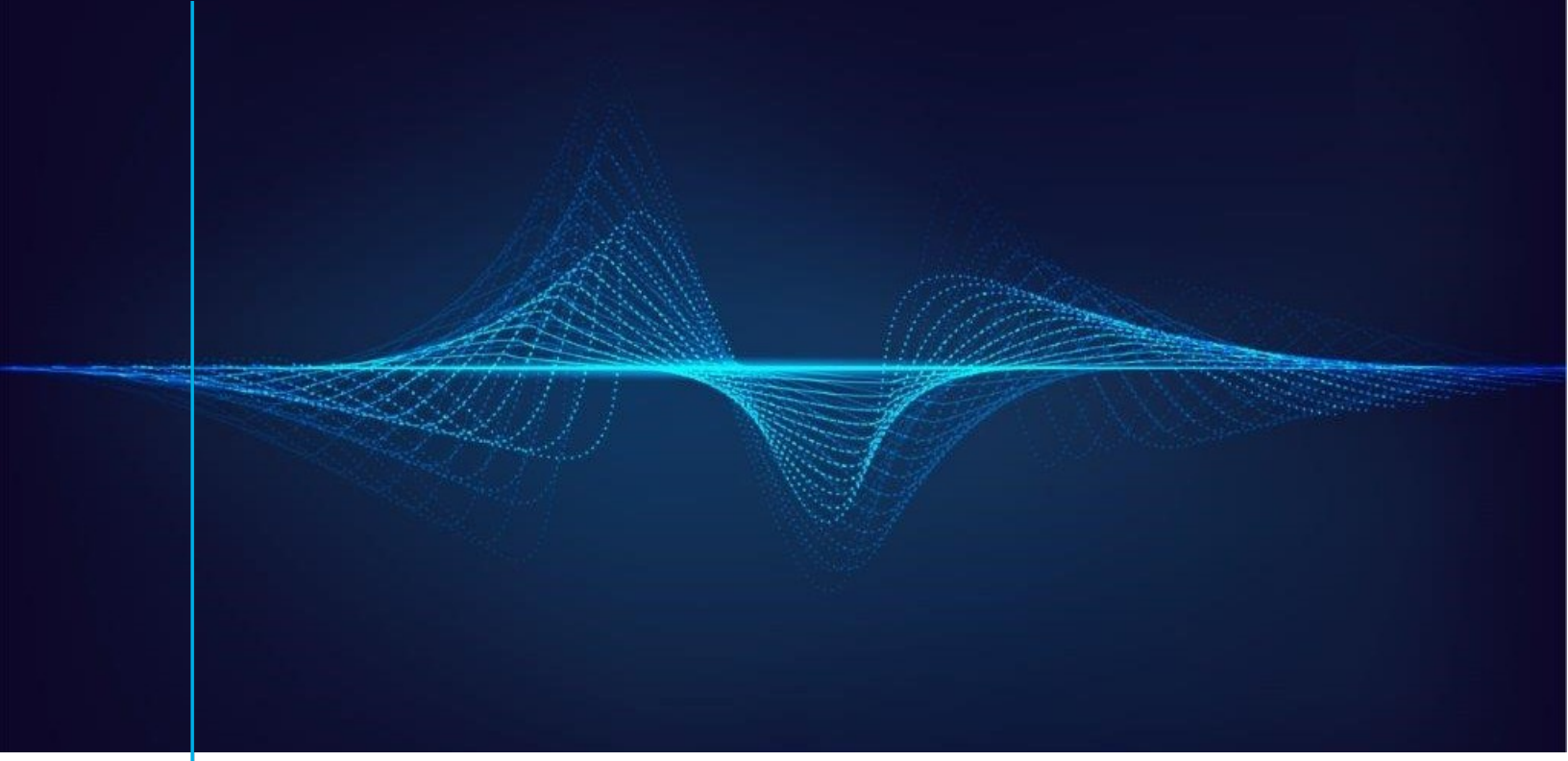

Final FTC Regulations Cause Double Taxation –Burden(s) Falls on Taxpayers

Bloomberg Tax

Baker McKenzie.

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Foreword

Dear Readers,

We hope the new year brings you good health.

Baker McKenzie is pleased to work with Bloomberg Tax again to address an issue of pressing concern to U.S.-parented multinational entities, which may be struggling to remain competitive in a post-pandemic global economy.

In the midst of ongoing efforts aimed at historic global tax reform targeting the U.S. technology and pharmaceutical industries, Treasury and the IRS published regulations last month that have the potential to create an additional double tax burden for U.S. multinationals across all industries. These foreign tax credit regulations indiscriminately limit the definition of a creditable foreign tax, resulting in, in many cases, double taxation on the same item of income.

While we question the validity of certain aspects of these regulations (especially where substantial changes were made to the proposed regulations without a proper notice and comment period), the regulations' effective date means that taxpayers must immediately address the significant consequences of these regulations.

With the erratic pace of global and federal tax developments, we feel strongly that protecting U.S. businesses is a shared responsibility. Our Tax Planning and Transactions practice group has been entrenched in internal conversations concerning these regulations, and attorneys across our U.S. offices prepared this Special Report to begin a conversation with you.

Please feel free to reach out to the authors with any questions.

Finally, a big thank you to all the Baker McKenzie attorneys who authored these articles, and others who offered their advice and insight, including: Mary Bennett, Christopher Hanna, and Julia Skubis Weber. I would also like to acknowledge our associates and professional staff who contributed to this Special Report: Taryn Baker, Elizabeth Boone, Eric Min, David Simon-Fajardo, Anne Hsiao, Steven Smith, Chengwen Tse and Camille Woodbury.

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Final FTC Regulations Cause Double Taxation – Burden(s) Fall on Taxpayers

Part 1: Net Gain and Attribution Requirements

I. Introduction

Just before New Year's, Treasury issued the most important foreign tax credit regulations in the last 40 years. These new regulations dramatically modify the analysis for determining whether a foreign levy is a creditable foreign tax, and taxpayers will be shocked to learn that many common previously creditable foreign taxes are no longer creditable.

Because of the breadth and importance of these changes, our coverage is broken down into a three-part series that will examine:

- Changes to the "net income tax" definition and other changes in Reg. §1.901-2[1] that restrict the ability of taxpayers to claim a foreign tax credit;
- Changes to the withholding and substitute tax rules in §903 that dramatically reduce the types of services and royalty withholding taxes that can qualify as creditable foreign taxes; and
- Changes to the disregarded payment rules in Reg. §1.861-20, the foreign tax credit timing rules under §901 and §905, and other foreign tax credit rules that taxpayers should be aware of.

In this first part, we focus on the new net gain requirement that a foreign income tax must satisfy to qualify as a creditable foreign "income" tax and other critical changes in Reg. §1.901-2(e), relating to the rules for determining the amount of a creditable foreign income tax.

Part 1 provides an overview of the most important changes to the "net gain" requirement in Reg. §1.901-2(b) – in particular, the new attribution requirement, and modifications to the cost recovery requirement. In addition, we analyze an important "treaty coordination" rule that generally allows a taxpayer to claim a foreign tax credit for certain foreign income taxes covered under an applicable U.S. income tax treaty, even though the net gain requirement is not satisfied. We also discuss possible planning responses that taxpayers may consider to minimize double-taxation under these new foreign tax credit regulations.

In the remaining parts of this article series, we will focus on other important provisions in new Reg. §1.901-2. These important provisions include: the compulsory payment rules, effective date considerations and rules that will likely adversely impact many taxpayers who have benefitted from local-country research and development tax credits and manufacturing incentives.

II. Satisfying New "Net Gain" Requirement Under Reg. §1.901-2(b)

A foreign tax must satisfy the "net gain" requirement to be considered a creditable "net income tax." The final regulations under Reg. §1.901-2 (the "Final Regulations") detail four requirements to meet the net gain requirement:

[1] All section references are to the Internal Revenue Code, as amended (the "Code"), or related Treasury regulations, unless otherwise indicated.

the realization, gross receipts, cost recovery, and attribution requirements.[2] This new four-part test is much stricter than the prior three-part requirement test in Former Reg. §1.901-2 and will result in U.S. taxpayers being able to claim fewer foreign tax credits (FTCs).

The most dramatic, and in some ways surprising, change in the entire regulatory package is the addition of the fourth part – the attribution requirement – referred to as the jurisdictional nexus requirement in the proposed regulations published in November 2020 (the "Proposed 2020 Regulations"[3]), under which the income being taxed must have sufficient nexus to the country imposing the tax in order to be creditable.[4] The rules under this new attribution requirement differ depending on whether the foreign tax is imposed on a resident or nonresident of the taxing country and depending on the type of income to which the tax is applied.

The new "net gain" requirement also makes material changes to the cost recovery requirement that could limit the types of creditable foreign taxes.[5] Fortunately, the gross receipts and realization requirements remain relatively unchanged compared to the prior regulations.[6] Helpfully, the Final Regulations also provide a treaty coordination rule that confirms when an applicable U.S. income tax treaty can provide a foreign tax credit notwithstanding the failure of the foreign tax to satisfy the attribution requirement.[7]

A. The New Attribution Requirement for Taxes on Nonresident Taxpayers

Treasury added the new attribution requirement to ensure that U.S. taxpayers can claim FTCs only for foreign taxes that have sufficient nexus to the income being taxed. The new attribution requirement was in response to the proliferation of digital service taxes ("DSTs") and other extraterritorial taxes that have been imposed on income, which in the view of the U.S. Treasury is not appropriately within the taxing jurisdiction of the country imposing the tax. In particular, certain countries have decided to impose DSTs that primarily target technology companies that have no physical presence or other traditional nexus within the taxing country. These DSTs are often based on location of customers, users, etc., rather than physical business operations within the taxing country.

Treasury's rationale for imposing the attribution requirement is apparently that a creditable "tax in the U.S. sense" must incorporate U.S. tax principles regarding nexus.[8] In the preamble, Treasury provided:

[The fundamental purpose of the FTC] is served most appropriately if there is substantial conformity in the principles used to calculate the base of the foreign tax and the base of the U.S. income tax. This conformity extends not just to ascertaining whether the foreign tax base approximates U.S. taxable income determined on the basis of realized gross receipts reduced by allocable expenses, but also to whether there is a sufficient nexus between the income that is subject to tax and the foreign jurisdiction imposing the tax.[9]

Comment: In the Proposed 2020 Regulations, Treasury specifically noted that it was actively engaged in negotiations with other countries, as part of the OECD/G20 Inclusion Framework on BEPS, to explore the possibility of a new international framework for allocating taxing rates. Treasury stated that if an agreement is reached that includes the United States, changes to the FTC system would be required.

Between the publication of the Proposed 2020 Regulations and the Final Regulations, the discussion regarding destination-based taxing rates and reallocation of taxing rights under "Pillar 1" had significantly evolved. However, while acknowledging that future changes in U.S. law may lead to a rethinking of rules for determining creditable foreign income taxes, Treasury noted

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[2] Reg. §1.901-2(b).

[3] *See* Preamble to Proposed Regulations, REG-101657-20, 85 Fed. Reg. 72,078 (Nov. 12, 2020).

[4] Reg. §1.901-2(b)(5).

[5] Reg. §1.901-2(b)(4).

[6] Reg. §1.901-2(b)(2), §1.901-2(b)(3).

[7] Reg. §1.901-2(a)(1)(iii).

[8] *See Biddle v. Commissioner*, 302 U.S. 573 (1938).

[9] T.D. 9959, 87 Fed. Reg. 276, at 285 (Jan. 4, 2022).

that the Final Regulations must be issued promptly "to address novel extraterritorial taxes" proliferating around the globe, because "[e]xisting law is unclear on the extent to which foreign taxes that are inconsistent with existing jurisdictional norms meet the definition of an income tax under §901."[10] Further, Treasury noted that these DSTs have already been adopted by many foreign jurisdictions and U.S. taxpayers have paid the taxes and claimed credits on the taxes, which would have an immediate and detrimental impact on the U.S. fisc. In short, Treasury will not allow U.S. taxpayers to credit DSTs to avoid "subsidizing" foreign jurisdictions at the expense of the U.S. fisc.[11]

In line with this reasoning, the attribution requirement provides two primary ways for a taxpayer to make the case that a foreign tax imposed on nonresidents conforms with U.S. tax "nexus" principles: (1) by establishing that the taxing country has sufficient nexus with the taxed income by proving that such income is attributable to the nonresident's activities in the taxing country (activities-based attribution rule);[12] and (2) by demonstrating that the foreign tax was imposed based on sourcing rules that are similar to U.S. tax sourcing rules (sourcing attribution rule).[13] In addition, nonresident taxes imposed on the disposal of real property interests in the taxing country can satisfy the attribution requirement (situs-of-property attribution rule).[14] Nevertheless, even when a foreign income tax on nonresidents does not satisfy the attribution requirement, the foreign tax may still be creditable under the treaty coordination rule.[15]

1. Satisfying the Activities-Based Attribution Requirement

The first way for a foreign tax on nonresidents to comply with the attribution requirement is by satisfying the activities-based attribution rule. Specifically, a foreign tax on nonresidents satisfies the activities-based attribution rule if the gross receipts and costs that are included in the base of the foreign tax are attributable, under reasonable principles, to the nonresident's activities within the foreign country imposing the foreign tax.[16] Reasonable factors that the tax could take into account include the nonresident's functions, assets, and risks located in the taxing country.

