INTERNAL REVENUE
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IRS

HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2022–3
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These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

EXCISE TAX

Rev. Proc. 2022-11, page 449.
The revenue procedure provides the indexing factor to be used by group health plans and health insurance issuers to calculate the qualifying payment amount (QPA) for items or services provided on or after January 1, 2022, and before January 1, 2023. Temporary regulations, jointly issued with the Departments of Health and Human Services and Labor and the Office of Personnel Management in July 2021, provide the methodology for calculating the QPA, which is generally the plan's median contracted rate for the same or similar item or service, indexed for inflation. Those temporary regulations provide that the Department of the Treasury and IRS will identify the annual indexing factor in guidance, rounded to 10 decimal places.

INCOME TAX

T.D. 9959, page 328.
This document contains final regulations relating to the foreign tax credit, including the disallowance of a credit or deduction for foreign income taxes with respect to dividends eligible for a dividends-received deduction; the allocation and apportionment of interest expense, foreign income tax expense, and certain deductions of life insurance companies; the definition of a foreign income tax and a tax in lieu of an income tax; the definition of foreign branch category income; and the time at which foreign taxes accrue and can be claimed as a credit. This document also contains final regulations clarifying rules relating to foreign-derived intangible income.

T.D. 9961, page 430.
These final regulations provide guidance on the tax consequences of the discontinuation of interbank offered rates (IBORs) that is expected to occur in the United States and many foreign countries. The final regulations mitigate many of the tax consequences that might otherwise arise when a taxpayer modifies a contract that references a discontinuing IBOR in anticipation of that discontinuation. For example, under the final regulations, modifying a debt instrument or derivative contract to replace a LIBOR-referencing rate with a qualified rate generally is not treated as a realization event for federal income tax purposes. The final regulations also mitigate tax consequences under the rules for integrated transactions and hedging transactions, withholding under chapter 4 of the Code, fast-pay stock, investment trusts, original issue discount, and real estate mortgage investment conduits.

Finding Lists begin on page ii.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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Part I

T.D. 9959

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Guidance Related to the Foreign Tax Credit; Clarification of Foreign-Derived Intangible Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the foreign tax credit, including the disallowance of a credit or deduction for foreign income taxes with respect to dividends eligible for a dividends-received deduction; the allocation and apportionment of interest expense, foreign income tax expense, and certain deductions of life insurance companies; the definition of a foreign income tax and a tax in lieu of an income tax; the definition of foreign branch category income; and the time at which foreign taxes accrue and can be claimed as a credit. This document also contains final regulations clarifying rules relating to foreign-derived intangible income (FDII). The final regulations affect taxpayers that claim credits or deductions for foreign income taxes, or that claim a deduction for FDII.

DATES: *Effective date*: These regulations are effective on March 7, 2022.

Applicability dates: For dates of applicability, see §§ 1.164-2(i), 1.245A(d)-1(f), 1.336-5, 1.338-9(d)(4), 1.367(b)-7(h), 1.367(b)-10(e), 1.861-3(e), 1.861-9(k), 1.861-10(h), 1.861-14(k), 1.861-20(i), 1.901-1(j), 1.901-2(h), 1.903-1(e), 1.904-6(g), 1.905-1(h), 1.905-3(d), 1.951A-7, and 1.960-7.

FOR FURTHER INFORMATION CONTACT: Concerning §§1.245A(d)-1, 1.336-2, 1.338-9, 1.861-3, 1.861-20, 1.904-6, 1.960-1, and 1.960-2, Suzanne M. Walsh, (202) 317-4908; concerning §§1.250(b)-1, 1.861-8, 1.861-9, and 1.861-14, Jeffrey P. Cowan, (202) 317-4924; concerning §1.250(b)-5, Brad McCormack, (202) 317-6911; concerning §§1.164-2, 1.901-1, 1.901-2, 1.903-1, 1.905-1, and 1.905-3, Tianlin (Laura) Shi, (202) 317-6987; concerning §§1.367(b)-3, 1.367(b)-4, and 1.367(b)-10, Logan Kincheloe, (202) 317-6075; concerning §§1.367(b)-7, 1.861-10, and 1.904-4, Jeffrey L. Parry, (202) 317-4916; concerning §§1.951A-2 and 1.951A-7, Jorge M. Oben and Larry Pounders, (202) 317-6934 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On December 7, 2018, the Treasury Department and the IRS published proposed regulations (REG-105600-18) relating to foreign tax credits in the **Federal Register** (83 FR 63200) (the "2018 FTC proposed regulations"). Those regulations addressed several significant changes that the Tax Cuts and Jobs Act (Pub. L. 115-97, 131 Stat. 2054 (2017)) (the "TCJA") made with respect to the foreign tax credit rules and related rules for allocating and apportioning deductions in determining the foreign tax credit limitation. Certain portions of the 2018 FTC proposed regulations were finalized as part of TD 9866, published in the **Federal Register** (84 FR 29288) on June 21, 2019. The remaining portions of the 2018 FTC proposed regulations were finalized in TD 9882, published in the **Federal Register** on December 17, 2019 (84 FR 69022) (the "2019 FTC final regulations"). On the same date, new proposed regulations (REG-105495-19) addressing changes made by the TCJA as well as other related foreign tax credit rules were published in the **Federal Register** (84 FR 69124) (the "2019 FTC proposed regulations"). Correcting amendments to the 2019 FTC final regulations and the 2019 FTC proposed regulations were published in the **Federal Register** on May 15, 2020. See 85 FR 29323 (2019 FTC final regulations) and 85 FR 29368 (2019 FTC proposed regulations). The 2019 FTC proposed regulations were finalized as part of TD 9922, published in the **Federal Register** (85 FR 71998) on November 12, 2020 (the "2020 FTC final regulations"). On the same date, the Treasury Department and the IRS published proposed regulations (REG-101657-20) in the **Federal Register** (85 FR 72078) (the "2020 FTC proposed regulations"). The 2020 FTC proposed regulations addressed changes made by the TCJA and other foreign tax credit issues. Correcting amendments to the 2020 FTC final regulations were published in the **Federal Register** on October 1, 2021. See 86 FR 54367. A public hearing on the 2020 FTC proposed regulations was held on April 7, 2021.

On July 15, 2020, the Treasury Department and the IRS finalized regulations under section 250 (the "section 250 regulations") in TD 9901, published in the **Federal Register** (85 FR 43042). The 2020 FTC proposed regulations also included revisions to the section 250 regulations.

This document contains final regulations (the "final regulations") addressing the following: (1) the determination of foreign income taxes subject to the credit and deduction disallowance provisions of section 245A(d); (2) the determination of oil and gas extraction income from domestic and foreign sources and of electronically supplied services under the section 250 regulations; (3) the impact of the repeal of section 902 on certain regulations issued under section 367(b); (4) the sourcing of inclusions under sections 951, 951A, and 1293; (5) the allocation and apportionment of interest deductions of certain regulated utilities; (6) a revision to the controlled foreign corporation ("CFC") netting rule; (7) the allocation and apportionment of section 818(f)(1) items of life insurance companies that are members of consolidated groups; (8) the allocation and apportionment of foreign income taxes, including taxes imposed with respect to disregarded payments; (9) the definitions of a foreign income tax and a tax in lieu of an income tax, including

changes to the net gain requirement, the replacement of the jurisdictional nexus rule with an attribution rule contained in the net gain requirement, the treatment of certain tax credits, the treatment of foreign tax law elections for purposes of the non-compulsory payment rules, and the substitution requirement under section 903; (10) the allocation of the liability for foreign income taxes in connection with certain mid-year transfers or reorganizations; (11) the foreign branch category rules in §1.904-4(f); and (12) the time at which credits for foreign income taxes can be claimed pursuant to sections 901(a) and 905(a).

This rulemaking finalizes, without substantive change, certain provisions in the 2020 FTC proposed regulations with respect to which the Treasury Department and IRS did not receive any comments. See §§1.164-2(d), 1.250(b)-1(c), 1.250(b)-5, 1.336-2(g)(3), 1.338-9(d), 1.367(b)-2, 1.367(b)-3, 1.367(b)-4, 1.367(b)-7, 1.367(b)-10, 1.461-1, 1.861-3(d), 1.861-8(e)(4), 1.861-8(e)(8)(v), 1.861-9(g)(3), 1.861-10(e)(8)(v), 1.861-10(f), 1.901-1, 1.901-2(e)(4), 1.901-2(f), 1.904-4(b), 1.904-4(c), 1.904-6, 1.905-3, 1.954-1, 1.960-1, and 1.960-2. These provisions are generally not discussed in this preamble.

No comments were received with respect to the transition rules contained in the 2020 FTC proposed regulations to account for the effect on loss accounts of net operating loss carrybacks to pre-2018 taxable years that are allowed under the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. 116-136, 134 Stat. 281 (2020). Section 1.904(f)-12(j) was finalized without change in TD 9956, published in the **Federal Register** (86 FR 52971) on September 24, 2021.

Comments that do not pertain to the 2020 FTC proposed regulations, or that are otherwise outside the scope of this rulemaking, are generally not addressed in this preamble but may be considered in connection with future guidance projects.

The rules contained in proposed §1.861-9(k) (election to capitalize certain expenses in determining tax book value of assets), §1.861-10(g) (requiring the direct allocation of interest expense in the case of certain foreign banking branches), and §§1.904-4(e)(1)(ii) and 1.904-5(b)(2) (relating to the definition of financial services income) are not finalized in this document. The Treasury Department and the IRS are continuing to study the comments received in connection with those provisions.

Summary of Comments and Explanation of Revisions

I. *Disallowance of Foreign Tax Credit or Deduction for Foreign Income Taxes under Section 245A(d)*

Proposed §1.245A(d)-1(a) generally provided that neither a credit under section 901 nor a deduction is allowed for foreign income taxes (as defined in §1.901-2(a)) paid or accrued by a domestic or foreign corporation that are attributable to a specified distribution or specified earnings and profits of a foreign corporation. The proposed rule defined a specified distribution — in the case of a distribution to a domestic corporation — as the portion of a dividend for which a deduction under section 245A(a) is allowed, a hybrid dividend, or a distribution of certain previously taxed earnings ("PTEP") related to section 245A(d) ("section 245A(d) PTEP"). In the case of a distribution to another foreign corporation, a specified distribution included the portion of the distribution attributable to section 245A(d) PTEP, or a tiered hybrid dividend that gives rise to a U.S. shareholder inclusion by reason of section 245A(e)(2) and §1.245A(e)-1(c)(1). Specified earnings and profits included the portion of the earnings and profits of a foreign corporation that would give rise to a specified distribution if an amount equal to the entire earnings and profits of the foreign corporation were distributed. Specified earnings and profits also included an amount equal to the portion of a U.S. return of capital amount, as that term is defined in §1.861-20(b), that is treated as arising in a section 245A subgroup, after the application of the asset method in §1.861-9. Proposed §1.245A(d)-1(a) relied upon the rules in §1.861-20 to associate gross income included in the foreign tax base ("foreign gross income") with these amounts and to allocate foreign income taxes to the foreign gross income. The proposed regulations also included an anti-avoidance rule to, for example, prevent taxpayers from using successive foreign law distributions to inappropriately associate withholding tax on the distributions with PTEP arising from inclusions under sections 951(a) and 951A(a). See proposed §1.245A(d)-1(b)(2). The Treasury Department and the IRS requested comments on possible revisions to §1.861-20 to address these concerns, including rules to require the maintenance of separate accounts that would reflect the effect of foreign law transactions on the earnings and profits of a foreign corporation. 85 FR at 72079.

A comment noted that proposed §1.245A(d)-1(a) explicitly treated as specified earnings and profits the portion of a U.S. return of capital amount that is deemed to arise pursuant to §1.861-20(d)(3)(i) in a section 245A subgroup under the asset method of §1.861-9, yet did not explicitly treat any amount as specified earnings and profits when the asset method of §1.861-9 applies under proposed §1.861-20(d)(3)(v) to characterize a disregarded payment that is a remittance as made from a section 245A subgroup. The comment also expressed concerns that proposed §1.245A(d)-1 did not adequately clarify the treatment of foreign tax imposed on a distribution received by a domestic or foreign corporation with respect to its interest in a partnership, or on the proceeds of a disposition of such an interest.

The comment also noted the uncertainty in proposed §1.245A(d)-1(a) over the use of the asset method of §1.861-9 to characterize foreign taxable income of a CFC and apply the disallowance rules of section 245A(d), including when a CFC receives a distribution that is a U.S. return of capital amount. The comment stated that, if the U.S. return of capital amount is treated as made from earnings in a section 245A subgroup of the distributing CFC, the disallowance under section 245A(d) of foreign taxes associated with the portion of the specified earnings and profits attributable to tested income of the recipient CFC not included by a United States shareholder has the inappropriate effect of double-counting the inclusion percentage of section 960(d).

With respect to the anti-avoidance rule of proposed §1.245A(d)-1(b)(2), the comment acknowledged the need to address successive foreign law distributions and

discussed three alternative approaches. One approach would revise §1.861-20(d)(2)(ii)(A) to treat a foreign law distribution as made ratably out of all of a foreign corporation's earnings and profits, including PTEP, if the amount of its earnings and profits exceeds the foreign gross income arising from the foreign law distribution. The second approach would maintain separate E&P accounts to track the effect of foreign law distributions; the comment viewed this option as overly complex and burdensome. The third approach would maintain the anti-avoidance rule of proposed §1.245A(d)-1(b)(2) and make no substantive changes to the operative rules. The comment indicated that a flexible, well-articulated anti-avoidance rule could be more effective at policing attempts to avoid section 245A(d) than a series of potentially manipulable mechanical rules.

The Treasury Department and the IRS agree that proposed §1.245A(d)-1 did not clearly describe the income under Federal income tax law to which foreign gross income should be treated as corresponding for purposes of allocating and apportioning foreign income taxes under §1.860-20. This lack of clarity resulted in uncertainty in determining the extent to which foreign income taxes on a U.S. return of capital amount, which can arise in a variety of transactions involving both stock and partnership interests, should be treated as attributable to income of a foreign corporation that would give rise to a deduction under section 245A(a) when distributed.

In response to these comments, §1.245A(d)-1(a) is revised to eliminate references to specified distributions and specified earnings and profits. Instead, §1.245A(d)-1(a) of the final regulations provides that no credit or deduction is allowed for foreign income taxes attributable to (1) "section 245A(d) income" of a domestic corporation, a successor of a domestic corporation, or a foreign corporation (see §1.245A(d)-1(a)(1)(i)-(ii) and (a)(2)), or (2) "non-inclusion income" of a foreign corporation (see §1.245A(d)-1(a)(1)(iii)).

Section 245A(d) income means, in the case of a domestic corporation, dividends or inclusions for which a deduction under section 245A(a) is allowed, a distribution of section 245A(d) PTEP, and hybrid dividends and inclusions related to tiered hybrid dividends under section 245A(e). In the case of a successor of a domestic corporation, section 245A(d) income means a distribution of section 245A(d) PTEP. In the case of a foreign corporation, section 245A(d) income means an item of subpart F income that gives rise to an inclusion for which a deduction under section 245A(a) is allowed, a tiered hybrid dividend, and a distribution of section 245A(d) PTEP. Under §1.245A(d)-1(b)(1), foreign income taxes are attributable to section 245A(d) income if the taxes are allocated and apportioned under §1.861-20 to the statutory grouping within each section 904 category (the "section 245A(d) income group") to which section 245A(d) income is assigned.

Accordingly, the disallowance under §1.245A(d)-1(a) applies not only to foreign income taxes that are paid or accrued with respect to certain distributions and inclusions, but also to taxes paid or accrued by reason of the receipt of a foreign law distribution with respect to stock, a foreign law disposition, ownership of a reverse hybrid, a foreign law inclusion regime, or the receipt of a disregarded payment described in §1.861-20(d)(3)(v)(B), to the extent the foreign income taxes are attributable to section 245A(d) income. The disallowance also applies where a foreign corporation pays or accrues foreign income taxes that are attributable to section 245A(d) income of the foreign corporation, in which case such taxes are not eligible to be deemed paid under section 960 in any taxable year. For example, the disallowance applies to foreign income taxes paid or accrued by reason of the receipt by the foreign corporation of a tiered hybrid dividend.

These revised rules ensure that §1.861-20, including the rules of §1.861-20(d)(2) for allocating and apportioning foreign income tax to a statutory or residual grouping in a year in which there is no income for Federal income tax purposes in the grouping, apply consistently to allocate and apportion foreign income taxes to the section 245A(d) income group. The rules of §1.861-20(d)(3) apply to determine the circumstances under which foreign gross income included by reason of a dividend or other distribution with respect to stock, a partnership distribution, a sale or exchange of stock, or a sale or exchange of a partnership interest is assigned to the section 245A(d) income group.

Non-inclusion income is defined as income other than subpart F income, tested income, or income described in section 245(a)(5), without regard to section 245(a)(12), (items of income constituting post-1986 undistributed U.S. earnings) of a foreign corporation. Section 1.245A(d)-1(b)(2)(ii) attributes foreign income taxes to non-inclusion income of a foreign corporation to the extent the foreign income taxes are allocated and apportioned to the domestic corporation's section 245A subgroup category of stock when applying §1.861-20 for purposes of section 904 as the operative section. The final rules also attribute foreign income taxes to the non-inclusion income of a reverse hybrid or foreign law CFC to the extent that they are allocated and apportioned to the non-inclusion income group under §1.861-20. See §1.245A(d)-1(b)(2)(iii).

The disallowance under §1.245A(d)-1(a)(1)(iii) therefore applies to foreign income taxes paid or accrued by a domestic corporation that are attributable to non-inclusion income of a foreign corporation in which the domestic corporation is a United States shareholder. For example, paragraph (a)(1)(iii) applies to foreign income taxes that a domestic corporation that is a United States shareholder of a foreign corporation pays or accrues by reason of its receipt from the foreign corporation of a distribution that is a U.S. return of capital amount to the extent the foreign income taxes are attributable to non-inclusion income of the foreign corporation. The final regulations at §1.245A(d)-1(b)(2)(ii) clarify that this rule extends to foreign income taxes the domestic corporation pays or accrues by reason of a remittance, a distribution that is a U.S. return of partnership basis amount, or a disposition that gives rise to a U.S. return of capital amount or a U.S. return of partnership basis amount. The disallowance under paragraph (a)(1)(iii) also applies to foreign income taxes that a domestic corporation that is a United States shareholder pays or accrues by reason of its ownership of a reverse hybrid or foreign law CFC, to the extent the foreign income taxes are attributable to non-inclusion income of the reverse hybrid or foreign law CFC and not otherwise disallowed under paragraph (a)(1)(i) or (ii).

The proposed anti-avoidance rule in §1.245A(d)-1(b)(2) is finalized without substantive change at §1.245A(d)-1(b)(3). While revising §1.861-20(d)(2)(ii)(A) to treat a foreign law distribution as made ratably out of all of a foreign corporation's earnings and profits would be a potentially feasible alternative approach, the Treasury Department and the IRS have determined that on balance the anti-avoidance rule provides an appropriate framework and the necessary flexibility to address section 245A(d) avoidance.

Finally, for the avoidance of doubt, the final regulations clarify that section 245A(d) operates to deny the credit or deduction for foreign taxes paid or accrued with respect to dividends for which a domestic corporation could claim a deduction under section 245A, regardless of whether the corporation claims the deduction on its return. See §1.245A(d)-1(c)(19) and (21) (defining section 245A(d) income and section 245A(d) PTEP). See also H.R. Rep. No. 115-466, at 600 (2017) (Conf. Rep.) ("No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any portion of a distribution treated as a dividend that qualifies for the DRD."); *id*. at 598 (describing section 245A as "an exemption for certain foreign income by means of a 100-percent deduction").

II. *Section 250 Regulations — Definition of Electronically Supplied Service*

Section 1.250(b)-5 provides rules for determining whether a service is provided to a person, or with respect to property, located outside the United States and therefore gives rise to foreign-derived deduction eligible income ("FDDEI service"). The rules identify specific enumerated categories, including a category for general services provided to either consumers or business recipients. For purposes of determining whether such a general service constitutes a FDDEI service, the rules require the location of the recipient to be identified.

The regulations contain special rules in §1.250(b)-5(d)(2) and §1.250(b)-5(e)(2)(iii) for determining the location at which "electronically supplied services" are provided. Section 1.250(b)-5(c)(5) defines the term "electronically supplied service" to mean a general service (other than an advertising service) that is delivered primarily over the internet or an electronic network, and provides that such services include cloud computing and digital streaming services. Proposed §1.250(b)-5(c)(5) revised that definition to clarify that, to qualify as an electronically supplied service, the value of the service to the end user must be derived primarily from the service's automation and electronic delivery and would not include, for example, legal, accounting, medical or teaching services "delivered electronically and synchronously." No comments were received on the proposed revised definition of an electronically supplied service.

By providing the example of professional or teaching services provided in real time (synchronously) as not constituting electronically supplied services, proposed §1.250(b)-5(c)(5) was intended to illustrate cases where the primary value of the service was not in its automation and electronic delivery. However, this example may have implied that the temporal aspect of when the service is rendered, relative to when the end user accesses that service, is a determinative factor in constituting an "electronically supplied service." The Treasury Department and the IRS had intended that services accessed by an end user outside of real time (asynchronously) also will not constitute an "electronically supplied service" if, under all the facts and circumstances, they primarily involve human effort. Therefore, the final regulations remove the reference to "and synchronously" from the fourth sentence of §1.250(b)-5(c)(5) to clarify that the definition does not depend on whether the services are rendered synchronously or asynchronously but rather depend on whether the services primarily involve human effort.

III. *Allocation and Apportionment of Expenses Under Section 861 Regulations*

A. Treatment of section 818(f)(1) items for consolidated groups

Proposed §1.861-14(h) provided that certain items of life insurance companies described in section 818(f)(1) that are members of a consolidated group are allocated and apportioned on a life subgroup basis but provided a one-time election to allocate and apportion these items on a separate company basis. The one comment received endorsed the approach in the 2020 FTC proposed regulations, which are finalized without change.

B. Allocation and apportionment of foreign income taxes

1. In general

The 2020 FTC proposed regulations provided more detailed and comprehensive guidance regarding the assignment of foreign gross income, and the allocation and apportionment of the associated foreign income taxes, to the statutory and residual groupings in certain cases. This guidance included rules for dispositions of stock and partnership interests, and rules for transactions that are distributions with respect to a partnership interest, under Federal income tax law. It also included new rules addressing the allocation and apportionment of foreign income taxes imposed by reason of disregarded payments.

2. Dispositions of stock

Proposed §1.861-20(d)(3)(i)(D) provided that the foreign gross income arising from a transaction that is treated as a sale, exchange, or other disposition of stock for Federal income tax purposes is assigned first to the statutory and residual groupings to which any U.S. dividend amount is assigned under Federal income tax law, to the extent thereof. Foreign gross income is next assigned to the grouping to which the U.S. capital gain amount is assigned, to the extent thereof. Any excess of the foreign gross income over the sum of the U.S. dividend amount and the U.S. capital gain amount is assigned to the statutory and residual groupings in the same proportions in which the tax book value of the stock is (or would be if the taxpayer were a United States person) assigned to the groupings under the rules of §1.861-9(g) in the U.S. taxable year in which the disposition occurs.

A comment recommended that, to the extent of any basis in the stock attributable to a previous increase under section 961, foreign gross income in excess of the U.S.

dividend amount be assigned to the same statutory grouping as the PTEP that gave rise to the basis increase. The comment noted that assigning foreign gross income in excess of the U.S. dividend amount to the grouping that produced the underlying PTEP would better conform the tax attribution consequences of a disposition of stock with the tax attribution consequences of a pre-sale distribution with respect to the stock.

Under §1.861-20(d)(1), Federal income tax law applies to characterize the transaction that gives rise to foreign gross income. The sale of stock may result in a U.S. dividend amount, a U.S. return of capital amount, and a U.S. capital gain amount for U.S. tax purposes. As noted in the preamble to the 2020 FTC proposed regulations, when a controlled foreign corporation has retained PTEP, the usual consequence will be to increase the portion of the amount realized on the sale of the corporation's stock that is treated as a return of capital for U.S. tax purposes, as a result of the basis adjustments under section 961. Accordingly, it is reasonable to conceive of 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, just as an amount of foreign gross income equal to a section 1248 amount that is included in the U.S. dividend amount is treated as a timing difference associated with those non-previously taxed earnings.

However, the approach suggested in the comment would create an additional compliance burden for taxpayers and administrative burdens for the IRS by requiring the separate tracking of basis in the stock attributable to a previous increase under section 961, which is not otherwise required for U.S. tax purposes. Additional rules would be required to associate PTEP with the particular shares of stock being sold, such as in the case of a taxpayer with PTEP in different statutory groupings who sells one class of stock but retains a different class of stock. The Treasury Department and the IRS have determined that the groupings to which the tax book value of the stock is assigned is an administrable and reasonably accurate surrogate for both the PTEP and the future, unrealized earnings of the corporation with which the foreign gross income is properly associated when foreign tax is imposed on a U.S. return of capital amount. For these reasons, the final regulations retain the rule in proposed §1.861-20(d)(3)(i)(D).

3. Partnership transactions

Proposed §1.861-20(d)(3)(ii)(B) assigned 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 the partner's distributive share of the partnership's assets (or, in the case of a limited partner with less than a 10 percent interest, the tax book value of the partnership interest), which are a surrogate for the partner's distributive share of earnings of the partnership that are not recognized in the year in which the distribution is made for U.S. tax purposes. This approach is based on principles similar to those underlying the rule in proposed §1.861-20(d)(3)(i)(D) for allocating and apportioning foreign tax imposed on an amount that is a return of capital with respect to stock for Federal income tax purposes. Similarly, the 2020 FTC proposed regulations associated foreign gross income from the disposition of a 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 (or, in the case of a limited partner with less than a 10 percent interest, the tax book value of the partnership interest). See proposed §1.861-20(d)(3)(ii)(C).

A comment recommended that, in the case of either a distribution with respect to a partnership or a disposition of a partnership interest, foreign gross income in excess of the U.S. capital gain amount be characterized instead by reference to the statutory and residual groupings of amounts maintained in partner-level accounts that track the partners' distributive shares of partnership earnings in prior years. According to the comment, the tax book value method potentially distorts the allocation of tax to U.S. income items in cases in which the amount of income produced by the asset is disproportionate to its basis. For this reason, the comment recommended tracing foreign gross income to amounts in the partner's cumulative distributive share account in order to provide for more accurate matching of foreign gross income to partners' distributive shares of partnership income for the current and prior years. The comment recommended that these new partner-level accounts be increased as a partner includes a distributive share of partnership income and decreased as the partnership makes distributions. Under this multi-year account approach, foreign gross income arising from partnership distributions would be characterized by reference to the earnings in the account out of which the distribution is made, and foreign gross income arising from a disposition of a partnership interest would be characterized by reference to the earnings in the account at the time of disposition. In either case, additional rules (such as providing for the use of a pro rata, last-in-first-out, or other approach) would be required to determine the earnings in the account out of which a distribution is considered to be made, and for cases in which the amount in the partner-level account exceeds the foreign gross income arising from a disposition of that partner's partnership interest.

Recognizing the additional record-keeping requirements and complexity required by this approach, the comment suggested in the alternative that foreign gross income in excess of a U.S. capital gain amount recognized by reason of a partnership distribution or disposition of a partnership interest be characterized based on the partner's distributive share of the partnership's current year income, to the extent thereof, with any excess assigned based on the tax book value method provided for in the 2020 FTC proposed regulations.

The final regulations retain the approach from the 2020 FTC proposed regulations for characterizing foreign gross income arising from a partnership distribution or disposition. The Treasury Department and the IRS do not agree that it is appropriate to treat a partnership distribution as made out of a partner's distributive share of partnership income. Contrary to the ordering rules that apply to distributions by a corporation, under Federal income tax law partnership distributions are not sourced from current or accumulated partnership income. Similarly, under Federal income tax law, a partnership distribution reduces a partner's basis in its

partnership interest without differentiating between basis from capital contributions and basis from a partner's distributive share of partnership income.

A common principle of the rules in §1.861-20 is that Federal income tax law applies to characterize foreign gross income. To the extent a partnership distribution or disposition is treated as a return of basis for Federal income tax purposes, §1.861-20(d)(3)(ii)(B) and (C) appropriately reflect this principle by allocating and apportioning any foreign tax imposed on the partnership distribution in the same manner as foreign tax on a return of capital with respect to stock. Furthermore, this approach to characterizing foreign gross income arising from a partnership distribution is consistent with the approach in §1.861-20(d)(3)(v)(C)(*1*) that applies to a distribution that is a remittance by a taxable unit.

As acknowledged by the comment, characterizing foreign gross income by reference to a partner's distributive share of partnership income in prior years would require creating new partner-level accounts to track the partner's aggregate distributive share of unremitted partnership income. That type of partner-level account is not otherwise required to be maintained to characterize partnership distributions for Federal income tax purposes and would be unduly burdensome for both taxpayers and the IRS, as well as being generally inconsistent with the Federal income tax rules for characterizing partnership distributions. In addition, the Treasury Department and the IRS have determined that the suggested alternative approach of characterizing foreign gross income by reference to a partner's distributive share of current year partnership income would be susceptible to manipulation by timing partnership distributions to maximize foreign tax credit benefits. Therefore, the comment is not adopted.

4. Disregarded payments

The 2020 FTC proposed regulations addressed the allocation and apportionment of foreign income taxes that are imposed by reason of a disregarded payment between taxable units. In the case of foreign income taxes paid or accrued by an individual or domestic corporation, the rules defined a taxable unit as a foreign branch, foreign branch owner, or non-branch taxable unit as defined in proposed §1.904-6(b)(2)(i)(B). In the case of foreign income taxes paid by a foreign corporation, the rules defined a taxable unit by reference to the tested unit definition in proposed §1.954-1(d)(2), as contained in proposed regulations (REG-127732-19) addressing the high-tax exception under section 954(b)(4), published in the **Federal Register** (85 FR 44650) on July 23, 2020 (the "2020 HTE proposed regulations"). See proposed §1.861-20(d)(3)(v)(E)(*9*).

In general, the 2020 FTC proposed regulations characterized a disregarded payment as either a payment out of the current income attributable to a taxable unit (a "reattribution payment"), a contribution to a taxable unit, or a remittance out of accumulated earnings of a taxable unit. See proposed §1.861-20(d)(3)(v). The rules assigned foreign gross income arising from a reattribution payment to the statutory and residual groupings of the recipient taxable unit based on the groupings to which the current income out of which the reattribution payment was made is assigned. See proposed §1.861-20(d)(3)(v)(B). The rules assigned foreign gross income arising from a contribution received by a taxable unit to the residual grouping, and assigned 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, which served as a proxy for the accumulated earnings of the payor taxable unit. See proposed §1.861-20(d)(3)(v)(C). For this purpose, the assets of a payor taxable unit were determined under the rules of §1.987-6(b), modified to include in a taxable unit's assets any stock that it owned, and in certain circumstances reattributed another taxable unit's assets to the taxable unit or reattributed the taxable unit's assets to another taxable unit. See proposed §1.861-20(d)(3)(v)(C)(*1*)(*ii*).

Comments criticized the tax book value method as an inaccurate surrogate for accumulated earnings of a taxable unit in the case of an asset with a basis that is disproportionate to the income produced by the asset and requested that foreign gross income arising from a remittance be assigned to the statutory and residual groupings based on the current earnings of a taxable unit. In addition, comments 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 compliance burden of the rules. Finally, a comment suggested that the modifications to the rules of §1.987-6(b) for purposes of determining the assets of a taxable unit should be expanded to include not only stock, but any interest of a taxable unit in another taxable unit, including a partnership.

The Treasury Department and the IRS do not agree that current earnings of a taxable unit, rather than the tax book value of its assets, should be the basis for characterizing foreign gross income included by reason of a remittance. The Treasury Department and the IRS have determined that, although the tax book value of the assets of a taxable unit may not be a perfect surrogate for the accumulated earnings of that taxable unit, it is a better surrogate than current-year earnings of the taxable unit. The use of current-year earnings is rejected because the current-year earnings may already have been accounted for through reattribution payments, may not reflect all of a taxable unit's assets, and could be subject to manipulation through the timing of disregarded payments, depending on the character of the earnings attributed to a taxable unit for a particular taxable year. Although a more accurate matching of foreign gross income to accumulated income for Federal income tax purposes could be achieved through the maintenance of multi-year accounts tracking accumulated earnings of a taxable unit, characterizing the accumulated earnings of a taxable unit by reference to the tax book value of its assets appropriately balances concerns about administrability, compliance burdens, manipulability, and accuracy.

The Treasury Department and the IRS do not agree that foreign gross income should be traced to income only when disregarded payments are made by a QBU,

rather than a taxable unit. The purpose of this rule in the 2020 FTC proposed regulations was to implement a tracing regime for foreign income tax imposed on disregarded payments that more accurately distinguished payments made out of current income from those made out of accumulated income, rather than treating all disregarded payments as either remittances or contributions. Tracing cannot achieve the policy goal of improved accuracy in matching disregarded payments to the current or accumulated earnings out of which the payment is made if it does not fully account for all disregarded payments. Accordingly, this recommendation is not adopted.

The Treasury Department and the IRS agree that for purposes of §1.861-20 the assets of a taxable unit should include not only stock that it owns, but also its interests in other taxable units. Asset tax book values serve as a surrogate for the accumulated earnings from which a taxable unit made a remittance; including a taxable unit's interests in all other taxable units appropriately reflects all of the income-producing assets of a taxable unit that could produce earnings. Accordingly, §1.861-20(d)(3)(v)(C)(*1*)(*ii*) of the final regulations provides that a taxable unit's assets include its pro rata share of the assets of another taxable unit in which it owns an interest.

The definitions of the terms "contribution" and "remittance" in §1.861-20(d)(3)(v)(E) of the final regulations are revised so that, together, they describe all payments that are not reattribution payments. The proposed regulations defined a "contribution" as a transfer of property to a taxable unit that would be treated as a contribution to capital described in section 118 or a transfer described in section 351 if the taxable unit were a corporation under Federal income tax law, or 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. The proposed regulations defined a "remittance" as a transfer of property that would be treated as a distribution by a corporation to a shareholder with respect to its stock if the taxable unit were a corporation for Federal income tax law, or the excess of a disregarded payment made by a taxable unit to a second taxable unit over the portion of the disregarded payment that is a reattribution payment, other than an amount treated as a contribution. The proposed definition of "contribution" did not encompass a disregarded payment that is neither a reattribution payment nor a transfer that would be described in section 351, such as, in some circumstances, disregarded interest payments. To fill this gap, §1.861-20(d)(3)(v)(E) of the final regulations defines a "contribution" as the excess of a disregarded payment made by a taxable unit to another taxable unit that the first taxable unit owns over the portion of the disregarded payment, if any, that is a reattribution payment. This definition encompasses a transfer of property to a taxable unit that would be treated as a contribution to capital described in section 118 or a transfer described in section 351 if the taxable unit were a corporation. In addition, §1.861-20(d)(3)(v)(E) of the final regulations defines a "remittance" as a disregarded payment that is neither a contribution nor a reattribution payment. This definition encompasses a transfer of property that would be treated as a distribution by a corporation to a shareholder with respect to its stock if the taxable unit were a corporation. These changes ensure that the final regulations provide rules for allocating foreign income taxes attributable to all disregarded payments.

In addition, the final regulations define a "taxable unit" by reference to the tested unit definition in §1.951A-2(c)(7)(iv)(A), a final regulation, instead of by reference to the definition of a taxable unit in proposed §1.954-1(d)(2). See §1.861-20(d)(3)(v)(E)(*9*).

The final regulations provide a special rule at §1.861-20(d)(3)(vi) for allocating and apportioning foreign income tax on foreign gross income included by a taxpayer by reason of its ownership of a U.S. equity hybrid instrument (defined in §1.861-20(b)(22) as an instrument that is stock or a partnership interest under Federal income tax law but that is debt or otherwise gives rise to the accrual of income that is not treated as a dividend or a distributive share of partnership income under foreign law). This special rule, which generally allocates foreign income tax on foreign gross interest income with respect to a U.S. equity hybrid instrument to the grouping to which distributions with respect to the instrument are assigned, clarifies how section 245A(d) and §1.245A(d)-1 apply to foreign income tax that is attributable to a hybrid dividend. As discussed in part I of this Summary of Comments and Explanation of Revisions, §1.245A(d)-1 relies upon the rules of §1.861-20 to determine whether foreign income tax is attributable to income described in section 245A, including a hybrid dividend described in section 245A(e), in which case a credit or deduction for the foreign income tax is disallowed.

Section 1.861-20(d)(3)(vi)(A) treats foreign gross income included by reason of an accrual of income with respect to a U.S. equity hybrid instrument as a distribution. Accordingly, it assigns the foreign gross income to the statutory and residual groupings as though the accrual were a foreign law distribution that was made on the date of the accrual. Section 1.861-20(d)(3)(vi)(B) provides an identical rule for a payment of interest under foreign law with respect to the U.S. equity hybrid instrument; therefore, withholding tax on the payment is also attributed to income (determined under Federal income tax law) from the instrument.

