Foreign Tax Credit Final Regulations and 2019 Proposed Regulations

December 5, 2019

Tax

On December 2, 2019, the U.S. Department of the Treasury ("Treasury Department") and the Internal Revenue Service ("IRS") released final regulations, as well as new proposed regulations (the “2019 proposed regulations”), addressing issues related to the determination of foreign tax credits in light of the changes made by the Tax Cuts and Jobs Act (“TCJA”). The final regulations are largely consistent with the proposed regulations that were published in December 2018 (the “2018 proposed regulations”), and generally apply to U.S. taxable years ending after December 4, 2018 (and thus to nearly all taxable years after the enactment of the TCJA). However, the 2019 proposed regulations include important new guidance related to the allocation of research and experimentation (“R&E”) expenditures, stewardship expenses, and the rules governing the allocation and apportionment of foreign taxes to income. The two packages also contain long-awaited final and re-proposed regulations under sections 905(c) and 986(a), which govern taxpayer’s obligations regarding foreign tax redeterminations and the translation of foreign taxes.

The Final Regulations

Expense Allocation and Look-Through. As with the overall package, the final regulations generally follow the 2018 proposed regulations with certain changes to the expense allocation rules. Most significantly, the final regulations adopt the approach of the 2018 proposed regulations by treating a portion of the stock of a controlled foreign corporation ("CFC") that earns global intangible low-taxed income ("GILTI") tested income or generates a tested loss as exempt to the extent of the U.S. shareholder’s deduction under section 250(a)(1)(B), thus reducing the amount of deductions allocated to the GILTI category for purposes of the foreign tax credit limitation under section 904(d) (the “FTC limitation”).[1] The final regulations do not otherwise alter or limit the expenses that are allocated to the GILTI category, but additional guidance is provided in the 2019 proposed regulations discussed below. Moreover, the final regulations continue to limit look-through on payments from CFCs to passive income, and thus do not permit look-through to the section GILTI category.[2] Helpfully, the final regulations revise the ratio used to determine the portion of a taxpayer’s assets that are exempt by reason of the shareholder’s section 250 deduction for foreign-derived intangible income ("FDII"). Under the final regulations, the ratio is now determined by dividing the amount of the deduction under

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[1] Treas. Reg. § 1.861-8(d)(2)(ii)(C).

[2] Treas. Reg. § 1.904-5.

section 250(a)(1)(A) by the taxpayer's gross foreign-derived deduction eligible income ("FDDEI").[3] This has the effect of lowering the portion of a taxpayer's assets that are treated as exempt by reason of the FDII deduction.

Transition Rules. Some of the more noteworthy changes in the final regulations were to the transition rules for carryovers of unused foreign taxes and related losses (including separate limitation losses, overall foreign losses, and overall domestic losses). The 2018 proposed regulations allowed taxpayers to either maintain existing foreign tax carryovers in the general category, or to reconstruct and reallocate a portion of the foreign taxes to the new foreign branch category. Loss carryovers were required to be reallocated (or not) on the same basis as foreign taxes.

In response to comments, the final regulations provide new simplified methods for reallocating tax and loss carryovers, and also permit taxpayers to elect different methods for allocating taxes and losses. With respect to unused foreign taxes, the final regulations adopt a commenter's suggestion that taxpayers be permitted to reallocate taxes based on a ratio equal to the amount of foreign income taxes that were paid or accrued by the taxpayer's foreign branches divided by the amount of all foreign income taxes assigned to the general category that were paid, accrued, or deemed paid by the taxpayer for the taxable year.[4] With respect to loss carryovers, taxpayers may choose to reconstruct the losses to determine how much should be in the foreign branch category or use a safe harbor (the nature of which depends on the specific loss carryover).[5] If a taxpayer chooses to allocate unused foreign taxes or a loss carryover to the foreign branch category, they must allocate all carryovers, but can elect between full reconstruction or the safe harbor for each separate carryover.[6]

Foreign Branch Category. While the rules for the foreign branch category remain much the same in the final regulations, important changes were made to the provision that reallocates income between the general and foreign branch category based on the disregarded transfer of certain intangible property. In response to comments, the final regulations limit the applicability of the rule to transfers occurring on or after the date the 2018 proposed regulations were published (December 7, 2018) and provide an exception for transitory transfers of property to a foreign branch.[7] The final regulations also note that the Treasury Department and the IRS continue to consider what additional special rules may be needed to apply the foreign branch category to regulated financial institutions, in particular around the treatment of disregarded payments of interest and allocation of interest expense, and request comments on those issues.

Deemed Paid Taxes. No significant changes were made to the rules that govern whether foreign taxes are considered "properly attributable" to subpart F income, tested income, or previously taxed earnings and profits ("PTEP"). Under the final regulations, foreign income taxes are allocated and apportioned in the single U.S. taxable year in which the taxes accrue, even if those taxes relate to a foreign taxable year that straddles multiple U.S. taxable years.[8]

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[3] Treas. Reg. § 1.861-8(d)(2)(ii)(C)(2)(i).
[4] Treas. Reg. § 1.904-2(j)(1)(iii)(B).
[5] See Treas. Reg. § 1.904(f)-12(j)(2) through (4).
[6] See Treas. Reg. § 1.904(f)-12(j)(5).
[7] Treas. Reg. § 1.904-4(f)(2)(vi)(D)(2) and (3).
[8] See Treas. Reg. § 1.960-1(b)(4).