The regulations explain that this requirement is satisfied if foreign tax law attributes gross receipts and expenses to a taxpayer under principles that are similar to the effectively connected income ("ECI") rules in §864(c). In response to comments, Treasury further clarified that reasonable principles do not include (1) rules that deem the existence of a trade or business or permanent establishment based on the activities of another person other than an agent (i.e., a related party) or (2) rules that attribute gross receipts or costs to a nonresident based on the activities of another person other than an agent.[17] Thus, foreign taxes based on the activities of independent agents that do not give rise to a permanent establishment do not satisfy this requirement.

> ***PRACTICE POINT.*** The activities-based attribution requirement should be satisfied if the country imposing the tax uses standards similar to the traditional "permanent establishment" analysis to attribute income to a nonresident (e.g., functions performed, assets used and risks assumed).

The attribution rules of the ECI regime are based on activities (business activities test), assets (asset-use test) and source (different ECI results for U.S.- and foreign-source income). The references to ECI in the Final Regulations do not indicate which are the necessary elements of the ECI regime.

It should also be noted that the language targeting DSTs did not change between the Proposed 2020 Regulations and the Final Regulations. By declaring that taking into account as a significant factor the location of the customers, users, or any other similar destination-based criterion is not a reasonable principle, Treasury effectively

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[10] T.D. 9959, 87 Fed. Reg. 276, at 286 (Jan. 4, 2022).

[11] However, once an agreement on Pillar One is secured, Treasury may be able to quickly amend the regulations to permit FTCs for taxes impose under Pillar One.

[12] Reg. §1.901-2(b)(5)(i)(A).

[13] Reg. §1.901-2(b)(5)(i)(B).

[14] Reg. §1.901-2(b)(5)(i)(C).

[15] Reg. §1.901-2(a)(1)(iii).

[16] Reg. §1.901-2(b)(5)(i)(A).

[17] Reg. §1.901-2(b)(5)(i)(A).

forecloses the possibility that a DST can satisfy the activities attribution rule. Thus, the Final Regulations reflect Treasury's conclusion that FTCs should not be allowed to offset U.S. tax on income that does not have a significant connection to the foreign jurisdiction taxing the income. Further, the Final Regulations are consistent with Treasury's belief that the statutory purpose of the FTC is to relieve double taxation only where the foreign country has the primary right to tax income.

2. Satisfying the Attribution Requirement for Nonresident Taxes Based on Source or Situs of Property

A foreign tax on nonresidents can also comply with the attribution requirement by satisfying either the sourcing attribution rule or the situs-of-property rule. A foreign tax on nonresidents satisfies the sourcing attribution rule if the foreign tax is imposed based on sourcing rules that that are "reasonably similar" to the sourcing rules under U.S. tax principles.[18]

> ***PRACTICE POINT.*** In many cases, the sourcing attribution rule will not be the focus of analyzing whether a foreign "income" tax qualifies as a creditable foreign tax. Instead, the sourcing attribution rule is much more important for analyzing whether a foreign withholding tax qualifies as a "covered withholding" tax under Reg. §1.903-1. As a result, the sourcing attribution rule and the myriad of issues that it raises will be extensively discussed in the second article that analyzes taxes under Reg. §1.903-1.

A foreign tax on nonresidents satisfies the situs of property attribution rule if the amount of gross receipts from the sale or disposition of property is taxed under rules reasonably similar to §897 (gain or loss from the disposition of a U.S. real property interest treated as ECI).[19] Thus, foreign income taxes imposed on a nonresident's sale of shares in a corporation that held significant amounts of real property can meet this requirement.

B. The New Attribution Requirement for Resident Taxpayers

DSTs are generally imposed on nonresident taxpayers that do not have operations in the taxing foreign country. Nevertheless, Treasury is also concerned about countries imposing other types of taxes on resident taxpayers when the taxable income of the resident is determined under non-arm's-length principles (e.g., diverted profit taxes, levies on income earned by affiliates related to the resident, etc.). As a result, Treasury also added an attribution requirement for foreign income taxes imposed on residents of the foreign country imposing the tax.

The resident attribution requirement permits the tax base of the foreign tax to include the resident's worldwide receipts.[20] However, the amount of the resident's receipts must be determined using arm's-length principles, without taking into account as a significant factor the location of customers, users, or any similar destination-based criteria.[21]

As such, it appears that the IRS could challenge the creditability of foreign income taxes that rely on non-arm's-length principles to determine the taxable income of its residents.

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[18] Reg. §1.901-2(b)(5)(i)(B).

[19] Reg. §1.901-2(b)(5)(i)(C).

[20] Reg. §1.901-2(b)(5)(ii).

[21] Reg. §1.901-2(b)(5)(ii).

> ***PRACTICE POINT.*** Some countries use non-arm's-length principles to determine a resident's taxable income based on certain fixed margins. Taxpayers will struggle with whether a country's use of non-arm's-length principles puts the entire amount of the foreign income taxes paid by the resident at risk of failing the resident attribution rule. Taxpayers may want to seek clarification as to whether only the tax attributable to the non-arm's-length income does not satisfy the resident attribution rule. In addition, query the status of an otherwise creditable withholding tax (a "covered withholding tax") if the underlying generally imposed net income tax is not a "foreign income tax" because it relies on non-arm's-length principles.[22]

In addition, the tax law of some countries incorporates extremely broad force-of-attraction principles that increase a resident's taxable income in ways that are not arm's length under U.S. tax principles. Depending on whether these force-of-attraction principles constitute a separate levy under Reg. §1.901-2(d), the IRS may seek to challenge the creditability of the entire income tax imposed under such a regime.

C. Onerous Changes in the New Cost Recovery Requirement

The Final Regulations significantly modify the cost recovery requirement that must be satisfied to meet the new net gain requirement and therefore for a foreign tax to qualify as a creditable income tax.[23] The new cost recovery requirement goes beyond targeting DSTs and will impact non-DST levies that had previously qualified as creditable foreign income taxes under Former Reg. §1.901-2(b).

Under prior law, a foreign tax could satisfy the cost recovery requirement if the foreign tax law permitted the taxpayer to reduce taxable income by either (1) "significant" costs and expenses or (2) an approximation of significant costs and expenses that was likely to reach net income in normal circumstances.[24] While this prior test was very broad, it reflected the reality that foreign countries are free to write their own income tax laws and that U.S. taxpayers do not need to drill down into the intricacies of a foreign income tax calculation to determine creditability.

The Final Regulations eliminate this broad prior rule and instead provide strict requirements that must be satisfied in order for a foreign income tax to satisfy the cost recovery requirement. In particular, unless an exception applies,[25] a foreign tax can satisfy the cost recovery requirement only if foreign tax law permits the taxpayer to recover capital expenditures (i.e., through immediate expensing, depreciation, or amortization), interest expense, rent costs, royalty costs, payments for wages and services, and research and experimental costs.[26]

> ***PRACTICE POINT.*** The new cost recovery requirement may require taxpayers to spend a significant amount of time analyzing foreign law to determine whether a foreign tax allows taxpayers to deduct the required costs when arriving at net income.

Helpfully, the Final Regulations allow taxpayers to take into account foreign expense limitation rules that are "consistent with the principles underlying the disallowances required under the Internal Revenue Code."[27] To this end, the regulations clarify that foreign rules similar to the business interest expense limitation in §163(j) and the hybrid rules in §267A would be consistent with U.S. tax principles. The regulations also state that foreign disallowance provisions that limit base erosion and profit shifting can be consistent with U.S. tax principles.

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[22] *See* Reg. §1.903-1(c)(1)(i).

[23] Reg. §1.901-2(b)(4).

[24] Former Reg. §1.901-2(b)(4)(i).

[25] There are certain exceptions for alternative cost allowances in Reg. §1.901-2(b)(4)(i)(B).

[26] Reg. §1.901-2(b)(4)(i)(C).

[27] Reg. §1.901-2(b)(4)(i)(C).

PRACTICE POINT. We expect that taxpayers will wrestle with many issues arising from whether an expense disallowance provision under foreign law is consistent with U.S. tax principles. For example, some foreign countries deny expenses attributable to stock that qualifies for a participation exemption. Some foreign countries also indiscriminately disallow deductions for payments to related parties (including royalties), even though such a disallowance may not raise base erosion and profit shifting considerations under U.S. tax principles.

D. Relying on the Treaty Coordination Rule if a Foreign Income Tax Does Not Satisfy the New "Net Gain" Requirement

If a foreign income tax does not satisfy the new net gain requirement, the foreign tax may still qualify as a creditable income tax under the "treaty coordination" rule in Reg. §1.901-2(a)(1)(iii). The treaty coordination rule contains two rules that apply depending on whether the entity paying the foreign tax is a U.S. resident or a controlled foreign corporation (CFC).

If the payor is a U.S. resident, then a foreign tax (which may not satisfy the net gain requirement under Reg. §1.901-2(b)) can qualify as a creditable income tax as long as: (1) the tax qualifies for relief under the relief from double tax article of the tax treaty between the United States and the country imposing the tax and (2) the U.S. resident elects benefits under the treaty.[28]

Comment: The meaning of the phrase "elects benefits under the treaty" in this context is not entirely clear. We believe the requirement is satisfied, for example, if the taxpayer elects to have a reduced rate of withholding apply to an item of income, rather than the domestic law rate.

Every U.S. income tax treaty has a relief from double taxation article, as does the U.S. Model Convention (Art. 23, 2016), providing generally that, subject to the limitations of U.S. law, the United States will allow a citizen or resident of the United States as a credit against their U.S. tax, the "income tax" that the citizen or resident paid to the treaty partner. "Income tax" refers to a tax described in the treaty's "covered taxes" article, typically Article 2. Thus, under the treaty coordination rule, a U.S. resident that pays a foreign income tax that is a covered tax under the applicable treaty generally can treat that foreign levy as a foreign income tax for purposes of §901.

Comment: Reg. §1.901-2(a)(1)(ii) provides that a foreign tax is a foreign income tax *only if* it is a net income tax or an in-lieu-of tax. However, Reg. §1.901-2(a)(1)(iii) provides that a foreign levy – that is treated as an income tax under the relief from double taxation article of an income tax treaty entered into by the United States and the foreign country imposing the tax – *is* a foreign income tax if paid by a U.S. citizen or resident who elects benefits under the treaty. The Final Regulations do not provide any rule for coordinating these two provisions. We believe Reg. §1.901-2(a)(1)(ii) applies only if Reg. §1.901-2(a)(1)(iii) does not apply.

The treaty coordination rule appears to be an acknowledgment that regulations cannot override the U.S.'s treaty obligations. This is certainly the expectation that taxpayers had, based on the statement in the preamble to the Proposed 2020 Regulations that "the proposed regulations, when finalized, would not affect the application of existing income tax treaties to which the United States is a party with respect to covered taxes (including any specifically identified taxes) that are creditable under the treaty."[29] On the other hand, this treatment would not extend to taxpayers who may pay the same foreign levy but who do not qualify for benefits under the treaty, or who qualify but do not "elect benefits under the treaty." In those situations, the foreign levy must meet the four-part net gain requirement to qualify as a foreign income tax.

[28] Reg. §1.901-2(a)(1)(iii).

[29] *See* Preamble to Proposed Regulations, REG-101657-20, 85 Fed. Reg. 72,078 (Nov. 12, 2020).

PRACTICE POINT. Query how the treaty coordination rule applies where there is a character mismatch (e.g., the foreign country characterizes an item of income as a royalty subject to withholding tax under a treaty, whereas the United States characterizes the same item of income as subject to the Business Profits article of the treaty and therefore not taxable by the source state absent a permanent establishment). In such a case, it is conceivable that the taxpayer would be required to invoke the mutual agreement procedure article of the treaty and to exhaust all "effective and practical" remedies to mitigate the tax.

Under the CFC coordination rule, a foreign levy is eligible to be claimed as an FTC – even though the foreign levy (without taking into account treaty modifications) does not satisfy the income tax requirements under Reg. §1.901-2(b) or the in-lieu-of tax requirements of Reg. §1.903-1(b) – provided that both (1) a treaty between the CFC paying the foreign levy and the jurisdiction imposing the tax covers the foreign levy, and (2) the foreign levy as modified by the applicable treaty qualifies as a net income tax or an in-lieu-of tax under the Final Regulations.[30] The regulations refer to a foreign levy as "modified" by a treaty because a treaty can limit the circumstances in which a country's domestic tax rules apply, and because these domestic tax rules would no longer apply in the context of a treaty, the foreign levy would no longer run afoul of the attribution requirement.

