KPMG report: Initial analysis of final regulations concerning foreign tax credit

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Introduction

The U.S. Treasury Department and IRS on December 28, 2021, released for publication in the Federal Register **final regulations** [PDF 978 KB] (T.D. 9959, and the "2021 Final Regulations") related primarily to the determination of the foreign tax credit ("FTC") and the allocation and apportionment of deductions (including foreign income taxes) in determining the FTC limitation. The 2021 Final Regulations were published in the Federal Register on January 4, 2022.

This regulation package marks the fourth significant revision of FTC regulations since the enactment of the 2017 U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017, and often referred to as the "Tax Cuts and Jobs Act" or "TCJA") implementing changes to the FTC enacted by the TCJA. (The prior major revisions were published in the Federal Register on December 7, 2018, December 17, 2019, and November 12, 2020). In addition, the 2021 Final Regulations substantially overhaul longstanding FTC regulations involving the determination of creditable foreign income taxes.

The 2021 Final Regulations finalize most aspects of the **proposed regulations** [PDF 615 KB] (REG-101657-20) released on September 29, 2020 and published in the Federal Register on November 12, 2020 (the "2020 Proposed Regulations"), with certain modifications to address the comments received on the 2020 Proposed Regulations. The preamble includes an extensive discussion of these comments, as well as the comments that were rejected in finalizing the regulations. In addition, certain rules contained in the 2020 Proposed Regulations have not yet been finalized and are noted below.

Most significantly, the 2021 Final Regulations finalize FTC-related provisions of the 2020 Proposed Regulations with respect to the determination of foreign income taxes subject to the credit and deduction disallowance provisions of section 245A(d); the allocation and apportionment of foreign income taxes, including taxes imposed with respect to disregarded payments; the definitions of foreign income tax and a tax in lieu of an income tax, including changes to the net gain requirement, the replacement of the jurisdictional nexus rule with an attribution rule contained in the net gain requirement, the treatment of certain tax credits provided under foreign law, the treatment of foreign tax law elections for purposes of the compulsory payment rules, and the substitution requirement under section 903; the allocation of the liability for foreign income taxes in connection with certain mid-year transfers or reorganizations; the foreign branch category rules in Reg. § 1.904-4(f); and the time at which credits for foreign income taxes can be claimed pursuant to sections 901 and 905(a).

The 2021 Final Regulations also finalize the 2020 Proposed Regulations addressing certain miscellaneous aspects of the FTC rules, including the sourcing of inclusions under sections 951, 951A and 1293; the allocation and apportionment of interest deductions of regulated utilities; a revision to the controlled foreign corporation ("CFC") interest netting rules; the characterization of assets for purposes of the allocation and apportionment of interest expense; and the allocation and apportionment of section 818(f) items of life insurance companies that are members of consolidated groups.

Finally, the 2021 Final Regulations finalize proposed rules not directly related to the determination of the FTC that address the determination of oil and gas extraction income from domestic and foreign sources, the meaning of electronically supplied services under the section 250 regulations, and the impact of the repeal of section 902 on certain regulations issued under section 367(b).

The 2020 Proposed Regulations also included rules for an election to capitalize certain expenses in determining the tax book value of assets (Prop. Reg. § 1.861-9(k)), rules requiring the direct allocation of interest expense in the case of certain foreign banking branches (Prop. Reg. § 1.861-10(g)), and rules defining financial services income (Prop. Reg. §§ 1.904-4(e)(1)(ii) and 1.904-5(b)(2)). The U.S. Treasury Department and IRS (collectively, "Treasury") continue to study the comments received in connection

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with these provisions and did not finalize those rules as part of the 2021 Final Regulations.

Contents

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Allocation and apportionment of foreign taxes

General rules for the allocation and apportionment of foreign income taxes

The 2020 Proposed Regulations responded to taxpayer requests for additional guidance on the allocation and apportionment of foreign income tax by providing additional special rules that apply for assigning foreign gross income to a grouping. The 2021 Final Regulations largely adopt the 2020 Proposed Regulations with few substantive changes. These changes include (as discussed in more detail below) (1) revised definitions of "contribution" and "remittance," (2) the addition of a rule to allocate and apportion foreign income taxes related to amounts accrued or received from a U.S. equity hybrid instrument, and (3) an expansion of the assets used to allocate and apportion foreign income taxes related to a remittance.

As finalized by the 2021 Final Regulations, these rules pertain to dispositions of stock and partnership interests, distributions with respect to a partnership interest, and disregarded payments (including foreign law transfers that are not treated as disregarded payments for U.S. federal income tax purposes in the U.S. tax year in which foreign income tax is paid or accrued).

The 2021 Final Regulations introduce several new defined terms that are used to implement these additional special rules. For example, the 2021 Final Regulations add the concept of a "taxable unit" to clarify that the disregarded payment (DRP) rules apply when a disregarded entity is not a qualified business unit ("QBU"). Instead of focusing on payments to or from a "foreign branch," the 2021 Final Regulations provide that the allocation and apportionment rules apply to a broader range of DRPs made to or by a taxable unit. If the taxpayer is an individual or a U.S. corporation, a taxable unit includes a foreign branch, a foreign branch owner, and a "non-branch taxable unit" (as defined below in the discussion of the changes to the foreign branch category income). If the taxpayer is a foreign corporation, a taxable unit is a "tested unit," as defined in the GILTI high-tax exception regulations. See Reg. § 1.951A-2(c)(7)(iv)(A).

Second, proposed regulations published on December 17, 2019 (84 Fed. Reg. 69124) (the "2019 Proposed Regulations") defined "disregarded payment" by reference to the definition in the foreign branch regulations provided by Reg. § 1.904-4(f). To account for the application of the proposed disregarded payment rules to taxable units, the 2021 Final Regulations instead provide a new, although generally similar, definition of disregarded payment. Under this new definition, disregarded payments include the transfer of an amount of property (within the meaning of section 317(a)) to or from a taxable unit. These payments include not just amounts that result in the reallocation of U.S. gross income from one taxable unit to another, but more broadly include any payment made in exchange for property or in satisfaction of an account payable, or a remittance or contribution, in connection with a transaction that is disregarded for U.S. federal income tax purposes and that is reflected on the taxable unit's separate set of books and records. A DRP also includes any other amount that is reflected on the taxable unit's separate set of books and records in connection with a transaction that is disregarded for U.S. federal income tax purposes and that would constitute an item of accrued income, gain, deduction, or loss if the transaction to which the amount is attributable were regarded for U.S. federal income tax purposes.

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Dispositions of stock

The 2021 Final Regulations provide a special rule for assigning foreign gross income to groupings with respect to a transaction treated as a sale, exchange, or other disposition of stock for U.S. federal income tax purposes that is similar to a rule in final regulations published on November 12, 2020 (85 Fed. Reg. 71998) (the "2020 Final Regulations") with respect to distributions on stock. First, the foreign gross income is assigned to the groupings to which any U.S. dividend amount (i.e., gain recharacterized as a dividend under section 1248(a) or 964(e)) is assigned. Second, any foreign gross income that exceeds the U.S. dividend amount is assigned to the grouping to which the U.S. capital gain amount is assigned. For this purpose, the U.S. capital gain amount includes the amount of any distribution that is treated as gain under section 301(c)(3)(A). Lastly, the deemed basis recovery—the excess of the foreign gross income over the sum of the U.S. dividend amount and the U.S. capital gain amount—is assigned to groupings based on the proportions in which the tax book value of the stock of the transferred corporation is assigned under the asset method in Reg. § 1.861-9 in the tax year in which the disposition occurs.

KPMG observation

The assignment of foreign gross income (and related foreign income taxes) related to a return of capital attributable to section 961(a) basis increases using the asset method in Reg. § 1.861-9 may result in a mismatch of groupings to which foreign income taxes and foreign gross income are assigned. For instance, consider USP owning a CFC with E&P entirely consisting of $100 in a section 951(a)(1)(A) previously taxed earnings and profits (PTEP) group within the general category. For U.S. tax purposes, USP's only basis in its CFC stock is section 961(a) basis of $100 from subpart F inclusions that gave rise to the PTEP. For foreign law purposes, USP has zero basis in its CFC stock. USP sells the stock of CFC for $100 and recognizes no gain for U.S. federal income tax purposes. USP recognizes $100 of gain for foreign law purposes that is subject to foreign income tax. Under the 2021 Final Regulations, there is no U.S. dividend amount or U.S. capital gain amount, so the $100 foreign gross income is assigned to the same groupings to which earnings equal to such amount would be assigned if they were recognized for federal income tax purposes. Although the CFC's earnings consist entirely of PTEP, the 2021 Final Regulations deem the CFC's earnings to arise in the same groupings to which the tax book value of the CFC stock would be assigned under the asset method in Reg. § 1.861-9. Therefore, foreign gross income (and related foreign income taxes) would potentially be assigned to statutory and residual groupings other than the section 951(a)(1)(A) PTEP group within the general category (i.e., the category to which a distribution of the PTEP would be assigned).

A comment recommended that foreign gross income (and related foreign income taxes) related to a return of capital attributable to section 961(a) basis increases be assigned to the same groupings as the PTEP that gave rise to the basis increase. In the example above, such a rule would result in the foreign gross income (and related foreign income taxes) being assigned to the general category. That result would better conform the tax attribution consequences of a disposition of stock with the tax attribution consequences of a pre-sale distribution with respect to the stock particularly in the case of a non-CFC "specified foreign corporation" for which an inclusion was required under section 965. Such comment was not adopted on administrability grounds.

Partnership transactions

Similarly, with respect to foreign gross income arising from a transaction treated as a partnership distribution or as a sale, exchange, or other disposition of an interest in a partnership for federal income tax purposes, the 2021 Final Regulations assign foreign gross income to the extent of the U.S. capital

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gain amount to the statutory or residual grouping to which the U.S. capital gain amount is assigned. For this purpose, the 2021 Final Regulations define a U.S. capital gain amount, in relevant part, to include gain recognized on the sale, exchange, or other disposition of an interest in a partnership, or the portion of a partnership distribution that exceeds the partner's outside basis in the partnership under section 731(a). Any excess of the foreign gross income amount over the U.S. capital gain amount is assigned to the groupings based on the proportions in which the tax book value of the partnership's assets (or in the case of a limited partner with less than a 10% interest, the tax book value of the partnership interest) are assigned for purposes of apportioning the partner's interest expense under Reg. § 1.861-9(e).

Disregarded payments

The 2019 Proposed Regulations provided specific rules to assign foreign gross income that a taxpayer includes on account of a DRP to a grouping. In response to comments criticizing the assignment of foreign branch owner to branch payments to the residual category, Treasury reserved on these rules in the 2020 Final Regulations and re-proposed revised rules in the 2020 Proposed Regulations to allow taxpayers additional time for comment. Such re-proposed rules were finalized by the 2021 Final Regulations.

The DRP rules in the 2021 Final Regulations provide rules for assigning foreign gross income that arises from a DRP that results in a reattribution of U.S. gross income from one taxable unit to another (such reattributed amount, a "reattribution amount") pursuant to the disregarded reattribution transaction rules contained in the foreign branch regulations finalized in 2019 (the "Foreign Branch DRT Rules") or the disregarded payment rules provided by the GILTI high-tax exception regulations (the "HTE DRP Rules"). In addition, these regulations provide additional rules for the assignment of foreign gross income that arises from DRPs that do not result in the reallocation of U.S. gross income, which are generally classified as either contributions or remittances. For this purpose, the 2021 Final Regulations add several defined terms that generally incorporate the principles of similar terms used in the Foreign Branch DRT Rules and the HTE DRP Rules but differ slightly to account for their application to the broader class of taxable units.

Reattribution payments

The 2021 Final Regulations provide that the sum of all reattribution amounts attributed to the recipient of a DRP on account of that DRP is a "reattribution payment." Whether all or any portion of a DRP constitutes a reattribution amount depends on the application of the Foreign Branch DRT Rules or the HTE DRT Rules, as relevant.

The Foreign Branch DRT Rules generally treat U.S. gross income as attributable to a foreign branch or a foreign branch owner based on the foreign branch's or the foreign branch owner's separate books and records, as modified to reflect U.S. federal income tax principles. In order to accurately reflect gross income attributable to a foreign branch or a foreign branch owner, the Foreign Branch DRT Rules generally provide that gross income attributable to a foreign branch must be adjusted for DRPs between a foreign branch and its owner or between foreign branches owned by the same owner (i.e., reattributed from the payor to the payee) if the payment would be deductible or capitalized if it were regarded for U.S. federal income tax purposes, subject to exceptions for certain payments including interest. These rules also have application where property is transferred in a disregarded transaction.

Similarly, the HTE DRP Rules generally adopt the principles of the Foreign Branch DRT rules (with some modifications (including that interest is a DRP for this purpose to the extent deductible under the law of the relevant foreign jurisdiction)) and apply those principles to attribute and, if necessary, reattribute, U.S. gross income to "tested units" of a CFC for purposes of the GILTI high-tax exception. Importantly, both sets of rules provide that the underlying source and character of the U.S. gross income that is attributed

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to a recipient taxable unit remains unchanged despite reattribution (e.g., U.S. gross income earned by a payor taxable unit that is tested income remains tested income in the hands of the recipient taxable unit irrespective of the type of DRP that results in the reattribution of this income).

The 2021 Final Regulations clarify that the amount of a DRP that is a reattribution payment is limited to the payor taxable unit's U.S. gross income. If the amount of a DRP exceeds the payor taxable unit's U.S. gross income, then the remaining portion of the DRP would be treated as either a contribution or a remittance.

In connection with a DRP that consists in whole or in part of a reattribution payment, once the statutory and residual groupings of such payment have been determined pursuant to the Foreign Branch DRT Rules or the HTE DRP Rules, as applicable, the 2021 Final Regulations assign foreign gross income arising from such DRP to the same statutory or residual groupings to which the reattribution amount (or amounts) that make up the reattribution payment are assigned when received by the taxable unit. Each item of U.S. gross income remaining with a taxable unit after taking into account all reattribution payments made and received by the unit is referred to as an "attribution item."