Finally, as part of finalizing the rules in §1.861-20(d)(3)(v), conforming changes are made to §1.951A-2(c)(7) and (8). In particular, §1.951A-2(c)(7)(iii)(B) is deleted and Examples 1 and 3 in §1.951A-2(c)(8)(iii)(A) and (C) are revised accordingly while Example 2 in §1.951A-2(c)(8)(iii)(B) is removed as obsolete. Section 1.951A-2(c)(7)(iii)(B) is removed from the final regulations because the special rules in that paragraph for allocating and apportioning current year taxes imposed by reason of a disregarded payment are rendered obsolete by the final rules in §1.861-20(d)(3)(v). Under §1.951A-2(c)(7)(iii)(A), deductible expenses (including expenses for current year taxes) are allocated and apportioned under the principles of §1.960-1(d)(3) and the rules in §1.861-20.

5. Applicability date

Section 1.861-20 (other than §1.861-20(h)) applies to taxable years that begin after December 31, 2019, and end on or after November 2, 2020. Section 1.861-

20(h) applies to taxable years beginning on or after December 28, 2021. In addition, the revisions to §1.951A-2(c)(7) and (8) apply to taxable years that begin after December 28, 2021; however, taxpayers may choose to apply the final rules to taxable years that begin after December 31, 2019, and on or before December 28, 2021, consistent with the applicability date of §1.861-20(d)(3)(v).

Several comments asked the Treasury Department and the IRS to provide a delayed applicability date for §1.861-20. The rules in proposed §1.861-20 revised the corresponding provisions in the 2019 FTC proposed regulations, which were not finalized with the 2020 FTC final regulations to provide an additional opportunity for comment. Because the regulations are finalized substantially as proposed, with primarily clarifying changes in response to comments, the Treasury Department and the IRS have determined that it is not appropriate to modify the proposed applicability date.

IV. *Creditability of Foreign Taxes Under Sections 901 and 903*

A. Jurisdictional nexus requirement

1. In general

The 2020 FTC proposed regulations added a jurisdictional nexus requirement for determining whether a foreign tax qualifies as a foreign income tax for purposes of section 901. Proposed §1.901-2(a)(3) and (c) generally required that, for a foreign tax to be a foreign income tax, the foreign country imposing the tax must have sufficient nexus to the taxpayer's activities or investment of capital or other assets that give rise to the income base on which the foreign tax is imposed. In the case of a foreign tax imposed by a foreign country on nonresident taxpayers, the 2020 FTC proposed regulations provided that a foreign tax satisfies the jurisdictional nexus requirement if it meets one of three nexus tests.

First, under proposed §1.901-2(c)(1)(i), a foreign tax meets the jurisdictional nexus requirement if it is imposed only on income that is attributable, under reasonable principles, to the nonresident's activities located in the foreign country (for this purpose, the nonresident's activities include its functions, assets, and risks) ("activities-based nexus"). To meet the activities-based nexus test, the allocation of a nonresident's income to the nonresident's activities in the foreign country cannot take into account, as a significant factor, the location of customers, users, or any similar destination-based criterion. Proposed §1.901-2(c)(1)(i) further provided that reasonable principles for determining income attributable to a nonresident's activities include rules similar to those for determining effectively connected income under section 864(c).

Second, under proposed §1.901-2(c)(1)(ii), a foreign tax imposed on the nonresident's income arising in the foreign country meets the jurisdictional nexus requirement only if the foreign tax law sourcing rules are reasonably similar to the sourcing rules that apply for Federal income tax purposes ("source-based nexus").

Third, under proposed §1.901-2(c)(1)(iii), a foreign tax imposed on income or gain from sales or other dispositions of property that is subject to tax in the foreign country on the basis of the situs of real or movable property meets the jurisdictional nexus requirement only if it is imposed with respect to income or gain from the disposition of real property situated in the foreign country or movable property forming part of the business property of a taxable presence in the foreign country (or from interests in certain entities holding such property) ("property-based nexus").

In the case of a foreign tax imposed by a foreign country on its residents, proposed §1.901-2(c)(2) provided that in determining whether the foreign tax meets the jurisdictional nexus requirement, any allocation of income, gain, deduction or loss between a resident taxpayer and a related or controlled entity under the foreign country's transfer pricing rules must follow arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.

Under the 2020 FTC proposed regulations, the jurisdictional nexus requirement also applied to determine whether a foreign levy is a tax in lieu of an income tax under section 903 (an "in lieu of tax"). Specifically, the 2020 FTC proposed regulations modified the substitution requirement to add proposed §1.903-1(c)(1)(iv), which required that the generally-imposed net income tax would either continue to qualify as a net income tax under proposed §1.901-2(a)(3), or would itself constitute a separate levy that is a net income tax if it were to be imposed on the excluded income that is covered by the tested in lieu of tax. This modification was intended to ensure that a foreign tax can qualify as an in lieu of tax only if the foreign country imposing the tax could instead have subjected the excluded income to a tax on net gain that would satisfy the jurisdictional nexus requirement in proposed §1.901-2(c). In addition, proposed §1.903-1(c)(2)(iii) provided that, to satisfy the substitution requirement, a withholding tax must meet the source-based jurisdictional nexus requirement in proposed §1.901-2(c)(1)(ii) to qualify as a "covered withholding tax." Comments regarding the jurisdictional nexus test of the substitution requirement are discussed in this part IV.A of this Summary of Comments and Explanation of Revisions; other comments regarding the proposed modifications to the in lieu of tax provisions are discussed in part IV.C of this Summary of Comments and Explanation of Revisions.

2. Reasonableness of jurisdictional nexus requirement

i. Text and history of the relevant statutory provisions

a. Income tax in the U.S. sense

Comments questioned the validity of the jurisdictional nexus requirement, stating that the requirement is inconsistent with the plain language, structure, and legislative history of the statutory foreign tax credit provisions. Comments stated that the plain meaning of "income tax" refers solely to whether the base of the tax is net income and does not require a justification (nexus) for the imposition of the tax. Some comments stated that the term "income tax" should not be interpreted to encompass U.S. rules or international norms regarding jurisdiction to tax because, according to those comments, when the foreign tax credit provisions were first enacted there were limited source rules in the Code and international norms for

determining the source of income were still developing. Other comments stated that the inclusion of a jurisdictional nexus requirement would require Congressional action and noted that other exceptions to creditability have been enacted by Congress (see, for example, section 901(f), (i) and (m)). Some comments stated that the Supreme Court in *Biddle v. Comm'r,* 302 U.S. 573 (1938), made only a passing reference to "an income tax in the U.S. sense," and that neither *Biddle* nor any other case has interpreted the statute to include a jurisdictional nexus requirement.

The Treasury Department and the IRS have determined that the addition of a jurisdictional nexus requirement is a valid exercise of the government's rulemaking authority. The Treasury Department and the IRS have determined that it is reasonable and appropriate to interpret the terms "income tax" and "tax in lieu of an income tax" in sections 901 and 903, respectively, to incorporate a jurisdictional nexus requirement. Judicial decisions and administrative guidance over the past century have interpreted the term "income, war profits, and excess profits tax," which is not defined in section 901 or by the limited initial explanation in the early legislative history. These interpretations have consistently followed the principle, introduced by the *Biddle* court, that the determination of whether a foreign tax is creditable under section 901 is made by evaluating whether such tax, if enacted in the United States, would be an income tax (in other words, whether the foreign tax is "an income tax in the U.S. sense"). See *PPL Corp. v. Comm'r*, 569 U.S. 329, 335 (2013). See also *Inland Steel Co. v. United States*, 230 Ct. Cl. 314, 325 (1982) ("Whether a foreign tax is an income tax under I.R.C. §901(b)(1) is to be decided under criteria established by United States revenue laws and court decisions."). It is well-settled that U.S. tax provisions should generally be interpreted with reference to domestic tax concepts absent a clear Congressional expression that foreign concepts control. *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 145 (1989). The jurisdictional nexus requirement is consistent with the principle that U.S. tax principles, not varying foreign tax law policies, should control the determination of whether a foreign tax is an income tax (or a tax in lieu of an income tax) that is eligible for a U.S. foreign tax credit.

U.S. tax law has long incorporated a jurisdictional nexus limitation in taxing income of foreign persons. For example, the United States only taxes income of foreign persons that have income that is effectively connected with a U.S. trade or business or attributable to U.S. real property, or have income that is fixed or determinable, annual or periodic (FDAP) income sourced in the United States. See sections 871, 881, 882, and 897. In addition, U.S. foreign tax credit rules reflect international norms of taxing jurisdiction that assign the primary right to tax to the source country, the secondary right to tax to the country where the taxpayer is a resident or engaged in a trade or business, and the residual right to tax to the country of citizenship or place of incorporation. See sections 904(a) (limiting foreign tax credits to U.S. tax on foreign source income) and 906(b)(1) (limiting foreign tax credits allowed to foreign persons engaged in a U.S. trade or business to foreign taxes on foreign source effectively connected income). In keeping with these traditional U.S. taxing rules, international taxing norms (such as provisions included in the OECD Model Tax Convention), and the longstanding approach of the courts to apply U.S. tax principles in determining whether a foreign tax is an income tax in the U.S. sense, it is appropriate for the definition of a creditable tax to incorporate the concept of jurisdictional nexus from the U.S. tax law. The fact that U.S. tax rules have changed since the foreign tax credit provisions were first enacted does not preclude an interpretation of the term "income tax" to reflect U.S. norms, because the principle of "an income tax in the U.S. sense" incorporates an evolving standard of what constitutes an income tax in the U.S. sense.

In addition, the net gain requirement in existing §1.901-2(b), which prescribes the elements of gross receipts and costs that must comprise the base of a foreign income tax, has historically reflected jurisdictional norms in limiting creditable taxes to those imposed on net income. The jurisdictional nexus requirement clarifies the limits on the scope of the items of gross receipts and costs that may properly be taken into account in computing the taxable base of a creditable foreign income tax. Absent this rule, U.S. tax on net income could be reduced by credits for a foreign levy whose taxable base was improperly inflated by unreasonably assigning income to a taxpayer, or by not appropriately taking into account significant costs that are attributable to gross receipts properly included in the taxable base.

Existing §1.901-2(b)(4)(i)(A) has long contained a form of a nexus rule, by requiring recovery of significant costs and expenses that are "attributable, under reasonable principles" to gross receipts included in the foreign tax base. A rule providing the extent to which gross receipts and costs are within the scope of a jurisdiction's right to tax is therefore necessary to determine which items of gross receipts and costs a foreign levy must include to satisfy the net gain rules.

To better reflect the role of the jurisdictional nexus rule as an element of the net gain requirement, the rule in proposed §1.901-2(c) is incorporated in the net gain requirement as new paragraph §1.901-2(b)(5). In addition, the term "jurisdictional nexus requirement" is replaced with "attribution requirement" to more clearly reflect that the rule provides limits on the scope of gross receipts and costs that are attributable to a taxpayer's activities and thus appropriately included in the foreign tax base for purposes of applying the other components of the net gain requirement.

b. Relationship to foreign tax credit limitation

Some comments asserted that Congress explicitly removed a jurisdictional nexus requirement from the predecessor to section 901 in 1921, and since then, Congress has addressed concerns regarding jurisdiction to tax through the foreign tax credit limitation under section 904 (and its predecessor provisions). The comments pointed out that the foreign tax credit provision, when first enacted under the Revenue Act of 1918, provided that U.S. tax was "credited with … the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, *upon income derived from sources therein*, or to any possession of the United States." Pub.

L. 65-254, §§ 222(a)(1) and 238(a), 40 Stat. 1057, 1073, 1080-81 (emphasis added). The comments stated that the phrase "upon income derived from sources therein" served as a jurisdictional nexus limit, which Congress eliminated and replaced by enacting the foreign tax credit limitation in the Revenue Act of 1921. The comments asserted that this legislative history shows that Congress has rejected including a jurisdictional nexus requirement in section 901. The comments also stated that the only concern regarding jurisdiction to tax discussed in the legislative history to the 1918 and 1921 Revenue Acts was Congress' desire to preserve U.S. primary taxing rights over U.S. source income.

The Treasury Department and the IRS disagree with the comments' conclusion that Congress has expressly rejected a jurisdictional nexus requirement for creditable foreign taxes. Although source-based taxing rights are an appropriate element of jurisdictional nexus, tax residence and conducting business in a foreign country also provide jurisdictional nexus. The Treasury Department and the IRS view the introduction of the foreign tax credit limitation in 1921 as merely refining the 1918 Revenue Act's limitation of credits to tax imposed upon foreign source income. The legislative history does not explain why Congress removed the phrase "upon income from sources therein" in 1921, nor does it suggest that Congress believed it was removing a jurisdictional nexus requirement and replacing it with a foreign tax credit limitation.

The Treasury Department and the IRS also disagree with the comments' assertion that statutory policy regarding jurisdiction to tax is confined to the section 904 foreign tax credit limitation. Congress has not explicitly addressed jurisdictional nexus with respect to the foreign tax credit. There is no statutory provision that addresses whether the foreign tax credit should be allowed for taxes imposed outside of traditional U.S. taxing norms. Section 904 does not address the threshold question of whether a foreign tax is an income tax in the U.S. sense. It only limits the allowable credit to the amount of pre-credit U.S. tax on particular categories of foreign source income, as revised by Congress from time to time. The foreign tax credit limitation preserves residual U.S. tax on foreign source income subject to a foreign rate of tax that is lower than the U.S. rate, but does not ensure that the foreign tax has an appropriate jurisdictional basis. The statute is silent with respect to jurisdictional nexus, and it is reasonable and appropriate for regulations to apply U.S. tax concepts in addressing the creditability of extraterritorial foreign levies that Congress could not have anticipated when the foreign tax credit provisions were first enacted.

c. Legislative re-enactment doctrine

Some comments argued that the addition of a jurisdictional nexus requirement is precluded by the legislative re-enactment doctrine. These comments noted that the 1980 temporary and proposed section 901 regulations, which contained similar nexus requirements, drew numerous adverse comments and were the subject of Congressional hearings, and that the Treasury Department and the IRS did not finalize those provisions in TD 7918 (48 FR 46276) ("the 1983 regulations"). These comments asserted that in passing the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (1986), and the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat 2054 (2017) ("TCJA"), Congress was aware of the 1983 regulations (which do not contain a jurisdictional nexus requirement) and did not amend the statute to add one, with the result that Congress implicitly endorsed the 1983 regulations and precluded the Treasury Department and the IRS from modifying them.

The Treasury Department and the IRS disagree with these comments. The legislative re-enactment doctrine does not preclude an agency from changing its regulatory interpretation of a statute if Congress amends related provisions. See *Helvering v. Reynolds*, 313 U.S. 428, 432 (1941) ("[The doctrine of legislative reenactment] does not mean that the prior construction has become so imbedded in the law that only Congress can effect a change."). See also *Helvering v. Wilshire Oil Co.*, 308 U.S. 90, 100 (1939) (holding that the legislative reenactment doctrine applies where "it does not appear that the rule or practice has been changed by the administrative agency through exercise of its continuing rule-making power"); *McCoy v. U.S.*, 802 F.2d 762 (4th Cir. 1986); *Interstate Drop Forge Co. v. Com.*, 326 F2d 743 (7th Cir. 1964).

Additionally, while a purported legislative re-enactment may indicate that Congress was aware of, and implicitly endorsed, the prior regulatory interpretation, a regulation or administrative ruling promulgated under a re-enacted statute is not treated as binding unless other evidence clearly manifests such a purpose. See *Oklahoma Tax Com. v. Texas Co.*, 336 U.S. 342 (1949); *Jones v. Liberty Glass Co.*, 332 U.S. 524 (1947). There is no indication that Congress intended to preclude the amendment of the section 901 and 903 regulations to add a jurisdictional nexus requirement. None of the comments identified any aspect of either the Tax Reform Act of 1986 or the TCJA that suggests that Congress intended to limit future regulations addressing the definition of creditable foreign taxes under sections 901 and 903. Therefore, the Treasury Department and the IRS have determined that the legislative re-enactment doctrine does not preclude the adoption of prospective regulations that include a jurisdictional nexus requirement.

ii. Policy and purpose of the statutory foreign tax credit provisions

Comments stated that adding a jurisdictional nexus requirement is contrary to the policy of the foreign tax credit, which is to mitigate double taxation of foreign source income. These comments asserted that double taxation results when the United States imposes tax on income that is taxed by another country, regardless of whether the other country had a proper jurisdictional basis for imposing the tax, and unrelieved double taxation could discourage foreign investment. The comments asserted that Congress enacted the foreign tax credit to enhance the competitiveness of American companies operating abroad, and the jurisdictional nexus requirement in the 2020 FTC proposed regulations would impede this competitiveness. The comments asserted that the policy goal of sections 901 and 903 is not to influence international norms or change the behavior of foreign governments.

However, another comment stated that the jurisdictional nexus requirement may

reasonably be viewed as consistent with the underlying principles and purposes of the foreign tax credit regime. This comment asserted that the allowance of a foreign tax credit for a tax levied on amounts that do not have a significant connection to the foreign jurisdiction taxing such income, particularly U.S. source income, could effectively convert the foreign tax credit regime into a means of subsidizing foreign jurisdictions at the expense of the U.S. fisc. Similarly, one comment that questioned the government's authority to include a jurisdictional nexus requirement also acknowledged that taxes that have no nexus whatsoever to the taxing jurisdiction would not properly be considered taxes.

The Treasury Department and the IRS agree with the comment that the jurisdictional nexus requirement is consistent with the policy goals of the foreign tax credit. The foreign tax credit is not intended to subsidize foreign jurisdictions at the expense of the U.S. fisc. The legislative history to the predecessor provisions to section 901, as well as subsequent statutory amendments, reflect Congress' consistent concern that foreign tax credits should not be allowed to offset U.S. tax on income that does not have a significant connection to the foreign jurisdiction taxing such income. See, for example, S. Rep. No. 67-275, at 17 (1921) (describing the need to avoid allowing a foreign tax credit to "wipe out" tax properly attributable to U.S. source income); Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984, at 392 (Comm. Print 1984) (describing the need for separate foreign tax credit limitation categories to prevent the U.S. Treasury from inappropriately "bear[ing] the burden" of foreign taxes).

The 2020 FTC proposed regulations are also consistent with the statutory purpose of the foreign tax credit to relieve double taxation of income through the United States ceding its own taxing rights only where the foreign country has the primary right to tax income. See *Bowring v. Comm'r*, 27 B.T.A. 449, 459 (1932) ("In the case of the citizen and resident alien, the United States recognizes the primary right of the foreign government to tax income from sources therein. . . and accordingly, grants a credit."). To ensure that the United States provides a foreign tax credit only where the foreign country appropriately asserts jurisdiction to tax income, creditable foreign levies must incorporate norms similar to those in U.S. tax law that limit the scope of income subject to the tax.

Some comments asserted that double taxation meriting relief exists in every case in which a foreign tax is not allowed as a foreign tax credit against U.S. tax. However, that assertion is inconsistent not only with the foreign tax credit limitation in section 904, but with the plain text of section 901. Section 901 allows a credit only for income, war profits, and excess profits taxes, and not for all foreign taxes that may be imposed by a foreign jurisdiction (such as value added taxes or sales taxes, which may qualify for a deduction under section 164), or for other levies such as tariffs. As explained in part IV.A.2.i.a of this Summary of Comments and Explanation of Revisions, determining which items of gross receipts and costs are properly included in a foreign taxable base is inherent to the determination of whether the foreign tax is an income tax in the U.S. sense.

As noted in the preamble to the 2020 FTC proposed regulations, the fundamental purpose of the foreign tax credit — to mitigate double taxation with respect to taxes imposed on income — 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 costs and 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. Therefore, the final regulations retain the requirement in the 2020 FTC proposed regulations that for a foreign tax to qualify as an income tax, the tax must conform with established international jurisdictional norms, reflected in the Internal Revenue Code and related guidance, for allocating profit between associated enterprises, for allocating business profits of nonresidents to a taxable presence in the foreign country, and for taxing cross-border income based on source or the situs of property.

Recently, many foreign jurisdictions have disregarded international taxing norms to claim additional tax revenue, resulting in the adoption of novel extraterritorial taxes that diverge in significant respects from U.S. tax rules and traditional norms of international taxing jurisdiction. These extraterritorial assertions of taxing authority often target digital services, where countries seeking additional revenue have chosen to abandon international norms to assert taxing rights over digital service providers.[1]

The Treasury Department and the IRS have determined that it is necessary and appropriate to adapt the regulations under sections 901 and 903 to address this change in circumstances, especially in relation to the taxation of the digital economy – a sector that did not exist when the foreign tax credit provisions were first enacted. Accordingly, regulations are necessary and appropriate to more clearly delineate the circumstances in which a tax does not qualify as an income tax in the U.S. sense due to the foreign jurisdiction's unreasonable assertion of jurisdictional taxing authority.

Some comments asserted that the jurisdictional nexus requirement in the 2020 FTC proposed regulations is inconsistent with Congressional policy reflected in the repeal of the per-country foreign tax credit limitation in favor of an overall foreign tax credit limitation. These comments suggested that the proposed jurisdictional nexus requirement would effectively revert to the more limited per-country lim-

[1] See OECD Inclusive Framework on BEPS, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint*, at 10 (Oct. 14, 2020) ("Globalisation and digitalisation have challenged fundamental features of the international income tax system, such as the traditional notions of permanent establishment and the arm's length principle (ALP), and brought to the fore the need for higher levels of enhanced tax certainty through more extensive multilateral tax co-operation. These transformational developments have taken place against a background of increasing public attention on the taxation of highly digitalised global businesses.").

itation and, more generally, that the repeal of the per-country limitation reflects a general policy favoring broader availability of foreign tax credits. The Treasury Department and the IRS disagree with these comments. The jurisdictional nexus requirement does not prevent cross-crediting within a particular separate category described in section 904, which has been amended numerous times by Congress. For example, the nexus requirement does not preclude a foreign tax credit against U.S. tax on foreign source general category income derived from one country for a foreign tax imposed by another country that is assigned to the general category, whereas under the former per-country limitation, such cross-crediting would not be allowed.

Additionally, while comments frame the per-country limitation as more restrictive than the overall limitation, the debate concerning the limitation also highlighted circumstances in which the overall limitation is in fact the more restrictive of the two.[2] In 1960, when adding back the overall limitation, but retaining the per-country limitation, Congress explained that the overall limitation may not be appropriate based on the business model of a particular taxpayer. See S. Rep. No. 86-1393, at 3773-74 (1960). Thus, the Treasury Department and the IRS do not agree with the comments' assertion that Congress' choice in 1976 to retain only the overall limitation supports the broadest allowance of foreign tax credits, because either the per-country or overall limitation may more significantly restrict the amount of foreign tax credit, depending on the circumstances of a particular taxpayer.

Similarly, the choice in 1976 to add back the overall limitation and make it the only limitation did not represent Congress's definitive choice to allow unlimited cross-crediting of high-rate foreign taxes against U.S. tax on foreign source income subject to a lower rate of foreign tax. S. Rep. No. 86-1393, at 3773-74. Rather, Congress has continually amended and debated the appropriate scope of the foreign tax credit limitation since 1962. The ongoing Congressional amendments to the foreign tax credit limitation show that Congress had not definitively resolved the permissible scope of cross-crediting when it enacted the predecessor provision to section 901.

In addition, Congress did not repeal the per-country limitation in 1976 primarily as a policy choice to allow cross-crediting. Rather, Congress repealed the per-country limitation because it allowed a taxpayer to reduce U.S. tax on U.S. source income by application of a foreign source loss, and later to reduce U.S. tax on foreign source income through a foreign tax credit. See S. Rep. No. 94-938, at 236 (1976); H.R. Rep. No. 94-658, at 225 (1975); Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, at 236 (1976). In conclusion, the comments' claim that the jurisdictional nexus requirement in the 2020 FTC proposed regulations is inconsistent with the Congressional policy reflected in the repeal of the per-country limitation is not supported by the legislative history and is contradicted by subsequent amendments to section 904.

Comments also stated that section 904(d)(2)(H)(i), which provides a rule for assigning to a separate category foreign tax imposed by a foreign country on an amount that does not constitute income under U.S. tax principles, provides further support for the view that foreign tax credit provisions should be construed broadly, with limited reference to U.S. rules. One comment pointed to cases, including *Schering Corp. v. Comm'r*, 69 T.C. 579 (1978) and *Helvering v. Campbell*, 139 F.2d 865 (1944), in which courts allowed a credit for foreign taxes on amounts that the U.S. does not tax due to timing or base differences, for example, as a result of characterization differences.

The Treasury Department and the IRS find these comments unpersuasive, because the jurisdictional nexus requirement in the 2020 FTC proposed regulations would not preclude a credit for foreign taxes imposed on an amount of taxable income that exceeds taxable income computed under U.S. tax law rules due to base or timing differences. The nexus rule requires that the activity subject to the tax have sufficient connection to the foreign country imposing the tax. It does not require that every item included in the foreign tax base conform in timing or amount to items included in U.S. taxable income. Consistent with section 904(d)(2)(H)(i), the jurisdictional nexus requirement in the 2020 FTC proposed regulations does not preclude a credit for foreign income taxes imposed on base difference amounts.

3. Other policy considerations

Several comments questioned the policy reasons discussed in the preamble to the 2020 FTC proposed regulations that motivated the Treasury Department and the IRS to add the jurisdictional nexus requirement. Comments disagreed with the notion that destination-based taxing rights lack sufficient connection to a jurisdiction. They noted that Congress's deliberations of alternative approaches to the U.S. corporate income tax and the current multilateral negotiations by the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting ("Inclusive Framework") with respect to reallocating taxing rights under the "Pillar 1" proposal demonstrate that there is a legitimate debate about claims to destination-based taxing rights. This ongoing debate, the comments stated, indicates that market-based or destination-based taxes are income taxes. As such, some comments asserted that the jurisdictional nexus rule in the 2020 FTC proposed regulations is inconsistent with changes that have occurred in how income can be generated through technology and changes that various taxing jurisdictions, including U.S. states, have made to their taxing regimes in response to those changes. The comments recommended that if the jurisdictional nexus requirement is not eliminated in the final regulations, the requirement should be modified such that it is more flexible and takes into account evolving jurisdictional norms. One comment asked that the requirement be expansive enough to allow credits for taxes imposed on income sourced to a jurisdiction based on the situs of users or customers, as well as taxes imposed on a taxpayer

[2] For example, both houses of Congress, in retreating from the overall limitation in 1954, explained that "[t]he effect of the [overall] limitation is unfortunate because it discourages a company operating profitably in one foreign country from going into another country where it may expect to operate at a loss for a few years. Consequently your committee has removed the overall limitation." H.R. Rep. No. 83-1337, at 4103 (1954); see also S. Rep. No. 83-1622, at 4739 (1954).

that generates income from customers in a jurisdiction without having a physical presence in that jurisdiction.

One comment pointed out that U.S. income tax principles incorporate destination-based taxing rights. As an example, the comment noted that proposed §1.861-18(f)(2)(ii) provided that when a copyrighted article is sold and transferred through an electronic medium, the sale is deemed to have occurred at the location of download or installation onto the end-user's device. As another example, the comment cited §1.250(b)-4(d)(1)(ii)(D), which provides that a sale of certain property that primarily contains digital content is for a foreign use if the end user downloads, installs, receives, or accesses the purchased digital content on the end user's device outside the United States. Another comment noted that Congress considered imposing a destination-based income tax as part of the 2017 tax reform.

In addition, comments stated that over half of U.S. states with a corporate income tax determine the amount of a taxpayer's income subject to the state's corporate income tax by apportioning the taxpayer's federal taxable income using sales as the single factor. The comments stated that under the proposed jurisdictional nexus requirements, these state income taxes would fail to be an "income tax" in the U.S. sense even though the income subject to the state corporate income taxes is based in significant respects on the taxpayer's taxable income determined under the Code. The comments also questioned whether this policy means that a foreign country can deny a foreign tax credit for otherwise eligible U.S. state corporate income taxes simply because the states rely on sales-based apportionment factors to source income and a market-based jurisdictional nexus standard.

In general, the Treasury Department and the IRS disagree with these comments. As explained in part IV.A.2 of this Summary of Comments and Explanation of Revisions, whether a foreign tax is creditable under section 901 depends on whether the tax is an "income tax in the U.S. sense." Neither prior unenacted legislative proposals nor potential future (yet undetermined) changes to the Code with respect to U.S. jurisdictional limits are determinative of what constitutes an income tax in the U.S. sense under current law.

The Treasury Department and the IRS acknowledged in the preamble to the 2020 FTC proposed regulations that future changes in U.S. law may necessitate rethinking the rules for determining creditable foreign income taxes. It is nevertheless important that these final regulations be issued promptly to address novel extraterritorial taxes. Existing 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 section 901, and the Treasury Department and the IRS had previously received comments requesting guidance on this matter.[3] In addition, to the extent these novel extraterritorial taxes, which many foreign jurisdictions have already adopted, are being paid by taxpayers and claimed as a foreign tax credit, this would have an immediate and detrimental impact on the U.S. fisc. Therefore, the Treasury Department and the IRS disagree with the suggestion in comments that the potential for future law changes necessitates a delay in the issuance of these necessary and appropriate regulations.

The Treasury Department and the IRS also disagree that the manner in which U.S. states determine the amount of income that is taxable in a particular state has any bearing on whether a foreign tax is an income tax in the U.S. sense. See, for example, *Heiner v. Mellon*, 304 U.S. 271, 279 (1937) ("It is well settled that in the interpretation of the words used in a federal revenue act, local law is not controlling unless the federal statute by express language or necessary implication, makes its own operation dependent upon state law."). Nothing in the Code, legislative history, or case law suggests that whether a tax is an income tax in the U.S. sense should be determined by reference to state, as opposed to Federal, income tax principles. Furthermore, it is immaterial whether a foreign country would provide a foreign tax credit under its own law for U.S. state income taxes.

In addition, U.S. tax law imposing U.S. tax on income of nonresidents is not based on notions of destination or customer location. See sections 864(c), 871, 881, and 882. Moreover, the comment citing section 250 is inapposite, as that provision merely defines the scope of sales and services that constitute income from export activity that qualifies for a special U.S. tax deduction; it does not operate to assert taxing jurisdiction over income of nonresidents. Similarly, while proposed §1.861-18(f)(2)(ii) interprets the place of sale as being the place of download solely for the purpose of determining the source of certain types of income from the sale or exchange of digital property in cases where the statutory source rule looks to the place where the sale occurs, this rule does not expand the scope of U.S. tax on income derived by nonresidents. U.S. law does not tax income from the sale or exchange of property by a nonresident unless the nonresident conducts a trade or business in the United States (if applicable, through a U.S. permanent establishment) or disposes of a United States real property interest as provided under section 897.

One comment stated that the jurisdictional nexus requirement may be reasonably viewed as consistent with the policy of the foreign tax credit regime, which, as discussed in part IV.A.2 of this Summary of Comments and Explanation of Revisions, is not intended to subsidize foreign jurisdictions at the expense of the U.S. fisc. However, the comment also asserted that defining what are acceptable standards of taxing jurisdiction based upon U.S. principles may be unduly restrictive and may result in non-creditability of foreign taxes even when the foreign tax law is mostly aligned with U.S. principles. As an example, the comment posited that if a foreign country's generally-imposed net income tax on its residents could in certain instances apply in a manner that is inconsistent with traditional arm's length principles, that tax would be non-creditable with respect to all resident taxpayers, even for taxpayers to which income would

[3] See New York State Bar Association Tax Section, *Report on Issues Relating to the Definition of a Creditable tax for Purposes of Sections 901 and 903 of the Code*, Rep't No. 1332 (Nov. 24, 2015).

be allocated in a manner consistent with arm's length principles.

Comments also pointed out that the jurisdictional nexus requirement that was included in the 1980 temporary and proposed regulations at §4.901-2(a)(1) (flush language) was a more flexible standard because it required only that the foreign tax follow reasonable rules regarding source of income, residence, or other bases for tax jurisdiction, and did not require specific rules that are similar to Federal income tax rules. In addition, one comment noted that the 1980 temporary regulations also provided that a foreign tax may satisfy the definition of an income tax even if the foreign tax law differs substantially from the income tax provisions of the Code. That comment recommended that the final regulations should provide flexibility to accommodate the continued evolution of international tax policy consensus, which may diverge from the U.S. view of traditional taxing norms.

Comments also asserted that certain U.S. sourcing rules reflect domestic policies other than jurisdiction to tax. As an example, one comment noted that the title passage rule for inventory in sections 861(a)(6) and 862(a)(6) reflects administrative simplification concerns, and former section 863(b) served as an incentive for certain activities. The comments argued that foreign countries that adopt a rule different from U.S. source rules due to different choices among competing policies should not cause the foreign tax to be non-creditable. One comment argued that diverging views of taxing rights, especially as between developed and developing countries, have long existed outside the context of novel extraterritorial taxes. The comment asserted that diverging views on taxing rights is what makes relief from double taxation necessary; it is not a reason to deny creditability of a foreign tax.

The Treasury Department and the IRS generally agree that different countries may diverge in their approach to asserting jurisdictional taxing rights, just as countries may have different approaches in determining the amounts of realized gross receipts and recoverable costs and expenses included in the foreign taxable base. As a result, the net gain requirement in existing §1.901-2, as well as in these final regulations, does not require strict conformity between foreign and U.S. tax law. However, the final regulations do require 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." These principles include not only those related to determining realization, gross receipts, and cost recovery, but also principles related to assertion of taxing rights. The purpose of section 901 is not to provide double tax relief in all cases in which foreign tax is imposed on income of a U.S. taxpayer, but rather, to relieve double taxation only in the case of foreign taxes that are "*income*, war profits, and excess profits taxes." Accordingly, the purpose of the regulations under section 901 is to provide clarity and certainty as to which income tax principles reflected in the Code the foreign tax law must have for a tax to be an income tax in the U.S. sense within the meaning of section 901. However, the Treasury Department and the IRS agree with the comments asserting that certain aspects of the source requirement can appropriately be revised to be more flexible; these changes are described in part IV.A.4 of this Summary of Comments and Explanation of Revisions.

Several comments recommended that the Treasury Department and the IRS address the policy concerns regarding extraterritorial taxes through alternative approaches. These comments recommended that the Treasury Department utilize international forums, such as the Inclusive Framework and bilateral treaty negotiations, to dissuade foreign jurisdictions from enacting or imposing these taxes. Comments argued that the denial of foreign tax credits is unlikely to prevent foreign jurisdictions from imposing extraterritorial taxes and will instead harm the U.S. taxpayers operating in those foreign jurisdictions. One comment asserted that the foreign tax credit regulations should not be used as a tool to further U.S. foreign policy goals. Another comment recommended that, instead of adopting the jurisdictional nexus requirement, the Treasury Department and the IRS consider an alternative approach for defining what exceeds appropriate taxing jurisdiction by reference to the criteria that the U.S. Trade Representative has used to evaluate whether these taxes are discriminatory and burden U.S. commerce. Finally, one comment asserted that the jurisdictional nexus requirement would disproportionately disallow credits for taxes imposed by developing countries, which are more likely to assert taxing rights in a manner that is inconsistent with international norms, as compared to taxes imposed by developed countries.

The Treasury Department and the IRS agree that international forums can be an effective way of discouraging foreign jurisdictions from enacting extraterritorial taxes; indeed, the Treasury Department is actively engaged in and supporting negotiations under the auspices of the Inclusive Framework that would result in their elimination.[4] However, contrary to the comments' assertion, the Treasury Department and the IRS's determination that regulations are necessary and appropriate to ensure that the U.S. fisc does not bear the costs of such taxes derives from the text, purpose, and policy of section 901, and not from any foreign policy goals. The Treasury Department and the IRS have concluded that these novel extraterritorial taxes (some of which are currently in force and being levied on U.S. taxpayers) are contrary to the text and purpose of section 901 and therefore must be addressed now. Furthermore, nothing in the text, structure, or history of section 901 suggests that the Treasury Department or the IRS should consider the level of economic development of a country in determining whether a foreign tax imposed by that country meets the standards in section 901. Lastly, the Treasury Department and the IRS have considered the recommendation to use the criteria used by the U.S. Trade Representative but have determined that those criteria are designed for a different purpose (that of evaluating whether the foreign tax is unreasonable or discrim-

[4] See OECD/G20 Base Erosion and Profit Shifting Project, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (October 8, 2021) (describing agreement reached by 136 countries to "remove all Digital Services Taxes and other relevant similar measures with respect to all companies, and to commit not to introduce such measures in the future.").

inatory and burdens or restricts U.S. commerce under U.S. trade laws), and are not suitable for purposes of defining whether a tax is an income tax in the U.S. sense for purposes of U.S. tax laws.

Finally, one comment recommended that the Treasury Department and the IRS develop a list of per se creditable and non-creditable taxes to provide taxpayers certainty and reduce compliance burdens. A per se list of creditable and non-creditable taxes would require significant government resources to analyze foreign taxes and maintain such a list, which would need to be updated every time foreign tax laws change. Therefore, the final regulations do not adopt this comment.