PRACTICE POINT. The treaty coordination rule applies to both (1) net income taxes, such as a tax on the business profits of a permanent establishment or on gains on sales of real property, and (2) taxes in lieu of an income tax, such as a withholding tax on dividends, interest, and royalties. In Part 2 of this article, we consider in more detail the application of the treaty coordination rule to withholding taxes. Suffice it to say at this juncture that the CFC treaty coordination rule does not appear to provide taxpayers much, if any, relief.

E. Possible Planning Opportunities for Foreign Taxes That No Longer Qualify as Creditable Foreign Income Taxes

In light of the Final Regulations, many taxpayers face the prospect of double taxation on income that had previously been subject to tax in only one jurisdiction. Consequently, we are seeing taxpayers realign their business structures to minimize such incidents of double taxation.

In particular, many taxpayers are considering whether it makes sense to begin operating in a foreign jurisdiction through a permanent establishment or local entity. By restructuring their foreign operations to create a taxable presence, the taxpayer will become subject to a local-country income tax that generally is creditable under the new four-part test in Reg. §1.901-2.

PRACTICE POINT. While creating taxable PEs and local entities may avoid incurring non-creditable DSTs, taxpayers will have to navigate the myriad of issues that arise from establishing local country operations. In particular, most taxpayers affected by DSTs are heavily dependent on IP, and to create a local taxable presence, such taxpayers will need to either (1) transfer IP to the local country or (2) put in place license agreements between the IP holder and the entity operating in the local country. Such IP arrangements can in themselves lead to different double-tax considerations – in particular with regard to royalty and service withholding taxes, which will be discussed in Part 2. Thus, taxpayers need to carefully consider how they modify their operations when seeking to eliminate double taxation.

Taxpayers are also structuring their operations to avoid foreign taxes imposed under broad "force-of-attraction" principles, which impose foreign tax on income of residents in a manner that is inconsistent with "traditional" arm's-length principles.[31]

[30] Reg. §1.901-2(a)(1)(iii).

[31] *See* Reg. 1.901-2(b)(5)(ii).

PRACTICE POINT. If the taxable income of a taxpayer's local-country operating entity is increased under a country's "force of attraction" rules, then the taxpayer may want to structure its group operations and its future third-party contracts so that all the income that would be taxed under such force of attraction principles is actually booked at the taxpayer's entity in that local country.

Many taxpayers are also wondering what will happen when countries start adopting Pillar 1 taxes that do not satisfy the new attribution requirements. Congress could of course amend the Code to allow taxpayers to claim FTCs for Pillar 1 taxes. However, it is not clear that Congress will be able to agree to implement Pillar 1 and to amend the Code to allow credits for Pillar 1 taxes.

Nevertheless, given the power that Treasury has stated it has in enacting the new foreign tax credit rules, we would hope that the Biden administration believes it also has the power to administratively amend the attribution rules to permit taxpayers to claim a foreign tax credit for Pillar 1 taxes – in the event that Congress were unable to amend §901 to allow such claim.

III. Important New Limitations on the Ability of U.S. Taxpayers to Benefit from Local-Country Tax Credits Under Reg. §1.901-2(e)(2)

Many taxpayers will be surprised by new rules that severely limit their ability to claim an FTC for foreign taxes that are reduced by refundable local-country credits (in particular local-country R&D credits).

Under prior law, taxpayers were able to a claim an FTC for a foreign tax liability that was reduced by local-country tax incentives (e.g., R&D incentives) that qualified as refundable credits.[32] For example, taxpayers previously claimed FTCs for foreign taxes that were reduced by local-country refundable R&D incentives, which could only be refunded in cash after first offsetting the taxpayer's local-country tax liability.

Under new rules in Reg. §1.901-2(e)(2), a taxpayer can no longer claim an FTC for foreign taxes that are reduced by a refundable local-country tax credit if the foreign law requires that credit first reduce the taxpayer's local-country tax liability before being refunded to the taxpayer.[33] As a result, a U.S. taxpayer may no longer be able to benefit from many local-country R&D and manufacturing incentives if it owes tax under GILTI or operates through an entity checked into the United States.

PRACTICE POINT. Taxpayers need to urgently review their local-country "above-the-line" tax credits for foreign R&D and manufacturing activities. Many taxpayers may be shocked to learn that they now owe GILTI tax as a result of this change to the FTC rules, because the U.S. shareholder is no longer able to claim an FTC for a foreign tax liability that has been offset by refundable R&D credits. This adverse effect on taxpayers will become much worse if a country-by-country FTC limitation is enacted, as proposed in the Build Back Better Act.

PRACTICE POINT. It may become difficult for some U.S.-based multinationals to compete in certain foreign jurisdictions if U.S.-based multinationals are no longer able to benefit from local-country R&D and manufacturing tax credits.

[32] *See* TAM 200146001 (Nov. 16, 2001).

[33] Reg. §1.901-2(e)(2)(ii).

Nevertheless, the Final Regulations do provide a helpful exception that was not included in the Proposed 2020 Regulations. Under this exception, taxpayers may still claim an FTC for foreign taxes that are reduced by local-country tax credits, provided that the local country tax credit is "fully" refundable in cash at the taxpayer's option.[34]

> ***PRACTICE POINT.*** Many foreign R&D and manufacturing incentives do not meet the requirement in Reg. §1.901-2(e)(2)(iii) that the taxpayer have the option to claim the amount of the credit "fully" in cash, rather than reducing its local tax owed. As a result, many taxpayers may not be able to benefit from this exception unless foreign countries change their laws to comply with the new regulations.

IV. Revisions to Compulsory Payment Rules

A foreign levy must require a "compulsory payment" to qualify as a creditable "tax."[35] The prior FTC regulations provided that a payment was not compulsory to the extent that the amount paid exceeds the amount of liability "under foreign law for tax."[36] A taxpayer historically would satisfy this standard if it met two requirements provided in the regulations: (i) the amount paid must be determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax; and (ii) the taxpayer must exhaust all effective and practical remedies.[37] The Final Regulations retain this basic framework, but Treasury supplemented the existing rules with new requirements and some helpful clarifications.

Treasury and the IRS perceived that some taxpayers interpreted the compulsory payment rule to require a reduction of any foreign tax, including non-income taxes. In response, the Final Regulations explicitly require taxpayers to minimize their liability for "foreign income tax."[38] Non-income taxes, however, still may be relevant to the creditable tax determination, as discussed below.

Although not clear under prior regulations, taxpayers historically have interpreted the requirement to exhaust all effective and practical remedies to necessitate a cost-benefit analysis of the available remedies. In response to comments, Treasury effectively blessed this approach, providing that a remedy is effective and practical only if the cost of pursuing it is reasonable considering the amount at issue and the likelihood of success.[39] As part of this cost-benefit analysis, taxpayers can take into account the reasonably expected risk of incurring an offsetting or additional foreign income tax *or other tax liability*.[40]

Comment: While taxpayers are charged with minimizing their liability for foreign income taxes, the Final Regulations explicitly allow taxpayers to take into account the cost of other taxes when determining whether an available remedy is effective or practical.

The Final Regulations also ask taxpayers to consider whether an "economically rational taxpayer" would pursue an available remedy, independent of the availability of a U.S. FTC.[41]

Treasury and the IRS decided to take the cost-benefit analysis one step further, requiring taxpayers to perform a reasonable cost analysis to minimize foreign income tax liabilities even in the absence of a foreign tax controversy.

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[34] Reg. §1.901-2(e)(2)(iii).
[35] Reg. § 1.901-2(a)(2)(i).
[36] Former Reg. § 1.901-2(e)(5)(i).
[37] Former Reg. § 1.901-2(e)(5)(i).
[38] Reg. §1.901-2(e)(5)(i).
[39] Reg. § 1.901-2(e)(5)(v).
[40] Reg. § 1.901-2(e)(5)(v).
[41] Reg. § 1.901-2(e)(5)(v).

PRACTICE POINT. Taxpayers are familiar with applying this type of analysis in the context of the requirement to exhaust all effective and practical remedies, which often necessitates that the taxpayer's foreign tax advisors prepare a foreign tax opinion. Taxpayers now seem to be required to perform the same type of analysis with respect to all otherwise creditable foreign income taxes. While this requirement may not necessitate formal tax opinions, taxpayers should prepare and maintain adequate documentation of the relevant cost-benefit analysis to support the creditability of any foreign income taxes.

The Final Regulations provide that, in performing this analysis, a taxpayer is not required to reduce its foreign income tax liability to the extent the reasonably expected, arm's-length costs of reducing the liability would exceed the amount by which the liability could be reduced.[42] In addition, consistent with the prior regulations, a taxpayer is not required to alter its "form of doing business, its business conduct, or the form of any business transaction" to minimize foreign tax,[43] Taxpayers are permitted to take into account the foreign costs of additional liability for non-income taxes (e.g., VAT), but "only to the extent the additional liability is determined in a manner consistent with the rules of [Reg. § 1.901-2(e)(5)]."[44]

Comment: It is not entirely clear what Treasury meant by requiring non-income taxes to be determined in a manner consistent with the rules of Reg. § 1.901-2(e)(5). The most logical interpretation is that Treasury does not want taxpayers taking non-income taxes into account in their cost-benefit analyses if the assertion of the non-income tax is not, itself, based on a reasonable interpretation of foreign law. Therefore, it appears that Treasury is requiring non-income taxes to satisfy that first requirement. However, requiring that taxpayers also exhaust all practical and effective remedies with respect to the non-income tax would seem to be overly burdensome.

The Final Regulations include new examples illustrating how taxpayers can take non-creditable taxes into account.[45] For example, where a taxpayer has a choice whether to claim a deduction that would reduce its foreign income tax liability, but increase its foreign non-income tax liability by a greater amount, the taxpayer can choose not to claim the income tax deduction without violating the noncompulsory payment rule.[46] Consistent with the Proposed 2020 Regulations, the Final Regulations also provide that whether a taxpayer has satisfied its obligation to minimize the aggregate amount of its liability for foreign income taxes over time is determined without regard to the present value of a deferred tax liability or other time value of money considerations.[47]

When the foreign tax law entitles a taxpayer to a benefit, the Final Regulations generally prohibit the taxpayer from voluntarily forgoing the tax benefit (but incurring incremental income tax as a result) unless the regulations provide otherwise.[48] For example, a taxpayer generally must take advantage of foreign law options and elections that permanently decrease a taxpayer's foreign income tax liability over time.[49] The Final Regulations provide two exceptions to this general rule. First, if foreign tax law provides an option or election to treat an entity as fiscally transparent or non-fiscally transparent, a taxpayer can freely choose to use or not use such option or election.[50] Second, a taxpayer can decide whether to use an option or election for one foreign entity to join in the filing of a consolidated return with another foreign entity, or to surrender its loss in order to offset the income of another foreign entity pursuant to a foreign group relief or other loss-sharing regime.[51]

The preamble to the Proposed 2020 Regulations affirmed Treasury's intention to withdraw

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[42] Reg. § 1.901-2(e)(5)(i).

[43] Reg. § 1.901-2(e)(5)(i).

[44] Reg. § 1.901-2(e)(5)(i).

[45] *See* Reg. § 1.901-2(e)(5)(vi)(G), *Ex.* 7; Reg. § 1.901-2(e)(5)(vi)(H), *Ex.* 8.

[46] Reg. § 1.901-2(e)(5)(vi)(G), *Ex.* 7.

[47] Reg. § 1.901-2(e)(5)(vi)(G), *Ex.* 7.

[48] Reg. § 1.901-2(e)(5)(ii).

[49] Reg. § 1.901-2(e)(5)(iii)(A).

[50] Reg. § 1.901-2(e)(5)(iii)(B)(1).

[51] Reg. § 1.901-2(e)(5)(iii)(B)(2).

regulations that it proposed in 2007,[52] which would have treated foreign entities within a modified affiliated group as a single taxpayer for purposes of the compulsory payment requirement.[53] As a result, the Final Regulations retain the general rule that Reg. § 1.901-2(e)(5) applies on a taxpayer-by-taxpayer basis. The Final Regulations provide a couple of explicit exceptions to this rule. The first is the loss-sharing exception discussed above.[54] In response to a comment, Treasury included a second exception for an increase in liability in connection with anti-hybrid rules.[55] The exception applies if a taxpayer (the "first taxpayer") that makes a payment to another taxpayer (the "second taxpayer") is permitted to increase the first taxpayer's liability for foreign income tax (e.g., by waiving an otherwise allowable deduction), and doing so results in a greater decrease in the amount of liability for foreign income tax of the second taxpayer by reason of the deactivation of a hybrid mismatch rule that would otherwise apply to the second taxpayer. This exception provides welcome relief to taxpayers dealing with ATAD and other complex anti-hybrid rules around the globe.