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

KPMG observation

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

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

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

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The 2021 Final Regulations clarify that if a taxpayer receives property in exchange for a DRP, any foreign gross income attributable to the exchange is assigned to the selling taxable unit's statutory or residual groupings under the general rules in the 2020 Final Regulations that apply when there is no corresponding U.S. item. The 2021 Final Regulations also provide that, if the payor of the DRP in the initial disregarded transaction subsequently disposes of the property in a regarded transaction, and recognizes U.S. gross income as a result, the foreign gross income attributable to the regarded sale is assigned to the selling taxable unit's statutory or residual groupings without regard to any reattribution of U.S. gross income as a result of the initial DRP. The preamble to the 2020 Proposed Regulations provided that ignoring the reattribution of U.S. gross income from the initial disregarded payment is appropriate with respect to the regarded disposition because it is assumed that the subsequent seller's basis in the property reflects the initial purchase price for foreign law purposes.

KPMG observation

In certain cases, this may result in the reattribution of U.S. gross income to a statutory or residual grouping while the related foreign income taxes are assigned to a different grouping. For example, if USP sells non-depreciable, non-inventory Asset A (with zero basis) used in its active trade or business to its foreign disregarded entity (FDE) for $500 in Year 1, and FDE subsequently sells Asset A to an unrelated third party in Year 2 for $500, $500 of U.S. gross income initially attributable to income of FDE in the foreign branch category would be reattributed to USP as general category income under the Foreign Branch DRT Rules for purposes of section 904.

Assuming that FDE's country of residence imposes $100 of foreign income tax on the $500 of foreign gross income attributable to the Year 2 regarded sale of Asset A, the 2021 Final Regulations assign the $500 of foreign gross income and the related $100 of foreign income taxes to the same grouping as the corresponding U.S. item ($500 in the foreign branch category), without regard to the reattribution of gain under the Foreign Branch DRT Rules. Consequently, the foreign income taxes would not end up in the same category as (and would not be available as a credit with respect to) the reattributed income.

Finally, if the amount of foreign gross income related to a reattribution payment differs from the amount of the reattribution payment, and the reattribution payment includes multiple reattribution amounts that have been assigned to multiple groupings, the 2021 Final Regulations assign foreign gross income to those same groupings on a pro rata basis. For example, if Foreign Branch 1 (FB1) earns $800 of U.S. gross income and makes a $1,000 disregarded payment to Foreign Branch 2 (FB2) that results in $800 of U.S. gross income being reattributed from FB1 to FB2 (i.e., the portion of the disregarded payment that is a reattribution payment) as $600 of foreign branch category income and $200 of passive category income (each a reattribution amount), and foreign gross income included by reason of the reattribution payment is $1,200, $900 of the foreign gross income is assigned to the foreign branch category and $300 of the foreign gross income is assigned to the passive category.

Remittances and contributions

The 2021 Final Regulations include revised definitions of "remittance" and "contribution" to assign to a grouping foreign gross income arising from a DRP that does not result in a reallocation of U.S. gross income under the foreign branch DRT rules or the HTE DRP rules. A contribution is defined as the excess of a disregarded payment made by a taxable unit to another taxable unit that the first taxable unit owns over the portion of the disregarded payment, if any, that is a reattribution payment. A remittance is defined as the excess of a DRP, other than an amount that is treated as a contribution, made by a taxable unit to a second taxable unit over the portion of the disregarded payment, if any, that is a reattribution payment.

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Thus, the amount of any payment that would not be subject to reallocation under the applicable branch DRT or HTE DRP rules is treated as either a contribution or remittance.

KPMG observation

Treasury noted in the preamble to the 2021 Final Regulations that the definition of "contribution" did not encompass a disregarded payment that is neither a reattribution payment nor a transfer that would be described in section 351. A disregarded interest payment was provided as an example of such a payment. The definitions of "contribution" and "remittance" were revised to correct this perceived problem and to ensure that the 2021 Final Regulations provide rules for allocating foreign income taxes attributable to all DRPs.

The 2021 Final Regulations assign foreign gross income that arises from a remittance to the same groupings out of which the remittance is made. For this purpose, a remittance is deemed to be made ratably out of the payor taxable unit's "accumulated after-tax income." Accumulated after-tax income is deemed to have arisen in statutory and residual groupings based on how the payor's assets are assigned to such groupings under the asset method in Reg. § 1.861-9 in the year in which the remittance is made. The payor's assets are determined under the rules for determining the character and source of a section 987 QBU owner's section 987 gain or loss under the section 987 regulations by treating the taxable unit as the section 987 QBU and by including stock held by the taxable unit, the portion of the value of reattribution assets assigned to the taxable unit, and the taxable unit's pro rata share of the assets of another taxable unit (other than a corporation or a partnership). In that later case, such pro rata share includes the portion of any reattribution assets assigned to such other taxable unit. The 2021 Final Regulations generally define a reattribution asset as an asset that produces one or more items of U.S. gross income to which a disregarded payment is allocated when applying the foreign branch DRT rules or the HTE DRP rules. If the payor taxable unit has no assets, foreign gross income attributable to the remittance is assigned to the residual grouping.

KPMG observation

Despite the reference to the payor taxable unit's "accumulated after-tax income," the determination of the groupings to which foreign gross income arising on account of a remittance is assigned depends entirely on the assets assigned to the taxable unit at the time of the remittance. The 2020 Proposed Regulations assumed that the use of the asset method to assign the foreign gross income items related to remittances would reasonably approximate the historical earnings of the taxable unit making the remittance. Comments regarding this rule in the 2020 Proposed Regulations emphasized such assumption was often incorrect because of the disparate yield percentage of assets relative to tax basis and / or because the operations of such entities may change over time. Treasury acknowledged that such distortions could arise but declined to revise the Regulations in response to such comments on administrability grounds.

Treasury did, however, revise the application of the asset method for assigning foreign gross income corresponding to a remittance. Comments requested that assets of disregarded entities or branches owned by the remitting disregarded entity or branch also be taken into account for such purposes because the earnings remitted could be related to the earnings of such lower tier disregarded entities or branches. Treasury agreed with this comment and revised Reg. § 1.861-20(d)(3)(C)(1)(ii) to include the assets of not only the remitting disregarded entity or branch but also the assets of any disregarded entity or branch owned by such remitting disregarded entity or

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branch.

The 2021 Final Regulations assign foreign gross income with respect to a contribution to the residual grouping. While foreign taxes paid or accrued by a CFC with respect to its foreign gross income that are allocated to the residual grouping are not creditable for U.S. federal income tax purposes, the instances in which foreign taxes will be paid in connection with a contribution should be rare in practice and even less common with the addition of the reattribution rules as well as an ordering rule that prioritizes treating a disregarded payment as a reattribution payment before treating it as a contribution. The 2021 Final Regulations however, also provide that foreign gross income arising from a contribution by one taxable unit to another may be assigned to the foreign branch category under the "foreign branch group contribution" rule contained in Reg. § 1.904-6 where section 904 is the operative section, as discussed below.

KPMG observation

Contributions can include DRPs that do not result in the reattribution of U.S. gross income from the payor to the payee under the Foreign Branch DRT Rules. As a result, more foreign gross income can be assigned to the residual grouping (or foreign branch categories where section 904 is the operative section pursuant to Reg. § 1.904-6) than one might otherwise expect. For example, if a foreign branch owner makes a disregarded interest payment to its foreign branch, the interest DRP would not cause the reattribution of income from the foreign branch owner to its foreign branch because interest and interest equivalents are generally excluded from application of the Foreign Branch DRT Rules. Therefore, the interest payment would fall within the broad definition of contribution under the 2021 Final Regulations and the related foreign gross income would be assigned to the residual grouping (or foreign branch category pursuant to Reg. § 1.904-6(b)(2)(ii)).

Foreign law transfers between taxable units that are not DRPs

The 2021 Final Regulations apply timing principles for assigning foreign gross income arising from a foreign law transfer between taxable units that is not treated as a disregarded payment for U.S. federal income tax purposes in the same year in which foreign income tax is paid or accrued. The 2021 Final Regulations address, for instance, a consent dividend or a stock dividend from one taxable unit to another taxable unit of a CFC that is treated as a distribution for foreign law purposes that gives rise to foreign gross income of the CFC and corresponding foreign income taxes but is not treated as a disregarded payment for U.S. federal income tax purposes.

In such a case, the 2021 Final Regulations assign the foreign gross income to the same grouping as gross income from a hypothetical DRP in the amount of the foreign gross income would be assigned (under the disregarded payment rules discussed above) for U.S. federal income tax purposes in the U.S. tax year in which the foreign income tax is paid or accrued.

U.S. equity hybrid instruments

The 2021 Final Regulations added additional rules for assigning foreign gross income related to a U.S. equity hybrid instrument (i.e., an instrument that is treated as equity for U.S. federal income tax purposes and that is treated as debt for foreign tax purposes). *See* Reg. § 1.861-20(d)(3)(vi). Foreign gross income related to an accrual under foreign law with respect to a U.S. equity hybrid instrument is treated as a foreign law distribution defined in Reg. § 1.861-20(b)(10) and is characterized pursuant to Reg. § 1.861-20(d)(2)(ii)(B). A distribution with respect to a U.S. equity hybrid instrument is characterized in the same

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manner as a distribution with respect to stock or a partnership interest, as the case may be, pursuant to the rules of Reg. § 1.861-20(d)(3)(i) or (ii).

In lieu of taxes

Under Reg. § 1.861-20(h), a tax that is a foreign income tax because it is an in lieu of tax is allocated and apportioned to the statutory and residual groupings in the same proportions as the foreign taxable income that comprises the excluded income (as such term is defined in Reg. § 1.903-1(c)(1), discussed below).

Applicability dates

The rules relating to the allocation and apportionment of foreign income taxes contained in the 2021 Final Regulations are generally applicable to tax years that begin after December 31, 2019 and that end on or after November 2, 2020. However, the rules for the allocation and apportionment of certain foreign in lieu of taxes apply to tax years beginning after December 28, 2021.

Allocation and apportionment of foreign income taxes when section 904 is the operative section

The 2021 Final Regulations include further guidance for the allocation and apportionment of foreign income taxes when section 904 is the operative section. As noted above, Reg. § 1.861-20(d) generally assigns foreign gross income arising from a DRP received by a taxable unit, as well as the associated foreign taxes, to statutory and residual groupings based on the current or accumulated income of the payor (for U.S. federal income tax purposes) depending on the nature of the DRP. Reg. § 1.904-6 specifically provides that these rules apply to all foreign gross income arising from DRPs made or received by a taxable unit owned a U.S. taxpayer, including a non-branch taxable unit.

Additionally, the 2021 Final Regulations modify the treatment of contributions under Prop. Reg. § 1.861-20 where section 904 is the operative section and the taxpayer owning the taxable unit is an individual or domestic corporation. Whereas under the general rule foreign gross income and the associated foreign taxes arising from a contribution are assigned to the residual category, when section 904 is the operative section, foreign taxes on contributions to a foreign branch (including a non- branch taxable unit owned by a foreign branch) are assigned to the foreign branch category.

Applicability date

The foregoing rules relating to the allocation and apportionment of Foreign Income Taxes when section 904 is the operative section apply to tax years that begin after December 31, 2019, and end on or after November 2, 2020.

Disallowance of foreign tax credit or deduction under section 245A(d)

Under section 245A, a corporate U.S. shareholder is generally allowed a deduction equal to the amount of the foreign-source portion of a dividend received from a specified 10% owned foreign corporation (a "section 245A DRD," and a dividend for which a section 245A DRD is allowed, a "section 245A DRD-eligible dividend"). Under section 245A(e), however, the section 245A DRD is not allowed for any portion of a hybrid dividend (which generally consists of a dividend paid by a CFC in respect of which the CFC received a deduction for foreign tax purposes) received from a CFC or the subpart F income that results from a tiered hybrid dividend received by a CFC. Section 245A(d) disallows credits and deductions for foreign income taxes with respect to section 245A DRD-eligible dividends, and section 245A(e) disallows

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credits and deductions for foreign income taxes paid or deemed paid with respect to hybrid dividends and the subpart F income that results from tiered hybrid dividends.

The 2020 Proposed Regulations provided rules for attributing foreign income taxes to "specified distributions" from, and "specified earnings and profits" of, foreign corporations, for purposes of applying sections 245A(d) and (e). The 2020 Proposed Regulations relied on Reg. § 1.861-20 to associate foreign income taxes with such amounts. (Because such terms are ultimately deleted from the 2021 Final Regulations, they are not defined herein.)

Comments regarding the 2020 Proposed Regulations highlighted various areas of uncertainty regarding how the proposed rules would operate in certain fact patterns and how they would interact with the rules of Reg. § 1.861-20 for allocating foreign taxes to statutory and residual groupings of income. Treasury agreed that aspects of the proposed rules were unclear and that this lack of clarity resulted in uncertainty about their application in certain situations. In response to these comments, the 2021 Final Regulations were revised to eliminate the references to specified distributions and specified earnings and profits.

Under the 2021 Final Regulations, no credit or deduction is allowed for foreign income taxes paid or accrued (i) by a domestic corporation (or a successor thereof) that are attributable to "section 245A(d) income"(as defined below) of the domestic corporation (or a successor), (ii) by a domestic corporation that is a U.S. shareholder of a foreign corporation (other than a corporation that is a PFIC with respect to such shareholder and not also a CFC) and that are attributable to "non-inclusion income" (as defined below) of the foreign corporation and not otherwise disallowed because they are attributable to section 245A(d) income in accordance with the regulation, or (iii) by a foreign corporation that are attributable to section 245A(d) income. A successor for this purpose means a person (including an individual who is a U.S. citizen or resident) that acquires from any other person any portion of the interest of a U.S. shareholder in a foreign corporation for purposes of section 959(a). Foreign income taxes of a foreign corporation that are attributed to section 245A(d) income are not eligible to be deemed paid under section 960 in any tax year. The disallowance of a credit or deduction does not affect whether the foreign income taxes reduce earnings and profits of a corporation.

