative net tested income item by treating the item as in a separate tested income group. Taxes accrue, and are taken into account in determining foreign taxes deemed paid under § 960(d), when all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. Therefore, withholding taxes accrue when the payment from which the tax is withheld is made, and net basis taxes on income recognized during a taxable period accrue on the last day of the taxable period.

(b) Comments suggested that the final regulations provide special rules to address distortions that can arise from a mismatch between the U.S. and foreign taxable years.

(c) Treasury and the IRS believe that foreign taxes should be associated with U.S. income consistently for all federal income tax purposes, and that deviating from established principles for determining when income and foreign taxes are taken into account for purposes of the GILTI high-tax exclusion would be inappropriate. Allowing foreign taxes to be taken into account in applying the GILTI high-tax exclusion in a different year from the year in which the foreign taxes accrue could lead to double counting, or double-non-counting, of the foreign taxes.

(d) Similar considerations would apply regarding the adoption of alternative methods of accounting for tentative tested income items, such as the adoption of a foreign fiscal year as the testing period or mark-to-market accounting. The use of these methods would lead to potential double counting of items of income, gain, deduction, or loss in different U.S. taxable years for different purposes, or would require complex coordination rules with material changes to established rules relating to when such items accrue for federal income tax purposes. The preamble states that changes such as these are beyond the scope of the GILTI rulemaking and were not adopted.

F. Authority. The preamble states that Treasury and the IRS are aware that questions have arisen regarding the statutory authority for the GILTI high-tax exclusion. As described in detail in the preamble to the 2019 proposed regulations, Treasury and the IRS believe that the GILTI high-tax exclusion is a valid interpretation of ambiguous statutory text in § 951A(c)(2)(A)(i)(III) and thus, after considering assertions to the contrary, concluded that this rationale provides authority to finalize the GILTI high-tax exclusion.

G. Applicability Dates.

1. Consistent with the applicability date in the 2019 proposed regulations, the final regulations provide that the GILTI high-tax exclusion applies to taxable years of foreign corporations beginning on or after July 23, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

2. Several comments requested that taxpayers be permitted to apply the GILTI high-tax exclusion earlier than the proposed regulations would have allowed (for example, to taxable years beginning after December 31, 2017). The final regulations permit taxpayers to choose to apply the GILTI high-tax exclusion to taxable years of foreign corporations that begin after December 31, 2017, and before July 23, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end. Any taxpayer that applies the GILTI high-tax exclusion retroactively must consistently apply the rules in this Treasury decision to each taxable year in which the taxpayer applies the GILTI high-tax exclusion.

PROPOSED SUBPART F HIGH-TAX REGULATIONS

A. Summary.

1. The proposed regulations (REG-127732-19) provide for a single election under § 954(b)(4) for purposes of both Subpart F and GILTI, modeled on the final GILTI High Tax Election regulations. The proposed regulations include the requirement that an election is made regarding all CFCs that are members of a CFC group (instead of an election made on a CFC-by-CFC basis) and provide that the determination of whether income is high-taxed is made on a tested unit- by-tested unit basis.

2. They also simplify the determination of high-taxed income and often eliminate the fact intensive analysis by grouping certain income that would otherwise qualify as Subpart F income together with income that would otherwise qualify as tested income for the purpose of determining the effective foreign tax rate. In addition, they would modify the method for allocating and apportioning deductions to items of gross income for the purposes of the high-tax exception.

3. As stated above, this regulation, when finalized, will be a big change.

B. Conforming the Rules.

1. Commentators recommended that various aspects of the GILTI high-tax exclusion be conformed with the Subpart F high-tax exception to ensure that the goals of the GILTI high-tax exclusion are not undermined.

2. Treasury and the IRS agreed that the GILTI high-tax exclusion and the Subpart F high-tax exception should be conformed but have determined that the rules applicable to the GILTI high-tax exclusion are appropriate and better reflect the changes made as part of the TCJA than the existing Subpart F high-tax exception. Accordingly, the proposed regulations generally revise and conform the provisions of the Subpart F high-tax exception with the provisions of the GILTI high-tax exclusion in the final regulations. This is not the "conforming" that most taxpayers wanted.

3. Another comment on the 2019 proposed regulations suggested that § 954(b)(4) should apply consistently to all of a CFC's items of gross income. In response to this comment, the proposed regulations provide for a single election under § 954(b)(4) for purposes of both Subpart F income and tested income (the "high-tax exception").

C. Effective Tax Rate of Tested Units.

1. In General.

(a) Under Treas. Reg. § 1.954-1(d), effective tax rates and the applicability of the Subpart F high-tax exception are determined on the basis of net foreign base company income of a CFC. Net foreign base company income generally means income described in Treas. Reg. § 1.954-1(c)(1)(iii) reduced by deductions. In general, single items of income tested for eligibility are determined by aggregating items of income of a certain type. For example, the aggregate amount of a CFC's income from dividends, interests, rents, royalties, and annuities giving rise to non-passive foreign personal holding company income constitutes a single item of income.

(b) In contrast, under the final regulations, effective tax rates and the applicability of the GILTI high-tax exclusion are determined by aggregating gross income that would be gross tested income (but for the GILTI high-tax exclusion) within a separate category to the extent attributable to a tested unit of a CFC. For this purpose, the tentative tested income items and foreign taxes of multiple tested units of a CFC (including the CFC itself) that are tax residents of, or located in (in the case of certain branches), the same foreign country, generally are aggregated.

(c) Applying these rules on a tested unit basis will ensure that high-taxed and low-taxed items of income are not inappropriately aggregated for purposes of determining the effective rate of tax, while at the same time allowing for some level of aggregation to minimize complexity. The preamble states that measuring the effective rate of foreign tax on a tested unit basis is also appropriate in light of the reduction of corporate federal income tax rate.

(d) For the same reasons that the GILTI high-tax exclusion applies on a tested unit basis, Treasury and the IRS believe that the Subpart F high-tax exception should apply on a tested unit basis. They also believe that for purposes of determining the applicability of § 954(b)(4), it is appropriate to group general category items of income attributable to a tested unit that would otherwise be tested income, foreign base company income, or insurance income. By grouping these items of income, taxpayers making a high-tax exception election may be able to forego the often-complex analysis required to determine whether income would meet the definition of Subpart F income. For example, taxpayers will not be required to determine whether income is foreign base company sales income versus tested income if the high-tax exception applies to the income.

(e) The proposed regulations generally group passive foreign personal holding company income in the same manner as existing Treas. Reg. § 1.954-1(c)(1)(iii)(B). However, Treasury and the IRS state they may propose conforming changes to the income grouping rules in Treas. Reg. § 1.904-4(c) as part of future guidance. Comments were requested.

(f) Certain income and deductions attributable to equity transactions (for example, dividends or losses attributable to stock) are also separately grouped for purposes of the high-tax exception if the income is subject to preferential rates or an exemption under the tax law of the country of residence of the recipient. The purpose of this separate equity grouping is to separately test income or loss that is subject to foreign tax at a different rate than other general category income attributed to the tested unit and that may be susceptible to manipulation through, for example, the timing of distributions or losses.

2. <u>Income Attributable to Tested Units</u>.

(a) The final regulations generally use items properly reflected on the separate set of books and records (within the meaning of Treas. Reg. § 1.989(a)-1(d)) as the starting point for determining gross

income attributable to a tested unit. Books and records are used for this purpose because they serve as a reasonable proxy for determining the amount of gross income that the foreign country of the tested unit is likely to subject to tax and, given that this approach is consistent with the approach taken in other provisions, it should promote administrability.

(b) The proposed regulations retain this general approach but replace the reference to "books and records" with a more specific standard based on items of gross income attributable to the "applicable financial statement" of the tested unit. For this purpose, an applicable financial statement refers to a "separate-entity" (or "separate-branch," if applicable) financial statement that is readily available, with the highest priority within a list of different types of financial statements. These financial statements include, for example, financial statements that are audited or unaudited, and that are prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"), international financial reporting standards ("IFRS"), or the generally accepted accounting principles of the jurisdiction in which the entity is organized or the activities are located ("local-country GAAP").

(c) Treasury and the IRS believe that this new standard will provide more accurate and reliable information and will promote certainty in cases where there may be various forms of readily available financial information. This standard is also expected to promote administrability because it is consistent with approaches taken under other provisions. Finally, Treasury and the IRS anticipate that the type of applicable financial statement will, in many cases, be the same from year to year and therefore will result in consistency and minimize opportunities for manipulation.

3. Deductions.

(a) The final regulations generally use items properly reflected on the separate set of books and records as the starting point for determining gross income attributable to a tested unit. In contrast, the final regulations do not allocate and apportion deductions to those items of gross income by reference to the items of deduction that are properly reflected on the books and records of a tested unit. Instead, they apply the general allocation and apportionment rules for purposes of determining a tentative tested income item regarding a tentative gross tested income item. This is so that deductions are generally allocated and apportioned under the principles of Treas. Reg. § 1.960-1(d)(3) by treating each tentative gross tested income item as income in a separate tested income

group, as that term is described in Treas. Reg. § 1.960-1(d)(2)(ii)(C).

(b) Under these principles, certain deductions, such as interest expense, are allocated and apportioned based on a specific factor (such as assets or gross income) among the separate items of gross income of a CFC so that deductions reflected on the books and records of a single tested unit, and generally taken into account for foreign tax purposes in computing the foreign taxable income, may not be fully taken into account for purposes of determining a tentative tested income item.

(c) Treasury and the IRS believe that the policy goal of § 954(b)(4) is to identify income of a CFC subject to a high effective rate of foreign tax. Thus, they believe the goal is better served by determining the effective foreign tax rate regarding items of income attributable to a tested unit by reference to an amount of income that approximates taxable income as computed for foreign tax purposes, rather than federal income tax purposes. However, the use of U.S. (rather than foreign) tax accounting rules to determine the amount and timing of items of income, gain, deduction, and loss included in the high-tax exception computation remains appropriate to ensure that the computation is not distorted by reason of foreign tax rules that do not conform to federal income tax principles.

(d) Therefore, these proposed regulations generally determine tentative net items by allocating and apportioning deductions, determined under federal income tax principles, to items of gross income to the extent the deductions are properly reflected on the applicable financial statement of the tested unit, consistent with the manner in which gross income is attributed to a tested unit. Treasury and the IRS believe that, under this method, a tentative net item better approximates the tax base upon which foreign tax is imposed than would be the case under the allocation and apportionment rules set forth in the regulations under § 861.

(e) The proposed regulations allocate and apportion deductions to the extent properly reflected on the applicable financial statement only for purposes of § 954(b)(4), and not for any other purpose, such as for determining U.S. taxable income of the CFC under §§ 954(b)(5) and 951A(c)(2)(A)(ii), and the associated foreign tax credits under § 960. In contrast to § 954(b)(4), under which the rules in the proposed regulations are intended to approximate the foreign tax base, taxable income and items of income for purposes of §§ 954(b)(5), 951A(c)(2)(A)(ii), and 960 continue to be

determined using the allocation and apportionment rules set forth in the regulations under § 861.

(f) Nevertheless, Treasury and the IRS are considering whether for purposes of §§ 954(b)(5), 951A(c)(2)(A)(ii), and 960 it would be appropriate, in limited cases (for example to reduce administrative and compliance burdens), to allocate and apportion deductions incurred by a CFC based on the extent to which they are properly reflected on an applicable financial statement, and requested comments in this regard.

(g) For example, a rule could allocate and apportion deductions (other than foreign tax expense) only to the extent of the items of gross income attributable to the tested unit, and allocate and apportion any deductions in excess of such gross income to all gross income of the CFC. In addition, applying a method based on applicable financial statements for purposes of the high-tax exception could, in certain circumstances, affect the allocation and apportionment of deductions for purposes of determining the amount of an inclusion regarding gross income of the CFC that is not eligible for the high-tax exception.

(h) Treasury and the IRS stated that one approach under consideration would be to provide that deductions allocated and apportioned to an item of gross income based on an applicable financial statement for purposes of calculating a tentative net item under the high-tax exception cannot be allocated and apportioned to a different item of gross income that does not qualify for the high-tax exception for purposes of calculating the inclusion under § 951(a) or § 951A.

(i) Such an approach would be a limited change to the traditional rules for allocating and apportioning deductions and would address concerns that, if deductions were not allocated and apportioned using a consistent method when the high-tax exception has been elected, they could be viewed as effectively being "double counted" by both reducing the tentative net item for purposes of determining whether an item of gross income is eligible for the high-tax exception and also reduce the amount of a U.S. shareholder's inclusions under §§ 951(a)(1) and 951A(a) regarding a different item of gross income. Comments were requested.

4. Losses: Negative Foreign Tax Rates.

(a) In certain cases, the effective foreign tax rate at which taxes are imposed on a tentative net item may result in an undefined value or a negative effective foreign tax rate. This may occur, for example, if foreign taxes are allocated and apportioned to the corresponding

item of gross income, and the tentative net item (plus the foreign taxes) <u>is negative because the amount of deductions allocated and apportioned to the gross income exceeds the amount of gross income (plus the foreign taxes)</u>.

(b) <u>The proposed regulations provide that the effective rate of foreign tax regarding a tentative net item that results in an undefined value or a negative effective foreign tax rate will be deemed to be high-taxed</u>. As a result, the item of gross income, and the deductions allocated and apportioned to such gross income under the rules set forth in the regulations under § 861, are assigned to the residual grouping, and no credit is allowed for the foreign taxes allocated and apportioned to such gross income. Nevertheless, Treasury and the IRS state they are considering whether this result is appropriate in all cases and request comments in this regard.

5. <u>Combination of De Minimis Tested Units</u>.

(a) The proposed regulations include a rule that, subject to an anti-abuse provision, combines tested units (on a non-elective basis) that are attributed gross income less than the lesser of 1% of the gross income of the CFC, or $250,000. This de minimis combination rule applies after the application of the "same foreign country" combination rule in Prop. Treas. Reg. § 1.954-1(d)(2)(iii)(A)(1) and, therefore, combines tested units that are not residents of (or located in) the same foreign country.

(b) Comments were requested regarding this de minimis combination rule, including whether the rule could be better tailored to reduce administrative burden without permitting an excessive amount of blending.

6. <u>Anti-Abuse Rules</u>.

(a) Treasury and the IRS are concerned that taxpayers may include, or fail to include, items on an applicable financial statement or make, or fail to make, disregarded payments, to manipulate the application of the high-tax exception. As a result, the proposed regulations include an anti-abuse rule to address such cases if undertaken with a significant purpose of avoiding the purposes of § 951, 951A, 954(b)(4), or Prop. Treas. Reg. § 1.954-1(d).

(b) Treasury and the IRS are also concerned that taxpayers may enter into transactions with a significant purpose of manipulating the eligibility of income for the high-tax exception. This could occur, for example, if a payment or accrual by a CFC is deductible for federal income tax purposes but not for purposes of the tax laws of

the foreign country of the payor. As a result, the deduction would reduce the tentative net items of the CFC but would not reduce the amount of foreign income taxes paid or accrued regarding the tentative net item, which would have the effect of increasing the foreign effective tax rate imposed on the item.

(c) Accordingly, the proposed regulations include an anti-abuse rule to address transactions or structures involving certain instruments or reverse hybrid entities that are undertaken with a significant purpose of manipulating whether an item of income qualifies for the high-tax exception.

(d) Treasury and the IRS state that they continue to study other transactions and structures that may be used to inappropriately manipulate the application of the high-tax exception, including transactions and structures with hybrid entities, and may expand the application of the anti-abuse rule in the final regulations such that it is not limited to specific types of transactions or structures.

D. Mechanics of the Election.

1. In General.

(a) Under current Treas. Reg. § 1.954-1(d), the election for the Subpart F high-tax exception is made separately regarding each CFC, unlike the GILTI high-tax exclusion election, which must be made regarding all of the CFCs that are members of a CFC group. As discussed in the preamble to the final regulations, the consistency requirement contained in the GILTI high-tax exclusion rules is necessary to prevent inappropriate cross-crediting regarding high-taxed income under § 904.

(b) As a result of the changes made by the TCJA, a consistency requirement is also appropriate for the Subpart F high-tax exception. The benefit of a CFC-specific election before the TCJA was to defer U.S. tax regarding high-tax income items. After the TCJA, the ability to exclude some high-taxed income from Subpart F, while claiming foreign tax credits regarding other high-taxed income, can produce inappropriate results under § 904. As a result, Treasury and the IRS believe that a single high-tax exception election applicable to all income of all CFCs that are members of a CFC group better reflects the purposes of §§ 904 and 954(b)(4) than a CFC-by-CFC election.

(c) Accordingly, the proposed regulations include a single unified election that applies for purposes of both Subpart F and GILTI,

incorporating a consistency requirement parallel to that in Treas. Reg. § 1.951A-2(c)(7)(viii)(A)(1) and (c)(7)(viii)(E).

2. Contemporaneous Documentation.

(a) Neither current Treas. Reg. § 1.954-1(d) nor the final regulations specify the documentation necessary for a U.S. shareholder to substantiate either the calculation of an amount excluded by reason of an election under § 954(b)(4) or that the requirements under current Treas. Reg. § 1.954-1(d) or the final regulations were met.

(b) To facilitate the administration of the rules regarding these elections, Treasury and the IRS believe that U.S. shareholders must maintain specific contemporaneous documentation to substantiate their high-tax exception computations. Accordingly, the proposed regulations include a contemporaneous documentation requirement. They would add this information to the list of information that must be included on Form 5471 ("Information Return of U.S. Persons With Respect to Certain Foreign Corporations").

E. Other Changes.

1. Coordination Rules.

(a) Earnings and Profits Limitation.

i. Treas. Reg. § 1.954-1(d)(4)(ii) provides that the amount of income that is a net item of income (an input in determining whether the Subpart F high-tax exception applies) is determined after the application of the earnings and profits limitation provided under § 952(c)(1). Section 952(c)(1)(A) generally limits the amount of Subpart F income of a CFC to the CFC's earnings and profits for the taxable year. In addition, § 952(c)(2) provides that if the Subpart F income of a CFC is reduced by reason of the earnings and profits limitation under § 952(c)(1)(A), any excess of the earnings and profits of the CFC for any subsequent taxable year over the CFC's Subpart F income for such taxable year is recharacterized as Subpart F income under rules similar to the rules under § 904(f)(5).

ii. Treasury and the IRS believe that this coordination rule can lead to inappropriate results. When the § 952(c)(1) limitation applies, the effective rate at which taxes are imposed under Treas. Reg. § 1.954-1(d)(2) would be calculated on a smaller net item of income than if the net item of income were determined before the limitation, but

the amount of foreign income taxes regarding the net item would be unchanged. They are concerned that this could have the effect of causing a net item of income to qualify for the Subpart F high-tax exception even though the item, without regard to the limitation, would not have so qualified.

iii. In addition, amounts subject to recharacterization as Subpart F income in a subsequent taxable year under § 952(c)(2) may not qualify for the Subpart F high-tax exception even if the net item of income to which the recapture amount relates did so qualify. As a result, the proposed regulations provide that the high-tax exception applies without regard to the limitation in § 952(c)(1). They also follow current Treas. Reg. § 1.951-1(a)(7), which provides that the Subpart F income of a CFC is increased by earnings and profits of the CFC that are recharacterized under § 952(c)(2) and Treas. Reg. § 1.952-1(f)(2)(ii) after determining the items of income of the CFC that qualify for the high-tax exception.

(b) Full Inclusion Rule.

i. The current regulations generally provide that, except as provided in § 953, adjusted gross foreign base company income consists of all gross income of the CFC other than gross insurance income (and amounts described in § 952(b)), and adjusted gross insurance income consists of all gross insurance income (other than amounts described in § 952(b)), if the sum of the gross foreign base company income and the gross insurance income for the taxable year exceeds 70% of gross income (the "full inclusion rule").

ii. Thus, under the current regulations the full inclusion rule generally applies before the application of the Subpart F high-tax exception (which occurs when adjusted net foreign base company income is determined). Under a special coordination rule, however, full inclusion foreign base company income is excluded from Subpart F income if more than 90% of the adjusted gross foreign base company income and adjusted gross insurance company income of a CFC (determined without regard to the full inclusion rule) is attributable to net amounts excluded from Subpart F income under the Subpart F high-tax exception.

iii. Treasury and the IRS believe that these rules could be simplified if the determination of whether income is foreign

base company income occurs before the application of the full inclusion rule. Current Treas. Reg. § 1.954-1, for example, requires taxpayers to determine whether income is foreign base company income or insurance income before applying the full inclusion rule or the high tax exception. Applying the high-tax exception first will eliminate the need to perform this factual analysis in many cases.

iv. Therefore, the proposed regulations provide that the high-tax exception applies before the full inclusion rule and, consequently, the special coordination rule in Treas. Reg. § 1.954-1(d)(6) is eliminated. In addition, the proposed regulations make conforming revisions to the coordination rule for full inclusion income and the high-tax election in the regulations under § 951A. The proposed regulations also would delete Treas. Reg. § 1.951A-2(c)(4)(iii)(C) and (iv)(C) (Example 3).

2. Elections on Amended Returns.

(a) Current Treas. Reg. § 1.954-1(d)(5) generally provides that a controlling U.S. shareholder (as defined in Treas. Reg. § 1.964-1(c)(5)) may make (or revoke) a Subpart F high-tax election by attaching a statement to its amended income tax return and that this election is binding on all U.S. shareholders of the CFC. In conforming the provisions of the Subpart F high-tax exception with the provisions of the GILTI high-tax exclusion in the final regulations (as modified by the proposed regulations), Treasury and the IRS believe that it is also necessary to revise the rules regarding elections on amended returns.

(b) The final regulations require that amended returns for all U.S. shareholders of the CFC for the CFC inclusion year must be filed within a single 6-month period within 24 months of the unextended due date of the original income tax return of the controlling domestic shareholder's inclusion year with or within which the relevant CFC inclusion year ends. As stated in the preamble to the final regulations, Treasury and the IRS believe that the requirement that all amended returns be filed by the end of this period is necessary to administer the GILTI high-tax exclusion and to allow the IRS to timely evaluate refund claims or make additional assessments.

(c) For this reason, the proposed regulations also provide that the high-tax election may be made (or revoked) on an amended federal income tax return only if all U.S. shareholders of the CFC file

amended returns (unless an original federal income tax returns has not yet been filed, in which case the original return may be filed consistently with the election (or revocation)) for the year (and for any other tax year in which their U.S. tax liabilities would be increased by reason of that election (or revocation)), within a single 6-month period within 24 months of the unextended due date of the original federal income tax return of the controlling domestic shareholder's inclusion year.

(d) They also provide that in the case of a U.S. shareholder that is a partnership, the election may be made (or revoked) with an amended Form 1065 or an administrative adjustment request, as applicable. Further, the proposed regulations provide that if a partnership files an administrative adjustment request, a partner that is a U.S. shareholder in the CFC is treated as having complied with these requirements (regarding the portion of the interest held through the partnership) if the partner and the partnership timely comply with their obligations under § 6227.

(e) Treasury and the IRS state they are aware that changes in circumstances occurring after the 24-month period may cause a taxpayer to benefit from making (or revoking) the election, for example, if there is a foreign tax redetermination regarding one or more CFCs. They request comments on rules that would permit a taxpayer to make (or revoke) an election after the 24-month period in cases where the taxpayer can establish that the election (or revocation) will not result in time-barred tax deficiencies.

F. Section 381(a).

1. Section 952(c)(2) generally provides that if Subpart F income of a CFC for a taxable year was reduced by reason of the current earnings and profits limitation in § 952(c)(1)(A), any excess of the earnings and profits of such CFC for any subsequent taxable year over the Subpart F income of such foreign corporation for such taxable year is recharacterized as Subpart F income under rules similar to the rules of § 904(f)(5). Treas. Reg. § 1.904(f)-2(d)(6) generally provides, in part, that in the case of a distribution or transfer described in § 381(a), an overall foreign loss account of the distributing or transferor corporation is treated as an overall foreign loss account of the acquiring or transferee corporation as of the close of the date of the distribution or transfer.