V. Applicability Date

The Final Regulations in Reg. §1.901-2 apply to foreign taxes that are "paid" (within the meaning of Reg. §1.901-2(g)) in tax years beginning after December 28,[56] Under Reg. §1.901-2(g)(5), the term "paid" means "paid or accrued" depending on the taxpayer's method of accounting.[57] The regulation further provides that the taxpayer's method of accounting for foreign income taxes refers to whether the taxpayer claims the foreign tax credit for taxes paid (that is, remitted) or taxes accrued (as determined under Reg. §1.905-1(d)) during the taxable year.[58] Thus, the special accrual rules in Reg. §1.905-1(d) should apply for purposes of determining whether a foreign tax has accrued to an accrual method taxpayer for foreign tax credit purposes.

The effect of the interaction of these rules is that an accrual method taxpayer's contested foreign taxes that relate back to tax years beginning before December 28, 2021 should still be subject to the three-part requirement and other rules in Former Reg. §1.901-[59]

> ***PRACTICE POINT.*** If an accrual method taxpayer gets into a dispute with a foreign tax authority over DSTs or withholding taxes that relate to tax years beginning before December 28, 2021, then those contested taxes should still be subject to the rules in Former Reg. §1.901-2 that do not contain the "attribution" requirement – even though those contested taxes are paid in 2022 and thereafter.

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[52] REG-156779-06, 72 Fed. Reg. 15,081 (Mar. 30, 2007).

[53] Preamble to Proposed Regulations, REG-101657, 85 Fed. Reg. 72,078 (Nov. 12, 2020).

[54] Reg. § 1.901-2(e)(5)(iii)(B)(2).

[55] *See* Reg. § 1.901-2(e)(5)(iv).

[56] Reg. §1.901-2(h).

[57] Reg. §1.901-2(g)(5).

[58] Reg. §1.901-2(g)(5).

[59] *See* Reg. §1.905-1(d)(3) and §1.905-1(d)(1)(ii).

Final FTC Regulations Cause Double Taxation – Burden(s) Fall on Taxpayers

Part 2: Covered Withholding Taxes and Other 'In Lieu Of' Taxes

I. Introduction

As noted in Part 1 of this article series, the Final Regulations tightened the "net gain requirement" to include, among other things, an "attribution requirement" (designated the "jurisdictional nexus requirement" in the proposed regulations). The justification for the new requirement is grounded in "the fundamental purpose of the foreign tax credit – to mitigate double taxation with respect to taxes imposed on income." The preamble posits that this purpose can be achieved not only by assuring "substantial conformity in the principles used to calculate the base of the foreign tax and the base of the U.S. income tax" (that is, whether the foreign tax base approximates the tax base determined under U.S. principles) but also by ensuring that "there is a sufficient nexus between the income that is subject to tax and the foreign jurisdiction imposing the tax."[1] The new attribution requirement, therefore, purports to serve a gatekeeping function to ensure that income is attributed to the base of the tax in a manner that conforms with "international norms [of taxation] reflected in the Internal Revenue Code and related guidance…." The preamble further notes that a foreign tax must be consistent with the general principles of income taxation reflected in the Code for it to be an "income tax in the U.S. sense [and that] these principles include not only those related to determining realization, gross receipts, and cost recovery, but also principles related to assertion of taxing rights."

Despite the focus on principles and international norms (as, in the view of Treasury and the IRS at least, reflected in U.S. law), the Final Regulations provide no rationale for requiring that royalties be sourced to the country in which the intangible property is used. The U.S.'s statutory place-of-use rule for royalties is an outlier among royalty sourcing rules, clearly not in conformance with established international jurisdictional norms. Moreover, the Final Regulations seem to focus singularly on the policy underpinnings of a foreign law's sourcing rules, rather than the substantive result. That is, if foreign law imposes withholding tax on the royalties on the basis of something other than place of use, the source attribution test will not be satisfied even if the U.S. sourcing rules would have resulted in withholding tax under §861, §881 and §1442 if applied to the same royalty paid by a U.S. person. Treasury and the IRS have provided no satisfactory rationale for such a rule. Moreover, Treasury did not provide taxpayers with sufficient notice or opportunity to comment.

II. Section 903 'In Lieu Of' Taxes

Section 901 provides a credit for "income, war profits, and excess profits taxes," and §903 provides that the term "income, war profits, and excess profits taxes" includes a tax paid in lieu of a tax on income, war profits, or excess profits that is otherwise generally imposed by any foreign country. Under regulations issued in 1983, a foreign levy qualified as an "in lieu of" tax, if it was a tax, a substitution requirement was met, and the

[1] Preamble to T.D. 9959, 87 Fed. Reg. 276 at 285 (Jan. 4, 2022).

tax was not a soak-up tax (liability for the foreign income tax is dependent on the availability of a credit for the tax to another country).

Comment: The most common types of in-lieu-of taxes are foreign withholding taxes on dividends, interest and royalties, and also foreign gross income taxes on a particular type of business activity being conducted in the foreign country, such as by financial institutions or insurance companies.

Under the Final Regulations, a foreign levy is a tax in lieu of an income tax only if (i) it is a foreign tax, and (ii) it satisfies the substitution requirement in Reg. §1.903-1(c).[2] The Final Regulations do not provide a definition of "foreign tax," but presumably it is the same as a "tax" under Reg. §1.901-2(a)(2)(i), which the Final Regulations did not change. A foreign tax (referred to in the Final Regulations as a "tested foreign tax") satisfies the substitution requirement if the tested foreign tax either (1) satisfies the four conditions set forth in Reg. §1.903-1(c)(i) through §1.903-1(c)(iv); or (2) is a covered withholding tax.[3] According to the preamble to the 2020 Proposed Regulations, the covered withholding tax alternative is a special rule applying the substitution requirement to certain "covered withholding taxes" imposed by a foreign country that also has a generally imposed net income tax.[4]

In this Part 2, we will first discuss covered withholding taxes, which must satisfy the source-based attribution requirement (among other things), and then will turn to other types of in-lieu-of taxes, which must satisfy the new substitution requirement.

III. Covered Withholding Taxes

A covered withholding tax must meet the following requirements: (i) the existence of a generally imposed net income tax; (ii) the tax is a withholding tax within the meaning of §901(k)(1)(B) that is imposed on gross income of persons who are nonresidents of the foreign country imposing the tax; (iii) the tax is not in addition to any net income tax that is imposed by the foreign country on any portion of the income subject to the withholding tax; and (iv) the income subject to the tested foreign tax satisfies the source-based attribution requirement in Reg. §1.901-2(b)(5)(i)(B).[5]

> ***PRACTICE POINT.*** If the generally imposed income tax is not a foreign income tax because it is not based on arm's-length principles, then it would appear that under the Final Regulations as currently drafted, the withholding tax imposed in lieu of that tax cannot be a covered withholding tax, even if the withholding tax meets the source-based attribution requirement.

Comment: The structure of the Final Regulations suggests that source-based attribution is the catch-all. If income is not attributed to the base of the tax on the basis of activities or situs of property, then it is attributed on the basis of something the Final Regulations call "source." This would mean that, even if foreign law does not have a concept of "source of income," the source-based attribution requirement applies. In that case, query what is meant by the term "sourcing rules of the foreign tax law" in the Final Regulations.

A. Separate Levies

Before discussing the application of the source-based attribution requirement to a foreign withholding tax, it is critical to recognize that, as explained in Part 1, each foreign levy must be analyzed separately to determine whether it is a tax in lieu of an income tax (or whether it is a net income tax). The Final Regulations provide governing rules for treating a levy as separate. The following are especially relevant in the context of withholding taxes imposed on cross-border payments:

- A foreign levy imposed on nonresidents is always treated as a separate levy from that imposed on residents, even if the base of

[2] Reg. §1.903-1(b)(2).

[3] Reg. §1.903-1(c)(1).

[4] *See* Preamble to Proposed Regulations, REG-101657-20, 85 Fed. Reg. 72,078 (Nov. 12, 2020).

[5] Reg. §1.903-1(c)(2).

the tax as applied to residents and nonresidents is the same, and even if the levies are treated as a single levy under foreign tax law.[6]

- Where the base of a foreign levy is computed differently for different classes of persons subject to the levy, the levy is considered to impose separate levies with respect to each such class of persons.[7]
- A withholding tax is treated as a separate levy as to each separate class of income described in §61 (e.g., interest, dividends, rents, or royalties) subject to the withholding tax.[8] Moreover, if with respect to any single class of gross income, foreign law uses different income attribution rules (e.g., if technical services are subject to tax based on the residence of the payor and other services are subject to tax based on where the services are performed), then each subset of that separate class of income is considered to be subject to a different levy.[9]
- In addition, a foreign levy that is limited or otherwise modified by an income tax treaty is a separate levy from the levy imposed under the domestic law. A foreign levy modified by one income treaty is a separate levy from the foreign levy as modified by a different income tax treaty, even if the two treaties modify the foreign levy in exactly the same manner.[10]

B. Source-Based Attribution Requirement

Among the requirements that a foreign tax must meet to qualify as a "covered withholding tax," the source-based attribution requirement will be the most significant for a typical withholding tax. The source-based attribution requirement has two components: (i) first, the base of the tax must be limited to gross income "arising from sources within" the foreign country that imposes the tax, and (ii) second, the "sourcing rules" of the foreign tax law must be "reasonably similar" to the sourcing rules that apply under the Internal Revenue Code.[11]

Comment: Foreign tax law is construed on the basis of the foreign country's statutes, regulations, case law, and administrative rulings or other official pronouncements, as modified by an applicable income tax treaty.

The Final Regulations provide that a foreign tax law's application of sourcing rules need not conform in all respects to U.S. tax law's application of those sourcing rules.[12] In addition, the Final Regulations clarify that, for purposes determining whether the sourcing rules of the foreign tax law are reasonably similar to those under U.S. tax law, the character of gross income is determined under foreign tax law (with the exception that a sale of copyrighted articles must be characterized as a sale of tangible property, even if foreign tax law characterizes the transaction as a license of intangible property).[13] Accordingly, the first step is to characterize the income under foreign tax law, and the second step is to compare the foreign sourcing rule for that category of income to determine whether it is "reasonably similar" to the U.S. sourcing rule for that category.

Comment: The "reasonably similar to" test will depend on the specific features of any given foreign tax law regime. Many foreign tax law regimes have more than one trigger for imposing a withholding tax on cross-border payments of royalties (for example, withholding may apply if either the payor is a resident, or the IP is used in-country). Another set of regimes has a general residence-of-payor rule *unless* the IP is attributable to a PE in another country. These are just two of many different cases that require further analysis.

As discussed further below, however, the "reasonably similar" test under the Final

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[6] Reg. §1.901-2(d)(1)(iii).

[7] Reg. §1.901-2(d)(1)(ii).

[8] Reg. §1.901-2(d)(1)(iii). To be discussed in more detail in Part 3.

[9] Reg. §1.901-2(d)(1)(iii).

[10] Reg. §1.901-2(d)(1)(iv).

[11] *See* Reg. §1.901-2(b)(5)(i)(B).

[12] *See* Reg. §1.901-2(b)(5)(i)(B).

[13] *See* Reg. §1.901-2(b)(5)(i)(B).

Regulations appears to be more rigid than the Proposed Regulations would have suggested.

The Final Regulations provide specific rules for sourcing a nonresident's income from services, royalties, and sales of property. The specific rules for royalties and sales of property were not included in the Proposed Regulations, but rather were added in the Final Regulations.

1. Services

Gross income from services must be based on where the services are performed under foreign tax law, as determined under reasonable principles.[14] Reasonable principles do not include determining the place of the performance of the services based on the location of the service recipient.[15] Therefore, a withholding tax that is imposed on payments for services performed in the foreign country imposing the tax would meet the source-based attribution requirement, but a withholding tax on fees for technical services performed outside of that foreign country would not meet the attribution requirement.

2. Royalties

The Final Regulations provide that gross income from royalties must be sourced based on the place of use of, or the right to use, the intangible property, which we refer to as the "place of use test."[16] This rule mirrors the U.S. sourcing rule for royalties under §861(a)(4) and §862(a)(4).

Comment: The requirement that the foreign tax law imposing a royalty withholding tax must attribute income to the base of the tax on the basis of place of use contradicts the preamble's intent to require the foreign levy to "conform with established international jurisdictional norms." As noted in the Introduction, the U.S.'s statutory place-of-use rule for royalties is an outlier among royalty sourcing rules, clearly not in conformance with established international jurisdictional norms.

The preamble explains that a principal reason for adding the attribution requirement is to ensure that "novel extraterritorial foreign taxes" that diverge in significant respects from norms of international taxing jurisdiction, such as digital services taxes, are not creditable. This explains the Final Regulations' sourcing rule for services. However, withholding tax on royalties based on grounds other than place of use is a far cry from any novel extraterritorial tax: it has been the historic international norm for decades and is included in several U.S. income tax treaties. Nowhere does Treasury justify the place-of-use test for royalties. Further, the Proposed Regulations did not clearly alert taxpayers to this possibility or allow them to comment on its impact.