Section 245A(d) income is defined with respect to a domestic corporation to mean a dividend (including a section 1248 dividend) or an inclusion under section 951(a)(1)(A) for which a section 245A DRD is allowed (*see, e.g.,* section 964(e)(4)), a distribution of section 245A(d) PTEP (as defined below), a hybrid dividend, or an inclusion under section 245A(e)(2) by reason of a tiered hybrid dividend received by an upper-tier CFC. With respect to a successor of a domestic corporation, the term section 245A(d) income means the receipt of a distribution of section 245A(d) PTEP. With respect to a foreign corporation, the term section 245A(d) income means an item of subpart F income that gives rise to a deduction under section 245A(a), a tiered hybrid dividend, or a distribution of section 245A(d) PTEP. Section 245A(d) PTEP includes PTEP that arises as a result of the disposition of a foreign corporation to which section 1248 or section 964(e)(4) applies and to which section 245A applies, as well as PTEP that arises from an inclusion under section 245A(e) on account of the receipt by an upper-tier foreign corporation of a tiered hybrid dividend.
Foreign income taxes are attributable to section 245A(d) income to the extent the taxes are allocated and apportioned under Reg. § 1.861-20 to the section 245A(d) income group, treating the section 245A(d) income group in each separate category as a statutory grouping and treating all other income as income in the residual grouping. The regulations cross-reference in particular Reg. §§ 1.861-20(d)(2) through (3) for rules regarding the allocation and apportionment of taxes if the taxpayer does not have a corresponding U.S. item of gross income in the same tax year that the foreign income taxes are paid or accrued. As such, foreign income taxes may be treated as attributable to section 245A(d) income even where they do not arise with respect to a payment of an actual dividend or inclusion (for U.S. tax purposes) because Reg. § 1.861-20 may associate foreign income taxes with section 245A(d) income in other instances, such as in connection with a foreign law distribution that is not treated as distribution for U.S. tax purposes. The 2021 Final Regulations contain an example that illustrates such result where a

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foreign income tax arises as a result of a stock distribution that is subject to section 305.

The regulations also provide detailed rules for attributing foreign income taxes paid or accrued by a corporate U.S. shareholder to non-inclusion income (i.e., income of a foreign corporation that is not subpart F income, that is not tested income that results in a GILTI inclusion and that is not income described in section 245(a)(5)) of a foreign corporation. These rules apply only in cases where foreign income taxes are allocated and apportioned under Reg. § 1.861-20 by reference to the characterization of the tax book value of stock (as determined for purposes of allocating and apportioning interest expense of the domestic corporation) held directly or indirectly through a pass-through entity, or by reference to the income of a foreign corporation that is a reverse hybrid or a foreign law CFC. Under these rules, for example, foreign income taxes are attributable to non-inclusion income to the extent they are allocable under Reg. § 1.861-20 to a section 245A subgroup of stock as the result of a distribution that is treated under section 301(c)(2) as a return of stock basis for federal income tax purposes or a distribution treated as a remittance. Additionally, foreign income taxes would be attributable under these rules to non-inclusion income of a reverse hybrid or foreign law CFC to the extent they are allocated and apportioned to the non-inclusion income group under Reg. § 1.861-20(d)(3).

Consistent with the 2020 Proposed Regulations, the 2021 Final Regulations also contain an anti-avoidance rule providing that foreign income taxes are treated as attributable to section 245A(d) income of a domestic or foreign corporation, or non-inclusion income of a foreign corporation, if a transaction, series of related transactions, or arrangement is undertaken with a principal purpose of avoiding the purposes of section 245A(d) (e.g., transactions that separate foreign income taxes from the related foreign income or the related E&P). Treasury considered more mechanical alternatives to the broad anti-abuse rule but determined that the anti-avoidance rule provided an appropriate framework and the necessary flexibility to address avoidance of section 245A(d). One purpose of the anti-avoidance rule is to prevent taxpayers from using successive foreign law distributions to inappropriately associate withholding tax with PTEP rather than section 245A(d) income.

KPMG observation

The 2021 Final Regulations illustrate the inappropriate use of such successive foreign law distributions where consent dividends are elected under foreign law in successive years (that give rise to foreign income taxes but do not give rise to taxable income for U.S. purposes) by a foreign corporation whose E&P consists in part of PTEP and in part of untaxed earnings to which section 245A(a) would apply if distributed. The example stipulates that such consent dividend elections were made with a principal purpose of avoiding the application of section 245A(d). The amount of each consent dividend does not exceed the foreign corporation’s PTEP. Because the consent dividends do not result in a dividend for U.S. tax purposes and therefore do not reduce the foreign corporation’s PTEP, the foreign income tax arising with respect to each consent dividend would be attributed to PTEP and therefore not subject to disallowance absent application of the anti-avoidance rule. The example concludes that the anti-abuse rule applies and disallows a credit or deduction in respect of the foreign income taxes arising with respect to each consent dividend.

The anti-avoidance rule provides an arguably harsh result in that it disallows all of the foreign income taxes paid with respect to each consent dividend. Under the facts of the example, if an actual dividend were paid in the amount of each consent dividend, only some of the foreign income taxes would be subject to disallowance as a portion of such taxes would be attributable to PTEP.

Applicability date

Consistent with their proposed effective date, the section 245A(d) rules contained in the 2021 Final

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Regulations apply to tax years of a foreign corporation beginning after December 31, 2019 and ending on or after November 2, 2020 and, with respect to a U.S. person, tax years in which or with which such tax years of the foreign corporation end.

Allocation and apportionment of other expenses

Controlled service transactions

The 2020 Proposed Regulations proposed minor changes to the rule in Reg. § 1.861-8(e)(4)(i) concerning the allocation of deductions to amounts paid or allocated with respect to controlled services transactions for clarity and to reflect the fact that such transactions may be between entities that are not corporations. The proposed changes were adopted by the 2021 Final Regulations without change.

Applicability date

The changes to Reg. § 1.861-8(e)(4)(i) apply to tax years ending on or after November 2, 2020.

Indebtedness of certain regulated utilities

The 2020 Proposed Regulations contained a rule under which if an automatically excepted regulated utility trade or business (as defined in regulations under section 163(j)) has qualified nonrecourse indebtedness (also as defined in regulations under section 163(j)), interest expense from the indebtedness is directly allocated to the taxpayer's assets in the manner and to the extent provided in Temp Reg. § 1.861-10T(b), dealing with the allocation of interest expense on qualified nonrecourse indebtedness (as defined in Temp Reg. § 1.861-10T(b)). The 2021 Final Regulations finalized that proposed regulation without change.

Applicability date

Reg. § 1.861-10(f) is applicable to tax years beginning on or after December 28, 2021.

Asset characterization and DRT transactions

The 2020 Proposed Regulations contained an amendment to Reg. § 1.861-9(g)(3) under which, for purposes of applying section 904 as the operative section, the grouping of income that assets generate, have generated, or may reasonably be expected to generate is determined after taking into account any reallocation of income required under Reg. § 1.904-4(f)(2)(vi) (dealing with the treatment of disregarded payments between a foreign branch and its foreign branch owner or another foreign branch). The proposed change was adopted without substantive change by the 2021 Final Regulations.

Applicability date

The amendment to Reg. § 1.861-9(g)(3) applies to tax years beginning on or after December 28, 2021.

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KPMG observation

The new rule in Reg. § 1.861-9(g)(3) affects the characterization of assets for interest allocation purposes. The new rule can be illustrated by an example in which USP owns FB, a disregarded entity conducting activities outside the United States that constitute a foreign branch. FB has an asset with a tax basis of 1000 that generates gross income of 100 that is reflected on FB's books and records and characterized as foreign branch income. FB makes a disregarded payment of 25 to USP for services that results in a reallocation of 25 of gross income from the foreign branch category to the general category under Reg. § 1.904-4(f)(2)(vi). Under Reg. § 1.861-9(g)(3) (and Temp. Reg. § 1.861-9T(g)(3)(ii)), FB's asset would appear to constitute a "multiple category asset" that generates 75 of foreign branch category income and 25 of general category income, resulting in 750 of the tax basis of the asset being characterized as a foreign branch category asset and 250 of the tax basis of the asset being characterized as a general category asset. See Reg. § 1.861-17(d)(1)(iii) for an analogous rule characterizing gross receipts for purposes of allocating and apportioning research and experimental expense under Reg. § 1.861-17.

CFC interest netting

Under prior CFC interest netting rules, if a U.S. shareholder made a capital contribution to a CFC which then made loans to other CFCs owned by the U.S. shareholder, such CFC-to-CFC loans were potentially treated as related group indebtedness. While no interest expense was generally allocated to income inclusions from the lender CFC, the debt nevertheless could have increased the amount of allocable related group indebtedness for which a reduction in assets is required under Reg. § 1.861-10(e)(7). The 2020 Proposed Regulations proposed to revise Reg. § 1.861-10(e)(8)(v) to provide that CFC-to-CFC loans are not treated as related group indebtedness for purposes of applying the CFC netting rules, and thus do not result in a reduction in assets under Reg. § 1.861-10(e)(7). The proposed change was adopted without change by the 2021 Final Regulations.

Applicability date

The amendment to Reg. § 1.861-10(e)(8)(v) applies to tax years ending on or after November 2, 2020.

Insurance companies and section 818(f) expenses (Reg. § 1.861-14(h))

The 2019 Proposed Regulations would have required life insurance companies that are members of a consolidated group to allocate and apportion deductions for reserves and certain other expenses ("section 818(f) expenses") on a separate company basis. Some comments supported the separate company approach, while others asserted that a single entity approach should apply for businesses operated on a group basis (a "life subgroup" approach), and yet others argued for electivity. In lieu of finalizing the 2019 proposed rule, the 2020 Proposed Regulations proposed a new rule that would apply a life subgroup approach, subject to a one-time election for the separate company approach. The election would be made by applying the separate entity method on a group's return for its first applicable tax year and would apply for all tax years thereafter, unless the Commissioner consents to its revocation. The 2021 Final Regulations finalized the rule in the 2020 Proposed Regulations without change.

Applicability date

The section 818(f) expenses rule applies to tax years beginning on or after December 28, 2021.

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Section 904 categories of income

Foreign branch category income

Income from U.S. activities and stock

Section 904(d)(2)(J)(i) defines foreign branch category income as business profits of a U.S. person that are attributable to non-U.S. QBUs. The 2019 Final Regulations provided, inter alia, that income attributable to a foreign branch excludes income arising from (i) activities carried out in the United States or (ii) stock that is not dealer property. The DRP rules contained in Reg. § 1.861-20(d)(3)(v) generally rely on the Foreign Branch DRT Rules, but income arising from activities carried out in the United States or stock may be attributable to a taxable unit in this context. The 2021 Final Regulations therefore amend the Foreign Branch DRT Rules to provide that income arising from U.S. activities or stock may be attributable to a foreign branch even though such income cannot be foreign branch category income.

Foreign branch DRT rules

The prior Foreign Branch DRT rules broadly applied to DRPs made to and from foreign branches (i.e., non-U.S. QBUs), but did not apply to DRPs to and from certain persons and interests that did not meet the definition of a foreign branch or foreign branch owner. To address this gap in the Foreign Branch DRT Rules, the 2021 Final Regulations modify the Foreign Branch DRT rules to apply in the case of DRPs made to and from a "non-branch taxable unit," as defined in Reg. § 1.904-6(b)(2)(i)(B).

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

The 2021 Final Regulations provide that the reattribution of current gross income may result from DRPs to and from non-branch taxable units. Gross income attributed to a non-branch taxable unit would then be re-attributed to a foreign branch (if the non-branch taxable unit were to belong to a "foreign branch group") or a foreign branch owner (if the non-branch taxable unit were to belong to a "foreign branch owner group"), respectively.

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

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The 2021 Final regulations also clarify the application of the Foreign Branch DRT rules by providing that the reattribution of gross income by reason of a DRP is limited to the amount of current gross income in the payor foreign branch or foreign branch owner, and such amount is translated to or from the foreign branch's functional currency at the spot rate as determined on the date of the DRP. In addition, the 2021 Final Regulations provide that a DRP made by a foreign branch to a second foreign branch is allocable to gross income of the payor foreign branch if such payment, if regarded, would be allocated and apportioned to gross income attributable to the payor foreign branch under the principles of 1.861-8 through -14T and -17 (without regard to exclusive apportionment) by treating foreign source and U.S. source gross income in each separate category as a statutory grouping.

Applicability date

These foreign branch category rules apply to tax years that begin after December 31, 2019, and end on or after November 2, 2020.

Other changes to Reg. § 1.904-4

The 2021 Final Regulations finalize a change to the definition of passive income in the 2020 Proposed Regulations. The 2020 Proposed Regulations proposed to revise Reg. § 1.904-4(b)(2)(i)(A) to make clear that any of the exceptions or exclusions to the definition of foreign personal holding company income as defined in 954(c) apply for purposes of determining whether income is of a kind that would be foreign personal holding company income if the taxpayer were a CFC. Those exceptions or exclusions specifically include the same country exception of 954(c)(3) and the look through rule of section 954(c)(6).

Applicability date

The passive income rules apply to tax years that begin after December 31, 2017 and end on or after December 4, 2018.