4. Modifications to the source-based nexus requirement

Comments argued that the determination of whether foreign sourcing rules are reasonably similar to U.S. sourcing rules would be complex and result in significant uncertainty because U.S. sourcing rules are not sufficiently well-defined. Comments pointed out that the preamble to the 2020 FTC proposed regulations acknowledged that the U.S. rules for determining income effectively connected with a U.S. trade or business have been developed through case law, are not strictly delineated, and thus were not used as the standard for the activities-based nexus requirement. The comments suggested that the U.S. sourcing rules for royalties and services are similarly addressed only in case law and not well-developed. They contended that it would be difficult to apply the sparse and inconsistent U.S. case law on royalty sourcing to determine if a foreign tax law's sourcing rules for royalties are reasonably similar to U.S. rules. In addition, comments asserted that the U.S. sourcing rules are designed to distinguish between U.S. and foreign source income, and are not well-suited for determining, for example, whether a royalty paid from one CFC to another is specifically sourced to the payor CFC's jurisdiction of residence. With respect to services income, one comment noted that it is unclear whether services should be sourced solely based on the source of the labor or by also taking into account the location of capital, especially when significant intangible property is involved. Another comment asked for clarification on how to evaluate whether a foreign withholding tax that is imposed both on services performed in the country imposing the tax and on technical service fees paid by a resident of such foreign country (regardless of where the services are performed) meets the source-based nexus requirement; this comment asked whether the determination of "reasonably similar" would depend on how important technical services are relative to that foreign country's economy.

In response to these comments, the final regulations modify the source-based nexus requirement to provide additional flexibility and clarity. Section 1.901-2(b)(5)(i)(B) continues to require that the foreign sourcing rules must be reasonably similar to the sourcing rules under the Code. However, in recognition that the Code does not provide detailed sourcing rules addressing every category of income, or every type of income within that category, and that the interpretation and application of the Code sourcing rules are sometimes addressed only in case law and sub-regulatory guidance, §1.901-2(b)(5)(i)(B) also provides that the foreign tax law's application of sourcing rules need not conform in all respects to the interpretation that applies for Federal income tax purposes. Thus, for example, the final regulations require that in the case of gross income arising from gross receipts from royalties, the foreign tax law must impose tax on such royalties based on the place of use of, or the right to use, the intangible property. However, the final regulations do not require that the foreign law, in determining the place of use of an intangible in a particular transaction or fact pattern, reach the same conclusion as the IRS in a particular revenue ruling or a U.S. court in a particular case.

The final regulations provide additional certainty by specifying the source principles that foreign tax law must apply to be considered reasonably similar to U.S. source rules. With respect to income from services, §1.901-2(b)(5)(i)(B)(*1*) provides that gross income arising from services must be sourced based on where the services are performed, as determined under reasonable principles, which do not include determining the place of performance based on the location of the service recipient. Thus, a withholding tax that is imposed on payments for services performed in the country imposing the tax would meet the source-based nexus requirement, but a withholding tax on fees for technical services performed outside of that country would not meet the source-based nexus requirement. In addition, the separate levy rules at §1.901-2(d)(1)(iii) are modified to provide that withholding taxes that apply different sourcing rules to subsets of a single class of gross income of nonresidents are treated as separate levies. Therefore, a withholding tax that applies a nonqualifying source rule to a subset of service income would not be creditable, but because it is treated as a separate levy the nonqualifying source rule would not prevent a withholding tax on other services that satisfies the source-based nexus requirement from qualifying as a creditable tax.

Several comments also pointed out that the United States and the foreign jurisdiction may disagree on how to characterize the income from a particular transaction, making it more difficult to determine whether the foreign tax meets the jurisdictional nexus requirement. The comments noted that issues of characterization are particularly prevalent with respect to cross border payments for digital goods. The comments stated that in respect of software transactions that are treated as sales of copyrighted articles under §1.861-18, some foreign countries regard some or all payments by their resident taxpayers for software copies as royalties, and accordingly, impose a royalty withholding tax on those payments. The comments also asserted that even in cases where a foreign country may not consider the payment subject to royalty withholding tax, the foreign country may nonetheless tax other copyrighted article transactions as royalties. As such, the comments argued, cross border payments for digital goods should be excepted from the jurisdictional nexus requirement. Another comment noted that similar characterization questions may arise when distinguishing between technical service fees and royalties; the comment queried whether a foreign withholding tax imposed on royalties that the United States would view as a payment for services would be determined to be non-creditable or would require an eval-

uation of the magnitude of the services relative to the royalty.

Comments also argued that the United States lacks guidance on the classification and sourcing of income from cloud computing transactions, noting that the Treasury Department and the IRS have not yet finalized the proposed cloud computing regulations that were issued in 2019. The comments asserted that given the evolving U.S. guidance on the character and source of cloud computing transactions, the creditability of a foreign tax imposed on such transactions should not depend on whether foreign law is reasonably similar to U.S. law.

In response to these comments, the final regulations provide that, in general, foreign tax law applies for purposes of determining the character of the gross income or gross receipts that arise from a transaction. See §1.901-2(b)(5)(i)(B). The determination of whether the foreign law source rule is reasonably similar to the source rules under the Code will follow from the foreign law characterization of that income. If there is no statutory source rule in the Code for a particular amount that is subject to foreign tax, then the foreign law source rule will satisfy the source-based nexus requirement if it is reasonably similar to the U.S. source rule that applies by closest analogy. However, the final regulations also clarify that in the case of copyrighted articles, to satisfy the source-based nexus requirement, the foreign tax law must treat a transaction that is considered the sale of a copyrighted article under §1.861-18 (where the acquirer receives only the right to use a copyrighted article and not, for example, the right to duplicate and publicly distribute, or the right to publicly display the article) as a sale of tangible property and not as a license. See §1.901-2(b)(5)(i)(B)(*3*). This rule is consistent with established U.S. law and international norms. See §1.861-18(c); see also OECD Model Tax Convention (2017), commentary to art. 12. The Treasury Department and the IRS have determined that this rule is necessary to ensure that foreign jurisdictions cannot reclassify income from sales of copyrighted articles as royalties to assert taxing rights that are extraterritorial in nature and outside the scope of what is an income tax in the U.S. sense.

Comments recommended that, if the jurisdictional nexus requirement is not withdrawn entirely in the final regulations, then payments for services and payments for digital goods should be excepted from the source-based nexus requirement. With respect to payment for services, the comments argued that the U.S. source rule for services is not the international norm; many countries impose withholding tax on payment for services made by a resident in the country (or by a nonresident with a permanent establishment in the country). Comments noted that the UN Model Tax Convention allows contracting states to impose withholding taxes on a variety of services fees, and that the United States has income tax treaties with foreign jurisdictions that allow the foreign country to withhold tax on payments for services not performed in that country. Several comments also asserted that withholding taxes on payments for services are not novel taxes, but rather are long-standing taxes that are also creditable under existing §1.903-1. Specifically, comments pointed to Example 3 of existing §1.903-1(b)(3), which concludes that a gross basis tax imposed on a nonresident for technical services performed outside the country imposing the tax are creditable. As such, the comments stated, these withholding taxes are consistent with international norms and the final regulations should continue to allow these taxes to be creditable.

In addition, comments expressed concern about the increased incidence of unrelieved double taxation in respect of cross-border payments for digital services. The comments suggested that under proposed §1.861-19, essentially all cloud transactions, as defined in those proposed regulations, will be classified as services for Federal income tax purposes. As such, foreign withholding taxes imposed on payments for those services, if not imposed on the basis that the services are performed in the country, would be non-creditable under the proposed source-based nexus requirement. Comments also pointed out that the effect of the source-based nexus requirement in the 2020 FTC proposed regulations is to create disparate treatment for software suppliers based on the approach a supplier adopts to commercializing the software. As an example, comments pointed out that a software supplier that makes software available through limited time subscription is treated under Federal income tax rules as receiving payments of service fees, whereas a software supplier that provides software to users through downloads under limited-time licenses is treated as receiving payments of rents. If a foreign country imposes withholding taxes on both payments, the withholding tax paid by the first software supplier would not be creditable (because the U.S. source rules would not permit the service payment to be sourced based on the location of the user) whereas the taxes paid by the second supplier would be creditable (because U.S. source rules would permit the rental payment to be sourced based on where the user installs the software copy). The comments argued that there is no policy justification for such disparate results.

The Treasury Department and the IRS have determined that it is necessary and appropriate to narrow the circumstances under existing law (for example, as illustrated in Example 3 of §1.901-1(b)(3)) in which withholding taxes on payment for services are creditable. The taxation of services performed by nonresidents, under U.S. tax law, is clearly limited to cases in which the services are performed in the United States. Nothing in the Code, legislative history, or case law indicates that a different approach is appropriate for technical or digital services. The Treasury Department and the IRS have determined that the assertion of foreign withholding taxes on income from services that are not performed within the foreign jurisdiction is not consistent with an income tax in the U.S. sense and therefore should not qualify for a credit under section 901.

Furthermore, the Code provides for disparate treatment of classes of income depending on whether the transaction that gives rise to the income is characterized as a service, license, sale, or something else. This different treatment is also reflected in existing international norms, including the OECD Model Tax Convention. Seeking to conform the treatment of digital transactions under the Code, or to anticipate possible future changes to the treatment or classification of digital transactions, is beyond the scope of these regulations. Instead, the Treasury Department and the IRS have determined that analyz-

ing whether a foreign tax is an income tax based on how such income is characterized under foreign law and comparing the foreign tax law sourcing rule to U.S. tax principles, provides adequate flexibility to account for differences between U.S. and foreign law, while adhering to the requirement that a foreign tax be an income tax in the U.S. sense to be creditable. Thus, the final regulations do not adopt the recommendation to except digital services from the jurisdictional nexus requirement.

One comment noted that the 2020 FTC proposed regulations could create different results for sales of software, depending on whether the software is delivered on tangible media or delivered by way of digital download because there are different U.S. source rules for such transactions. As an example, the comment explained that a sale of a software copy that is delivered on tangible media is sourced, under U.S. income tax principles, based on title passage, whereas the sale of a copyrighted article delivered through an electronic medium is deemed to occur, under proposed §1.861-18(f)(2)(ii), at the location of download or installation. The comment further noted that if proposed §1.861-18(f)(2)(ii) is not finalized, and the title passage rule continues to apply to digital deliveries, then for U.S. income tax purposes, the source of the income would be determined based upon where the servers from which the software copy is made available is located. The comment argued that these distinctions should not be the basis for causing the supplier of the software to be eligible or ineligible for a foreign tax credit.

The Treasury Department and the IRS have determined that it is unnecessary to require a foreign tax law's sourcing rule for income derived from the sale or other disposition of property to conform with U.S. source rules. This is because under the Code, the United States imposes tax on such income of a nonresident only if the nonresident conducts a U.S. trade or business (if applicable, through a U.S. permanent establishment) or the income is derived from real or movable property situated in the United States. Thus, the final regulations provide that, with respect to foreign tax imposed on income derived from the sale or other disposition of property, including copyrighted articles sold through an electronic medium, the tax meets the attribution requirement only if the inclusion of the income in the foreign tax base meets the activities-based nexus requirement in §1.901-2(b)(5)(i)(A) or the property-based nexus requirement in 1.901-2(b)(5)(i)(C).

5. Activities-based nexus requirement

One comment stated that the physical presence and permanent establishment standard is not an inherent part of the U.S. tax system; rather, it is a political invention in the 1920s that was the result of bargaining between the United States and its treaty partners. The comment stated that by adopting this standard in the 2020 FTC proposed regulations, the Treasury Department and the IRS ignored the economic realities of digital economies and lacked reasoned decision-making. The comment recommended that the final regulations provide that the jurisdictional nexus requirement is satisfied when consumers of a service rendered by a foreign corporation are located in the taxing jurisdiction.

The Treasury Department and the IRS disagree with the comment's assertion that the physical presence and permanent establishment standard is not an appropriate measure for nexus. The permanent establishment standard is a critical part of the U.S. Model Income Tax Convention, existing U.S bilateral tax treaties, and the OECD Model Tax Convention. Furthermore, a physical presence standard is consistent with the nexus rules in section 864, which provide that only income effectively connected with a trade or business that a foreign resident conducts in the United States is subject to U.S. tax. Contrary to the comment's contention, the 2020 FTC proposed regulations did not ignore the economic realities of digital economies; rather, they adopted a standard based on the existing Code and traditional international taxing norms. The Treasury Department and the IRS have determined that the income tax principles in the Code do not allow for the assertion of taxing rights based solely on the existence of consumers in a jurisdiction.

One comment asserted that, where the foreign law includes elements in common with the effectively connected income standard under section 864(c), a broader standard for attributing income to nonresidents on the basis of the nonresidents' activities as well as activities of the nonresident's related parties should satisfy the activities-based nexus requirement of the 2020 FTC proposed regulations. The Treasury Department and the IRS disagree with this comment. Taking into account activities of the nonresident's related parties would be inconsistent with the principles reflected in the U.S. Model Income Tax Convention, and the OECD Model Tax Convention, as well as in section 864 (unless the other party is acting on behalf of the nonresident). Accordingly, the final regulations at §1.901-2(b)(5)(i)(A) clarify that the activities-based attribution requirement is not met when the nonresident is deemed to have a trade or business in the taxing jurisdiction by reason of activities conducted by another person, or when the foreign tax law attributes profits to the nonresident based upon the activities of another person, other than in the case of a party acting on behalf of the nonresident or in the case of a pass-through entity of which the nonresident is an owner. In addition, the final regulations clarify in §1.901-2(b)(5)(i)(A) that foreign tax law that attributes income to a nonresident by taking into account as a significant factor the mere location of persons from which a nonresident makes purchases does not meet the activities-based nexus requirement.

Comments requested that taxes paid to Puerto Rico be exempted from the application of the jurisdictional nexus requirement because, as a U.S. territory, its taxes should not be treated in the same manner as taxes imposed by a foreign country. For Federal income tax purposes, a credit is allowed for income taxes paid or accrued to any foreign country or United States territory. See section 901(b)(1); see also section 903. As no distinction is made between taxes imposed by foreign countries and those imposed by U.S. territories, the final regulations follow the 2020 FTC proposed regulations in applying the same standards in defining what is a creditable income tax regardless of whether the tax is imposed by a foreign country or a U.S. territory. However, as described in more detail in part IV.F.2 of this Summary of Comments and Explanation of Revisions,

a special transition rule applies to defer for one year the applicability date of the final regulations under section 903 with respect to certain taxes paid to Puerto Rico.

Another comment recommended that the example in proposed §1.901-2(c)(3) (§1.901-2(b)(5)(iii) of the final regulations) be expanded to illustrate the application of the attribution requirement in the case where a nonresident taxpayer is earning income from electronically supplied services in a country that imposes tax on such services (ESS tax) and the taxpayer either (1) maintains its own branch in the foreign country imposing the tax, with employees of the branch conducting routine sales, marketing, and customer support functions or (2) uses a related party disregarded entity resident in that country to perform local marketing, customer support, and other routine functions. With respect to the second scenario, the comment noted that where the ESS tax is imposed on the resident disregarded entity, if the entity's tax base is determined under arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion, then the ESS tax would meet the residence-based nexus requirement and would be creditable. The comment suggested that in the first scenario, although the ESS tax is not imposed on the basis of a nonresident's activities located in the country, the portion of the ESS tax that corresponds to the portion of a separate nonresident corporate income tax imposed on the branch's effectively-connected income that would meet the activities-based requirement (based on the actual activities performed by the branch) should be considered to meet the activities-based nexus requirement if the country does not impose the tax on the branch's effectively-connected income.

The Treasury Department and the IRS agree with the comment's analysis and conclusion in the second scenario but disagree with the analysis and conclusion in the first scenario. Whether a foreign tax meets the requirements of §1.901-2(b), including the attribution requirement, is determined based solely on the terms of the foreign tax law, and not on a taxpayer's specific facts. Thus, the fact that a separate levy that the foreign country could have imposed on nonresident taxpayers with respect to their branch operations in the foreign country could meet the attribution requirement in a particular factual circumstance does not mean that a different tax that is an ESS tax, or any portion of an ESS tax, would be deemed to meet the attribution requirement.

6. Property-based nexus requirement

One comment requested clarification on whether a foreign tax law similar to the U.S. Foreign Investment in Real Property Tax Act (FIRPTA) regime under section 897 would satisfy the proposed property-based nexus requirement. It noted that under the 2020 FTC proposed regulations, a foreign tax law identical to FIRPTA may not meet the proposed property-based nexus rule if (consistent with section 897) it included in the tax base a portion of the gain from the sale of shares in a foreign real property holding corporation (within the meaning of section 897(c)(2)) that does not correspond to foreign real property interests. The comment further noted that a foreign levy imposed on a nonresident's gain from the sale of shares of a corporation attributable to real property in the taxing jurisdiction would be creditable under the proposed property-based nexus rule, even if (inconsistent with section 897) the corporation is not a resident of the taxing jurisdiction.

In response to this comment, the final regulations at §1.901-2(b)(5)(i)(C) clarify that a foreign tax may include in its base gross receipts that are attributable to the sale or disposition of real property situated in the foreign country, or to the disposition of an interest in a corporation or other entity that is a resident of the foreign country that owns real property situated in the foreign country, under rules reasonably similar to those in section 897. In addition, a foreign tax imposed on the basis of the situs of property may include in its base gains derived from the sale or other disposition of property forming part of the business property of a taxable presence in the foreign country as well as gains from the disposition of an interest in a partnership or other passthrough entity that has a taxable presence in the foreign country to the extent the gains are attributable to the entity's business property in that foreign country, under rules that are reasonably similar to those in section 864(c). A foreign tax on any other gains of a nonresident will not satisfy the property-based attribution requirement.

7. Interaction with income tax treaties

The preamble to the 2020 FTC proposed regulations confirmed that the proposed regulations in §§1.901-2 and 1.903-1, 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.

One comment recommended that the final regulations expressly provide that the regulations will not affect the creditability of foreign taxes covered by an existing income tax treaty. The comment also argued, however, that relying on the U.S. treaty network as the sole mechanism for relieving double tax for companies operating in foreign countries with source or other jurisdictional taxing norms that differ from U.S. taxing norms is not equitable. It noted that the United States only has income tax treaties with 68 countries, and that the United States has few treaties with countries in South America and Africa. The comment stated that the treaty negotiation process is laborious and that the Treasury Department considers the level of trade and investment between the countries in determining with which countries it engages in treaty negotiations, with the result being that the United States has historically declined to negotiate treaties with countries that have smaller economies, including developing countries.

Another comment requested that the Treasury Department and the IRS specifically address the interaction of the jurisdictional nexus requirement with U.S. income tax treaties that have allowed the treaty partner to impose a capital gains tax on a nonresident taxpayer on the sale of stock of a corporation resident in the treaty country regardless of whether the shares constitute a real property interest or are attributable to a permanent establishment in the treaty country. The comment noted that, despite the statement in the preamble to the 2020 FTC proposed regulations, it is unclear how the double taxation articles of U.S. income tax treaties, which often

provide that the United States agrees to allow a foreign tax credit subject to the limitations of U.S. law, would be interpreted in light of these regulations. The comment recommended that the Treasury Department and the IRS modify the jurisdictional nexus requirement such that foreign taxes imposed on gains from the disposition of stock of a corporation sourced on the basis of residence of the corporation continue to be creditable.

Comments also asked for clarification regarding the effect the final regulations would have on a foreign tax that is a covered tax under an existing U.S. income tax treaty if the foreign tax is paid by a CFC, which is not eligible for the benefits given to U.S. residents under the treaty. One comment noted that because CFCs are not U.S. residents, taxes paid by the CFC on a foreign-to-foreign payment would not be creditable under the U.S. income tax treaty with the source country. The comment questioned whether this means that a foreign tax would not be creditable when paid or accrued by a CFC even though it would be creditable if paid or accrued directly by a U.S. taxpayer.[5] The comment pointed out that in this case, the United States has already acknowledged the legitimacy of the treaty partner's claim to taxing rights, even if it conflicts with U.S. principles; thus, the tax should be creditable even if paid by a CFC. Another comment similarly noted that, in respect of foreign taxes imposed on gains from the disposition of stock of a resident corporation that are creditable under certain U.S. treaties, such treaties would ensure creditability of those taxes only when paid by U.S. persons, and not, for example, when paid by an upper-tier CFC upon the disposition of lower-tier CFC stock.

In response to these comments, the final regulations clarify in §1.901-2(a)(1)(iii) that a foreign tax that is treated as an income tax under the relief from double taxation article of an income tax treaty that the United States has entered into with the country imposing the tax meets the definition of a foreign income tax as to U.S. citizens and residents of the United States that elect to claim benefits under that treaty. However, as the comments noted, CFCs are not treated as U.S. residents under U.S. income tax treaties, so CFCs resident in a third country do not qualify for benefits under U.S. income tax treaties. Because U.S. income tax treaties do not limit the application of the treaty partner's taxes imposed on third-country CFCs, the final regulations clarify that taxes paid to a U.S. treaty partner by a third-country CFC are treated as a separate levy that must independently satisfy the requirements of section 901 or 903 to be creditable.

However, the final regulations clarify that any limitations that a foreign country has agreed to under its treaties with other jurisdictions that apply to nonresident CFCs would be taken into account in determining whether such levy meets the requirements of §1.901-2(b) or §1.903-1(b) when paid by the CFC. See §1.901-2(a)(1)(iii). Thus, for example, in determining whether a foreign country's nonresident corporate income tax meets the activities-based jurisdictional requirement of §1.901-2(b)(5)(i)(A), when the tax is paid by a CFC that is resident in a third country, any limitations or modifications that the first foreign country has agreed to under the permanent establishment and business profits articles of an income tax treaty with the third country are taken into account. The final regulations make corresponding modifications to the separate levy rules to provide that a foreign levy that is modified by a particular treaty is treated as a separate levy. See §1.901-2(d)(1)(iv).

B. Net gain requirement

1. In general

The 2020 FTC proposed regulations modified the net gain requirement to limit the role of the predominant character analysis in determining whether a tax meets each of the components of the net gain requirement — the realization requirement, the gross receipts requirement, and the net income requirement (which under the 2020 FTC proposed regulations is referred to as the cost recovery requirement). The 2020 FTC proposed regulations also limited the prevalence of the empirical analysis required by the existing regulations, which asks whether a foreign tax is likely to reach net gain in the "normal circumstances" in which it applies. Instead, the 2020 FTC proposed regulations generally provided that the determination of whether a tax satisfies each of the realization, gross receipts, and cost recovery requirements under the net gain requirement is based on the terms of the foreign tax law governing the computation of the tax base. See proposed §1.901-2(a)(3). The preamble to the 2020 FTC proposed regulations explained that reduced reliance on empirical analysis would allow taxpayers and the IRS to evaluate the nature of the foreign tax based on objective and readily available information and would lead to more consistent and predictable outcomes.

Several comments recommended that instead of finalizing the proposed modifications to the net gain requirement, the Treasury Department and the IRS should either retain the predominant character test of the existing regulations or propose less extensive changes to the net gain requirement and provide transition rules. Some of these comments stated that the proposed rules would create too rigid a standard that would lead to increased instances of double taxation, putting U.S. companies at a competitive disadvantage. One comment stated that under the proposed standard, a credit may not be allowed for a foreign tax that is an income tax in the U.S. sense based on the actual operation of the foreign tax. Another comment asserted that the proposed standard would place U.S. multinationals operating in developing countries at a significant competitive disadvantage compared with foreign competitors operating in the same developing countries that do not face the same risk of double taxation because they are subject to a participation exemption or a less restrictive foreign tax credit regime.

Comments stated that the predominant character and facts and circumstances

[5] Another comment made a similar point in connection with recommending that all proposed revisions to the net gain requirement be withdrawn. That comment noted that taxpayers that are operating in a country with which the United States has an income tax treaty may not be insulated from uncertainty regarding the creditability of foreign taxes because the treaties are unclear as to the creditability of foreign taxes listed in the treaty that are incurred by foreign subsidiaries and deemed paid by U.S. taxpayers under section 960. That comment is addressed in this part IV.A.7. of the Summary of Comments and Explanation of Revisions.

analysis of the existing regulations is a better approach because there is a lack of uniformity in the income tax systems across different jurisdictions and because a particular country's tax system can regularly change over time. Comments stated that the existing regulations provide the necessary flexibility to allow a credit to be claimed for foreign taxes that are calculated with variations from U.S. tax principles. In addition, several comments questioned whether administrative difficulties with applying the predominant character test of the existing regulations was a legitimate or sufficient justification for removing the test, noting that the controversies over creditability of foreign taxes have not been pervasive or unresolved enough to justify the new more objective standard.[6] Several comments stated that instead of reducing administrative burdens the proposed changes add complexity and reduce certainty because they require taxpayers to compare foreign and U.S. tax law, including statutes, regulations, case law, rulings, and pronouncements, with any subsequent changes to either foreign or U.S. law requiring re-evaluation of whether there is sufficient conformity.

Comments also asserted that it is not realistic for the Treasury Department and the IRS to expect foreign tax law to conform substantially to U.S. tax law. These comments noted that different jurisdictions use different means to protect their tax base and that some countries may have a relatively simple tax regime and choose to protect their base through disallowance of deductions. Comments suggested that a foreign tax should not have to strictly conform to U.S. rules; it should be creditable if it has the essential elements of an income tax in the U.S. sense. Comments also asserted that the Code definition of gross income and allowable deductions reflect evolving priorities of Congress and should not serve as the determinative standard of a model income tax that other countries should follow. Finally, another comment stated that the significant changes made by the 2020 FTC proposed regulations would fundamentally change existing U.S. tax laws and policies to a degree that only Congress can implement through legislation.

As explained in part IV.A.2 of this Summary of Comments and Explanation of Revisions, Congress did not prescribe a fixed definition of the term "income tax" for purposes of section 901 or 903. As a result, the meaning of the term has been developed and refined through administrative guidance and case law since 1919. This body of law has followed the guiding principle that the determination of whether a foreign tax is an income tax for purposes of sections 901 and 903 is made by reference to U.S. tax law. The 1983 final regulations followed this principle and, influenced by court opinions decided in the years preceding those regulations, adopted an approach that required a foreign tax to be examined in the normal circumstances in which the tax is applied to determine whether the predominant character of the tax is that of an income tax in the U.S. sense. As explained in the preamble to the 2020 FTC proposed regulations, the IRS's experience over the past 40 years has highlighted the significant administrative difficulties with applying the predominant character test, the ambiguities inherent in the empirical analysis required to apply the test, and the inconsistent outcomes that may result from applying the predominant character test. See 85 FR 72089-72092. In addition, the courts that applied the 1983 regulations further brought into focus the type of quantitative empirical evidence, such as private financial data on the extent of disallowed expenses, that the IRS and the taxpayer may need to obtain and analyze to determine whether a foreign tax is an income tax under the empirical tests of the existing regulations. See, for example, *Texasgulf Inc. v. Comm'r*, 172 F.3d 209, 216 (2d Cir. 1999) (court examined statistics for claimed processing allowances and for nonrecoverable expenses across a 13-year period derived from a study conducted by taxpayer's expert to determine if alternative allowance provided under the Ontario Mining Tax effectively compensated for nonrecovery of significant expenses); *Exxon Corp. v. Comm'r*, 113 T.C. 338 (1999) (both parties relied heavily on expert witnesses from the petroleum industry, the U.K. government, and from legal, tax, accounting, and economic professions).

The comments that recommended against the approach in the 2020 FTC proposed regulations did not suggest any alternative approaches that would not require the empirical analysis necessitated by the existing regulations. Due to the difficulty that taxpayers and the IRS face in properly applying the existing regulations, the Treasury Department and the IRS have determined that it is necessary and appropriate to finalize the rule in the 2020 FTC proposed regulations that the determination of whether a foreign tax meets the net gain requirement is primarily based on the terms of the foreign tax law governing the computation of the tax base. This approach allows taxpayers and the IRS to evaluate the nature of the foreign tax based on more objective and readily available information.

The Treasury Department and the IRS disagree with the comments that suggested that the existing regulations entail minimal administrative burdens or that the rules in the 2020 FTC proposed regulations will increase administrative burdens. Although the final regulations require a comparison of foreign law to U.S. law, that comparison is generally done by examining the terms of the foreign tax law, which taxpayers must do in any case in order to compute their foreign tax liability, rather than by examining difficult-to-obtain foreign tax return and private financial data to determine the effect of the tax (as is required under the existing regulations).

In addition, the Treasury Department and the IRS disagree that the final regulations will add complexity or create more disputes. The fact that relatively few court cases have addressed the definition of an income tax under §1.901-2 does not suggest that the existing regulations are clear and easy to apply, but rather that they are challenging for the IRS to administer. It is unclear whether taxpayers are correctly applying the existing requirements in §1.901-2 by per-

[6] One comment made this assertion specifically with respect to the removal of the alternative gross receipts test of the existing regulation, noting that there have been only three court cases involving the gross receipts test over the past four decades. That comment is addressed in this part IV.B.1 of the Summary of Comments and Explanation of Revisions; other comments regarding the gross receipts requirement are discussed in part IV.B.2 of the Summary of Comments and Explanation of Revisions.

forming the empirical analysis required by the regulations. Because the existing regulations are difficult for taxpayers to apply and for the IRS to administer, there is potential for the requirements in existing §1.901-2 to be applied incorrectly, a result that is detrimental to sound tax administration.

The Treasury Department and the IRS have determined that the changes made in the final regulations will increase certainty and will prevent the need for the IRS to gather and evaluate data that are not readily available in order to ensure that taxpayers are appropriately applying the relevant empirical analysis — particularly in the case of novel extraterritorial taxes that are generally imposed on a gross basis (such as digital services taxes) and that would meet the requirements of the existing regulations only if the nonrecoverable costs and expenses attributable to that gross income, together with the tax paid by all persons subject to the tax, can empirically be proven almost never to result in a loss. The Treasury Department and the IRS disagree with comments that suggest that administrative concerns are not a sufficient reason for revising the regulations. Having clear, administrable rules that can be consistently applied is critical to sound tax administration.

The Treasury Department and the IRS also disagree with the comments suggesting that the 2020 FTC proposed regulations reflect a fundamental change to existing foreign tax credit policies or that the existing regulations do not require taxpayers to compare foreign and U.S. tax law (including statutes, regulations, case law, rulings, and pronouncements) to determine whether a tax is creditable. In fact, for a foreign taxable base that deviates from the U.S. computational norm of realized gross receipts reduced by significant costs and expenses, the predominant character test by its terms requires taxpayers to perform an empirical analysis every year to determine whether a tax is creditable, such that changes in the empirical impact of a foreign tax (despite no change in the terms of the tax) could impact the creditability analysis. The final regulations will simplify the determination of whether a foreign levy is an income tax in the U.S. sense by eliminating this burdensome inquiry.

Furthermore, the Treasury Department and the IRS disagree that the final regulations will result in additional double taxation in a manner that is inconsistent with the statute, or that they inappropriately place U.S. multinationals at a competitive disadvantage compared to foreign competitors from a country with a participation exemption regime or a less-restrictive foreign tax credit system. Section 901 allows credits only for foreign taxes that are income taxes in the U.S. sense, and this standard is met only if there is substantial conformity in the principles used to calculate the foreign tax base and the U.S. tax base. Absent such conformity, no credit is appropriate under section 901. Finally, the manner in which foreign countries relieve double taxation for its resident taxpayers does not have any bearing on the appropriate interpretation of section 901, which provides a credit only for foreign income taxes, not all foreign taxes.

In addition, some comments stated that the proposed rules, which focus on the terms of the foreign law in determining whether the net gain requirement is met, inappropriately shift the analysis from the substance to the form of a foreign levy. In particular, some comments asserted that this is inconsistent with court cases, including *PPL Corp. v. Comm'r*, 569 U.S. 329 (2013), in which courts have stated that the substantive effects of a tax should be considered when determining whether a tax constitutes a foreign income tax. Other comments stated that the predominant character analysis of the existing regulations better reflects the guidance from cases such as *Biddle* and *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894 (3rd Cir. 1943), which confirm that whether a foreign tax is creditable should be determined on the basis of its substantive resemblance to an income tax in the U.S. sense.

The Treasury Department and the IRS disagree with comments suggesting that the approach adopted in the 2020 FTC proposed regulations to minimize the role of empirical analysis is inconsistent with the principles applied by the courts in *PPL*, *Biddle*, or *Keasbey* to determine whether a foreign tax is an income tax in the U.S. sense. The Supreme Court in *Biddle* established that statutory terms such as "income tax" are properly interpreted to have the meaning understood under U.S. tax law; the *Keasbey* court, citing *Biddle*, stated that "a tax paid [to] a foreign country is not an income tax within the meaning of [section 901] unless it conf[o]rms in its substantive elements to the criteria established under our revenue laws." *Keasbey*, 133 F.2d at 897. The Supreme Court in *PPL* determined the creditability of the U.K. windfall tax by applying the predominant character test of the existing regulations, which evaluates the substantive effect of the tax by resort to empirical analysis of the effect of alternative methods of determining gross receipts and deductible expenses. Citing *Biddle*, the Supreme Court stated that "instead of the foreign government's characterization of the tax, the crucial inquiry is the tax's economic effect. In other words, foreign tax creditability depends on whether the tax, if enacted in the U.S., would be an income, war profits, or excess profits tax." *PPL*, 569 U.S. at 335.

Consistent with the guiding principle that a creditable tax must be an income tax in the U.S. sense, the 2020 FTC proposed regulations required a comparison of the foreign tax law to the U.S. tax law to determine whether the provisions for computing the base on which the foreign tax is imposed conforms with U.S. criteria for an income tax (that is, a tax imposed on realized gross receipts reduced by allocable costs and expenses). Under the 2020 FTC proposed regulations, the foreign government's characterization of the tax or the name given to the tax do not control the determination of creditability; rather, the determination involves an examination of the substantive provisions of the foreign tax law that govern the computation of the income that is subject to tax. The Supreme Court in *PPL* was applying the predominant character test in the existing regulations and was not interpreting the statute. Because the final regulations modify the standard for determining whether a foreign levy is an income tax in the U.S. sense, the final regulations do not conflict with the *PPL* decision. Thus, the Treasury Department and the IRS disagree with the comments' contentions that the 2020 FTC proposed regulations have inappropriately shifted the inquiry away from the substance, or the substantive economic effect, of the foreign tax.

2. Alternative gross receipts test

The 2020 FTC proposed regulations removed the "alternative gross receipts test" in existing §1.901-2(b)(3), which provided that a foreign tax meets the gross receipts requirement if it is computed under a method that is likely to produce an amount that is not greater than the fair market value of actual arm's length gross receipts. Under proposed §1.901-2(b)(3)(i), a foreign tax meets the gross receipts tests only if the tax is imposed on actual gross receipts, or is imposed on deemed gross receipts arising from pre-realization timing difference events (for example, a mark-to-market regime, tax on the physical transfer, processing, or export of readily marketable property, or a deemed distribution or inclusion), or is imposed on the basis of gross receipts from an insignificant non-realization event. In addition, proposed §1.901-2(b)(3)(i) provided that, for purposes of the gross receipts test, amounts that are properly allocated to a taxpayer under the jurisdictional nexus rules in proposed §1.901-2(c), such as pursuant to transfer pricing rules that properly allocate income to a taxpayer on the basis of costs incurred by that entity, are treated as the taxpayer's actual gross receipts.

Several comments criticized the removal of the alternative gross receipts test and asked that it be retained. Comments stated that eliminating the alternative gross receipts test creates an overly restrictive gross receipts requirement that can cause foreign taxes to not qualify as income taxes due to small or formalistic differences in how foreign law measures gross receipts as compared to U.S. law. One comment noted that it is not unusual for taxing jurisdictions to provide alternate measures of gross receipts to avoid compliance difficulties. The comment also noted that U.S. tax law uses alternative gross receipts, such as using the applicable Federal rate (determined by the IRS) to determine interest deemed to be received by certain lenders. Other comments noted that the U.S. standards for measuring gross receipts and gross income have changed over time, and there is no static view of gross receipts against which to measure foreign law. One such comment pointed to realized cash receipts, the accrual method, financial statement income, and in limited instances mark-to-market as examples of varying ways to compute gross receipts. Another comment pointed to the changes to the rules for determining the taxable year for income inclusions under section 451 from 2012 to 2018.

One comment asserted that the proposed regulation's treatment of alternative measures of gross receipts determined by applying a markup to costs (which does not meet the gross receipts requirement) is irreconcilable with the rule in proposed §1.901-2(b)(3)(i) that treated allocations of gross income under transfer pricing methods to a taxpayer as actual gross receipts. The comment contended that there is no logical reason for treating a foreign law that allows taxpayers to use a cost-plus transfer pricing methodology as meeting the gross receipts test, but not a foreign law that uses a measurement of gross receipts based on costs, and that the 2020 FTC proposed regulations will result in significant controversy in distinguishing the two situations. The comment recommended that the Treasury Department and the IRS continue to treat foreign income taxes based on alternative measurements of gross receipts as meeting the gross receipts test, so long as the taxpayer can show that the alternative is likely to produce an amount not greater than fair market value.

One comment requested clarification on how the proposed rules would apply in situations where the foreign jurisdiction imposes a levy on a combination of actual gross receipts and receipts computed based on some other method.