As noted in the Introduction, the Final Regulations seem to focus not only on the technical aspect of the foreign law sourcing rule by which the foreign tax law attributes income to the base of the tax, but also the policy underpinnings for those rules. Even if the U.S. sourcing rules would have resulted in withholding tax under §861, §881, and §1442 if applied to the same royalty paid by a U.S. person, if the foreign law that results in withholding on a royalty paid by the foreign person attributes the income to the base of the tax on the basis of something other than place of use, the source attribution test will not be satisfied.

This is illustrated by two new examples in the §903 Final Regulations. In Example 3 of Reg. §1.903-1(d), a foreign country imposes withholding tax on royalties based on the residence of the payor. The payor is a resident of the foreign country and pays royalties to a nonresident for use of the intangible property both inside and outside the foreign country, but the foreign country imposes withholding tax on the full amount.[17] The Example concludes that the withholding tax, in full, does not meet the attribution requirement because the foreign country's source rule for royalties (residence of the payor) is not "reasonably similar"

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[14] Reg. §1.901-2(b)(5)(i)(B)(1).

[15] Reg. §1.901-2(b)(5)(i)(B)(1).

[16] Reg. §1.901-2(b)(5)(i)(B)(2). The actual language of the Final Regulations is: "A foreign tax on gross income from royalties must be sourced based on the place of use of, or the right to use, the intangible property." We've paraphrased here what we believe this language is trying to say.

[17] *See* Reg. §1.903-1(d)(3).

to the source rule that applies under the Code. In Example 4, the facts are the same, except that the payor uses the intangible property *only* in the foreign country. Incredibly, however, the result is the same.[18] The tax in full is not creditable, as the foreign country's source rule, based on the residence of the payor, is not "reasonably similar" to the U.S. royalty source rule. As evidenced in the examples, regardless of whether the taxpayer in fact uses the intangible property at the place of its business activities in the source country, if the "sourcing rule" does not rely on place of use to attribute income to the base of the withholding tax, then it seems that the attribution requirement would not be met.

Comment: The Examples are clear in some respects but a key "fact" — whether the "source rule" under foreign tax law has a place-of-use test — is more a legal conclusion than a fact. The Examples do not explain what features of the source rule led to the conclusion that it is based on residence of payor, and the regulations provide no guidance how to make that determination. As noted elsewhere, foreign tax law (and presumably its "source rule") includes a foreign country's statutes, regulations, case law, and administrative rulings or other official pronouncements, as modified by an applicable income tax treaty. Taxpayers are now apparently required to become experts in any number of foreign countries' sourcing rules.

> ***PRACTICE POINT.*** The requirement that royalties meet the place-of-use test might make it quite difficult for a wide variety of royalty withholding taxes to satisfy the source-based attribution requirement because many countries that impose a withholding tax on cross-border payments for royalties appear, upon first reading, to do so on the basis that the payor is a resident of that country. That said, it may be possible in some cases to support the position that even these types of regimes may be "reasonably similar" to the U.S. rules.

As noted above, the Final Regulations also provide a special rule for foreign tax on payments that the foreign tax law characterizes as royalties, but U.S. tax law characterizes as payments for the purchase of copyrighted articles. Such payments do not meet the attribution requirement based on activities or source (the situs of property attribution would not likely be attributable to royalties) and therefore will not be creditable.[19] Some foreign countries characterize, for example, an enterprise license for software as a license of intangible property because the licensee is permitted to make copies of the software for use in its organization. If U.S. tax law characterizes the enterprise license as a sale of copyrighted articles, then any withholding tax that the foreign country imposes on payments for the enterprise license will not be creditable for failure to meet any attribution requirement.

3. Sales of Property

Gross income arising from gross receipts from sales or other dispositions of property, including copyrighted articles sold through an electronic medium, must be included in the foreign tax base on the basis of the nonresident's activities or the situs of the property, not on the basis of source.[20] The rules on attribution based on situs of property contain rules that apply to gains from the sale of stock.[21] The preamble to the Final Regulations indicates that this attribution requirement for income from sales of property reflects the U.S. sourcing rules that apply to a nonresident's income from sales of property: the Code imposes tax on sales of property only if in general the nonresident's activities give rise to a U.S. trade or business or if the property is situated in the United States.

C. The Treaty Coordination Rule

In the first article, we discussed the CFC treaty coordination generally. In this article, we consider in more detail how the CFC treaty coordination rule applies to withholding taxes, in particular on

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[18] *See* Reg. §1.903-1(d)(4).

[19] *See* Reg. §1.901-2(b)(5)(i)(B)(3) (providing that a foreign tax satisfies the attribution requirement only if the transaction is treated as a sale of tangible property and not as a license of intangible property).

[20] *See* Reg. §1.901-2(b)(5)(i)(B)(3).

[21] *See* Reg. §1.901-2(b)(5)(i)(C).

royalties. As noted in the Part 1, if a CFC pays a foreign levy that is a covered tax under a treaty, the foreign levy is not a "foreign income tax" — and therefore the CFC's U.S. shareholders are not eligible for a deemed paid credit — unless the foreign levy as modified by the treaty meets the requirements of a foreign income tax under the Final Regulations.[22] In particular, a withholding tax on royalties paid to a CFC must meet the source-based attribution requirement to be creditable (to the U.S. shareholder), i.e., to be a "covered withholding tax."[23] As discussed above, a royalty meets the source-based attribution requirement only if the sourcing rules of the foreign tax law attribute royalty income to the base of the tax on the basis of place of use of, or the right to use, the intangible property.[24]

Determining whether a sourcing rule under a treaty is reasonably similar to the U.S. sourcing rule is an intricate and complex analysis. Many treaties that allow withholding tax on royalties provide that royalties may be taxed in the country in which they "arise," and then provide a rule that explains the meaning of the term if the royalties are "borne by" or "attributed to" a permanent establishment in another country — in which case the royalties are deemed to arise in the country where the permanent establishment is located. For example, the royalties article in the Australia-Ireland income tax treaty contains the following "source rule":

Royalties shall be deemed to arise in a Contracting State when the payer is that State itself or a political subdivision or local authority of that State or a person who is a resident of that State for the purposes of its tax. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State or outside both Contracting States a permanent establishment or fixed base in connection with which the liability to pay the royalties was incurred, and the royalties are borne by the permanent establishment or fixed base, then the royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.[25]

The overall rule has two parts, the first sentence includes a "residence of the payor" rule. The rule in the second sentence looks to whether there is a connection between the royalty and a permanent establishment of the payor, and to whether the permanent establishment bears the royalty expense. Neither is expressly a place of use test, but is the second sourcing rule "reasonably similar" to the Code's place of use test — and does the interaction of the two make the overall sourcing rule reasonably similar to the U.S. place of use test? Would use of intangible property within the permanent establishment jurisdiction provide the connection between the royalties and permanent establishment which would cause the royalties to be "sourced" to the permanent establishment jurisdiction under that provision, making the second prong "reasonably similar" to a place of use test?

In addition, certain treaties, such as Ireland-Japan, merely provide that royalties may be taxed in the country in which they "arise," but do not provide a royalty sourcing rule.[26] In such a case, presumably the meaning of the term "arise" is determined under the domestic law of the country imposing the tax (essentially mooting the CFC treaty coordination rule).

Comment: The practical impact of the CFC treaty coordination rule will be that deemed paid credits may be denied in many cases in which they were previously allowed. This could result in double taxation of CFC income, first by the country imposing the withholding tax, and second by the United States under GILTI or subpart F. The refusal to acknowledge a withholding tax under treaties as a "foreign income tax" runs counter to international

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[22] Reg. §1.901-2(a)(1)(iii).

[23] *See* Reg. §1.903-1(c)(2).

[24] Reg. §1.901-2(b)(5)(i)(B)(2).

[25] Agreement Between The Government Of Australia And The Government Of Ireland For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income And Capital Gains, Article 13(5).

[26] *See* Convention Between Ireland And Japan For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income, Article 13.

tax norms. A deeper analysis will be required to determine whether some CFC treaties have sourcing rules similar to a "place of use" test. In any event, we question whether Treasury has the authority to fundamentally change the creditability of foreign taxes in this manner.

D. Planning Responses

Although it is still early, there are a number of potential planning strategies that taxpayers may wish to avail themselves of to ensure that their foreign withholding taxes remain creditable under the Final Regulations.

First, where a foreign country imposes withholding on income for services performed abroad (meaning the attribution rule for services is not satisfied), taxpayers may seek to modify the underlying commercial arrangement such that the payments are characterized as royalties under that country's law. If the foreign law does have, or arguably has, a place-of-use rule for royalties, the change in income characterization under local law should have the result in making the withholding tax a covered withholding tax. Or perhaps the withholding tax rate for royalties is lower than the rate applicable to services, such that if the tax is not creditable, at least the double tax burden has been reduced.

Second, taxpayers may consider whether to establish a licensing hub structure, particularly in Latin America. The licensing hub would be designed to eliminate or reduce withholding taxes under the applicable double tax treaties vis-a`-vis the payor countries. Implementing this type of structure requires a careful analysis of local country treatment of payments by the local entity to the licensing hub to ensure that these payments are either treated as business profits under the applicable tax treaties or otherwise characterized in such a way to reduce or eliminate withholding tax under domestic law or under the applicable treaty.[27] If the hub country has a treaty with the United States, withholding tax imposed on royalties paid by the hub to the United States should qualify for the U.S. treaty coordination rule.

Third, taxpayers may want to consider contributing IP to the capital of a subsidiary entity in exchange for a royalty-free license, maybe of limited duration. Alternatively, operating in branch form rather than separate entity form may have the effect of transforming the royalty payment to the licensor into a potentially non-withholdable branch remittance to the head office. Prior to implementing this structure, extra care should be taken in the event that the "head office" entity that has the PE pays a royalty to a licensor entity. In such case, taxpayers should evaluate whether the PE country might attribute some portion of that royalty to the PE.

IV. The Substitution Requirement for Other In-Lieu-Of Taxes

As noted above, a foreign tax satisfies the substitution requirement if the foreign tax is a covered withholding tax, or if it satisfies the four conditions set forth in Reg. §1.903-1(c)(i) through §1.903-1(c)(iv). In this section, we discuss the four conditions, which we refer to as "the substitution requirement."

Apparently targeting DSTs, the Final Regulations substantially changed the substitution requirement for a foreign tax (other than a covered withholding tax) to qualify as an in-lieu-of tax. Prior to the issuance of the new regulations, the substitution requirement was satisfied "if the [foreign] tax in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed."[28] Under the new regulations, a foreign tax, referred to in the regulations as a "tested foreign tax," is an in-lieu-of tax if it either is a covered withholding tax (discussed above) or meets the substitution requirement.[29] The substitution requirement contains four conditions (or requirements), all of which must be met for the tested foreign tax to

[27] Needless to say, such a change would require careful consideration of anti-treaty shopping rules.

[28] Former Reg. §1.903-1(b)(1).

[29] Reg. §1.903-1(b)(2).

qualify as an in-lieu-of tax (unless it is a covered withholding tax).[30]

First, the foreign country that is imposing the tested foreign tax must generally impose a separate levy that is a "net income tax" as described in Reg. §1.901-2(a)(3) (generally imposed net income requirement).[31]

Comment: Treasury received a comment on the 2020 Proposed Regulations that requiring a separate levy to qualify as a net income tax as described in Prop. Reg. §1.901-2 (particularly as it has been revised to require more similarity to U.S. tax principles) would unduly limit a foreign levy's qualification as a creditable in-lieu-of tax. It appears that the commentator's concerns were well-founded.

Second, the non-duplication requirement states that the foreign country's generally imposed net income tax (or any other net income tax imposed by the foreign country) cannot be imposed with respect to any portion of the income that forms the base of the tested foreign tax (the "excluded income").[32] If a net income tax imposed by the foreign country applies to the excluded income, the tested foreign tax does not satisfy the non-duplication requirement.

Comment: In an example,[33] Treasury provides a fact pattern in which Country X imposes a (generally imposed) net income tax on resident companies and also imposes a (generally imposed) net income tax on the income of nonresident companies that is attributable, under reasonable principles, to the nonresident's permanent establishment within Country X. Country X also imposes a 3% tax on the gross receipts of companies, wherever resident, from furnishing specified types of electronically supplied services to customers located in Country X. The 3% tax does not satisfy the non-duplication requirement of the substitution requirement, because by its terms the income to which the gross receipts subject to the 3% tax relate is also subject to one of the two generally imposed net income taxes imposed by Country X.

Third, the close connection requirement requires a close connection between the tested foreign tax and the generally imposed net income tax, so that if the tested foreign tax did not exist, the excluded income would have otherwise been subject to the generally imposed net income tax.[34] A close connection must be established with proof that the foreign country made a cognizant and deliberate choice to impose the tested foreign tax instead of the generally imposed net income tax. Such proof generally has to be based on the foreign tax law or the legislative history of the relevant foreign taxes, and the basis of the proof is dependent on whether the tested foreign tax was enacted contemporaneously with the generally imposed net income tax.[35] If the tested foreign tax was enacted contemporaneously, 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, or the generally imposed net income tax by its terms does not apply to, but does not expressly exclude, the excluded income. If the tested foreign tax was not enacted contemporaneously with the generally imposed net income tax (which was not amended contemporaneously with respect to the excluded income), a close connection can be established only by reference to the legislative history of the tested foreign tax (or a predecessor in lieu of tax).