2. Treasury and the IRS believe that, because of some lack of certainty whether recapture accounts carry over in transactions to which § 381(a) applies, it is appropriate to provide clarification. Therefore, the proposed regulations clarify that recapture accounts carry over to the acquiring corporation (including foreign corporations that are not CFCs) in a

distribution or transfer described in § 381(a). Treasury and the IRS believe that this clarification is consistent with general successor principles as may be applied under current law in certain successor transactions such as transactions described in § 381(a).

G. Applicability Dates.

1. The proposed regulations under Treas. Reg. § 1.951A-2, 1.952-1(e), and Treas. Reg. § 1.954-1 are proposed to apply to taxable years of CFCs beginning after the date the Treasury decision adopting the rules as final regulations is filed with the Federal Register, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

2. The proposed regulations under Treas. Reg. § 1.952-1(f)(4) are proposed to apply to taxable years of a foreign corporation ending on or after July 20, 2020. As a result of this applicability date, Prop. Treas. Reg. § 1.952-1(f)(4) would apply regarding recapture accounts of an acquiring corporation for taxable years of the corporation ending on or after July 20, 2020, even if the distribution or transfer described in § 381(a) occurred in a taxable year ending before July 20, 2020.

IV. SECTION 245A.

A. The § 245A regulations, in the form of temporary regulations, initially came as a major surprise to many tax advisors and taxpayers in the summer of 2019. Many tax advisors and taxpayers felt Treasury and the IRS were trying to change the effective date of the statute enacted as a part of TCJA. They disallow § 245A benefits in the case of "extraordinary dispositions" and "extraordinary reductions." These are different transactions with different rules applying under the regulation.

B. The temporary and final regulations create duplicate taxation of the same income in some situations, and the proposed regulations were intended to provide a solution to that problem. The difficulty is that the proposed regulations, in an attempt to solve the problem, are among the most complicated regulations ever written by Treasury and the IRS. They provide a so-called "simple" case that is not simple (it's quite complex), and a so-called "complex" case that is probably best described as beyond comprehension.

C. Treasury and the IRS adopted that proposed regulation as final following the receipt of only one written comment which Treasury and the IRS stated was "not substantially related to, and did not suggest any revisions to, the proposed regulations." (So why is it counted as a comment?) That comment was not further discussed in the preamble to the final regulations. There also was no hearing because there were no requests to testify.

D. Only one, minor change was made. Treasury and the IRS believe that the DQB reduction rule should also apply by reason of a prior extraordinary disposition amount described in Treas. Reg. § 1.245A-5(c)(3)(i)(D)(1)(i) through (iv) and therefore the final regulations provide a rule to this effect. They stated that absent such an approach, gains to which the extraordinary disposition E&P and disqualified basis are attributable could in effect be taxed by reason of the disqualified basis rule and a provision other than the extraordinary disposition rule. As we said, these rules are quite complicated.

E. Many taxpayers and tax advisors believe the temporary – and now the final – regulations would seem to rewrite the statute and that this will likely lead to litigation. Indeed, the first such case was filed in court: *Liberty Global, Inc. v. United States* was filed in the District Court of Colorado. The complaint was well drafted and filed on November 27, 2020. It states that "the § 245A Temporary Regulations are substantively and procedurally invalid …" and that they are "contrary to the controlling statutes."

F. Carrie Brandon Elliot further discussed finalization of the latter *Tax Notes International* March 15, 2021.

G. The Extraordinary Disposition rules apply in the context of certain "disqualified period" transactions. The § 245A regulations also contain rules dealing with *Extraordinary Reduction* transactions that can apply in situations in which there was no disqualified period transaction and that consequently could surprise tax advisors working on generic M&A transactions. *See* Treas. Reg. §§ 1.245A-5(e) and (j) Examples 3,4 and 6. An elective exception is available to close the relevant CFC's tax year.

H. It is the Extraordinary Reduction transaction rules that are at issue in the *Liberty Global* case.

I. The House Ways and Means proposals regarding enacting the Biden Administration's tax proposals, or a legislative equivalent thereof, contain a proposal to retroactively authorize the disputed § 245A regulations.

V. § 163(j).

A. Final § 163(j) Regulations.

1. Treasury and the IRS released a second set of final § 163(j) regulations regarding the limitations on the deduction for business interest expense. They address the application of the § 163(j) limitation in contexts involving passthrough entities, regulated investment companies ("RICs"), and the international area. We will address only the international area.

2. On September 14, 2020, Treasury and the IRS published the first set of final regulations under § 163(j) (T.D. 9905). While many sections of the 2018 Proposed Regulations were finalized, nearly all of the previously

proposed international regulations were re-proposed in modified form rather than finalized.

3. One important issue relates to areas in this regulation regarding which Treasury and the IRS "reserve," state they are continuing to study the issue or state that further guidance will be forthcoming.

B. Treas. Reg. § 1.163(j)-7. Treas. Reg. § 1.163(j)-7 provides rules for applying § 163(j) to relevant foreign corporations and their United States shareholders ("U.S. shareholders"). Most of these proposed regulations were adopted as final in the second set of final regulations, although some of them remain in proposed form. Changes and comments are discussed below.

C. Negative ATI of CFC Group Members.

1. Prop. Treas. Reg. § 1.163(j)-7(c) provided rules for applying § 163(j) to CFC group members. Prop. Treas. Reg. § 1.163(j)-7(c)(2)(i) provided that a single § 163(j) limitation is computed for a specified period of a CFC group based on the sum of the current-year business interest expense, disallowed Business Interest Expense ("BIE") carryforwards, Business Interest Income ("BII"), floor plan financing interest expense, and Adjusted Taxable Income ("ATI") of each CFC group member. For this purpose, the ATI and other items of a CFC group member were generally computed on a separate-entity basis. Under the general rule of Treas. Reg. § 1.163(j)-1(b)(1)(vii), ATI of a taxpayer cannot be less than zero (no-negative ATI rule).

2. In response to comments, Treasury and the IRS agreed that the ATI of CFC group members should take into account amounts less than zero for purposes of determining the ATI of a CFC group. Accordingly, the final regulations provide that the "no-negative" ATI rule applies regarding the ATI of a CFC group, rather than a CFC group member.

D. Transactions Between CFC Group Members.

1. In general, intragroup transactions are taken into account for purposes of computing a CFC group's § 163(j) limitation. However, Prop. Treas. Reg. § 1.163(j)-7(c)(2)(ii) provided an anti-abuse rule that disregarded an intragroup transaction between CFC group members if a principal purpose of entering into the transaction was to affect the CFC group's or a CFC group member's § 163(j) limitation by increasing or decreasing the CFC group or a CFC group member's ATI. Some comments requested a broader rule to permit taxpayers to elect annually to disregard BII and BIE between CFC group members for purposes of applying § 163(g). They stated that this election would reduce taxpayers' compliance burdens.

2. The final regulations do not include an election to disregard intragroup BII and BIE. Treasury and the IRS believe that the effect of the requested

election would be to allow a deduction for all intragroup BIE and to cause the § 163(j) limitation applicable to other BIE (that is, BIE regarding debt that is not between members of a CFC group) to be determined without regard to intragroup BII. Although the requested election would not affect the total amount of deductible BIE within the CFC group, it would change the location of the deduction within the CFC group (that is, the CFC group member for which a deduction is allowed). Moving a BIE deduction from one CFC group member to another could have significant Federal income tax consequences.

3. For example, the location of a CFC group's interest deduction could affect the amount of a CFC group member's subpart F income and tested income (or tested loss) and, therefore, the amount of a U.S. shareholder's income inclusion under § 951(a) or 951A(a), respectively. Thus, the requested election could be used to inappropriately manipulate the impact of BIE deductions within a CFC group.

4. However, <u>the final regulations expanded the anti-abuse rule from applying only to certain intragroup transactions that affect ATI, to any intragroup transaction entered into with a principal purpose of affecting a CFC group or a CFC group member's § 163(j) limitation by increasing the CFC group or a CFC group member's BII</u>. This rule is intended to prevent taxpayers from artificially increasing the total amount of BII and BIE within a CFC group for a specified period in order to shift disallowed BIE from one CFC group member to another or change the timing of deductions of BIE.

5. For example, a payment of BIE by a payor CFC group member to a payee CFC group member will generally result in an equal increase in the CFC group's § 163(j) limitation (and therefore the amount of deductible BIE) as a result of the increase in the CFC group's BII. However, the increase in the CFC group's § 163(j) limitation is not necessarily allocated to the payor.

6. Under the ordering rules of Treas. Reg. § 1.163(j)-7(c)(3), the additional § 163(j) limitation would be allocated first to the payee to the extent it has BIE, and then may be allocated to other CFC group members. This type of transaction would be subject to the anti-abuse rule if it was entered into with a principal purpose of increasing the amount of BIE deductible by other CFC group members.

E. <u>High-Tax Exceptions</u>.

1. One comment suggested that Treasury and the IRS consider a special rule for the application of § 163(j) to CFC group members that are subject to the subpart F high-tax exception ("HTE") under Treas. Reg. § 1.954-1(d) or the GILTI high-tax exclusion under Treas. Reg. § 1.951A-2(c)(7) (together, high-tax exceptions). For example, the comment suggested a

multi-step approach under which § 163(j) would first be applied to CFC group members on a separate-entity basis for purposes of applying the high-tax exceptions, and then ATI and BIE of CFC group members subject to the high-tax exceptions could be excluded in computing the CFC group's § 163(j) limitation.

2. Treasury and the IRS believe that applying § 163(j) first to each CFC group member on a separate-entity basis, then applying the high-tax exceptions, and then reapplying § 163(j) to a CFC group by excluding income eligible for the high-tax exceptions, would significantly increase the administrative and compliance burdens of § 163(j) and therefore reduce the benefits of making a CFC group election.

3. Furthermore, they believe that such an approach would be inconsistent with the general concept and purpose of a consolidated approach to the CFC group election; for example, it would increase the relevance of the location of intragroup debt and ATI within a CFC group and could inappropriately enhance the effective foreign tax rate of such income. Accordingly, the final regulations did not adopt this recommendation.

F. <u>BIE Carryforwards and HTE</u>.

1. Section 163(j) and the § 163(j) regulations generally apply to determine the deductibility of BIE of a relevant foreign corporation (which includes an applicable CFC) in the same manner as those provisions apply to determine the deductibility of BIE of a domestic C corporation. Treas. Reg. § 1.163(j)-7(b). One comment requested that Treasury and the IRS confirm that a CFC to which the high-tax exceptions apply can still have a disallowed BIE carryforward.

2. <u>Treasury and the IRS stated that the high-tax exception does not modify the rules for determining the § 163(j) limitation or the amount of an applicable CFC's disallowed BIE carryforward</u>. Accordingly, an applicable CFC may have disallowed BIE carryforwards if the applicable CFC is subject to a high-tax exception in the taxable year(s) in which the disallowed BIE carryforwards arose.

G. <u>Allocation of CFC Group Items</u>.

1. Prop. Treas. Reg. § 1.163(j)-7(c)(2)(iii) provided that, for purposes of allocating items to an excepted trade or business under Treas. Reg. § 1.163(j)-10, all CFC group members are treated as a single C corporation. Similarly, Prop. Treas. Reg. § 1.163(j)-7(c)(2)(iv) provided that, for purposes of determining whether certain amounts are treated as interest within the meaning of Treas. Reg. § 1.163(j)-1(b)(22), all CFC group members are treated as a single taxpayer.

2. Several comments addressed the method of allocating items of a CFC group member to an excepted trade or business under Treas. Reg. § 1.163(j)-10. Treasury and the IRS continue to study the proper method for allocating CFC group members' items to an excepted trade or business and when it is appropriate to treat a CFC group as a single entity. They stated that they might address these issues in future guidance and will consider the comments at that time. Accordingly, the final regulations reserve on Treas. Reg. § 1.163(j)-7(c)(2)(iii) and (iv).

H. Limitations.

1. Pre-group Disallowed BIE Carryforwards.

(a) The 2020 Proposed Regulations provided special rules relating to disallowed BIE carryforwards of a CFC group member that arose in a taxable year before it joined the CFC group (pre-group disallowed BIE carryforwards). Under Prop. Treas. Reg. § 1.163(j)-7(c)(3)(iv)(A)(1), a CFC group member cannot deduct pre-group disallowed BIE carryforwards in excess of the cumulative § 163(j) pre-group carryforward limitation. This limitation is determined in a manner similar to the limitation on the use of carryovers of a member of a consolidated group arising in a separate return limitation year ("SRLY"). *See* Treas. Reg. § 1.1502-21(c).

(b) One comment requested that the limitation on pre-group disallowed BIE carryforwards be removed, because it increases the compliance burden on taxpayers and any potential for loss trafficking could adequately be addressed by an anti-abuse rule.

(c) Treasury and the IRS believe that it would be inappropriate for the limitation on deduction of pre-group disallowed BIE carryforwards to be replaced with an anti-abuse rule focused on loss trafficking. Loss trafficking concerns may arise anytime the ATI or BII of one CFC group member is used to allow a deduction for BIE of another CFC group member attributable to a taxable year before the other CFC group member joined the CFC group. As a result, the final regulations retain the limitation on the deduction of pre-group disallowed BIE carryforwards.

2. Joining or Leaving a CFC Group.

(a) As a general matter, the SRLY limitations described in Treas. Reg. §§ 1.1502-21(c) and 1.163(j)-5(d) do not apply to a member of a consolidated group if their application would result in an overlap with the application of § 382 (SRLY overlap rule). *See* Treas. Reg. §§ 1.1502-21(g)(1) and 1.163(j)-5(f). One comment

requested clarification as to whether § 382 applies to a CFC that does not have ECI. The comment generally supported the limitation on pre-group disallowed BIE carryforwards but suggested that, if § 382 applies to CFCs, a rule similar to the SRLY overlap rule should be adopted to prevent the limitation on pre-group disallowed BIE carryforwards from applying to a CFC group member if its application would result in an overlap with the application of § 382.

(b) Treasury and the IRS stated that § 382, by its terms, applies to the disallowed BIE carryforwards of foreign corporations regardless of whether they have ECI. However, they also stated that they continue to study certain aspects of the application of §§ 163(j) and 382 to foreign corporations, including the possible application of a SRLY overlap rule to applicable CFCs joining or leaving a CFC group, as well as the computation of any relevant § 382(a) limitation. Treasury and the IRS could address these issues in future guidance and will consider the comments at that time.

I. Specified Groups and Specified Group Members.

1. The 80-Percent Ownership Threshold.

(a) Prop. Treas. Reg. § 1.163(j)-7(d) provided rules for determining a specified group and specified group members. A specified group includes one or more chains of applicable CFCs connected through stock ownership with a specified group parent, but only if the specified group parent owns stock meeting the requirements of § 1504(a)(2)(B) (which requires 80-percent ownership by value) in at least one applicable CFC, and stock meeting the requirements of § 1504(a)(2)(B) in each of the applicable CFCs (except the specified group parent) is owned by one or more of the other applicable CFCs or the specified group parent. Indirect ownership through a partnership or through a foreign estate or trust is taken into account for this purpose.

(b) Some comments requested that the ownership threshold for applying this rule be reduced to 50%, or "more than 50%," in order to make the rule consistent with the ownership rules in §§ 957 and 954(d)(3). Another comment requested that the ownership threshold be reduced to 50% regarding a CFC that has only one U.S. shareholder.

(c) Treasury and the IRS believe that it would be inappropriate to reduce the specified group ownership threshold below 80%. The application of § 163(j) to a CFC group is modeled on the rules for applying § 163(j) to a U.S. consolidated group under Treas. Reg.

§ 1.163(j)-5. Accordingly, the definition of a specified group is generally consistent with the definition of an affiliated group under § 1504. In certain respects, the rules of Treas. Reg. § 1.163(j)-7(c) have the effect of treating a CFC group as a single entity for purposes of § 163(j). This treatment is not appropriate for CFCs that do not share at least 80% common ownership, that is, CFCs that are not highly related. Moreover, because one CFC group member's ATI and BII can be used by other CFC group members to deduct BIE, reducing the specified ownership threshold would increase the potential for one CFC group member to disproportionately benefit, or suffer a detriment, from the attributes of another CFC group member even though those CFCs are not highly related.

(d) As an alternative, one comment requested that a U.S. shareholder be permitted to take into account its pro rata share of CFC attributes in computing the CFC group § 163(j) limitation without regard to the percentage of the U.S. shareholder's ownership interest. This approach was not adopted in the final regulations because it would require different U.S. shareholders to calculate the § 163(j) limitation differently and separately track disallowed BIE carryforwards regarding the same CFC.

2. Determining a Specified Group.

(a) The final regulations made several clarifying changes to the rules for determining a specified group and specified group members. First, the definition of specified group in Treas. Reg. § 1.163(j)-7(d)(2)(i) is modified to clarify that a specified group may exist when a qualified U.S. person directly owns all of its applicable CFCs rather than owning one or more chains of applicable CFCs. Second, the definition of specified group member in Treas. Reg. § 1.163(j)-7(d)(3) was modified to clarify that there must be at least two applicable CFCs in a specified group in order for any applicable CFC to be a specified group member and for a CFC group election to be available.

(b) Finally, the rule in Treas. Reg. § 1.163(j)-7(d)(2)(vii) (concerning when a specified group ceases to exist) was modified to clarify that references to the common parent in Treas. Reg. § 1.1502-75(d)(1), (d)(2)(i) through (d)(2)(ii), and (d)(3)(i) through (d)(3)(iv) are treated as references to the specified group parent. This is the case even if the specified group parent is a qualified U.S. person and therefore not included in the specified group.

J. CFC Group Election.

1. Timing and Revocation.

(a) Prop. Treas. Reg. § 1.163(j)-7(e) provided rules and procedures for treating specified group members as CFC group members and for determining a CFC group. Prop. Treas. Reg. § 1.163(j)-7(e)(5) provided rules for making and revoking a CFC group election.

(b) Under the 2020 Proposed Regulations, a CFC group election could not be revoked regarding any specified period of the specified group that begins during the 60-month period following the last day of the first specified period for which the election was made. Similarly, once revoked, a CFC group election could not be made again regarding any specified period of the specified group that begins during the 60-month period following the last day of the first specified period for which the election was revoked.

(c) The preamble to the proposed regulations requested comments as to whether a specified group that does not make a CFC group election when it first comes into existence (or for the first specified period following 60 days after the date of publication of the Treasury decision adopting the 2020 Proposed Regulations as final in the Federal Register) should be precluded from making the CFC group election for the following 60-month period.

(d) Some comments requested that taxpayers be permitted to make or revoke the CFC group election on an annual basis, due to the difficulty of predicting the effect of the election five years in advance (including the potential for changes in fact or law that could interact adversely with the CFC group election).

(e) Treasury and the IRS believe that taxpayers should not be permitted to revoke the CFC group election for a specified period beginning within 60 months after the specified period for which it is made or to make the CFC group election for a specified period beginning within 60 months after the specified period for which it is revoked. The CFC group rules are based in part on the consolidated return rules, which do not allow affiliated groups that have elected to file a consolidated return to discontinue the filing of a consolidated return without the consent of the Commissioner (which generally requires a showing of good cause). *See* Treas. Reg. § 1.1502-75(c). In addition, if a corporation ceases to be a member of a consolidated group, that corporation generally is not permitted to rejoin the consolidated group before the 61st month beginning after its first taxable year in which it ceased to be a member of the group. § 1504(a)(3)(A).

(f) They further believe that an annual election would enable taxpayers to use § 163(j) to inappropriately control the timing of BIE deductions. In general, the CFC group election is intended, in large part, to reduce taxpayer burden, including compliance costs and costs that might otherwise be incurred to restructure the location of debt within a CFC group solely for purposes of § 163(j), and to permit allocation of a CFC group's § 163(j) limitation to CFC group members with BIE. The CFC group election is not intended to allow taxpayers to select the most favorable result in every taxable year.

(g) Treasury and the IRS agreed that it is not necessary to impose the 60-month waiting period on specified groups that have neither made nor revoked a CFC group election. Accordingly, the final regulations do not impose a 60-month waiting period on a specified group for which a CFC group election is not made for the first specified period in which a specified group exists (or the specified period beginning 60 days after the regulations are finalized).

(h) The final regulations provide, consistent with the 2020 Proposed Regulations, that the 60-month period begins after the last day of the specified period for which the election was made or revoked. *See* Treas. Reg. § 1.163(j)-7(e)(5). Therefore, if an election is made or revoked regarding a specified period, the 60-month period begins to run on the day after the end of that specified period.

(i) Finally, Treasury and the IRS continue to study whether an exemption to the 60-month rule for revoking a CFC group election is appropriate when the ownership of the CFC group changes but the specified group continues and, therefore, the CFC group would also otherwise continue absent an exemption.

K. Disclosure. Under the 2020 Proposed Regulations, a designated U.S. person makes a CFC group election by attaching a statement to its relevant Federal income tax or information return. Prop. Treas. Reg. § 1.163(j)-7(e)(5)(iv). However, the 2020 Proposed Regulations did not require a statement to be filed for taxable years following the taxable year for which an election is made. In order to facilitate ongoing disclosure of the computation of the CFC group 163(j) limitation in subsequent taxable years, the final regulations provide that (in accordance with publications, forms, instructions, or other guidance) each designated U.S. person must attach a statement to its relevant Federal income tax or information return for each of its taxable years that includes the last day of a specified period of a specified group for which a CFC group election is in effect. *See* Treas. Reg. § 1.163(j)-7(e)(6). The CFC group election remains in effect even if the required statement is not filed.

L. Effectively Connected Income.

1. Prop. Treas. Reg. § 1.163(j)-7(f) provided that if a CFC group member has income that is effectively connected with the conduct of a U.S. trade or business (ECI), then ECI items and related attributes of the CFC group member are not included in the calculation of the § 163(j) limitation of the CFC group or in the allocation of the limitation among CFC group members, but are treated as items of a separate CFC (ECI deemed corporation) that is not treated as a CFC group member.

2. A comment requested clarification concerning the proper method for allocating assets between the CFC group member and the ECI deemed corporation, which is relevant to the allocation of BII and BIE to an excepted trade or business under Treas. Reg. § 1.163(j)-10.

3. Treasury and the IRS continue to study the application of § 163(j) to foreign corporations with ECI. They stated they might address these issues in future guidance and will consider the comment at that time. Before the issuance of any such guidance, taxpayers should use a reasonable method for allocating assets between the CFC group member and the ECI deemed corporation. The method must be consistently applied to all CFC group members and each specified period of the CFC group after the first specified period in which it is applied.

4. In addition, because Treasury and the IRS continue to study the application of § 163(j) to foreign corporations with ECI, the final regulations reserve on Treas. Reg. § 1.163(j)-7(f)(2) (ordering rule with Treas. Reg. § 1.163(j)-8 when a CFC group member has ECI).

M. ATI Computation of Applicable CFC.

1. Foreign Income Taxes.

(a) The 2020 Proposed Regulations provided that, for purposes of computing the ATI of a relevant foreign corporation for a taxable year, tentative taxable income takes into account a deduction for foreign income taxes. Prop. Treas. Reg. § 1.163(j)-7(g)(3). The preamble to the 2020 Proposed Regulations requested comments on whether, and the extent to which, the ATI of a relevant foreign corporation should be determined without regard to a deduction for foreign income taxes.

(b) Some comments asserted that all foreign income taxes, or foreign income taxes imposed by the country in which a CFC is organized or a tax resident, should not be taken into account as a deduction for purposes of computing a CFC's ATI. They stated that this would provide parity between CFCs and domestic corporations, which do not deduct Federal income taxes. Several comments

stated that the rule in the proposed regulations would penalize CFCs operating in high-tax jurisdictions.

(c) In an important change from the proposed regulations, Treasury and the IRS agreed that it is appropriate to determine the ATI of a relevant foreign corporation without regard to a deduction for foreign income taxes that are eligible to be claimed as a foreign tax credit. Accordingly, the final regulations provide that no deduction for foreign income taxes (within the meaning of Treas. Reg. § 1.960-1(b)) is taken into account for purposes of determining the ATI of a relevant foreign corporation. Thus, regardless of whether an election is made to claim a credit for these foreign income taxes, the foreign income taxes do not reduce ATI.