In addition, comments pointed out that the Treasury Department and the IRS previously proposed to eliminate the alternative gross receipts test in the 1980 proposed and temporary regulations under sections 901 and 903, but after extensive consideration decided to retain it in the 1983 final regulations. The comments asked the Treasury Department and the IRS to justify the reconsideration of the elimination of the alternative gross receipts test, given that such elimination was previously rejected.

The Treasury Department and the IRS have determined that it is necessary and appropriate to remove the alternative gross receipts test because, in general, a tax that is imposed on an amount greater than actual realized gross receipts, or greater than the value of property, is not an income tax in the U.S. sense. In addition, the decision to provide an alternative gross receipts test in the 1983 final regulations, even if made in response to comments, does not preclude the Treasury Department and the IRS from later re-evaluating and removing the rule. The IRS' experience with applying the alternative gross receipts test has shown that the test is vague and unduly burdensome to administer because of the empirical evaluation needed to determine whether the alternative method is likely to produce an amount that is not greater than fair market value.

However, in response to comments received, the final regulations provide that deemed gross receipts resulting from deemed realization events or insignificant non-realization events that meet the realization requirement in §1.901-2(b)(2) will meet the gross receipts requirement if the deemed gross receipts are reasonably calculated to produce an amount that is not greater than fair market value. For example, deemed gross receipts resulting from a mark-to-market regime or foreign tax law that imputes interest income under a provision similar to section 7872 would satisfy the gross receipts requirement.

The Treasury Department and the IRS disagree with the comment that seems to conflate a situation when actual gross receipts arise from a transaction between related parties that is priced under a cost-plus transfer pricing methodology with the transactions contemplated in the 2020 FTC proposed regulations. Such a related-party transaction is distinct from a foreign levy that imposes tax on deemed gross receipts that are determined based upon a markup of costs rather than the actual gross receipts from the transaction among unrelated parties. The former involves using a transfer pricing methodology to determine the appropriate payment (that is, the actual gross receipts as reported or adjusted for tax purposes) that a taxpayer in a transaction with a related party should receive based upon arm's length principles. In contrast, in the context of transactions between unrelated parties, using a measure of deemed gross receipts based on costs may have no relationship to the actual gross receipts.

However, the Treasury Department and the IRS have determined that the reference in proposed §1.901-2(b)(3)(i) to gross receipts that are properly allocated to a taxpayer under a foreign tax meeting the jurisdictional nexus requirement was potentially confusing and unnecessary, because such a related party transfer pricing methodology would result in actual gross receipts, either by means of an actual payment or a constructive payment resulting from a receivable recorded on the taxpayer's books and records. Accordingly, the reference to gross receipts determined under a transfer pricing methodology is removed from the final regulations, and an example is added to the final regulations at §1.901-2(b)(3)(ii)(B) to illustrate the intended application of the rule.

3. Cost recovery requirement

The 2020 FTC proposed regulations modified various aspects of the net income test of the existing regulations (referred to as the "cost recovery requirement" under the 2020 FTC proposed regulations) to ensure that a foreign tax is a creditable tax only if the determination of the foreign tax base conforms in essential respects to the determination of taxable income under the Code.

Several comments recommended against adopting the proposed changes to the cost recovery requirement out of concern that the proposed changes will result in more instances of unrelieved double taxation. One comment asserted that the effect of the revisions to the cost recovery requirement would be to limit creditability of foreign levies that have been traditionally characterized as income taxes based solely on minor deviations between U.S. tax principles and the foreign law. The comment asserted that the revised standard is stricter than the standard traditionally applied by the courts, and unreasonably narrows the standard since the term "foreign income, war profits, and excess profits taxes" in the statute has not been changed.

In general, the Treasury Department and the IRS disagree with comments that the revised cost recovery standard will result in additional unrelieved double taxation in a manner that is inconsistent with the policies underlying section 901. This is because double taxation that merits relief under section 901 occurs only if there is substantial conformity in the principles used to calculate the foreign tax base and the U.S. tax base. However, the final regulations modify certain aspects of the cost recovery requirement in order to provide additional flexibility and to reduce instances where minor deviations between U.S. principles and foreign tax law could cause a foreign levy to be non-creditable; these changes are described in part IV.B.3.ii and iii of this Summary of Comments and Explanation of Revisions.

i. Gross basis taxes

The 2020 FTC proposed regulations removed the nonconfiscatory gross basis tax rule of the existing regulations. That rule provided that a foreign levy whose base is gross receipts is treated as meeting the cost recovery requirement if the foreign levy is almost certain to reach net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Instead, proposed §1.901-2(b)(4)(i)(A) provided that a foreign levy must permit recovery of the significant costs and expenses attributable to such gross receipts, or permit recovery of an alternative amount that by its terms may be greater, but will never be less, than the actual amounts of such significant costs and expenses. Proposed §1.901-2(b)(4)(i)(A) further provided that a foreign tax that is imposed on gross receipts or gross income and that does not permit recovery of any costs or expenses does not meet the cost recovery requirement, even if in practice there are no or few costs and expenses attributable to all or particular types of gross receipts included in the foreign tax base.

One comment stated that the removal of the nonconfiscatory gross basis tax rule is inconsistent with court decisions that predate the 1983 regulations and that have concluded that a tax on gross receipts may qualify as a creditable income tax so long as it reaches net income. The comment specifically cited *Seatrain Lines, Inc. v. Comm'r*, 46 B.T.A. 1076 (1942), *Santa Eulalia Mining Co. v. Comm'r*, 2 T.C. 24 (1943), and *Bank of America Nat. Trust & Sav. Ass'n v. U. S.*, 459 F.2d 513 (Ct. Cl. 1972). The comment stated that in determining whether a foreign levy is an income tax, the courts focus on the nature of the income that is the subject of the tax and whether that type of income is likely to involve significant expenses that could result in a net loss being realized from the activity being taxed. The comment further contended that digital services taxes would qualify as creditable income taxes under this analysis, because the amounts of costs and expenses associated with the type of gross receipts subject to the digital services taxes are never so high as to cause businesses subject to the tax to incur a loss after payment of the tax. No explanation or evidence (whether empirical or anecdotal) was provided to support this assertion.

The comment further asserted that the explanation for the proposed change in the preamble to the 2020 FTC proposed regulations is unpersuasive. It contended that the court decisions involving the net gain requirement have not reflected any administrative difficulties. As such, the comment stated that the removal of the nonconfiscatory gross basis tax rule in the 2020 FTC proposed regulations is unjustified and recommended that the existing rule be retained.

The Treasury Department and the IRS have determined that foreign taxes that do not permit recovery of significant costs and expenses are not income taxes in the U.S. sense. Although some cases preceding the 1983 regulations, such as those cited in the comment, determined that a gross basis tax could be an income tax in the U.S. sense, other cases reached a different conclusion. See *C.I.R. v. American Metal Co.*, 221 F.2d 134 (1955) (a Mexican Production Tax was not creditable because it applied regardless of whether miners made a profit or sales); *Keasbey*, 133 F.2d 894 (tax imposed under the Quebec Mining Act was not an income tax in the U.S. sense because the levy permitted deductions only for costs incurred in the mining operation, and not for expenses incident to the general conduct of the business); *Bank of America*, 459 F.2d 513 (gross basis tax on income of banks did not qualify as an income tax under section 901). The Treasury Department and the IRS do not agree

that a tax is properly considered a tax on net income so long as empirical evidence demonstrates that the nonrecoverable costs and expenses attributable to the gross receipts or gross income are almost never so high as to eliminate any profit after the tax is paid. It is unlikely, as a practical matter, that the data required to make such an empirical showing of the amounts of disallowed expenses of all taxpayers subject to the tax will be available to either taxpayers or the IRS other than in the context of a targeted tax of narrow application such as the levies considered in *Texasgulf* or *Exxon*. In any event, such a gross basis tax is so dissimilar to the U.S. income tax against which the foreign tax credit is allowed that the Treasury Department and the IRS have determined it should not qualify as an income tax in the U.S. sense. With respect to the comment that asserted that gross basis digital services taxes never result in a loss to affected companies, the fact that the comment failed to provide any evidence may be indicative of the difficulty of making this empirical showing. Furthermore, comments made by the affected industries have made clear that gross basis taxes are inconsistent with the fundamental nature of an income tax, and could in fact result in taxation of companies that are in a loss position.[7] Accordingly, the final regulations largely maintain the approach of the 2020 FTC proposed regulations in eliminating the nonconfiscatory gross basis tax rule.

However, upon consideration of the comments, the Treasury Department and the IRS agree that a gross basis tax may meet the cost recovery requirement if in fact there are no significant costs and expenses attributable to the gross receipts included in the taxable base. Accordingly, the final regulations at §1.901-2(b)(4)(i)(A) remove the rule in the 2020 FTC proposed regulations that provided that a gross basis tax could never meet the cost recovery requirement, even if in practice there are no significant costs and expenses attributable to the gross receipts included in the foreign tax base. Instead, §1.901-2(b)(4)(i)(A) provides that a gross basis tax satisfies the cost recovery requirement if there are no significant costs and expenses attributable to the gross receipts included in the foreign tax base that must be recovered under the rules of §1.901-2(b)(4)(i)(C)(*1*). In addition, the Treasury Department and the IRS recognize that the Code contains various limitations on the recovery of non-business expenses that have been modified from time to time. For example, miscellaneous itemized deductions, including unreimbursed employee expenses, are generally not deductible. Thus, the final regulations provide in §1.901-2(b)(4)(i)(C)(*2*) that a foreign tax law that does not permit recovery of costs and expenses attributable to wages and investment income not derived from a trade or business satisfies the cost recovery requirement. Furthermore, the final regulations clarify in §1.901-2(b)(4)(i)(A) that a foreign tax need not permit recovery of costs and expenses, such as certain personal expenses, that are not attributable, under reasonable principles, to gross receipts included in the foreign taxable base.

ii. Significant costs

Proposed §1.901-2(b)(4)(i)(A) provided that the cost recovery requirement is satisfied if the foreign tax law permits recovery of significant costs and expenses attributable to the gross receipts included in the foreign tax base. The significance of the cost is determined based on whether, for all taxpayers in the aggregate to which the foreign tax applies, the item of cost or expense constitutes a significant portion of the taxpayers' total costs and expenses. See proposed §1.901-2(b)(4)(i)(B)(*2*). In addition, proposed §1.901-2(b)(4)(i)(B)(*2*) specified that certain costs — such as costs or expenses related to capital expenditures, interest, rents, royalties, services, and research and experimentation — are always treated as significant, and thus, must be recoverable.

The 2020 FTC proposed regulations also addressed foreign expense disallowance provisions. Proposed §1.901-2(b)(4)(i)(B)(*2*) provided that a foreign levy that disallows recovery of all or a portion of a significant cost or expense meets the cost recovery requirement if such disallowance is consistent with the types of disallowances reflected in the Code.

Several comments recommended that the Treasury Department and the IRS retain the standard in the existing regulations and withdraw the list of "per se" significant costs and expenses in proposed §1.901-2(b)(4)(i)(B)(*2*). Although some comments acknowledged the rationale for adding the list of expenses that are always treated as significant and thus must be recoverable, they also asserted that this rule would create complexities because it would require continued evaluation and re-evaluation of U.S. and foreign tax rules. One comment noted that there could be changes to either the foreign tax law or the U.S. tax law that could cause a foreign tax to be no longer creditable. It suggested, as an example, that a foreign tax that includes rules identical to current section 163(j), which took effect in 2018, would have likely failed the cost recovery requirement in 2017 but would have met the cost recovery requirement in 2018.

One comment recommended that if the per se list of recoverable expenses is retained, it should apply only to taxpayers that in fact incur a significant amount of such cost or expense, for example, amounts in excess of a certain percentage of the particular taxpayer's gross receipts. The comment recognized that its recommendation conflicts with the rule in the existing and proposed regulations that a foreign tax either satisfies or does not satisfy the definition of a foreign income tax in its entirety, for all persons subject to the foreign tax, but asserted that such a deviation is appropriate because a taxpayer should not be denied a credit for a foreign tax because the foreign law does not permit or limits recovery of an expense if the particular taxpayer does not incur a significant amount of that expense.

One comment questioned why the Treasury Department and the IRS retained

[7] United States Trade Representative, Section 301 Investigation, Report on France's Digital Services Tax at 57-58 (Dec. 2, 2019), available at https://ustr.gov/sites/default/files/Report_On_France%27s_Digital_Services_Tax.pdf (quoting numerous comments from digital companies and industry groups attesting that the digital service taxes' application to revenue rather than income is inconsistent with prevailing principles of international taxation). In particular, a member from National Foreign Trade Council stated that a "tax imposed on gross revenue has no relationship to net income or profits, which are the only proper bases for a corporate income tax." *Id*. at 57. Another industry representative stated that a "tax on ordinary business profits, imposed on gross revenue, has no relationship to net income. . . . Gross revenue has no relationship to net income, and therefore such taxes are not limited to taxing the gains of an enterprise, and will drive companies into deeper losses if they are not profitable. Thus, such a tax is likely to harm growing companies . . . ."). *Id*. at 58.

the empirical analysis in the definition of significance, noting that it is contrary to the stated overall purpose of the proposed modifications of the net gain requirement to minimize reliance on empirical evidence.

Comments also disagreed with the policy of the 2020 FTC proposed regulations of requiring foreign expense disallowance rules to be consistent with U.S. disallowances. Comments noted that foreign countries have different ways of structuring deduction disallowances and different policy goals that they want to achieve through deduction disallowances. One comment pointed to interest deduction disallowance rules as an example, noting that the U.S. rules have a myriad of restrictions on interest deductions, including because in certain circumstances interest payments may reflect a return on capital. The comment stated that if a foreign jurisdiction prohibits deductions for interest payments in some or most circumstances because it views interest as a return on capital, that could cause the foreign tax to be no longer creditable. The comment asserted that a foreign levy should not be non-creditable simply because the foreign jurisdiction has more restrictive limitations on interest deductibility. Comments also pointed to deduction disallowances for related-party interest payments, noting that foreign governments may significantly restrict deductions for interest incurred on related party debt. The comments contended that such limitations would not be unreasonable, but that it is unclear whether a foreign levy with such restrictions would be creditable under the 2020 FTC proposed regulations. One comment further asserted that it is unfair to disallow foreign tax credits when a foreign country adopts disallowance provisions different from U.S. rules, because denial of the credit results in double taxation of U.S. taxpayers that have no control over the foreign country's policy decisions. Another comment stated that the statute does not require strict conformity with U.S. tax principles for a foreign tax to be creditable. Thus, foreign tax law deviations from U.S. tax law should not cause a foreign levy to be non-creditable unless the foreign law expense disallowances are so pervasive as to make the foreign base not related to net income.

Comments also stated that the requirement that foreign cost disallowances must be consistent with the types of disallowances in the Code will lead to additional administrative burdens for the IRS and compliance burdens for taxpayers because the 2020 FTC proposed regulations provide insufficient guidance on the application of the rule. Comments noted it is unclear the degree to which the foreign tax disallowance rule must be similar to U.S. disallowance rules. The comment also asked how temporary changes to the U.S. tax rules that are intended to ameliorate shorter-term economic or policy concerns, such as the changes to section 163(j) under the Coronavirus Aid, Relief, and Economic Security Act, P.L. 116-136, 134 Stat. 281 (2020), are intended to affect the application of the rule. Similarly, another comment noted that foreign countries may have a similar policy goal as the United States but may adopt limitations, for example as part of the BEPS initiative, on a different timeline than the United States.

Other comments noted that it is unclear if foreign expense disallowance provisions that are not similar to disallowances under the Code but that are necessitated by sound tax policy would cause a foreign levy to be non-creditable under the 2020 FTC proposed regulations. For example, one comment asked whether a foreign country that permits full expensing of capital expenditures but disallows any deduction for interest expense (which the comment asserts only avoids economically duplicative deductions in the case of debt-financed investments) would run afoul of the proposed rules because it is not consistent with the disallowances in section 162 of the Code. A comment queried whether disallowance of deductions under an alternative minimum tax regime similar to section 55 or section 59A would be deemed consistent with Federal income tax principles for purposes of the cost recovery requirement. Comments recommended that if the proposed modifications to the cost recovery requirement are finalized, the Treasury Department and the IRS should provide additional examples illustrating the application of the rule, including examples of permissible disallowances as well as examples of disallowances that are not identical to Federal income tax rules but are considered consistent with U.S. tax principles.

After consideration of the comments, the Treasury Department and the IRS have determined that the final regulations should generally maintain the approach of the 2020 FTC proposed regulations, which reflects the appropriate balance between accuracy and administrability in determining whether the foreign tax law permits recovery of the significant costs and expenses attributable to the gross receipts included in the foreign taxable base. The costs and expenses that are deemed significant under the 2020 FTC proposed regulations are those costs and expenses that represent substantial deductions claimed by U.S. taxpayers in computing the base of the U.S. income tax. Therefore, it is reasonable to presume that those enumerated costs also reflect substantial costs and expenses of taxpayers operating abroad. The Treasury Department and the IRS have determined that it would be impossible, as a practical matter, for either taxpayers or the IRS to obtain both the private financial data and tax return data, for all taxpayers subject to a generally-imposed foreign tax, that would be needed to apply the empirical test of the existing regulations to determine whether in fact all such taxpayers in the aggregate incurred substantial costs and expenses for which deductions were not allowed in determining the foreign taxable base. Accordingly, the final regulations at §1.901-2(b)(4)(i)(C)(*1*) retain the requirement that the foreign tax law by its terms must allow recovery of significant costs and expenses, including recovery of costs and expenses related to capital expenditures, interest, rents, royalties, wages or other payments for services, and research and experimentation. In addition, §1.901-2(b)(4)(i)(C)(*1*) clarifies that the foreign tax law applies to determine the character of a particular deduction. For example, if a foreign country denies a deduction for a payment made on an instrument that is treated as equity for foreign tax purposes, the cost recovery requirement is met even if the instrument is treated as debt for U.S. tax purposes. In response to comments, §1.901-2(b)(4)(i)(C)(*1*) also clarifies that foreign tax law that does not permit recovery of a significant cost or expense (such as interest expense) is not considered to allow recovery of

such significant cost or expense by reason of the time value of money attributable to the acceleration of a tax benefit for a different expense (such as current expensing of capital expenditures).

However, the Treasury Department and the IRS agree that the final regulations should clarify the scope of permissible foreign tax law expense disallowance rules. Accordingly, the final regulations include additional rules and examples at §1.901-2(b)(4)(i)(C)(*1*) and §1.901-2(b)(4)(iv), respectively, illustrating that foreign tax law rules need not mirror U.S. expense disallowance rules, but need only be consistent with the principles reflected in U.S. tax law. For example, §1.901-2(b)(4)(i)(C)(*1*) provides that a rule limiting interest deductions to 10 percent of a reasonable measure of taxable income (determined either before or after deductions for depreciation and amortization) based on principles similar to those underlying section 163(j) would qualify.

iii. Alternative allowance rule

Under the "alternative allowance rule" in §1.901-2(b)(4) of the existing regulations, a foreign tax that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is treated as meeting the cost recovery requirement. The 2020 FTC proposed regulations modified the alternative allowance rule to provide that an alternative allowance meets the cost recovery requirement only if the foreign tax law, by its terms, permits recovery of an amount that equals or exceeds the actual amounts of such significant costs and expenses. See proposed §1.901-2(b)(4)(i)(A).

Several comments criticized the modification of the alternative allowance rule and recommended that the Treasury Department and the IRS retain the standard of the existing regulations. One comment asserted that the proposed rules would cause a foreign levy to be non-creditable even if the foreign levy provides an allowance that in fact equals or exceeds the taxpayer's actual expenses; the comment contends that this is arguably inconsistent with the language of the statute. Some comments asserted that foreign levies are unlikely to meet the requirement that the foreign tax law expressly guarantee that the alternative allowance will equal or exceed actual costs because alternative allowances are generally designed to avoid compliance burdens related to the determination of actual costs. Thus, the comments stated, the proposed rules could cause alternative tax regimes that foreign countries impose to be non-creditable, even if those regimes allow equivalent recovery of expenses in most if not all circumstances.

Some comments disagreed with the statement in the preamble of the 2020 FTC proposed regulations that alternative allowances fundamentally diverge from the approach to cost recovery in the Code; the comments pointed out that the Code also has examples of alternative allowances (citing to rules regarding travel expense reimbursement, the return on intangible income for global intangible low tax income ("GILTI") and foreign-derived intangible income ("FDII"), the standard deduction, and certain safe harbor methods for determining home office deductions). Comments further stated that U.S. tax rules have allowed the use of estimates of expenses in certain circumstances through, for example, application of the "*Cohan* rule" (*Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930)), which permits courts to allow a tax benefit, such as a deduction, if a taxpayer proves entitlement to a tax benefit but fails to substantiate the exact amount of the benefit.

Some comments questioned the preamble's assertion that it is difficult in practice for taxpayers and the IRS to determine whether an alternative allowance under foreign tax law effectively compensates for the nonrecovery of significant costs or expenses, noting that the taxpayer was able to do so in *Texasgulf*. One comment asserted that many court decisions show that a foreign levy that provides alternative allowances for deductions can still be an income tax in the U.S. sense. The comment did not cite any court decisions in support of this assertion.

For the reasons explained in part IV.B.1 of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS disagree with comments that the alternative allowance rule of the existing regulations is an appropriate or administrable rule. In addition, the use of percentages of the basis of certain tangible property to compute income for GILTI and FDII purposes is distinguishable from providing an alternative allowance in lieu of actual costs and expenses to compute the taxable base because these allowances are in addition to, and not in substitution for, provisions in the Code that allow deductions for the actual costs and expenses attributable to gross receipts included in the U.S. tax base. Moreover, nothing in the final regulations precludes a foreign tax law from allowing deductions in excess of those needed to recover the actual, significant costs and expenses of earning taxable gross receipts. Finally, the *Cohan* rule is a judicial doctrine that permits approximating actual costs and expenses in limited circumstances where the taxpayer demonstrates that it incurred a business expense but kept inadequate records to substantiate the exact amounts of such expense. Where a taxpayer can substantiate the actual amounts of its business expenses, the Code allows those expenses as deductions. Thus, the *Cohan* rule establishes a substantiation standard, but does not modify the Code rule allowing actual costs and expenses to be recovered. Accordingly, the final regulations retain the rule that a foreign tax law must permit the recovery of significant costs and expenses to be an income tax in the U.S. sense.

However, the Treasury Department and the IRS recognize that some foreign jurisdictions, in order to relieve administrative and compliance burdens on certain small businesses, may provide an alternative method for determining deductible costs attributable to gross receipts, either as an optional alternative method or as the sole method. As the comments noted, the Code contains alternative allowances or safe-harbor rules for determining deductible business expenses in limited circumstances. As a result, the final regulations at §1.901-2(b)(4)(i)(B)(*1*) provide that the cost recovery requirement is satisfied if the foreign tax law allows the taxpayer to choose between deducting actual costs or expenses or an optional allowance in lieu of actual costs and expenses. In addition, the Treasury Department and the IRS have determined that additional flexibility is warranted to accommodate alternative allowances in lieu of actual cost recovery, if the alternative measures are designed to

minimize administrative or compliance burdens with respect to small taxpayers. Accordingly, the final regulations at §1.901-2(b)(4)(i)(B)(*2*) provide an exception for these types of alternative allowances.

C. Tax in lieu of income tax

1. In general

Section 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 the 2020 FTC proposed 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. See proposed §1.903-1(b)(2). A foreign tax (the "tested foreign tax") satisfies the substitution requirement, if based on the foreign tax law, it meets the four requirements in proposed §1.903-1(c)(1): the generally-imposed net income tax requirement, the non-duplication requirement, the close connection requirement, and the jurisdiction-to-tax requirement.

2. Generally-imposed net income tax requirement

To meet the generally-imposed net income tax requirement, a separate levy that is a net income tax (as defined in proposed §1.901-2(a)(3)) must be generally imposed by the same foreign country (the "generally-imposed net income tax") that imposed the tested foreign tax. Comments stated that the 2020 FTC proposed regulations would unduly limit a foreign levy's qualification as a creditable "in lieu of tax" by requiring the generally-imposed net income tax to satisfy proposed §1.901-2, particularly as it has been revised to require more similarity to U.S. tax principles. One comment further explained that a tested foreign tax would not satisfy the generally-imposed net income tax requirement with respect to a foreign jurisdiction that limits the deductibility of interest under rules that are inconsistent with the Code. Because these comments request relaxation of the rules in proposed §1.901-2, as opposed to changes to proposed §1.903-1, the responses to these comments are addressed above at part IV.A of this Summary of Comments and Explanation of Revisions, with respect to the jurisdictional nexus requirement, and at part IV.B, with respect to the net gain requirement.

3. Non-duplication requirement

Under the non-duplication requirement, neither the generally-imposed net income tax nor any other net income tax imposed by the foreign country may be imposed with respect to any portion of the income to which the amounts that form the base of the tested foreign tax relate (the "excluded income"). A tested foreign tax does not meet this requirement if a net income tax imposed by the same country applies to the excluded income of any persons that are subject to the tested foreign tax, even if not all persons subject to the tested foreign tax are subject to the net income tax.

Comments asserted that the non-duplication requirement is inconsistent with the interpretation of the substitution requirement in *Metropolitan Life Ins. Co. v. United States*, 375 F. 2d 835 (Ct. Cl. 1967), which held that the Canadian premiums tax was "in lieu of" the income tax for mutual life insurance companies, which were only subject to the premiums tax, even though other types of insurance businesses were subject to both the Canadian premiums tax and the generally-imposed net income tax. As such, comments recommended that the non-duplication requirement apply on a taxpayer-by-taxpayer basis, and any loss of creditability of taxes paid should be limited to income that is actually subject to both the generally-imposed net income tax and the tested foreign tax.

Under the existing regulations, a foreign levy is either creditable or not creditable for all taxpayers subject to the levy. This "all or nothing rule" applies under existing §1.903-1 to the determination of whether a foreign tax is an in lieu of tax. The 2020 FTC proposed regulations similarly provided as part of the non-duplication requirement that a foreign levy that is imposed in addition to the generally-imposed net income tax with respect to some taxpayers is not a tax that is imposed in substitution for, or in lieu of, a generally-imposed net income tax. The Treasury Department and the IRS have determined that analyzing each tested foreign tax based on how it applies to each taxpayer (instead of analyzing the tax as a whole) would significantly increase compliance and administrative burdens for taxpayers and the IRS. Moreover, allowing a tested foreign tax to qualify as an in lieu of tax for any taxpayer when some taxpayers pay both the tested foreign tax and the generally-imposed income tax on income from the same activity is inconsistent with the notion that the foreign country made a deliberate choice to create and impose a separate levy instead of imposing the generally-imposed net income tax on the excluded income. Accordingly, the final regulations retain the "all or nothing" rule in the non-duplication requirement.

Comments stated that it would be difficult for both the IRS and taxpayers to determine how a tested foreign tax would apply to all taxpayers subject to the levy, given that the tax can be applied on a basis other than income. The 2020 FTC proposed regulations apply based on the terms of the foreign tax law, not how the tax applies in practice. To determine whether a tested foreign tax is creditable, the taxpayer is not required to analyze how the tested foreign tax applies on a taxpayer-by-taxpayer basis in practice, but instead is required only to analyze the foreign tax law. Therefore, the provision is finalized without change.

4. Close connection requirement

The close connection requirement in the 2020 FTC proposed regulations requires that, but for the existence of the tested foreign tax, the generally-imposed net income tax would otherwise have been imposed on the excluded income. The requirement is met only if the imposition of the tested foreign tax bears a close connection to the failure to impose the generally-imposed net income tax on the excluded income. A close connection exists if the generally-imposed net income tax would apply by its terms to the income, but for the fact that the excluded income is expressly excluded. Otherwise, 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. This proof must be based on foreign tax law, or the legislative history of either the tested foreign tax or the generally-imposed net income tax.

One comment suggested that the close connection requirement can be read to be met only if the tested foreign tax applies to activities that were initially subject to the generally-imposed net income tax and then expressly excluded from its scope, and not if the activities subject to the tested foreign tax were never within the scope of the generally-imposed net income tax. The Treasury Department and the IRS did not intend for the regulations to apply in this manner. Therefore, the final regulations at §1.903-1(c)(1)(iii) clarify that a close connection also exists if the generally-imposed net income tax by its terms does not apply to the excluded income, and the tested foreign tax is enacted contemporaneously with the generally-imposed net income tax.

Comments asserted that the close connection requirement goes beyond the language of section 903, which comments maintained requires only that the tested foreign tax be imposed in place of the generally-imposed net income tax; not that the generally-imposed net income tax would otherwise apply to the taxpayer. Comments also asserted that the close connection requirement should be removed because the non-duplication requirement is sufficient for ensuring that the tested foreign tax does not duplicate the tax base of the generally-imposed net income tax. Some comments also stated that the requirement that the taxpayer provide proof that the generally-imposed net income tax "would be imposed" absent the tested foreign tax contradicts the court's finding in *Metropolitan Life*.

The Treasury Department and the IRS have determined that the close connection requirement is consistent with a reasonable construction of the term "in lieu of" in section 903. According to Black's Law Dictionary, "in lieu of" means "to be instead of" which implies a connection between the imposition of the tested foreign tax and the absence of a generally-imposed net income tax. Otherwise, the statute would have provided that a credit would be allowed for any tax paid by persons not subject to a generally-imposed net income tax. The mere fact that two taxes may be mutually exclusive with respect to some subset of taxpayers does not demonstrate that one is "in lieu" of the other.

Furthermore, the requirement that taxpayers demonstrate a close connection is consistent with the text of section 903 as well as court decisions interpreting section 903. The Treasury Department and the IRS disagree that the close connection requirement contradicts the court's finding in *Metropolitan Life*. Rather, the "close connection" requirement is taken directly from *Metropolitan Life*, 375 F.2d at 839-40 ("We have found 'a very close connection between the imposition of the Canadian premiums taxes involved here and the failure to impose 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."). Therefore, the comments are not adopted.

Other comments stated that the close connection requirement would result in significant administrative burdens and uncertainties because jurisdictions with less sophisticated legislative processes and tax regimes may lack specific statutory language or legislative histories to determine whether there was a close connection between the tested foreign tax and the generally-imposed net income tax.

In response to the comments, the final regulations at §1.903-1(c)(1)(iii) clarify that a close connection also exists if the generally-imposed net income tax by its terms does not apply to the excluded income, and the tested foreign tax is enacted contemporaneously with the generally-imposed net income tax. Therefore, legislative history is not always required to establish that the tested foreign tax satisfies the close connection requirement.

5. Jurisdiction-to-tax requirement

The jurisdiction-to-tax requirement provides that if the generally-imposed net income tax were applied to the excluded income, the generally-imposed net income tax would either continue to qualify as a net income tax under proposed §1.901-2(a)(3), or would constitute a separate levy from the generally-imposed net income tax that would itself be a net income tax under proposed §1.901-2(a)(3). One comment noted that the reference to proposed § 1.901-2(a)(3) incorporates both the jurisdictional nexus requirement and the net gain requirement. The comment questioned how a taxpayer can determine whether a hypothetical generally-imposed net income tax would reach net gain.

In response to the comment, the final regulations clarify 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 must meet the attribution requirement in §1.901-2(b)(5) but does not need to meet the other net gain requirements contained in §1.901-2(b).

D. Separate levy determination

The 2020 FTC proposed regulations retained the general rule of the existing regulations, which provides that whether a foreign levy is an income tax for purposes of sections 901 and 903 is determined independently for each separate foreign levy, but modified the rules to clarify the principles used to determine whether one foreign levy is separate from another foreign levy. See proposed §1.901-2(d)(1). Proposed §1.901-2(d)(1)(ii) provided that separate levies are imposed on particular classes of taxpayers if the taxable base is different for those taxpayers.

One comment requested clarification of the treatment of a foreign tax imposed on a distribution that is, in part, a dividend and, in part, gives rise to capital gain. The comment noted that §1.861-20(g)(5) includes an example that treats the tax imposed on the dividend amount as a separate levy from the tax imposed on the capital gain amount of the distribution, but it is unclear whether the separate levy determination results from the fact that two different tax rates apply to the same distribution, or because the taxes apply to two different types of income. The comment recommended that the final rules clarify the analysis for identifying separate levies in the case of different taxable bases, or to elaborate on the policy considerations underlying the separate levy rules.

One comment recommended that the Treasury Department and the IRS further consider the application of the separate levy rules to minimum tax regimes to ensure they do not prevent creditability of amounts that would otherwise be treated as foreign income taxes. The comment noted that if a regime imposes an incremental alternative minimum tax that would not be creditable under section 901 or section 903, creditability of the net income tax could depend on whether the two amounts are considered separate levies.

Another comment stated that because the 2020 FTC proposed regulations require separate determinations of creditability for each class of taxpayers for which the application of the foreign levy results in a significantly different tax base (rather than determining whether a foreign levy applies to net income in the normal instance), the application of the separate levy rules and the net gain requirements is complex. It stated that the determination of a separate levy is both fact intensive and nuanced because all deviations from the "pure" income tax system of the Code will have to be identified and some deviations will create a separate class of taxpayers (and therefore a separate levy) while other deviations would simply have to be weighed for significance.

The Treasury Department and the IRS have determined that additional clarification of the separate levy rules is not needed in connection with the example in §1.861-20(g)(5), because the rules for allocating and apportioning the foreign income tax on the facts of the example would be the same whether the tax on the foreign law dividend and capital gain amounts was imposed pursuant to a single levy or separate levies. However, in response to comments, the final regulations at §1.901-2(d)(3) provide additional examples to illustrate the application of the separate levy rules to minimum tax regimes and other foreign tax regimes involving separate levies that include some common elements. In particular, §1.901-2(d)(3)(ix) (Example 9) illustrates that a foreign tax containing a limitation on interest deductions that applies only to one class of taxpayers subject to the tax does not cause the tax to be treated as a separate levy as to that class of taxpayers.

E. Amount of tax that is considered paid

1. Refundable credits

The 2020 FTC proposed regulations modified §1.901-2(e)(2)(ii) of the existing regulations to provide explicit rules regarding the effect of foreign law tax credits in determining the amount of tax a taxpayer is considered to pay or accrue. Proposed §1.901-2(e)(2)(ii) provided that a tax credit allowed under foreign law is considered to reduce the amount of foreign income tax paid, regardless of whether the amount of the tax credit is refundable in cash to the extent it exceeds the taxpayer's liability for foreign income tax. Proposed §1.901-2(e)(2)(iii) provided an exception to this rule for credits in respect of overpayments of a different tax liability that are refundable in cash at the taxpayer's option and applied to satisfy the taxpayer's foreign income tax liability.

While one comment agreed with the rule in proposed §1.901-2(e)(2), other comments disagreed with the proposed rule, including the example illustrating these rules in proposed §1.901-2(e)(4)(ii)(A), asserting that refundable tax credits should be treated as government grants administered through the foreign country's tax system. Under that view, refundable tax credits should be treated as a constructive payment of cash to the taxpayer that the taxpayer uses to constructively pay the amount of foreign income tax liability that is offset or satisfied by application of the tax credit. These comments argue that refundable tax credits provide an economic benefit that is not tied to taxable income or tax liability, which is similar to a government grant and unlike non-refundable tax credits or subsidies described in section 901(i). They further argue that accounting standards under IFRS and GAAP, as well as OECD commentary, treat refundable tax credits as a government expenditure, and that the IRS has issued guidance in the past that suggests that refundable tax credits may be deemed to satisfy, rather than reduce, a foreign tax liability (TAM 200146001; Rev. Rul. 86-134, 1986-2 C.B. 104).

Comments also stated that the IRS's administrative concerns about the difficulty of distinguishing between refundable and non-refundable tax credits could be addressed through additional guidance, through data collection, or by requiring that any excess of a tax credit over a taxpayer's cumulative foreign income tax liability cannot be indefinitely carried forward but must be paid to the taxpayer in cash after a certain period. Comments argued that the proposed treatment of refundable tax credits would increase taxpayers' worldwide tax costs by reducing effective foreign tax rates of taxpayers' controlled foreign corporations and thereby subjecting more taxpayers to residual U.S. tax on GILTI inclusions. Finally, one comment requested guidance on the treatment of transferable tax credits, which are tax credits that are acquired by a taxpayer from another taxpayer and used to satisfy the acquiring taxpayer's tax liability. The comment suggested that transferable tax credits should be treated similarly to refundable tax credits.

The Treasury Department and the IRS generally disagree that refundable tax credits are appropriately treated as offsetting constructive payments of cash to the taxpayer followed by a constructive payment of an (unreduced) foreign income tax liability. Refundable tax credits that are payable in cash only to the extent they exceed a taxpayer's foreign income tax liability, either in the current year or over a period of years, are not similar to unrestricted cash grants. Tax revenue foregone by a foreign taxing jurisdiction by means of such a tax credit reflects a policy choice to forego revenue, and that may be viewed as a tax expenditure, but a tax expenditure is distinct from a cash outlay. Revenue foregone by granting a tax credit that the taxpayer does not have the option to receive in cash reduces its tax liability in exactly the same manner whether the credit is fully nonrefundable or potentially refundable only to the extent the credit exceeds the taxpayer's tax liability. In both cases, the taxpayer does not have the option to receive the applied amount of the credit in cash. No comments suggested that a nonrefundable credit should be treated as constructively received in cash by the taxpayer and used to pay an unreduced tax liability. The Treasury Department and the IRS have determined that it is inappropriate to treat the nonrefundable portion of a refundable credit differently from a fully nonrefundable credit.