Comment: Treasury noted that the close connection requirement was taken directly from the U.S. Court of Claims' opinion in *Metropolitan Life Ins. Co. v. United States*, 375 F.2d 835 (Ct. Cl. 1967) ("We have found `a very close connection between the imposition of the Canadian premiums taxes involved here and the failure to impose

[30] Reg. §1.903-1(c)(1).

[31] Reg. §1.903-1(c)(1)(i).

[32] Reg. §1.903-1(c)(1)(ii).

[33] Reg. §1.903-1(d)(1).

[34] Reg. §1.903-1(c)(1)(iii).

[35] In response to comments that providing proof utilizing a foreign country's legislative history could result in significant administrative burdens and uncertainness, Treasury noted that legislative history is not always required to establish that the tested foreign tax satisfies the close connection requirement.

income taxes.' …The Canadian jurisdictions, we also found, made 'a cognizant and deliberate choice…between the application of premiums taxes or income taxes for mutual life insurance companies.").

Fourth, the jurisdiction-to-tax requirement requires that if the generally imposed net income tax, or a hypothetical new tax that is a separate levy with respect to the generally imposed net income tax, were applied to the excluded income, such generally imposed net income tax or separate levy would meet the attribution requirement described in Reg. §1.901-2(b)(5).[36]

Comment: In an example aimed apparently at DSTs,[37] Country X imposes a (generally imposed) net income tax on resident companies and also imposes a (generally imposed) net income tax on the income of nonresident companies that is attributable, under reasonable principles, to the nonresident's permanent establishment within Country X. Country X also imposes a 3% tax on the gross receipts of companies, wherever resident, from furnishing specified types of electronically supplied services (ESS) to customers located in Country X. With respect to nonresidents, the 3% tax applies only if the nonresident does not have a permanent establishment in Country X. The nonresident 3% tax does not meet the jurisdiction-to-tax requirement because if Country X had chosen to apply the nonresident income tax (rather than the nonresident 3% tax) to the excluded income, the modified nonresident income tax would fail the attribution requirement in Reg. §1.901-2(b)(5) (the modified tax would fail the activities attribution requirement because it would not apply to income attributable under reasonable principles to the nonresident's activities within the foreign country, because the modified tax is determined by taking into account the location of customers; the modified tax would fail the sourcing attribution requirement because the excluded income is from services performed outside of Country X; the modified tax would fail the situs of property attribution requirement because the excluded income is not from sales or dispositions of real property located in Country X or from property forming part of the business property of a taxable presence in Country X).

V. Applicability Date

The Final Regulations in Reg. §1.901-2 and §1.903-1 apply to foreign taxes that are "paid" (within the meaning of Reg. §1.901-2(g)) in tax years beginning on or after December 28,[38] Under Reg. §1.901-2(g)(5), the term "paid" means "paid or accrued" depending on the taxpayer's method of accounting.[39] The regulation further provides that the taxpayer's method of accounting for foreign income taxes refers to whether the taxpayer claims the foreign tax credit for taxes paid (that is, remitted) or taxes accrued (as determined under Reg. §1.905-1(d)) during the taxable year.[40] Thus, the special accrual rules in Reg. §1.905-1(d) should apply for purposes of determining whether a foreign tax has accrued to an accrual method taxpayer for foreign tax credit purposes.

The effect of the interaction of these rules is that an accrual method taxpayer's contested foreign taxes that relate back to tax years beginning before December 28, 2021 should still be subject to the three-part requirement and other rules in Former Reg. §1.901-[41]

[36] Reg. §1.903-1(c)(1)(iv).

[37] Reg. §1.903-1(d)(2).

[38] Reg. §1.901-2(h), §1.903-1(e).

[39] Reg. §1.901-2(g)(5).

[40] Reg. §1.901-2(g)(5).

[41] *See* Reg. §1.905-1(d)(3) and §1.905-1(d)(1)(ii).

Final FTC Regulations Cause Double Taxation – Burden(s) Fall on Taxpayers

Part 3: The Best of the Rest – FTC Timing Rules and Disregarded Payments

I. Introduction

For our third and final installment, we highlight the remaining portions of the Final Regulations[1] not covered in our first two articles. Although not as notorious as the new attribution rules, these rules are significant and will create additional burdens for most taxpayers. While there are dozens of additional updates in the Final Regulations, in this article we focus on provisions we believe will affect most taxpayers: (i) the new foreign tax credit (FTC) timing rules in Reg. §1.905-1;[2] and (ii) the revised disregarded payment rules in Reg. §1.861-20.

II. Foreign Tax Credit Timing Rules (§901 and §905)

The Final Regulations provide new and revised regulations under §901 and §905 regarding the timing of FTCs. Prior to the Final Regulations, the timing rules for FTCs largely were located in revenue rulings and case law that interpreted §901 and §905 in the context of the income tax accounting rules.[3] In response to comments seeking clarification on when foreign taxes accrue and can be claimed as FTCs, Treasury and the IRS issued new regulations that attempt to distill and clarify existing law, while making some important modifications.

A. Choosing to Deduct or Credit Foreign Income Taxes

The Final Regulations provide new guidance on the election between a credit and a deduction for foreign income taxes. Taxpayers generally can claim a deduction for paid or accrued foreign income taxes,[4] but can elect instead to claim a credit for such taxes on a year-by-year basis.[5] If a taxpayer makes this election, no deduction is allowed for any foreign income taxes.[6]

In interpreting these rules, the prior FTC regulations provided that the choice to claim a credit applied to all foreign income taxes paid or accrued in the taxable year, and no deduction for these taxes would be allowed in the current taxable year or in any succeeding taxable year.[7]

Taxpayers were concerned that this rule could restrict a taxpayer from taking either a deduction or a credit for a contested foreign tax if the taxpayer: (i) chose to deduct foreign income taxes in the earlier year to which the contested tax relates; but (ii) elected to credit foreign income taxes in the year in which the taxpayer resolves the

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[1] For purposes of this article, "Final Regulations" refers to all of the regulations finalized by T.D. 9959, 87 Fed. Reg. 276 (Jan. 4, 2022).

[2] All section references are to the Internal Revenue Code, as amended (the "Code"), or related Treasury regulations, unless otherwise indicated.

[3] *See, e.g.*, *Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516 (1944); Rev. Rul. 58-55, Rev. Rul. 70-290, Rev. Rul. 84-125.

[4] *See* §164(a)(3).

[5] §§901(a); 904(c).

[6] §275(a)(4).

[7] Former Reg. §1.901-1(c).

contest and pays the tax.[8] Treasury and the IRS determined that Congress did not intend this result in enacting §275(a)(4) and provided an exception to this general rule. The exception allows an accrual basis taxpayer that elects to claim a credit for foreign income taxes accrued in a taxable year to also claim a deduction in that taxable year for any finally determined and paid foreign income taxes that relate to a prior taxable year in which the taxpayer claimed a deduction for foreign income taxes.[9] Treasury and the IRS also added an exception that allows a deduction (not otherwise denied under §275) when a credit for a foreign income tax is disallowed.[10]

The Final Regulations also revise Reg. §1.901-1(d) to provide that, while taxpayers have a 10-year limitation period to claim a credit or to change from claiming a deduction to claiming a credit for a given tax year, taxpayers only have a three-year limitation period (as extended pursuant to §6511(c)) to claim a deduction or to change from claiming a credit to claiming a deduction.

> ***PRACTICE POINT.*** The prior regulations permitted taxpayers to choose between a deduction or credit at any time before the expiration of the 10-year limitation in §6511(d)(3)(A). Now, the choice to change from a credit to deduction is limited to the three-year period in §6511(a) (which can be extended under §6511(c)). To protect the ability to choose, taxpayers could default to claiming a deduction for foreign income taxes on their original returns, especially if the FTCs will be carried forward and there are concerns about the ability to use the FTCs in future years.

The Final Regulations also clarify that a taxpayer makes the choice between a deduction or credit on an original or amended return for the relevant taxable year within the period specified in the revised rule.[11]

Finally, the Final Regulations provide that a change in election between a credit and a deduction will be treated as a §905(c) foreign tax redetermination, even if the foreign income tax liability remains unchanged.[12] As explained in the Preamble to the Proposed Regulations, the effect of this rule is that the IRS may assess and collect any U.S. tax deficiencies in intervening years that result from the taxpayer's change in election, even if the three-year assessment period under §6501(a) has expired.

B. When a Taxpayer Can Claim a Foreign Tax Credit

Treasury and IRS condensed decades of case law and IRS authorities into new Reg. §1.905-1. While the resulting rules are not perfect, the Final Regulations provide helpful guidance for taxpayers that are determining when they are permitted to claim an FTC. Importantly, these rules apply to both direct credits under §901 and indirect credits of a controlled foreign corporation (CFC) under §[13]

1. Cash Method Taxpayers

The rules for cash method taxpayers are fairly straightforward. Cash method taxpayers generally can claim FTCs in the year in which foreign income taxes are paid, which is generally the year the taxes are remitted to a foreign country.[14] Foreign income taxes that are withheld from gross income are considered paid in the taxable year withheld. Consistent with this general rule, a contested tax is not creditable until the taxpayer resolves the contest and remits the tax.[15] A taxpayer that remits a contested amount prior to resolving the contest may elect to claim an FTC in the year it remits the tax.[16] Reg. §1.905-1(e) provides rules whereby a cash method taxpayer can elect to claim FTCs on an accrual basis.

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[8] A detailed description of the foreign tax accrual and relation-back rules is included in Part II.B of this article.

[9] Reg. §1.901-1(c)(3).

[10] Reg. §1.901-1(c)(2).

[11] Reg. §1.901-1(d)(2).

[12] Reg. §1.905-3(a).

[13] *See* Reg. §1.960-1(b)(4) ("See §1.905-1 for rules on when foreign income taxes are considered paid or accrued for foreign tax credit purposes….").

[14] Reg. §1.905-1(c)(1).

[15] Reg. §1.905-1(c)(2).

[16] Reg. §1.905-1(c)(3).

2. Accrual Method Taxpayers

The Final Regulations provide two separate sets of general rules that apply to accrual method taxpayers, consistent with prior existing law. First, the Final Regulations provide accrual rules that must be satisfied before an accrual method taxpayer can claim a current-year FTC, which are generally consistent with the all-events test under Reg. §1.446-1(c)(1)(ii)(A).[17] In summary, an accrual method taxpayer can claim an FTC only if: (i) all the events that establish the fact of the foreign tax liability have occurred; and (ii) the amount of the foreign tax liability can be determined with reasonable accuracy. The economic performance prong of the all-events, however, does not apply when claiming an FTC.[18] A foreign income tax generally will be considered to have accrued at the close of the foreign taxable year of a taxpayer, and can be claimed as a credit by the taxpayer in the U.S. taxable year with or within which the taxpayer's foreign taxable year ends. Likewise, foreign withholding taxes representing advance payments of foreign income tax also accrue at the close of the foreign taxable year. On the other hand, foreign withholding taxes imposed on a payment giving rise to an item of gross income accrue on the date the payment from which the tax is withheld is made.

Comment: These rules can result in mismatches between foreign income and foreign taxes. For example, for a CFC with a U.S. taxable year ending on November 30 and a calendar foreign taxable year, any foreign income taxes of the entity accrue on December 31, one month after the U.S. taxable year (which includes 11 months of the entity's income for the calendar year) already has closed. One comment suggested that these accrual rules were not appropriate and argued that foreign income taxes in situations like this one should accrue at the end of the U.S. taxable year. Treasury and the IRS rejected this comment, confirming that foreign net income taxes accrue at the end of the foreign taxable year and can be claimed as a credit by an accrual basis taxpayer only in the U.S. taxable year with or within which the taxpayer's foreign taxable year ends.

Second, the Final Regulations provide separate rules that clarify the application of the relation-back doctrine, which determines the appropriate year in which to claim a credit for additional tax that is paid in a later year.[19] In summary, additional tax paid relates back and is considered to accrue at the end of the foreign taxable year with respect to which the tax is imposed (the "relation-back year"). The rules clarify that this rule also applies to additional withholding tax paid as a result of a change in the amount of an item of foreign gross income, and identifies the relevant relation-back year as the year in which the payment from which the additional tax is withheld is made. If a taxpayer has foreign income taxes which are treated as refunded under Reg. §1.905-3(a) due to the taxpayer's failure to pay the foreign income taxes within 24 months of the close of the taxable year in which the foreign income taxes accrued, the foreign income taxes are considered to accrue in the relation-back year once the taxpayer makes the payment.