Creditability of foreign taxes

Definition of foreign income tax

The 2021 Final Regulations finalize, with substantial modifications, additional requirements introduced in the 2020 Proposed Regulations that must be satisfied for a foreign levy to qualify as a creditable foreign income tax. Under the 2021 Final Regulations, foreign taxes described in the regulations under section 901 are referred to as "net income taxes," while foreign taxes described under section 903 and the regulations thereunder are referred to as "in lieu of income taxes" or "in lieu of taxes," and the two together are referred to as "foreign income taxes." In particular, the 2021 Final Regulations impose an attribution requirement that must be satisfied for a foreign levy to qualify as a foreign income tax and revise the "net gain" requirement that must be satisfied for a foreign levy to qualify as a net income tax.

Attribution requirement (previously, the jurisdictional nexus requirement)

In finalizing the rules, the preamble to the 2021 Final Regulations responded to a significant number of comments regarding the appropriateness of the jurisdictional nexus requirement. In doing so, Treasury noted that the existing "net gain" requirement (discussed further below) for a foreign levy to qualify as a creditable net income tax has historically involved a form of nexus determination by requiring that a

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foreign tax base allow for the recovery of appropriate expenses in respect of income included in the foreign tax base. Consistent therewith, the jurisdictional nexus requirement was finalized as part of the "net gain" requirement (discussed below) and renamed an "attribution requirement," to reflect its role in determining the gross receipts that may be appropriately included in a foreign tax base. Thus, under the 2021 Final Regulations, a foreign levy must satisfy a jurisdictional nexus requirement, now referred to as the attribution requirement, to qualify as a net income tax eligible for a foreign tax credit under section 901. As discussed further below, a foreign levy also must satisfy the attribution requirement to qualify as an "in lieu of tax" under section 903.

The introduction of a jurisdictional nexus test was motivated by the proliferation of taxes enacted by foreign jurisdictions that Treasury believes are inconsistent with international norms of taxation. In that vein, the preamble to the 2020 Proposed Regulations expressed a concern that allowing a FTC for these "novel extraterritorial taxes" (such as digital services taxes) would undermine the purpose of the FTC to mitigate double taxation of income that is properly attributable to a taxpayer's activities or investment in a foreign country (i.e., income over which the foreign country would have the primary taxing right under traditional international tax principles). The preamble to the 2021 Final Regulations reiterates Treasury's belief that a tax asserted by a foreign jurisdiction based on the location of customers or end-users (or similar destination-based criteria) is inconsistent with international norms of taxation and should not be creditable. The attribution requirement achieves this aim by providing an exclusive set of criteria that may form the basis for taxation of non-residents by a foreign jurisdiction, which would generally prevent the creditability of digital service taxes and other destination-based taxes.

KPMG observation

The OECD/G20 Inclusive Framework on BEPS (the "Inclusive Framework") is currently considering a new international framework that would create a limited taxing right with respect to the largest and most profitable companies based on the location of their ultimate customer or end user (known as "Pillar One"). If Pillar One is ultimately implemented, taxes imposed under this new taxing right generally would not satisfy the attribution requirement. The preamble to the 2020 Proposed Regulations noted that, in the event a multilateral agreement is reached on Pillar One that includes the United States, further changes to the U.S. FTC system may be required. However, the preamble to the 2021 Final Regulations also provides that, because the current proliferation of extraterritorial taxes currently threaten the U.S. fisc, the potential for future law changes should not delay the adoption of the attribution requirement.

The attribution requirement provides separate rules to determine whether a foreign tax is creditable based on whether the tax is imposed on residents or nonresidents of the jurisdiction imposing the tax. For a tax on nonresidents to be creditable, it must meet one of three attribution requirements: activities-based nexus, source-based nexus, or property-based nexus.

Under the activities-based nexus test, which is generally unchanged from the 2020 Proposed Regulations, the gross receipts and costs included in the foreign tax base must be determined, under reasonable principles, by reference to the nonresident's activities (including its functions, assets, and risks) located in the foreign country. The effectively connected income ("ECI") standard under section 864(c) is the sole example cited of reasonable principles for attributing income to activities. Importantly, the regulations provide that a tax based on the location of customers or users would not be creditable under this standard, nor would a tax based on the location of persons from whom the nonresident makes purchases. In response to a comment recommending that a foreign jurisdiction should be able to take the activities of a nonresident's related parties into account without disqualifying its tax under the activities-based nexus requirement, the activities-based nexus test was clarified to provide that reasonable principles do **not** include rules that deem the existence of a trade or business or permanent

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establishment based on the activities of another person, unless the other party is an agent or otherwise acting on behalf of the nonresident or is a pass-through entity of which the nonresident is an owner.

Under the source-based nexus test, for a tax based on the source of income (rather than on activities) to meet the attribution requirement, the foreign law's sourcing rule for a category of gross income (or subset thereof) must be "reasonably similar" to the U.S. sourcing rule. The 2021 Final Regulations expand upon the source-based nexus requirement contained in the 2020 Proposed Regulations with the intention of providing additional flexibility and clarity.

In particular, Treasury received comments to the 2020 Proposed Regulations pointing out that that the United States and the foreign jurisdiction may disagree on the characterization of a particular transaction, rendering it difficult to determine whether source-based nexus is satisfied. To provide additional flexibility regarding the extent to which U.S. and foreign law must align, the 2021 Final Regulations provide that foreign tax law generally applies for determining the character of the gross income or gross receipts (e.g., as sales income or services income) subject to the foreign tax. Thus, as a general matter, the foreign rules for determining the character of income need not align with the U.S. rules. Instead, the foreign country's source rule for the character of the income as determined under foreign law is compared to the U.S. source rule for that character of income. The 2021 Final Regulations, however, provide a notable exception to this deference to foreign law characterization in respect of copyrighted articles; the relevant foreign tax law must treat a transaction that is treated as a sale of a copyrighted article for U.S. purposes (as determined under rules similar to Reg. § 1.861-18) as a sale of tangible property rather than a license.

KPMG observation

The 2021 Final Regulations likely refer to "rules similar to Reg. § 1.861-18" because that final regulation only applies to software and not to other digital content like a book or song, though the principles of Reg. § 1.861-18, which were developed through case law, have been applied by analogy to other digital content. and Prop. Reg. § 1.861-18 would explicitly apply to other digital content.

KPMG observation

Given the relatively formalistic distinctions between licenses and sales of copyrighted articles in the context of digital resellers (see Examples 8 and 9 of Reg. § 1.861-18(h) and Example 19 of Prop. Reg. § 1.861-18(h)), it is somewhat surprising that Treasury views those rules as so fundamental to establishing nexus for a creditable income tax that foreign law conformity on the issue is required.

To provide additional certainty regarding the meaning of "reasonably similar," the 2020 Proposed Regulations provided a per se rule for when a foreign law's sourcing rule for services would be considered reasonably similar to the U.S. sourcing rule, namely that such income must be sourced based on where the services are performed (as opposed to the location of the service recipient). The 2021 Final Regulations finalize this requirement and additionally provide that, for a sourcing rule for royalties to be reasonably similar to the U.S. rule, royalties must be sourced based on the place of use, or the right to use, the intangible property.

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KPMG observation

Although the 2021 Final Regulations generally defer to the characterization of income under the foreign tax law, this likely is an area where the specifics of the relevant foreign tax law will matter. For example, under the plain meaning of the regulations, if the foreign tax law characterizes as a license a transaction that U.S. tax law characterizes as a service, the foreign sourcing rule for royalties would need to be assessed for whether it is reasonably similar to the U.S. sourcing rule for royalties based on whether foreign law sources royalties based on the place of use, or the right to use, the intangible property. On the other hand, a foreign tax law that merely provides that a particular transaction should be taxed "as if" it were a license likely would not allow the attribution requirement to be satisfied based on whether the foreign and U.S. rules for sourcing royalties are reasonably similar. In the latter circumstance, it seems more likely that the foreign law would be viewed as providing a separate sourcing rule for a subset of services transactions, with the result that the withholding tax imposed on that subcategory of services would be treated as a separate levy, as discussed below under the heading, *Separate Levies.*

Commenters also observed that, in particular, the law regarding the application of the U.S. source rules for royalties and services is not well-developed, and, in particular, case law and sub-regulatory guidance have produced conflicting results regarding the application of the source rules for royalties, all of which would make it difficult to determine whether a foreign tax law's sourcing rules are reasonably similar to U.S. rules. In response, a sentence was added to Reg. § 1.901-2(b)(5)(i)(B) providing that "[a] foreign tax law's application of such sourcing rules need not conform in all respects to the application of those sourcing rules for Federal income tax purposes." The preamble states that this change is intended to add flexibility in applying the source-based nexus requirement. As an example of the flexibility afforded by this addition, the preamble provides that, while royalties must be sourced based on place of use of an intangible, foreign law need not reach the same conclusion as U.S. tax law regarding the place in which an intangible is used.

On the less flexible front, in response to comments pointing out the incongruities that can exist under U.S. law with respect to the sourcing rules for sales of software on tangible and intangible media, Treasury concluded that source-based nexus is never a sufficient basis to tax dispositions of property under U.S. law. Accordingly, the 2021 Final Regulations provide that, to be creditable, a foreign tax imposed on gross income from dispositions of property may not be imposed solely on the basis of source and instead must be imposed under an assertion of activities-based nexus or property-based nexus.

KPMG observation

A foreign tax imposed on a sale of property (as characterized under foreign tax law or in respect of copyrighted articles (as determined under Reg. § 1.861-18)) will not satisfy the attribution requirement unless it satisfies the activities-based nexus or property-based nexus requirements. For example, assume US Corporation sells copyrighted articles (as determined under Reg. § 1.861-18) to Country X customers, and Country X taxes US Corporation's gross receipts as a royalty payment sourced in Country X based on the customer's use of the property within Country X. Because Country X's character will not control the determination with respect to a transaction treated as a sale of a copyrighted article for U.S. purposes, the Country X tax would be tested as a sale of tangible property and would fail the attribution requirement test because it would not satisfy the activities-based nexus requirement or the property-based nexus requirement.

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KPMG observation

Treasury received numerous comments pointing out that differences in the form of economically equivalent transactions could render different results under the source-based nexus requirement. For example, a U.S.-based software supplier that makes software available through limited time subscription (presumably using its own servers) is treated as receiving service fees under U.S. tax law. If the jurisdiction in which the subscriber resides also characterizes the income as service fees and imposes a withholding tax on the payments, the tax would not satisfy the source-based nexus requirement as the services are not rendered where the subscriber is located. If, however, the supplier made the software available through downloads subject to time-based nominal "licenses," the supplier would be treated as receiving rents under U.S. tax law. If the jurisdiction in which the customer resides also characterizes the income as rents, the source-based nexus requirement would be satisfied in respect of a withholding tax imposed on the basis of where the software is used. Because the character of the gross income generally is determined under foreign law in applying the source-based nexus requirement, if the relevant jurisdiction instead characterized the income in the first transaction as a rent or a royalty, a withholding tax imposed based on where the software is used would appear to satisfy the source-based nexus requirement, despite that the U.S. characterizes the income as service fees.

The property-based nexus test provides the conditions that must be satisfied for a foreign tax imposed on the sale or disposition of property by a nonresident based on the situs of property to satisfy the attribution requirement. Gross receipts from the disposition of property (including corporate stock or an interest in a partnership or other pass-through entity) included in the tax base of a foreign jurisdiction on the basis of real property located therein must be determined under rules reasonably similar to the U.S. Foreign Investment in Real Property Tax Act ("FIRPTA") regime under section 897. Gross receipts from the disposition of property other than corporate stock, but including an interest in a pass-through entity, included in the tax base of a foreign jurisdiction on the basis of the situs of the property (other than real property) may only include gross receipts attributable to property forming part of the business property of a taxable presence in the jurisdiction under rules reasonably similar to the rules of section 864(c).

KPMG observation

Under the 2020 Proposed Regulations, a foreign tax law identical to FIRPTA did not appear to satisfy the property-based nexus requirement because such tax base could include a portion of gain from the sale of shares in a company that owns real property situated in the country that does not correspond to gain in such real property. Under FIRPTA, a nonresident's entire gain on the sale of shares of a U.S. corporation is subject to U.S. tax if the fair market value of the U.S. real property interests held by such corporation exceed 50% of the corporation's real property interests and other trade or business assets, but the 2020 Proposed Regulations suggested that only the portion of the gain on the shares attributable to real property located in the foreign country may be included in the country's tax base, rather than the entire gain on the shares. The modifications made in the 2021 Final Regulations align the property-based nexus requirement with respect to real property with the FIRPTA regime.

KPMG observation

While the attribution requirement was largely aimed at the recent proliferation of novel

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extraterritorial taxes such as digital services taxes, the attribution requirement also denies credits for taxes with a longer history of being creditable against U.S. tax. For example, many jurisdictions tax the gain from the sale of shares of resident corporations without regard to whether the shares constitute a real property interest or are themselves attributable to a trade or business in the jurisdiction. The preamble to the 2021 Final Regulations makes clear that those taxes are not creditable, absent the application of an applicable tax treaty.

In contrast, akin to the U.S. rules, foreign tax imposed on gains from the disposition of a partnership interest may satisfy the property-based nexus requirement if imposed under rules similar to section 864(c)(8), which generally treats certain gain from the sale of a partnership interest as income effectively connected with the conduct of a trade or business in the U.S. to the extent gain from the sale of assets held by the partnership would be so treated.

The 2021 Final Regulations expressly defer to U.S. tax treaties by providing that a foreign tax that is treated as an income tax under an applicable income tax treaty that the United States has entered into with the country imposing the tax meets the definition of a foreign income tax as to U.S. citizens and residents of the United States that elect to claim benefits under that treaty. Because a CFC is not eligible to claim benefits under a U.S. tax treaty, the same foreign levy may not be creditable as a deemed paid tax if it does not satisfy the attribution requirement. However, any modifications to the foreign levy included in a tax treaty between the jurisdiction of the CFC and the jurisdiction imposing the tax are taken into consideration in determining whether the modified foreign levy meets the attribution requirement. In this respect, it is significant that the foreign levy, as modified by the relevant tax treaty, is treated as a separate levy that may or may not meet the attribution requirement. The delineation of separate levies is discussed further below.

