ABA Tax Section Midyear Meeting
Foreign Tax Credit Update
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Agenda

• R&E expense allocation and apportionment
• Foreign branch category income
• Allocation and apportionment of foreign taxes
• Foreign tax redeterminations
• Other FTC items
R&E expense allocation and apportionment
Prop. Reg. § 1.861-17
Highlights of new proposed R&E rules

• Highly anticipated guidance on allocation and apportionment of R&E expenditures

• For FTC purposes, no R&E expenses are allocated or apportioned to amounts included under sections 951, 951A, or 1293

• Welcome relief from an FTC perspective that prevents US taxpayers owing more under the GILTI rules than otherwise
Step 1: Allocation

• Allocate taxpayer’s R&E expenditures to all items of the taxpayer’s “gross intangible income” reasonably connected with the SIC code category

• Rationale:
  ◦ R&E expenses that are deductible under section 174 generally give rise to intangible property
  ◦ Under sections 367(d) and 482, the person incurring the R&E expenses must be compensated when such intangible property gives rise to income

• Gross intangible income is:
  ◦ All GI earned by a TP that is attributable to intangible property derived from R&E expenditures
  ◦ Does not include dividends or any amounts included under section 951, 951A, or 1293
Step 1: Allocation Con’t

• Examples of gross intangible income:
  ◦ GI from sales or leases of products or services from IP
  ◦ Income from sales of IP
  ◦ Income from platform contribution transactions
  ◦ Royalty income from the licensing of IP
  ◦ Amounts taken into account under section 367(d)
Step 2: Apportionment

2A: 50% Exclusive Apportionment

- Solely for purposes of section 904, the proposed regulations provide for a 50% exclusive apportionment based on the predominant location of performance of the R&E

- The proposed regulations eliminate:
  ◦ The ability to establish an increased exclusive apportionment based on facts and circumstances
  ◦ The special rule for R&E undertaken solely to meet legal requirements imposed by a political entity
Step 2: Apportionment

2B: Apportionment Based on Gross Receipts

- Apportion R&E based on TP’s gross receipts from sales and services that are related to GII within the statutory grouping and in the residual grouping.

- Certain gross receipts of controlled or uncontrolled party taken into account *if* the TP can reasonably be expected to license, sell, or transfer to that party IP that would arise from the TP’s current R&E expenditures.

- But a controlled corporation’s gross receipts from cost shared intangibles are not taken into account.

- The proposed regulations eliminate the optional gross income method of allocating R&E expenses.
Step 2: Apportionment

2B: Apportionment Based on Gross Receipts

Assignment or Gross Receipts

• Gross receipts are assigned to the grouping to which the GII related to the sale or service is assigned.

• Where the TP licenses IP to a CFC which, in turn, sells products or services incorporating the IP, the gross receipts of the CFC are assigned to a grouping based on the source and character of the related royalty included by the TP.
Proposed 1.861-17(g)(3), Ex. 1

**Allocation:**
- R&E expenditures allocable to USP’s GII related to the SIC code category (sales income and royalty, not GILTI or interest income)

**Exclusive Apportionment:**
- $30K (50% x $60K) of R&E expenditures is apportioned to US source GII

**Apportionment Based on Gross Receipts**
- $11,250 ($30K x $300K/800K) is apportioned to USP’s GII attributable to the license to CFC (i.e., foreign source general category income).
- Remaining $18,750 is apportioned to US source income.
Proposed 1.861-17(g)(3), Ex. 3

- **Allocation:**
  - $60K of R&E expenditures allocable to USP’s GII related to the SIC code category (sales income and PCT payment, not GILTI)

- **Exclusive Apportionment:**
  - $30K (50% x $60K) of R&E expenditures is apportioned to US source GII

- **Apportionment Based on Gross Receipts**
  - None of CFC’s gross receipts taken into account b/c attributable to the cost shared intangible
  - Remaining $30K of R&E is apportioned to US source income.

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**USP R&E**
- R&E in SIC code category: $60K (research costs of $85K but cannot deduct $25K by reason of the CST payment from CFC)

**USP Gross Income**
- US-source sales of products using IP: $200K
- PCT Payment: $50K
- GILTI: $100K

**Gross Receipts**
- USP: US source gross receipts of $600K
- CFC: Foreign gross receipts of $400K
Expense Allocation for FDII Purposes

• This approach, if applicable for FDII purposes, could result in a greater amount of R&E expense allocated to reduce the amount eligible for the FDII deduction.

• Treasury and the IRS will address comments on allocating and apportioning R&E expenditures for FDII purposes in connection with the finalization of the FDII regulations.
Foreign branch category income
Treas. Reg. § 1.904-4(f)
Foreign Branch Basket
Overview

• Section 904(d)(1)(B) provides a separate category for foreign tax credit limitation purposes with respect to foreign branch income.