The Final Regulations also provide a special FTC timing rule for taxpayers that use a 52–53 week taxable year under Reg. §1.441-2. If: (i) a taxpayer's 52–53 week taxable year ends in the same calendar month of its foreign taxable year, and (ii) its U.S. taxable year closes within six days of the close of its foreign taxable year, then the taxpayer's U.S. taxable year will be deemed to end on the last day of its foreign taxable year for purposes of determining the amount of foreign income tax that accrues during the U.S. taxable year.[20]

Comment: This rule is welcome relief for taxpayers that use a 52–53 week taxable year. Although some foreign jurisdictions also permit a foreign 52–53 week taxable year that aligns with the U.S. year, others strictly require a certain taxable year or require the taxable year to end on the same day each year. Absent this special rule, significant mismatches between foreign income and foreign income taxes would occur. This rule does not

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[17] *See* Reg. §1.905-1(d)(1)(i).

[18] Reg. §1.461-4(g)(6)(iii)(B).

[19] *See* Reg. §1.905-1(d)(1)(ii).

[20] Reg. §1.905-1(d)(2).

provide relief in all situations, so some mismatches may still occur.

3. Special Rules for Contested Taxes

The Final Regulations provide special rules for contested foreign taxes.[21] Section 905(c)(2) provides that no credit is allowed for any accrued tax that is not paid within 24 months of the close of the relation-back year until the tax is actually remitted and considered paid. As a result, the Final Regulations provide that contested foreign taxes do not accrue and cannot be claimed as an FTC until the contest is resolved and the tax is considered paid, even if the taxpayer paid all or a portion of the contested liability in an earlier year. Once the taxpayer resolves the contest and pays the tax, the tax liability accrues and is considered to accrue in the relation-back year for FTC purposes.[22]

For temporary relief, the Final Regulations provide an elective provisional credit for contested foreign taxes that the taxpayer remits before resolving the contest.[23] Taxpayers may only claim a provisional credit, not a provisional deduction. If a taxpayer claims a provisional credit for a contested foreign tax liability incurred by its CFC, it may claim the deemed paid credit in the relation-back year and its CFC may claim a deduction to compute its taxable income in the relation-back year.

Taxpayers electing a provisional credit must agree not to assert the statute of limitations as a defense and must agree to comply with annual reporting requirements. The Final Regulations removed Prop. Reg. §1.905-1(d)(4)(v), which deemed a failure to comply with annual reporting requirements as a refund of the amount of the contested foreign income tax liability, resulting in a Reg. §1.905-3(b) redetermination.

4. Correction of Improper Accrual

The Final Regulations also contain comprehensive rules (including several examples) for accrual method taxpayers that are changing from an improper method to a proper method for accruing foreign income taxes.[24] Generally, the change from an improper method to a proper method is considered a change in accounting method. As a result, taxpayers must obtain IRS consent to change to a proper method. A "modified cutoff approach" allows taxpayers to adjust the amount of foreign income taxes that can be claimed as a credit or deduction in the taxable year of the method change. The regulations provide a procedure for taxpayers to properly group and adjust its foreign income taxes in the taxable year of the method change.

> ***PRACTICE POINT.*** Taxpayers should examine their prior methods of accruing foreign income taxes to ensure those methods are proper under the new rules discussed above. A taxpayer generally establishes an improper method of accounting for an item once it has treated the item consistently in two consecutive tax years. If a taxpayer identifies an improper method, the taxpayer must file a Form 3115 to change to a proper method.

5. Creditable Foreign Tax Expenditures of Partnerships

The Final Regulations also provide rules for the timing of FTCs for partners in a partnership.[25] Generally, a partner electing to claim an FTC in a taxable year may claim its distributive share of creditable foreign tax expenditures that the partnership paid or accrued during the partnership's taxable year that ends with or within the partner's taxable year.[26] A cash method partner may claim a credit for its distributive share of an accrual method partnership's foreign income taxes even if the partnership has not paid the taxes to

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[21] *See* Reg. §1.905-1(d)(3).

[22] The regulations contain a cross-reference to the relation-back year rule in Reg. §1.905-1(d)(1).

[23] *See* Reg. §1.905-1(d)(4).

[24] *See* Reg. §1.905-1(d)(5).

[25] *See* Reg. §1.905-1(f).

[26] *See* §703(a)(2)(B) (partnership does not deduct foreign income taxes); §703(b)(3) (election to deduct or credit foreign income taxes made at the partner level); §702(a)(6) (foreign income taxes a separately stated item).

the foreign country during the partner's taxable year. However, if additional foreign taxes result from a redetermination of the partnership's foreign tax liability for a prior taxable year, a cash method partner may claim a credit for its distributive share of such additional taxes only in the partner's taxable year with or within which the taxable year of the partnership in which it pays the taxes ends. Both a cash method and an accrual method partner may elect to claim a provisional FTC in a relation-back year for its share of a contested foreign income tax liability that the partnership has remitted to the foreign country, even if the contested tax has not yet accrued.

These principles also apply to determine the year in which a shareholder of an S corporation, or the grantor or beneficiary of an estate or trust, may claim a foreign tax credit (or a deduction) for its proportionate share of foreign income taxes paid or accrued by the S corporation, estate, or trust.

C. Conforming Changes to Regulations Under §960

The Final Regulations make several changes to definitions in Reg. §1.960-1(b) to account for changes in the §901 and §905 regulations. The prior §960 regulations included their own accrual and relation-back rules for foreign taxes in the definition of "current year tax."[27] The Final Regulations adjust the meaning of "current year tax" under §960 to mean a foreign income tax that is paid or accrued by a CFC in a current taxable year, cross-referencing to Reg. §1.905-1 to determine when these foreign income taxes are considered paid or accrued for FTC purposes.[28]

The final regulations also adjust the meaning of "foreign income tax" to conform to the new regulations in Reg. §1.901-2(a).[29] Finally, the final regulations add a term "eligible current year tax" to mean any current year tax, other than a current year tax for which a credit is disallowed or suspended at the level of the CFC.[30] As such, an eligible current year tax can include a current year tax that may be deemed paid but for which a credit is disallowed at the level of the U.S. shareholder. Conforming changes were then made to Reg. §1.960-2 to provide that deemed paid computations are made only with respect to eligible current year taxes.

D. Applicability Dates

The new rules of Reg. §1.905-1 apply to foreign income taxes paid or accrued in taxable years beginning on or after December 28,[31] The special elective provisional credit for contested foreign taxes applies to taxes remitted after December 28, 2021, for taxes that relate to a taxable year beginning before December 28, 2021, presumably because those taxes have yet to accrue and the provision may not otherwise be applicable.

The new definitions in Reg. §1.960-1(b) similarly apply to taxable years of foreign corporations beginning on or after December 28, 2021, and to each taxable year of a domestic corporation that is a U.S. shareholder of the foreign corporation in which or with which such taxable year of such foreign corporation ends.[32]

III. Allocation and Apportionment of Foreign Income Taxes (Reg. §1.861-20)

Treasury finalized the first version of Reg. §1.861-20 in November 2020 to provide rules on how to allocate and apportion foreign income taxes to groupings of income under the Code. At the same time, Treasury re-proposed certain of these rules to provide more detailed and comprehensive guidance regarding the assignment of foreign gross income and the allocation and apportionment of the associated foreign income tax expense. The Final Regulations finalized these rules (with some modifications), which include new rules for disregarded payments, dispositions of

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[27] *See* Former Reg. §1.960-1(b)(4).

[28] Reg. §1.960-1(b)(4).

[29] Reg. §1.960-1(b)(6).

[30] Reg. §1.960-1(b)(5).

[31] Reg. §1.905-1(h).

[32] Reg. §1.960-7(b).

stock, and distributions with respect to a partnership interest.[33]

A. Disregarded Payments

The most significant rules that Treasury re-proposed were the disregarded payment rules. The Proposed Regulations contained a new comprehensive set of rules addressing the allocation and apportionment of foreign income taxes relating to disregarded payments. The Final Regulations largely follow the proposed rules, with minor deviations.[34] A full explanation of the final disregarded payment rules is outside of the scope of this article. However, because the rules are a sea of new terms and confusing cross-references, we provide a summary of the rules to provide context for the changes made in the Final Regulations.

> ***PRACTICE POINT.*** The disregarded payment rules are complex and can have a significant impact on taxpayers' FTC positions, particularly on §904 basketing and in applying the §960 "properly attributable to" standard. Prior to these rules, taxpayers were scratching their heads, wondering how to apply the earlier "timing difference" rules to disregarded payments. Taxpayers that analyzed their ongoing disregarded flows or prior disregarded transactions under prior guidance should revisit those analyses under the Final Regulations, particularly for transactions occurring in taxable years beginning after December 31, 2019, for which these regulations are effective.

The framework of the disregarded payment rules relies on characterizing disregarded payments between "taxable units" as a reattribution payment, a remittance, a contribution, or a sale or exchange of property. The operative rules then generally assign foreign gross income arising from the receipt of disregarded payments and the associated foreign tax to the recipient's statutory and residual groupings based on the current or accumulated income of the payor (as computed for U.S. federal income tax purposes) out of which the disregarded payment is considered to be made. After applying these rules, taxpayers can allocate and apportion the foreign income tax of each taxable unit to the items of foreign gross income.

The regulations introduce a new term, "taxable unit," which piggybacks off of definitions in other sections of the regulations. For a taxpayer that is an individual or domestic corporation, taxable unit means a foreign branch, a foreign branch owner, or a non-branch taxable unit as defined in Reg. §1.904-6(b)(2)(i)(B).[35] Although not clear from the regulations, the proper definitions of "foreign branch" and "foreign branch owner" presumably are located in Reg. §1.904-4(f)(3). For a taxpayer that is a CFC, taxable unit means a "tested unit" as defined in the GILTI high-tax exception rules under Reg. §1.951A-2(c)(7)(iv)(A).[36]

> ***PRACTICE POINT.*** The definition of a "tested unit" in the GILTI high-tax exception includes a combination rule that treats tested units in the same country as a single tested unit, subject to certain exceptions. It is not clear how the disregarded payment rules in Reg. §1.861-20 interact with this combination rule. There is no similar combination rule for foreign branches of a U.S. taxpayer.

Comment: In the proposed rules, the cross-reference for the definition of a "tested unit" was to the proposed subpart F high-tax exception definition in Prop. Reg. §1.954-1(d)(2).

In July 2020, Treasury proposed new subpart F high-tax exception rules, which would conform the existing rules to the final GILTI high-tax exception rules in Reg. §1.951A-2(c)(7). Treasury has yet to finalize these conforming subpart F high-tax exception rules. As a result, Treasury needed to update the cross-reference for the definition of a "tested unit" to the existing GILTI high-tax exception rules. Treasury also had to update several other similar cross-references throughout the disregarded payment rules, most notably in the

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[33] The Final Regulations also include other Reg. §1.861-20 rules that are not discussed herein (e.g., a special rule for foreign gross income included by a taxpayer by reason of owning a U.S. equity hybrid instrument).

[34] The Final Regulations also finalized revised rules under Reg. §1.904-4(f), which are not discussed in detail in this article.

[35] Reg. §1.861-20(d)(3)(v)(E)(9).

[36] *Id.*

reattribution payment rules, discussed below. Treasury also made corresponding changes to portions of the rules in Reg. §1.951A-2(c)(7) and §1.951A-2(c)(8) to account for changes in the disregarded payment rules in Reg. §1.861-20(d)(3)(v).

Once a disregarded payment between taxable units is identified, the taxpayer must characterize the payment as a reattribution payment, a contribution, a remittance, or a sale or exchange of property. Each of these payment types then provides an operative rule, which dictates how to adjust the gross income of each taxable unit to account for the disregarded payment. The rules in Reg. 1.904-4(f)(2), on which these rules rely, contain an ordering rule for multiple disregarded payments.[37] Taking into account these adjustments, the taxpayer can then determine how to allocate and apportion the foreign income taxes of each taxable unit under Reg. §1.861-20(f).

Reattribution Payments. At a high level, a reattribution payment exists if the disregarded payment results in an adjustment under the attribution rules of Reg. §1.904-4(f)(2) (or, for a taxpayer that is a CFC, would result in an adjustment under the principles of Reg. §1.904-4(f)(2)(vi)). Those rules generally result in an adjustment to the extent that a deduction for the disregarded payment, if regarded, would be allocated to gross income of the payor under the principles of Reg. §1.861-8 through §1.861-14T and §1.861-17. The amount of a reattribution payment is capped at the U.S. gross income of the payor taxable unit for the U.S. taxable year in which the disregarded payment is made.[38] The excess amount is treated as either a contribution or a remittance, as discussed below.

Comment: The Final Regulations cross-reference to two different sets of rules, depending on whether the taxpayer is: (i) an individual or a domestic corporation (cross-references are to Reg. §1.904-4(f)(2)); or (ii) a CFC (cross-references are to Reg. §1.951A-2(c)(7)(ii)(B)). Although the rules are slightly different, the rules for a CFC apply the principles of Reg. §1.904-4(f)(2)(vi) to reflect disregarded payments.[39] For simplicity purposes, we discuss these rules together.