2. Anti-Abuse Rule.

(a) Prop. Treas. Reg. § 1.163(j)-7(g)(4) provided that, if certain conditions are met, when one specified group member or applicable partnership (specified borrower) pays interest to another specified group member or applicable partnership (specified lender), and the payment is BIE to the specified borrower and income to the specified lender, then the ATI of the specified borrower is increased by the amount necessary for the BIE of the specified borrower not to be limited under § 163(j). A partnership is an applicable partnership if at least 80% of the interests in capital or profits is owned, in the aggregate, directly or indirectly through one or more other partnerships, by specified group members of the same specified group.

(b) The final regulations provide that, for purposes of determining whether a partnership is an applicable partnership, a partner's interests in the profits and capital of the partnership are determined in accordance with the rules and principles of Treas. Reg. § 1.706-1(b)(4)(ii) through (iii).

N. Safe Harbor in Treas. Reg. § 1.163(j)-7(h).

1. Prop. Treas. Reg. § 1.163(j)-7(h) provided a safe-harbor election for stand-alone applicable CFCs and CFC groups. If the safe-harbor election is in effect for a taxable year of a stand-alone applicable CFC or specified taxable year of a CFC group member, no portion of the BIE of the stand-alone applicable CFC or of each CFC group member, as applicable, is disallowed under § 163(j).

2. The safe-harbor election is intended to reduce the compliance burden regarding applicable CFCs that would not have disallowed BIE if they applied § 163(j) by allowing taxpayers in general to use subpart F income

and GILTI items in lieu of ATI. In general, the safe-harbor election measures whether BIE is less than or equal to the sum of 30% of the applicable CFC's subpart F income and GILTI (not to exceed the applicable CFC's taxable income), taking into account only amounts attributable to a non-excepted trade or business.

3. The preamble to the 2020 Proposed Regulations requested comments on appropriate modifications, if any, to the safe-harbor election that would further the goal of reducing the compliance burden on stand-alone applicable CFCs and CFC groups that would not have disallowed BIE if they applied the § 163(j) limitation. In this regard, comments requested that the safe harbor be expanded to cover applicable CFCs and CFC groups that have BII that is greater than or equal to BIE. The comments noted that an application of § 163(j) would not disallow any BIE of an applicable CFC or CFC group that has net BII.

4. Treasury and the IRS agree that it is appropriate for the safe-harbor to be expanded as requested because an application of § 163(j) in this case would not disallow any BIE. Accordingly, the final regulations provide that a safe-harbor election may be made regarding a stand-alone applicable CFC or CFC group if its BIE does not exceed either (i) its BII, or (ii) 30% of the lesser of its eligible amount (in general, the sum of the applicable CFC's subpart F income and GILTI, taking into account only items properly allocable to a non-excepted trade or business) or its qualified tentative taxable income (that is, the applicable CFC's tentative taxable income determined by taking into account only items properly allocable to a non-excepted trade or business).

5. Thus, under the final regulations, if either a stand-alone applicable CFC or a CFC group has BII that is greater than or equal to its BIE, it is not necessary to determine its qualified tentative taxable income or eligible amount in order to make the safe-harbor election. However, consistent with the 2020 Proposed Regulations, the election may not be made for a CFC group that has pre-group disallowed BIE carryforwards.

6. In addition, the determination of the eligible amount of a stand-alone applicable CFC or a CFC group has been modified to account for tested losses, if any, of an applicable CFC. *See* § 1.163(j)-7(h)(3). Rather than providing a formula for calculating each component of the eligible amount, the final regulations rely on existing rules under §§ 951, 951A, 245A (to the extent provided in § 964(e)(4)), and 250 to determine the taxable income a domestic corporation would have had if it wholly owned the stand-alone applicable CFC or CFC group members and had no other assets or income. *See* Treas. Reg. § 1.163(j)-7(h)(3).

7. <u>While the safe-harbor election is a potentially helpful simplification, it is important to note that making the election means that no portion of any</u>

CFC excess taxable income is included in the U.S. shareholder's ATI. Prop. Treas. Reg. § 1.163(j)-7(j)(3)(i).

O. Increase in ATI of U.S. Shareholders.

1. Prop. Treas. Reg. § 1.163(j)-7(j) provides rules that can beneficially increase a U.S. shareholder's ATI by a portion of its specified deemed inclusions (as defined in Treas. Reg. § 1.163(j)-1(b)(1)(ii)(G)). Several comments were submitted regarding these rules. However, those comments were not discussed in the preamble to the final regulation.

2. Treasury and the IRS state that they continue to study the method for determining the portion of the specified deemed inclusions of a U.S. shareholder that should increase its ATI. They stated that they may address this issue in future guidance and will consider the comments at that time. Accordingly, the final regulations reserve on these potentially important rules.

3. Consequently, the only relevant guidance on this subject continues to be that set forth in Prop. Treas. Reg. § 1.163(j)-7(j). *See also* the #4 paragraph under "Applicable Dates" below regarding applying Prop. Treas. Reg. § 1.163(j)-7(j) (and other provisions "reserved" in final regulations).

4. A Treasury spokesperson was quoted in a report by Andrew Velarde as stating "Don't read too much into [our] not finalizing certain parts of the regulations. [Prop. Treas. Reg. § 1.163(j)-7(j)] was one where we thought it warranted a little bit more thought about the formula for the push up. … It's not necessarily that the proposed regulation does or does not work. There's some fine-tuning we wanted to do." Tax Notes Today January 15, 2021.

P. Treas. Reg. § 1.163(j)-8. Prop. Treas. Reg. § 1.163(j)-8 provides rules for applying § 163(j) to a nonresident alien individual or foreign corporation with ECI. Treasury and the IRS continue to study methods of determining the amount of deductible BIE and disallowed business interest expense carryforwards that are allocable to ECI, such as the ATI ratio defined in Prop. Treas. Reg. § 1.163(j)-8(c)(1)(ii) and the interaction of Prop. Treas. Reg. § 1.163(j)-8 with the tiered partnership rules in Prop. Treas. Reg. § 1.163(j)-6(j). They anticipate addressing[10] these issues in future guidance and will consider the comments at that time. Accordingly, the final regulations reserve on Treas. Reg. § 1.163(j)-8. Thus, here, too, the only relevant guidance would seem to be in the proposed regulations.

[10] Note the interestingly different language: Regarding Prop. Treas. Reg. § 1.163(j)-8, Treasury and the IRS "anticipate addressing" the open issues in future guidance whereas regarding Prop. Treas. Reg. § 1.163(j)-7(j), they state that they "may address" the open issue in future guidance.

Q. Applicability Dates.

1. The Treas. Reg. § 1.163(j)-7 regulations that were finalized with the second set of § 163(j) final regulations (discussed above) apply to taxable years beginning on or after 60 days after publication in the Federal Register (i.e., for calendar year taxpayers, in 2022). Those Treas. Reg. § 1.163(j)-7 regulations that were finalized with the first set of § 163(j) final regulations apply, in the case of a calendar year taxpayer in 2021 (taxable years beginning after November 13, 2020).

2. Taxpayers and their related parties, within the meaning of § 267(b) (determined without regard to § 267(c)(3)) and 707(b)(1), may choose to apply the rules of the final regulations to a taxable year beginning after December 31, 2017, and before 60 days after publication in the federal register, provided that they consistently apply the § 163(j) regulations contained in T.D. 9905 as modified by the final regulations and, if applicable, a number of other stated provisions.

3. Alternatively, taxpayers and their related parties, within the meaning of § 267(b) (determined without regard to § 267(c)(3)) and 707(b)(1), may rely on the rules in the 2020 Proposed Regulations to the extent provided in the 2020 Proposed Regulations.

4. To the extent that a rule in the 2020 Proposed Regulations was not finalized in these regulations, taxpayers and their related parties, within the meaning of § 267(b) (determined without regard to § 267(c)(3)) and 707(b)(1), may rely on that rule for a taxable year beginning on or after 60 days after publication in the federal register, provided that they consistently follow all of the rules in the 2020 Proposed Regulations that were not finalized as to that taxable year and each subsequent taxable year beginning on or before the date the Treasury decision adopting that rule as final is applicable or other guidance regarding continued reliance is issued.

5. A CFC group or safe-harbor election can be made for a period that ends with or within a taxable year of a designated U.S. person ending before November 13, 2020 on an amended Federal income tax return filed on or before the date (taking into account extension, if any) of the original Federal income tax return for the first taxable year of each designated U.S. person ending on or after November 13, 2020.

R. Worldwide Interest Apportionment.

1. Section 864(f) was scheduled to become effective in 2021. This is the provision that would have permitted an election for worldwide interest apportionment and that was enacted some 16 years ago although its operative effect was repeatedly delayed by Congress.

2. However, § 864(f) was repealed in its entirety by § 9671(a) of the American Rescue Plan Act of 2021 (P.L. 117-2). That bill passed Congress on March 10, 2021 and was signed into law by the President the following day.

3. The demise of § 864(f) was discussed in an interesting article by Robert Goulder who succinctly stated that "[t]he operative lifespan of § 864(f) wasn't simply brief; it was nonexistent." *See* TNI of April 5, 2021 starting at p. 121. This complete repeal is unfortunate. The provision never saw the light of day, and was repealed as a revenue raiser.

VI. FOREIGN TAX CREDITS.

A. Treasury and the IRS proposed regulations on November 12, 2020 addressing:

1. the determination of foreign income taxes subject to the credit and deduction disallowance provision of § 245A(d);

2. the determination of oil and gas extraction income from domestic and foreign sources and of electronically supplied services under the § 250 regulations;

3. the impact of the repeal of § 902 on certain regulations issued under § 367(b) (foreign reorganizations);

4. the sourcing of inclusions under §§ 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 § 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 regarding disregarded payments;

8. changes to the definitions of a creditable 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 § 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 (2020);

11. the foreign branch category rules in Treas. Reg. § 1.904-4(f) and the definition of a financial services entity for purposes of § 904; and

12. the time at which credits for foreign income taxes can be claimed pursuant to §§ 901(a) and 905(a).

B. They finalized the regulations described in No. 10 above in September, 2021, but that rulemaking did not finalize other portions of those proposed regulations. The preamble stated "The Treasury Department and IRS intend to finalize those portions of the 2020 proposed regulations separately."

C. NYSBA FTC Comments.

1. The New York State Bar Association Tax Section ("NYSBA") submitted comments on the 2020 FTC Proposed Regulations. These are important proposed regulations that would materially change a number of FTC rules without any underlining congressional support.

2. The 2020 FTC Proposed Regulations propose significant revisions to the Treasury Regulations under §§ 901 and 903 concerning the creditability of foreign income taxes. They also address a number of technical issues remaining after the 2020 Final Regulations including (1) the allocation and apportionment of FTCs related to dispositions of stock and partnership interests, partnership distributions, and disregarded transactions; (2) the disallowance of FTCs regarding § 245A dividends; (3) the treatment of E&P and foreign incomes taxes of a foreign corporation involved in a § 381 nonrecognition transaction; (4) the definition of financial services income; (5) rules regarding when the FTC can be claimed; (6) the source of inclusions; (7) the allocation of FTCs after certain ownership and entity classification changes; (8) transition rules for accounting for net operating loss carrybacks; (9) changes to the definition of electronically supplied services for purposes of calculating foreign-derived intangible income ("FDII"); and (10) the determination of domestic oil and gas extraction income and foreign oil and gas extraction income for purposes of calculating FDII and GILTI, respectively.

D. Creditability.

1. The NYSBA voiced concerns about the jurisdictional nexus requirement rules and recommend that they be separated from the remainder of the rules in the 2020 FTC Proposed Regulations and considered subject to an

extended comment period and in light of further international developments, particularly the ongoing work at the OECD.

2. The NYSBA notes that the jurisdictional nexus requirement is generally not precipitated by statutory changes enacted as a part of the TCJA.

3. The Report states that the NYSBA appreciates the government's concern regarding the allowance of an FTC for a foreign income tax levied on income that does not have a significant connection to the foreign jurisdiction taxing such income, including U.S.-source income. This could effectively convert the FTC regime into a means of subsidizing foreign jurisdictions at the expense of the U.S. fisc. However, it can also be argued that Congress intended § 904, rather than the concept of an "income tax" in § 901, to be the sole mechanism for preventing this abuse of the FTC regime. Moreover, in the case of foreign-source income, but for which one foreign jurisdiction taxes income that the U.S. views as attributable to another jurisdiction, the failure to provide a credit will result in double taxation in the U.S. regarding such income and potentially a corresponding decrease in foreign investment.

4. Regardless of whether the proposed jurisdictional nexus requirement is appropriate as a policy matter, the NYSBA is concerned that the proposal represents a significant departure from existing law and thus its adoption would have significant ramifications for U.S. taxpayers.

5. If the jurisdictional nexus requirement is adopted, the NYSBA recommends that final regulations allow a foreign levy that assesses a capital gains tax on the stock of a resident corporation to satisfy the property-based nexus standard. By limiting creditability to foreign levies, the proposed regulations would prevent long-standing direct and indirect capital gains taxes from being creditable. This significant consequence, unaddressed by Treasury and the IRS in the Preamble, is particularly surprising as it relates to foreign taxation of gains expressly sanctioned by double tax treaties (which also contemplate the availability of a corresponding FTC) and raises questions about regulatory treaty override. If this recommendation is rejected, then the final regulations should specifically address the interaction of the jurisdictional nexus requirement with treaties.

6. The Report also recommends that, in lieu of a specific list of deductions that are necessary to be allowed for a foreign levy to satisfy the cost recovery requirement, the final regulations retain the facts and circumstances inquiry of the existing regulations. If the proposed changes to the cost recovery requirement are adopted in the final regulations, the NYSBA recommends examples of disallowances that would and would not be considered "consistent" with U.S. federal income tax principles.

7. There may be instances in which the disallowance of a deduction that is not similar to the disallowances provided for U.S. federal income tax purposes may nonetheless be necessitated by sound tax policy and not inconsistent with an income tax in the U.S. sense. For instance, if a foreign tax law allows full expensing of capital expenditures, an additional allowance for interest expense would be duplicative in the case of debt-financed investments and potentially result in a negative tax rate. It is unclear whether a disallowance of interest expense in such circumstances would run afoul of the cost recovery requirement, because, as a provision necessitated by tax policy, it may not be deemed consistent with the disallowances in § 162, which are generally based on social policy, rather than tax policy.

8. It is also unclear whether the disallowance of deductions pursuant to an alternative minimum tax like the tax historically imposed on corporations under § 55 ("AMT") or the base erosion and anti-avoidance tax ("BEAT") currently imposed under § 59A, would be deemed consistent with U.S. federal income tax principles for this purpose.

9. The NYSBA recommends the removal of the requirement that a "close connection" between the imposition of an in lieu of tax on income and the failure to impose the generally-imposed net income tax on such income 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."

10. Clarification also was requested under the "jurisdiction to tax" requirement for an in lieu of tax, the hypothetical application of the generally-imposed net income tax to the excluded income need only satisfy the jurisdictional nexus requirement and not also the net gain requirement. If the hypothetical application of the generally-imposed net income tax also satisfy the net gain requirement, the final regulations should clarify the nature of this analysis.

11. The final regulations should also clarify when components of a foreign tax should be considered separate levies.

12. Current law is unclear as to whether a foreign income tax liability offset by a credit that is computed by reference to amounts other than foreign tax payments (e.g., investment credits) (a "non-tax credit") should nonetheless be treated as "paid" for purposes of the FTC regime. Some NYSBA members recommend that the rule treating refundable credits as reducing the amount of income tax paid be finalized, while others recommend that the rule not be finalized and instead that guidance be issued treating the use of refundable credits and transferable credits in satisfaction of a foreign income tax as a payment of such tax. If the latter recommendation were adopted, rules could allow payment treatment only for credits that

are actually regularly refunded in more than de minimis amounts by foreign governments.

13. Government grants payable in cash and administered outside of the tax system should not be treated as a reduction in the amount of tax paid, but rather that a tax satisfied by application of such a grant should be treated as paid.

E. Allocation and Apportionment.

1. The Report states that most of the complexity in allocating and apportioning foreign income taxes arises in the first step – assigning foreign gross income to the relevant statutory groupings. In general, an item of foreign gross income that also gives rise in the same taxable year to an item of U.S. gross income (a "corresponding U.S. item") is assigned to the grouping to which the corresponding U.S. item is assigned. Special rules apply for assigning foreign gross income where there is no corresponding U.S. item (e.g., as a result of a timing or base difference) or where the gross income item arises from a distribution regarding corporate stock (regardless of whether there is a corresponding U.S. item) or from a foreign law inclusion regime similar to Subpart F or GILTI.

2. The 2020 FTC Proposed Regulations provide additional special rules for assigning foreign gross income arising from distributions regarding partnership interests, dispositions of stock or partnership interests, and disregarded payments.

3. The 2020 FTC Final Regulations provide that foreign gross income of a taxpayer arising from a § 301(c)(2) distribution is assigned to the same groupings to which the tax book value ("TBV") of the stock of the distributing corporation is (or would be if the taxpayer were a U.S. person) assigned under the asset method in Treas. Reg. § 1.861-9 in the U.S. taxable year in which the distribution is made (the "TBV method").

4. The NYSBA generally supports the approach for basketing foreign income taxes related to a § 301(c)(2) distribution or a disposition of stock based on the TBV method. In particular, the NYSBA agrees that foreign income taxes arising from a § 301(c)(2) distribution more often relates to a timing difference than to a base difference, and thus should not be assigned per se to the residual category. In order to better conform the FTC consequences of distributions with those of dispositions, the NYSBA recommends that, to the extent of basis in stock attributable to PTEP under § 961, foreign gross income in excess of the U.S. dividend amount be assigned to the same grouping as the underlying PTEP.

5. The report supports the general approach for basketing foreign income taxes related to a partnership distribution or a disposition of partnership

interests based on the TBV method. The report recommends that partners' distributive shares of the income of a hybrid partnership be tracked and foreign gross income treated as a dividend for foreign law purposes upon a distribution by the hybrid partnership be assigned proportionately to the income included in this partner-level account to the extent thereof. In the alternative, at a minimum, foreign gross income arising from a foreign law dividend should be attributed based on a partner's distributive share of the current year income of the partnership to the extent thereof.

6. If the foregoing recommendation concerning distributions from hybrid partnerships is adopted, the NYSBA recommends that in order to conform the FTC consequences of distributions with those of dispositions, in the case of a disposition of a hybrid partnership interest, an amount of foreign gross income equal to the disposing partner's § 705 basis attributable to undistributed partnership income be assigned to relevant groupings in the same manner as if such amount were distributed.

7. The NYSBA recommends that, for purposes of assigning foreign gross income arising from a remittance, the assets of a taxable unit include not only stock, but also the assets of any other taxable unit owned by the taxable unit, and any interest in a partnership or the taxable unit's pro rata share of the assets of the partnership, as applicable.

8. For purposes of applying § 904, interest expense is allocated and apportioned based on the adjusted basis of assets, rather than on the fair market value of assets or gross income. The 2020 FTC Proposed Regulations would provide taxpayers an election to capitalize their R&E and advertising expenses solely for purposes of allocating and apportioning interest expense. Under the election, R&E expenses would be capitalized and amortized over a 15-year period, and 50% of advertising expenditures would be capitalized and amortized over a 10-year period. NYSBA recommends that the election to capitalize R&E and advertising expenses for purposes of allocating and apportioning interest expense be extended to apply for purposes of allocating and apportioning any expense that is apportioned under the asset method, including litigation- related expenses and stewardship expenses.

F. Disallowance of FTCs Related to § 245A Dividends.

1. The 2020 FTC Proposed Regulations propose rules under § 245A(d) to disallow an FTC or deduction for any foreign income tax attributable to a specified distribution or specified E&P. Foreign income taxes are attributable to a specified distribution from a foreign corporation to the extent such taxes are allocated and apportioned under Treas. Reg. § 1.861-20 to foreign taxable income arising from the specified distribution.

2. Because of the rules related to specified E&P, the FTC disallowance rules of 2020 FTC Prop. Treas. Reg. § 1.245A(d)-1 do not depend on the actual receipt of a § 245A dividend. Rather, § 245A(d) could be implicated by reason of a § 301(c)(2) distribution or even presumably a disregarded payment.

3. The NYSBA recommends clarification that § 245A(d) may apply to disallow an FTC regarding a foreign income tax that arises by reason of a remittance and that Treas. Reg. § 1.861-13 does not apply to characterize lower-tier CFC stock in order to disallow FTCs under § 245A(d).

4. The Report also recommends either an anti-abuse rule or modifying the foreign law distribution rule to address successive foreign law distributions rather than adopting an approach based on maintaining accounts for tracking E&P and basis.

G. Financial Services Income.

1. The NYSBA expressed reservations regarding the proposed rule that would prevent income of a financial services entity that is treated as passive income under a look-through rule from qualifying as financial services income. If such rule is finalized, clarification is needed on the purpose for the rule and whether the exclusion from financial services income of passive category income under a look-through rule applies solely to related party payments.

2. Insurance-related active financing income, including the thresholds applicable for purposes of determining investment asset limitations and their interaction with the definitions of total insurance liabilities for different categories of companies needs clarification.

3. Clarification is needed on active financing income taken into account for purposes of computing the AFI percentage includes insurance income of a U.S. company attributable to a policy of insurance or reinsurance regarding which the person (directly or indirectly) insured is a related person to the company.

H. Redeterminations.

1. Each partner's distributive share of additional tax paid by an accrual-method partnership as a result of a change in the foreign tax liability should be treated as paid or accrued by the partner in its taxable year with which or within which the partnership's relation-back year ends.

2. The provisional credit election should be available to any partner of an accrual-method partnership without regard to whether the partner is an accrual-method taxpayer or has elected to use the accrual method for purposes of computing FTCs.

3. In the event that a provisional credit election for a contested tax liability is made, a CFC-level deduction for the relation-back year should also be provided in advance of accrual.

I. U.S. Chamber of Commerce FTC Comments.

1. The U.S. Chamber of Commerce also provided comments on the 2020 FTC Proposed Regulations.

2. The Chamber recommends deleting the jurisdictional nexus requirement. The denial of foreign tax credits for US multinationals operating in jurisdictions which impose novel extraterritorial taxes is not only unlikely to persuade the jurisdictions from imposing such taxes but is actively penalizing the very companies in which the novel taxes are likely to impact. Alternative options should be exhausted before taking unilateral and discriminatory steps against the very same companies which suffer the taxation regime imposed as a result of these extraterritorial taxes. Instead, the focus, at least in the first instance, should be on utilizing other international forums to dissuade the enactment of discriminatory taxes.

3. Its comments also recommend the predominant character test should be retained as its elimination would frustrate the purpose of § 901 and will likely create numerous instances of double taxation. If Treasury's goal is "to simplify and clarify the application of the rules," the elimination of the predominant character tests runs counter to this goal.

4. These determinations would be both fact intensive and nuanced: Fact intensive because all deviations from the "pure" income tax system of the Internal Revenue Code ("Code") will have to be identified and nuanced because some deviations will create a separate class of taxpayers (and therefore a separate levy) while other deviations would simply have to be weighed for significance. Additionally, because neither the U.S. tax system nor foreign tax systems are static, these assessments would have to be done on an annual basis to determine whether even small changes to either system would render a previously creditable tax non-creditable (or vice versa). The practical impact will be the government (and taxpayers) will have to undertake much more frequent assessments on the credibility of foreign taxes due to the ever-evolving nature of U.S. and foreign tax rules.

5. The Chamber also recommends eliminating the requirements limiting creditability to foreign tax regimes which are more consistent with U.S. tax principles. Changing the standard from a review of the "normal circumstances" in which a tax applies to "solely on the basis of the foreign law governing the calculation" creates a more rigid standard in analyzing whether a foreign law meets the proposed narrowed definition of a "foreign income tax" and likely will lead to double taxation.

6. The “alternative gross receipts test” also should be retained. The Chamber believes that elimination of the alternative measures of gross receipts, proves problematic in three specifics ways. First, it seeks to deny the credibility of foreign taxes based upon minor differences from the U.S. measure of gross receipts even if those differences result in a tax demonstrably imposed on income. Second, by rejecting estimated measures of gross receipts based on costs, it contradicts the very same regulation’s recognition of cost-plus transfer pricing rules, apparently relying on a logically indefensible distinction between transfer pricing rules and rules measuring gross receipts. Third, the proposal ignores relevant regulatory history, and would effectively reverse judicial interpretations of the statute.