• A foreign branch is a qualified business unit (“QBU”), within the meaning of Treas. Reg. §1.989(a)-1(b)(2)(ii) and (3), that conducts a trade or business outside the United States.
  ◦ A PE under the relevant US tax treaty is a per se foreign branch

• Subject to certain exceptions (e.g., income from U.S. activities, sales of disregarded entities, etc.), gross income is attributable to a foreign branch to the extent the gross income (as adjusted to conform to Federal income tax principles) is reflected on the separate set of books and records of the foreign branch.
  ◦ Passive category income excluded from foreign branch income
  ◦ Financial services income can be foreign branch income
Foreign Branch Basket Overview (cont’d)

• Books and records method.
• The decision to sell foreign disregarded entity assets versus foreign disregarded entity stock has heightened importance.
Foreign Branch Basket
Disregarded Payment Rules

• Treas. Reg. §1.904-4(f)(2)(vi) provides certain rules reallocating income with respect to disregarded payments:
  ◦ By a foreign branch to a foreign branch owner - Reducing the gross income attributable to the foreign branch and increasing the gross income attributable to the foreign branch owner;
  ◦ By a foreign branch owner to a foreign branch – Reducing the gross income attributable to the foreign branch owner and increasing the gross income attributable to the foreign branch; and
  ◦ By a foreign branch to another foreign branch – Reducing the gross income attributable to the payor foreign branch and increasing the gross income attributable to the payee foreign branch.

• Interest payments, remittances, and contributions are excluded from the disregarded payment rules
• Application of Treas. Reg. §1.1502-13?
Foreign Branch Basket
Basic Services

- **P** earns $1000 from its services to 3rd parties, and records such income on its books and records.
  - $400 is foreign source income related to services performed by FDE outside of the U.S.
  - $600 is U.S. source income related to services performed by **P** in the U.S.

- **$400 of P’s foreign source gross income** is assigned to the foreign branch basket.
P owns property with an adjusted basis of $200.

In Year 1, P sells the property to FDE for $500.

In Year 2, P is entitled to a $20 depreciation deduction with respect to the property.

- $18 of the depreciation is allocated and apportioned to non-passive income. $2 is allocated and apportioned to passive income.
- If the Year 1 transfer were respected for U.S. federal income tax purposes, FDE would be entitled to a $50 depreciation deduction. Based on the above, 90% of the $30 (i.e., $27) additional depreciation is allocable to non-passive income.

In Year 2, the non-passive income attributable to FDE is reduced by $27, and the non-passive income attributable to P is increased by $27.
In Year 3, FDE sells the property to a 3rd party for $600.

- The “adjusted disregarded gain” on the property is $270 - i.e., the lesser of
  1.) $270 - FDE’s adjusted disregarded basis in the property ($470) less the adjusted basis in the property as of the original transfer ($200); and
  2.) $420 - the gain attributable to the regarded sale or exchange of property

- The non-passive income attributable to FDE is reduced by $270, and the non-passive income attributable to P is increased by $270.
Foreign Branch Basket
Transfers of Intangible Property

• Transfers of Intangible property subject to special rules, applying principles of sections 367(d) and 482.

• These special rules for transfers of intangible property do not apply to the following:
  ◦ Transfers of intangible property prior to December 7, 2018; or
  ◦ Transfers by a foreign branch or branch owner that owns the IP transitorily (i.e., neither developed or exploited by the foreign branch or foreign branch owner (or predecessor) prior to transfer).
Foreign Branch Basket
IP Transfer

• P transfers intangible property, within the meaning of section 367(d)(4), to its foreign disregarded entity.

• Income earned by FDE is reassigned to P’s categories of gross income under the principles of section 367(d).

• Assuming a deemed payment of $100 were to arise with respect to the transfer in a given year pursuant to section 367(d), P’s income would increase by $100 and foreign branch basket income would decrease by $100.
Allocation and apportionment of foreign taxes
Prop. Reg. § 1.861-20
New Proposed Reg. Sec. 1.861-20

• Provides greater clarity on “base v timing” differences
  ◦ Does not “fix” the Code, which allocates taxes on base differences to the branch basket

• Provides clarity on how to associate current year taxes with different groupings of income

• Particular attention should be paid to the rules regarding disregarded payments made to/from CFC owners
  ◦ Many taxes will be put in the “residual category”
  ◦ Once put in the residual category at the CFC level, these taxes will never be accessed by the US shareholder
Allocating and Apportioning Current Year Foreign Taxes

- General Rule: A foreign income tax is allocated or apportioned to the statutory and residual grouping that include the items of foreign gross income included in the base on which the tax is imposed. The following three step process applies for this purpose.