KPMG observation

Although the preamble to the 2020 Proposed Regulations indicated that the proposed changes would have no effect on the creditability of taxes covered by a U.S. tax treaty, the 2021 Final Regulations include explicit regulatory language regarding the interaction with tax treaties, rather than merely preamble language, in response to requests in comments. Therefore, although a foreign levy imposed on the sale of stock of a corporation resident in the taxing jurisdiction would not satisfy the attribution requirement where such stock is not a real property interest, such taxes may nonetheless be creditable pursuant to a U.S. tax treaty with the taxing jurisdiction. The interaction of the new attribution requirements and tax treaties is illustrated in three scenarios below.

Scenario 1: Assume US Corp sells shares of CFCX, a Country X corporation that is not a real property interest. Country X imposes capital gains tax on transfers of the stock of Country X corporations, which would not meet the attribution requirement. If the United States-Country X income tax treaty treats the capital gains tax as an income tax, and US Corp elects the benefits of the United States-Country X income tax treaty, the Country X capital gains tax may be creditable pursuant to Reg. § 1.901-2(a)(1)(iii) notwithstanding that such tax does not otherwise meet the attribution requirement.

Scenario 2: Same facts as Scenario 1, except that US Corp also owns CFCY and CFCY also owns shares of CFCX. US Corp and CFCY each sell their shares of CFCX, and the Country Y-Country X income tax treaty is similar to the United States-Country X income tax treaty. The Country X capital gains tax imposed on US Corp may be creditable pursuant to the United States-Country X income tax treaty, but the Country X tax imposed on CFCY would not be creditable because CFCY is not

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treated as a U.S. resident under U.S. income tax treaties and the Country X tax imposed on CFCY does not satisfy the attribution requirement.

Scenario 3: Same facts as Scenario 2, except that the Country Y-Country X income tax treaty only allows Country X to impose tax on the sale of CFCX shares in a manner similar to the U.S. FIRPTA regime under section 897. As a result, the Country X tax as modified by the Country Y-Country X income tax treaty may satisfy the attribution requirement taking into account the modifications contained in the Country Y-Country X income tax treaty pursuant to Reg. § 1.901-2(a)(1)(iii).

For taxes imposed on residents of a jurisdiction, the resident's worldwide gross receipts may be subject to tax, but the profits subject to the tax must be determined by applying transfer pricing rules to transactions with affiliates that are consistent with the arm's length principle, without taking into account as a significant factor the location of end-users or other destination-based criteria.

The 2021 Final Regulations under section 903 also require a foreign levy to meet the attribution requirement in order to qualify as an "in lieu of" tax under section 903, by requiring that the attribution requirement would be satisfied if a net income tax were instead imposed with respect to the income subject to the "in lieu of tax." In particular, a withholding tax must satisfy the source-based nexus requirement. This and other changes to the section 903 regulations are discussed in detail below.

KPMG observation

The attribution requirement for "in lieu of" taxes (including withholding taxes) under section 903 generally makes withholding taxes imposed on payments for services performed outside of the taxing jurisdiction non-creditable. As discussed below, a withholding tax is treated as a separate levy as to each separate class of gross income described in section 61 and as to each subset of a class of gross income that is subject to different sourcing rules. Thus, even if a jurisdiction's withholding tax does not meet the attribution requirement with respect to services, it may meet the attribution requirement with respect to royalties. In some cases, it may be possible to restructure a value chain to provide for a royalty rather than a service fee, though treatment as a royalty may or may not be beneficial depending on many factors, including the withholding rates applicable to services and royalties and whether the jurisdiction's sourcing rule for royalties is based on the use, or the right to use, intangible property within the jurisdiction.

Changes to net gain requirement

For a foreign levy to qualify as a net income tax, the prior FTC regulations required a factual inquiry as to whether the "predominant character" of the tax is that of an income tax. The "predominant character" analysis required a determination as to whether the tax is imposed on "net gain" in the "normal circumstances" in which it applies. Whether a tax is imposed on net gain has historically required a tax to meet three requirements: realization, gross receipts, and net income. Determining whether a tax satisfies the net gain requirement has historically required fact-intensive analysis, which Treasury characterizes as administratively burdensome in the preamble to the 2021 Final Regulations. For example, a tax that is not imposed with respect to actual gross receipts could satisfy the gross receipts requirement under the prior regulations if the tax base computes gross receipts "under a method that is likely to produce an amount that is not greater than fair market value" of the actual gross receipts. As an additional example, the net income requirement could be satisfied under the prior regulations a if the taxpayer was permitted to deduct amounts "computed under a method that is likely to produce an amount that approximates, or is greater than" the actual costs and expenses incurred by the taxpayer that are attributable to the income included in the tax base.

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The 2020 Proposed Regulations retained the net gain requirement but introduced significant changes so that the standard applies based on the terms of the foreign tax law itself to address the uncertainties and administrative difficulties that Treasury perceives arose under the empirical analysis required under prior law. The 2021 Final Regulations are largely consistent with the approach of the 2021 Proposed Regulations but include several modifications in response to comments. Under the 2021 Final Regulations, the net gain requirement includes the new attribution requirement described above, and retains revised versions of the realization requirement, the gross receipts requirement, and the requirement for the allowance of significant cost recovery (referred to in the prior final regulations as a net income requirement).

The realization requirement generally may be satisfied in one of three ways. First, the requirement is satisfied if the foreign tax is imposed in connection with (or subsequent to) an event that would be a realization event under U.S. tax principles. Second, foreign tax may be imposed upon a "pre-realization event" that results in the recapture of a prior tax allowance accorded to the taxpayer. Finally, foreign tax may be imposed upon certain "pre-realization timing difference events," such as a mark-to-market regime or a deemed distribution or inclusion regime, as long as a second tax is not later imposed with respect to the same income (unless a credit is granted with respect to the second tax for the tax paid in connection with the pre-realization timing difference event).

The 2021 Final Regulations also provide that inclusion in the tax base of an insignificant amount of income (measured based on the application of the tax to all taxpayers) that is not tied to a realization or pre- realization event (and, therefore, that does not meet the realization requirement) does not prevent qualification of the tax as a net income tax.

Consistent with the general goal of minimizing empirical analysis, the 2021 Final Regulations removes the general rule in the gross receipts requirement that allowed computation under a method that is "likely" to produce an amount not greater than gross receipts and instead requires the foreign tax be imposed on actual gross receipts or deemed gross receipts in respect of a pre-realization event or pre-realization timing difference event. In addition, in connection with an insignificant nonrealization amount (described above) or a realization event that does not result in actual gross receipts, the 2021 Final Regulations allow for tax to be imposed on an amount "reasonably calculated" to not exceed fair market value.

Consistent with the 2020 Proposed Regulations, the 2021 Final Regulations remove the nonconfiscatory gross basis tax rule contained in the prior regulations, so that a gross basis tax cannot qualify as a net income tax regardless of effect, subject to the limited exception described below.

Pursuant to the 2021 Final Regulations, the cost recovery requirement is satisfied if the tax base allows the recovery of significant costs and expenses attributable to the gross receipts included in the tax base. In connection therewith, the regulations specify certain significant costs and expenses that must be allowed as a deduction for the cost recovery requirement to be satisfied, which are capital expenditures, interest, rents, royalties, wages or other payments for services, and research and experimentation. Otherwise, empirical analysis is still required for determining whether a cost or expense is significant based on whether the expense constitutes a significant portion of the taxpayers' total costs and expenses (considering all taxpayers to which the tax applies). The imposition of disallowances under foreign law consistent with the principles of U.S. tax law (e.g., section 163(j), section 267A, or section 162) does not prevent satisfaction of the cost recovery requirement. The availability of a deduction for foreign income tax is irrelevant to the satisfaction of the cost recovery requirement.

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KPMG observation

The 2021 Final Regulations require that a foreign tax allow deductions for interest expense in order to qualify as a potentially creditable net income tax, subject to deduction limitations that are consistent with the limitations in the Code. From an economic standpoint, however, if a foreign tax allows full expensing (or, to a lesser extent, accelerated depreciation) for debt-financed capital investments, also allowing interest deductions on the debt that finances the investment would provide an inconsistent double benefit. Nevertheless, the regulations provide that current expensing of debt-financed investments in lieu of allowing a deduction for interest paid on the associated debt does not satisfy the cost recovery requirement.

In response to comments, the 2021 Final Regulations introduced a limited exception that allows foreign tax that does not provide for cost recovery to satisfy the cost recovery requirement if there are no significant costs attributable to gross receipts included in the tax base.

In a change from the 2020 Proposed Regulations, the 2021 Final Regulations provide additional flexibility in that the cost recovery requirement may be met if a foreign tax regime that allows taxpayers to choose to either (i) deduct actual costs and expenses or (ii) deduct an optional allowance in lieu of actual costs and expenses. Where the foreign tax does not allow for the recovery of a significant expense, the cost recovery requirement may be satisfied if the foreign tax provides an alternative allowance that by its terms is never less than the actual amount of the expense. An alternative allowance may also be allowed in the case such allowance is provided pursuant to a small business exception in the foreign tax law regime.

The 2021 Final Regulations also clarify that differences in timing of a cost recovery deduction, whether allowed before or after an amount would be allowed under U.S. tax law, generally would not prevent satisfaction of the cost recovery requirement, and that the time value of money is not taken into account in determining the amount recovered.

Applicability date

The foregoing modifications to Reg. § 1.901-2 in respect of the qualification of a tax as a foreign income tax apply to foreign taxes paid or accrued in tax years beginning on or after December 28, 2021. However, a special one-year deferral rule applies with respect to taxes paid to Puerto Rico under section 1035.05 of the Puerto Rico Internal Revenue Code of 2011, as amended—accordingly, the foregoing rules apply to such taxes paid to Puerto Rico in tax years beginning on or after January 1, 2023.

KPMG observation

Treasury received comments requesting that taxes paid to Puerto Rico be exempted from the application of the attribution requirement because, as a U.S. territory, some commentators argued that Puerto Rico's taxes ought to not be treated in the same manner as taxes imposed by a foreign country. Additionally, in Notice 2011-29, 2011-16 I.R.B. 663, Treasury announced that it would not challenge a taxpayer's assertion of creditability with respect to the Puerto Rico excise tax on a controlled group member's acquisition from another group member of certain personal property manufactured in Puerto Rico and certain services performed in Puerto Rico. Treasury disagreed that there is a meaningful distinction between taxes imposed by U.S. territories and those imposed by foreign countries; however, Treasury determined that a delayed applicability date was necessary and appropriate, and thus the 2021 Final Regulations included a special one-year deferral rule with

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respect to taxes paid to Puerto Rico.

"In lieu of" taxes under section 903

Section 903 allows a taxpayer to take a foreign tax credit in respect of certain foreign taxes paid "in lieu of a tax on income, war profits, or excess profits" imposed by a foreign country or U.S. possession (such a tax referred to herein as an "in lieu of tax"). An in lieu of tax is not subject to the net gain requirement and therefore its base may be gross income or receipts. The regulations under section 903 provide requirements that must be satisfied in order for such a tax to be creditable.

The 2021 Final Regulations under section 903 are generally consistent with the 2020 Proposed Regulations (but include several additional examples) and completely replace the existing regulations under section 903. The 2021 Final Regulations retain the basic requirement of the prior regulations that to qualify as an in lieu of tax under section 903 a foreign levy must: (i) be a tax (as determined under Reg. § 1.901-2(a)(2)); and (ii) satisfy a substitution requirement. However, the 2021 Final Regulations would substantially modify the substitution requirement to include four requirements that must be satisfied in respect of the tested tax that is not a "covered withholding tax" or the tested tax must instead qualify as a "covered withholding tax" (as described below).

Under the first prong, the foreign jurisdiction must generally impose a net income tax as defined under Reg. § 1.901-2(a)(3) (the "generally imposed net income tax requirement"). Under the second prong, neither the generally imposed net income tax nor any other net income tax may be imposed by the foreign country on income (the "excluded income") to which the base of the tested tax relates (the "non-duplication requirement"). It should be noted that a foreign tax is either creditable or not creditable with respect to all taxpayers and that the creditability of a given tax is not determined on a taxpayer-by-taxpayer basis. Therefore, in order for the non-duplication requirement to be satisfied, no taxpayer that is subject to the tested tax may be subject to any net income tax imposed by the foreign country in respect of the excluded income.

Under the third prong, the imposition of the tested tax must bear a close connection to the failure to impose the generally imposed net income tax on the excluded income (the "close connection requirement"). The close connection requirement requires that the foreign jurisdiction deliberately excluded the excluded income from its net income tax in favor of subjecting it to the tested tax. A close connection exists if the generally imposed net income tax would apply by its terms to the excluded income, but for the fact that the excluded income is expressly excluded. The 2021 Final Regulations also provide that a tested tax enacted contemporaneously with a generally-imposed net income tax may satisfy the close connection requirement if such net income tax does not apply to the excluded income. If the tested tax is not enacted contemporaneously with a generally-imposed net income tax, and is not accompanied by an amendment to such net income tax that excludes the excluded income from the such tax, a close connection can only be established by the legislative history of the tested tax or its predecessor.

The fourth prong requires that, if the generally imposed net income tax or a hypothetical new tax that is a separate levy were applied to the excluded income, the generally imposed net income tax (or hypothetical new tax) would meet the attribution requirement (described above) in Reg. § 1.901-2(b)(5) (the "jurisdiction-to-tax requirement").

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KPMG observation

The jurisdiction-to-tax requirement in the 2020 Proposed Regulations cross-referenced Prop. Reg. § 1.901-2(a)(3), which would thus have included both the net gain requirement and the jurisdictional nexus requirement. This led to confusion as to how a taxpayer could determine whether a hypothetical generally imposed net income tax would reach net gain. In response, the 2021 Final Regulations updated the jurisdiction-to-tax requirement to provide that only the attribution requirement need be satisfied.