7. Considering the related elimination of the predominant character tests, the proposed gross receipts rule would deny credits on the basis that a mere possibility exists the foreign tax could ultimately depart in any significant way from the base under the U.S. law even if it is unlikely. This departure ignores many years of case law emphasizing the substance of a foreign tax determines its credibility and would violate the limited purpose for mitigation of double taxation set forth in the preamble.

8. The existing “alternative allowance rule” should be retained. The 2020 FTC Proposed Regulations would require costs or expenses related to capital expenditures, interest, rents, royalties, services, and research and experimentation to generally be fully deductible in order to meet the cost recovery requirement. Foreign levies should not become non-creditable simply because more restrictive limitations on interest deductibility (or rents, services, etc.) are imposed based on such jurisdiction’s base protecting policies.

9. The Chamber recommends clarifying that FTCs paid or accrued in taxable years prior to finalization and carried forward to taxable years post finalization are not subject to the new rules.

10. The comments recommend modifying non-duplication rule to focus solely on the application of foreign law to the specific taxpayer and where only a portion, but not all, of the tested foreign tax base is also subject to a generally imposed net income tax, only a proportionate amount of the tested foreign tax should fail the non-duplication requirement.

11. The Chamber also believes that a number of changes to the financial services income rules including the financial services entity and group tests.

12. Finally, the Chamber recommends against requiring additional tracking of E&P accounts when assigning items of foreign gross income to the statutory and residual groupings.

J. USCIB FTC Comments.

1. The United States Council for International Business ("USCIB") also provided comments on the 2020 FTC Proposed Regulations.

2. The USCIB also recommends that the jurisdictional nexus requirement be removed and that it is inconsistent with the purpose of § 901 of mitigating double tax on foreign earnings. Denying FTCs for taxes that do not meet the proposed jurisdictional nexus requirement is not consistent with the plain meaning, structure, or legislative history of the FTC provisions, or tax policy. The imposition of a new rigid requirement for another country's nexus rules to closely align with U.S. rules would be inconsistent with the history and the plain meaning of the text of § 901 (virtually unchanged since 1921), by severely restricting the availability of credits for foreign taxes imposed on net income and thereby undermining Congress's intent for the foreign tax credit to mitigate the double taxation of foreign income so that U.S. companies can compete abroad on an equal footing.

3. This dramatic change would have particularly harsh results for companies operating in developing countries with less sophisticated approaches to determining the source and character of income. In addition, the proposed jurisdictional nexus requirement would lead to significant uncertainty and protracted controversies, in particular when only some aspects of a foreign levy run afoul of the requirement, with especially inequitable consequences for taxpayers that are not affected by those particular aspects of the rules.

4. In addition to the legislative history and historical context, requiring a jurisdictional basis for imposing tax is contrary to the plain meaning of the term "income tax," which is generally defined as any tax imposed on net income, indicating that one need only evaluate the measurement base for a tax without regard to the jurisdictional justification for its imposition.

5. The USCIB also notes that determining whether foreign sourcing rules are "reasonably similar" to U.S. sourcing rules would be complex and result in significant uncertainty, inconsistent outcomes, and protracted controversies.

6. The U.S. government should not impose double tax on domestic companies because it disagrees with another country's jurisdictional basis for imposing a tax. USCIB states that while it understands the government's frustration with the proliferation of unilateral claims of taxing rights, including by treaty partners through provisions that appear inconsistent with the spirit of the treaty, leadership in the OECD Pillar One and Pillar Two negotiations, as well as treaty negotiations, is the better avenue to address the issue—as opposed to using the mechanism for

providing double tax relief to U.S. taxpayers as a tool to influence foreign jurisdictions to change their rules. Indeed, we think it is unlikely that imposing double taxation on U.S. multinationals will be effective in convincing foreign jurisdictions to change their rules.

7. Moreover, the proposed rules are significantly broader than the novel extraterritorial taxes that motivated them, and would affect many longstanding taxes, especially of less developed countries, hurting the ability of U.S. multinationals to compete abroad and particularly in emerging markets. In addition to the economic burden of double taxation, and in particular with respect to non-OECD countries, the requirement to do a comprehensive comparison of a country's nexus rules to those of the U.S. for each "separate levy" will impose substantial administrative burdens and uncertainty as to when a deviation in a country's rules "tips the scale."

8. The regulatory process is not the appropriate avenue for dealing with such major policy decisions with wide-reaching economic impact on U.S. companies.

9. The proposed changes to the cost-recovery requirement add more complexity, rather than simplicity. We encourage Treasury and the IRS to maintain the current standard. If the current standard is to be changed, Treasury and the IRS should provide some relief by limiting application of the per se list to taxpayers who, in fact, incur a significant amount of such costs.

10. The USCIB requests the withdraw of the changes to the net gain requirement in Prop. Treas. Reg. § 1.901-2(b).

11. The current law treatment of refundable expenditure-based credits that are available without regard to a taxpayer's tax liability is sufficiently clear and aligns with the economic substance of such credits as government subsidies that are only administered through the tax system. The proposed rule would depart from the general treatment of refundable credits for purposes of determining income tax expense under U.S. GAAP. The proposed rule also would be inconsistent with the suggested treatment of refundable tax credits for purposes of determining the tax base and covered taxes under the OECD's BEPS Pillar Two GloBE rules.

12. Similar to a refundable charitable contribution credit, a refundable credit that incentivizes certain business activities should not be treated as a separate levy under the multiple levy rule. Thus, finalization of the proposed multiple levy rule should not affect the treatment of refundable credits.

13. Given the extensive changes made by the 2020 FTC Proposed Regulations to various important disregarded payment rules, USCIB recommends that the proposed § 1.861-20 regulations be effective for taxable years that begin after the date when the final regulations are filed in the Federal Register.

14. The comments also recommend that the foreign taxes paid should be allocated and apportioned (or assigned) at the QBU level, and the taxes paid by each QBUs should be summed at the CFC owner level. USCIB members are concerned about the provisions for assigning items of foreign gross income to the statutory and residual groupings in Prop. Treas. Reg. § 1.861-20(d). Specifically, the concern is that the use of tax book value and interest expense apportionment rules to characterize remittances creates unusual results. Remittances should be characterized proportionately to the earnings of the taxable unit making the remittance.

15. USCIB members do not believe that additional tracking and reporting is required for purposes of ensuring compliance with § 245A(d). The associated compliance burden is disproportionate to the scope of any potential issue, especially in light of the anti-abuse rule contained in Prop. Treas. Reg. § 1.245A(d)-1.

16. The USCIB urges Treasury to reconsider these proposed changes and either retain current law definitions or revise the definitions to provide that entities such as those that operate as treasury centers for a group of related companies be permitted to treat related party income (i.e., from lending or hedging activities) as qualifying financial services income. In addition, they respectfully urge Treasury to permit taxpayers to rely on current-law definitions with respect to any pre-existing attributes such as qualified deficits that were generated in the years before the definition change, so that future income that could be offset with a qualified deficit under the current, long-standing regulations can continue to be offset (as if there were no definition change).

17. Finally, the comments also recommend that no annual certification be required for contested liabilities if the taxpayer elects to claim the provisional foreign tax credit. The taxpayer should notify the IRS by filing the amended tax return(s) for the year(s) the contested liability is related to and at the time of resolution. At a minimum, if taxpayers were to be required to file an annual certification for a contested liability, there should be available means for them to cure any inadvertent failure to file or delays in filing without the harsh penalty of being treated as a deemed refund.

K. Fenwick FTC Comments.

1. Fenwick & West partners David Forst, Adam Halpern, Larissa Neumann, and Julia Ushakova-Stein also provided comments on the creditability changes in the 2020 FTC Proposed Regulations. The 2020 FTC Proposed Regulations offer guidance on a range of issues related to the determination of the foreign tax credit after TCJA.

2. The Fenwick comment letter focuses on the new "jurisdictional nexus requirement" that would significantly narrow the foreign income taxes and "in lieu of" taxes that could be claimed as a credit and the other proposed changes that would substantially erode the long-established "normal circumstances" and "predominant character" tests for deciding whether foreign taxes are creditable income taxes.

3. These proposals would fundamentally change existing U.S. tax laws and policies to such a degree that they should be implemented, if at all, only by Congress.

4. In § 901 of the Code, Congress announced that the foreign tax credit is allowed for any "income, war profits, and excess profits taxes" (referred to in this letter simply as "income taxes") imposed by a foreign country or U.S. possession. Congress first introduced this rule in the Revenue Act of 1918, and the quoted language has remained the same for over 100 years.

5. From time to time, Congress has enacted exceptions to the general rule that foreign income taxes are creditable. For example, § 901(i) of the Code denies a credit in certain cases for income taxes that are used by the foreign country to provide a subsidy. More recently, Congress enacted § 901(m) of the Code, denying a credit for certain foreign income taxes in connection with a "covered asset acquisition."

6. Treasury regulations issued under § 901 of the Code have generally provided technical guidance (*e.g.*, addressing the boundary between income taxes and other taxes, and when a tax should be treated as paid) or elaborated on specific legislation (*e.g.*, regulations issued pursuant to §§ 901(m) and 909).

7. Absent a statutory exception, however, taxes that are plainly foreign income taxes paid by the taxpayer are creditable under the plain, simple, and longstanding language of § 901 of the Code.

VII. SUBPART F.

A. Whirlpool Branch Rule Case.

1. The Tax Court ruled against Whirlpool in its branch income Subpart F income dispute holding that the company's income earned through its

Mexican branch was foreign base company sales income ("FBCSI"). The tax year was 2009 and the new § 954 substantial contribution and branch rule regulations did not apply.

2. Through a branch in Mexico, Whirlpool used a maquiladora structure and its Luxembourg CFC acted as the manufacturer of the appliances and sold the appliances to Whirlpool's U.S. parent company and Whirlpool's Mexican CFC, which distributed the appliances for sale to consumers.

3. The IRS asserted that the income earned by the Luxembourg CFC from sales of appliances constituted FBCSI under § 954(d) and was Subpart F income.

4. Whirlpool filed a motion for partial summary judgment contending that the sales income was not FBCSI because the appliances sold by the Luxembourg CFC were substantially transformed by its Mexican branch from the component parts and raw materials it had purchased.

5. The Tax Court held that whether or not the appliances sold by the Luxembourg CFC were actually manufactured by it, the sales income was FBCSI because the Mexican branch was treated as a subsidiary of the Luxembourg CFC under the manufacturing branch rule, and the sales income earned by the Luxembourg CFC constituted FBCSI.

6. The threshold question was whether Whirlpool Luxembourg carried on activities in Mexico "through a branch or similar establishment."

7. Section 954(d)(2) establishes two preconditions for its application: (1) the CFC must be carrying on activities "through a branch or similar establishment" outside its country of incorporation, and (2) the conduct of activities in this manner must have "substantially the same effect" as if the branch were a wholly owned subsidiary of the CFC.

8. The IRS argued that Whirlpool Luxembourg did business in Mexico through a branch or similar establishment, and that it would be difficult to contend otherwise.

9. The court held that the first precondition was clearly met here: Whirlpool Luxembourg was incorporated in Luxembourg, and it carried on its manufacturing activities "through a branch or similar establishment" in Mexico. The Tax Court agreed with the IRS and held that, although Whirlpool Luxembourg had no employees in Mexico, it owned assets in Mexico, acted as a "contract manufacturer" in Mexico, and sold to related parties the products that it manufactured in Mexico. Its presence in Mexico necessarily took the form of a branch or division of itself. The Tax Court also noted the fact that Whirlpool represented to Luxembourg tax authorities (and received a ruling from them) that it had a "permanent establishment" in Mexico. Whirlpool had also received a maquiladora

ruling in Mexico. The Tax Court held that the conclusion was thus inescapable that Whirlpool Luxembourg carried on activities in Mexico "through a branch or similar establishment."

10. The court concluded that second precondition was met because this manner of operation had "substantially the same effect," for U.S. tax purposes, as if the Mexican branch were a wholly owned subsidiary of Whirlpool Luxembourg.

11. It stated that by carrying on its activities "through a branch or similar establishment" in Mexico, Whirlpool Luxembourg avoided any current taxation of its sales income. Whirlpool thus achieved "substantially the same effect" – deferral of tax on its sales income—that it would have achieved under U.S. tax rules if its Mexican branch were a wholly owned subsidiary deriving such income.

12. To determine whether the tax effect is substantially the same, the regulations dictate a two-phase inquiry. The first phase requires an income allocation between the branch and the remainder of the CFC. The second phase requires a comparison between the actual and hypothetical effective rates of tax applicable to the sales income allocated to the remainder.

13. <u>The court stated that proper allocation of income between the branch and the remainder was intuitively clear</u>: The Mexican branch earned all of the manufacturing income, and all of the sales income was allocable to the remainder. The regulation, however, applies specific rules in this regard and they do not lead to this result.

14. The court also stated that the regulations yield the same result but by a more complicated process which is designed to ensure that only sales income (and not manufacturing income) is allocated to the remainder in this scenario and that while the objective seems clear, the process is somewhat "tedious." <u>We do not think the regulations lead to this result, but this is what the IRS sought as a result in the court case</u>.

15. In short, the Service successfully argued that because all of the remainder's income would be FBCSI under the general rules of § 954(d)(1), all of the non-manufacturing income should be allocated to it. We believe the allocation is a factual matter, perhaps to be resolved by applying arm's length rules. <u>This is how a previous case docketed in the Tax Court was settled</u>. *Copper Industries v. Commissioner*. The IRS's APA attorneys once said they would entertain a case on this subject to resolve the matter using § 482 functional analysis principles.

16. The regulation next mandates a comparison of tax rates. In effect, it asks whether the sales income allocated to Whirlpool Luxembourg was taxed at

an appreciably lower tax rate than the rate at which Mexico would have taxed that income.

17. The court concluded sales income that the regulation allocates to the remainder of Whirlpool Luxembourg was taxed during 2009 at a rate of 0%. Although Mexico imposed a 17% tax rate on the manufacturing income, Whirlpool Luxembourg, as a foreign principal under the maquiladora decree, was deemed to have no PE in Mexico and was thus immune from Mexican tax. But for Luxembourg tax purposes Whirlpool Luxembourg was deemed to have a PE in Mexico, and it was thus immune from Luxembourg tax. Thus, Whirlpool Luxembourg paid no tax to either jurisdiction in 2009.

18. The regulation requires a comparison of the 0% actual rate of tax to the effective rate of tax that would apply to the sales income, under Mexican law, if Whirlpool Luxembourg were a Mexican corporation doing business in Mexico through a PE in Mexico and deriving all of its income from Mexican sources allocable to that PE. Under these assumptions the court determined Whirlpool Luxembourg would not have qualified for the 17% reduced rate of tax applicable to maquiladora companies. The court stated that its income would therefore have been taxed by Mexico at a 28% rate, the rate applicable to Mexican corporations generally.

19. The court determined that the tax rate disparity test was satisfied because the 0% rate at which Whirlpool Luxembourg's allocated sales income was actually taxed during 2009 was less than 90% of, and more than 5 percentage points below, the 28% rate at which its income would have been taxed by Mexico on the assumptions mandated by the regulation. Thus, the court concluded Whirlpool Luxembourg's use of a branch in Mexico is considered to have had "substantially the same tax effect as if the branch" if it were a wholly owned subsidiary corporation.

20. Having determined that Whirlpool Luxembourg (the remainder) and its Mexican branch are to be treated as separate corporations, the court stated that the next step is to determine whether the remainder has foreign base company sales income.

21. The court concluded that products were manufactured outside of Luxembourg and sold for use or consumption outside Luxembourg and thus the sales income derived by Whirlpool Luxembourg constituted FBCSI under § 954(d) and was taxable as Subpart F income under § 951(a).

22. The court stated this conclusion comports with the overall statutory structure and with Congress's purpose in enacting Subpart F. The sales income with which Congress was concerned was income of a selling subsidiary which has been separated from manufacturing activities of a

related corporation merely to obtain a lower rate of tax for the sales income. The court concluded that this is precisely the objective that Whirlpool aimed to achieve here.

23. Whirlpool argued that because Whirlpool Luxembourg (the remainder) had only one part-time employee, that the remainder performed no sales or purchasing activities and hence that the manufacturing branch rule was inapplicable. We believe this is a correct analysis.

24. The court stated that Whirlpool's asserting that Luxembourg's activities were insubstantial "is a classic example of an attempt to have one's cake and eat it too." The court said that in making a separate § 954(d)(1) argument, Whirlpool had argued that Luxembourg's activities were substantial. Whirlpool's Mexican ruling also indicated that Whirlpool performed no selling activities in its Mexican branch. The court also held that making sales is necessarily a "sales activity." The court stated that under that structure Whirlpool Luxembourg was the company that owned the products and sold the products and that it is not plausible that Whirlpool Luxembourg "performed no sales activities."

25. Whirlpool contended that there was no tax rate disparity and that the effective Luxembourg tax rate should be 24.2% rather than 0% and that the hypothetical Mexican tax rate should be 0.56% rather than 28%. The hypothetical Mexican rate of 0.56% assumes that, if all of Whirlpool Luxembourg's income were taxed by Mexico, Whirlpool Luxembourg would still qualify for Mexican tax incentives under the maquiladora program.

26. The court disagreed with that assumption. If Whirlpool Luxembourg had a PE in Mexico and all of its income were allocable to that PE, it would be taxed in Mexico at a rate of 28%.

27. Whirlpool asserted that it derived a 24.2% Luxembourg tax rate by noting that Whirlpool Luxembourg in 2009 paid Luxembourg tax of €6,566 on income (mostly interest income) of €27,135.

28. The court stated this argument ignores the instructions of the regulations, which require an allocation of sales income to Whirlpool Luxembourg as "the remainder" of the CFC, and then consider the rate at which the income allocated to the remainder is, by statute, treaty obligation, or otherwise, taxed in the year when earned. The court held you do not look to the rate of tax that Whirlpool Luxembourg paid on its miscellaneous other income; the regulation directs you look to the worldwide rate of tax that was actually imposed on its allocated sales income.

29. Whirlpool argued that the "same country exception" applied since Whirlpool Luxembourg purchased the raw materials and component parts

used to manufacture the products, and it held title to the work-in-process inventory throughout the manufacturing process.

30. The court rejected that argument and stated that Whirlpool Luxembourg was organized in Luxembourg and the products were manufactured in Mexico. The court held that the "same country manufacturing exception" thus has no application to Whirlpool Luxembourg's activities or income.

31. Finally, as an alternative Whirlpool contended that the regulations were invalid and that the manufacturing branch rule of Treas. Reg. § 1.954-3(b)(1)(ii) exceeded the scope of the authority granted by the plain language of § 954(d)(2).

32. The court stated that there is nothing in the statute that prevents the Secretary from prescribing regulations that address manufacturing branches. Thus, whether the court treated the statute as ambiguous or silent on the matter, the question was whether the manufacturing branch regulations are valid under *Chevron* step two.

33. The court stated that the legislative history of Subpart F left no doubt that Congress's intent in enacting the foreign base company provisions was to capture sales income that had been artificially separated from the manufacturing activities of a related entity.

34. Regardless of whether § 954(d)(2) is viewed as ambiguous or silent on the "manufacturing branch" issue, the court concluded that the manufacturing branch regulations were a "reasonable interpretation" of the statute.

35. *Whirlpool* is on appeal to the Sixth Circuit. The appeal was argued on June 9, 2021.

VIII. MISCELLANEOUS DEVELOPMENTS.

A. Priority Guidance Plan.

1. On September 9 the 2021-2022 priority guidance plan was issued. This is the first priority guidance plan issued by the new Administration. The 2021-2022 priority guidance plan contains 193 guidance projects that will be the focus of Treasury and the IRS resources during the 12-month period from July 1, 2021, through June 30, 2022 (the plan year). The plan does not provide any specifics or timeframes.

2. Treasury and the IRS solicited recommendations for items to be included in the plan from all interested parties in Notice 2021-28. They noted that the plan will be updated throughout the year with periodic updates to allow flexibility.

3. Some of the projects that were included in the prior year plan were not included because they are no longer considered priorities.

4. The plan has five transfer pricing projects. The first one is the annual report on the advance pricing agreement program that was published in April (*see* Section I. above). The second is regulations addressing the changes under §§ 367(d) and 482. The §§ 367(d) and 482 temporary regulations that were published on September 16, 2015 expired in 2018. The third project is new and is to clarify the effects of group membership on the arm's length pricing, including specifically for financial transactions. The fourth transfer pricing project is a new project to further clarify certain aspects of the arm's length standard including (1) coordination of the best method rule with guidance on specified methods for different categories of transactions, (2) discretion to determine the allocation of risk based on the facts and circumstances of transactions and arrangements, and (3) periodic adjustments. Lastly, the APA guidelines need updating. There are two § 367(d) projects listed on regulations addressing the inbound transfer of intangible property and on modifying the regulations for triangular reorganizations.

5. There is a foreign tax credit project addressing the allocation and apportionment of interest expense, the definition of a foreign income tax, and the timing of when foreign taxes accrue and may be claimed as a credit.

6. A priority project addresses the character and source of income arising in transactions involving intellectual property and the provision of digital goods and services.

7. Another international tax project is stated as regulations under Subpart F, including coordination with the repeal of § 958(b)(4) and regulations under §§ 959 and 961 concerning previously taxed earnings and profits.

B. Certain § 1446 Regulations Deferred.

1. In Notice 2021-51, the IRS and Treasury announced the deferral of the applicability date of certain withholding regulations under §§ 1446(a) and (f) to January 1, 2023. The IRS will amend the regulations to reflect the new 2023 applicability date.

2. Section 1446 requires 10% withholding on effectively connected income of a foreign partner. On November 30, 2020, in TD 9926, the final regulations were published relating to withholding and information reporting under § 1446(f).

3. The Notice states that the withholding regulations in Treas. Reg. § 1.1446(f)-3, which requires partnerships to withhold amounts not withheld by a transferee of a partnership interest on any distributions to

the transferee, would be amended to only apply to transfers that occur on or after January 1, 2023. Section 1446(f)(4) provides that if a transferee fails to withhold any amount required to be withheld under § 1446(f)(1), the partnership must deduct and withhold from distributions to the transferee a tax in an amount equal to the amount the transferee failed to withhold (plus interest).

4. The publicly traded partnership interest ("PTP interest") final regulations will also be amended to alight with this change in effective date.

5. The final regulations include withholding and reporting requirements under § 1446(f)(1) for brokers effecting transfers of PTP interests on behalf of foreign persons. The final regulations require a broker that pays an amount realized to a foreign broker to withhold on the amount realized, unless the foreign broker is a qualified intermediary ("QI") (or a U.S. branch treated as a U.S. person) that assumes primary withholding responsibility under § 1446(f)(1). Treasury and the IRS stated that the requirement for a PTP to withhold under § 1446(f)(4) was included to ensure that PTPs exercise due diligence.

6. The IRS and Treasury received a number of comments that the final regulations would be difficult for PTPs to comply with the regulations and that more time was needed to design, build and test data systems to comply with the withholding and reporting requirements.

7. Thus, the applicability date in Treas. Reg. § 1.1446(f)-4(f) for the withholding and reporting on transfers of PTP interests under § 1446(f)(1) will apply to transfers that occur on or after January 1, 2023. In addition, the applicability date of the modifications to Treas. Reg. § 1.1446-4 listed in Treas. Reg. § 1.1446-7 will be amended to apply to distributions with respect to PTP interests made on or after January 1, 2023.

8. Taxpayers can rely on the Notice regarding the modified applicability date immediately.

C. FTC Treaty Case.

1. In a recent Tax Court case, *Toulouse v. Commissioner*, 157 T.C. No. 4 (Aug. 16, 2021), an individual who is a U.S. citizen ("Petitioner"), but resident in a foreign country, filed a Federal income tax return for 2013 claiming a carryover of her foreign tax credit ("FTC") for tax that she paid to France and Italy in prior years to offset the net investment income tax under § 1411. Although Petitioner conceded that the Code does not provide a foreign tax credit against the net investment income tax, Petitioner contended that Article 24(2)(a) of the U.S. income tax treaty with France and Article 23(2)(a) of the U.S. income tax treaty with Italy establish independent bases for a credit.