- Step 1: Assign the taxpayer’s foreign gross income to statutory and residual groupings
  - Amount determined under foreign law but characterized under US law
  - If a corresponding US item exists in same US tax year, foreign gross income assigned to same grouping as corresponding US item
    - The corresponding US item can be of a different amount, but special rules apply if the corresponding US item is zero or less
  - If a corresponding US item not recognized, or recognized in different US tax year, foreign gross income assigned as if the event resulted in the recognition of US gross income in the US tax year in which the tax is paid
  - If a corresponding US item is recognized but excluded from US gross income, foreign source gross income is assigned as if the foreign gross income is includible in US gross income
  - Foreign tax paid on exclusive list of base differences are assigned to residual grouping (foreign branch basket in the case of a US taxpayer)

- Step 2: Allocate and apportion the deductions allowed under foreign law to the foreign gross income in the statutory and residual groupings

- Step 3: Allocate and apportion foreign income tax by reference to the foreign taxable income in the statutory and residual groupings
## Special Rules

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Special Rule for Allocation and Apportionment of Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributions that are recognized for US and foreign tax purposes</td>
<td>Assigned to the same category as the corresponding US dividend and capital gain amounts (to the extent thereof), with any foreign distribution that corresponds to a US return of capital being treated as a base difference</td>
</tr>
<tr>
<td>Distributions that are recognized only for foreign tax purposes</td>
<td>Assigned as if a distribution were made for US purposes in the year the foreign tax is paid</td>
</tr>
<tr>
<td>Disregarded payments by a foreign branch</td>
<td>Deemed to be made ratably out of the branch’s accumulated after-tax income, which is allocated by reference to the relative tax book values of the branch’s assets (including stock)</td>
</tr>
<tr>
<td>Disregarded payments by an owner to its branch</td>
<td>With one exception, assigned to the residual grouping (i.e., branch category for US owners, residual income for CFC owners)</td>
</tr>
<tr>
<td>Taxes paid by a US shareholder on inclusions from reverse hybrids</td>
<td>Allocated and apportioned by reference to the reverse hybrid's foreign income; however, Prop. Reg. §1.904-6(f) assigns to the GILTI basket based on the GILTI inclusion percentage</td>
</tr>
<tr>
<td>Gain on the sale of a disregarded entity</td>
<td>Assigned as if the DRE’s assets were sold for foreign tax purposes (e.g. by reference to the DRE’s inside asset basis under foreign law)</td>
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Relevant Definitions

- A **foreign disregarded entity** is an entity described in Reg. §301.7701-2(c)(2) that is disregarded as an entity separate from its owner for US tax purposes.

- A **foreign branch** is a qualified business unit (QBU), as defined in Reg. §1.989(a)-1(b)(2)(ii) and (b)(3), that conducts a trade or business outside the United States.
  - Reg. 1.989(a)-1(b)(2)(ii) provides that activities of a corporation, partnership, trust, estate, or individual qualify as a QBU if the activities constitute a trade or business; and a separate set of books and records is maintained with respect to the activities.
  - Activities of a partnership that constitute a trade or business are deemed to satisfy the separate set of books and records requirement (and therefore constitute a foreign branch).
  - Reg. 1.989(a)-1(b)(3) provides that any activity (wherever conducted and regardless of its frequency) that produces ECI income or loss shall be treated as a separate QBU, provided the books and records requirement is satisfied.

- A **foreign branch owner** means, with respect to a foreign branch, the person (including a foreign or domestic partnership or other pass-through entity) that owns the foreign branch, either directly or indirectly through one or more disregarded entities.
  - Cannot be the foreign branch or another foreign branch of the foreign branch owner.
Relevant Definitions

• The **taxpayer** is the person considered, under Reg. 1.901-2(f)(1), on whom foreign law imposes legal liability for such tax, even if another person remits such tax.

• A **disregarded payment** is:
  - an amount that is transferred to or from a disregarded entity in connection with a transaction that is disregarded for US tax purposes and that is reflected on the separate set of books and records of a foreign branch; and
  - any amount reflected on the separate set of books and records of a foreign branch that would constitute an item of income, gain, deduction, or loss (not otherwise reflected on the books and records of the foreign branch), a distribution to or contribution from the foreign branch owner, or a payment in exchange for property if the transaction to which the amount is attributable were regarded for US tax purposes.
Actual Distributions and Reverse Hybrids

Actual Distributions

- **CFC1**
- **CFC2**

**Facts**
- Foreign: $1000x dividend
- US: $400x dividend, $500x return of capital, $100x capital gain
- $100x foreign withholding tax

**Allocation of Foreign Taxes**
- $40x general category
- $50x residual income grouping (no credit)
- $10x passive category

Reverse Hybrid

- **USP**
- **RH**

**Facts**
- $1000x tested income
- $100x foreign taxes
- 60% §951A inclusion percentage

**Allocation of Foreign Taxes**
- $60x – §951A category
- $40x – general category
Disregarded Payment By Foreign Branch

Facts
- $400x payment included in CFC’s foreign gross income
- $80x foreign taxes paid by the taxpayer (CFC)
- FDRE assets: 75% general; 25% passive

Allocation of foreign gross income and foreign taxes
- 75% general; 25% passive
- $60x general category foreign taxes
- $20x passive category foreign taxes
Disregarded Payments By a Foreign Branch Owner

• What is considered a payment by a foreign branch owner to a foreign branch?