As described above, under the 2021 Final Regulations, the substitution requirement is satisfied in respect of a tested tax that qualifies as a "covered withholding tax." The definition of "covered withholding tax" incorporates certain of the four requirements described above that apply to tested taxes that are not covered withholding taxes with modifications, but does not incorporate the close connection requirement. In order for a tested tax to qualify as a covered withholding tax, the generally imposed net income tax requirement must be satisfied. Additionally, such tested tax must be a withholding tax imposed on gross income of nonresidents of the taxing country and must not be imposed in addition to a net income tax imposed on the same income. Finally, the income subject to the tested tax must satisfy the source-based nexus requirement (discussed above and which generally requires the income be sourced to the country imposing the withholding tax under U.S. tax principles).

Applicability date

The foregoing modifications to Reg. § 1.903-1 in respect of "in lieu of" taxes apply to foreign taxes paid or accrued in tax years beginning on or after December 28, 2021. However, a special one-year deferral rule applies with respect to taxes paid to Puerto Rico under section 3070.01 of the Puerto Rico Internal Revenue Code of 2011, as amended—accordingly, the foregoing rules apply to taxes paid to Puerto Rico in tax years beginning on or after January 1, 2023.

Separate levy rules

Whether a foreign levy imposed by a given jurisdiction qualifies as a foreign income tax is determined separately from any other foreign levy imposed by such jurisdiction. The 2021 Final Regulations finalized modifications contained in the 2020 Proposed Regulations in respect of the separate levies analysis and included additional rules in respect of foreign levies that are modified contractually or pursuant to an applicable income tax treaty and introduce several new examples aimed at clarifying the determination as to whether a foreign country imposes separate levies.

In general, and consistent with the 2020 Proposed Regulations, the 2021 Final Regulations treat levies as separate levies if they have separately determined bases or are imposed by different tax authorities. In addition, a foreign levy imposed on nonresidents is always be treated as a separate levy from that imposed on residents of the taxing jurisdiction (even if the base is the same for both), to ensure that if a generally imposed income tax on residents is also imposed on an extraterritorial basis to nonresidents, only the portion of the levy that applies to nonresidents will fail to qualify as a foreign income tax. For similar reasons, a withholding tax on the gross income of nonresidents would be treated as a separate levy with respect to each class of gross income (as listed in section 61) to which it applies. The 2021 Final Regulations also provide that separate levies are imposed with respect to subsets of the same class of gross income if such subsets are subject to withholding tax based on different income attribution rules.

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KPMG observation

The rule that separates levies are considered imposed with respect to subsets of the same class of income where such subsets are subject to withholding tax based on different income attribution rules was not contained in the 2020 Proposed Regulations. The 2021 Final Regulations provide as an example that separate levies would be considered imposed on subsets of services income where technical services are subject to tax based on the residence of the payor and other services are subject to tax based on the place of performance. As discussed in the preamble to the 2021 Final Regulations, treating the withholding tax imposed on each subset of services income as a separate levy has significant ramifications because each levy is tested separately as a foreign income tax. Because a withholding tax on services based on the residence of the payor would not satisfy the source-based nexus requirement (as discussed above), if the withholding tax on services was treated as a single levy, neither the withholding tax on technical services nor the withholding tax on other services would be creditable. However, as a separate levy, the withholding tax on other services may be creditable because subject such services to tax based on the place of performance would satisfy the source-based nexus requirement.

The 2021 Final Regulations provide that a foreign levy modified by an applicable income tax treaty is treated as a separate levy from both the unmodified levy imposed by domestic law and the levy as modified by a different income tax treaty (even if both treaties modify the levy in an identical manner). Finally, the 2021 Final Regulations provide that contractual arrangements between one or more persons and a foreign jurisdiction modifying a levy result in the modified levy applied to such persons being treated as a separate levy from the levy unmodified by the contractual arrangements that applies to other persons.

Applicability date

The foregoing modifications to Reg. § 1.901-2 apply to foreign taxes paid or accrued in tax years beginning on or after December 28, 2021. However, a special one-year deferral rule applies with respect to taxes paid to Puerto Rico under section 1035.05 of the Puerto Rico Internal Revenue Code of 2011, as amended—accordingly, the foregoing rules apply to such taxes paid to Puerto Rico in tax years beginning on or after January 1, 2023.

Amount of tax that is considered paid

Refundable credits

The 2020 Proposed Regulations contained modifications to the rules under section 901 concerning the amount of foreign income tax that is considered paid and eligible for credit. One of these modifications related to whether a tax is considered paid for foreign tax credit purposes to the extent it is satisfied through the application of a credit available under foreign law. In a change that Treasury seemed to acknowledge was a departure from a fair reading of current law, the 2020 Proposed Regulations provided that, as a general rule, a tax would not be considered paid or accrued if it is satisfied via the application of a tax credit, regardless of whether the tax credit is refundable in cash to the extent it exceeds the taxpayer's foreign income tax liability. The 2020 Proposed Regulations provided an exception where a taxpayer's liability for one foreign income tax is satisfied with a credit resulting from the taxpayer's overpayment of another tax. The 2021 Final Regulations adopt these proposed amendments, with certain modifications.

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Under the IRS's prior administrative practice, a reduction in foreign tax liability due to the application of government incentives in the form of tax credits (for example, R&D or investment credits) that are refundable under foreign law to the extent they exceed a taxpayer's tax liability did not reduce the amount of foreign income taxes paid for purposes of the foreign tax credit, provided that it could be established that the foreign government issued more than a de minimis amount of cash payments to taxpayers whose available credit exceeded their foreign tax liability. See TAM 200146001 (November 16, 2001), General Counsel Memorandum 39617 (Aug. 27, 1986), and Rev. Rul. 86-134, 1986-2 C.B. 104, contrasting the satisfaction of foreign income tax liability with refundable and nonrefundable credits under prior law. Instead, such credits were treated as constructive payments of cash that gave rise to taxable income. Comments on the 2020 Proposed Regulations asserted that this treatment should continue to apply because a refundable credit that does not depend on a taxpayer owing tax functions more like a government grant for engaging in the incentivized activity that, for convenience, is administered through the tax system and provided first as an offset to any income tax otherwise due. Treasury disagreed with these comments on the grounds that such credits represent foregone tax revenue in the nature of tax expenditures and therefore are not similar to government cash grants. Treasury also expressed concern that foreign countries may design tax credits that have the same economic effect as reducing tax rates without reducing the amount of tax that is treated as paid for U.S. FTC purposes.

KPMG observation

The change in the treatment of refundable credits reflects a departure from the prevailing interpretation of U.S. GAAP. Companies generally do not treat refundable tax credits (e.g., where a taxpayer may receive a refund despite being in a taxable loss position) as part of income taxes for financial statement reporting purposes. Consequently, the benefit from the refundable credit generally is not recorded as a reduction to income tax expense, but rather as an adjustment to pre-tax income (e.g., a reduction of R&D expense).

The 2021 Final Regulations are also inconsistent with the treatment of refundable tax credits for purposes of determining the tax base and covered taxes under the BEPS Pillar Two Model GloBE rules that were recently released by the OECD. These rules generally provide that refundable tax credits do not reduce covered taxes and are instead included in the tax base, provided that the credit becomes refundable within four years from when it is first provided. The Inclusive Framework determined that this approach generally aligns with the financial accounting treatment of government grants versus non-refundable tax credits under IFRS, and, therefore, that such treatment will not require adjustments to the financial statements under the Pillar Two GloBE rules.

The preamble to the 2020 Proposed Regulations generally describes the proposed change to the treatment of refundable credits as intended to improve certainty and administrability, particularly with respect to the administrative burden of establishing that a foreign country in practice issued more than a de minimis amount of cash refunds. In finalizing the rules, Treasury rejected comments asserting that the government's administrative concerns regarding refundable tax credits detailed in the 2020 Proposed Regulations could be addressed through additional guidance, including by requiring, consistent with the OECD Model Pillar Two GloBE rules to be treated as a refundable credit that would not reduce creditable foreign taxes, that to be treated as refundable any excess of a tax credit over a taxpayer's cumulative foreign income tax liability could not be indefinitely carried forward but must be paid in cash after a certain period.

The 2021 Final Regulations did, however, expand the exception for tax overpayments to include credits that are fully refundable in cash at the taxpayer's option. Under the modified tax overpayments exception, if foreign law allows the full amount of a tax credit to be paid in cash at the taxpayer's option,

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the taxpayer's choice to apply all or a portion of the tax credit in satisfaction of its foreign income tax liability is treated as a constructive payment of cash to the taxpayer in the amount so applied, followed by a constructive payment of the foreign income tax liability against which the credit is applied. Such treatment applies even if the tax credit is subject to a lien or otherwise seized in order to satisfy a different, pre-existing liability of the taxpayer to the foreign government or to a third party.

In response to a comment, the 2021 Final Regulations extend the treatment of refundable tax credits under the general rule to also apply to transferrable tax credits acquired from another taxpayer. Thus, a foreign income tax liability satisfied through the use of a transferrable tax credit acquired by the taxpayer would not be treated as paid for foreign tax credit purposes.

The 2021 Final Regulations provide four new examples illustrating the application of the refundable credit rules.

KPMG observation

A number of foreign R&D incentives are administered through a refundable credit regime (e.g., the UK, the Netherlands, France, and Canada). Given that the statutory UK corporate rate is currently 19% and the GILTI high tax exception cutoff rate is 18.9%, the change in the treatment of the UK RDEC could cause some taxpayers to no longer qualify for the GILTI high tax exception with respect to the UK.

KPMG observation

The application of the refundable credit rules to transferable tax credits can have harsh results. For example, assume Taxpayer 1 purchases 100x of Country X transferable tax credits from Taxpayer 2 for 90x of cash and uses the credit to completely offset its 100x Country X foreign income tax liability. Under the 2021 Final Regulations, no amount of the foreign income tax liability satisfied by the credit is treated as paid for U.S. FTC purposes even though Taxpayer 1 paid 90x of cash for the credit. As noted in the preamble to the 2021 Final Regulations, Treasury believes that partially refundable credits and transferable tax credits should be treated similarly because both represent foregone revenue that is not received by a foreign country. The preamble also references section 901(i) and Reg. § 1.901-2(e)(3), suggesting that Treasury views transferable tax credits similar to subsidies, although those rules remain substantively unchanged.

Noncompulsory payments

The 2020 Proposed Regulations also contained amendments to Reg. § 1.901-2(e) regarding whether a foreign income tax payment is "compulsory" and thus considered a tax paid for foreign tax credit purposes. The 2021 Final Regulations finalize these rules, with modifications. Consistent with the 2020 Proposed Regulations, the 2021 Final Regulations clarify that that the noncompulsory payment rules require taxpayers to take reasonable steps to minimize foreign income taxes, and not foreign taxes (including non-income taxes such as excise taxes) as an aggregate.

Generally, a foreign amount paid is treated as a compulsory payment if the taxpayer has reasonably interpreted and applied the relevant foreign tax law and exhausted all effective and practical remedies to reduce its foreign income tax liability over time. Pursuant to the 2021 Final Regulations, such determination is made without taking into account the time value of money.

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The 2021 Final Regulations include new guidance regarding the efforts taxpayers must undertake to minimize their foreign income tax liability. Specifically, the 2021 Final Regulations provide that the requirement to minimize foreign income tax liability is met to the extent that the reasonably expected, arm's length costs of reducing the foreign income tax liability would exceed the amount of the potential reduction. For purposes of this "reasonable costs analysis," the 2021 Final Regulations provide that reasonably anticipated foreign non-income tax liabilities (but not U.S. taxes) may be taken into account as relevant costs.

The 2021 Final Regulations also clarify the rules applicable for determining whether a taxpayer has reasonably interpreted and applied foreign law. The 2021 Final Regulations add that voluntarily forgoing a tax benefit to which a taxpayer is entitled under foreign law results in a foreign payment in excess of the taxpayer's liability for foreign income tax.

Treasury has historically interpreted the compulsory tax rules as applying on a taxpayer-by-taxpayer basis, but proposed regulations issued in 2007 proposed to allow certain commonly controlled foreign entities to be treated as a single taxpayer for this purpose. In response to comments criticizing the 2007 proposed regulations, Treasury intends to withdraw them. However, a strict application of the taxpayer-by-taxpayer determination of noncompulsory payments, under which each taxpayer would be required to minimize its own tax liability, could prevent crediting certain taxes imposed on taxpayers that are subject to a foreign law consolidation or loss-sharing regime. Accordingly, the 2020 Proposed Regulations included rules that would provide that a decision to surrender (or not surrender) a loss or to join in a consolidation regime would not give rise to a noncompulsory payment. Furthermore, the 2020 Proposed Regulations proposed to clarify that a decision to make (or not make) an entity classification election available under foreign law would not give rise to a noncompulsory payment.

The 2021 Final Regulations adopt both exceptions to the noncompulsory payment rules proposed by the 2020 Proposed Regulations (relating to entity classification and foreign law options or elections in the context of loss sharing regimes) without modification. The 2021 Final Regulations also add an additional rule not contained in the 2021 Proposed Regulations regarding the effect of a taxpayer's use of options or elections under foreign law on the compulsory nature of a foreign income tax paid. The new rule provides that if a taxpayer has the option to determine its foreign income tax liability under only one of multiple separate levies each of which is a foreign income tax under foreign law, then the amount of foreign income tax paid equals the smallest liability of the amounts that would be due under each of the alternative levies, regardless of which levy the taxpayer uses to determine its foreign income tax liability.
The 2021 Final Regulations also include an additional limited exception to the noncompulsory payment rules for transactions that increase one taxpayer's liability for foreign income tax but reduce a second taxpayer's liability for foreign income tax. The exception generally applies where one taxpayer makes a payment to another taxpayer and foreign hybrid mismatch rules result in an increase to the first taxpayer's foreign income tax liability (for example, by waiving an otherwise allowable deduction) but a greater decrease in the second taxpayer's foreign income tax liability by deactivating a hybrid mismatch rule that would otherwise apply to the second taxpayer. For this purpose, a "hybrid mismatch rule" is a foreign tax law rule substantially similar to sections 245A(e) and 267 and includes rules designed to eliminate the double non-taxation outcomes of hybrid arrangements.