2. The Court found that Petitioner is not entitled to a FTC to offset her net investment income tax under either the U.S. income tax treaty with France or Italy. In its discussion, the Court stated that § 901 clearly provides that FTCs allowable under the Code reduce only tax imposed under chapter 1, such as § 1 regular tax, whereas § 1411 is in chapter 2A, subtitle A. Although the regulations under § 1411 provide that IRC provisions that apply under chapter 1 to determine taxable income also apply to determine the tax imposed by § 1411, the court stated that tax credits are not taken into account in determining taxable income under § 63(a) and, therefore, do not apply against the net investment income tax.

3. Prior to analyzing Petitioner's treaty argument, the Court notes that § 894(a)(1) provides that the Code should be applied taking U.S. treaties into account. The Court then determined that the plain text of the treaties subjects the treaties and any allowable credit to the provisions and limitations of the Code, which does not provide for a credit against § 1411. In addition, the Court stated that the enactment of § 1411 after the execution of these treaties is not determinative as the treaties state that their terms are subject to identical or substantially similar tax imposed after the effective date of each treaty. It further stated that treaties recognize that U.S. tax laws may be subsequently amended and that their purpose is not to provide absolute protection, but to reduce, double taxation (so long as the allowance of a credit is retained).

4. The FTC provisions in the U.S. income tax treaties with France and Italy are the same as the U.S. model tax treaty. However, the language of each treaty would need to be analyzed to determine if it is similar to the treaties analyzed in this case.

D. FTC Practice Unit.

1. The IRS LB&I Division issued a "Concept Unit" entitled "FTC (Business) General Principles." The Practice Unit covers at a very high-level foreign tax credit ("FTC") general principles for corporations, incorporating TCJA changes, including an overview of world-wide taxation, double taxation, and the foreign tax credit limitation. The Practice Unit also provides an overview of taxpayers eligible to claim FTCs, the types of taxes that qualify for the FTC, the § 78 gross-up, choosing between a foreign tax credit and a deduction, and carrybacks and carryforwards of unused credits.

2. The Practice Unit discusses neither the complex limitation rules under § 904 nor the § 962 election for individuals to claim FTCs on § 951 Subpart F income and § 951A GILTI, which it states will be covered by another Practice Unit. It does discuss the direct and indirect tax credit, including that indirect FTCs can be claimed when they relate to (1) Subpart F inclusions under § 951(a)(1)(A), although no foreign income

taxes are deemed paid for a § 956 investment in U.S. property inclusion under § 951(a)(1)(B), (2) distributions from previously taxed earnings and profits, (3) GILTI inclusions under § 951A, and (4) dividends and deemed repatriations under Subpart F, including § 956 and 965, in pre-2018 tax years.

3. The Practice Unit briefly covers § 905 and provides that § 905(c) foreign tax redeterminations related to deemed paid taxes for Subpart F and GILTI will relate back to the tax year associated with the redetermined foreign taxes, although taxpayers may elect to reflect adjustments to CFC taxes for all pre-2018 tax years in the CFCs' last pooling year. The Practice Unit states that, as a result, post-TCJA taxpayers are expected to have an increase in amended tax returns because of § 905(c).

4. In addition, a high level Treasury official stated during a webinar sponsored by the Practicing Law Institute (https://www.taxnotes.com/tax-notes-today-federal/foreign-tax-credit/final-regs-will-keep-ftc-nexus-rule-clarifications/2021/09/03/7834y) that Treasury and the IRS are targeting year-end 2021 to finalize certain portions of the proposed FTC regulations discussed in Section VI. These proposed changes, including the jurisdictional nexus rule, would affect the discussion in this FTC Practice Unit.

E. GILTI Practice Unit.

1. The IRS LB&I released a new Practice Unit on Global Intangible Low-Taxed Income.

2. The Practice Unit provides a good general overview of how the GILTI rules work and compares the GILTI rules to the Subpart F rules. For example, both GILTI and Subpart F income are included in a U.S. shareholder's gross income currently, and taxpayers may claim foreign tax credits ("FTCs") with respect to both subpart F income and GILTI. Domestic corporations are deemed to have paid 80% of the foreign income taxes attributable to the GILTI inclusion. The FTC limitation is generally computed separately for GILTI, and unused credits in the GILTI category may not be carried back or forward (i.e., credits not used in the current year are permanently lost).

3. The Practice Unit then outlines who is subject to GILTI - U.S. shareholders who directly or indirectly own 10% or more of the vote or value of the stock of a CFC - and then explains how the GILTI formula works and the computation. In computing GILTI the Practice Unit explains how to calculate tested income / loss and qualified Business Asset Investment ("QBAI").

4. In computing GILTI the Practice Unity explains that specified interest expense is a U.S. shareholder-level item. It is the excess of the aggregate of the U.S. shareholder's pro rata share of each CFC's tested interest expense over the aggregate of the U.S. shareholder's pro rata share of each CFC's tested interest income. Tested interest expense is interest expense that is included in the deductions properly allocable to gross tested income. The Practice Unit notes that the final regulations reduce the tested interest expense of a tested loss CFC by an amount equal to the notional return on the QBAI that the tested loss CFC would have if the CFC were instead a tested income CFC.

5. The Practice Unity then describes the GILTI inclusion. A U.S. shareholder of a CFC that owns stock of the CFC within the meaning of IRC 958(a) must include in gross income its GILTI for the taxable year. The GILTI inclusion is treated as an amount included under Subpart F for certain provisions of the Code, including: previously-taxed earnings and profits ("PTEP") (IRC 959), basis adjustments (IRC 961), IRC 962 elections, IRC 1248(b)(1) and (d)(1), and the six-year statute of limitations rule under IRC 6501(e)(1)(C). There is also authority to extend to other Code sections by regulation.

6. The allocation of GILTI among CFCs is then discussed. If a CFC has no tested income, the amount allocated is zero, and If a CFC has tested income, a proportionate amount is allocated based on the relative tested income. The amount of GILTI allocated to a particular CFC is relevant in determining PTEP and basis adjustments with respect to the CFC.

7. The Practice Unit notes that the final regulations generally adopt a "single U.S. entity" approach for consolidated group. The consolidated group aggregates the pro rata shares of QBAI, tested loss, and specified interest expense of each consolidated group member. A portion of each consolidated CFC tested item is allocated back to each member based on the member's GILTI allocation ratio, which equals the ratio of the member's aggregate pro rata share of tested income to consolidated tested income.

8. The GILTI anti-abuse rules are discussed including temporarily-held specific tangible property and the disqualified basis rules for certain asset transfers.

9. The Practice Unit then discusses the implications for corporate U.S. shareholders. The GILTI inclusion is generally taxed at an effective rate of 10.5% (13.125% beginning in 2026) because corporate U.S. shareholders are generally entitled to a deduction equal to 50% (37.5% beginning in 2026) of the GILTI inclusion. Corporate U.S. shareholders are deemed to have paid 80% of the foreign income taxes paid or accrued by the CFC with respect to the CFC's tested income that results in the U.S.

shareholder's GILTI inclusion. However, the related IRC 78 "gross up" includes 100% of the taxes deemed paid with respect to GILTI.

10. There is also a comprehensive GILTI example in the Practice Unit with four CFCs with different amounts of gross taxable income, tangible property, deductions and tested interest expense. The example describes how to calculate net CFC tested income, how to calculate the net DTIR (deemed tangible income return), how to calculate the GILTI inclusions, and how to allocate the GILTI among the CFCs.

F. Interesting § 987 Practice Unit.

1. The IRS LB&I released a new Practice Unit on Global Intangible Low-Taxed Income.

2. The IRS LB&I Division issued a "Concept Unit" entitled "Overview of IRC 987 and Branch Operations in a Foreign Currency." For such an incredibly complex area as § 987 is proposed to be under the Treasury and the IRS's regulations, the Practice Unit contains only 11 pages of text and charts.

3. Most interestingly, the Practice Unit states there are several methodologies used by taxpayers to comply with the requirements under IRC 987. It states that some of the most common methods are:

   (a) The methodology set forth in the 1991 proposed regulations;

   (b) The "earnings only" variation in the 1991 proposed regulations;

   (c) The methodology set forth in the 2006 proposed regulations; and

   (d) The methodology set forth in the 2016 final regulations.

4. Anyone who has ever tried to comprehend complying with the methodologies and the various iterations of the methodologies under the proposed and suspended final regulations would find this chart interesting. The very issues under those various iterations of the rules is what has caused the problem. We've wondered what the National Office would tell its examining agents. Perhaps the solution to the difficulties Treasury and the IRS have had regarding these widely criticized iterations of the rules would be to simplify them as they are stated in the Practice Unit.

5. The Practice Unit also discusses the rules requiring a deferral of certain § 987 exchange gains or losses under Treas. Reg. § 1.987-12 which was finalized in 2019 and which was not a part of the § 987 rules that since have been suspended/deferred. These rules defer § 987 losses when there is a continuity of ownership of the qualified business unit within a single controlled group in certain cases.

6. History of § 987 Regulations.

(a) While not fully discussed in the Practice Unit, the § 987 regulations' history starts with the 1986 Tax Act and a 1991 set of proposed regulations that Treasury and the IRS decided later that they didn't like. Then came a new set of 2006 proposed regulations. They, too, largely ended up on the scrap pile, although some significant portions of those regulations seem to have survived a 2016 purge and have some continuing vitality. It's been a tumultuous 35-year history so far and it appears that we soon might have § 987 regulations that nobody seems to like. Treasury itself even put them on the Executive Order 13789 President's list of problematic regulations that resulted in undue financial burden and/or undue complexity but so far without any announced improvements. Treasury and the IRS subsequently suspended the operation of these regulations until taxable years beginning January 1, 2022 for calendar year taxpayers. See Notice 2020-73, which the Practice Unit does not even cite.

(b) On December 8, 2016, Treasury and the IRS issued Treasury Decision 9794 (the "2016 final regulations"). These regulations contain rules relating to the determination of the taxable income or loss of a taxpayer regarding a § 987 QBU, as well as to the timing, amount, character, and source of any § 987 gain or loss and other provisions. Treasury and the IRS also published Treasury Decision 9795 (the "temporary § 987 regulations") on that date as well as a notice of proposed rulemaking by cross-reference to those temporary regulations.

(c) On October 16, 2017, Treasury and the IRS issued Notice 2017-57, 2017-42 I.R.B. 325, announcing that future guidance would defer the applicability dates of Temp. Treas. Reg. §§ 1.987-2T, 1.987-4T, and 1.987-7T and certain other provisions of the 2016 final regulations and temporary § 987 regulations by one year (generally to 2019 for calendar year taxpayers). The temporary § 987 regulations provide that these sections apply to taxable years beginning on or after the day that is one year after the first day of the first taxable year following December 7, 2016. See Temp. Treas. Reg. §§ 1.987-2T(e), 1.987-4T(h), 1.987-7T(d).

(d) On June 25, 2018, Treasury and the IRS published Notice 2018-57, 2018-26 IRB 774, announcing that future guidance would defer the applicability dates of Temp. Treas. Reg. §§ 1.987-2T, 1.987-4T, and 1.987-7T and certain other provisions of the 2016 final regulations and temporary § 987 regulations by one additional year (generally to 2020 for calendar year taxpayers).

(e) New 2019 § 987 regulations finalized Temp. Treas. Reg. §§ 1.987-2T and 1.987-4T, relating to combinations and separations of QBUs, and Temp. Treas. Reg. § 1.987-12T, which requires deferral of foreign currency gain or loss under § 987 in certain transactions defined as deferral events or outbound loss events--transactions that generally include QBU terminations and certain partnerships transactions. Treasury and the IRS also withdrew Temp. Treas. Reg. § 1.987-7T, which provides a liquidation value percentage methodology for allocating assets and liabilities of certain partnerships (§ 987 aggregate partnerships, as defined in Treas. Reg. § 1.987-1(b)(5) of the 2016 final regulations).

(f) The temporary § 987 regulations also include the following rules that were not addressed in the new 2019 regulation: an annual deemed termination election for a § 987 QBU; an elective method, available to taxpayers that make the annual deemed termination election, for translating all items of income or loss regarding a § 987 QBU at the yearly average exchange rate; rules regarding the treatment of § 988 transactions of a § 987 QBU; rules regarding QBUs with the U.S. dollar as their functional currency; rules regarding the translation of income used to pay creditable foreign income taxes; and rules under § 988 regarding the deferral of certain § 988 loss that arises with respect to related-party loans. These regulations remain in their temporary and proposed form.

7. Back to the Future: 2022.

(a) As noted above, Notice 2020-73 further suspended the operation of these regulations. They now are scheduled to become effective in 2022 for calendar year taxpayers. Thus, as noted above, the § 987 regulations that nobody seems to like soon will become effective, at least, unless there's a further deferral of their effective date.

(b) When (and if) they do become effective, the § 987 Practice Unit will need to be expanded to 50-100 (or more) pages to illustrate all of the complex new rules. It will be a set of rules that taxpayers will have great difficulty in applying to potentially thousands of transactions (if they even can), as numerous commentors have stated, and that IRS examiners will have great difficulty in applying to potentially thousands of transactions during audits (if they even can). We call this a regulation that's "compliance proof" (it's so complicated that taxpayers cannot comply) and "audit proof" (it's so complex that IRS examining agents cannot audit what taxpayers do or don't do).

G. FDII Practice Unit.

1. The IRS LB&I Division also issued a "Concept Unit" entitled "IRC Section 250 Deduction: Foreign-Derived Intangible Income ("FDII")."

2. This practice unit is short at 20 pages and predominantly summarizes how FDII is calculated, including a single example. The FDII Concept Unit only mentions that the § 250 deduction is subject to a taxable income limitation, but does not provide any additional information with respect to the limitation. This may be because the IRS and Treasury reserved on the issue of ordering of deductions and income limitations for purposes of calculating the taxable income limitation.

3. The FDII Practice Unit begins by providing that "the [§] 250 deductions helps neutralize the role that tax considerations play when a domestic corporation chooses the location of intangible income attributable to foreign-market activity." It also provides that the FDII deduction "comes down to two basic questions:" (1) what is the intangible income a domestic corporation is deemed to produce? and (2) what part of this intangible income is foreign derived? After summarizing the basic calculation of the § 250 deduction (i.e., 50% of GILTI and § 78 gross-up plus 37.5% of FDII), the FDII Practice Unit summarizes how to calculate FDII and each of its components (i.e., deduction eligible income ("DEI"), deemed intangible income ("DII"), and foreign-derived deduction eligible income ("FDDEI")), which it states is needed to answer the two basic questions.

4. In describing DEI, the FDII Concept Unit has a summary of the excluded categories of income from DEI: (1) amounts included in gross income under § 951(a)(1) (including § 78 gross up amounts); (2) global intangible low-taxed income ("GILTI") under § 951A (including § 78 gross up amounts); (3) financial services income (as defined in § 904(d)(2)(D) and Treas. Reg. § 1.904-4(e)(1)(ii)); (4) dividends received from a CFC; (5) domestic oil and gas extraction income; and (6) foreign branch income (as defined in § 904(d)(2)(J)). The FDII Practice Unit also provides a very basic summary of FDDEI sales and FDDEI services, but does otherwise mention the many nuances present in the final regulations to determine whether income qualifies as from FDDEI sales or services.

5. The FDDI Practice Unit also briefly addresses how foreign tax credits relate to FDII, stating that they are not part of the FDII computation, but makes some related observations. First, it notes that FDII eligible sales and services gross income, which is also foreign source, is typically included in the general category of income for purposes of Form 1118. It also states that the FDII deduction amount allocated and apportioned to foreign source income entered on Form 1118 may not tie to the FDII deduction reported on Form 8993, because the deductions may be

allocated to FDII eligible income that is U.S. source for FTC purposes. Moreover, it provides that foreign source income for Form 1118 purposes is not the same as foreign derived income for FDII. It also states that it is possible for certain income to receive a deduction under § 250 as well as an FTC.

6. In addition, the FDII Practice Unit addresses the timeline of the proposed and final regulations, including that the final § 250 regulations apply to tax years beginning on or after January 1, 2021 and that for tax years beginning before 2021 taxpayers have three choices: (1) to rely on the proposed regulations in their entirety (but taxpayers may rely on the special transition rule for documentation for all taxable years beginning before 2021), (2) apply the final regulations in their entirety (excluding certain substantiation requirements and once applied, must be applied for all subsequent years), or (3) apply to a reasonable interpretation of the statute.

7. Lastly the FDII Practice Unit analyses a very simple example where the US domestic corporation that manufactures and sells property to unrelated foreign and domestic customers and only has deduction eligible income (i.e., no excluded categories of income). The example assumes a QBAI amount and assumes the amount of deductions allocated to income from each type of customer, U.S. customers and foreign customers. The example concludes on the amount of the FDII deduction under § 250 without addressing any potential taxable income limitation.

H. Revised Form 5471

1. We thought we would mention an interesting article by Lewis J. Greenwald, Brainard L. Patton and Brendan Sinnott regarding the highly complex new Form 5471 (Rev. December 2020) and in particular the reporting of previously taxed earnings and profits ("PTEP") on that form. Tax Notes Federal August 2, 2021. The "Instructions for Form 5471" were revised in January 2021. PTEP and the new form can present complex recordkeeping and reporting issues that in their view are unnecessary in many cases. The article proposes an interesting solution.

2. They describe the Revised Form 5471 as "grossly expanded" and one that could not have been imagined four years ago. Pages and complexity were added, four new schedules must be completed and Schedule G "Other Information" was expanded from 8 to 22 questions with a new line 19 that leads to 22 additional questions.

3. Their focus, in particular, is on the reporting of PTEP. While PTEP reporting became more complex under the Tax Cuts and Jobs Act, they state that virtually all CFC E&P is now PTEP. Finally, the proposed § 960 regulations provided for 10 possible PTEP groups (expanded to 16 under

Notice 2019-1) which later were effectively reduced to five groups. These groups are relevant for foreign tax credit purposes and the § 986(c) foreign currency rules.

4. Messrs. Greenwald, Patton and Sinnott state that the possible availability of an additional foreign tax credit has no relevance or benefit if the CFC making the PTEP distribution has no CFC subsidiaries making § 959(b) distributions or the U.S. shareholder is an individual. Accordingly, they suggest that the reporting requirements could be made much simpler if Treasury and the IRS were to provide for an annual election to forego the benefit of any additional deemed paid credits under § 960(b)

IX. INTERESTING RECENT IRS LETTER RULINGS.

A. Section 367 Successor Ruling.

1. The IRS ruled in PLR 202110014 that a subsequent transfer of shares of Transferee Foreign Corporation Stock ("TFC Stock") will not constitute a triggering event as long the successors enter into a new gain recognition agreement ("GRA") and the period of limitations is extended.

2. Originally, the U.S. shareholder ("X") transferred stock of a domestic corporation to a foreign corporation ("Transferee Foreign Corporation" or "TFC") in exchange for TFC Stock in a § 354 outbound transfer and timely entered into a GRA pursuant to Treas. Reg. §§ 1.367(a) - 3(c)(1) and 1.367(a)-8.

3. X then transferred shares of TFC Stock to a grantor trust. That transfer did not constitute a disposition under § 367 since for federal income tax purposes the X continued to be the owner of the TFC Stock.

4. X then died resulting in, for federal income tax purposes, the trust becoming a non-grantor trust and a deemed transfer of the TFC Stock from the grantor trust to the non-grantor trust. Z, a U.S. citizen, is the current trustee of the non-grantor trust.

5. Pursuant to the X's will, and with respect to shares not owned by the grantor trust, Z will receive some of X's shares of TFC Stock and a non-resident alien individual ("NRA") will receive X's other shares of TFC Stock.

6. In general, gain subject to a GRA is triggered and recognized under Treas. Reg. § 1.367(a)-8(j)(7) if an individual U.S. transferor dies. <u>However, the death of a U.S. transferor will not constitute a triggering event if a ruling is obtained from the IRS providing for one or more successors</u>. Treas. Reg. § 1.367(a)-8(k)(9)(iii).

7. The ruling states that if Z enters into a new GRA that replaces the Existing GRA pursuant to Treas. Reg. § 1.367(a)-8(c)(5), and extends the period of limitations on assessments of tax on the outbound transfer pursuant to Treas. Reg. § 1.367(a)-8(f)(2), then Z will be treated, under Treas. Reg. § 1.367(a)-8(k)(9)(iii), as a successor to X under the Existing GRA. As a result, the ruling concludes that the death of X, and the transfers of TFC Stock to the non-grantor trust, NRA and Z will not constitute triggering events (within the meaning of Treas. Reg. § 1.367(a)-8(j)) with respect to the Existing GRA.

B. Foreign Use of DCL PLR.

1. In PLR 202110015 the IRS ruled that there was not a foreign use for purposes of the dual consolidated loss ("DCL") rules solely as a result of an item of deduction of loss attributable to a timing difference liability.

2. In the ruling a domestic Parent wholly owns a domestic disregarded LLC (USDE) that wholly owns a foreign corporation, F-1. F-1 and Parent own a Country B controlled foreign corporation, F-2.

3. Almost all of F-2's assets are used or held for use in F-2's trade or business operations, and the assets are located in Country B. F-2 is subject to Country B corporate income tax and files a Country B corporate income tax return.

4. The ruling applies in the context of a proposed transaction with four steps.

5. In Step 1 Parent will transfer to F-1 all its economic rights and obligations in F-2 for cash but retain legal title to the equity for certain legal purposes.

6. In Step 2, USDE will make an entity classification election to be treated as a corporation for U.S. federal income tax purposes (and become "US-1").

7. In Step 3, F-2 will make an entity classification election to be treated as a disregarded entity for U.S. federal income tax purposes (and become "FDE").

8. Then, in Step 4, F-1 will transfer to US-1 its equity interest in FDE and the beneficial rights and obligations that it holds in FDE, in exchange for cash.

9. Parent made a number of representations in the ruling.

10. The first representation is that Step 1 will be treated as the transfer of the benefits and burdens of the ownership and that thereafter F-1 will be treated as the sole owner of all of the equity interests in F-2.

11. As a result of USDE's entity classification election in Step 2 (with the entity becoming US-1), Parent will be treated as contributing all of the

assets and liabilities of USDE to US-1 in exchange for stock of US-1 immediately before the close of the day before.

12. F-2's entity classification election in Step 3 will cause F-2 to be treated as distributing all of its assets and liabilities to F-1 in liquidation of F-2 immediately before the close of the day before (with F-2 becoming FDE).

13. As a result of F-1's transfer of its equity interests in FDE to US-1 in exchange for cash in Step 4, US-1 will be treated as acquiring all the assets of FDE and assuming all of FDE's liabilities. US-1's adjusted basis in the assets acquired in Step 4 will not be determined in whole, or in part, by reference to the adjusted basis of such transferred assets in the hands of F-1.

14. US-1's interest in FDE will be a Country B hybrid entity separate unit (the "HESU") and FDE's business operations in Country B will be a foreign branch separate unit (the "FBSU"). The HESU and the FBSU will become part of Parent's existing Country B combined separate unit.

15. Parent anticipates that its Country B combined separate unit will incur a DCL and intends to file a domestic use election.

16. Parent expects that certain Country B DCLs will consist of U.S. tax items of deduction or loss attributable to one or more liabilities assumed by US-1 in Step 4, and that (i) all or a portion of these U.S. tax items of deduction or loss will correspond to items of deduction or loss under Country B income tax law attributable to these liabilities, and (ii) all or a portion of the Country B income tax items were made available under the income tax laws of Country B to offset or reduce, directly or indirectly, an item that is recognized as income or gain of FDE under Country B income tax law for a taxable year that includes a day on which, for U.S. federal income tax purposes, FDE was classified as a foreign corporation, i.e., as F-2. These liabilities are termed "Timing Difference Liabilities."

17. The Timing Difference Liabilities were incurred in the ordinary course of F-2's trade or business. The Timing Difference Liabilities have not created, and will not create, items of deduction or loss under the tax laws of any country other than Country B and the U.S.

18. The ruling concluded that a foreign use will not be considered to occur with respect to a Country B DCL solely as a result of an item of deduction or loss attributable to the Timing Difference Liabilities.

C. BEAT Ruling.

1. In the first IRS ruling on BEAT (the Base Erosion and Anti-Abuse Tax), PLR 202109001, the IRS ruled that an assumption reinsurance transaction

between a U.S. corporation and a foreign affiliate did not create a BEATable base erosion payment.