Additionally, the controversial rules barring the availability of deemed paid foreign tax credits on inclusions under sections 956 and 951(a)(1)(B) remain in place.[9] The final regulations also update the rules regarding the maintenance of PTEP groups consistent with the guidance in Notice 2019-01, while simplifying them to some extent by consolidating the number of groups from 16 to 10.[10]

Foreign Tax Redeterminations Under Sections 905(c). The final regulation do adopt some of the rules included in 2007 proposed and temporary regulations under sections 905(c), while other rules have been re-proposed and are discussed below. The final regulations include rules that define the term foreign tax redetermination consistent with the 2007 rules, as a change in the liability for a foreign income tax and certain other items described in the regulations that may affect a taxpayer's foreign tax credit.[11] However, the regulations make a number of small changes, including specifying that a foreign tax redetermination occurs if any tax that is claimed as a credit or added to PTEP group taxes is subsequently refunded.[12] The 2007 temporary regulations addressing foreign tax redeterminations of foreign taxes claimed as a direct credit by a U.S. taxpayer were also finalized with additional guidance on how the rules apply when a taxpayer is in an excess credit position.[13]

Foreign Currency Issues Under Section 986(a). The final regulations also include rules under section 986(a) with respect to the translation of foreign taxes. The rules are generally consistent with the 2007 temporary regulations, with certain clarifying changes made in response to comments, including changes to the treatment of inflationary currencies and the election to translate accrued taxes using the exchange rate on the date of payment.[14]

The final regulations relating to sections 905(c) and 986(a) generally apply for taxable years ending on or after the date the final regulations are filed in the Federal Register (so presumably 2019).[15]

The 2019 Proposed Regulations

R&E Expenditures. The 2019 proposed regulation include a substantial overhaul of the rules that govern the allocation and apportionment of R&E expenditures. In general, the rules adopt the approach recommended by a number of comments that R&E expenditures are allocable to the income generated by the intangible (the "gross intangible income") related to the relevant Standard Industrial Classification Manual ("SIC") code as a class.[16] In practical terms, this means that, because gross intangible income is defined to exclude amounts included under GILTI, R&E expenditures of a U.S. taxpayer will not be allocated to the GILTI category. The proposed regulations also eliminate a number of favorable provisions in the existing final regulations, including an election to allocate expenses of the basis of gross income, the

[9] Treas. Reg. § 1.960-2(b)(1).
[10] Treas. Reg. § 1.960-3(c)(2).
[11] Treas. Reg. § 1.905-3(a).
[12] *Id.*
[13] Treas. Reg. § 1.905-3(b).
[14] Treas. Reg. § 1.986(a)-1.
[15] Treas. Reg. §§ 1.905-3(d); 1.986(a)-1(f).
[16] Prop. Treas. Reg. § 1.861-17(b).

exception for R&E expenditures undertaken to meet legal requirements, and the rule permitting taxpayers to prove that an additional amount of R&E expenditures should be subject to exclusive apportionment. Additionally guidance is provided on the definition of R&E expenditures, which includes not just amounts deducted under section 174 but amounts capitalized and deducted under section 59(e),[17] and on the treatment of cost sharing arrangements ("CSAs").[18] The rules apply to taxable years beginning after December 31, 2019,[19] with the ability for taxpayers who are on the sales method to rely on the rules for the 2018 and 2019 taxable years if they do so consistently. The final regulations provide an additional opportunity for taxpayers to change their method for their 2018 or 2019 taxable year without the consent of the Commissioner.[20]

Stewardship Expenses. Under existing regulations, stewardship expenses are treated as definitely related and allocable to dividends received, or to be received from the related corporation, and no specific apportionment method is prescribed.[21] However, a significant portion of the return on an investment in a foreign corporation is now taxed immediately under the subpart F or GILTI provisions, and dividends are generally exempt from tax. Accordingly, the proposed regulations generally provide that stewardship expenses are allocable to dividends or inclusions from related corporations, including amounts included under section 78, subpart F, GILTI, or the passive foreign investment company regime.[22] Stewardship expenses are apportioned based on the relative values of the stock in each grouping held by a taxpayer, as determined and characterized under the rules for purposes of allocating and apportioning the taxpayer's interest expense.[23] These rules are proposed to apply to taxable years ending on or after the proposed regulations are filed in the Federal Register (so presumably 2019).[24]

Allocation and Apportionment of Taxes to Income. The final regulations include the rules from the 2018 proposed regulations relating to the allocation and apportionment of taxes to the various foreign tax credit categories, including rules around base and timing differences, with no substantial changes.[25] However, the 2019 proposed regulations contain new and much more comprehensive guidance on these issues in new Treasury regulation section 1.861-20 that also will apply for purposes other than the foreign tax credit limitation.