KPMG observation

The preamble to the 2020 Proposed Regulations notes that Treasury is concerned about potentially inappropriate results under loss surrender regimes, in particular the potential to shift taxes between FTC limitation categories. Although finalizing the exception related to foreign law options or elections in the context of loss sharing regimes, Treasury reiterated its position regarding the general application of the noncompulsory payment rules on a taxpayer-by-taxpayer basis in the

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preamble to the 2021 Final Regulations, explaining that applying the noncompulsory payment rules on a group-wide basis would be too difficult and an administrative burden.

Applicability date

The foregoing rules regarding the amount of tax that is considered paid are applicable to foreign taxes paid or accrued in tax years beginning on or after December 28, 2021.

Proper time for claiming a foreign tax credit

The 2020 Proposed Regulations proposed to revise and significantly expand the existing regulations addressing when a foreign tax credit can be claimed. Those regulations were finalized by the 2021 Final Regulations largely without substantive change, except as noted below. The 2021 Final Regulations provide detailed rules that clarify when a foreign tax credit may be claimed by either a cash method or an accrual method taxpayer and, for an accrual method taxpayer, clarify the application of the "relation-back doctrine." The 2021 Final Regulations also address mismatch and time-barred deficiency issues resulting from the application of the relation-back doctrine, as well as the application of the "contested tax doctrine" for purposes of determining when contested foreign income taxes can be claimed as a foreign tax credit. The 2021 Final Regulations also address improper accruals of foreign income taxes and treat a change from an improper method to a proper method of accruing foreign taxes as a change in method of accounting. The 2021 Final Regulations also clarify when foreign income taxes paid or accrued by a partnership or other pass-through entity, including contested taxes, can be claimed as a credit or a deduction by such entity's partners, shareholders, or beneficiaries.

General rule

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

Cash method taxpayers

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

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Pursuant to section 905(a) and consistent with existing regulations, a cash method taxpayer may make an irrevocable election under the 2021 Final Regulations to credit foreign income taxes in the year that they accrue. Such election must be made on a timely filed original return for the year the foreign income taxes accrue and is irrevocable. If the election is made for the first tax year for which the taxpayer claims foreign tax credits, it can also be made on an amended return. The 2021 Final Regulations also contain rules to prevent the loss of foreign tax credits due to a change from the cash method to the accrual method.

KPMG observation

Comments to the 2020 Proposed Regulations argued that a cash basis taxpayer should be entitled to make an election to take foreign income taxes into account on the accrual basis on an amended return. Treasury rejected this comment. The only exception to the general rule is for a cash method taxpayer that is claiming a foreign tax credit for the first time. Such a taxpayer may make an election to take foreign income taxes into account on an accrual basis on an amended return because such a taxpayer has not taken an action that is inconsistent with the position the taxpayer seeks to adopt by making the election.

Accrual method taxpayers

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

KPMG observation

Comments to the 2020 Proposed Regulations argued that Reg. § 1.905-1 misapplied the all events test of section 461. One comment stated that a foreign net income tax could be accrued prior to the close of the foreign tax year because, in normal circumstances, the amount of the liability can be determined with reasonable accuracy based upon the amount of foreign income that had accrued through a certain point in time and the applicable tax rate. Another comment noted that withholding or estimated payments of foreign income tax could be used as the basis of an accrual. Under the all events test, a foreign income tax accrues when all of the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. Foreign net income taxes therefore accrue at the end of the foreign tax year because it is only after the close of the foreign accounting period that no other events can occur that would change the amount of the taxpayer's foreign net income tax liability such that the taxpayer's foreign net income tax liability can be factually established and can be determined with reasonable accuracy. Treasury therefore rejected the comments made with respect to the application of the all events test described in Reg. § 1.905-1 and confirmed that foreign net income taxes accrue at the end of the foreign tax year.

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Reg. § 1.905-1(d) addresses the application of the "relation-back doctrine" to additional foreign income taxes paid by an accrual method taxpayer that relate to a prior tax year. That regulation provides that additional foreign income tax paid as a result of a change in foreign tax liability, including as the result of the resolution of a contest with a foreign tax authority, relates back and is considered to accrue for foreign tax credit purposes at the end of the foreign tax year with respect to which the taxes were imposed (the "relation-back year"). This rule is consistent with case law addressing the relation-back doctrine (discussed in more detail below). The relation-back doctrine generally does not apply to foreign income taxes for which the taxpayer claims a deduction. Additional withholding taxes resulting from a change in the amount of an item of foreign gross income also relate back and are considered to accrue in the year in which the relevant payment was made (or treated as made under foreign law).

Under Reg. § 1.905-3(a), foreign income taxes that are not paid within 24 months after the close of the tax year in which they were accrued are treated as refunded and result in a section 905(c) foreign tax redetermination. Reg. § 1.901-1(d) provides that, when such taxes are subsequently paid, another section 905(c) foreign tax redetermination occurs, and the foreign income taxes are allowed as a credit in the relation-back year.

Taxpayers generally may elect to use a "52/53 week" U.S. tax year for determining taxable income that will typically end on a day other than the last day of a month. A CFC may also be required to use a 52/53 week U.S. tax year under section 898 if it has a majority U.S. shareholder that has a 52/53 week U.S. tax year. Often, those taxpayers will have foreign tax years ending on the last day of the corresponding month rather than on the same day as the 52/53 week year. In such cases, foreign income taxes that relate to foreign income recognized within the U.S. tax year may accrue in a different U.S. tax year, resulting in a mismatch between the year of accrual of the foreign income and the related foreign taxes.
The 2021 Final Regulations adopt a convention that generally would avoid this mismatch. Under the 2021 Final Regulations, if a taxpayer has elected pursuant to section 441(f) to use a 52/53 week U.S. tax year, and such U.S. tax year closes within six calendar days of the end of the taxpayer's foreign tax year, the determination of when foreign income taxes accrue under the general rule is made by deeming the taxpayer's U.S. tax year to end on the last day of its foreign tax year.

KPMG observation

The 2021 Final Regulations' rule for taxpayers with 52/53 week tax years applies to all taxpayers with 52/53 week years and is not elective. The regulation addresses tax year mismatches narrowly as it only addresses those mismatches that arise in the case of 52/53 week year taxpayers. Similar mismatches will continue to occur in other cases where taxpayers have different U.S. and foreign tax years, for example where a taxpayer uses a fiscal year for U.S. tax purposes but is required to use a calendar year for foreign tax purposes.

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

The IRS has provided an exception to the contested tax doctrine for foreign tax credit purposes in revenue rulings. In particular, Rev. Rul. 70-290, 1970-1 C.B. 160, provides that contested foreign income taxes that have been paid to a foreign country may be provisionally accrued and claimed as a foreign tax

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credit, even if the liability for the contested tax has not accrued because the contest has not been resolved. See also Rev. Rul. 84-125, 1984-2 C.B. 125. These rulings have allowed taxpayers to avoid the expiration of the statute of limitations for claiming a foreign tax credit where it would otherwise expire before the foreign contest is resolved.

The 2021 Final Regulations address the application of the contested tax doctrine in a manner generally consistent with the case law. The 2021 Final Regulations first provide as a general rule that a foreign tax credit for a contested income tax liability cannot be claimed by an accrual method taxpayer until such time as both the contest is resolved, and the tax is actually paid. Thus, an accrual method taxpayer generally cannot claim a foreign tax credit for a contested foreign tax, even if remitted to the foreign government before the contest is resolved.

The 2021 Final Regulations provide an exception to this general rule, however, that allows a provisional foreign tax credit in the relation-back year to the extent the taxpayer remits the contested amount to the foreign country pending settlement of the dispute. As a condition to this provisional credit, the taxpayer must enter into an agreement with the IRS that describes the details regarding the contested tax and allows the IRS to audit the claim for credit when the contest is resolved. The taxpayer is also required to provide annual certifications regarding the status of the contest and must agree for a three-year period not to assert the statute of limitations as a defense to the assessment of additional taxes relating to the contested tax that may arise from a determination that the contested tax is noncompulsory.

The 2020 Proposed Regulations would have allowed an accrual method taxpayer to elect a provisional foreign tax credit for contested taxes if certain administrative requirements were satisfied. The election was not, however, available to cash method taxpayers under the 2020 Proposed Regulations. As finalized by the 2021 Final Regulations, Reg. § 1.905-1(c) is amended to also allow a cash method taxpayer a provisional foreign tax credit for contested foreign income taxes if the taxpayer makes an election to claim such provisional foreign tax credit and satisfies the same administrative requirements applicable to accrual method taxpayers.

KPMG observation

Prop. Reg. § 1.905-1(d)(4) provided that while a taxpayer may claim a provisional foreign tax credit for the amount of contested tax actually paid (again, if certain administrative requirements were satisfied), no deduction would be allowed for any contested foreign income tax until the contest was resolved. A comment to the 2020 Proposed Regulations requested clarification regarding the limitation on deducting foreign income taxes when the contested tax was assessed on a CFC. The 2021 Final Regulations clarify that if a taxpayer elects to claim a provisional foreign tax credit for a contested tax of a CFC, the CFC may deduct the foreign income tax in the relation back year. That clarification ensures that the amount of a taxpayer's section 78 gross-up for the amount of foreign income tax provisionally claimed as a foreign tax credit in the relation back year and the CFC's deduction for such amount in such year properly offset. The 2021 Final Regulations also clarify that the provisional foreign tax credit can only be claimed for foreign income taxes that relate to a tax year for which the taxpayer has elected to credit foreign income taxes.

KPMG observation

The administrative requirements that apply when a taxpayer elects to claim a provisional foreign income tax credit include annual certifications providing information regarding the status of the contest and the amount of foreign income tax at issue. Those administrative requirements also

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require taxpayers to notify Treasury in the tax year in which the contest is resolved. That notification must include the date of resolution and the amount of the finally determined foreign income tax liability. See Treas. Reg. § 1.905-1(d)(4). The 2020 Proposed Regulations provided that if such annual certification requirements were not satisfied then the taxpayer would be deemed to have received a refund of the amount of the contested tax claimed as a provisional tax credit. That deemed refund would result in a foreign tax redetermination. Such deemed refund provision was not finalized by the 2021 Final Regulations because, as noted in the preamble, Treasury's interests are adequately protected by the statute of limitations waiver required when making the provisional foreign tax credit election.

KPMG observation

Treasury noted in the preamble to the 2020 Proposed Regulations that Treasury intends to withdraw Rev. Rul. 70-290 and Rev. Rul. 84-125 as part of finalizing the 2020 Proposed Regulations. The preamble to the 2021 Final Regulations does not discuss withdrawing those rulings. Nevertheless, the regulatory language is quite explicit that the mechanisms provided in Reg. §§ 1.905-1(c)(3) and (d)(4) are the exclusive method for claiming a credit for payment of a contested tax. Thus, for payments subject to these rules (i.e., remittances occurring in tax years beginning after December 28, 2021 without regard to the tax years to which they relate) the Revenue Rulings appear to be deadwood and inapplicable.

Prop. Reg. § 1.905-1 also provided that a change in the timing for accruing foreign income tax expense generally would be a change in method of accounting. A change from an improper method of accounting to a proper method of accrual under the 2021 Final Regulations is treated as a change in method of accounting without regard to whether the taxpayer deducts or credits such taxes in any tax year. An improper method for this purpose does not, however, include corrections to estimated accruals or errors in computing the amount of the foreign income tax. The 2021 Final Regulations provide detailed rules regarding the filing of IRS Form 3115 to obtain the Commissioner's consent to a change in method of accounting and a "modified cut-off approach" to implementing a change in method of accounting for accrued foreign income taxes to prevent the omission or duplication of any amount of foreign income tax paid.

KPMG observation

Although no comments were made with respect to the application of the modified cutoff approach, Treasury determined that the rule as proposed did not provide a clear rule when the taxpayer has both downward and upward adjustments to foreign income taxes in the year of change. Thus and as finalized, Reg. § 1.905-1(d)(5)(ii) clarifies that under the modified cutoff approach, the amount of properly accrued foreign income tax in each statutory and residual grouping is first adjusted upward and then adjusted downward (but not below zero), and that any downward adjustment in excess of the amount of property accrued foreign income tax in any grouping, as increased by the upward adjustment, is carried forward to reduce properly accrued foreign income tax in the relevant grouping in subsequent years.

The 2021 Final Regulations clarify that a partnership takes foreign income taxes into account based upon its method of accounting, consistent with Reg. § 1.703-1(b)(2), and that a partner in such partnership may claim a foreign tax credit for their distributive share of those foreign income taxes even if the partner uses a different method of accounting for foreign income taxes than the partnership. Thus, for example,

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a cash method partner can generally claim a credit for its distributive share of foreign income taxes for a year even though they are taken into account by the partnership on an accrual basis. The 2021 Final Regulations also address the treatment of foreign income taxes relating to a prior tax year, as well as the treatment of contested foreign income taxes. Such rules apply only to a partner's distributive share of foreign income taxes. Foreign income taxes for which a cash method partner is the technical taxpayer (e.g., if a partnership is fiscally transparent for foreign tax purposes) are taken into account by the cash method partner only when paid even if the taxes relate to flow-through income that is subject to tax on an accrual basis under foreign law. Rules similar to those for partnerships apply to S corporations, trusts and estates, and their shareholders, grantors, and beneficiaries.