2. An assumption reinsurance transaction changes one of the parties to the arrangement by relieving the original insurer of its obligations and allowing the obligations of the original insurer under the existing policies to be assumed by the reinsurer.

3. Under § 59A(d)(3), base erosion payments include any premium or other consideration paid or accrued to a foreign person that is a related party for any reinsurance payments that are taken into account under §§ 803(a)(1)(B) or 832(b)(4)(A).

4. Under the assumption reinsurance transaction one related foreign party was substituted for a different related foreign party as the counter-party. The transaction is treated as resulting in a sale by between the two related foreign parties. As a result, any amount paid or accrued on the reinsurance transaction occurred between the two related foreign parties.

5. The ruling stated that the change in the counterparty under a contract does not always result in a deemed termination of the contract and cited Rev. Rul. 82-122, 1982-1 C.B. 80. The transaction does not result in a deduction under § 832(b)(4)(A) from the amount of gross premiums written on insurance contracts during the taxable year for premiums paid for reinsurance and does not alter the dates the reissuance premiums were paid.

6. The IRS concluded that the assumption reinsurance transaction would not affect the taxpayer's liability under § 59A and that the taxpayer would not be treated as making a base erosion payment. However, any future amounts paid or accrued by the taxpayer pursuant to the reinsurance agreements could be BEATable.

D. Entity Classification.

1. The IRS held in AM 2021-002 (April 2, 2021) that a foreign eligible entity whose classification had never been relevant as defined in Treas. Reg. § 301.7701-3(d)(1) has a federal classification pursuant to the entity classification rules during the period in which its classification was not relevant. The Memorandum also states that Treas. Reg. § 301.7701-3(c)(1)(iv) does not apply if that foreign entity elects to change its classification after it becomes relevant for US tax purposes. That section prohibits an entity that makes an election to change its classification from making another election to change its classification during the 60 months following the effective date of the first election.

2. The Memorandum discusses two fact patterns:

(a) Situation 1. On date 1, S1 and S2, each a nonresident alien individual, form X, a foreign business entity that is eligible to make an entity classification election. On date 2, S1 acquires all of S2's interest in X and becomes the sole owner of X. On date 3, S1 becomes a US citizen. On date 4, X makes a valid election, effective on date 3, to be classified as an association. Before date 3, the classification of X was not relevant for US tax purposes. Neither S1 nor S2 has limited liability with respect to X at any time during their ownership.

(b) Situation 2. The facts are the same as in Situation 1, except that S1 does not become a US citizen and the classification of X is never relevant for US tax purposes under the entity classification elections.

3. In Situation 1, the classification of X is relevant for US tax purposes on date 3 because the classification affects the federal tax or information reporting liability of S1 as of that date. Treas. Reg. § 301.7701-3(d)(2) applies to initially determine X's default classification on date 3. The default classification of X is a partnership on date 1 and through to the end of the day before date 2 and a disregarded entity on date 2 and through to the end of the day before date 3. Pursuant to its classification election, X is treated as an association as of date 3.

4. X's classification election is treated for purposes of Treas. Reg. § 301.7701-3(c)(1)(iv) as though it were effective on the date that X was formed and, therefore, that regulation does not preclude X from making an election to change its classification within 60 months after date 3.

5. In Situation 2, the classification of X is never relevant for US tax purposes as defined in Treas. Reg. § 301.7701-3(d)(1)(i). However, as a result of the entity classification election and pursuant to Treas. Reg. § 301.7701-3(d)(1)(ii), the classification of X is deemed to be relevant for US tax purposes on date 3. As a result, X's entity classification is initially determined on that date. Consequently, the conclusion in Situation 2 is the same as in Situation 1: X is classified as a partnership on date 1 and through to the end of the day before date 2; X is classified as a disregarded entity on date 2 and through to the end of the day before date 3; X is classified as an association as of date 3; and the 60-month limitation rule does not apply as a result of the election effective on date 3.

E. Entity Election Not Rescindable.

1. In LTR 202123001, a foreign limited liability entity ("X") previously had elected to be treated as a partnership effective on Date 2. In the subject ruling request, X sought relief to make a late entity classification election to be treated as a corporation also effective on Date 2 in hopes of

effectively reverting to its original classification, as though it had never elected to be a partnership.

2. In an unfavorable ruling the IRS stated that X is not permitted to change its entity classification to be treated as a corporation effective on Date 2 because that would be a change of classification within 60 months of X's previous change in classification. X argued that the change would not be one made during the 60 months *succeeding* the effective date of the unwanted election because it would be an election effective on the date of the unwanted election.

3. The Service stated that the taxpayer's suggestion that there can be two elections made on the same day is incompatible with Treas. Reg. § 301.7701-3(g)(3)(i) which provides that a change of classification occurs at the start of the day for which the election is effective, with the corresponding deemed liquidation occurring immediately before the close of the day before. The Service also stated that such an election would be tantamount to a revocation of the original election. Revocation of an election is not an election contemplated or permitted under the entity characterization regulations.

4. The ruling also states that though X's request was made in the form of a late election, in substance X was seeking a ruling permitting a rescission of the deemed transaction that occurred in a prior year. Using an overlapping election to rescind the transaction is different from making a second election and is not provided for in the entity characterization regulations. The ruling further states that a rescission, in general, would raise other considerations, citing Rev. Rul. 80-58, 1980-1 C.B. 181 (the annual accounting period principle precludes rescission of a transaction completed in a prior year).

F. Inbound Reorganization.

1. LTR 202118004 describes a foreign parent company that owns a number of foreign and U.S. subsidiaries. One of the foreign subsidiaries, FS-2, owns a domestic parent company ("P"). P in turn owns a large group of U.S. companies and files U.S. consolidated federal income tax returns. The goal of the restructuring appears to be to separate the businesses by having different foreign holding companies own certain businesses.

2. P will distribute various of its domestic subsidiaries to FS-2 which then will restructure the ownership by selling the stock of the distributed company to a foreign related party or otherwise. There were a significant number of distributions. The Service ruled that the distributions would qualify as tax-free distributions under §§ 355 and 368(a)(1)(D).

3. Not only are the restructurings interesting, but the speed with which the letter ruling issued is also perhaps notable: it took only six months from filing of the ruling request to the issuance of the ruling. To the Service's credit the whole process took place during the pandemic.

G. FTC Election Change.

1. On August 20, the IRS released CCA 202133013 addressing amending the foreign tax credit ("FTC") election, the statute of limitation ("SOL") provisions, and the mitigation provisions in §§ 1311 through 1314.

2. The taxpayer requested advice after the IRS refused to process an amended return to reflect changes in its election to deduct foreign tax paid and instead to claim a foreign tax credit under § 901(a). The IRS rejected the amended returns that reflected U.S. tax deficiencies attributable to reversing out deductions on the grounds that the three-year period of limitations under § 6501(a) had expired. The taxpayer then filed an amended return to claim a refund for the carryover foreign tax credit under § 904(c) but that amended return was not processed by the IRS.

3. Under § 901(a) the taxpayer has the option, for each taxable year, to claim a FTC (subject to the limitations under § 904) or deduct the foreign income taxes under § 164(a)(3). Under § 275(a)(4) these two provisions are mutually exclusive. Section 901(a) further provides that the choice to claim the FTC "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."

4. Section 6511(a) provides that a claim for credit or refund of an overpayment must be filed within three years from the time the return was filed or two years from when the tax is paid, whichever is later. However, under § 6511(d)(3), if the refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country for which a credit is allowed under § 901, the taxpayer has ten 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. Treas. Reg. § 1.901-1(d) provides that a taxpayer can claim the benefits of § 901 at any time before the expiration of the period prescribed by § 6511(d)(3)(A).

5. The CCA stated that the taxpayer's election to claim § 901(a) FTCs in lieu of foreign tax deductions was timely made and that the taxpayer was entitled to change its election and to claim credits since they were within the 10-year period in Treas. Reg. § 1.901-1(d).

6. However, the election change that gave rise to the foreign tax credit carryforward resulting in the overpayment in a later year also gave rise to underpayments in an earlier year as the result of eliminating the

deductions originally claimed for those same foreign tax payments. If assessment and collection of the tax due in the earlier years is time-barred, then taxpayer would retain the benefit of both a deduction and a credit for a single payment of foreign tax. The CCA states that the law does not permit this result.

7. The IRS stated that the law is currently unclear how, under § 275(a)(4), equitable doctrines such as equitable recoupment, or the mitigation provisions under §§ 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. Equitable recoupment is an equitable remedy that precludes a taxpayer from treating one transaction differently from year to year.

8. Proposed regulations address this uncertainty and would amend Treas. Reg. § 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. The effect of treating it as a foreign tax redetermination is that the IRS can 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 § 6501(a) has expired.

9. Sections 1311 through 1314 provide mitigation provisions that can apply when: (1) an error occurred in a taxable year which cannot otherwise be corrected by operation of law; (2) there was a determination for another year with respect to the item giving rise to the error; (3) the determination was within one of the categories enumerated in § 1312 as a circumstance of adjustment; and (4) the party who prevailed in the determination maintained a position that was adopted there and that was inconsistent with the erroneous treatment.

10. The IRS stated that the circumstance of the adjustment would be a double allowance of a deduction or credit under § 1312(2) and that whether the foreign taxes are a deduction or a credit for the same year is an inconsistent position under § 1311(b)(1). The CCA states that since the taxpayer is pursuing a refund, there is a determination which can be used to apply the mitigation provisions allowing the IRS to assess and collect the deficiencies in accordance with § 1314. Alternatively, the IRS may enter into a closing agreement to allow the refund subject to the elimination of the deductions for the same taxes on the earlier year returns and the payment of any resulting deficiencies.

H. <u>Exclusion of Controlled Group Reimbursement From Income</u>.

1. IRS Office of Chief Counsel issued Chief Counsel Advice (CCA) 202132009 (8/13/2021) addressing whether a corporation that is a member of a controlled group that pays a prescription drug fee is per se entitled to

exclude from gross income a reimbursement of all or a portion of the fee from other members of the controlled group who are jointly and severally liable for the fee. The CCA determined that joint and several liability among members of a controlled group does not result in a per se exclusion from the paying member's gross income and that whether the reimbursement is income generally depends on whether the remitting member benefits from the fee payment. In determining whether, and to what extent, the paying member is the beneficiary of payment of the prescription drug fee, the CCA states that several non-dispositive factors must be evaluated.

2. In this CCA the taxpayer is a U.S. corporation that is a member of an affiliated group of U.S. and foreign corporations that develops, manufactures, and distributes medical care products, including branded prescription drugs. The foreign members manufacture the drugs and own all of the intellectual property ("IP") associated with the drugs. The foreign members contact with the U.S. corporation to distribute the drugs in the U.S. and, pursuant to an intercompany agreement, the foreign members license U.S. branding and distribution rights to the U.S. member so it can market and distribute the drugs in the U.S. The U.S. corporation views itself as a limited risk distributer and receives a fixed profit margin from the drug sales, with excess profits or losses beyond a specific operating profit margin being allocated to the foreign members.

3. A domestic law imposes a fee on entities that manufacture or import these types of prescription drugs and that the fee is treated as a nondeductible excise tax under § 275(a)(6). It requires that controlled groups be treated as a single entity with all members being jointly and severally liable for the fee, although only one entity in the group can pay the fee to the U.S. Treasury. Pursuant to an intercompany agreement, the foreign members reimburse the U.S. member for the entire amount of the fee.

4. In its analysis, the CCA points out that the payment of expenses of a taxpayer by another is generally includible in the taxpayer's gross income, but that a taxpayer generally does not have gross income when it is reimbursed for an expense that it paid as an agent or conduit on behalf of the reimbursing party. In addition, the CCA states that a corollary principle is that when a person pays the expenses of a taxpayer to advance the business interests of the payor, the payments are not included in the taxpayer's gross income, notwithstanding any incidental or indirect economic benefit to the taxpayer. Thus, even when a taxpayer is legally obligated to pay a certain expense, reimbursement by another party will generally not be income to the taxpayer when the expense is undertaken for the reimbursing party's own benefit and not for the benefit of the reimbursed party.

5. The CCA provides that in cases in which a taxpayer pays an expense that benefits both the taxpayer and another party, it may be appropriate to treat the reimbursement of a portion of the expense as excludable from the taxpayer's gross income notwithstanding that the taxpayer also benefitted from the overall expense; however, the amount of reimbursement must be commensurate with the reimbursing party's benefit and the taxpayer must not be in the business of receiving compensation for services of the type that are reimbursed.

6. Joint and several liability does not by itself determine the ultimate beneficiary of an expense, although it may be relevant. Instead, multiple factors must be evaluated to determine whether, and to what extent, the U.S. company taxpayer is the beneficiary of the payment of the fee, including: (1) whether the parties intended that the foreign members will bear the economic burden of the fee; (2) whether the U.S. member has an unconditional obligation to remit the amount received by the foreign members as payment of the Fee; (3) whether the U.S. member profits, gains, or benefits from the amount received and remitted; (4) whether the U.S. member claims the amount received as its own; and (5) whether the amount is received by the U.S. member in exchange for services provided by it. The CCA does not make a final determination on whether these factors were present here.

7. The CCA also states that the evaluation of which entity receives the benefits and bears the risks of the activities associated with the fee is relevant to the U.S. member's transfer pricing for the foreign-manufactured drugs and their U.S. branding/distribution rights under § 482 because they are controlled taxpayers.

8. We would think that in the fact pattern at issue, the arm's length rules of § 482 should apply. The U.S. company is a limited risk distributor. There would seem to be no way, dealing at arm's length, that the payment by the U.S. company is anything except a payment on behalf of the foreign members that own the relevant IP and earn the residual profits.

I. Relief for GAP Period Transaction.

1. The IRS released private letter ruling (PLR) 202135006 (9/3/2021) where it granted relief to make a late entity classification election under Treas. Reg. § 301.7701-3 to treat a US corporation's controlled foreign corporation (CFC) as a disregarded entity (check-the-box election) so the group would not run afoul of the § 245A Treasury regulations that were released with a retroactive effective date and would capture an extraordinary disposition transaction undertaken with respect to this CFC. The § 245A Treasury regulations were issued in 2019 with extraordinary disposition rules that retroactively affected transactions taken after the TCJA was enacted and during the period beginning after Dec. 31, 2017

and ending on the last day of the CFC's last tax year beginning before Jan. 1, 2018 when GILTI did not apply (a gap period).

2. In the PLR, the US parent is a publicly traded corporation that owns CFCs, including "FSub" that wholly owns "X." After X is formed, FSub contributed assets to X in exchange for newly issued common and preferred shares that did not qualify for nonrecognition under § 351 and resulted in gain by FSub and an increased basis in the assets for X. Section 245A Treasury regulations were issued after this contribution, but applying to transactions beginning prior to this contribution. These regulations affect the tax treatment of future dividend distributions that FSub may make out of earnings and profits ("E&P") generated from the gain recognized in the contribution. In particular, these regulations were meant to address transactions such as the contribution where the gain would not be treated as Subpart F income and would not have otherwise been taxable in the U.S. during the gap period before § 965 and GILTI applied, but that could result in various benefits from the increase in E&P. One of the benefits prevented by these regulations is being able to utilize the dividends-received deduction under § 245A and the exception to foreign personal holding company income in § 954(c)(6), which can cause a dividend made out of the increased E&P to result in net taxable income or subpart F income.

3. The group requested the PLR to obtain a check-the-box election as of a date between X's formation and the contribution so it would be treated as a disregarded transaction. If X is a disregarded entity, no gain would be recognized on the contribution and X's basis in the assets would not increase. The PLR states that the group represented that its tax advisors did not advise it of the possibility that Treasury regulations issued after the contribution could impact the tax treatment of future dividend distributions made by FSub and of the tax consequences if a check-the-box election were not made. In granting the request, the IRS stated that X represented it was unaware of the negative tax consequences that could result if an election were not made.

J. <u>§ 482 and Stock-Based Compensation</u>.

1. On July 13, 2021 the IRS released AM 2021-004 dealing with § 482 adjustments for cost sharing agreements ("CS Agreements") with reverse claw-back provisions. The guidance was written by the IRS Associate Chief Counsel (International). Thus, even though it is non-precedential, it is clearly meant to set out the IRS's current position on these issues.

2. The memorandum discusses stock-based compensation ("SBC") adjustments post Altera, addressing in particular reverse claw back clauses in intercompany agreements - clauses that call for a true-up payment if the

law changes on whether SBC must be cost-shared. The memorandum addresses three issues:

(a) The appropriate year for the adjustment

(b) Whether an IRS adjustment in an earlier year reduces the outstanding amount of the contractual true-up obligation in the reverse claw-back provision

(c) Whether the IRS can make an adjustment in another year

3. For the first issue the AM concludes that the IRS is entitled to adjust the cost-shared SBC amounts in the year they arose, even if the intercompany agreement calls for a reverse claw-back in a later year. The IRS can make allocations to adjust any intangible development cost ("IDC") to equal the reasonably anticipated benefit ("RAB") share in the year in which the IDCs were incurred.

4. In terms of the second issue, if the IRS adjusts the cost-shared SBC amounts in the year they arose, the reverse claw-back under the agreement may be reduced by the amount of the adjustment.

5. On the third issue, the memorandum states that if the IRS does not adjust the cost-shared SBC amounts in the year they arose (e.g., because the SOL is closed), it may instead adjust the amounts in the later year -- based on the reverse claw-back clause in the intercompany agreement, or "to ensure that the Non-SBC CS Agreement produces results that are consistent with an arm's length result within the meaning of Treas. Reg. § 1.482-1(b)(1)." In addition, if a taxpayer disregards a reverse claw-back clause or modifies it, to defer or remove the obligation, the IRS may make appropriate allocations to "produce results consistent with the unmodified contract or otherwise to reflect an arm's length result."

X. PROPOSED U.S. TAX LEGISLATION.

A. Wyden Senate Proposal.

1. A draft proposed overhaul of the U.S.'s international tax regime was released by Senate Finance Committee Chair Ron Wyden of Oregon and fellow Finance Committee Democrats Sherrod Brown of Ohio and Mark Warner of Virginia. The Wyden Proposal includes changes to the GILTI, BEAT and FDII regimes and changes to the calculation and availability of foreign tax credits.

2. GILTI Changes.

(a) The Wyden Proposal would eliminate the offsets for QBAI and tested losses. It would also turn the GILTI high-tax exception into

a mandatory high-tax exclusion. All "high-taxed tested income" and associated foreign taxes would be removed from the GILTI calculation. A mandatory high-tax exclusion would generally eliminate the ability to cross credit high-taxed foreign income against low-taxed foreign income.

(b) CFC tested income would be considered "high taxed tested income" if the effective foreign tax rate is greater than the GILTI rate. The effective foreign rate would be computed separately for each tested unit of a CFC.

(c) The term "tested unit" would largely be consistent with the current GILTI high-tax exception ("HTE") regulations. A tested unit of a CFC would mean (1) the CFC, (2) an interest held directly or indirectly by the CFC in a pass-through entity that is a tax resident of a foreign country or is treated as a corporation (or otherwise as not fiscally transparent) under the CFC's home-country tax law, and (3) any branch whose activities are carried on directly or indirectly by the CFC and that gives rise to a taxable presence in the country where it is located.

(d) The Wyden Proposal would also include a tested unit combination rule similar to that in the GILTI HTE regulations, but would be slightly broader. All tested units of a CFC that are tax residents of the same foreign country would be treated as a single tested unit. Additionally, if two or more CFCs are members of the same expanded affiliated group, their tested units would combined and treated as a single tested unit, but only for purposes of applying GILTI to U.S. shareholder group members. The "expanded affiliated group" would be as defined under § 1504(a), but substituting "more than 50%" for "at least 80%," and including foreign corporations and insurance companies. Partnerships could not be used to break affiliation. Regulations could also include branch tested units in the combined tested unit concept.

(e) No guidance was provided on the computational aspects of determining the effective foreign rate. It is unclear if it is based on a books and records approach or how to allocate deductions and foreign taxes to different tested units. Similar to the current regulations, it does say that an item is generally assigned to the lowest-tier tested unit.

(f) The Wyden Proposal would specifically provide that tested units with tested losses would be treated as high-taxed. Thus, tested losses would be excluded from the GILTI calculation.

(g) Foreign taxes imposed on high-taxed income could not be credited or deducted. There is a placeholder for timing issues, which could cover NOL carryovers.

(h) There are also changes to the GILTI foreign tax credit ("FTC") under § 960(d). The "haircut" could be between 0 - 20% but the amount is bracketed and thus left as an item for future discussion. Regulations could expand the definition of tested foreign income taxes to include income taxes paid by a U.S. shareholder's foreign parent company on CFC income.

(i) A new Form 5471 reporting requirement would be added to report tested unit gross income, deductions and taxes.

(j) The effective date would be prospective and apply to taxable years of foreign corporations beginning after the date of enactment. This would generally mean 2022 for calendar-year CFCs.

3. Subpart F Changes.

(a) The Subpart F FTC rules would also be updated to make them more closely align with the GILTI rules. An FTC haircut would apply and could be anywhere from 0 - 20%. The discussion draft notes that the FTC haircuts for Subpart F and GILTI could be the same, but that they do not necessarily have to be the same.

(b) The FTC haircut would also be added to FTCs on previously taxed earnings and profits ("PTEP") so that withholding taxes and net income taxes are treated similarly.

(c) As with GILTI, the percentage limitations would not apply for purposes of determining the § 78 gross-up.

(d) Similar to GILTI, the high-tax exception for Subpart F would be mandatory when the effective foreign tax rate is higher than the maximum U.S. corporate rate. The 90% factor would be eliminated. The effective foreign rate would be determined on a CFC-tested unit basis, separately for general and passive basket income.

(e) Thus, the Subpart F high-tax exclusion rules would generally be the same as the rules for the GILTI high-tax exclusion, including the use of the tested unit, the aggregation rules, and the rules for losses. The main difference would be the tax rate used to measure whether income is "high taxed."

(f) These changes would also be prospective only: they would apply to CFC tax years beginning after the date of enactment. This would generally mean 2022 for calendar-year CFCs.

4. High-Tax Foreign Branch Income.

(a) The Wyden Proposal would create a new high-tax exclusion rule for foreign branches in § 139J. Income would be considered high-tax foreign branch income if it is subject to a tax rate greater than the highest U.S. corporate rate or greater than the highest individual rate. High-tax foreign branch income earned by a U.S. corporation would be exempt from tax.

(b) The effective foreign income tax rate would be computed separately for each foreign branch, but an aggregation rule would apply to same-country branches.

(c) The foreign tax credits that are taken into account in determining the effective rate of foreign tax would be potentially subject to a haircut of 0 - 20%, though the amount is still bracketed.

(d) There would be no FTC or deduction for foreign taxes imposed on high-tax foreign branch income. FTCs would also be disallowed for loss branches.

(e) The Wyden Proposal would define a "foreign branch" to mean any branch if (1) its activities are carried on directly or indirectly by the taxpayer; (2) it is not a tested unit of a CFC of the taxpayer; and (3) it gives rise to a taxable presence in its country.

(f) The changes would also be prospective, applying to taxable years beginning after the date of enactment.

5. FDII Changes.

(a) FDII would be retained but would be more of an "innovation box" to incentivize R&D and job-training activities in the U.S. However, there is a concern that it could still be considered an export incentive. The expense allocations and the taxable income limitation, would not change.

(b) The amount of the § 250 deduction would be limited to the "domestic innovation income." Qualified R&D would include expenses allowed as a deduction under § 174 and attributable to activities performed in the U.S. Qualified job training expenses must be incurred for the benefit of non-highly compensated employees.

(c) The new proposals would also correct the perverse effects of the current rules regarding QBAI as a limitation on the FDII deduction.

6. Allocation and Apportionment Relief.

(a) The Wyden Proposal would give taxpayers relief from allocation and apportionment of certain expenses against foreign source income, by providing that all U.S.-conducted R&D expense and all U.S.-based stewardship functions are allocated solely to domestic source income. This is aimed at encouraging multinational companies to retain R&D and headquarters jobs in the U.S.

(b) The Wyden Proposal does not address changes to § 265 to disallow deductions attributable to the tax-exempt portion of GILTI.