In addition, a rule that required the IRS to obtain empirical data on the refundability in practice of nominally refundable tax credits would be too difficult for taxpayers and the IRS to apply. Because the foreign law rules governing such credits often limit the refundable portion to the amount by which the credit exceeds the taxpayer's tax liability over a period of years, taxpayers would have to make speculative determinations, or post-hoc adjustments based on whether the excess portion of credits granted in one year actually became refundable in later years, in order to determine whether the application of the credit could be treated as a payment (rather than a reduction) of foreign tax.

The Treasury Department and the IRS generally agree with the comment that transferable tax credits granted by a foreign country, which presumably are never fully refundable in cash at the taxpayer's option since that option would eliminate the benefit taxpayers derive from selling tax credits to other taxpayers, should be analyzed under the same rules as other foreign law tax credits. The application of a purchased tax credit to satisfy a foreign tax liability, similar to other tax credits that are not fully refundable in cash at the taxpayer's option, represents foregone revenue that is not received or retained by the foreign country. In order to constitute an amount of foreign income tax paid for purposes of section 901, an amount must be both owed and remitted to the foreign country, and not used to provide a benefit to the taxpayer, to a related person, to any party to the transaction, or to any party to a related transaction. See section 901(i) and §1.901-2(e)(3). Accordingly, §1.901-2(e)(2)(ii) of the final regulations confirms that applying a foreign law tax credit, including credits that are refundable in cash only to the extent they exceed tax liability and credits that are transferred from another taxpayer, to reduce a foreign income tax liability is not considered a payment of foreign tax that is eligible for a credit.

These regulations do not address whether the use of a transferred tax credit to satisfy a foreign (or other) income tax liability may constitute the payment of a liability for purposes of other provisions of the Code, such as section 164. However, section 275 generally disallows a deduction for foreign income taxes paid or accrued in a taxable year for which the taxpayer claims to any extent the benefit of the foreign tax credit.

However, the Treasury Department and the IRS agree that refundable tax credits may appropriately be treated as a means of paying, rather than reducing, a foreign income tax liability if the taxpayer has the option to receive in cash the full amount of the tax credit, rather than just the portion that exceeds the taxpayer's foreign income tax liability. Accordingly, the final regulations expand the tax overpayment exception in proposed §1.901-2(e)(2)(iii) to apply to any tax credit that is fully refundable in cash at the taxpayer's option. The final regulations also clarify that a tax credit will not be considered not fully refundable solely by reason of the fact that the amount of the tax credit could be subject to seizure or garnishment to satisfy a different, pre-existing debt of the taxpayer to the government or a third party.

2. Noncompulsory payments

The 2020 FTC proposed regulations clarified that the references to a "foreign tax" in §1.901-2(e)(5)(i) of the existing final regulations, defining the amount of tax paid for purposes of sections 901 and 903, are only to creditable foreign income taxes (and in lieu of taxes). As under the existing final regulations, the 2020 FTC proposed regulations provided that an amount remitted is not a compulsory payment, and so is not an amount of foreign income tax paid, to the extent the taxpayer failed to minimize the amount of foreign income tax due over time. Comments disagreed with the clarification, arguing that when taxpayers settle tax controversies with foreign tax authorities, a credit should be allowed for foreign income taxes that were paid in exchange for a greater reduction in foreign non-income taxes. A comment argued that foreign non-income taxes should be treated like litigation costs or any other costs of pursuing a remedy in determining whether a taxpayer has acted reasonably to minimize its foreign income tax liability.

The final regulations retain the clarification that §1.901-2(e)(5) requires taxpayers to take reasonable steps to minimize their liability for foreign income taxes, including by exhausting remedies that an economically rational taxpayer would pursue whether or not the amount at issue was eligible for the foreign tax credit. However, the Treasury Department and the IRS agree that this requirement is met if the reasonably expected, arm's length costs of reducing foreign income tax liability would exceed the amount of the potential reduction, and that reasonably expected costs may include the cost of a reasonably anticipated offsetting foreign non-income tax liability. In addition, the Treasury Department and the IRS have determined that this reasonable cost analysis should apply not only in the exhaustion of remedies context, but also in evaluating whether a taxpayer has appropriately applied foreign tax law to minimize its foreign income tax liabilities even in the absence of a foreign tax controversy. The final regulations are modified to reflect these changes. In addition, an example is added to the final regulations at §1.901-2(e)(5)(vi)(G) (*Example 7*) to illustrate that where a taxpayer has a choice to claim or forgo 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 requirement.

The 2020 FTC proposed regulations added provisions clarifying the scope of a taxpayer's obligation under the noncompulsory payment rules to take advantage of foreign law options and elections that may minimize the taxpayer's foreign income tax liability. The final regulations clarify that a taxpayer must take advantage of foreign law options and elections that relate to the computation of tax liability as applied to the facts that affect the taxpayer's liability, but do not require taxpayers to modify any other conduct that may have tax consequences, including, for example, choices relating to business form or the maintenance of books and records on which income is reported, or the terms of contracts or other business arrangements.

The 2020 FTC proposed regulations also exempted foreign law options or elections relating to loss sharing and entity classification from the noncompulsory payment rules. One comment suggested that the final regulations should also include an exception for options and

elections that have the effect of increasing the tax liability of the taxpayer while also reducing the tax liability of a related person by a greater amount and provided an example related to foreign law anti-hybrid regimes. The Treasury Department and the IRS have determined that applying the noncompulsory payment rule on a group-wide basis would be too difficult for taxpayers to comply with and for the IRS to administer, due to the difficulty of defining the related group in a way that properly accounts for differences in U.S. and foreign tax law and prevents abuse. However, the final regulations at §1.901-2(e)(5)(iv) include an additional limited exception for certain transactions that increase one person's foreign income tax liability but result in a reduction in another person's foreign income tax liability through the application of foreign law hybrid mismatch rules, provided that such reduction in the second person's liability is greater than the increase in the first person's liability.

F. Applicability date

1. In general

Proposed §1.901-2(h) provided that the revised rules in proposed §1.901-2 apply to foreign taxes paid or accrued in taxable years beginning on or after the date that the final regulations adopting the rules are filed with the Federal Register. Proposed §1.903-1(e) similarly provided that proposed §1.903-1 applies to foreign taxes paid or accrued in taxable years beginning on or after the date that the final regulations are filed with the Federal Register.

One comment asked that the final regulations include a delayed applicability date. The comment stated that, given the potentially significant impact of the jurisdictional nexus requirement discussed in part IV.A of this Summary of Comments and Explanation of Revisions on the creditability of foreign levies and uncertainty regarding whether the proposed amendments to the section 901 and 903 regulations would be finalized, it is unreasonable to expect that taxpayers would modify their business operations before the regulations are finalized. The comment recommended that the final regulations should delay the applicability date to allow taxpayers ample time to assess the impact of the regulations on their business and to adjust their operations accordingly. Another comment recommended that the Treasury Department and the IRS defer finalizing the regulations and provide an additional extended comment period.

The Treasury Department and the IRS have determined that it is not appropriate to delay the applicability date of §§ 1.901-2 and 1.903-1 beyond the date indicated in the 2020 FTC proposed regulations. The Treasury Department and the IRS recognized the potentially significant impact of the jurisdictional nexus requirement, and thus, provided a fully prospective applicability date in the 2020 FTC proposed regulations. The 2020 FTC proposed regulations provided ample notice to taxpayers that extraterritorial taxes that are not an income tax in the U.S. sense would not be creditable, and these final regulations largely adopt §1.901-2 and §1.903-1 as proposed. The Treasury Department and the IRS disagree with the comment's assertion that applicability dates of significant final regulations should be deferred to allow time for taxpayers to modify their business operations to take into account the new rules. The Treasury Department and the IRS have also determined that sufficient time has been afforded for stakeholders to provide comments. Ten comments were received in relation to the jurisdictional nexus requirement, all of which were carefully considered in finalizing the regulations. In addition, the Treasury Department and the IRS have determined that it is essential to finalize these regulations and to retain the applicability date announced in the 2020 FTC proposed regulations to avoid the detrimental impact to the U.S. fisc if, due to ambiguities under existing regulations, novel extraterritorial taxes are inappropriately allowed as a foreign tax credit against U.S. tax.

Comments asked for confirmation that foreign taxes paid or accrued in a taxable year before the regulations are finalized but that are carried forward and claimed as a credit (and thus "deemed" paid or accrued under section 904(c)) in a taxable year after the final regulations become applicable will not be subject to the final regulations.

For the avoidance of doubt, the final regulations clarify that the term "paid," which for purposes of §§1.901-2 and 1.903-1 means "paid" or "accrued" depending on whether the taxpayer is claiming a foreign tax credit on the cash or accrual basis, does not refer to foreign taxes that are carried over and "deemed" paid or accrued under section 904(c) or to taxes paid by CFCs that are "deemed paid" by a U.S. shareholder under section 960. See §1.901-2(g)(5). The applicability date provisions in §§1.901-2(h) and 1.903-1(e) have been conformed to cross-reference the revised definition of "paid" in §1.901-2(g)(5). Because the Treasury Department and the IRS view the revised definition to be a clarification, not a change, to existing law, no inference is intended with respect to the proper interpretation of the applicability date of existing foreign tax credit regulations that are not modified by these final regulations.

2. Deferred application to certain Puerto Rican taxes

Notice 2011-29, 2011-16 IRB 663, announced that the IRS and the Treasury Department were evaluating the novel issues raised by legislation enacted by Puerto Rico on October 25, 2010. The legislation added new rules ("Expanded ECI Rules") to section 1123 of the Puerto Rico Internal Revenue Code of 1994 ("1994 PR IRC") that characterize certain income of nonresident corporations, partnerships, and individuals as effectively connected with the conduct of a trade or business in Puerto Rico. The legislation also added section 2101 to the 1994 PR IRC, which imposes an excise tax ("Puerto Rico Excise Tax") on a controlled group member's acquisition from another group member of certain personal property manufactured or produced in Puerto Rico and certain services performed in Puerto Rico.[8] Pending the resolution of the novel issues involved in the determination of the creditability of

[8] The provisions implementing the Expanded ECI Rules and the Puerto Rico Excise Tax were incorporated into sections 1035.05 and 3070.01, respectively, of the Puerto Rico Internal Revenue Code of 2011 (13 L.P.R.A §§ 30155, 31771).

the Puerto Rico Excise Tax, Notice 2011-29 announced that the IRS will not challenge a taxpayer's position that the Puerto Rico Excise Tax is a tax in lieu of an income tax under section 903, and that any change in the foreign tax credit treatment of the Puerto Rico Excise Tax would be prospective.

Notwithstanding the general applicability of §§1.901-2 and 1.903-1 to foreign taxes paid or accrued in taxable years beginning on or after the date these final regulations are filed with the Federal Register, the final regulations provide that §1.901-2 will apply to Puerto Rico income tax paid by reason of the Expanded ECI Rules, and §1.903-1 will apply to Puerto Rico Excise Tax, paid or accrued in taxable years beginning on or after January 1, 2023. The Treasury Department and the IRS have determined that a delayed applicability date is necessary and appropriate in light of the status of Puerto Rico as a territory of the United States, the special treatment of the Puerto Rico Excise Tax under Notice 2011-29 that has been in place since 2011, and with respect to the Expanded ECI Rules, the interconnectedness between such rules and the Puerto Rico Excise Tax under Puerto Rico's statutory scheme. Notice 2011-29 will continue to apply until the final regulations are applicable with respect to the Puerto Rico Excise Tax.

V. *Definition of Foreign Branch Category Income in Connection with Intercompany Payments*

Proposed §1.904-4(f)(4)(xv) (*Example 15*) illustrated the application of the matching rule in §1.1502-13 to a regarded intercompany payment between one affiliated group member and a foreign branch of a different member. One comment noted that the example does not illustrate how §1.1502-13(b)(2) would apply to limit the amount of an intercompany item taken into account under §1.1502-13(c). The comment also suggested that additional examples would help clarify how intercompany payments for R&D services required to be taken into account under §1.1502-13, or disregarded payments for such services, are accounted for in determining the amount and source of foreign branch category income.

The 2020 FTC proposed regulations did not modify the application of §1.1502-13(b) in the foreign branch category context, and additional examples illustrating the application of the intercompany transaction regulations, the R&E expense allocation rules, and the foreign branch category are beyond the scope of the issues considered in the 2020 FTC proposed regulations. Accordingly, the foreign branch examples are finalized without substantive change. However, the Treasury Department and the IRS may address these issues in a future guidance project.

VI. *Sections 901(a) and 905(a) — Rules Regarding When the Foreign Tax Credit Can Be Claimed*

A. Timing of foreign tax accruals

The 2020 FTC proposed regulations provided rules regarding when a taxpayer can claim a credit for foreign income taxes paid or accrued, depending on the taxpayer's method of accounting. For taxpayers that use the accrual method of accounting or that have made an election under section 905(a) to claim foreign tax credits on the accrual basis, proposed §1.905-1(d)(1)(i) provided that foreign income taxes accrue and can be claimed as a credit in the taxable year in which all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy (that is, in the taxable year when the all events test under §1.446-1(c)(1)(ii)(A) has been met). Proposed §1.905-1(d)(1)(i) further provided that in the case of a foreign income tax that is computed based on items of income, deduction, and loss that arise in a foreign taxable year ("foreign net income tax"), the tax accrues at the close of the foreign taxable year and can be claimed as a credit in the U.S. taxable year with or within which the taxpayer's foreign taxable year ends. Foreign withholding taxes that represent advance payments of a foreign net income tax liability determined on the basis of a foreign taxable year accrue at the close of the foreign taxable year. See proposed §1.905-1(d)(1)(i). In contrast, foreign withholding taxes that are 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. *Id*.

One comment argued that the rule in proposed §1.905-1(d)(1)(i) providing that foreign net income tax accrues at the close of the foreign taxable year is an incorrect application of the all events test in section 461. The comment acknowledged that the proposed rule incorporated the long-standing position of the Treasury Department and the IRS reflected in Revenue Ruling 61-93, 1961-1 C.B. 390, but argued that that ruling reached the wrong conclusion because it asserted that the liability accrues when all events have occurred to establish the fact of the liability and the amount of the liability, whereas section 461(h) only requires that the amount of the liability can be determined with reasonable accuracy. The comment argued that in cases where the foreign and U.S. taxable years do not coincide, the fact of the liability for foreign taxes on income earned during the U.S. taxable year is established, and, in normal circumstances, the amount of the liability should be determinable with reasonable accuracy at the end of the U.S. taxable year, because both the amount of income and applicable foreign tax rate will be known. The comment further noted that in the case of taxpayers employed in a foreign country, the employer will also withhold and remit foreign tax on the taxpayer's salary to the foreign country throughout the year. The comment further argued that the proposed rule would result in instances where the taxpayer has to pay U.S. tax on foreign source income in a U.S. taxable year earlier than the year in which the foreign taxable year ends and the credit for foreign tax on the income may be claimed, creating a mismatch that may not be addressed by section 904(c) carryback rules.

The Treasury Department and the IRS disagree with the comment's contention that proposed §1.905-1(d)(1)(i) is inconsistent with the all events test in section 461 and that the all events test can be satisfied, in the case of a foreign net income tax, before the close of the foreign taxable year. First, the comment's contention that Revenue Ruling 61-93 reached the wrong conclusion because it misapplied the all events test is incorrect. The revenue ruling was issued before Congress codified in section 461(h)(4) the all events test

that had developed through case law. The ruling's statement of the all events test is consistent with the Supreme Court's description of the standard in *Dixie Pine Products Co. v. Comm'r*, 320 U.S. 516, 519 (1944) ("all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid.").

Second, the comment's argument regarding whether the all events test requires the amount of the liability to be fixed or only to be determinable with reasonable accuracy is misplaced, because in the case of a foreign net income tax, neither the fact of the liability nor the amount due can be determined with reasonable accuracy until the accounting period closes and the amount of the taxpayer's taxable income for that period can be computed. An estimate does not meet the standard required by the all events test to accrue a foreign tax expense; all events through the close of the taxable year must have occurred before the fact and amount of the liability can be determined with reasonable accuracy. See Rev. Rul. 72-490, 1972-2 C.B. 100. Before the accounting period closes, any number of events, such as a large loss incurred late in the foreign taxable year, could occur that could affect the taxpayer's taxable income and resulting foreign income tax liability for that period. Although withholding taxes or estimated payments made to satisfy a projected net income tax liability are readily determinable by a taxpayer, the basis for the calculation of the final foreign income tax liability is not knowable until the foreign taxable year ends. For these reasons, the final regulations do not adopt the comment and confirm 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.

B. Cash to accrual basis election

Proposed §1.905-1(e) provided rules related to the election in section 905(a) for a cash method taxpayer to claim foreign tax credits on the accrual basis. Proposed §1.905-1(e)(1) provided that, in general, the election must be made on a timely-filed original return by checking the appropriate box on Form 1116 (Foreign Tax Credit (Individual, Estate, or Trust)) or Form 1118 (Foreign Tax Credit—Corporations) indicating the cash method taxpayer's choice to claim the foreign tax credit in the year the foreign income taxes accrue. However, the 2020 FTC proposed regulations also provided an exception in proposed §1.905-1(e)(2), which permitted a taxpayer who has never previously claimed a foreign tax credit to elect to claim the foreign tax credit on an accrual basis, even if such initial claim for credit is made on an amended return.

One comment asserted that an election to change from the cash to the accrual method under section 905(a) should be allowed to be made on an amended return. In support of that assertion, the comment argued that the purpose of the election is to allow better matching between the credit for the foreign tax and the U.S. tax on the foreign income. The comment further argued that cases such as *Dougherty v. CIR*, 60 T.C. 917 (1973), support the principle that elections should be allowed to be made on an amended return when circumstances that are not known at the time of the filing of the initial return are material to the decision for making the election. The comment further argued that the case discussed in the preamble of the 2020 FTC proposed regulations in support of the rule not allowing an election change to be made on an amended return, *Strong v. Willcuts*, 17 AFTR 1027 (D. Minn. 1935), did not hold that the election cannot be made on an amended return, and that the court's discussion of the issue was dictum and does not represent legal authority.

The Treasury Department and the IRS disagree with this comment. First, section 905(a) requires that if a cash basis taxpayer elects to claim foreign tax credits on the accrual basis, "the credits for all subsequent years shall be taken on the same basis." This statutory language plainly allows only a one-time change from the cash to the accrual method for determining the year in which the credit is taken and precludes a taxpayer from ever again changing that choice. If the one-time choice to switch from the cash to the accrual method were permitted to be made retroactively on an amended return, then the taxpayer would have to file amended returns for intervening years in which credits had been originally claimed on the cash basis to comply with the statutory mandate and prevent duplicative credits for foreign taxes that accrued in one year and were paid (and claimed as credits on the cash basis) in a different year. Because the applicable statutes of limitation for assessments and refunds relating to foreign tax credits may expire at different times, in the absence of a foreign tax redetermination any retroactive revisions to the year in which foreign tax credits are properly claimed could result in time-barred U.S. tax deficiencies. The Treasury Department and the IRS have determined that the compliance burdens and administrative complexity that would follow from deviating from the rule requiring the election to be made prospectively outweigh the benefits for taxpayers of any flexibility that would follow from allowing the accrual basis election to be made on an amended return for a year in which the taxpayer originally claimed foreign tax credits on the cash basis.

In addition, although the legislative history indicates that Congress, in enacting the predecessor to the section 905(a) election, was concerned with better matching of U.S. and foreign taxes on the same income, that does not mean that Congress intended taxpayers to be able to make the election on an amended return. See S. Rep. No. 68-398 (1924); H.R. Rep. No. 68-179 (1924). Cases from the 1940s examined whether section 131(a), which between 1932 and 1942 provided that the election to claim a foreign tax credit was made "[i]f the taxpayer signifies in his return his desire to have the benefits of this section," allowed taxpayers to change their choice from deducting to crediting foreign taxes after they filed their original return. In one such case, the Second Circuit noted that:

> Section 131(a) was intended, we think, to prevent a taxpayer, fully cognizant of the facts when making its return, from subsequently changing its position, but not to hold a taxpayer to a choice made when unaware that its choice had practical consequences. *That such was the legislative purpose is emphasized by Sec. 131(d) which does preclude a shift of position by a taxpayer, knowingly electing to claim a credit, as to a cash or accrual basis.*

W.K. Buckley, Inc., v. Comm'r, 158 F.2d 158, 162 (2d Cir. 1946) (emphasis added). Congress amended section 131(a) in the Revenue Act of 1942 to provide that the election to claim a credit can be made or changed before the expiration of the refund period. See Revenue Act of 1942, Pub. L. 77-753, §158, 56 Stat. 798, 857. Notably, Congress has never amended section 905(a) to prescribe a time by which the section 905(a) election must be made.

The Treasury Department and the IRS also disagree with the comment's assertion that *Strong v. Willcuts* does not support the position that the accrual basis election cannot be made on an amended return. In that case, the court denied the taxpayer's claim on two bases. The first was that, in the court's view, the statute contemplates that the election must be made when the return is originally filed and that there is no basis to assume that a taxpayer can shift his position after the filing of his return. *Strong v. Willcuts*, 17 AFTR 1027. The court addressed "another and even more formidable obstacle" to taxpayer's claim, but that did not mean that the first issue was not relevant to the court's decision. *Id*.

In addition, although the *Dougherty* court held that the taxpayer could make a section 962 election on an amended return, it acknowledged that there are limits on when a taxpayer can make a late election. The court reviewed prior case law and concluded that "the critical question involved in determining the timeliness of a delayed election is whether the original action (or the failure to act) on the part of the taxpayer did not amount to an election against, and was not inconsistent with, the position which the taxpayer ultimately did adopt." *Dougherty*, 60 T.C. at 940. In addition, the court noted that it was significant that the granting of a right of late election did not permit the taxpayer, in effect, to play both ends against the middle as the result of hindsight. *Id*. Proposed §1.905-1(e)(2) already provided an exception that, consistent with the above principles, permitted a taxpayer who is claiming a foreign tax credit for the first time to make the election on an amended return, because in that case, the taxpayer has not taken an action (claiming a foreign tax credit on the cash basis) that is inconsistent with the position the taxpayer seeks to adopt by making a section 905(a) election (claiming a foreign tax credit on the accrual basis). For the above reasons, the final regulations do not adopt the comment's recommendation.

C. Provisional credit for contested taxes

1. In general

The 2020 FTC proposed regulations provided that, in general, contested foreign income taxes do not accrue and cannot be claimed as a credit in the relation-back year until the contest is resolved, even if the taxpayer remits the contested taxes to the foreign country in an earlier year. See proposed §1.905-1(d)(3). Proposed §1.905-1(d)(4), however, provided an elective exception for accrual basis taxpayers to claim a provisional credit for the portion of the contested taxes that the taxpayer has paid, even though the contest has not been resolved and the taxes have not yet accrued. As a condition for making this election, a taxpayer must agree to not assert the statute of limitations as a defense to the assessment of additional taxes and interest if, after the contest has been concluded, the IRS determines that the tax was not a compulsory payment. The taxpayer must also agree to comply with annual reporting requirements.

Proposed §1.905-1(d)(4)(i) provided that a taxpayer may make an election to claim a foreign tax credit, but not a deduction, for contested foreign income taxes. One comment asked for clarification on whether this limitation on deducting a contested tax applies to CFC-level deductions, or whether this limitation was intended to apply only to a U.S. taxpayer claiming a deduction, rather than a foreign tax credit, for the contested foreign taxes. The comment recommended that the final regulations address the application of the contested tax liability rules to the deductions of CFC taxpayers and argued that if a provisional credit election is made, the CFC should be allowed a deduction for the relation-back year in advance of the accrual. In response to this comment, the final regulations clarify that the provisional foreign tax credit can only be made for contested foreign income taxes that relate to a taxable year in which the taxpayer has made the election under section 901 to claim a credit (instead of a deduction) for foreign income taxes that accrue in such year. See §1.905-1(d)(4)(i). The final regulations also clarify that if an election is made by the U.S. taxpayer with respect to a contested foreign income tax liability incurred by a CFC, the taxpayer may claim the deemed paid credit in the relation-back year; in addition, the CFC can take the deduction for the contested foreign income tax into account in computing its taxable income in the relation-back year. *Id*.

2. Annual reporting

Proposed §1.905-1(d)(4)(iii) provided annual reporting requirements associated with the election to claim a provisional foreign tax credit for contested foreign income taxes. Proposed §1.905-1(d)(4)(v) provided that a taxpayer that fails to comply with those annual reporting requirements will be treated as receiving a refund of the amount of the contested foreign income tax liability, resulting in a redetermination of the taxpayer's U.S. tax liability pursuant to §1.905-3(b). Comments argued that an annual reporting requirement is unnecessary because taxpayers must waive the assessment statute to make the election and recommended instead that taxpayers should be required to file an amended return notifying the IRS when the contest is resolved. Alternatively, if the final regulations retain an annual reporting requirement, comments recommended that the deemed refund consequence for failure to comply be removed because it is overly harsh.

The Treasury Department and the IRS have determined that annual reporting is necessary and appropriate to ensure that taxpayers and the IRS properly track ongoing contests for which a provisional foreign tax credit has been allowed. However, the Treasury Department and the IRS agree that an inadvertent failure to timely report an ongoing contest or the conclusion of a contest need not result in a deemed refund, because the government's interests are adequately protected by the statute waiver required by the election. The terms of the election guarantee the IRS sufficient time after being notified of the conclusion of the contest to evaluate whether the taxpayer failed to exhaust ef-

fective and practical remedies to minimize its foreign income tax if it fails to secure a refund of the contested tax, and to assess any resulting underpayment of U.S. tax. Accordingly, the final regulations omit the deemed refund rule.

D. Creditable foreign tax expenditures of partnerships and other pass-through entities

1. Foreign tax redeterminations for cash method partners

Proposed §1.905-1(f)(1) provided that a partner that elects to claim a foreign tax credit in a taxable year may claim its distributive share of foreign income taxes that the partnership paid or accrued (as determined under the partnership's method of accounting) during the partnership's taxable year that ends with or within the partner's taxable year. Under this rule, a cash method taxpayer may claim a credit for its distributive share of an accrual method partnership's foreign income taxes even if the partnership has not paid (that is, remitted) the taxes to the foreign country during the partner's taxable year with or within which the partnership's tax expense accrued. However, proposed §1.905-1(f)(1) further provided that 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 only take into account its distributive share of such additional taxes for foreign tax credit purposes in the partner's taxable year with or within which the taxable year of the partnership in which it pays the taxes ends.

One comment recommended that the final regulations extend the application of the principles of the relation-back rule in proposed §1.905-1(d)(1)(ii) to partners of an accrual method partnership by treating a cash method partner's distributive share of additional tax paid by the partnership as a result of a change in the foreign tax liability as paid or accrued by the partner in its taxable year with or within which the partnership's relation-back year ends. The comment stated that this would be more consistent with the principle espoused in proposed §1.905-1(f)(1) that the partnership's method of accounting for foreign income taxes generally controls for purposes of determining the taxable year in which a partner is considered to pay or accrue its distributive share of those taxes.

The Treasury Department and the IRS disagree with the comment's suggestion that proposed §1.905-1(f)(1) should essentially cause a partner's method of accounting to be the same as the partnership's method with regard to any partnership items of foreign income tax. The proposed regulation is consistent with §§1.702-1(a)(6) and 1.703-1(b)(2)(i), which provide that when a partnership takes into account a creditable foreign tax expenditure under its method of accounting, the partner takes its distributive share of the foreign tax into account as if it was properly taken into account under the partner's method of accounting in the partner's year with or within which the partnership's taxable year ends. These rules do not change the partner's method of accounting to conform to the partnership's method of accounting with respect to its distributive share of the partnership's taxes. Thus, for example, in the case of an accrual method partnership and a cash method partner, if the partnership accrues, but has not yet paid, an amount of foreign income tax, the cash method partner takes into account its distributive share of the foreign tax expense as if it had been paid in the partner's taxable year with or within which the partnership's taxable year ends. Similarly, if the partnership later accrues and pays an additional amount of foreign income tax with respect to the same taxable year pursuant to a foreign tax redetermination described in section 905(c)(2)(B), a cash method partner takes its distributive share of the additional amount of foreign tax into account in its taxable year with or within which ends the partnership's taxable year in which the foreign tax redetermination occurs, because the additional foreign tax is considered to be paid by the partner in that year, not in the former taxable year to which additional foreign tax of the accrual-basis partnership relates. Therefore, the final regulations do not adopt the comment's recommendation.

2. Provisional credit for cash method taxpayers

Proposed §1.905-1(f)(2) provided that a partnership takes into account and reports a contested foreign income tax to its partners only when the contest concludes and the finally determined amount of the liability has been paid by the partnership. However, proposed §1.905-1(f)(2) allowed an accrual method partner to elect to claim a provisional foreign tax credit, in the relation-back year, for its share of a contested foreign income tax liability that the partnership has remitted to the foreign country, even though the contested tax has not yet accrued. The procedures for making this election were set forth in proposed §1.905-1(d)(4).

One comment recommended the same election be made available for cash method partners. The Treasury Department and the IRS agree that a cash method partner should be allowed to elect to claim a provisional foreign tax credit for its share of a contested foreign income tax liability that the partnership has paid to the same extent as an accrual basis partner, even though under §1.901-2(e)(2) a contested tax is not a reasonable approximation of the final tax liability to the foreign country and so in the absence of the election is not treated as an amount of tax paid. The final regulations, at §1.905-1(c)(3), extend the election provided for in proposed §1.905-1(d)(4) to allow cash method taxpayers to claim a provisional foreign tax credit for a contested foreign income tax in the year the contested tax is remitted. The election is available for contested foreign income taxes paid directly by the taxpayer or paid by a partnership in which the taxpayer is a partner. The procedure and requirements for making this election are the same as those that apply under proposed §1.905-1(d)(4), which is being finalized with the modifications discussed in part VI.D.1 of this Summary of Comments and Explanation of Revisions.

E. Correction of improper accrual

Proposed §1.905-1(d)(5) provided rules for accrual method taxpayers that are changing from an improper method to a proper method for accruing foreign income taxes. Proposed §1.905-1(d)(5)(ii) provided a modified cutoff approach under which taxpayers were required 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

(and, if applicable, in subsequent years) to prevent duplication or omission of any amount of foreign income tax paid. Specifically, proposed §1.905-1(d)(5)(ii) provided that the amount of foreign income tax in a statutory or residual grouping that properly accrues in the taxable year of change is adjusted either downward, but not below zero, by the amount of foreign income tax in the same grouping that the taxpayer improperly accrued and deducted or credited in a prior taxable year, or conversely, adjusted upward by the amount of foreign income tax that properly accrued but that had not been taken as a deduction or credit by the taxpayer in a taxable year before the year of change.

No comments were received regarding the rules in proposed §1.905-1(d)(5) and they are generally finalized as proposed. However, the Treasury Department and the IRS have determined that there are circumstances in which a taxpayer may have both a downward and an upward adjustment to the properly accrued foreign income taxes in a statutory or residual grouping in the taxable year of change, and that in those circumstances, proposed §1.905-1(d)(5)(ii) was unclear whether the rule provided that the downward adjustment alone could not reduce the properly accrued taxes below zero, or that the downward adjustment, net of the upward adjustment, could not reduce the properly accrued taxes below zero. Section 1.905-1(d)(5)(ii) has been revised to clarify that, under the modified cutoff approach, the amount of properly accrued foreign income tax in each statutory and residual grouping is first adjusted upward and then adjusted downward (but not below zero), and that any downward adjustment in excess of the amount of properly accrued foreign income tax in any grouping, as increased by the upward adjustment, is carried forward and reduces the properly accrued foreign income tax in the grouping in subsequent years.

In addition, the Treasury Department and the IRS determined that proposed §1.905-1(d)(5)(ii) was unclear regarding the treatment of foreign income taxes for which a credit is never allowed under section 901, but for which a deduction under section 164(a)(3) is allowed because section 275 does not apply. See, for example, sections 901(j), (k), (l), and (m). Accordingly, the final regulations clarify that the modified cut-off approach is applied separately with respect to amounts of these foreign income taxes. See §1.905-1(d)(5)(ii).

Special Analyses

I. *Regulatory Planning and Review*

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility.

The final regulations have been designated by the Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these regulations as economically significant under section 1(c) of the MOA. Accordingly, the OMB has reviewed these regulations.

A. *Background and need for the final regulations*

The U.S. foreign tax credit (FTC) regime alleviates potential double taxation by allowing a non-refundable credit for foreign income taxes paid or accrued that could be applied to reduce the U.S. tax on foreign source income. Although the Tax Cuts and Jobs Act (TCJA) eliminated the U.S. tax on some foreign source income by enacting a dividends received deduction, the United States continues to tax other foreign source income, and to provide foreign tax credits against this U.S. tax. The calculation of how foreign taxes can be credited against U.S. tax operates by defining different categories of foreign source income (a "separate category") based on the type of income.[9] Foreign taxes paid or accrued, as well as deductions for expenses borne by U.S. parents and domestic affiliates that support foreign operations, are allocated to the separate categories based on the income to which such taxes or deductions relate. These allocations of deductions reduce foreign source taxable income and therefore reduce the allowable FTCs for the separate category, since FTCs are limited to the U.S. income tax on the foreign source taxable income (that is, foreign source gross income less allocated expenses) in that separate category. Therefore, these expense allocations help to determine how much foreign tax credit is allowable, and the taxpayer can then use allowable foreign tax credits allocated to each separate category against the U.S. tax owed on income in that category.

The Code and existing regulations further provide definitions of the foreign taxes that constitute creditable foreign taxes. Section 901 allows a credit for foreign income taxes, war profits taxes, and excess profits taxes. The existing regulations under section 901 define these "foreign income taxes" such that a foreign levy is an income tax if it is a tax whose predominant character is that of an income tax in the U.S. sense. Under the existing regulations, this requires that the foreign tax is likely to reach net gain in the normal circumstances in which it applies (the "net gain requirement"), and that it is not a so-called soak-up tax.

The "net gain requirement" of the existing regulations is made up of the realization, gross receipts, and net income requirements. Generally, the creditability of the foreign tax under the existing regulations relies on the definition of an income tax under U.S. principles, and on several aggregate empirical tests designed to determine if in practice the tax base upon which the tax is levied is an income tax base. However, compliance and administrative challenges faced by taxpayers and the IRS in implementing the existing definition of an income tax necessitate chang-

[9] Before the TCJA, these categories were primarily the passive income and general income categories. The TCJA added new separate categories for global intangible low-taxed income (the section 951A category) and foreign branch income.

es to the existing structure. These final regulations set forth such changes.

Additionally, as a dollar-for-dollar credit against United States income tax, the foreign tax credit is intended to mitigate double taxation of foreign source income. This fundamental purpose is most appropriately served 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, not only with respect to the definition of the income tax base, but also with respect to the jurisdictional nexus upon which the tax is levied. Further, countries, including the United States, have traditionally adhered to consensus-based norms governing jurisdictional nexus for the imposition of tax. However, the adoption or potential adoption by foreign countries of novel extraterritorial foreign taxes that diverge in significant respects from these norms of taxing jurisdiction now suggests that further guidance is appropriate to ensure that creditable foreign taxes in fact have a predominant character of "an income tax in the U.S. sense."

Finally, these regulations are necessary in order to respond to outstanding comments raised with respect to other regulations and in order to address a variety of issues arising from the interaction of provisions in other regulations.

The Treasury Department and the IRS in 2019 issued final regulations (84 FR 69022) (2019 FTC final regulations) and proposed regulations (84 FR 69124) (2019 FTC proposed regulations), which were finalized in 2020 (85 FR 71998) (2020 FTC final regulations). The Treasury Department and the IRS received comments with respect to the 2019 FTC proposed regulations, some of which were addressed in proposed regulations (85 FR 72078) published in 2020 (2020 FTC proposed regulations) instead of in the 2020 FTC final regulations in order to allow further opportunity for notice and comment. The 2020 FTC proposed regulations, which also addressed additional issues, are finalized in these final regulations.

The following analysis provides an overview of the regulations, discussion of the costs and benefits of these regulations as compared with the baseline, and a discussion of alternative policy choices that were considered.

B. *Overview of the structure of and need for final regulations*

These final regulations address a variety of outstanding issues, most importantly with respect to the existing definition of a foreign income tax. Section 901 allows a credit for foreign income taxes, and the existing regulations define the conditions under which foreign taxes will be considered foreign income taxes. These final regulations revise aspects of this definition in light of challenges that taxpayers and the IRS have faced in applying the rules of the existing regulations. In particular, the requirements in the existing regulations presuppose conclusions based on country-level or other aggregated data that can be difficult for taxpayers and the IRS to obtain and analyze for purposes of determining whether the foreign tax is imposed on net gain, causing both administrative and compliance burdens and difficulties resolving disputes. Therefore, the final regulations revise the net gain requirements such that, in cases where data-driven conclusions have been difficult to establish historically, the requirements rely less on data of the effects of the foreign tax, and instead rely more on the terms of the foreign tax law (See Part I.C.3.i. of this Special Analyses for alternatives considered and affected taxpayers). For example, a foreign tax, to be creditable, must generally be levied on realized gross receipts (and certain deemed gross receipts) net of deductions for expenses. Under these final regulations, the use of data to demonstrate that an alternative base upon which the tax is levied is in practice a gross receipts equivalent cannot be used to satisfy the gross receipts portion of the net gain requirement.