KPMG observation

A comment was made with respect to Prop. Reg. § 1.905-1(f)(1), which provided that a partner that elects to claim a foreign tax credit in a tax year may claim its distributive share of foreign income taxes that the partnership paid or accrued (as determined under the partnership's method of accounting) during the partnership's tax year that ends with or within the partner's tax year. The comment recommended that additional foreign income tax paid by an accrual method partnership in a tax year that relates back to a prior tax year of the partnership be taken into account by a cash method partner in the partnership in such relation back year. Treasury rejected this comment and reiterated that such a cash method partner would take the additional foreign income tax into account in the tax year in which the foreign tax redetermination occurs rather than in the relation back year.

The accrual and payment of an additional foreign income tax constitutes a foreign tax redetermination that, in the case of an accrual method taxpayer, must be taken into account in the relation back year rather than the year of accrual and payment. Under the relation back doctrine, such a foreign tax is treated as if it accrued in the relation back year for purposes of the foreign tax credit. Thus, finalized Reg. § 1.905-1(f) could be difficult to administer given that many accrual method partnerships will be required to file administrative adjustment requests to take additional foreign income taxes into account in the relation back year pursuant to Reg. § 1.905-4(b). *See e.g.*, 84 Fed. Reg. 69124, 69137 ("The use of the AAR process, even if the period under section 6227(c) is closed, is intended to further the purpose of sections 905(c), 6227(d), 6235(a), and 6241(11). An AAR is analogous to an amended return, which is required from other taxpayers who have a foreign tax redetermination, and provides an administrable process whereby a partnership, and its partners, can satisfy their obligations under section 905(c)."), *finalized by*, 685 Fed. Reg. 71998 (November 12, 2020).

Applicability date

Reg. § 1.905-1 as finalized by the 2021 Final Regulations is applicable to foreign income taxes paid or accrued in tax years beginning on or after December 28, 2021. The election to take contested taxes as a provisional foreign tax credit may also be made with respect to amounts of contested tax that are remitted in tax years beginning on or after December 28, 2021 and that relate to a tax year beginning before December 28, 2021.

Other changes to Reg. § 1.901-1

The 2021 Final Regulations also finalize the proposed updates to the rules in Reg. § 1.901-1. Although

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largely non-substantive, the updates reflect that certain taxes for which a credit is disallowed (such as under section 901(j) or (m)) may be allowed as a deduction. They also reflect that a deduction may be allowed in a year for which a credit is otherwise taken, if the deduction is for taxes resulting from a foreign tax redetermination relating to a year in which a deduction was claimed.

The 2021 Final Regulations reference the applicable refund period for purposes of determining the period in which a taxpayer may change its choice of credit or deduction (i.e., generally three years for a deduction or to change to a deduction, and currently 10 years for a credit or to change to a credit). The 2021 Final Regulations therefore shorten the period during which a taxpayer can change an election to credit foreign income taxes to a deduction for foreign income taxes.

Applicability date

The foregoing rules apply to foreign taxes paid or accrued in tax years beginning on or after December 28, 2021.

The "technical taxpayer" rule and mid-year transactions

The 2020 Proposed Regulations contained rules that would modify the application of the technical taxpayer rule with respect to foreign income taxes imposed on partnerships and disregarded entities as well as the allocation of foreign income taxes that arise in a year in which certain other mid-year transactions occur. Treasury noted in the preamble to the 2021 Final Regulations that no comments were received on these proposed rules, and the proposed rules were finalized without change.

The technical taxpayer rules in prior Reg. § 1.901-2(f) provided that the technical taxpayer with respect to foreign income taxes imposed at the entity level of a partnership is the partnership (but because a partnership is not liable for U.S. federal income tax, a partner on the date the foreign income taxes accrue may be eligible to credit its distributive share of the foreign income taxes) and the technical taxpayer with respect to foreign income taxes imposed on a disregarded entity is the person treated as owning the assets of the disregarded entity for U.S. tax purposes. The prior regulations provided for the allocation of foreign income taxes imposed on a partnership or disregarded entity subject to certain ownership changes during the relevant foreign tax year among the various owners during the year, even though the foreign income taxes did not accrue during such owner's period of ownership. For example, the regulations provided for an allocation (in accordance with the principles of Reg. § 1.1502- 76(b), as described below) of foreign income taxes arising in a foreign tax year in which a technical termination of a partnership or a transfer of an interest in a disregarded entity occurred. However, the regulations did not provide for an allocation of foreign income taxes in respect of a foreign tax year in which an entity classification change occurs with respect to a disregarded entity.

The 2021 Final Regulations expand the scope of "covered events" that require foreign income taxes to be allocated among the owners of the relevant entity in the foreign tax year in which the event occurs, so that a covered event includes a partnership termination under section 708(b)(1), a transfer of a disregarded entity, and a change in the entity classification of a disregarded entity or a corporation. The allocation rules also apply to certain "variances" in a partner's interest in a partnership.

The final regulations provide rules for allocating foreign income taxes (other than withholding taxes) paid or accrued in respect of a foreign tax year in which a covered event occurs that does not result in the closing of the foreign tax year between relevant taxpayers (e.g., a partnership or corporation that undergoes a covered event, or the owner of a disregarded entity that is transferred or is subject to an entity classification election, during such foreign tax year). Such foreign income taxes are allocated

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between the relevant taxpayers based on the respective portions of the foreign tax base that are attributable under the principles of Reg. § 1.1502- 76(b) to the period of ownership of each taxpayer. Under the principles of Reg. § 1.1502-76(b), taxpayers are permitted to allocate the foreign tax base between relevant taxpayers based either on a "closing of the books" method or a "ratable allocation" method.

Consistent with the 2020 Proposed Regulations, the 2021 Final Regulations allocate foreign taxes among multiple prior owners if multiple covered events occur during the same tax year and exclude withholding taxes from the application of the allocation rules, because withholding taxes, in contrast to net basis taxes, generally accrue contemporaneously with the payment of the income to which they relate.

KPMG observation

In limiting the application of the allocation rule to "covered events," the 2021 Final Regulations potentially leave room for other situations where U.S. tax rules may see a transfer between taxpayers and the close of a U.S. tax year while foreign law sees no event whatsoever, such as the continuation of a foreign entity into the United States without relinquishing its foreign corporate charter.

The 2021 Final Regulations also modify the rules for allocating foreign income taxes in respect of a foreign tax year in which a section 338 election is made to conform to the existing rules that apply in the case of a section 336(e) election. Specifically, the final regulations provide that such foreign income taxes are allocated between old and new targets based on the respective portions of foreign taxable income attributable to the old and new targets under Reg. § 1.1502-76(b) principles, similar to the existing foreign income tax allocation rules for section 336(e) elections. The regulations clarify that when there are multiple section 338 elections with respect to the target during target's foreign tax year, foreign income tax paid or accrued with respect to that foreign tax year is allocated among all old targets and new targets. The 2021 Final Regulations provide that, if a section 338 election is made for a target that holds an interest in a disregarded entity or partnership, the foreign tax allocation rules apply with respect to foreign income taxes paid by the disregarded entity or partnership. Finally, the 2021 Final Regulations clarify that withholding taxes are not subject to allocation in the case of either a section 336(e) or 338 election.

Applicability date

The modifications to the technical taxpayer rule and the allocation of foreign income taxes in connection with mid-year transactions generally apply to foreign income taxes paid in tax years beginning on or after December 28, 2021. However, the applicability date of the provision in Reg. § 1.901-2 is deferred one year with respect to certain taxes paid to Puerto Rico.

Other provisions

Source of subpart F, GILTI and PFIC inclusions

The 2020 Proposed Regulations contained a rule governing the source of subpart F and GILTI inclusions, as well as PFIC inclusions under section 1293. The proposed regulation was adopted without substantive change. Under Reg. § 1.861-3(d), inclusions with respect to a CFC under section 951 or 951A or a PFIC

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under section 1293, and any related section 78 gross up, are sourced in the same manner as a dividend paid directly by the CFC or PFIC regardless of whether the CFC or PFIC is directly held by the relevant U.S. taxpayer. As a result, deemed inclusions from a CFC or PFIC and the section 78 gross up generally are treated as foreign source income unless the foreign corporation earns a significant amount of effectively connected income (or the income is resourced under section 904(h)). This rule is needed to fill the gap Treasury left when it removed the prior sourcing rule in Reg. § 1.960-1(h) to align the section 960 regulations with the TCJA; under the prior sourcing rule, inclusions would generally have been foreign source without regard to the amount of the foreign corporation's effectively connected income.

Applicability date

The sourcing rules in Reg. § 1.861-3(d) apply to tax years ending on or after November 2, 2020.

FDII clarifications

Definition of electronically supplied services

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

The 2020 Final FDII Regulations treat ESS as a subcategory of general services and create a new standard for determining whether such service generates FDDEI services income (i.e., the location of the device accessing the service). The 2020 Final FDII regulations define an ESS as a general service (other than an advertising service) that is delivered primarily over the internet or an electronic network. The 2020 Proposed Regulations proposed to modify this definition, providing that, for a service to be considered an ESS, its value must be derived primarily from the service's automation or electronic delivery. The provision of access to digital content, on-demand network access to computing resources, the provision or support of a presence on a network, online intermediation platform services, and automatically generated services are all listed as examples of ESS. In contrast, a service that primarily involves human effort (other than the human effort involved in the development or maintenance of the technology enabling the electronically supplied service) would not be an ESS. Examples of services that are not ESS are legal, accounting, medical, or teaching services, even if "provided electronically and synchronously."

The 2021 Final Regulations adopt the proposed change to the definition of ESS proposed by the 2020 Proposed Regulations, except that the reference to services provided "synchronously" has been eliminated.

KPMG observation

Treasury was concerned that use of the term "synchronously" in the proposed amendment to the definition of ESS would suggest that only services such as legal, accounting, medical, or teaching services specifically provided in real-time would be considered when determining whether the services should be excluded as primarily involving human effort. The preamble notes that deleting the reference to "synchronously" in the 2021 Final Regulations is necessary to clarify the intent that the main consideration is whether, under all the facts and circumstances, the services primarily involve human effort, not whether the services are accessed by end users in or outside of real

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time.

For example, consider a webcast or instructional video made available electronically that is accessed after a live stream from a catalogue of content of the provider from which it remains available and accessible on demand by its customers. Under the 2020 Proposed Regulations, it was unclear whether such services could be treated as ESS because they are accessed asynchronously (i.e., outside of real time). However, the 2021 Final Regulations clarify that whether the webcast is accessed via live stream or subsequently via on-demand library is not determinative, and the value of the provider's service would likely be treated as derived primarily from the human effort of the presenters rather than its electronic delivery.

Definitions of FOGEI and DOGEI

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

In order to address concerns that taxpayers could use different methods of determining DOGEI and FOGEI in order to maximize FDII (by minimizing DOGEI) and minimize GILTI (by maximizing FOGEI), respectively, the 2020 Proposed Regulations proposed a requirement that a taxpayer use a consistent method for determining both DOGEI and FOGEI. The 2021 Final Regulations adopt the proposed changes without modification. For further discussion of these changes, read ***KPMG Report: Analysis of final and proposed foreign tax credit regulations*** [PDF 750 KB] (November 24, 2020).

Applicability date

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

Foreign-foreign nonrecognition transactions and section 367(b)

Section 367(b) and the regulations thereunder generally provide rules for the carryover of E&P and foreign taxes under section 381 in certain nonrecognition transactions involving a foreign corporation and require the recognition of income in the case of acquisitions of foreign corporation stock or assets by foreign corporations in certain nonrecognition transactions. The section 367(b) regulations provide detailed mechanisms involving the treatment of hovering deficits, post-1986 E&P and foreign taxes, and pre-1987 E&P and foreign taxes to account for the fact that, prior to the TCJA, E&P and foreign tax pooling was required in order to compute the foreign income taxes deemed paid on a dividend distribution or inclusion from a foreign corporation.

The 2020 Proposed Regulations included amendments to the regulations under section 367(b) to account for the repeal of section 902 by the TCJA. The 2021 Final Regulations adopt the proposed amendments to the section 367(b) regulations without substantive modification.

Under prior Reg. § 1.367(b)-4(b)(2), certain exchanging shareholders with respect to a foreign acquired

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corporation were required to include amounts in income on the receipt of preferred or in some cases other stock if, immediately after the exchange, a domestic corporation met the ownership threshold specified by former section 902(a) or (b) for claiming deemed paid foreign tax credits (generally a 10% voting stock ownership threshold) with respect to a transferee foreign corporation. Given TCJA's repeal of section 902, the 2021 Final Regulations delete the references to section 902(a) and (b) and modify the ownership threshold requirement with respect to a transferee foreign corporation to consider not only voting power but value as well. Thus, Reg. § 1.367(b)-4(b)(2)(i)(B) as revised requires an income inclusion on the receipt of preferred or other stock only if a domestic corporation owns at least 10% of the voting power or value of the transferee foreign corporation.

Additionally, the 2021 Final Regulations create special rules for the treatment of earnings and foreign taxes for post-2017 tax years (i.e., post-TCJA years for which the repeal of section 902 is effective). First, the 2021 Final Regulations treat all foreign acquiring corporations, foreign target corporations, and foreign surviving corporations as non-pooling corporations. Therefore, earnings in each post-TCJA year create a separate annual layer of E&P. The 2021 Final Regulations also provide a transition rule that treats all untaxed E&P remaining from pre-TCJA years as within a single pre-pooling annual layer in post-2017 tax years. However, foreign taxes related to non-previously taxed E&P accumulated in tax years before the current year, or in a foreign target's tax year that ends on the date of a section 381 transaction, are not treated as current year taxes in any post-2017 tax year (i.e., those foreign taxes are not current year taxes for purposes of any section 960 deemed paid credit). This includes foreign taxes attributable to E&P deficits that create hovering deficits that are later absorbed in post-2017 tax years.

Applicability date

The amendments to the section 367(b) regulations apply to tax years ending on or after November 2, 2020.

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