7. BEAT.

(a) If SHIELD (stopping harmful inversions and ending low-tax developments) were adopted, BEAT would seem to be unnecessary and it is unclear how the legislation envisions BEAT interacting with SHIELD. We discussed SHIELD in our previous columns (*Tax Notes Int'l*, June 7, 2021, p. 1315 and *Tax Notes Int'l*, July 5, 2021, p. 25).

(b) Nonetheless, the Wyden Proposal would revise the BEAT formula to be more effective in raising revenue from inbound companies. Currently, the BEAT is imposed only if the taxpayer's modified tax liability, determined at a 10% rate without regard to base erosion tax deductions, exceeds the taxpayer's regular tax liability. In the case of an inbound situation, where the U.S. group does not have significant NOLs or foreign tax credits, the formula by its terms allows a significant degree of base erosion through deductible-related party payments. However, a U.S. parented group which makes related party payments to its subsidiaries is more likely to incur a BEAT liability to the extent FTCs reduce regular tax liability.

(c) The Wyden Proposal would change the treatment of credits to permit all of the taxpayer's general business credits to be used, whereas current law only allows 80% of certain general business credits to be used.

(d) Other aspects of the BEAT, such as treatment of NOLs and foreign tax credits, the cliff effect of being an "applicable taxpayer" with 3% base erosion payments, and treatment of COGS, would remain unchanged.

(e) The interaction between the BEAT and GILTI changes could be interesting. High-taxed CFC tested income would be excluded from the U.S. return and since the BEAT does not allow for FTCs, the GILTI change could reduce the BEAT.

B. Ways and Means House Proposal.

1. The House Ways and Means Committee released the tax portion of its reconciliation bill ("WM Proposal"). Similar to the Wyden Proposal, Biden Tax Proposals and the Treasury green book, the WM Proposal includes significant changes to GILTI, BEAT, FDII, and the FTC regime. We discussed these in our previous columns (including *Tax Notes Int'l*, May 3, 2021, p. 597 and *Tax Notes Int'l*, June 7, 2021, p. 1315). The WM Proposal also contains a number of other international tax changes. Most of the provisions would be effective for tax years beginning after December 31, 2021 with some important exceptions noted below.

2. Rate Changes. The WM Proposal would increase the corporate tax rate beginning with taxable years beginning after Dec. 31, 2021 to a graduated rate structure of 18% on the first $400,000 of taxable income, 21% on additional income of up to $5,000,000, and 26.5% on taxable income above $5,000,000. These graduated rates phase out for corporations with more than $10,000,000 in taxable income.

3. FTC Changes.

(a) The WM Proposal would add a new § 901(n) to address foreign tax credit ("FTC") limitations on dual capacity taxpayers, which are U.S. companies that are both subject to levy in, and receive specific economic benefits from, a foreign country or possession of the U.S. To ensure that dual capacity taxpayers cannot claim foreign tax credits for payments that are not deemed to be income taxes, this new subsection would provide that any amount paid by a dual capacity taxpayer to a foreign country would not be considered a tax to the extent it exceeds the generally applicable income tax of that country or if the country does not have an income tax.

(b) The WM Proposal would also add § 904(e) to require that foreign tax credit determinations be made on a country-by-country basis for purposes of §§ 904, 907, and 960. These foreign tax credit computations entail assigning each item of income and loss to a taxable unit of the taxpayer which is a tax resident of a country (or, in the case of a branch, has a taxable presence in such country). Taxable units of the taxpayer are: (1) the person that is the taxpayer, (2) controlled foreign corporations (CFC), (3) interests held by the taxpayer or any CFC in a pass through entity if such

pass-through entity is a tax resident of a country other than the country of the taxpayer or the CFC, and (4) each branch the activities of which are carried on by the taxpayer or any CFC, and which give rise to a taxable presence in the country where it is located. The statute would provide that regulations should be issued to address situations when units are residents of multiple countries or no country, on hybrids and PFICs, and on how to assign items of deductions to units.

(c) In addition, the changes to § 904 would repeal the foreign branch income basket.

(d) The changes would also limit the carryforward of excess foreign tax credit limitation to five succeeding taxable years (compared with 10 years under current law) and FTC carryovers would apply to foreign tax credits in the GILTI basket. The carryback of such foreign tax credit limitation would be repealed (compared with 1 year carryback under current law).

(e) Section 245A dividends would be taken into account in applying the FTC limitation because the WM Proposal would strike current § 904(b)(4), but would not be taken into account in allocating interest expense under § 864(e)(3).

(f) Section 904(b) would also be amended to add a new paragraph so that, for the purpose of determining the foreign tax credit limitation with respect to the GILTI basket, the taxpayer's foreign source income is determined by allocating only deductions that are directly allocable to that income (i.e., § 250 deduction). In addition, § 904(b) would be amended so that in the case of any covered asset dispositions, the principle of § 338(h)(16) would apply in determining the source and character of any item for FTC purposes.

(g) Lastly, § 905 would be amended to require notification to the IRS if the taxpayer makes a timely change in its choice to credit or deduct foreign taxes or if there is any change to the amount or treatment of taxes that affects the taxpayer's tax liability. The effective date of these § 905 changes would be 60 days after the enactment of this law.

4. <u>Section 250 Deduction</u>.

(a) The WM Proposal would reduce the § 250 deduction for FDII to 21.875% and for GILTI to 37.5%, which, in combination with the proposed 26.5% corporate income tax rate, would generally result in a 16.5625% GILTI rate and a 20.7% FDII rate. A transition rule

is provided for taxable years that include but do not end on December 31, 2021. In addition, if the § 250 deduction for GILTI or FDII exceeds taxable income, the excess is allowed as a deduction, which will increase the net operating loss for the taxable year.

(b) The WM Proposal also adds three types of income as excluded from deduction eligible income (DEI): (1) income of a kind that would be foreign personal holding company income under § 954(c); (2) inclusions under § 1293 from making a QEF election, and (3) disqualified extraterritorial income.

5. GILTI.

(a) Like the other proposals, the WM Proposal would apply GILTI on a country-by-country basis based on the CFC taxable unit. A CFC taxable unit is defined in new § 904(e)(2)(B), and is similar to the Wyden CFC taxable unit definition. Any reference to a CFC would be treated as a reference to a CFC taxable unit and net CFC tested income, net deemed tangible income return, qualified business asset investment ("QBAI"), and interest expense would all be determined separately on a country-by-country basis.

(b) Calculating GILTI country-by-country would mean that tested losses in one country could not reduce the GILTI inclusion in another country.

(c) The tested unit combination rules in the Wyden Proposal are not addressed in the WM Proposal. It is unclear if this means that, for example, CFCs that are each tax resident in the same foreign country would be treated as separate tested units. That would create a lot of extra work and does not seem right.

(d) Under the current GILTI rules there is no carryover of GILTI tested losses, but that would be changed to provide for a carryover of country-specific net CFC tested loss to the succeeding taxable year.

(e) Under GILTI, QBAI reduces GILTI and taxpayers could exclude 10% of the QBAI. For example, if a company had $100,000 of foreign assets, then its QBAI deduction would be 10% of that amount, or $10,000. The WM Proposal contains a provision that would replace 10% of QBAI with 5% of QBAI. The reduction from 10% to 5% would not apply to CFC taxable units in the territories of the U.S.

(f) Under the current GILTI rules, GILTI FTCs are limited to 80% of their value. The 20% GILTI haircut can result in the GILTI rate

being considerably higher for some taxpayers. Under the WM Proposal, the FTC haircut is reduced from 20% to 5% and to 0% for U.S. territories.

(g) The WM proposal would also retroactively remove the Section 78 gross up.

(h) Section 951A would also be amended to give Treasury and the IRS broad authority to write regulations necessary to prevent the avoidance of GILTI including property transfers and adjustments to basis and earnings and profits.

(i) The WM Proposal also includes foreign oil and gas extraction income and related deductions in the determination of tested income and tested loss.

6. Subpart F.

(a) The WM Proposal contains a new provision that would limit Foreign Base Company Sales and Services Income under §§ 954(d) and (e) to residents of the U.S., passthrough entities, and branches. Thus, Subpart F Foreign Base Company Sales and Services Income would be taxed as GILTI instead of Subpart F unless the transaction directly or indirectly (through a passthrough or branch) involves a U.S. resident. CFC to CFC Foreign Base Company Sales and Services Income transactions would be taxed as GILTI.

(b) The pro rata share of Subpart F income would no longer be determined only on the "last day" of the tax year in which the foreign corporation is a CFC. The pro rata share would also include the shareholder's nontaxed current dividend share. The provision generally would apply prospectively but *retroactively* for distributions occurring after December 31, 2017.

7. Dividends.

(a) The WM Proposal would narrow the § 245A participation exemption by making it available only for CFCs. Currently, it applies to dividends received from a specified 10-percent-owned foreign corporation.

(b) The WM proposal provides a CFC election, where taxpayers can elect to treat the foreign corporation as a CFC. However, this election would subject the U.S. shareholders to GILTI and Subpart F.

(c) In a curious 5-year retroactive re-write of the statute, the WM Proposal would provide broad regulatory authority to deny the participation exemption in certain related-party gap period transactions and related-party stock transfers that reduced a U.S. shareholder's pro rata share of Subpart F or tested income. This authority would apply to distributions made after December 31, 2017.

(d) Section 1059 would be amended to require US shareholders to reduce their basis in CFC stock for CFC dividends paid out of earnings and profits earned, or gain on property acquired, during a disqualified period. The disqualified period is any period when the foreign corporation was not a CFC or did not have U.S. shareholders. This change could increase the cost of foreign acquisitions.

8. BEAT.

(a) The WM Proposal would increase the BEAT rate and make significant changes to the calculation of modified taxable income and inventory costs.

(b) The BEAT rate would be increased from 10% to 12.5% in taxable years beginning after December 31, 2023 and then would increase again to 15% for any taxable year beginning after December 31, 2025.

(c) The term base erosion payments would be amended to include amounts that are required to be capitalized in inventory and inventory which exceed the costs of the property to the foreign related party. A safe harbor would be available to deem base erosion payments attributable to indirect costs of foreign related parties as 20% of the amount paid to the related party.

9. Interest.

(a) The WM Proposal would add a new § 163(n) to limit the interest deduction of certain domestic corporations that are members in an international financial reporting group. This interest limitation would apply only to domestic corporations whose average excess interest expense over interest includible over a three year period exceeds $12,000,000 and would apply in addition to § 163(j) that was added by TCJA. For these purposes, all domestic corporations that are members of the same international financial reporting group would be treated as one domestic corporation. The limitation would not apply to any small business exempted under

§ 163(j)(3), S corporations, real estate investment trusts, and regulated investment companies.

(b) International financial reporting group would be defined as a group of two or more entities if either (1) at least one entity is a foreign corporation engaged in a U.S. trade or business, or (2) at least one entity is a domestic corporation and another entity is a foreign corporation, and these entities are included in the same applicable financial statement. An applicable financial statement is generally defined as a Form 10-K or an audited financial statement prepared under GAAP or IFRS.

(c) The interest deduction limitation for a domestic corporation would be limited to its proportionate share (called an allowable percentage) of 110% of the net interest expense. A domestic corporation's allowable percentage would mean the ratio of such corporation's allocable share of the group's net interest expense over such corporation's reported net interest expense. A domestic corporation's allocable share of the group's net interest expense would be the portion of such expense which bears the same ratio to the total group expense as the corporation's EBITDA bears to the group's total EBITDA. If EBITDA of the international financial reporting group is zero or less there is no limitation under this new section and if EBITDA of the specified domestic corporation is zero or less then the allowable percentage would be zero.

(d) The WM Proposal would also add a new § 163(o), which allows for the disallowed interest expense as a result of §§ 163(j) or (n), whichever imposes the lower limitation, to be carried forward for 5 years. Interest would be treated as a deduction on a first-in, first-out basis.

10. Downward Attribution. The WM Proposal would reinstate § 958(b)(4) to prohibit downward attribution retroactive to December 31, 2017 to fix this legislative glitch.

11. Additional International Provisions. The WM Proposal would repeal the ability of a specified foreign corporation, including a controlled foreign corporation, to elect as its taxable year a taxable year beginning 1 month earlier than the majority U.S. shareholder year by striking § 898(c)(2). As a result, a specified foreign corporation will be required to have its taxable year match its majority U.S. shareholder's taxable year. These changes would apply to taxable years of specified foreign corporations beginning after November 30, 2021.

C. Other Pending Bills.

1. A number of U.S. Senators and House Members (stated to be "over 100") introduced the "No Tax Breaks for Outsourcing Act" (the Bill, numbered S.714 in the Senate). The Bill would require multinational corporations to pay U.S. tax at the same rate on profits earned abroad as they do for U.S. profits. This would appear to be in accord with statements made by President Biden during his 2020 campaign. Biden also indicated that rate would be increased to 28% from 21%, although the Bill does not address the relevant tax rate.

2. The Bill would eliminate the § 250 deductions for global intangible low-tax income (GILTI) and foreign-derived intangible income (FDII) and apply GILTI on a per-country basis. Foreign tax credits would be determined on a per-county basis based on taxable units. The Bill also would eliminate the exemption from tax on the 10% return on tangible investments made oversees. The Subpart F high-tax exception would be repealed.

3. Foreign corporations worth $50 million or more that are managed and controlled in the U.S. would be treated as U.S. entities. The "managed and controlled" rules will consider, under regulations, the executive officers and senior management who exercise day-to-day responsibility for making decisions including strategic, financial and operational policies of the corporation and whether substantially all of those persons are located primarily within the U.S. These rules are to apply to taxable years beginning on or after the date which is two years after the date of enactment whether or not the operative regulations have been issued.

4. The anti-inversion rules would be tightened by deeming certain mergers between U.S. companies and smaller foreign firms to result in U.S. taxpayers, no matter where the new company is headquartered. The combined company would be treated as a domestic corporation if the historic shareholders of the U.S. company own more than 50% of the new entity. If the new entity is managed and controlled in the U.S. and continues to conduct significant business in the U.S., it would be treated as a domestic company regardless of the percentage ownership.

5. The Bill also would disallow interest deductions for U.S. corporations that are part of a multinational corporate group in situations in which a disproportionate share of the worldwide group's debt is located in the U.S. entity.

6. The Bill would eliminate the foreign oil and gas extraction income rules. This income would be treated as Subpart F income.

7. Except as noted otherwise above, the amendments would apply to taxable years beginning after December 31, 2020, i.e., retroactively to the beginning of this year for calendar year taxpayers. Other provisions would apply to taxable years of foreign corporations beginning after December 31, 2020 and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. The inverted company rules would apply to taxable years ending after December 22, 2017.

8. Another bill, the "Stop Tax Haven Abuse Act" ("STHAA," numbered H.R. 1786 in the House) would tighten the base erosion and anti-abuse tax ("BEAT") rules by reducing the threshold amount from $500 million to $100 million. The 3% base erosion percentage for BEAT to apply would be eliminated.

9. STHAA also would repeal the check-the-box rules for most foreign entities. The definition of "Corporation" in § 7701(a)(3) would include "any foreign business entity that (A) has a single owner that does not have limited liability, or (B) has one or more members all of which have limited liability."

10. Detailed country-by-country disclosure would be required regarding revenues, profits, tax, employees, etc., and would be publicly available.

11. Section 954(c)(6), the CFC-to-CFC look through rules, would be repealed.

12. Interest would be due on deferred tax for electing under § 965(h) to pay the § 965 transaction tax in installments, retroactive to the original § 965 inclusion date.

13. Foreign Base Company Oil Related Income would be Subpart F income, and foreign tax credits for dual capacity taxpayers would be materially reduced.

14. The transfer of intangibles to specified partnerships would be taxable under § 367(d)(2). A specified partnership generally is one with a foreign partner.

15. FACTA would be "strengthened" and other "additional measures to combat tax evasion" would be enacted.

D. President Biden's Proposed Legislation.

1. President Biden's "American Jobs Plan" includes proposed changes in the US's international tax rules that are the same as or similar to those that we discussed above.

2. The corporate tax rate would be increased to 28%. The Global Intangible Low-Taxed Income ("GILTI") rules would be "strengthened" and the tax rate on GILTI would be 21%, the Foreign-Derived Intangible Income ("FDII") provisions would be repealed, US Corporations would be prevented from inverting or claiming tax havens as their residence and "tax preferences" for fossil fuels would be eliminated. The primary revenue raisers are the first two proposals (28% tax rate and GILTI).

3. One proposal would replace "ineffective" earnings-stripping provisions, which apparently is targeted at the Base Erosion and Anti-Abuse Tax ("BEAT"). BEAT would be replaced by an "under-taxed payments rule" to bring the US rules more in line with the OECD's Pillar 2.

4. The President's proposals also would eliminate deductions related to offshoring jobs and create tax credits related to onshoring jobs, ramp up corporate tax enforcement and enact a 15% minimum tax on corporate "book income."

5. Significantly, they also propose to "achieve global agreement on a strong corporate minimum tax through multilateral negotiations," which presumably will involve the OECD's Pillar 2. According to the Wall Street Journal on April 6, 2021, "[s]hould the Biden plan be enacted without a global minimum tax, a US address becomes a potential disadvantage, meaning that foreign-owned businesses operating overseas could be significantly more profitable than competitors owned by US companies."

6. The view of Senate Democrats will be important given the 50-50 Democrat-Republican split in that house. The Wall Street Journal (also on April 6, 2021) reported that some moderate Senate Democrats prefer less onerous changes than those proposed by President Biden, although they also would move the US tax system in the same general direction as the Biden plan. For example, some Senate Democrats would prefer a 25% corporate tax rate or to retain the FDII rules.

E. Biden Tax Proposals.

1. Chip Harter III of PwC had some very interesting comments on the Biden Administration's tax proposals at the recent American Bar Association Section of Taxation virtual meeting, as reported by Andrew Velarde in TNT of May 14, 2021 (Doc 2021-19740). He discussed the Administration's non-comments on GILTI's 20% foreign tax "haircut" given to foreign tax credits and how the proposals could result in foreign businesses based outside the U.S. paying tax at a 12.5% global minimum tax rate while U.S. multinationals could face a 26% rate on that same type of income. He also suggested that SHIELD might not make up for revenue lost by BEAT's repeal.

2. The U.S. has proposed 15% as a starting point for OECD negotiations on a global minimum corporate tax regime. This could relate indirectly to the U.S. rate ultimately imposed on foreign source income under the GILTI tax rules as modified by the Biden Administration proposals since there could be a tie in between these two rates. Discussions on a minimum rate previously hoovered around a 12.5% rate. The EU would require a directive concerning a minimum tax rate that all EU members would have to adopt. It would seem not likely that countries such as Ireland would be interested in supporting a 15% rate. The U.S.'s proposed 15% is further discussed below in the "OECD Matters" section.

F. The Administration's Green Book.

1. The Administration's Green Book describing the government's tax proposals was released on May 28, 2021. It does not add much to what was discussed above. It involves nearly all of the proposals discussed above and devotes only 20 pages to them. There is, of course, no proposed statutory language to consider.

2. Most of the Administration's proposals had already been made public (above), but there were some helpful points made. For example, Subpart F and the GILTI high tax exceptions would be repealed, and a separate FTC limitation would need to be computed for each foreign jurisdiction, but these were stated, or were implicit in what was stated, previously. Also, § 338(h)(16) would be extended to the sale of a hybrid entity. *See* generally Andrew Velande's report in the June 7, 2021 issue of Tax Notes International starting at p. 1303.

3. No clarification was stated regarding the GILTI FTC haircut issue. Treasury officials, however, said the haircut will remain.

4. The new international tax rules would generally apply to taxable years beginning after December 31, 2021, including the repeal of FDII.

5. BEAT would be repealed and replaced with SHIELD. Under SHIELD, payments to low-taxed members would be disallowed in their entirety. These rules would apply to taxable years beginning after December 31, 2022.

XI. EU TAX REFORM PLANS.

A. On May 18, 2021, the European Commission issued a communication on "Business Taxation for the 21st Century." The announcements in the communication are expected to translate into actual legislative proposals in the next three years. If implemented they would represent a systemic change to corporate taxation in the EU. The Commission's longer term ambition is to adopt a common set of rules to determine an EU consolidated corporate tax base to be

shared between member states according to a formulary apportionment, although tax rates would still be determined nationally.

B. This type of systemic change could raise a number of U.S. tax issues. For example, one question might involve the U.S.'s foreign tax credit rules, including those still in proposed form. Would such a tax allocated pursuant to formulary apportionment constitute a creditable foreign income tax for U.S. purposes? Additional issues could arise under the Biden Administration's proposed GILTI per country rules. Presumably, such a formulary apportionment would have to be accepted for U.S. tax purposes. Additional questions could arise regarding U.S. income tax treaties. Would revisions to the U.S. treaties with EU countries have to be made to reflect this formulary apportionment? How would competent authority be proceeding work, especially regarding transfer pricing?

C. At the very least, such a proposed set of rules would significantly increase complexity and complicate planning. Other proposals include having the EU move forward with a tax on digital income despite the OECD's discussions regarding Pillar One.

XII. OECD MATTERS.

A. OECD Financial Transactions Guidance.

1. The OECD released important new final guidance on financial transactions which is in the form a new chapter in the OECD transfer pricing guidelines. This is the first final OECD guidelines guidance on the transfer pricing aspects of financial transactions. The OECD had released a discussion draft on July 3, 2018. The discussion draft received more than 75 comments including very good comments by TEI and The Silicon Valley Tax Directors Group (SVTD) raising a number concerns with the discussion draft. It is not clear that the final OECD guidelines fixed all of the problems.

2. The report describes the transfer pricing aspects of financial transactions, including a number of examples. The basic principles of the OECD transfer pricing report were adapted to cover financial transactions including loans, treasury functions, guarantees, cash pooling, captive insurance and hedging. The new guidance reiterates the OECD transfer pricing concept of accurate delineation analyzing risks and functions.

3. Debt Characterization.

(a) The report first discusses whether a purported loan should be regarded as a loan for tax purposes. The report states that particular labels or descriptions assigned to financial transactions do not constrain the transfer pricing analysis.

(b) The report notes that the following economically relevant characteristics may be useful indicators, depending on the facts and circumstances: (1) the presence or absence of a fixed repayment date; (2) the obligation to pay interest; (3) the right to enforce payment of principal and interest; (4) the status of the funder in comparison to regular corporate creditors; (5) the existence of financial covenants and security; (6) the source of interest payments; (7) the ability of the recipient of the funds to obtain loans from unrelated lending institutions; (8) the extent to which the advance is used to acquire capital assets; (9) and the failure of the purported debtor to repay on the due date or to seek a postponement.

(c) While most of these debt factors are similar to the US common law debt factors, some of them are different. For example, under US common law the US the obligation to pay interest is important, but the source of the interest payment is traditionally not a factor. Under US common law, the ability obtain the loan on a similar economical term is a very important factor, but courts typically do not look as much at the extent to which the advanced is used to acquire capital assets.

(d) The report notes that this guidance is not intended to prevent countries from implementing approaches to address the balance of debt and equity funding of an entity and interest deductibility under domestic legislation, nor does it seek to mandate the only approach for determining whether purported debt should be respected as debt.

(e) The report provides an example were a portion of the loan should be treated as equity. Company B receives an advance of funds from related Company C, denominated as a 10 year loan. The example states that assume that, in light of all good-faith financial projections of Company B for the next 10 years, it is clear that Company B would be unable to service the loan. Based on facts and circumstances, it can be concluded that an unrelated party would not be willing to provide the loan to Company B due to its inability to repay. Accordingly, the accurately delineated amount of Company C's loan to Company B for transfer pricing purposes would be a function of the maximum amount that an unrelated lender would have been willing to advance to Company B, and the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow from Company C, including the possibilities of not lending or borrowing any amount.

4. Treasury Function.

(a) The guidelines state that when evaluating the transfer pricing issues related to treasury activities, as with any case, it is important to accurately delineate the actual transactions and determine exactly what functions an entity is carrying on rather than to rely on a general description such as "treasury activities."

(b) In considering the commercial and financial relations between the borrower and lender, and in an analysis of the economically relevant characteristics of the transaction, both perspectives should be taken into account, acknowledging that these perspectives may not align in every case. The guidelines discuss the use of credit ratings. The creditworthiness of the borrower is one of the main factors that independent investors take into account in determining the interest rate.