The operative rule, relying on Reg. §1.904-4(f)(2), starts with the initial gross income attributed to the taxable unit under U.S. federal income tax principles, meaning disregarded payments are not taken into account.[40] The payor taxable unit adjusts its gross income downward to reflect the reattribution payment and the recipient taxable unit adjusts its gross income upward by the same amount.[41] To determine how to assign this additional gross income to the relevant statutory or residual groupings, the Final Regulations essentially apply a look-though rule by reference to another new term, "reattribution amount."[42] Subject to more nuanced rules, the additional gross income of the recipient taxable unit generally is assigned to the same statutory or residual groupings as the gross income of the payor taxable unit to which the disregarded payment was allocated.

Importantly, the reattribution payment does not affect the allocation and apportionment of the payor taxable unit's foreign income taxes.[43] In other words, the payor taxable unit allocates and apportions its foreign income taxes to the relevant statutory and residual groupings as though the reattribution payments did not occur. In addition, none of the foreign income taxes of the payor taxable unit shift to the recipient taxable unit as a result of the reattribution payment.

Contributions. The Proposed Regulations defined a "contribution" as: (i) a transfer of property to a taxable unit that would be treated as a §118 contribution to capital or a transfer described in §351 if the taxable unit were a corporation under U.S. federal income tax law; or (ii) the excess of a disregarded payment made by a taxable unit to another taxable unit that the first taxable unit owns over the portion of the disregarded payment that is a reattribution payment. Recognizing that this

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[37] *See* Reg. §1.904-4(f)(2)(vi)(F).

[38] Reg. §1.861-20(d)(3)(v)(B)(2).

[39] *See* Reg. §1.951A-2(c)(7)(ii)(B)(2).

[40] *Id.*

[41] *Id.*; Reg. 1.904-4(f)(2)(vi)(A).

[42] Reg. §1.861-20(d)(3)(v)(B)(1).

[43] *See* Reg. §1.861-20(d)(3)(v)(B)(3).

definition might not encompass all relevant payments, Treasury revised the term "contribution" to mean the excess of a disregarded payment made by a taxable unit to another taxable unit that it owns over the portion of the disregarded payment, if any, that is a reattribution payment.[44] This definition still encompasses transfers described in either §118 or §351.

An item of foreign gross income that a taxpayer includes by reason of the receipt of a contribution by a taxable unit is assigned to the residual grouping, except for items of foreign gross income assigned to the foreign branch basket under Reg. §1.904-6(b)(2)(ii).[45] For §901 taxpayers, any income (and the related taxes) assigned to the residual grouping are allocated to the general basket. For §960 taxpayers (i.e., CFCs), any taxes assigned to the residual grouping are not creditable.[46]

> ***PRACTICE POINT.*** CFC taxpayers cannot take a §960 credit for any items assigned to the residual grouping. Therefore, taxpayers should attempt to avoid any disregarded payments that create foreign gross income and fit the definition of a contribution. The definition of a contribution, however, is broader than the traditional definition. For example, if a CFC makes a $70 payment to a disregarded entity that it owns, but only $60 of the payment constitutes a reattribution payment, the remaining $10 is treated as a contribution.

Remittances. The Proposed Regulations defined a "remittance" as: (i) a transfer of property by a taxable unit that would be treated as a distribution if the taxable unit were a corporation under U.S. federal income tax law; or (ii) the excess of a disregarded payment made by a taxable unit to another taxable unit that the first taxable unit owns over the portion of the disregarded payment that is a reattribution payment, other than the amount that is treated as a contribution. To help close the gap on disregarded payments that might fall outside of the various payment definitions, Treasury revised the definition of a remittance to mean a disregarded payment that is neither a contribution nor a reattribution payment.[47]

> ***PRACTICE POINT.*** The revised definition treats remittances as a catchall for any disregarded payment that is not a reattribution payment or a contribution (or a payment with respect to a sale or exchange of property). Like contributions, this definition is broader than the typical definition of a remittance, but remittances can occur even if a payment is not to an owner. For example, if a taxable unit makes a $70 payment to another taxable unit that it does not own (e.g., a brother-sister taxable unit), but only $60 of the payment constitutes a reattribution payment, the remaining $10 is treated as a remittance.

The operative rule assigns foreign gross income arising from a remittance by reference to the statutory and residual groupings to which the assets of the payor taxable unit were assigned for purposes of apportioning interest expense, a proxy for the accumulated earnings of the payor taxable unit.[48] If the payor taxable unit is determined to have no assets, then the foreign gross income that is included by reason of the receipt of the remittance is assigned to the residual grouping.

For this purpose, the Proposed Regulations provided that assets of a payor taxable unit were determined under the rules of Reg. §1.987-6(b), modified to include in a taxable unit's assets any stock that is owned and, in certain circumstances, reattributed from another taxable unit's assets to the taxable unit or reattributed to another taxable unit.

Comments to the Proposed Regulations: (i) criticized the tax book value method, alleging inaccuracy for calculating the accumulated earnings of a taxable unit; (ii) requested that, rather than trace foreign gross income arising from disregarded payments to current or accumulated earnings of a taxable unit, the definition of which generally includes disregarded entities, the rules should only trace such foreign gross income to current or accumulated income of a qualified business unit (QBU) to reduce the complexity and

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[44] Reg. §1.861-20(d)(3)(v)(E)(2).

[45] Reg. §1.861-20(d)(3)(v)(C)(2).

[46] *See* Reg. §1.960-1(e).

[47] Reg. §1.861-20(d)(3)(v)(E)(8).

[48] *See* Reg. §1.861-20(d)(3)(v)(C)(1).

compliance burden of the rules; and (iii) suggested that the modifications to Reg. §1.987-6(b) for the purposes of determining assets of a taxable unit should include not only stock but also any interest in a taxable unit by another unit.

Treasury and the IRS refused to adopt the first two suggestions, citing compliance and administrative issues as well as doubts as to whether the suggestions could achieve the policy objectives of the rules. Treasury and the IRS, however, agreed that, for the purposes of Reg. §1.861-20, the assets of a taxable unit should include not only stock that it owns, but other interests. Accordingly, the Final Regulations provide that a taxable unit's assets include its pro rata share of the assets of another taxable unit in which it owns an interest, and retained the reattribution rules from the Proposed Regulations.[49]

Sales or Exchanges of Property. The Final Regulations provide that foreign gross income attributable to gain recognized under foreign law by reason of a disregarded payment received in exchange for property is subject to a special rule, and is characterized and assigned under Reg. §1.861-20(d)(2), which generally applies to regarded payments for which no U.S. income is realized or recognized.[50] These rules generally assign foreign gross income to the grouping to which U.S. income would be assigned if the transaction was regarded, subject to special rules for certain types of payments. The Final Regulations also provide that if a taxpayer recognizes U.S. gross income as a result of a disposition of property that was previously received in exchange for a disregarded payment, any item of foreign gross income that the taxpayer recognizes as a result of that same disposition is assigned to a statutory or residual grouping under the general rule of Reg. §1.861-20(d)(1), without regard to any reattribution of U.S. gross income from the disregarded payment.

B. Dispositions of Stock

The Proposed Regulations included an addition to the Reg. §1.861-20 rules for foreign gross income arising from a disposition of stock. The proposed rule provided that foreign gross income arising from a sale, exchange, or other disposition of stock would be assigned in the following order: (i) first, to the statutory and residual groupings to which any U.S. dividend amount is assigned; (ii) second, to the groupings to which U.S. capital gain would be assigned; and (iii) third, to the statutory and residual groupings in the same proportion in which the tax book value of the stock would be assigned to the groupings under the rules of Reg. §1.861-9(g) in the taxable year in which the disposition occurs.[51]

A comment recommended that, to the extent of any §961 basis in the stock attributable to a prior subpart F or GILTI inclusion, foreign gross income in excess of the U.S. dividend amount should be assigned to the same statutory grouping as the previously taxed earnings and profits (PTEP) that gave rise to the basis increase. Treasury and the IRS conceded that it is reasonable to analogize foreign gross income in the amount of the basis attributable to retained PTEP as a timing difference associated with the earnings represented by the PTEP. Due to concerns with creating substantial compliance burdens for taxpayers and administrative burdens for the IRS in tracking this basis, however, Treasury and the IRS rejected the comment and finalized the rule as proposed.[52]

C. Partnership Transactions

The Proposed Regulations also included an addition to the Reg. §1.861-20 rules for foreign gross income included by a taxpayer by reason of its ownership of an interest in a partnership. The proposed rule would assign foreign gross income arising from a partnership distribution in excess of the U.S. capital gain amount by reference to the asset apportionment percentages of the tax book value of a partner's distributive share of partnership assets.[53] The proposed rules also would associate foreign gross income from the

[49] Reg. §1.861-20(d)(3)(v)(C)(1)(ii).

[50] Reg. §1.861-20(d)(3)(v)(D).

[51] Prop. Reg. §1.861-20(d)(3)(i)(D).

[52] *See* Reg. §1.861-20(d)(3)(i)(D).

[53] Prop. Reg. §1.861-20(d)(3)(ii)(B).

disposition of partnership interest in excess of the U.S. capital gain amount with a hypothetical distributive share that is determined by reference to the tax book value of the partnership's assets.[54] A comment recommended changes to these rules, which would have required tracking new partner-level accounts. Due to the administrative complexity in implementing the approach, Treasury and the IRS rejected the comment and finalized the rules as proposed.[55]

D. Retroactive Applicability Date

As mentioned above, Treasury and the IRS re-proposed most of these rules at the same time they finalized the initial portions of Reg. §1.861-20. The rules of Reg. §1.861-20 generally apply to taxable years that begin after December 31, 2019, and end on or after November 2, 2020, and these rules were proposed to have the same effective date.[56] Several comments asked to delay the applicability of these rules, but Treasury and the IRS determined to retain the same effective date because they finalized the regulations "substantially as proposed."

> ***PRACTICE POINT.*** These rules retroactively apply to taxable years that begin after December 31, 2019. Taxpayers may need to examine prior transactions and analyses, particularly if they had not followed the proposed rules.

The modifications to Reg. §1.951A-2(c)(7) and §1.951A-2(c)(8) were not included in the Proposed Regulations, so those revisions apply to taxable years that begin after December 28, 2021. Taxpayers may choose to apply these final rules to taxable years that begin after December 31, 2019, and on or before December 28, 2021, consistent with the applicability date of Reg. §1.861-20(d)(3)(v).

IV. Other Provisions in the Final Regulations

The Final Regulations contain other new rules that are not discussed in detail this article. For example, the Final Regulations include detailed new rules under §245A(d) that generally deny a credit or deduction for foreign income taxes paid or accrued: (i) by a domestic corporation that are attributable to "§245A(d) income" of the domestic corporation; (ii) by a successor to a domestic corporation that are attributable to §245A(d) income of the successor; (iii) by a domestic corporation that is a U.S. shareholder of a foreign corporation (other than a PFIC that is not also a CFC) and that are attributable to "non-inclusion income" of the foreign corporation and not otherwise disallowed; or (iv) by a foreign corporation that are attributable to §245A(d) income.[57] These rules attribute foreign income taxes to §245A income under the rules of Reg. §1.861-20, as modified by Reg. §1.245A-1(b).

The Final Regulations also make a few other noteworthy changes to Reg. §1.901-2. Consistent with prior guidance, Reg. §1.901-2(a)(1)(i) defines a "foreign income tax" to include both: (i) an income, war profits, or excess profits tax allowed as a credit under §901; and (ii) a tax paid in lieu of such a tax and allowed as a credit under §903.

The Final Regulations also include revised technical taxpayer rules under Reg. §1.901-2(f) with respect to: (i) foreign income taxes imposed on disregarded entities and partnerships; and (ii) the impact of mid-year transactions.[58] For taxpayers searching for the rule prohibiting a credit for "soak-up taxes," it has found a new home, leaving Reg. §1.901-2(c) for new Reg. §1.901-2(e)(6). Other than some language updates, the rule is substantively the same with the addition of a new example.[59]

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[54] Prop. Reg. §1.861-20(d)(3)(ii)(C).

[55] *See* Reg. §1.861-20(d)(3)(ii).

[56] Reg. §1.861-20(i).

[57] *See* Reg. §1.245A(d)-1(a).

[58] *See* Reg. §1.901-2(f)(4)–§1.901-2(f)(6).

[59] *See* Reg. §1.901-2(e)(6)(ii)(E) *Ex.* 5.

The Final Regulations also include, among other things: (i) a new definition of an "electronically supplied service" for purposes of the FDII rules;[60] (ii) revised rules under §367(b) that account for the repeal of §902; (iii) certain rules clarifying the application of Reg. §1.904-4(f) to disregarded payments; and (iv) sourcing rules for subpart F, GILTI, and certain PFIC inclusions (and the corresponding §78 gross-ups).[61]

[60] *See* Reg. §1.250(b)-5(c)(5).

[61] *See* Reg. §1.861-3(d).

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