In addition to these changes, the final regulations adopt the jurisdictional nexus requirement introduced by the 2020 FTC proposed regulations (renamed the "attribution requirement" in the final regulations) for purposes of determining whether a foreign tax is an income tax in the U.S. sense. Under this requirement, the foreign tax law must require a sufficient nexus between the foreign country and the taxpayer's activities or investment of capital or other assets that give rise to the income being taxed. Therefore, a tax imposed by a foreign country on income that lacks sufficient nexus to activity in that foreign country (such as operations, employees, factors of production) is not creditable. This limitation is designed to ensure that the foreign tax is an income tax in the U.S. sense by requiring that there is an appropriate nexus between the taxable amount and the foreign taxing jurisdiction (see Part I.C.3.ii of this Special Analyses for discussion of alternatives considered and taxpayers affected). Together, the clarifications and changes to the net gain requirement and the attribution requirement will tighten the rules governing the creditability of foreign taxes and will likely restrict creditability of foreign taxes to some extent relative to the existing regulations.

Finally, these final regulations address other issues raised in comments to the 2019 FTC proposed regulations or resulting from other legislation. For example, comments on the 2019 FTC proposed regulations asked for clarification of uncertainty regarding the appropriate level of aggregation (affiliated group versus subgroup) at which expenses of life insurance companies should be allocated to foreign source income, and comments asked for clarification on when contested taxes (that is, taxes owed to a foreign government which a taxpayer disputes) accrue for purposes of the foreign tax credit. With respect to the life insurance issue, the 2019 FTC proposed regulations specified an allocation method, but requested comments regarding whether another method might be superior. Subsequent comments supported both methods for different reasons, and the Treasury Department and the IRS found both methods to have merit. Therefore, the 2020 FTC proposed regulations and the final regulations allow taxpayers to choose the most appropriate method for their circumstances. (See Part I.C.3.iii of this Special Analyses for alternatives considered and affected taxpayers).

With respect to the contested tax issue, the final regulations establish that contested taxes do not accrue (and therefore cannot be claimed as a credit) until the contest is resolved. However, the final regulations will allow taxpayers to claim a provisional credit for the portion of taxes already remitted to the foreign government, if the taxpayer agrees to notify the IRS when the contest concludes and agrees not to assert

the statute of limitations as a defense to assessment of U.S. tax if the IRS determines that the taxpayer failed to take appropriate steps to secure a refund of the foreign tax. (See Part I.C.3.iv of this Special Analyses for alternatives considered and affected taxpayers). In this way, the final regulations alleviate taxpayer cash flow constraints that could result from temporary double taxation during the period of dispute resolution, while still providing the taxpayer with the incentive to resolve the tax dispute and providing the IRS with the ability to ensure that appropriate action was taken regarding dispute resolution.

The guidance and specificity provided by these regulations clarify which foreign taxes are creditable as income taxes, and (with respect to contested taxes) when they are creditable. The guidance also helps to resolve uncertainty and more generally to address issues raised in comments.

C. *Economic analysis*

1. Baseline

In this analysis, the Treasury Department and the IRS assess the benefits and costs of these final regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these regulations.

2. Summary of economic effects

The final regulations provide certainty and clarity to taxpayers regarding the creditability of foreign taxes. In the absence of the enhanced specificity provided by these regulations, similarly situated taxpayers might interpret the creditability of foreign taxes differently, particularly with respect to new extraterritorial taxes, potentially resulting in inefficient patterns of economic activity. For example, some taxpayers may forego specific economic projects, foreign or domestic, that other taxpayers deem worthwhile based on different interpretations of the tax consequences alone. The guidance provided in these regulations helps to ensure that taxpayers face more uniform incentives when making economic decisions. In general, economic performance is enhanced when businesses face more uniform signals about tax treatment.

In addition, these regulations generally reduce the compliance and administrative burdens associated with information collection and analysis required to claim foreign tax credits, relative to the no-action baseline. The regulations achieve this reduction because they rely to a significantly lesser extent on data-driven conclusions than the regulatory approach provided in the existing regulations and instead rely more on the terms and structure of the foreign tax law.

To the extent that taxpayers, in the absence of further guidance, would generally interpret the existing foreign tax credit rules as being more favorable to the taxpayer than the final regulations provide, the final regulations may result in reduced international activity relative to the no-action baseline. This reduced activity may have included both activities that could have been beneficial to the U.S. economy (perhaps because the activities would have represented enhanced international opportunities for businesses with U.S. owners) and activities that may not have been beneficial (perhaps because the activities would have been accompanied by reduced activity in the United States). Thus, the Treasury Department and the IRS recognize that foreign economic activity by U.S. taxpayers may be a complement or substitute to activity within the United States and that to the extent these regulations lead to a reduction in foreign economic activity relative to the no-action baseline, a mix of results may occur. To the extent that foreign governments, in response to these regulations, alter their tax regimes to reduce their reliance on taxes that are not income taxes in the U.S. sense, any such reduction in foreign economic activity by U.S. taxpayers as a result of these regulations, relative to the no-action baseline, will be mitigated.

The Treasury Department and the IRS project that the regulations will have economic effects greater than $100 million per year ($2021) relative to the no-action baseline. This determination is based on the substantial size of many of the businesses potentially affected by these regulations and the general responsiveness of business activity to effective tax rates,[10] one component of which is the creditability of foreign taxes. Based on these two magnitudes, even modest changes in the treatment of foreign taxes, relative to the no-action baseline, can be expected to have annual effects greater than $100 million ($2021).

The Treasury Department and the IRS have not undertaken quantitative estimates of the economic effects of these regulations. The Treasury Department and the IRS do not have readily available data or models to estimate with reasonable precision (i) the tax stances that taxpayers would likely take in the absence of the final regulations or under alternative regulatory approaches; (ii) the difference in business decisions that taxpayers might make between the final regulations and the no-action baseline or alternative regulatory approaches; or (iii) how this difference in those business decisions will affect measures of U.S. economic performance.

In the absence of such quantitative estimates, the Treasury Department and the IRS have undertaken a qualitative analysis of the economic effects of the final regulations relative to the no-action baseline and relative to alternative regulatory approaches. This analysis is presented in Part I.C.3 of this Special Analyses.

3. Options considered and number of affected taxpayers, by specific provisions

i. "Net gain requirement" for determining a creditable foreign tax

a. Summary

Under existing regulations, a foreign tax is creditable if it reaches "net gain," which is determined based in part on data-driven analysis. Therefore, under the existing regulations, a gross basis tax can in certain cases be creditable if it can be shown that the tax as applied does not result in taxing more than the taxpayer's profit. In certain cases, in order to determine creditability, the IRS requests country-level or other aggregate

[10] See E. Zwick and J. Mahon, "Tax Policy and Heterogeneous Investment Behavior," at *American Economic Review* 2017, 107(1): 217-48 and articles cited therein.

data to analyze whether the tax reaches net gain. The creditability determination is made based on data with respect to a foreign tax in its entirety, as it is applied to all taxpayers. In other words, the tax is creditable or not creditable based on its application to all taxpayers rather than on a taxpayer-by-taxpayer basis. However, different taxpayers can and do take different positions with respect to what the language of the existing regulations and the empirical tests imply about creditability.

b. Options considered for the final regulations

The Treasury Department and the IRS considered three options to address concerns with the "net gain" test. The first option is not to implement any changes and to continue to determine the definition of a foreign income tax based in part on conclusions based on country-level or other aggregate data. This option would mean that the determination of whether a tax satisfies the definition of foreign income tax would continue to be administratively difficult for taxpayers and the IRS, in part because it requires the IRS and the taxpayer to obtain information from the foreign country to determine how the tax applies in practice to taxpayers subject to the tax. The existing regulations apply a "predominant character" analysis such that deviations from the net gain requirement do not cause a tax to fail this requirement if the predominant character of the tax is that of an income tax in the U.S. sense. For example, the existing regulations allow a credit for a foreign tax whose base, judged on its predominant character, is computed by reducing gross receipts by significant costs and expenses, even if gross receipts are not reduced by all allocable costs and expenses. This requires some judgment in determining whether the exclusion of some costs and expenses causes the tax to fail the net gain requirement.

The second option considered is not to use data-driven conclusions for any portion of the net gain requirement and rely only on foreign tax law to make the determination. This rule would be easier to apply compared with the first option because it requires looking only at foreign law, regulations, and rulings. However, this option could result in an overly harsh outcome, to the extent the rules determine whether a levy is an income tax in its entirety (that is, not on a taxpayer-by-taxpayer basis). For example, if a country had a personal income tax that satisfied all the requirements, except that the country also included imputed rental income in the tax base, the Treasury Department and the IRS would not necessarily want to disallow as a credit the entire personal income tax system of that country due to the one deviation from U.S. tax law definitions of income tax. As part of this option, the Treasury Department and the IRS therefore considered also allowing a parsing of each tax for conforming and non-conforming parts. For example, in the prior example, only a portion of the income tax could be disallowed (that is, the portion attributable to imputed rental income). However, this approach would be extremely complicated to administer since there would need to be special rules for determining which portion of the tax relates to the non-conforming parts and which do not. It would also imply that taxpayers could not know from the outset whether a particular levy is an income tax but would instead have to analyze the tax in each fact and circumstances in which it applied to a particular taxpayer.

The third option considered is to use data-driven conclusions only for portions of the net gain requirement. The Treasury Department and the IRS considered retaining data-based conclusions in portions of the realization requirement and the cost-recovery requirement but removing them in the gross receipts requirement. This is the approach taken in these regulations. In these regulations, the cost recovery requirement retains the rule that the tax base must allow for recovery of significant costs and expenses. Data are still used in limited circumstances as part of the cost recovery analysis to determine whether a cost or expense is significant with respect to all taxpayers; however, in order to provide clarity and certainty to taxpayers, the final regulations contain a non-exclusive per se list of significant costs and expenses.

Because these options differ in terms of the creditability of foreign taxes, they may increase or decrease foreign activity by U.S. taxpayers. The Treasury Department and the IRS have not projected the differences in economic activity across the three alternatives because they do not have readily available data or models that capture these effects. It is anticipated that the final regulations will reduce taxpayer compliance costs relative to the baseline by significantly reducing the circumstances in which taxpayers must incur costs to obtain data (which may or may not be readily available) in order to evaluate the creditability of a tax.

The Treasury Department and the IRS do not have data or models that would allow them to quantify the reduced administrative burden resulting from these final regulations relative to alternative regulatory approaches. The Treasury Department and the IRS expect that the regulations will reduce administrative burden and compliance burdens because the collection and analysis of empirical data is time consuming for taxpayers and the IRS, and the existing regulations have resulted in a variety of disputes. Hence a reduction in required data collection should reduce burdens. Further, greater reliance on legal definitions rather than empirical review of available data has the potential to reduce the number of disputes, which also should reduce burdens.

c. Number of affected taxpayers

The Treasury Department and the IRS have determined that the population of taxpayers potentially affected by the net gain provisions of the final regulations includes any taxpayer with foreign operations claiming foreign tax credits (or with the potential to claim foreign tax credits). Based on currently available tax filings for tax year 2018, there were about 9.3 million Form 1116s filed by U.S. individuals to claim foreign tax credits with respect to foreign taxes paid on individual, partnership, or S corporation income. There were 17,500 Form 1118s filed by C corporations to claim foreign tax credits with respect to foreign taxes paid. In addition, there were about 16,500 C corporations with CFCs that filed at least one Form 5471 with their Form 1120 return, indicating a potential to claim a foreign tax credit even if no credit was claimed in 2018. Similarly, in these data there were about 41,000 indi-

viduals with CFCs that e-filed at least one Form 5471 with their Form 1040 return. In 2018, there were about 3,250 S corporations with CFCs that filed at least one Form 5471 with their Form 1120S return. The identified S corporations had an estimated 23,000 shareholders. Finally, the Treasury Department and the IRS estimate that there were approximately 7,500 U.S. partnerships with CFCs that e-filed at least one Form 5741 in 2018. The identified partnerships had approximately 1.7 million partners, as indicated by the number of Schedules K-1 filed by the partnerships; however, this number includes both domestic and foreign partners. Furthermore, there is likely to be some overlap between the Form 5471 and the Form 1116 and/or 1118 filers.

These numbers suggest that between 9.3 million (under the assumption that all Form 5471 filers or shareholders of filers also filed Form 1116 or 1118) and 11 million (under the assumption that filers or shareholders of filers of Form 5471 are a separate pool from Form 1116 and 1118 filers) taxpayers will potentially be affected by these regulations. Based on Treasury tabulations of Statistics of Income data, the total volume of foreign tax credits reported on Form 1118 in 2016 was about $90 billion. Data do not exist that would allow the Treasury Department or the IRS to identify how this total volume might change as a result of these regulations; however, the Treasury Department and the IRS anticipate that only a small fraction of existing foreign tax credits would be impacted by these regulations.

ii. Jurisdictional nexus

a. Summary

Rules under existing §1.901-2 do not explicitly require, for purposes of determining whether a foreign tax is a creditable foreign income tax, that the tax be imposed only on income that has a jurisdictional nexus (or adequate connection) to the country imposing the tax. In order to ensure that creditable taxes under section 901 conform to traditional international norms of taxing jurisdiction and therefore are income taxes in the U.S. sense, these regulations add a jurisdictional nexus requirement.

b. Options considered for the final regulations

The Treasury Department and the IRS considered the following three options for designing a nexus requirement. The first option considered is to create a jurisdictional nexus requirement based on Articles 5 (Permanent Establishment) and 7 (Business Profits) in the U.S. Model Income Tax Convention (the "U.S. Convention"). The U.S. Convention includes widely accepted and understood standards with respect to a country's right to tax a nonresident's income. The relevant articles of the U.S. Convention generally require a certain presence or level of activity before the country can impose tax on business income, and the tax can only be imposed on income that is attributable to the business activity. This option was rejected due to concerns that this standard would be too rigid and prescriptive in light of the fact that the Code contains a broader rule for determining when a nonresident is taxed on its income attributable to an activity in the United States.

The second option considered was to create a jurisdictional nexus requirement based on Code section 864, which contains a standard for income effectively connected with the conduct of a U.S. trade or business (ECI). The Code does not provide a definition of U.S. trade or business; it is instead defined in case law, and the definition is therefore not strictly delineated. This option was therefore rejected as potentially being ambiguous, and not necessarily targeting the primary concern with respect to the new extraterritorial taxes, which is that, in contrast to traditional international income tax norms governing the creditability of taxes, they are imposed based on the location of customers or users, or other destination-based criteria.

The third option considered was to require that foreign tax imposed on a nonresident must be based on the nonresident's activities located in the foreign country (including its functions, assets, and risks located in the foreign country) without taking into account as a significant factor the location of customers, users, or similar destination-based criteria. This more narrowly tailored approach better addresses the concern that extraterritorial taxes that are imposed on the basis of location of customers, users, or similar criteria should not be creditable under traditional norms reflected in the Internal Revenue Code that govern nexus and taxing rights and therefore should be excluded from creditable income taxes. Taxes imposed on nonresidents that would meet the Code-based ECI requirement could qualify, as well as taxes that would meet the permanent establishment and business profit standard under the U.S. Convention. This is the option adopted by the Treasury Department and the IRS.

This approach is consistent with the fact that under traditional norms reflected in the Internal Revenue Code, income tax is generally imposed taking into account the location of the operations, employees, factors of production, residence, or management of the taxpayer. In contrast, consumption taxes such as sales taxes, value-added taxes, or so-called destination-based income taxes are generally imposed on the basis of the location of customers, users, or similar destination-based criteria. Although the tax incidence of these two groups of taxes may vary, tax incidence does not play a role in the definition of an income tax in general, or an income tax in the U.S. sense. Therefore, the choice among regulatory options was based on which option most closely aligned the definition of foreign income taxes to taxes that are income taxes in the U.S. sense.

The Treasury Department and the IRS have not attempted to estimate the differences in economic activity that might result under each of these regulatory options because they do not have readily available data or models that capture (i) the jurisdictional nexus of taxpayers' activities under the different regulatory approaches and (ii) the economic activities that taxpayers might undertake under different jurisdictional nexus criteria. In addition, the Treasury Department and the IRS have not attempted to estimate the difference in compliance costs under each of these regulatory options.

c. Number of affected taxpayers

The Treasury Department and the IRS have determined that the population of taxpayers potentially affected by the jurisdictional nexus requirement of the regula-

tions includes any taxpayer with foreign operations claiming foreign tax credits (or with the potential to claim foreign tax credits). Based on currently available tax filings for tax year 2018, there were about 9.3 million Form 1116s filed by U.S. individuals to claim foreign tax credits with respect to foreign taxes paid on individual, partnership, or S corporation income. There were 17,500 Form 1118s filed by C corporations to claim foreign tax credits with respect to foreign taxes paid. In addition, there were about 16,500 C corporations with CFCs that filed at least one Form 5471 with their Form 1120 return, indicating a potential to claim a foreign tax credit, even if no credit was claimed in these years. Similarly, for the same period, there were about 41,000 individuals with CFCs that e-filed at least one Form 5471 with their Form 1040 return. In 2018, there were about 3,250 S corporations with CFCs that filed at least one Form 5471 with their Form 1120S return. The identified S corporations had an estimated 23,000 shareholders. Finally, the Treasury Department and the IRS estimate that there were approximately 7,500 U.S. partnerships with CFCs that e-filed at least one Form 5471 in 2018. The identified partnerships had approximately 1.7 million partners, as indicated by the number of Schedules K-1 filed by the partnerships; however, this number includes both domestic and foreign partners. Furthermore, there is likely to be overlap between the Form 5471 and the Form 1116 and/or 1118 filers.

These numbers suggest that between 9.3 million (under the assumption that all Form 5471 filers or shareholders of filers also filed Form 1116 or 1118) and 11 million (under the assumption that filers or shareholders of filers of Form 5471 are a separate pool from Form 1116 and 1118 filers) taxpayers will potentially be affected by these regulations. Based on Treasury Department tabulations of Statistics of Income data, the total volume of foreign tax credits reported on Form 1118 in 2016 was about $90 billion. Data do not exist that would allow the Treasury Department or the IRS to identify how this total volume might change as a result of these regulations; however, the Treasury Department and the IRS anticipate that only a small fraction of existing foreign tax credits would be impacted by these regulations.

iii. Allocation and apportionment of expenses for insurance companies

a. Summary

Section 818(f) provides that for purposes of applying the expense allocation rules to a life insurance company, the deduction for policyholder dividends, reserve adjustments, death benefits, and certain other amounts ("section 818(f) expenses") are treated as items that cannot be definitely allocated to an item or class of gross income. That means, in general, that the expenses are apportioned ratably across all of the life insurance company's gross income.

Under the expense allocation rules, for most purposes, affiliated groups are treated as a single entity, although there are exceptions for certain expenses. The statute is unclear, however, about how affiliated groups are to be treated with respect to the allocation of section 818(f) expenses of life insurance companies. Depending on how section 818(f) expenses are allocated across an affiliated group, the results could be different because the gross income categories across the affiliated group could be calculated in multiple ways. The Treasury Department and the IRS received comments and are aware that in the absence of further guidance taxpayers are taking differing positions on this treatment. Some taxpayers argue that the expenses described in section 818(f) should be apportioned based on the gross income of the entire affiliated group, while others argue that expenses should be apportioned on a separate company or life subgroup basis taking into account only the gross income of life insurance companies.

b. Options considered for the final regulations

The Treasury Department and the IRS are aware of at least five potential methods for allocating section 818(f) expenses in a life-nonlife consolidated group. First, the expenses might be allocated solely among items of the life insurance company that has the reserves ("separate entity method"). Second, to the extent the life insurance company has engaged in a reinsurance arrangement that constitutes an intercompany transaction (as defined in §1.1502-13(b)(1)), the expenses might be allocated in a manner that achieves single entity treatment between the ceding member and the assuming member ("limited single entity method"). Third, the expenses might be allocated among items of all life insurance members ("life subgroup method"). Fourth, the expenses might be allocated among items of all members of the consolidated group (including both life and non-life members) ("single entity method"). Fifth, the expenses might be allocated based on a facts and circumstances analysis ("facts and circumstances method").

The 2019 FTC proposed regulations proposed adopting the separate entity method because it is consistent with section 818(f) and with the separate entity treatment of reserves under §1.1502-13(e)(2). The Treasury Department and the IRS recognized, however, that this method may create opportunities for consolidated groups to use intercompany transactions to shift their section 818(f) expenses and achieve a more advantageous foreign tax credit result. Accordingly, the Treasury Department and the IRS requested comments on whether a life subgroup method more accurately reflects the relationship between section 818(f) expenses and the income producing activities of the life subgroup as a whole, and whether the life subgroup method is less susceptible to abuse because it might prevent a consolidated group from inflating its foreign tax credit limitation through intercompany transfers of assets, reinsurance transactions, or transfers of section 818(f) expenses. Comments received supported both methods and the 2020 FTC proposed regulations provided that the life subgroup method should generally be used, because it minimizes opportunities for abuse and is more consistent with the general rules for allocating expenses among affiliated group members. However, recognizing that the separate entity method also has merit, the 2020 FTC proposed regulations and the final regulations permit a taxpayer to make a one-time election to use the separate entity method for all life insurance members in the affiliated group. This election is binding for all future years and

may not be revoked without the consent of the Commissioner. Because the election is binding and applies to all members of the group, taxpayers will not be able to change allocation methods from year to year depending on which is most advantageous. The Treasury Department and the IRS may consider future proposed regulations to address any additional anti-abuse concerns (such as under section 845), if needed.

The Treasury Department and the IRS have not attempted to assess the differences in economic activity that might result under each of these regulatory options because they do not have readily available data or models that capture activities at this level of specificity. The Treasury Department and the IRS further have not estimated the difference in compliance costs under each of these regulatory options because they lack adequate data.

c. Number of affected taxpayers

The Treasury Department and the IRS have determined that the population of taxpayers potentially affected by these insurance expense allocation rules consists of life insurance companies that are members of an affiliated group. The Treasury Department and the IRS have established that there are approximately 60 such taxpayers.

iv. Creditability of contested foreign income taxes

a. Summary

Section 901 allows a taxpayer to claim a foreign tax credit for foreign income taxes paid or accrued (depending on the taxpayer's method of accounting) in a taxable year. Foreign income taxes accrue in the taxable year in which all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy ("all events test"). When a taxpayer disputes or contests a foreign tax liability with a foreign country, that contested tax does not accrue until the contest concludes because only then can the amount of the liability be finally determined. However, under two IRS revenue rulings (Rev. Ruls. 70-290 and 84-125), a taxpayer is allowed to claim a credit for the portion of a contested tax that the taxpayer has remitted to the foreign country, even though the taxpayer continues to dispute the liability. While this alleviates cash flow constraints associated with temporary double taxation, it is not consistent with the all events test. In addition, it potentially disincentivizes the taxpayer from continuing to contest the foreign tax, since the tax is already credited and the dispute could be time-consuming and costly, which could result in U.S. tax being reduced by foreign tax in excess of amounts properly due.

The final regulations clarify the treatment of contested foreign taxes of accrual basis taxpayers. As described in part VI.D.2 of the Summary of Comments and Explanation of Revisions, the final regulations also clarify, in response to comments, the circumstances in which cash method taxpayers may claim a foreign tax credit for contested taxes that are remitted before the contest has been concluded.

b. Options considered for the final regulations

The Treasury Department and the IRS considered three options for the treatment of contested foreign taxes. The first option considered is to not make any changes to the existing rule and to continue to allow taxpayers to claim a credit for a foreign tax that is being contested but that has been paid to the foreign country. The Treasury Department and the IRS determined that this option is inconsistent with the all events test for accrual method taxpayers and with the §1.901-2(e) compulsory payment requirement. It would also result in an accrual basis taxpayer potentially having two foreign tax redeterminations (FTRs) with respect to one contested liability: one FTR at the time the taxpayer pays the contested tax to the foreign country, and a second FTR when the contest concludes (if the finally determined liability differs from the amount that was paid and claimed as a credit). Furthermore, this option impinges on the IRS's ability to enforce the requirement in existing §1.902-1(e) that a tax has to be a compulsory payment in order to be creditable — if a taxpayer claims a credit for a contested tax, then surrenders the contest once the assessment statute closes, the IRS would be time-barred from challenging that the tax was not creditable on the grounds that the taxpayer failed to exhaust all practical remedies.

The second option considered is to only allow taxpayers to claim a credit when the contest concludes. In some cases, the taxpayer must pay the tax to the foreign country in order to contest the tax or in order to stop the running of interest in the foreign country. This option would leave the taxpayer out of pocket to two countries (potentially giving rise to cash flow issues for the taxpayer) while the contest is pending, which could take several years. The Treasury Department and the IRS determined that this outcome is unduly harsh.

The third option considered is to allow taxpayers the option to claim a provisional credit for an amount of contested tax that is actually paid, even though in general, taxpayers can only claim a credit when the contest is resolved. This is the option adopted in §1.905-1(c)(3) and (d)(4). As a condition for making this election, the taxpayer must enter into a provisional foreign tax credit agreement in which it agrees to notify the IRS when the contest concludes and agrees to not assert the expiration of the assessment statute (for a period of three years from the time the contest resolves) as a defense to assessment, so that the IRS is able to challenge the foreign tax credit claimed with respect to the contested tax if the IRS determines that the taxpayer failed to exhaust all practical remedies.

The Treasury Department and the IRS have not attempted to assess the differences in economic activity that might result under each of these regulatory options because they do not have readily available data or models that capture taxpayers' activities under the different treatments of contested taxes. The Treasury Department and the IRS further have not attempted to estimate the difference in compliance costs under each of these regulatory options.

c. Number of affected taxpayers

The Treasury Department and the IRS have determined that the final regulations potentially affect U.S. taxpayers that claim foreign tax credits and that contest a foreign income tax liability with a for-

eign country. Although data reporting the number of taxpayers that claim a credit for contested foreign income tax in a given year are not readily available, the potentially affected population of taxpayers would, under existing §1.905-3, generally have a foreign tax redetermination. Data reporting the number of taxpayers subject to a foreign tax redetermination in a given year are not readily available; however, some taxpayers currently subject to such redetermination will file amended returns. Based on currently available tax filings for tax year 2018, the Treasury Department and the IRS have determined that approximately 11,400 filers would be affected by these regulations. This estimate is based on the number of U.S. corporations that filed an amended return that had a Form 1118 attached to the Form 1120; S corporations that filed an amended return with a Form 5471 attached to the Form 1120S or that reported an amount of foreign tax on the Form 1120S, Schedule K; partnerships that filed an amended return with a Form 5471 attached to Form 1065 or that reported an amount of foreign tax on Schedule K; U.S. individuals that filed an amended return and had a Form 1116 attached to the Form 1040.

II. *Paperwork Reduction Act*

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) ("Paperwork Reduction Act") requires that a federal agency obtain the approval of the OMB before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit.

A. *Overview*

The collections of information in these final regulations are in §§1.905-1(c)(3), (d)(4) and (d)(5), 1.901-1(d)(2), and 1.905-3. These collections of information are generally the same as the collections of information in the 2020 FTC proposed regulations, except for the addition of §1.905-1(c)(3), which extends the election and filing requirements in §1.905-1(d)(4) for claiming a provisional foreign tax credit for contested foreign income to cash method taxpayers. See Part VI.D.2 of the Summary of Comments and Explanation of Revisions for explanation of this change.

The collections of information in §§1.905-1(c)(3) and (d)(4) apply to taxpayers that elect to claim a provisional credit for contested foreign income taxes before the contest resolves. Under the final regulations, both cash and accrual method taxpayers making this election are required to file an agreement described in §1.905-1(d)(4)(ii) as well as an annual notification described in §1.905-1(d)(4)(iv). The collection of information in §1.905-1(d)(5) requires taxpayers that are correcting an improper method of accruing foreign income tax expense to file a Form 3115, Application for Change in Accounting Method, to obtain the Commissioner's permission to make the change. Sections 1.901-1(d)(2) and 1.905-3 require taxpayers that make a change between claiming a credit and a deduction for foreign income taxes to comply with the notification and reporting requirements in §1.905-4, which generally require taxpayers to file an amended return for the year or years affected, along with an updated Form 1116 or Form 1118 if foreign tax credits are claimed, and a written statement providing specific information.

The burdens associated with collections of information in §§1.905-1(d)(4)(iv) and (d)(5), 1.901-1(d)(2), and 1.905-3, which will be conducted through existing IRS forms, are described in Part II.B of this Special Analyses. The burden associated with the collection of information in §1.905-1(d)(4)(ii), which will be conducted on a new IRS form, is described in Part II.C of this Special Analyses.

B. *Collections of information — §§1.905-1(d)(4)(iv), 1.905-1(d)(5), 1.901-1(d)(2), and 1.905-3*

The Treasury Department and the IRS intend that the information collection requirements described in this Part II.B of this Special Analyses will be set forth in the forms and instructions identified in Table 1.

Table 1. Table of Tax Forms Impacted

Tax Forms Impacted		
Collection of Information	Number of respondents (estimated)	Forms to which the information may be attached
§1.905-1(d)(4)(iv)	11,400	Form 1116, Form 1118
§1.905-1(d)(5)	465,500 - 514,500	Form 3115
§1.901-1(d)(2), §1.905-3	10,400 - 13,500	Form 1065 series, Form 1040 series, Form 1041 series, and Form 1120 series

Source: [MeF, DCS, and IRS's Compliance Data Warehouse]

As indicated in Table 1, the Treasury Department and the IRS intend the annual notification requirement in §1.905-1(d)(4)(iv), which applies to taxpayers that elect to claim a provisional credit for contested taxes, will be conducted through amendment of existing Form 1116, Foreign Tax Credit (Individual, Estate, or Trust) (covered under OMB control numbers 1545-0074 for individuals, and 1545-0121 for estates and trusts) and existing Form 1118, Foreign Tax Credit (Corporations) (covered under OMB control number 1545-0123). The collection of information in §1.905-1(d)

(4)(iv) will be reflected in the Paperwork Reduction Act submission that the Treasury Department and the IRS will submit to OMB for these forms. The current status of the Paperwork Reduction Act submissions related to these forms is summarized in Table 2. The estimate for the number of impacted filers with respect to the collection of information in §1.905-1(d)(4)(iv), as well as with respect to the collection of information in §1.905-1(d)(4)(ii) (described in Part II.C), is based on the number of U.S. corporations that filed an amended return that had a Form 1118 attached to the Form 1120; S corporations that filed an amended return with a Form 5471 attached to the Form 1120S or that reported an amount of foreign tax on the Form 1120S, Schedule K; partnerships that filed an amended return with a Form 5471 attached to Form 1065 or that reported an amount of foreign tax on Schedule K; and U.S. individuals that filed an amended return and had a Form 1116 attached to the Form 1040.

The Treasury Department and the IRS expect that the collection of information in §1.905-1(d)(5) will be reflected in the Paperwork Reduction Act submission that the Treasury Department and the IRS will submit to OMB for Form 3115 (covered under OMB control numbers 1545-0123 and 1545-0074). See Table 2 for the current status of the Paperwork Reduction Act submission for Form 3115. Exact data is not available to estimate the number of taxpayers that have used an incorrect method of accounting for accruing foreign income taxes, and that are potentially subject to the collection of information in §1.905-1(d)(5). The estimate in Table 1 of the number of taxpayers potentially affected by this collection of information is based on the total number of filers in the Form 1040, Form 1041, Form 1120, Form 1120S, and Form 1065 series that indicated on their return that they use an accrual method of accounting, and that either claimed a foreign tax credit or claimed a deduction for taxes (which could include foreign income taxes). This represents an upper bound of potentially affected taxpayers. The Treasury Department and the IRS expect that only a small portion of this population of taxpayers will be subject to the collection of information in §1.905-1(d)(5), because only taxpayers that have used an improper method of accounting are subject to §1.905-1(d)(5).

The collection of information resulting from §§1.901-1(d)(2) and 1.905-3, which is contained in §1.905-4, will be reflected in the Paperwork Reduction Act submission that the Treasury Department and the IRS will submit for OMB control numbers 1545-0123, 1545-0074 (which cover the reporting burden for filing an amended return and amended Form 1116 and Form 1118 for individual and business filers), OMB control number 1545-0092 (which covers the reporting burden for filing an amended return for estate and trust filers), OMB control number 1545-0121 (which covers the reporting burden for filing a Form 1116 for estate and trust filers), and OMB control number 1545-1056 (which covers the reporting burden for the written statement for FTRs). Exact data are not available to estimate the additional burden imposed by §§1.901-1(d)(2) and 1.905-3, which amend the definition of a foreign tax redetermination in §1.905-3 to include a taxpayer's change from claiming a deduction to claiming a credit, or vice versa, for foreign income taxes. Taxpayers making or changing their election to claim a foreign tax credit, under existing regulations, must already file amended returns and, if applicable, a Form 1116 or Form 1118, for the affected years. The Treasury Department and the IRS do not anticipate that regulations that will require taxpayers making this change to comply with the collection of information and reporting burden in §1.905-4 will substantially change the reporting requirement. Exact data are not available to estimate the number of taxpayers potentially subject to §§1.901-1(d)(2) and 1.905-3. The estimate in Table 1 is based upon the total number of filers in the Form 1040, Form 1041, and Form 1120 series that either claimed a foreign tax credit or claimed a deduction for taxes (which could include foreign income taxes), and filed an amended return. This estimate represents an upper bound of potentially affected taxpayers.

OMB control number 1545-0123 represents a total estimated burden time for all forms and schedules for corporations of 1.085 billion hours and total estimated monetized costs of $44.279 billion ($2021). OMB control number 1545-0074 represents a total estimated burden time, including all other related forms and schedules for individuals, of 2.14 billion hours and total estimated monetized costs of $37.960 billion ($2021). OMB control number 1545-0092 represents a total estimated burden time, including related forms and schedules, but not including Form 1116, for trusts and estates, of 307,844,800 hours and total estimated monetized costs of $14.077 billion ($2018). OMB control number 1545-0121 represents a total estimated burden time for all estate and trust filers of Form 1116, of 2,506,600 hours and total estimated monetized costs of $1.744 billion ($2018). OMB control number 1545-1056 has an estimated number of 13,000 respondents and total estimated burden time of 54,000 hours and total estimated monetized costs of $2,583,840 ($2017).

The overall burden estimates provided for OMB control numbers 1545-0123, 1545-0074, and 1545-0092 are aggregate amounts that relate to the entire package of forms associated with these OMB control numbers and will in the future include but not isolate the estimated burden of the tax forms that will be revised as a result of the information collections in the final regulations. The difference between the burden estimates reported here and those future burden estimates will therefore not provide an estimate of the burden imposed by the final regulations. The burden estimates reported here have been reported for other regulations related to the taxation of cross-border income. The Treasury Department and IRS urge readers to recognize that many of the burden estimates reported for regulations related to taxation of cross-border income are duplicates and to guard against overcounting the burden that international tax provisions impose. The Treasury Department and the IRS have not identified the estimated burdens for the collections of information in §§1.905-1(d)(4)(iv) and (d)(5), 1.901-1(d)(2), and 1.905-3 because no burden estimates specific to §§1.905-1(d)(4)(iv) and (d)(5), 1.901-1(d)(2), and 1.905-3 are currently available. The Treasury Department and the IRS estimate burdens on a taxpayer-type basis rather than a provision-specific basis.

Table 2. Status of current Paperwork Reduction submissions.

Form	Type of Filer	OMB Number(s)	Status
Form 1116	Trusts & estates (NEW Model)	1545-0121	Approved by OMB through 12/31/2023.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=202010-1545-010		
	Individual (NEW Model)	1545-0074	Approved by OMB through 12/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=202108-1545-001		
Form 1118	Business (NEW Model)	1545-0123	Approved by OMB through 12/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=202012-1545-012		
Form 3115	Business (NEW Model)	1545-0123	Approved by OMB through 12/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=202012-1545-012		
	Individual (NEW Model)	1545-0074	Approved by OMB through 12/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=202108-1545-001		
Notification of FTRs		1545-1056	Approved by OMB through 7/31/2024.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=202105-1545-005		
Amended returns	Business (NEW Model)	1545-0123	Approved by OMB through 12/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=202012-1545-012		
	Individual (NEW Model)	1545-0074	Approved by OMB through 12/31/2021.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=202108-1545-001		
	Trusts & estates	1545-0092	Approved by OMB through 5/31/2022.
	https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201806-1545-014		

C. *Collections of information — §§1.905-1(c)(3) and 1.905-1(d)(4)(ii)*

The collection of information contained in §1.905-1(d)(4)(ii) — relating to the provisional foreign tax credit agreement that taxpayers electing to claim a provisional credit for contested foreign income taxes must file — was submitted to the OMB for review in accordance with the Paperwork Reduction Act and was approved under OMB control number 1545-2296. No comments regarding this collection of information were received. As described in Part II.A of this Special Analyses, the final regulations, under §1.905-1(c)(3), extend the provisional credit election and associated collection of information in §1.905-1(d)(4)(ii) to cash method taxpayers. The burden estimates for control number 1545-2296 will be updated to reflect this change.