(c) Different approaches to intragroup loan transfer pricing methods are discussed. The guidelines discuss the Comparable uncontrolled price method (CUP method) to determine arm's length interest rates. The report states that in the absence of comparable uncontrolled transactions, the cost of funds approach could be used as an alternative to price intra-group loans in some circumstances.

(d) The report notes that certain industries rely on economic models to price intra-group loans by constructing an interest rate as a proxy to an arm's length interest rate. In their most common variation, economic models calculate an interest rate through a combination of a risk-free interest rate and a number of premiums associated with different aspects of the loan – e.g. default risk, liquidity risk, expected inflation or maturity. The reliability of economic models' outcomes depends upon the parameters factored into the specific model and the underlying assumptions adopted.

(e) In some circumstances taxpayers may seek to evidence the arm's length rate of interest on an intra-group loan by producing written opinions from independent banks, sometimes referred to as a "bankability" opinion, stating what interest rate the bank would apply were it to make a comparable loan to that particular enterprise. Such an approach would represent a departure from an arm's length approach based on comparability since it is not based on comparison of actual transactions.

(f) The use of a cash pool is popular among multinational enterprises as a way of achieving more efficient cash management. The accurate delineation of cash pooling arrangements would need to

take into account not only the facts and circumstances of the balances transferred but the wider context of the conditions of the pooling arrangement as a whole. The appropriate reward of the cash pool leader will depend on the facts and circumstances, the functions performed, the assets used and the risks assumed in facilitating a cash pooling arrangement. Determining the arm's length interest rates for the cash pool intra-group transactions may be a difficult exercise due to the lack of comparable arrangements between unrelated parties.

(g) As part of the cash pooling arrangement, cross-guarantees and rights of set-off between participants in the cash pool may be required. This raises the question of whether guarantee fees should be payable. Cross-guarantees and set-off rights are a feature of an arrangement which would not occur between independent parties.

(h) Where the centralised treasury function arranges a hedging contract that the operating entity enters into, that centralised function can be seen as providing a service to the operating entity, for which it should receive compensation on arm's length terms. Difficult transfer pricing issues arise if the positions are not matched within the same entity, although the MNE group position is protected.

5. Financial Guarantees.

(a) The accurate delineation of financial guarantees requires initial consideration of the economic benefit arising to the borrower beyond the one that derives from passive association. From the borrower perspective, a financial guarantee may affect the terms of the borrowing. From the perspective of a lender, the consequence of one or more explicit guarantees is that the guarantor(s) are legally committed; the lender's risk would be expected to be reduced by having access to the assets of the guarantor(s) in the event of the borrower's default.

(b) The report states that the CUP method could be used where there are external or internal comparables; independent guarantors providing guarantees in respect of comparable loans to other borrowers or where the same borrower has other comparable loans which are independently guaranteed.

(c) The yield approach quantifies the benefit that the guaranteed party receives from the guarantee in terms of lower interest rates. The method calculates the spread between the interest rate that would have been payable by the borrower without the guarantee and the interest rate payable with the guarantee.

(d) The cost approach method aims to quantify the additional risk borne by the guarantor by estimating the value of the expected loss that the guarantor incurs by providing the guarantee (loss given default). Alternatively, the expected cost could be determined by reference to the capital required to support the risks assumed by the guarantor.

(e) The valuation of expected loss method would estimate the value of a guarantee on the basis of calculating the probability of default and making adjustments to account for the expected recovery rate in the event of default. This would then be applied to the nominal amount guaranteed to arrive at a cost of providing the guarantee. The guarantee could then be priced based on an expected return on this amount of capital based on commercial pricing models such as the Capital Asset Pricing Model (CAPM).

(f) The capital support method may be suitable where the difference between the guarantor's and borrower's risk profiles could be addressed by introducing more capital to the borrower's balance sheet. It would be first necessary to determine the credit rating for the borrower without the guarantee (but with implicit support) and then to identify the amount of additional notional capital required to bring the borrower up to the credit rating of the guarantor. The guarantee could then be priced based on an expected return on this amount of capital to the extent that the expected return so used appropriately reflects only the results or consequences of the provision of the guarantee rather than the overall activities of the guarantor-enterprise.

6. Captive Insurance.

(a) In the guidance, the term captive insurance is intended to refer to an insurance undertaking or entity substantially all of whose insurance business is to provide insurance policies for risks of entities of the group to which it belongs. The principles of accurate delineation of the actual transactions and allocation of risk apply to captive insurance and reinsurance in the same manner that they apply to any other intra-group transactions.

(b) The report states that a frequent concern when considering the transfer pricing of captive insurance transactions is whether the transaction concerned is genuinely one of insurance. The following are indicators, all or substantially all of which would be found if the captive insurance was found to undertake a genuine insurance business:

- there is diversification and pooling of risk in the captive insurance;
- the economic capital position of the entities within the MNE group has improved as a result of diversification and there is therefore a real economic impact for the MNE group as a whole;
- both the captive insurance and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk assumption and appropriate capital levels;
- the insured risk would otherwise be insurable outside the MNE group;
- the captive insurance has the requisite skills, including investment skills, and experience at its disposal;
- the captive insurance has a real possibility of suffering losses.

(c) The report notes that there may be internal comparables if the captive insurance has suitably similar business with unrelated customers, or there may be external comparables. The application of the CUP method to a transaction involving a captive insurance may encounter practical difficulties to determine the need for and quantification of comparability adjustments.

(d) Alternatively, actuarial analysis may be an appropriate method to independently determine the premium likely to be required at arm's length for insurance of a particular risk.

(e) The remuneration of the captive insurance can be arrived at by considering the arm's length profitability of the captive insurance by reference to a two staged approach which takes into account both profitability of claims and return on capital.

(f) Where the captive insurance insures the risk and reinsures it in the open market, it should receive an appropriate reward for the basic services it provides. The remaining group synergy benefit should be allocated among the insured participants by means of discounted premiums.

7. <u>Risk Free and Risk-Adjusted Rates</u>.

(a) If the accurate delineation of the actual transaction shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a

financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain. A risk-free rate of return is the hypothetical return which would be expected on an investment with no risk of loss. Ultimately, there is no investment with zero risk, and the reliability of available proxies for approximating a risk-free rate of return will depend on prevailing facts and circumstances.

(b) The report notes that in determining the risk-adjusted rate, it is important to identify and differentiate the financial risk which is assumed by the funder in carrying on its financing activity, and the operational risk that is assumed by the funded party and is connected to the use of the funds, e.g. for developing an intangible asset.

B. OECD Model Rules for Platform Operators.

1. On July 3, 2020, the OECD published model rules for platform operators to collect data on their sellers and report that information to tax administrations for compliance purposes. The OECD stated that the "sharing" and "gig" economies are growing rapidly and that rules are need to collect information. As a result, the report states that tax administrations may wish to consider adapting the OECD platform operator compliance strategies.

2. The objective is to ensure timely access to high-quality and relevant information on the consideration earned by platform sellers, in order to enhance compliance and minimize compliance burdens. At the same time, the rules also aim to ensure that activities by such sellers do not remain undetected by tax administrations in instances where such sellers do not declare income earned through the platforms. They also promote standardization of reporting rules between jurisdictions and international cooperation. While the primary focus is on facilitating and enhancing compliance with direct tax obligations, the information reported may also have relevance for other domains, such as indirect taxes, local taxes and social security contributions.

3. The Model Rules have three dimensions: (i) a targeted scope of transactions to be reported, focusing on accommodation, transport and other personal services; (ii) a broad scope of platform operators and sellers, to ensure that as many relevant transactions as possible are being reported; and (iii) due diligence and reporting rules that ensure that accurate information gets reported without imposing overly burdensome procedures on platform operators.

4. A broad and generic definition of the term platform covers all software products that are accessible by users and allow sellers to be connected to

other users for the provision of relevant services, including arrangements for the collection of consideration on behalf of sellers.

5. Platform operators are defined as entities that contract with sellers to make available all or part of a platform. There are optional exclusions for small-scale platform operators, in particular targets at start-ups, and platforms that do not allow sellers to derive a profit from the consideration received or that do not have reportable sellers.

6. The scope of sellers covers both entities and individuals, although exclusions are foreseen for hotel businesses, publicly-traded entities and governmental entities.

7. The information required includes the name, address, TIN (including the jurisdiction of issuance) and the seller's date of birth or business registration number.

C. OECD Pillars One and Two. The OECD released important reports discussing tax changes that the OECD has proposed. These changes, if implemented, would materially change the world order from a global tax perspective. One is termed "Pillar One," and the other, "Pillar Two."

1. Pillar One.

(a) The OECD summary states that so-called Pillar One seeks to adapt the international income tax system to new business models through changes to the profit allocation and nexus rules applicable to business profits. Within this context, it would expand the taxing rights of market jurisdictions (which, for some business models, are the jurisdictions where the users are located) where there is an active and sustained participation of a business in the economy of that jurisdiction through activities in, or remotely directed at, that jurisdiction. According to the OECD, Pillar One also aims to improve tax certainty by introducing innovative dispute prevention and resolution mechanisms. Finally, Pillar One seeks to balance the different objectives of the 135 so-called "Inclusive Framework" members and to result in the removal of relevant unilateral measures.

(b) The OECD groups the key elements of Pillar One into three components: a new taxing right for market jurisdictions over a share of residual profit calculated at a multinational enterprise ("MNE") group (or segment) level (Amount A); a fixed return for certain baseline marketing and distribution activities taking place physically in a market jurisdiction, in line with the arm's length principle (Amount B); and processes to improve tax certainty through effective dispute prevention and resolution mechanisms.

Eleven so-called "building blocks" are stated to be essential to the construction of Pillar One.

(c) There are a number of open issues regarding key features of Pillar One that can only be resolved through political decisions. Thus, political decisions are required on a number of issues including the following:

(d) Scope: The Inclusive Framework members tried to bridge the gap between those members seeking to focus Pillar One on a narrow group of "digital" business models and those insisting that the approach should cover a wider scope of activities. As a result, two categories of activities to be included in the scope of the new taxing right created by Pillar One were identified: Automated Digital Services ("ADS") and Consumer Facing Businesses ("CFB"). Political agreement has not been reached on the use of these categories, and the scope of Pillar One has not yet been resolved. In order to deliver an approach in accordance with the G20 mandate, some members have advocated for a phased implementation with ADS coming first and CFB following later. One member proposed implementing the new taxing right on a "safe harbour" basis, which would enable an MNE group to elect on a global basis to be subject to Pillar One. The scope of Amount A remains to be agreed upon.

(e) Amount of profit to be reallocated: Agreement on how much residual profit would be reallocated under the new taxing right, which depends on the determination of different threshold amounts and percentages for the purpose of scope, nexus and profit allocation (the formula), is conditioned on agreement on scope. Some Inclusive Framework members are of the view that, beyond residual profit, a portion of routine profit should also be allocated to market jurisdictions in the case of remote marketing and distribution activities facilitated by digitalization. Other members proposed "differentiation mechanisms" in order to increase the amount of profit allocated to market jurisdictions for certain business activities (for example, ADS), or a scalable allocation depending on the profitability of the business (profit escalator). These variations to the Amount A profit allocation rules proposed by some Inclusive Framework members have not been decided upon.

(f) Extent of tax certainty: While all members have agreed on the need for an innovative solution to deliver early certainty and effective dispute prevention and resolution for Amount A, there continue to be differences of view on the scope of mandatory binding dispute resolution beyond Amount A. The blueprint

contains proposals to bridge these divergent views. A decision on this issue will need to be part of a comprehensive agreement also covering the other two open political issues on amount and scope.

(g) Scope and application of Amount B: While the blueprint contains an outline of a solution that assumes that in-scope distributors are to be identified based on a narrow scope of baseline activities, there is interest by some members to explore the feasibility of broadening the scope of Amount B. Some Inclusive Framework members have expressed the need to further refine the design of Amount B such that the intended simplification benefits are achieved, and further consider that implementation through a pilot program at first might allow for some evaluation of the benefits in practice. The Inclusive Framework members will therefore need to decide how to proceed.

2. Pillar Two.

(a) The OECD states that reforming the international tax system to address the tax challenges arising from the digitalization of the economy has been a priority of the international community for several years, with commitments to deliver a consensus-based solution by the end of 2020.

(b) These tax challenges were first identified as one of the main areas of focus of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, leading to the 2015 BEPS Action 1 Report. The Action 1 Report found that the whole economy was digitalizing and, as a result, it would be difficult, if not impossible, to ring-fence the digital economy. In March 2018, the Inclusive Framework members, working through their Task Force on the Digital Economy, issued Tax Challenges Arising from Digitalisation – Interim Report 2018 which stated the need for a global solution.

(c) Under the Second Pillar, the Inclusive Framework members agreed to explore an approach that is focused on the remaining BEPS challenges and proposes a system designed to ensure that all internationally operating businesses pay a minimum level of tax. In so doing, they believe it helps to address the remaining BEPS challenges linked to the digital economy, where the relative importance of intangible assets as profit drivers makes highly digitalized business often ideally placed to avail themselves of profit shifting planning structures. Pillar Two leaves jurisdictions free to determine their own tax system, including whether they have a corporate income tax and where they set their tax rates, but also considers the right of other jurisdictions to apply the rules

contained in this report where income is taxed at an effective rate below a minimum rate.

(d) Members of the Inclusive Framework believe that any rules developed under this pillar should not result in taxation where there is no economic profit nor should they result in double taxation. Mindful of limiting compliance and administrative burdens, they further believe that the rules should be as simple as the tax policy context permits, including through the exploration of simplification measures.

(e) A public consultation was held on December 9, 2019 that received over 150 written submissions, running to over 1,300 pages submitted by a wide range of businesses, industry groups, law and accounting practitioners, and non-governmental organizations, which provided critical input into the design of many of the aspects of Pillar Two. In January 2020 the Inclusive Framework members issued a progress report on the status of the technical work. The members have progressed the work and the engagement with stakeholders continued through digital channels including through the maintenance of digital contact groups set up at the OECD.

(f) The blueprint for Pillar Two identifies technical design components of Pillar Two. It also identifies those areas linked to implementation and simplification, which would benefit from further stakeholder input, and where further technical work is required prior to finalization. The finalization of Pillar Two also requires political agreement on key design features of the "subject to tax" rule including carve-outs, blending, and tax rates regarding which, at present, diverging views continue to exist.

(g) Pillar Two addresses remaining BEPS challenges and is designed to ensure that large internationally operating businesses pay a minimum level of tax regardless of where they are headquartered or the jurisdictions in which they operate. It does so via a number of interlocking rules that seek to (i) ensure minimum taxation while avoiding double taxation or taxation where there is no economic profit, (ii) cope with different tax system designs by jurisdictions as well as different operating models by businesses, (iii) ensure transparency and a level playing field, and (iv) minimize administrative and compliance costs.

(h) The principal mechanism to achieve this outcome is the income inclusion rule ("IIR") together with the undertaxed payments rule ("UTPR") acting as a backstop. The operation of the IIR is, in some respects, based on traditional controlled foreign company ("CFC") principles and triggers an inclusion at the level of the

shareholder where the income of a controlled foreign entity is taxed at below the effective minimum tax rate. It is complemented by a switch-over rule ("SOR") that removes treaty obstacles from its application to certain branch structures and applies where an income tax treaty otherwise obligates a contracting state to use the exemption method.

(i) The UTPR is a secondary rule and only applies where a constituent entity is not already subject to an IIR. The UTPR serves as back-stop to the IIR, ensures a level playing field and addresses inversion risks that might otherwise arise.

(j) The subject to tax rule ("STTR") complements these rules. It acknowledges that denying treaty benefits for certain deductible intra-group payments made to jurisdictions where those payments are subject to no or low rates of nominal taxation may help source countries to protect their tax base, notably for countries with lower administrative capacities. To ensure tax certainty and avoid double taxation Pillar Two also addresses questions of implementation and effective rule coordination.

(k) Both the IIR and the UTPR use a common tax base. The determination of the base starts with the financial accounts prepared under the accounting standard used by the parent of the multinational group to prepare its consolidated financial statements. This must be IFRS or another acceptable accounting standard. OECD states that the use of financial accounts as a common basis ensures a level playing field for both jurisdictions and MNEs, enhances transparency and leverages off existing systems thereby minimizing compliance cost.

(l) Certain adjustments are then made to the financial accounts to eliminate specific items of income from the tax base, such as intragroup dividends and to incorporate certain expenses, such as tax deductible stock based compensation. This is necessary where the outcomes of the financial accounting rules would otherwise distort the tax policy objectives of Pillar Two.

(m) The IIR and the UTPR also use a common definition of taxes. The definition of taxes, referred to as "covered taxes" is derived from the definition of taxes used for statistical purposes by many international organizations including the OECD, EU, IMF, World Bank and the UN. The definition is deliberately kept broad to avoid legalistic distinctions and accommodate different tax systems provided they substantively impose taxes on an entity's income or profits.

(n) The effective tax rate ("ETR") is determined by applying the tax base and covered taxes on a jurisdictional basis. This requires an assignment of the income and taxes among the jurisdictions in which the MNE operates and to which it pays taxes. The tax computation calculation also includes two important additional adjustments; a mechanism to mitigate the impact of volatility in the ETR from one period to the next and a formulaic substance carve-out.

(o) The mechanism to address volatility is based on the principle that Pillar Two should not impose tax where the low ETR is simply a result of timing differences in the recognition of income or the imposition of taxes. The rules therefore allow an MNE to carry-over losses incurred or excess taxes paid in prior periods into a subsequent period in order to smooth-out any potential volatility arising from such timing differences.

(p) The formulaic substance carve-out excludes a fixed return for substantive activities within a jurisdiction from the scope of the rules. Excluding a fixed return from substantive activities focuses on "excess income," such as intangible-related income, which is most susceptible to BEPS challenges.

(q) If an MNE's jurisdictional ETR is below the agreed minimum rate, the MNE will be liable for an incremental amount of tax that is sufficient to bring the total amount of tax on the excess profits up to the minimum rate. The ETR calculation therefore operates both as a trigger for the imposition of the tax liability and as a measure of the amount of top-up tax imposed under the rules.

(r) This design is intended to provide a level playing field as all MNE's pay a minimum level of tax in each jurisdiction in which they operate while the top up mechanism coupled with the common base makes sure that they face the same level of top-up tax irrespective of where they are based. The amount of top up tax is collected either by application of the IIR, or - where no IIR applies - by the application of the UTPR.

(s) The subject to tax rule (STTR) complements these rules. It is a treaty-based rule that specifically targets risks to source countries posed by BEPS structures relating to intragroup payments that take advantage of low nominal rates of taxation in the other contracting jurisdiction (that is, the jurisdiction of the payee). It allows the source jurisdiction to impose additional taxation on certain covered payments up to the agreed minimum rate. Any top up tax imposed under the STTR will be taken into account in determining the ETR for purposes of the IIR and the UTPR.

3. GILTI Co-Existence.

(a) The United States enacted the Global Intangible Low-Taxed Income ("GILTI") regime in 2017 as part of a substantial reform of the US international tax rules. The GILTI regime, which draws on elements of the BEPS Action 3 Report, provides for a minimum level of tax on the foreign income of an MNE Group. While the GILTI and the proposed new rules as described in the blueprint have a similar purpose and overlapping scope, the design of GILTI differs in a number of important respects.

(b) While GILTI results largely, but not completely, in a global blending of foreign income and taxes, in a number of other respects, the proposed new rules, as described in the blueprint, would be more permissive than GILTI, depending also on their final design. These include the carry-forward of losses and excess taxes, a broader definition of covered taxes and a carve-out based on a broader range of tangible assets and payroll.

(c) Furthermore, GILTI applies without threshold limitations and incorporates expense allocation rules in the calculation of foreign tax credits which can result in effective rates of taxation above the minimum rate.

(d) Given the pre-existing nature of the GILTI regime and its legislative intent there are reasons for treating GILTI as a qualified income inclusion rule for purposes of the proposed new rules provided that the coexistence achieves reasonably equivalent effects. This treatment would need to be reviewed if subsequent legislation or regulations in the US had the effect of materially narrowing the GILTI tax base or reducing the legislated rate of tax. The Inclusive Framework members recognize that an agreement on the co-existence of the GILTI and the proposed new rules would need to be part of the political agreement regarding Pillar Two.

(e) At a technical level, further consideration will be given to how the interactions between the GILTI and the proposed new rules are coordinated. That includes the coordination with the application of the GILTI to US intermediate parent companies of foreign groups headquartered in countries that apply an IIR. Moreover, considering the role of the undertaxed payments rule as a back-stop to the IIR, the Inclusive Framework on BEPS strongly encourages the U.S. to limit the operation of the Base Erosion and Anti-abuse Tax ("BEAT") in respect of payments to entities that are subject to the IIR.

D. G-7, G-20 and Inclusive Framework Agreements.

1. The Finance Ministers of the so-called Group of Seven leading rich nations (the "G-7," consisting of the U.S., Canada, France, Germany, Italy, the U.K. and Japan) committed on June 5, 2021 to the principal design of the OECD's two-pillar approach for international tax reform, including imposing Pillar Two minimum taxes on multinational companies using a 15% tax rate, as proposed by the U.S., thereby ending years of disagreement between the U.S. and Europe on this issue.

2. New taxing rights will be allocated to market jurisdictions of at least 20% of profit exceeding a 10% margin for the "largest and most profitable multinational enterprises" under Pillar One.

3. The G-20 agreed, and nearly all of the 135 Inclusive Framework countries have agreed.

4. As to the U.S., the Wall Street Journal noted on June 7, 2021 that some Democrats might not go along. For example, some have "balked at [the proposed higher corporate tax] rates." Senate Republicans also might be needed if treaties are involved, as those would require a two-thirds vote in the Senate for ratification.

E. Revenue Cost to the U.S.

1. In an interesting June 4, 2021 letter that Treasury Secretary Janet Yellen wrote to Senate Finance Committee Ranking Member Mike Crapo (R-Idaho), she said "Treasury takes seriously the protection of the U.S. fisc" and that "A multilateral agreement at the OECD must not harm U.S. businesses, workers, or tax sovereignty; must recognize Congress's role in setting domestic tax policy; and must safeguard U.S. revenues." *See* Stephanie Soong Johnston's report in Tax Notes Today of June 9, 2021.

2. Yellen further stated that "Our Pillar 1 comprehensive scope proposal will be largely revenue neutral for the United States since we will be on both the receiving and giving end of the proposed profit allocations …. Indeed, one interesting feature of Pillar 1 estimates is that they demonstrate the extent to which both U.S.- and foreign-headquartered corporations have managed to shift profits derived from sales to U.S. customers outside the United States for years, including under the 2017 [TCJA]." Emphasis added.

3. The other G-20 countries and the 135 Inclusive Framework countries expect that they will get a larger share of U.S. multinational corporations' profits to tax under Pillars 1 and 2 (viewing both together). This likely will happen. Yellen's comment might assume that because of GILTI's foreign tax credit rules, the additional cost will be borne by U.S.-based multinational corporations, not the U.S. government. This obviously

would serve as another disadvantage to a corporation's being U.S.-based. If the U.S. were to allow foreign tax credits for those additional taxes to avoid double taxation for these U.S.-based multinationals, the result would simply be a shifting of U.S. government tax revenues to over 100 foreign countries.

4. If countries seek to apply Pillar 1 to U.S.-based multinationals directly, rather than through a subsidiary of the U.S. parent company, direct tax and an unlimited foreign tax credit would result (subject to § 904). In this case, there would seem to be a shift of U.S. tax revenue to those 100+ other countries involved.

5. Numerous, complex issues will arise. Who will determine the correctness of the amount taxed by the other countries? It won't be transfer pricing-driven, and arm's length rules won't apply. How will the proposed U.S. foreign tax credit country-by-country rules work? Some of the U.S. parent's income will have to be sourced for U.S. tax purposes to the countries taxing it, and thus new source rules will become necessary. What if multiple jurisdictions try to tax overlapping portions of the U.S. parent companies income? Who decides what to do?

6. In Stephanie Soong Johnston's June 9, 2021 TNT report, she also said that Senate Finance Committee Chair Ron Wyden (D-Ore.) stated it will take at least several months for negotiators to get all countries onboard and finalize the agreement. Johnston added that Congressional Republicans have already made it clear that they are unlikely to support a deal.