It includes a newly narrowed definition of taxes on base differences, which will be defined to comprise only seven items enumerated in the regulations, specifically: foreign taxes imposed on life insurance proceeds, gifts, contributions to capital under section 118, the receipt of money or property described in section 1032 or 721, the portion of a distribution treated as a return of basis under section 301(c)(2), and a distribution to a partner described in section 733.[26] Additionally, instead of providing a single principle-based rule for timing differences that is intended to apply to a wide array of factual patterns, the regulation also provides a number of

[17] Prop. Treas. Reg. § 1.861-17(a).
[18] Prop. Treas. Reg. § 1.861-17(d)(4)(iv).
[19] Prop. Treas. Reg. § 1.861-17(h).
[20] Treas. Reg. § 1.861-17(e)(3).
[21] Treas. Reg. § 1.861-8(e)(4)(ii).
[22] Prop. Treas. Reg. § 1.861-8(e)(4)(ii)(B).
[23] Prop. Treas. Reg. § 1.861-8(e)(4)(ii)(C).
[24] Prop. Treas. Reg. § 1.861-8(h)(2).
[25] Treas. Reg. § 1.904-6.
[26] Prop. Treas. Reg. § 1.861-20(d)(2)(ii)(B).

specific rules to address not only timing differences, but also rules addressing, among other things, taxes paid on distributions and under foreign CFC regimes, taxes paid on disregarded payments, and taxes paid by owners of reverse hybrids.[27] Where section 904 is the operative section, newly proposed Treasury regulation section 1.904-6 provides special rules that apply for purposes of section 904, including rules that can assign taxes incurred by a U.S. shareholder to the GILTI category if those taxes are associate with foreign income from a foreign law CFC or reverse hybrid.[28]

These rules apply to taxable years beginning after December 31, 2019.[29] However, new proposed rules that address the attribution of taxes to distributions for purposes of applying section 965(g), particularly in the case of foreign law distributions that are not recognized for U.S. tax purposes, apply to taxable years ending on or after the proposed regulations are filed in the Federal Register.[30]

Foreign Tax Redeterminations Under Section 905(c). In addition to the rules in the final regulations, the 2019 proposed regulations contain rules to address foreign tax redeterminations that have been updated to account for the changes made by the TCJA. In particular, because of the repeal of the pooling system under section 902, section 905(c) was amended to remove the ability of taxpayers to make current year adjustments to account for changes in foreign taxes incurred at the CFC level rather than amending a prior year return. The proposed regulations specify that the required adjustments that must be made as a result of a foreign tax redetermination include not only changes to deemed paid taxes, but also adjustments to the foreign corporation's earnings and profits, and any related subpart F or GILTI inclusions.[31]

For redeterminations before a taxpayer's 2018 taxable year, the proposed regulations require the taxpayer to relate the tax back to the relevant year, and take into account the redetermination in the relation back year, any subsequent pre-2018 year in which a deemed paid credit was calculated, as well as any year to which the relevant taxes are carried.[32] For redeterminations following the taxpayer's 2017 taxable year, the 2019 proposed regulations generally require the taxpayer to file amended returns for a foreign tax redetermination, and do not attempt to provide an alternative method for addressing the issues created by the repeal of the pooling system.[33] However, the Treasury Department and the IRS have requested comments on the transition rule, as well as the general notification requirement. These rules generally apply to taxable years of U.S. shareholders ending after the proposed regulations are filed in the Federal Register, and taxable years of foreign corporations that end with or within those years.[34]

Other Issues. The 2019 proposed regulations also contain a number of other significant changes to the rules. For example, the rules propose changes to the definition of financial services income and entity that would more closely align those rules with the active financing

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[27] See Prop. Treas. Reg. § 1.861-20(d)(2)(i), (d)(3).
[28] Prop. Treas. Reg. § 1.904-6(f).
[29] Prop. Treas. Reg. §§ 1.861-20(h); 1.904-6(h).
[30] Prop. Treas. Reg. §§ 1.965-5(b)(2), 1.965-9(c).
[31] Prop. Treas. Reg. § 1.905-3(b)(2)(ii).
[32] Prop. Treas. Reg. §1.905-5.
[33] Prop. Treas. Reg. § 1.905-4(b).
[34] Prop. Treas. Reg. §§ 1.905-3(d); 1.905-4(f); 1.905-5(e).

exception under subpart F and other similar provisions;[35] new guidance on the allocation and apportionment of expenses related to damages/settlement payments and net operating loss deductions;[36] and guidance on certain issues around the definition of exempt income and assets and the allocation of expenses relevant to insurance companies.[37]

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[35] Prop. Treas. Reg. § 1.904-4(e)(1)(ii) and (2). These rules apply only to taxable years after the ending on or after the date the final regulations are filed in the Federal Register. Prop. Treas. Reg. § 1.904-4(q)(3).
[36] Prop. Treas. Reg. § 1.861-8(e)(5), (8).
[37] Prop. Treas. Reg. §§ 1.861-8(d)(2)(v); 1.861-14(h).