The likely respondents are U.S. persons who pay or accrue foreign income taxes.

Estimated total annual reporting burden: 22,800 hours.

Estimated average annual burden per respondent: 2 hours.

Estimated number of respondents: 11,400.

Estimated frequency of responses: annually.

III. *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that the final regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act.

The final regulations provide guidance needed to comply with the statutory rules under sections 245A(d), 861, 901, 903, 904, 905, and 960 and affect U.S. individuals and corporations that claim a credit or a deduction for foreign taxes. The domestic small business entities that are subject to these Code provisions and to the rules in the final regulations are those that operate in foreign jurisdictions or that have income from sources outside of the United States and pay foreign taxes. The final regulations also contain clarifying rules relating to foreign derived intangible income (FDII) under section 250. Specifically, §1.250(b)-1(c)(7) provides a clarification regarding the determination of domestic oil and gas extraction income and §1.250(b)-5(c)(5) clarifies the meaning of the term "electronically supplied services" as used in the section 250 regulations. Because these rules only clarify the intended meaning of terms in the section 250 regulations, they do not change the economic impact that the section 250 regulations have on small business entities. See the Regulatory Flexibility Act analysis of TD 9901, 85 FR 43078-79.

Many of the important aspects of the final regulations, including the rules in §§1.245A(d)-1, 1.367(b)-4, 1.367(b)-7, 1.367(b)-10, 1.861-3, and 1.960-1, apply only to U.S. persons that are at least 10 percent shareholders of foreign corporations, and thus are eligible to claim dividends received deductions or compute foreign taxes deemed paid under section 960 with respect to inclusions under subpart F and section 951A from CFCs. Other provisions of the final regulations, specifically the rules in §1.861-14, apply only to members of an affiliated group of in-

surance companies earning income from sources outside of the United States. It is infrequent for domestic small entities to operate as part of an affiliated group, to operate as an insurance company, or to operate outside the United States in corporate form. Consequently, the Treasury Department and the IRS do not expect that the final regulations will likely affect a substantial number of domestic small business entities. However, the Treasury Department and the IRS do not have adequate data readily available to assess the number of small entities potentially affected by the final regulations.

The Treasury Department and the IRS have determined that the final regulations will not have a significant economic impact on domestic small business entities. A significant part of the final regulations is the modification of the requirements in §§1.901-2 and 1.903-1 for determining whether a foreign tax is a creditable "foreign income tax" or a creditable "tax in lieu of an income tax" under sections 901 and 903, respectively. Of particular note, the final regulations add a jurisdictional nexus requirement to the existing creditability requirements. A principal reason for adding the jurisdictional nexus requirement is to ensure that certain novel extraterritorial foreign taxes, such as digital services taxes, are not creditable. Many of these novel extraterritorial taxes only apply to large multinational corporations; as such, small business entities are unlikely to be impacted by the denial of credits for such extraterritorial taxes. In addition, as described in Part I.C.3.i of this Special Analysis, the final regulations remove the empirical analysis required by the existing creditability requirements under §1.901-2 in favor a creditability analysis based principally on the terms of foreign tax law. The Treasury Department and the IRS anticipate that the final regulations will reduce taxpayer compliance costs relative to the existing regulations by significantly reducing the circumstances in which taxpayers must incur costs to obtain data in order to evaluate the creditability of a tax.

To provide an upper bound estimate of the impact these final regulations could have on business entities, the Treasury Department and the IRS calculated, based on information from the Statistics of Income 2017 Corporate File, foreign tax credits[11] as a percentage of three different tax-related measures of annual receipts (see Table for variables) by corporations. As demonstrated by the data in the table below, foreign tax credits as a percentage of all three measures of annual receipts is substantially less than the 3 to 5 percent threshold for significant economic impact for corporations with business receipts less than $250 million. The Treasury Department and the IRS anticipate that only a small fraction of existing foreign tax credits would be impacted by these regulations, and thus, the economic impact of these regulations will be considerably smaller than the effects shown in the table.

Size (by Business Receipts)	under $500,000	$500,000 under $1,000,000	$1,000,000 under $5,000,000	$5,000,000 under $10,000,000	$10,000,000 under $50,000,000	$50,000,000 under $100,000,000	$100,000,000 under $250,000,000	$250,000,000 or more
FTC/Total Receipts	0.12%	0.00%	0.00%	0.00%	0.01%	0.01%	0.02%	0.28%
FTC/(Total Receipts-Total Deductions)	0.61%	0.03%	0.09%	0.05%	0.35%	0.71%	1.38%	9.89%
FTC/Business Receipts	0.84%	0.00%	0.00%	0.00%	0.01%	0.01%	0.02%	0.05%
Source: RAAS: (Tax Year 2017 SOI Data)								

A portion of the economic impact of these final regulations derive from the collection of information requirements in §§1.905-1(c)(3), (d)(4), and (d)(5), 1.901-1(d)(2), and 1.905-3. The data to assess precise counts of small entities affected by §§1.905-1(c)(3), (d)(4), and (d)(5), 1.901-1(d)(2), and 1.905-3 are not readily available. However, the Treasury Department and the IRS do not anticipate that these collections of information significantly add to the burden on small entities, compared to the existing regulatory and statutory requirements. The rules in §§1.901-1(d)(2), and 1.905-3, which treat a taxpayer's change between claiming a deduction and a credit for foreign income taxes as a foreign tax redetermination and thus require the taxpayer to comply with reporting requirements in §1.905-4, do not significantly add to the taxpayer's burden because taxpayers making this change must already file amended returns, along with Forms 1116 or 1118, if applicable, for the affected years. In fact, these rules reduce the uncertainty faced by taxpayers seeking to make the change but that have a time-barred deficiency in one or more intervening years and provide an efficient process by which taxpayers can change

[11] Although certain parts of the final regulations, such as the rules under §1.901-1(d) and §1.905-1, also impact taxpayers that claim a deduction, instead of a credit, for foreign income taxes, the Treasury Department and the IRS expect that the vast majority of taxpayers that have creditable foreign income taxes would choose a dollar-for-dollar credit, instead of a deduction, for such taxes. In addition, a significant aspect of these final regulations, specifically the rules under §§ 1.901-2 and 1.903-1 regarding the definition of a foreign income tax and a tax in lieu of an income tax, only impact taxpayers that elect to claim a foreign tax credit. Thus, the data in this table measuring foreign tax credit against various variables is a reasonable estimate of the economic impact of these final regulations.

between crediting and deducting foreign income taxes. Similarly, under the existing rules, taxpayers that remit a contested foreign tax liability to a foreign country and seek to claim a foreign tax credit for such liability would be subject to the reporting requirements related to foreign tax redeterminations under §1.905-4, and may have a second foreign tax redetermination when the contest is resolved if the taxpayer receives a refund of any of the taxes claimed as a credit. Under §§1.905-1(c) and (d) of these final regulations, taxpayers do not claim a credit for the foreign taxes until the contest is resolved (and thus, would generally only have one foreign tax redetermination). The reporting requirements in §§1.905-1(c)(3) and (d)(4), relating to taxpayers claiming a provisional credit for contested foreign income taxes, apply only if the taxpayer elects to claim the foreign tax credit early. If a taxpayer makes this election, it must file a provisional foreign tax credit agreement described in Part II.C of this Special Analysis and comply with annual reporting requirements described in Part II.B of this Special Analysis. The Treasury Department and the IRS estimate that the average burden of the provisional foreign tax credit agreement will be 2 hours per response. In addition, the Treasury Department and the IRS expect that the annual reporting requirement, which will be added to the existing Forms 1116 and 1118, will only marginally increase the burden for completing those forms. Finally, the Treasury Department and the IRS expect that the collection of information in §1.905-1(d)(5), which requires taxpayers seeking to change their method of accounting for foreign income taxes to file a Form 3115, will not significantly impact small business entities because only taxpayers that have deducted or credited foreign income taxes and that have used an improper method of accounting for such taxes are subject to the rules in §1.905-1(d)(5).

The Treasury Department and the IRS do not have readily available data to determine the incremental burdens these collections of information will have on small business entities. However, as demonstrated in the table in this Part III of the Special Analyses, foreign tax credits do not have a significant economic impact for any gross-receipts class of business entities. Therefore, the final regulations do not have a significant economic impact on small business entities. Accordingly, it is hereby certified that the final regulations will not have a significant economic impact on a substantial number of small entities.

IV. *Section 7805(f)*

Pursuant to section 7805(f), the proposed regulations preceding these final regulations (REG-101657-20) were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses. The proposed regulations also request comments from the public regarding the RFA certification. No comments were received.

V. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This final rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

VI. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. This final rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive order.

Drafting Information

The principal authors of the final regulations are Corina Braun, Karen J. Cate, Jeffrey P. Cowan, Moshe A. Dlott, Logan M. Kincheloe, Brad McCormack, Jeffrey L. Parry, Teisha M. Ruggiero, Tianlin (Laura) Shi, and Suzanne M. Walsh of the Office of Associate Chief Counsel (International), as well as Sarah K. Hoyt and Brian R. Loss of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1 – INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry for §1.245A(d)-1 in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805* * *

* * * * *

Section 1.245A(d)-1 also issued under 26 U.S.C. 245A(g).

* * * * *

Par. 2. Section 1.164-2 is amended by revising paragraph (d) and adding paragraph (i) to read as follows:

§1.164-2 Deduction denied in case of certain taxes.

* * * * *

(d) *Foreign income taxes*. Except as provided in §1.901-1(c)(2) and (3), foreign income taxes, as defined in §1.901-2(a), paid or accrued (as the case may be, depending on the taxpayer's method of accounting for such taxes) in a taxable year, if the taxpayer chooses to take to any extent the benefits of section 901, relating to the credit for taxes of foreign countries and possessions of the United States, for taxes that are paid or accrued (according to the taxpayer's method of accounting for such taxes) in such taxable year.

* * * * *

(i) *Applicability dates*. Paragraph (d) of this section applies to foreign taxes paid or accrued in taxable years beginning on or after December 28, 2021.

Par. 3. Section 1.245A(d)-1 is added to read as follows:

§1.245A(d)-1 Disallowance of foreign tax credit or deduction.

(a) *No foreign tax credit or deduction allowed under section 245A(d)*—(1) *Foreign income taxes paid or accrued by domestic corporations or successors*. No credit under section 901 or deduction is allowed in any taxable year for:

(i) Foreign income taxes paid or accrued by a domestic corporation that are attributable to section 245A(d) income of the domestic corporation;

(ii) Foreign income taxes paid or accrued by a successor to a domestic corporation that are attributable to section 245A(d) income of the successor; and

(iii) Foreign income taxes paid or accrued by a domestic corporation that is a United States shareholder of a foreign corporation, other than a foreign corporation that is a passive foreign investment company (as defined in section 1297) with respect to the domestic corporation and that is not a controlled foreign corporation, that are attributable to non-inclusion income of the foreign corporation and are not otherwise disallowed under paragraph (a)(1)(i) or (ii) of this section.

(2) *Foreign income taxes paid or accrued by foreign corporations*. No credit under section 901 or deduction is allowed in any taxable year for foreign income taxes paid or accrued by a foreign corporation that are attributable to section 245A(d) income, and such taxes are not eligible to be deemed paid under section 960 in any taxable year.

(3) *Effect of disallowance on earnings and profits*. The disallowance of a credit or deduction for foreign income taxes under this paragraph (a) does not affect whether the foreign income taxes reduce earnings and profits of a corporation.

(b) *Attribution of foreign income taxes*—(1) *Section 245A(d) income*. Foreign income taxes are attributable to section 245A(d) income to the extent that the foreign income taxes are allocated and apportioned under §1.861-20 to the section 245A(d) income group. For purposes of this paragraph (b)(1), §1.861-20 is applied by treating the section 245A(d) income group in each section 904 category of a domestic corporation, successor, or foreign corporation as a statutory grouping and treating all other income, including the receipt of a distribution of previously taxed earnings and profits other than section 245A(d) PTEP, as income in the residual grouping. See §1.861-20(d)(2) through (3) for rules regarding the allocation and apportionment of foreign income taxes to the statutory and residual groupings if the taxpayer does not realize, recognize, or take into account a corresponding U.S. item in the U.S. taxable year in which the foreign income taxes are paid or accrued. In the case of a foreign law distribution or foreign law disposition, a corresponding U.S. item is assigned to the statutory and residual groupings under §1.861-20(d)(2)(ii)(B) and (C) without regard to the application of section 246(c), the holding periods described in sections 964(e)(4)(A) and 1248(j), and §1.245A-5.

(2) *Non-inclusion income of a foreign corporation*—(i) *Scope*. This paragraph (b)(2) provides rules for attributing foreign income taxes paid or accrued by a domestic corporation that is a United States shareholder of a foreign corporation to non-inclusion income of the foreign corporation. It applies only in cases in which the foreign income taxes are allocated and apportioned under §1.861-20 by reference to the characterization of the tax book value of stock, whether the stock is held directly or indirectly through a partnership or other passthrough entity, for purposes of allocating and apportioning the domestic corporation's interest expense, or by reference to the income of a foreign corporation that is a reverse hybrid or foreign law CFC.

(ii) *Foreign income taxes on a remittance, U.S. return of capital amount, or U.S. return of partnership basis amount*. This paragraph (b)(2)(ii) applies to foreign income taxes paid or accrued by a domestic corporation that is a United States shareholder of a foreign corporation with respect to foreign taxable income that the domestic corporation includes by reason of a remittance, a distribution (including a foreign law distribution) that is a U.S. return of capital amount or U.S. return of partnership basis amount, or a disposition (including a foreign law disposition) that gives rise to a U.S. return of capital amount or a U.S. return of partnership basis amount. These foreign income taxes are attributable to non-inclusion income of the foreign corporation to the extent that they are allocated and apportioned to the domestic corporation's section 245A subgroup of general category stock, section 245A subgroup of passive category stock, or section 245A subgroup of U.S. source category stock in applying §1.861-20 for purposes of section 904 as the operative section. For purposes of this paragraph (b)(2)(ii), §1.861-20 is applied by treating the domestic corporation's section 245A subgroup of general category stock, section 245A subgroup of passive category stock, and section 245A subgroup of U.S. source category stock as the statutory groupings and treating the tax book value of the non-section 245A subgroup of stock for each separate category as tax book value in the residual grouping.

(iii) *Foreign income taxes on income of a reverse hybrid or a foreign law CFC*. This paragraph (b)(2)(iii) applies to foreign income taxes paid or accrued by a domestic corporation, other than a regulated investment company (as defined in section 851), real estate investment trust (as defined in section 856), or S corporation (as defined in section 1361), that is a United States shareholder of a foreign corporation that is a reverse hybrid or foreign law CFC with respect to the foreign law pass-through income or foreign law inclusion regime income of the reverse hybrid or foreign law CFC, respectively. These taxes are attributable to the non-inclusion income of a reverse hybrid or foreign law CFC to the extent that they are allocated and apportioned to the non-inclusion income group under §1.861-20. For purposes of this paragraph (b)(2)(iii), §1.861-20 is applied by treating the non-inclusion income group in each section 904 category of the domestic corporation and the foreign corporation as a statutory grouping and treating all other income as income in the residual grouping.

(3) *Anti-avoidance rule*. Foreign income taxes are treated as attributable to section 245A(d) income of a domestic corporation or foreign corporation, or non-inclusion

income of a foreign corporation, if a transaction, series of related transactions, or arrangement is undertaken with a principal purpose of avoiding the purposes of section 245A(d) and this section with respect to such foreign income taxes, including, for example, by separating foreign income taxes from the income, or earnings and profits, to which such foreign income taxes relate or by making distributions (or causing inclusions) under foreign law in multiple years that give rise to foreign income taxes that are allocated and apportioned with reference to the same previously taxed earnings and profits. See paragraph (d)(4) of this section (*Example 3*).

(c) *Definitions*. The following definitions apply for purposes of this section.

(1) *Corresponding U.S. item*. The term *corresponding U.S. item* has the meaning set forth in §1.861-20(b).

(2) *Foreign income tax*. The term *foreign income tax* has the meaning set forth in §1.901-2(a).

(3) *Foreign law CFC*. The term *foreign law CFC* has the meaning set forth in §1.861-20(b).

(4) *Foreign law disposition*. The term *foreign law disposition* has the meaning set forth in §1.861-20(b).

(5) *Foreign law distribution*. The term *foreign law distribution* has the meaning set forth in §1.861-20(b).

(6) *Foreign law inclusion regime*. The term *foreign law inclusion regime* has the meaning set forth in §1.861-20(b).

(7) *Foreign law inclusion regime income*. The term *foreign law inclusion regime income* has the meaning set forth in §1.861-20(b).

(8) *Foreign law pass-through income*. The term *foreign law pass-through income* has the meaning set forth in §1.861-20(b).

(9) *Foreign taxable income*. The term *foreign taxable income* has the meaning set forth in §1.861-20(b).

(10) *Gross included tested income*. The term *gross included tested income* means, with respect to a foreign corporation that is described in paragraph (b)(2)(iii) of this section, an item of gross tested income multiplied by the inclusion percentage of a domestic corporation that is described in paragraph (b)(2)(iii) of this section for the domestic corporation's U.S. taxable year with or within which the foreign corporation's taxable year described in §1.861-20(d)(3)(i)(C) or §1.861-20(d)(3)(iii) ends.

(11) *Hybrid dividend*. The term *hybrid dividend* has the meaning set forth in §1.245A(e)-1(b)(2).

(12) *Inclusion percentage*. The term *inclusion percentage* has the meaning set forth in §1.960-1(b).

(13) *Non-inclusion income*. The term *non-inclusion income* means the items of gross income of a foreign corporation other than the items that are described in §1.960-1(d)(2)(ii)(B)(*2*) (items of income assigned to the subpart F income groups) and section 245(a)(5) (without regard to section 245(a)(12)), and other than gross included tested income.

(14) *Non-inclusion income group*. The term *non-inclusion income group* means the income group within a section 904 category that consists of non-inclusion income.

(15) *Non-section 245A subgroup*. The term *non-section 245A subgroup* means each non-section 245A subgroup determined under §1.861-13(a)(5), applied as if the foreign corporation whose stock is being characterized were a controlled foreign corporation.

(16) *Pass-through entity*. The term *pass-through entity* has the meaning set forth in §1.904-5(a)(4).

(17) *Remittance*. The term *remittance* has the meaning set forth in §1.861-20(d)(3)(v)(E).

(18) *Reverse hybrid*. The term *reverse hybrid* has the meaning set forth in §1.861-20(b).

(19) *Section 245A subgroup*. The term *section 245A subgroup* means each section 245A subgroup determined under §1.861-13(a)(5), applied as if the foreign corporation whose stock is being characterized were a controlled foreign corporation.

(20) *Section 245A(d) income*. With respect to a domestic corporation, the term *section 245A(d) income* means a dividend (including a section 1248 dividend and a dividend received indirectly through a pass-through entity) or an inclusion under section 951(a)(1)(A) for which a deduction under section 245A(a) is allowed, a distribution of section 245A(d) PTEP, a hybrid dividend, or an inclusion under section 245A(e)(2) and §1.245A(e)-1(c)(1) by reason of a tiered hybrid dividend. With respect to a successor of a domestic corporation, the term *section 245A(d) income* means the receipt of a distribution of section 245A(d) PTEP. With respect to a foreign corporation, the term *section 245A(d) income* means an item of subpart F income that gave rise to a deduction under section 245A(a), a tiered hybrid dividend or a distribution of section 245A(d) PTEP. An item described in this paragraph (c)(20) that qualifies for the deduction under section 245A(a) is considered section 245A(d) income regardless of whether the domestic corporation claims the deduction on its return with respect to the item.

(21) *Section 245A(d) income group*. The term *section 245A(d) income group* means an income group within a section 904 category that consists of section 245A(d) income.

(22) *Section 245A(d) PTEP*. The term *section 245A(d) PTEP* means previously taxed earnings and profits described in §1.960-3(c)(2)(v) or (ix) if such previously taxed earnings and profits arose either as a result of a dividend that gave rise to a deduction under section 245A(a), or as a result of a tiered hybrid dividend that, by reason of section 245A(e)(2) and §1.245A(e)-1(c)(1), gave rise to an inclusion in the gross income of a United States shareholder. For purposes of this paragraph (c)(22), a dividend that qualifies for the deduction under section 245A(a) is considered to have given rise to a deduction under section 245A(a) regardless of whether the domestic corporation claims the deduction on its return with respect to the dividend.

(23) *Section 904 category*. The term *section 904 category* has the meaning set forth in §1.960-1(b).

(24) *Section 1248 dividend*. The term *section 1248 dividend* means an amount of gain that is treated as a dividend under section 1248.

(25) *Successor*. The term successor means a person, including an individual who is a citizen or resident of the United States, that acquires from any person any portion of the interest of a United States shareholder in a foreign corporation for purposes of section 959(a).

(26) *Tested income*. The term *tested income* has the meaning set forth §1.960-1(b).

(27) *Tiered hybrid dividend*. The term *tiered hybrid dividend* has the meaning set forth in §1.245A(e)-1(c)(2).

(28) *U.S. capital gain amount*. The term *U.S. capital gain amount* has the meaning set forth in §1.861-20(b).

(29) *U.S. return of capital amount*. The term *U.S. return of capital amount* has the meaning set forth in §1.861-20(b).

(30) *U.S. return of partnership basis amount*. The term *U.S. return of partnership basis amount* means, with respect to a partnership in which a domestic corporation is a partner, the portion of a distribution by the partnership to the domestic corporation, or the portion of the proceeds of a disposition of the domestic corporation's interest in the partnership, that exceeds the U.S. capital gain amount.

(d) *Examples*. The following examples illustrate the application of this section.

(1) *Presumed facts*. Except as otherwise provided, the following facts are presumed for purposes of the examples:

(i) USP is a domestic corporation;

(ii) CFC is a controlled foreign corporation organized in Country A, and is not a reverse hybrid or a foreign law CFC;

(iii) USP owns all of the outstanding stock of CFC;

(iv) USP would be allowed a deduction under section 245A(a) for dividends received from CFC;

(v) All parties have a U.S. dollar functional currency and a U.S. taxable year and foreign taxable year that correspond to the calendar year; and

(vi) References to income are to gross items of income, and no party has deductions for Country A tax purposes or deductions for Federal income tax purposes (other than foreign income tax expense).

(2) *Example 1: Distribution for foreign and Federal income tax purposes—(i) Facts*. As of December 31, Year 1, CFC has $800x of section 951A PTEP (as defined in §1.960-3(c)(2)(viii)) in a single annual PTEP account (as defined in §1.960-3(c)(1)), and $500x of earnings and profits described in section 959(c)(3). On December 31, Year 1, CFC distributes $1,000x of cash to USP. For Country A tax purposes, the entire $1,000x distribution is a dividend and is therefore a foreign dividend amount (as defined in §1.861-20(b)). Country A imposes a withholding tax on USP of $150x with respect to the $1,000x of foreign gross dividend income under Country A law. For Federal income tax purposes, USP includes in gross income $200x of the distribution as a dividend for which a deduction is allowable under section 245A(a). The remaining $800x of the distribution is a distribution of PTEP that is excluded from USP's gross income and not treated as a dividend under section 959(a) and (d), respectively. The entire $1,000x dividend is a U.S. dividend amount (as defined in §1.861-20(b)).

(ii) *Analysis*—(A) *In general*. The rules of this section are applied by first determining the portion of the $150x Country A withholding tax that is attributable under paragraph (b)(1) of this section to the section 245A(d) income of USP, and then by determining the portion of the $150x Country A withholding tax that is described in paragraph (b)(2)(i) of this section and that is attributable under either paragraph (b)(2)(ii) or (b)(2)(iii) of this section to the non-inclusion income of CFC. No credit or deduction is allowed in any taxable year under paragraph (a)(1)(i) of this section for any portion of the $150x Country A withholding tax that is attributable to the section 245A(d) income of USP, or, under paragraph (a)(1)(iii) of this section, for any portion of that tax that is attributable to the non-inclusion income of CFC, to the extent the tax is not disallowed under paragraph (a)(1)(i) of this section.

(B) *Attribution of foreign income taxes to section 245A(d) income*. Under paragraph (b)(1) of this section, the $150x Country A withholding tax is attributable to the section 245A(d) income of USP to the extent that it is allocated and apportioned to the section 245A(d) income group (the statutory grouping) under §1.861-20. Section 1.861-20(c) allocates and apportions foreign income tax to the statutory and residual groupings to which the items of foreign gross income that were included in the foreign tax base are assigned under §1.861-20(d). Section 1.861-20(d)(3)(i) assigns foreign gross income that is a foreign dividend amount, to the extent of the U.S. dividend amount, to the statutory and residual groupings to which the U.S. dividend amount is assigned. The $1,000x foreign dividend amount is therefore assigned to the statutory and residual groupings to which the $1,000x U.S. dividend amount is assigned under Federal income tax law. The $1,000x U.S. dividend amount comprises a $200x dividend for which a deduction under section 245A(a) is allowed, which is an item of section 245A(d) income, and $800x of section 951A PTEP, the receipt of which is income in the residual grouping. Accordingly, $200x of the $1,000x of foreign gross dividend income is assigned to the section 245A(d) income group, and $800x is assigned to the residual grouping. Under §1.861-20(f), $30x ($150x x $200x / $1,000x) of the $150x Country A withholding tax is apportioned to the section 245A(d) income group and is attributable to the section 245A(d) income of USP. The remaining $120x ($150x x $800x / $1,000x) of the tax is apportioned to the residual grouping.

(C) *Attribution of foreign income taxes to non-inclusion income*. Under paragraph (b)(2) of this section, the $150x Country A withholding tax may be attributed to non-inclusion income of CFC if the tax is allocated and apportioned under §1.861-20 by reference to either the characterization of the tax book value of stock under §1.861-9 or the income of a foreign corporation that is a reverse hybrid or foreign law CFC. CFC is neither a reverse hybrid nor a foreign law CFC. In addition, no portion of the $150x Country A withholding tax is allocated and apportioned under §1.861-20 by reference to the characterization of the tax book value of CFC's stock. See §1.861-20(d)(3)(i). Therefore, none of the tax is attributable to non-inclusion income of CFC.

(D) *Disallowance*. Under paragraph (a)(1)(i) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $30x portion of the Country A withholding tax that is attributable to section 245A(d) income of USP.

(3) *Example 2: Distribution for foreign law purposes*—(i) *Facts*. As of December 31, Year 1, CFC has $800x of section 951A PTEP (as defined in §1.960-3(c)(2)(viii)) in a single annual PTEP account (as defined in §1.960-3(c)(1)), and $500x of earnings and profits described in section 959(c)(3). On December 31, Year 1, CFC distributes $1,000x of its stock to USP. For Country A tax purposes, the entire $1,000x stock distribution is treated as a dividend to USP and is therefore a foreign dividend amount (as defined in §1.861-20(b)). Country A imposes a withholding tax on USP of $150x with respect to the $1,000x of foreign gross dividend income that USP includes under Country A law. For Federal income tax purposes, USP does not recognize gross income as a result of the stock distribution under section 305(a). The $1,000x stock distribution is therefore a foreign law distribution.

(ii) *Analysis*—(A) *In general*. The rules of this section are applied by first determining the portion of the $150x Country A withholding tax that is attributable under paragraph (b)(1) of this section to the section 245A(d) income of USP, and then by determining the portion of the $150x Country A withholding tax that is described in paragraph (b)(2)(i) of this section and that is attributable under either paragraph (b)(2)(ii) or (b)(2)(iii) of this section to the non-inclusion income of CFC. No credit or deduction is allowed in any taxable year under paragraph (a)(1)(i) of this section for any portion of the $150x Country A withholding tax that is attributable to the section 245A(d) income of USP or, under paragraph (a)(1)(iii) of this section, for any portion of that tax that is attributable to the non-inclusion income of CFC, to the extent the tax is not disallowed under paragraph (a)(1)(i) of this section.

(B) *Attribution of foreign income taxes to section 245A(d) income*. Under paragraph (b)(1) of this section, the $150x Country A withholding tax is attributable to the section 245A(d) income of USP to the extent that it is allocated and apportioned to the section 245A(d) income group (the statutory grouping) under §1.861-20. Section 1.861-20(c) allocates and apportions foreign income tax to the statutory and residual groupings to which the items of foreign gross income that were included in the foreign tax base are assigned under §1.861-20(d). In general, §1.861-20(d) assigns foreign gross income to the statutory and residual groupings to which the corresponding U.S. item is assigned. If a taxpayer does not recognize a corresponding U.S. item in the year in which it pays or accrues foreign income tax with respect to foreign gross income that it includes by reason of a foreign law dividend, §1.861-20(d)(2)(ii)(B) assigns the foreign dividend amount to the same statutory or residual groupings to which the foreign dividend amount would be assigned if a distribution were made for Federal income tax purposes in the amount of, and on the date of, the foreign law distribution. Further, §1.861-20(d)(2)(ii)(B) computes the U.S. dividend amount (as defined in §1.861-20(b))

as if the distribution occurred on the date the distribution occurs for foreign law purposes. Therefore, the foreign dividend amount is assigned to the same statutory and residual groupings to which it would be assigned if a $1,000x distribution occurred on December 31, Year 1 for Federal income tax purposes. If such a distribution occurred, it would result in a $200x dividend to USP for which a deduction would be allowed under section 245A(a). The remaining $800x of the distribution would be excluded from USP's gross income and not treated as a dividend under section 959(a) and (d), respectively. Under paragraphs (c)(20) and (b)(1) of this section, the $1,000x U.S. dividend amount comprises a $200x dividend for which a deduction under section 245A(a) would be allowed, which is an item of section 245A(d) income, and $800x of section 951A PTEP, which is income in the residual grouping. Accordingly, $200x of the $1,000x foreign gross dividend income is assigned to the section 245A(d) income group, and $800x is assigned to the residual grouping. Under §1.861-20(f), $30x ($150x x $200x / $1,000x) of the Country A foreign income tax is apportioned to the section 245A(d) income group and is attributable to the section 245A(d) income of USP. The remaining $120x ($150x x $800x / $1,000x) of the tax is apportioned to the residual grouping.

(C) *Attribution of foreign income taxes to non-inclusion income*. Under paragraph (b)(2) of this section, the $150x Country A withholding tax may be attributed to non-inclusion income of CFC if the tax is allocated and apportioned under §1.861-20 by reference to either the characterization of the tax book value of stock under §1.861-9 or the income of a foreign corporation that is a reverse hybrid or foreign law CFC. CFC is neither a reverse hybrid nor a foreign law CFC. In addition, no portion of the $150x Country A withholding tax is allocated and apportioned under §1.861-20 by reference to the characterization of the tax book value of CFC's stock. See §1.861-20(d)(3)(i). Therefore, none of the tax is attributable to non-inclusion income of CFC.

(D) *Disallowance*. Under paragraph (a)(1)(i) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $30x portion of the Country A withholding tax that is attributable to section 245A(d) income of USP.

(4) *Example 3: Successive foreign law distributions subject to anti-avoidance rule*—(i) *Facts*. For Year 1, CFC earns $500x of subpart F income that gives rise to a $500x gross income inclusion to USP under section 951(a), and income that creates $500x of earnings and profits described in section 959(c)(3). CFC earns no income in Years 2 through 4. As of January 1, Year 2, and through December 31, Year 4, CFC has $500x of earnings and profits described in section 959(c)(3) and $500x of section 951(a)(1)(A) PTEP (as defined in §1.960-3(c)(2)(x)) in a single annual PTEP account (as defined in §1.960-3(c)(1))). In each of Years 2 and 3, USP makes a consent dividend election under Country A law that, for Country A tax purposes, deems CFC to distribute to USP, and USP immediately to contribute to CFC, $500x on December 31 of each year. For Country A tax purposes, each deemed distribution is a dividend of $500x to USP, and each deemed contribution is a non-taxable contribution of $500x to the capital of CFC. Each $500x deemed distribution is therefore a foreign dividend amount (as defined in §1.861-20(b)). Country A imposes $150x of withholding tax on USP in each of Years 2 and 3 with respect to the $500x of foreign gross dividend income that USP includes in income under Country A law. For Federal income tax purposes, the Country A deemed distributions in Years 2 and 3 are disregarded such that USP recognizes no income, and the deemed distributions are therefore foreign law distributions. On December 31, Year 4, CFC distributes $1,000x to USP, which for Country A tax purposes is treated as a return of contributed capital on which no withholding tax is imposed. For Federal income tax purposes, $500x of the $1,000x distribution is a dividend to USP for which a deduction under section 245A(a) is allowed; the remaining $500x of the distribution is a distribution of section 951(a)(1)(A) PTEP that is excluded from USP's gross income and not treated as a dividend under section 959(a) and (d), respectively. The entire $1,000x dividend is a U.S. dividend amount (as defined in §1.861-20(b)). The Country A consent dividend elections in Years 2 and 3 are made with a principal purpose of avoiding the purposes of section 245A(d) and this section to disallow a credit or deduction for Country A withholding tax incurred with respect to USP's section 245A(d) income.

(ii) *Analysis*—(A) *In general*. The rules of this section are applied by first determining the portion of the $150x Country A withholding tax paid by USP in each of Years 2 and 3 that is attributable under paragraph (b)(1) of this section to the section 245A(d) income of USP, and then by determining the portion of the $150x Country A withholding tax paid by USP in each of Years 2 and 3 that is described in paragraph (b)(2)(i) of this section and that is attributable under either paragraph (b)(2)(ii) or (b)(2)(iii) of this section to the non-inclusion income of CFC. Finally, the anti-avoidance rule under paragraph (b)(3) of this section applies to treat any portion of the $150x Country A withholding tax paid by USP in each of Years 2 and 3 as attributable to section 245A(d) income of USP or non-inclusion income of CFC, if a transaction, series of related transactions, or arrangement is undertaken with a principal purpose of avoiding the purposes of section 245A(d) and this section. No credit or deduction is allowed in any taxable year under paragraph (a)(1)(i) of this section for any portion of the $150x Country A withholding tax paid by USP in each of Years 2 and 3 that is attributable to the section 245A(d) income of USP or, under paragraph (a)(1)(iii) of this section, for any portion of that tax that is attributable to the non-inclusion income of CFC, to the extent the tax is not disallowed under paragraph (a)(1)(i) of this section.

(B) *Attribution of foreign income taxes to section 245A(d) income*. Under paragraph (b)(1) of this section, the $150x Country A withholding tax paid by USP in each of Years 2 and 3 is attributable to the section 245A(d) income of USP to the extent that it is allocated and apportioned to the section 245A(d) income group (the statutory grouping) under §1.861-20. Section 1.861-20(c) allocates and apportions foreign income tax to the statutory and residual groupings to which the items of foreign gross income that were included in the foreign tax base are assigned under §1.861-20(d). In general, §1.861-20(d) assigns foreign gross income to the statutory and residual groupings to which the corresponding U.S. item is assigned. If a taxpayer does not recognize a corresponding U.S. item in the year in which it pays or accrues foreign income tax with respect to foreign gross income that it includes by reason of a foreign law dividend, §1.861-20(d)(2)(ii)(B) assigns the foreign dividend amount to the same statutory or residual groupings to which the foreign dividend amount would be assigned if a distribution were made for Federal income tax purposes in the amount of, and on the date of, the foreign law distribution. Therefore, the $500x foreign dividend amount in each of Years 2 and 3 is assigned to the same statutory and residual groupings to which it would be assigned if a $500x distribution occurred on December 31 of each of those years for Federal income tax purposes.

(*1*) *Year 2 $500x deemed distribution*. CFC made no distributions in Year 1 and earned no income and made no distributions in Year 2 for Federal income tax purposes. As of December 31, Year 2, CFC has $500x of earnings and profits described in section 959(c)(3) and $500x of section 951(a)(1)(A) PTEP. If CFC distributed $500x on that date, the distribution would be a distribution of section 951(a)(1)(A) PTEP. A distribution of previously taxed earnings and profits is a U.S. dividend amount. Section 1.861-20(d)(3)(i) assigns the foreign dividend amount, to the extent of the U.S. dividend amount, to the statutory and residual groupings to which the U.S. dividend amount is assigned. The receipt of a distribution of previously taxed earnings and profits is assigned to the residual grouping under paragraph (b)(1) of this section. Therefore, all $500x foreign dividend amount would be assigned to the residual grouping, and none of the $150x withholding tax paid or accrued by USP in Year 2 would be treated as attributable to section 245A(d) income of USP.

(*2*) *Year 3 $500x deemed distribution*. CFC made no distributions in Year 1 and earned no income and made no distributions in Year 2 or Year 3 for Federal income tax purposes. Consequently, as of December 31, Year 3, CFC has $500x of earnings and profits described in section 959(c)(3) and $500x of section 951(a)(1)(A) PTEP. If CFC distributed $500x on that date, the distribution would be a distribution of section 951(a)(1)(A) PTEP. For the reasons described in paragraph (d)(4)(ii)(B)(*1*) of this section, all $500x of the foreign dividend amount would be assigned to the residual grouping, and none of the $150x withholding tax paid or accrued by USP in Year 2 would be treated as attributable to section 245A(d) income of USP.