• What if the taxpayer does not include, under foreign law, an item of income because of the disregarded payment?
Disregarded Payments in Exchange for Property

Facts
- $900x disregarded property sale
- $1000 3rd party property sale
- $100x foreign taxes

Allocation of foreign gross income
- $900x – Residual grouping, domestic income
- $100x – foreign branch category
Foreign tax redeterminations
Section 905(c)
Foreign Tax Redeterminations Under Section 905(c)

• New Proposed and Final Regulations
  ◦ Repeal of pooling regime requires amended returns in all cases
    ◦ Audits & Contested Taxes
    ◦ Two-Year Rule
    ◦ Currency Fluctuations between Accrual and Payment
    ◦ Prospects for de minimis exceptions or other rules to promote administrability?
  ◦ Impact of foreign tax redeterminations on GILTI high-tax exception
  ◦ Comments Requested on Predecessor / Successor

• Notification to the IRS
  ◦ If foreign tax redetermination only impacts FTC carryback/carryover, rules are relaxed
  ◦ Pass-through Entities
  ◦ Alternative Notification Procedures for LB&I Taxpayers
Other FTC Items
Miscellaneous “Fixes”

• Interest Allocation and Apportionment
  ◦ Guarantee Payments
  ◦ Capitalized Interest (section 163(l))

• Stewardship expense allocation and apportionment
Interest Expense Allocation and Apportionment

• Guaranteed Payments for the use of Capital
  ◦ Treated as interest expense for allocation and apportionment purposes and as “interest equivalents” that are foreign personal holding company income under §954(c)

• Partnership to Partner Loans
  ◦ Harmonizes the treatment of loans made by a partnership to its partner(s) with the treatment of downstream partnership loans
  ◦ Requires the matching of interest income to the statutory and residual categories to which the interest expense is attributable

• Assets Funded by Disallowed Interest
  ◦ Clarifies that certain assets are not connected with capitalized, deferred or disallowed interest, including interest disallowed under §163(l)
Stewardship Expenses

• Proposed Regulations generally retain the scope of expenses covered in the existing regulations
  ◦ Expenses “from ‘overseeing’ functions undertaken for a corporation’s own benefit as an investor in a related corporation”
  ◦ Expenses “from ‘duplicative activities’ (as defined in § 1.482-9(l)(3)(iii)) or “shareholder activities” (as defined in § 1.482-9(l)(3)(iv)) of the corporation with respect to the related corporation

• For example, stewardship includes expenses of:
  ◦ An activity the sole effect of which is either to protect the corporation's capital investment in the related corporation, or
  ◦ Compliance with reporting, legal, or regulatory requirements applicable specifically to the corporation, or both
Stewardship Expenses

• **Step 1**: Allocate to dividends and inclusions received or accrued (or to be received or accrued) from related corporations
  ◦ Stewardship expenses allocated to GILTI and subpart F inclusions, as well as §78 gross-up amounts

• **Step 2**: Apportion based on relative values of taxpayer’s stock assets in the same manner that is applied for allocating and apportioning interest expense
  ◦ The only “asset” for this asset-based apportionment is stock (and not the underlying business assets)
  ◦ Treas. Reg. § 1.861-11T(c) eliminates stock of affiliated corporations

• **Applicability**: generally applies to taxable years that end on or after the date proposed regs are filed in the federal register

• **It is now more important to properly identify what activities and costs constitute stewardship.**
Simplified Example 18 from the Proposed Regulations

USP does not elect to consolidate with USS, but still entitled to a 100% DRD

- Same result if USP and USS elect to consolidate
- Can expenses allocable to DE be directly allocated?

USP

USS
Active Business Income
Excluded under Treas. Reg. § 1.861-11T(c)

US DE
Active Business Income
Excluded because allocation is solely to stock

CFC2
Subpart F, Passive Income
Included in Full – US Tax Basis Adjusted for E&P

CFC3
GILTI and Exempt Income

- GILTI Portion Included at 50% Under 864(e)(3)
- Exempt Portion Included but Subject to 904(b)(4)