(*3*) *Year 4 $1,000x distribution*. The Year 4 $1,000x distribution is, for Country A purposes, a return of capital distribution that is not subject to withholding tax. For Federal income tax purposes, it comprises a $500x dividend for which a deduction under section 245A(a) is allowed, which is an item of section 245A(d) income of USP, and a $500x distribution of section 951(a)(1)(A) PTEP, the receipt of which is income in the residual grouping.

(C) *Attribution of foreign income taxes to non-inclusion income*. Under paragraph (b)(2) of this section, the $150x Country A withholding tax paid by USP in each of Years 2 and 3 may be attributed to non-inclusion income of CFC if the tax is allocated and apportioned under §1.861-20 by reference to either the characterization of the tax book value of stock under §1.861-9 or the income of a foreign

corporation that is a reverse hybrid or foreign law CFC. CFC is neither a reverse hybrid nor a foreign law CFC. In addition, no portion of the Country A withholding tax is allocated and apportioned under §1.861-20 by reference to the characterization of the tax book value of CFC's stock. See §1.861-20(d)(3)(i). Therefore, none of the tax is attributable to non-inclusion income of CFC.

(D) *Attribution of foreign income taxes pursuant to anti-avoidance rule*. USP made two successive foreign law distributions in Years 2 and 3 that were subject to Country A withholding tax and that did not individually exceed, but together exceeded, the section 951(a)(1)(A) PTEP of CFC. The Country A withholding tax on each consent dividend is allocated to the residual grouping rather than to the statutory grouping of section 245A(d) income under §§1.861-20(d)(2)(ii) and 1.861-20(d)(3)(i). USP paid no Country A withholding tax on the Year 4 distribution as a result of the Country A consent dividends in Years 2 and 3. If CFC had distributed its earnings and profits in Year 4 without the prior consent dividends, the distribution would have been subject to withholding tax, a portion of which would have been attributable to the section 245A(d) income arising from the distribution. But for the application of the anti-avoidance rule in paragraph (b)(3) of this section, USP would avoid the disallowance under section 245A(d) with respect to this portion of the withholding tax. Because USP made foreign law distributions that caused withholding tax from multiple foreign law distributions to be associated with the same previously taxed earnings and profits with a principal purpose of avoiding the purposes of section 245A(d) and this section, the $150x Country A withholding tax paid by USP in each of Years 2 and 3 is treated as being attributable to section 245A(d) income of USP.

(E) *Disallowance*. Under paragraph (a)(1)(i) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $150x Country A withholding tax paid by USP in each of Years 2 and 3 that is attributable to section 245A(d) income of USP.

(5) *Example 4: Distribution that is in part a dividend and in part a return of capital*—(i) *Facts*. CFC uses the modified gross income method to allocate and apportion its interest expense, and its stock has a tax book value of $10,000x. For Year 1, CFC earns $500x of income that is specified foreign source general category gross income as that term is defined in §1.861-13(a)(1)(i)(A)(*9*) and is therefore neither tested income nor subpart F income of CFC. As of December 31, Year 1, CFC has $500x of earnings and profits described in section 959(c)(3). On that date, CFC distributes $1,000x of cash to USP. For Country A tax purposes, the entire $1,000x distribution is a dividend to USP and is therefore a foreign dividend amount (as defined in §1.861-20(b)). Country A imposes a withholding tax on USP of $150x with respect to the $1,000x of foreign gross dividend income that USP includes under the law of Country A. For Federal income tax purposes, USP includes $500x of the distribution in its gross income as a dividend for which a $500x deduction is allowed to USP under section 245A(a); the remaining $500x of the distribution is applied against and reduces USP's basis in its CFC stock under section 301(c)(2). The portion of the distribution that is a $500x dividend is a U.S. dividend amount (as defined in §1.861-20(b)). The remaining $500x of the distribution is a U.S. return of capital amount.

(ii) *Analysis*—(A) *In general*. The rules of this section are applied by first determining the portion of the $150x Country A withholding tax that is attributable under paragraph (b)(1) of this section to the section 245A(d) income of USP, and then by determining the portion of the $150x Country A withholding tax that is described in paragraph (b)(2)(i) of this section and that is attributable under either paragraph (b)(2)(ii) or (b)(2)(iii) of this section to the non-inclusion income of CFC. No credit or deduction is allowed under paragraph (a)(1)(i) of this section for any portion of the $150x Country A withholding tax that is attributable to the section 245A(d) income of USP or, under paragraph (a)(1)(iii) of this section, for any portion of that tax that is attributable to the non-inclusion income of CFC, to the extent the tax is not disallowed under paragraph (a)(1)(i) of this section.

(B) *Attribution of foreign income taxes to section 245A(d) income*. Under paragraph (b)(1) of this section, the $150x Country A withholding tax is attributable to the section 245A(d) income of USP to the extent that it is allocated and apportioned to the section 245A(d) income group (the statutory grouping) under §1.861-20. Section 1.861-20(c) allocates and apportions foreign income tax to the statutory and residual groupings to which the items of foreign gross income that were included in the foreign tax base are assigned under §1.861-20(d). Section 1.861-20(d)(3)(i) assigns foreign gross income that is a foreign dividend amount, to the extent of the U.S. dividend amount, to the statutory and residual groupings to which the U.S. dividend amount is assigned. Of the $1,000x foreign dividend amount, $500x is therefore assigned to the statutory and residual groupings to which the $500x U.S. dividend amount is assigned under Federal income tax law. The entire $500x U.S. dividend amount is a dividend for which a section 245A(a) deduction is allowed and is therefore section 245A(d) income that is assigned to the section 245A(d) income group. Accordingly, $500x of the foreign dividend amount is assigned to the section 245A(d) income group. Under §1.861-20(f), $75x ($150x x $500x / $1,000x) of the Country A withholding tax is allocated to the section 245A(d) income group and so under paragraph (b)(1) of this section is attributable to the section 245A(d) income of USP.

(C) *Attribution of foreign income taxes to non-inclusion income*. The remaining $75x of the Country A withholding tax is described in paragraph (b)(2)(i) of this section because the $500x of foreign dividend amount that corresponds to the $500x U.S. return of capital amount is assigned, and the remaining withholding tax imposed on that foreign dividend amount is allocated and apportioned, by reference to the characterization of the tax book value of the stock of CFC. Under paragraph (b)(2)(ii) of this section, the remaining $75x Country A withholding tax is attributable to non-inclusion income of CFC to the extent that the tax is allocated and apportioned under §1.861-20 to USP's section 245A subgroup of general category stock, section 245A subgroup of passive category stock, and section 245A subgroup of U.S. source category stock (the statutory groupings) for purposes of section 904 as the operative section. Under §1.861-20(d)(3)(i), the $500x portion of the foreign dividend amount that corresponds to the $500x U.S. return of capital amount is assigned to the statutory and residual groupings to which $500x of earnings of CFC would be assigned if CFC recognized them in Year 1. Those earnings are deemed to arise in the statutory and residual groupings in the same proportions as the proportions of the tax book value of CFC's stock in the groupings for Year 1 for purposes of applying the asset method of expense allocation and apportionment under §1.861-9. Under §1.861-9, §1.861-9T(f), and §1.861-13, for purposes of section 904 as the operative section, all of the tax book value of the stock of CFC is assigned to USP's section 245A subgroup of general category stock because CFC uses the modified gross income method to allocate and apportion its interest expense and earns only specified foreign source general category gross income for Year 1. Under §1.861-20(d)(3)(i), if CFC recognized $500x of earnings in Year 1 these earnings would be deemed to arise in the section 245A subgroup of general category stock. Accordingly, the remaining $500x of foreign dividend amount is assigned to USP's section 245A subgroup of general category stock. Under §1.861-20(f), the remaining $75x of withholding tax is allocated to the section 245A subgroup and, under paragraph (b)(2)(ii) of this section, is attributable to the non-inclusion income of CFC.

(D) *Disallowance*. Under paragraph (a)(1)(i) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $75x portion of the Country A withholding tax that is attributable to section 245A(d) income of USP. Under paragraph (a)(1)(iii) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $75x portion of the Country A withholding tax that is attributable to non-inclusion income of CFC.

(6) *Example 5: Income of a reverse hybrid*—(i) *Facts*. CFC is a reverse hybrid. In Year 1, CFC earns a $500x item of services income that is non-inclusion income. CFC also earns for Federal income tax purposes and Country A tax purposes a $1,000x item of royalty income, of which $500x is gross included tested income and $500x is non-inclusion income. USP includes the $500x item of foreign gross services income and the $1,000x item of foreign gross royalty income in its Country A taxable income, and the items are foreign law pass-through income. If CFC included these items under Country A tax law, its $1,000x of royalty income for Federal income tax purposes would be the corresponding U.S. item for the foreign gross royalty income, and its $500x of services income for Federal income tax purposes would be the corresponding U.S. item for the foreign gross services income. Country A imposes a $150x foreign income tax on USP with respect to $1,500x of foreign gross income.

(ii) *Analysis*—(A) *In general*. The rules of this section are applied by first determining the portion of the $150x Country A tax that is attributable under paragraph (b)(1) of this section to the section 245A(d) income of USP, and then by determining the portion of the $150x Country A tax that is described in paragraph (b)(2)(i) of this section and that is at-

tributable under either paragraph (b)(2)(ii) or (iii) of this section to the non-inclusion income of CFC. No credit or deduction is allowed under paragraph (a)(1)(i) of this section for any portion of the $150x Country A tax that is attributable to the section 245A(d) income of USP or, under paragraph (a)(1)(iii) of this section, for any portion of that tax that is attributable to the non-inclusion income of CFC, to the extent the tax is not disallowed under paragraph (a)(1)(i) of this section.

(B) *Attribution of foreign income taxes to section 245A(d) income*. Under paragraph (b)(1) of this section, the $150x Country A tax is attributable to section 245A(d) income to the extent the tax is allocated and apportioned to the section 245A(d) income group (the statutory grouping) under §1.861-20. Section 1.861-20(c) allocates and apportions foreign income tax to the statutory and residual groupings to which the items of foreign gross income that were included in the foreign tax base are assigned under §1.861-20(d). In general, §1.861-20(d) assigns foreign gross income to the statutory and residual groupings to which the corresponding U.S. item is assigned. Section 1.861-20(d)(3)(i)(C) assigns the foreign law pass-through income that USP includes by reason of its ownership of CFC to the statutory and residual groupings by treating USP's foreign law pass-through income as foreign gross income of CFC, and by treating CFC as paying the $150x of Country A tax in CFC's U.S. taxable year within which its foreign taxable year ends (Year 1). CFC is therefore treated as including a $1,000x foreign gross royalty item and a $500x foreign gross services income item and paying $150x of Country A tax in Year 1. These foreign gross income items are assigned to the statutory and residual groupings to which the corresponding U.S. items are assigned under Federal income tax law. No foreign gross income is assigned to the section 245A(d) income group because neither the corresponding U.S. item of royalty income nor the corresponding U.S. item of services income is assigned to the section 245A(d) income group. Therefore, none of USP's Country A tax is allocated to the section 245A(d) income group.

(C) *Attribution of foreign income taxes to non-inclusion income*. The $150x Country A tax is described in paragraph (b)(2) of this section because USP is a United States shareholder of CFC, CFC is a reverse hybrid, and §1.861-20(d)(3)(i)(C) allocates and apportions the tax by reference to the income of CFC. Under paragraph (b)(2)(iii) of this section, the $150x Country A tax is attributable to the non-inclusion income of CFC to the extent that the foreign income taxes are allocated and apportioned to the non-inclusion income group under §1.861-20. For the reasons described in paragraph (d)(6)(ii)(B) of this section, under §1.861-20(d)(3)(i)(C) CFC is treated as including a $1,000x foreign gross royalty item and a $500x foreign gross services income item and paying $150x of Country A tax in Year 1. These foreign gross income items are assigned to the statutory and residual groupings to which the corresponding U.S. items are assigned under Federal income tax law. For Federal income tax purposes, the $500x item of services income and $500x of the $1,000x item of royalty income are items of non-inclusion income that are therefore assigned to the non-inclusion income group. The remaining $500x of the foreign gross royalty income item is assigned to the residual grouping. Under §1.861-20(f), $100x ($150x x $1,000x / $1,500x) of the Country A tax is apportioned to the non-inclusion income group, and $50x ($150x x $500x / $1,500x) is apportioned to the residual grouping. Under paragraph (b)(2)(iii) of this section, the $100x of Country A tax that is apportioned to the non-inclusion income group under §1.861-20(d)(3)(i)(C) is attributable to non-inclusion income of CFC.

(D) *Disallowance*. Under paragraph (a)(1)(iii) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $100x of Country A foreign income tax that is attributable to non-inclusion income of CFC.

(e) *Applicability date*. This section applies to taxable years of a foreign corporation that begin after December 31, 2019, and end on or after November 2, 2020, and with respect to a United States person, taxable years in which or with which such taxable years of the foreign corporation end.

§1.245A(e)-1 [AMENDED]

Par. 4. Section 1.245A(e)-1 is amended by adding the language "and §1.245A(d)-1" after the language "rules of section 245A(d)" in paragraphs (b)(1)(ii), (c)(1)(iii), (g)(1)(ii) introductory text, (g)(1)(iii) introductory text, and (g)(2)(ii) introductory text.

Par. 5. Section 1.250(b)-1 is amended by adding two sentences to the end of paragraph (c)(7) to read as follows:

§1.250(b)-1 Computation of foreign-derived intangible income (FDII).

* * * * *

(c) * * *

(7) * * * A taxpayer must use a consistent method to determine the amount of its domestic oil and gas extraction income ("DOGEI") and its foreign oil and gas extraction income ("FOGEI") from the sale of oil or gas that has been transported or processed. For example, a taxpayer must use a consistent method to determine the amount of FOGEI from the sale of gasoline from foreign crude oil sources in computing the exclusion from gross tested income under §1.951A-2(c)(1)(v) and the amount of DOGEI from the sale of gasoline from domestic crude oil sources in computing its section 250 deduction.

* * * * *

Par. 6. Section 1.250(b)-5 is amended by revising paragraph (c)(5) to read as follows:

§1.250(b)-5 Foreign-derived deduction eligible income (FDDEI) services.

* * * * *

(c) * * *

(5) *Electronically supplied service*. The term *electronically supplied service* means, with respect to a general service other than an advertising service, a service that is delivered primarily over the internet or an electronic network and for which value of the service to the end user is derived primarily from automation or electronic delivery. Electronically supplied services include the provision of access to digital content (as defined in §1.250(b)-3), such as streaming content; on-demand network access to computing resources, such as networks, servers, storage, and software; the provision or support of a business or personal presence on a network, such as a website or a webpage; online intermediation platform services; services automatically generated from a computer via the internet or other network in response to data input by the recipient; and similar services. Electronically supplied services do not include services that primarily involve the application of human effort by the renderer (not considering the human effort involved in the development or maintenance of the technology enabling the electronically supplied services). Accordingly, electronically supplied services do not include certain services (such as legal, accounting, medical, or teaching services) involving primarily human effort that are provided electronically.

* * * * *

Par. 7. Section 1.336-2 is amended by:

1. Revising the paragraph (g)(3)(ii) heading.

2. In paragraph (g)(3)(ii)(A):

a. Revising the first sentence; and

b. In the second sentence, removing the language "foreign tax" and adding in its place the language "foreign income tax".

3. Revising paragraphs (g)(3)(ii)(B) and (g)(3)(iii).

4. Removing both occurrences of paragraph (h) at the end of the section.

The revisions read as follows:

§1.336-2 Availability, mechanics, and consequences of section 336(e) election.

* * * * *

(g) * * *

(3) * * *

(ii) *Allocation of foreign income taxes*—(A) * * * Except as provided in paragraph (g)(3)(ii)(B) of this section, if a section 336(e) election is made for target and target's taxable year under foreign law (if any) does not close at the end of the disposition date, foreign income tax as defined in §1.960-1(b) (other than a withholding tax as defined in section 901(k)(1)(B)) paid or accrued by new target with respect to such foreign taxable year is allocated between old target and new target. * * *

(B) *Foreign income taxes imposed on partnerships and disregarded entities.* If a section 336(e) election is made for target and target holds an interest in a disregarded entity (as described in §301.7701-2(c)(2)(i) of this chapter) or partnership, the rules of §1.901-2(f)(4) and (5) apply to determine the person who is considered for Federal income tax purposes to pay foreign income tax imposed at the entity level on the income of the disregarded entity or partnership.

(iii) *Disallowance of foreign tax credits under section 901(m)*. For rules that may apply to disallow foreign tax credits by reason of a section 336(e) election, see section 901(m) and §§1.901(m)-1 through 1.901(m)-8.

* * * * *

Par. 8. Section 1.336-5 is revised to read as follows:

§1.336-5 Applicability dates.

Except as otherwise provided in this section, the provisions of §§1.336-1 through 1.336-4 apply to any qualified stock disposition for which the disposition date is on or after May 15, 2013. The provisions of §1.336-1(b)(5)(i)(A) relating to section 1022 apply on and after January 19, 2017. The provisions of §1.336-2(g)(3)(ii) and (iii) apply to foreign income taxes paid or accrued in taxable years beginning on or after December 28, 2021.

Par. 9. Section 1.338-9 is amended by revising paragraph (d) to read as follows:

§1.338-9 International aspects of section 338.

* * * * *

(d) *Allocation of foreign income taxes*—(1) *In general*. Except as provided in paragraph (d)(3) of this section, if a section 338 election is made for target (whether foreign or domestic), and target's taxable year under foreign law (if any) does not close at the end of the acquisition date, foreign income tax as defined in §1.901-2(a)(1) (other than a withholding tax as defined in section 901(k)(1)(B)) paid or accrued by new target with respect to such foreign taxable year is allocated between old target and new target. If there is more than one section 338 election with respect to target during target's foreign taxable year, foreign income tax paid or accrued with respect to that foreign taxable year is allocated among all old targets and new targets. The allocation is made based on the respective portions of the taxable income (as determined under foreign law) for the foreign taxable year that are attributable under the principles of §1.1502-76(b) to the period of existence of each old target and new target during the foreign taxable year.

(2) *Foreign income taxes imposed on partnerships and disregarded entities*. If a section 338 election is made for target and target holds an interest in a disregarded entity (as described in §301.7701-2(c)(2)(i) of this chapter) or partnership, the rules of §1.901-2(f)(4) and (5) apply to determine the person who is considered for Federal income tax purposes to pay foreign income tax imposed at the entity level on the income of the disregarded entity or partnership.

(3) *Disallowance of foreign tax credits under section 901(m)*. For rules that may apply to disallow foreign tax credits by reason of a section 338 election, see section 901(m) and §§1.901(m)-1 through 1.901(m)-8.

(4) *Applicability date*. This paragraph (d) applies to foreign income taxes paid or accrued in taxable years beginning on or after December 28, 2021.

* * * * *

§1.367(b)-2 [Amended]

Par. 10. Section 1.367(b)-2 is amended by removing the last sentence of paragraph (e)(4) *Example 1*.

§1.367(b)-3 [Amended]

Par. 11. Section 1.367(b)-3 is amended:

1. In paragraph (b)(3)(ii), by removing the last sentence of paragraph (ii) of *Example 1* and paragraph (ii) of *Example 2*.

2. In paragraph (c)(5), by removing the last sentence of paragraph (iii) of *Example 1*.

Par. 12. Section 1.367(b)-4 is amended:

1. By revising paragraph (b)(2)(i)(B).

2. By adding a sentence to the end of paragraph (h).

The revision and addition read as follows:

§1.367(b)-4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.

* * * * *

(b) * * *

(2) * * *

(i) * * *

(B) Immediately after the exchange, a domestic corporation directly or indirectly owns 10 percent or more of the voting power or value of the transferee foreign corporation; and

* * * * *

(h) * * * Paragraph (b)(2)(i)(B) of this section applies to exchanges completed in taxable years of exchanging shareholders ending on or after November 2, 2020, and to taxable years of exchanging shareholders ending before November 2, 2020 resulting from an entity classification election made under §301.7701-3 of this chapter that was effective on or before November 2, 2020 but was filed on or after November 2, 2020.

Par. 13. Section 1.367(b)-7 is amended:

1. By adding a sentence to the end of paragraph (b)(1).

2. By revising paragraph (g).

3. By adding paragraph (h).

The revision and additions read as follows:

§1.367(b)-7 Carryover of earnings and profits and foreign income taxes in certain foreign-to-foreign nonrecognition transactions.

* * * * *

(b) * * *

(1) * * * See paragraph (g) of this section for rules applicable to taxable years of foreign corporations beginning on or after January 1, 2018, and taxable years of United States shareholders in which or with which such taxable years of foreign corporations end ("post-2017 taxable years").

* * * * *

(g) *Post-2017 taxable years*. As a result of the repeal of section 902 effective for taxable years of foreign corporations beginning on or after January 1, 2018, all foreign target corporations, foreign acquiring corporations, and foreign surviving corporations are treated as nonpooling corporations in post-2017 taxable years. Any amounts remaining in post-1986 undistributed earnings and post-1986 foreign income taxes of any such corporation in any separate category as of the end of the foreign corporation's last taxable year beginning before January 1, 2018, are treated as earnings and taxes in a single pre-pooling annual layer in the foreign corporation's post-2017 taxable years for purposes of this section. Foreign income taxes that are related to non-previously taxed earnings of a foreign acquiring corporation and a foreign target corporation that were accumulated in taxable years before the current taxable year of the foreign corporation, or in a foreign target's taxable year that ends on the date of the section 381 transaction, are not treated as current year taxes (as defined in §1.960-1(b)(4)) of a foreign surviving corporation in any post-2017 taxable year. In addition, foreign income taxes that are related to a hovering deficit are not treated as current year taxes of the foreign surviving corporation in any post-2017 taxable year, regardless of whether the hovering deficit is absorbed.

(h) *Applicability dates*. Except as otherwise provided in this paragraph (h), this section applies to foreign section 381 transactions that occur on or after November 6, 2006. Paragraph (g) of this section applies to taxable years of foreign corporations ending on or after November 2, 2020, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

Par. 14. Section 1.367(b)-10 is amended:

1. In paragraph (c)(1), by removing the language "sections 902 or" and adding in its place the language "section".

2. In paragraph (e), by revising the heading and adding a sentence to the end of the paragraph.

The revision and addition read as follows:

§1.367(b)-10 Acquisition of parent stock or securities for property in triangular reorganizations.

* * * * *

(e) *Applicability dates*. * * * Paragraph (c)(1) of this section applies to deemed distributions that occur in taxable years ending on or after November 2, 2020.

§1.461-1 [AMENDED]

Par. 15. Section 1.461-1 is amended by removing the language "paragraph (b)" and adding in its place the language "paragraph (g)" in the last sentence of paragraph (a)(4).

Par. 16. Section 1.861-3 is amended:

1. By revising the section heading.

2. By redesignating paragraph (d) as paragraph (e).

3. By adding a new paragraph (d).

4. In newly redesignated paragraph (e):

i. By revising the heading.

ii. By removing "this paragraph" and adding "this paragraph (e)," in its place.

iii. By adding a sentence to the end of the paragraph.

The revisions and additions read as follows:

§1.861-3 Dividends and income inclusions under sections 951, 951A, and 1293 and associated section 78 dividends.

* * * * *

(d) *Source of income inclusions under sections 951, 951A, and 1293 and associated section 78 dividends*. For purposes of sections 861 and 862 and §§1.861-1 and 1.862-1, and for purposes of applying this section, the amount included in gross income of a United States person under sections 951, 951A, and 1293 and the associated section 78 dividend for the taxable year with respect to a foreign corporation are treated as dividends received directly by the United States person from the foreign corporation that generated the inclusion. See section 904(h) and §1.904-5(m) for rules concerning the resourcing of inclusions under sections 951, 951A, and 1293.

(e) *Applicability dates*. * * * Paragraph (d) of this section applies to taxable years ending on or after November 2, 2020.

Par. 17. Section 1.861-8 is amended:

1. By removing the language "and example (17) of paragraph (g) of this section" from the third sentence of paragraph (b)(2).

2. By revising paragraph (e)(4)(i).

3. By adding paragraph (h)(4).

The revision and addition read as follows:

§1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(e) * * *

(4) * * *

(i) *Expenses attributable to controlled services*. If a taxpayer performs a controlled services transaction (as defined in §1.482-9(l)(1)), which includes any activity by one member of a group of controlled taxpayers (the renderer) that results in a benefit to a controlled taxpayer (the recipient), and the renderer charges the recipient for such services, section 482 and §1.482-1 provide for an allocation where the charge is not consistent with an arm's length result. The deductions for expenses incurred by the renderer in performing such services are considered definitely related to the amounts so charged and are to be allocated to such amounts.

* * * * *

(h) * * *

(4) Paragraph (e)(4)(i) of this section applies to taxable years ending on or after November 2, 2020.

Par. 18. Section 1.861-9 is amended by adding a sentence to the end of paragraph (g)(3) and revising paragraph (k) to read as follows:

§1.861-9 Allocation and apportionment of interest expense and rules for asset-based apportionment.

* * * * *

(g) * * *

(3) * * * In applying §1.861-9T(g)(3), for purposes of applying section 904 as the operative section, the statutory or residual grouping of income that assets generate, have generated, or may reasonably be expected to generate is determined after taking into account any reallocation of income required under §1.904-4(f)(2)(vi).

* * * * *

(k) *Applicability dates*. (1) Except as provided in paragraphs (k)(2) and (3) of this section, this section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

(2) Paragraphs (b)(1)(i), (b)(8), and (e)(9) of this section apply to taxable years that end on or after December 16, 2019. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and also end before December 16, 2019, see §1.861-9T(b)(1)(i) as contained in 26 CFR part 1 revised as of April 1, 2019.

(3) The last sentence of paragraph (g)(3) of this section applies to taxable years beginning on or after December 28, 2021.

Par. 19. Section 1.861-10 is amended:

1. By adding paragraph (a).

2. By revising paragraphs (e)(8)(v) and (f).

3. By adding paragraphs (g) and (h).

The additions and revisions read as follows:

§1.861-10 Special allocations of interest expense.

(a) *In general*. This section applies to all taxpayers and provides exceptions to the rules of §1.861-9 that require the allocation and apportionment of interest expense based on all assets of all members of the affiliated group. Section 1.861-10T(b) provides rules for the direct allocation of interest expense to the income generated by certain assets that are subject to qualified nonrecourse indebtedness. Section 1.861-10T(c) provides rules for the direct allocation of interest expense to income generated by certain assets that are acquired in an integrated financial transaction. Section 1.861-10T(d) provides special rules that apply to all transactions described in §1.861-10T(b) and (c). Paragraph (e) of this section requires the direct allocation of third-party interest expense of an affiliated group to such group's investments in related controlled foreign corporations in cases involving excess related person indebtedness (as defined therein). See also §1.861-9T(b)(5), which requires the direct allocation of amortizable bond premium. Paragraph (f) of this section provides a special rule for certain regulated utility companies. Paragraph (g) of this section is reserved. Paragraph (h) of this section sets forth applicability dates.

* * * * *

(e) * * *

(8) * * *

(v) *Classification of loans between controlled foreign corporations*. In determining the amount of related group indebtedness for any taxable year, loans outstanding from one controlled foreign corporation to a related controlled foreign corporation are not treated as related group indebtedness. For purposes of determining the foreign base period ratio under paragraph (e)(2)(iv) of this section for a taxable year that ends on or after November 2, 2020, the rules of this paragraph (e)(8)(v) apply to determine the related group debt-to-asset ratio in each taxable year included in the foreign base period, including in taxable years that end before November 2, 2020.

* * * * *

(f) *Indebtedness of certain regulated utilities*. If an automatically exempted regulated utility trade or business (as defined in §1.163(j)-1(b)(15)(i)(A)) has qualified nonrecourse indebtedness within the meaning of the second sentence in §1.163(j)-10(d)(2), interest expense from the indebtedness is directly allocated to the taxpayer's assets in the manner and to the extent provided in §1.861-10T(b).

(g) [Reserved]

(h) *Applicability dates*. Except as provided in this paragraph (h), this section applies to taxable years ending on or after December 4, 2018. Paragraph (e)(8)(v) of this section applies to taxable years ending on or after November 2, 2020, and paragraph (f) of this section applies to taxable years beginning on or after December 28, 2021.

§1.861-13(a) [AMENDED]

Par. 20. Section 1.861-13(a) is amended by removing the language "section 904," and adding the language "sections 245A and 904," in its place.

Par. 21. Section 1.861-14 is amended by revising paragraphs (h) and (k) to read as follows:

§1.861-14 Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations.

* * * * *

(h) *Special rule for the allocation and apportionment of section 818(f)(1) items of a life insurance company*—(1) *In general*. Except as provided in paragraph (h)(2) of this section, life insurance company items specified in section 818(f)(1) ("section 818(f)(1) items") are allocated and apportioned as if all members of the life subgroup (as defined in §1.1502-47(b)(8)) were a single corporation ("life subgroup method"). See also §1.861-8(e)(16) for rules on the allocation of reserve expenses with respect to dividends received by a life insurance company.

(2) *Alternative separate entity treatment*. A consolidated group may choose not to apply the life subgroup method and may instead allocate and apportion section 818(f)(1) items solely among items of the life insurance company that generated the section 818(f)(1) items ("separate entity method"). A consolidated group indicates its choice to apply the separate entity method by applying this paragraph (h)(2) for purposes of the allocation and apportionment of section 818(f)(1) items on its Federal income tax return filed for its first taxable year to which this section applies. A consolidated group's use of the separate entity method constitutes a binding choice to use the method chosen for that year for all members of the consolidated group and all taxable years of such members thereafter. The choice to use the separate entity method may not be revoked without the prior consent of the Commissioner.

* * * * *

(k) *Applicability dates*. Except as provided in this paragraph (k), this section applies to taxable years beginning after December 31, 2019. Paragraph (h) of this section applies to taxable years beginning on or after December 28, 2021.

Par. 22. Section 1.861-20 is amended:

1. In paragraph (b)(4), by removing the language "301(c)(3)(A)" and adding in its place the language "301(c)(3)(A) or section 731(a)".

2. By revising paragraph (b)(7).

3. By redesignating the paragraphs in the first column as the paragraphs in the second column:

Old paragraph	New paragraph
(b)(17)	(b)(18)
(b)(18)	(b)(19)
(b)(19)	(b)(20)
(b)(20)	(b)(21)
(b)(21)	(b)(23)
(b)(22)	(b)(24)
(b)(23)	(b)(25)
(b)(24)	(b)(26)

4. By adding new paragraph (b)(17).

5. By revising newly-redesignated paragraph (b)(20).

6. By adding new paragraph (b)(22).

7. By revising newly-redesignated paragraph (b)(25).

8. By revising the first and second sentences in paragraph (c) introductory text.

9. In paragraph (d)(2)(ii)(B), by adding the language ", and paragraph (d)(3)(ii)(B) of this section for rules regarding the assignment of foreign gross income arising from a distribution by a partnership" at the end of the paragraph.

10. By adding paragraph (d)(2)(ii)(D).

11. In paragraph (d)(3)(i)(A), by removing the language "foreign and Federal income tax law or an inclusion of foreign law pass-through income" and adding the language "foreign law and Federal income tax law, an inclusion of foreign law pass-through income, or a disposition under both foreign law and Federal income tax law" in its place.

12. In the first sentence of paragraph (d)(3)(i)(B)(*2*), by removing the language "from which a distribution of the U.S. dividend amount is made" and adding the language "to which a distribution of the U.S. dividend amount is assigned" in its place.

13. In the second sentence of paragraph (d)(3)(i)(B)(*2*), by removing the language "to which earnings equal to the U.S. return of capital amount" and adding the language "to which earnings of the distributing corporation" in its place.

14. By adding paragraphs (d)(3)(i)(D), (d)(3)(ii), (v) and (vi), (g)(10) through (14), and (h).

15. By revising paragraph (i).

The additions and revisions read as follows:

§1.861-20 Allocation and apportionment of foreign income taxes.

* * * * *

(b) * * *

(7) *Foreign income tax*. The term *foreign income tax* has the meaning provided in §1.901-2(a).

* * * * *

(17) *Previously taxed earnings and profits*. The term *previously taxed earnings and profits* has the meaning provided in §1.960-1(b).

* * * * *

(20) *U.S. capital gain amount*. The term *U.S. capital gain amount* means gain recognized by a taxpayer on the sale, exchange, or other disposition of stock or an interest in a partnership or, in the case of a distribution with respect to stock or a partnership interest, the portion of the distribution to which section 301(c)(3)(A) or 731(a)(1), respectively, applies. A U.S. capital gain amount includes gain that is subject to section 751 and §1.751-1, but does not include the portion of any gain recognized by a taxpayer that is included in gross income as a dividend under section 964(e) or 1248.

* * * * *

(22) *U.S. equity hybrid instrument*. The term *U.S. equity hybrid instrument* means an instrument that is treated as stock or a partnership interest for Federal income tax purposes but for foreign income tax purposes is treated as indebtedness or otherwise gives rise to the accrual of income to the holder with respect to such instrument that is not characterized as a dividend or distributive share of partnership income for foreign tax law purposes.

* * * * *

(25) *U.S. return of capital amount*. The term *U.S. return of capital amount* means, in the case of the sale, exchange, or other disposition of stock, the taxpayer's adjusted basis of the stock, or in the case of a distribution with respect to stock, the portion of the distribution to which section 301(c)(2) applies.

* * * * *

(c) * * * A foreign income tax (other than certain in lieu of taxes described in paragraph (h) of this section) is allocated and apportioned to the statutory and residual groupings that include the items of foreign gross income included in the base on which the tax is imposed. Each such foreign income tax (that is, each separate levy) is allocated and apportioned separately under the rules in paragraphs (c) through (f) of this section. * * *

* * * * *

(d) * * *

(2) * * *

(ii) * * *

(D) *Foreign law transfers between taxable units*. This paragraph (d)(2)(ii) applies to an item of foreign gross income arising from an event that foreign law treats as a transfer of property, or as giving rise to an item of accrued income, gain, deduction, or loss with respect to a transaction, between taxable units (as defined in paragraph (d)(3)(v)(E) of this section) of the same taxpayer, and that would be treated as a disregarded payment (as defined in paragraph (d)(3)(v)(E) of this section) if the transfer of property occurred, or the item accrued, for Federal income tax purposes in the same U.S. taxable year in which the foreign income tax is paid or accrued. An item of foreign gross income to which this paragraph (d)(2)(ii) applies is characterized and assigned to the grouping to which a disregarded payment in the amount of the item of foreign gross income (or the gross receipts giving rise to the item of foreign gross income) would be assigned under the rules of paragraph (d)(3)(v) of this section if the event giving rise to the foreign gross income resulted in a disregarded payment in the U.S. taxable year in which the foreign income tax is paid or accrued. For example, an item of foreign gross income that a taxpayer recognizes by reason of a foreign law distribution (such as a stock dividend or a consent dividend) from a disregarded entity is assigned to the same statutory or residual groupings to which the foreign gross income would be assigned if a distribution of property in the amount of the taxable distribution under foreign law were made for Federal income tax purposes on the

date on which the foreign law distribution occurred.

* * * * *

(3) * * *

(i) * * *

(D) *Foreign gross income items arising from a disposition of stock*. An item of foreign gross income that arises from a transaction that is treated as a sale, exchange, or other disposition for both foreign law and Federal income tax purposes of an interest that is stock in a corporation for Federal income tax purposes is assigned first, to the extent of any U.S. dividend amount that results from the disposition, to the same statutory or residual grouping (or ratably to the groupings) to which the U.S. dividend amount is assigned under Federal income tax law. If the foreign gross income item exceeds the U.S. dividend amount, the foreign gross income item is next assigned, to the extent of the U.S. capital gain amount, to the statutory or residual grouping (or ratably to the groupings) to which the U.S. capital gain amount is assigned under Federal income tax law. Any excess of the foreign gross income item over the sum of the U.S. dividend amount and the U.S. capital gain amount is assigned to the same statutory or residual grouping (or ratably to the groupings) to which earnings equal to such excess amount would be assigned if they were recognized for Federal income tax purposes in the U.S. taxable year in which the disposition occurred. These earnings are deemed to arise in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the stock is (or would be if the taxpayer were a United States person) assigned to the groupings under the asset method in §1.861-9 in the U.S. taxable year in which the disposition occurs. See paragraph (g)(10) of this section (*Example 9*).

(ii) *Items of foreign gross income included by a taxpayer by reason of its ownership of an interest in a partnership*—(A) *Scope*. The rules of this paragraph (d)(3)(ii) apply to assign to a statutory or residual grouping certain items of foreign gross income that a taxpayer includes in foreign taxable income by reason of its ownership of an interest in a partnership. See paragraphs (d)(1) and (2) of this section for rules that apply in characterizing items of foreign gross income that are attributable to a partner's distributive share of income of a partnership. See paragraph (d)(3)(iii) of this section for rules that apply in characterizing items of foreign gross income that are attributable to an inclusion under a foreign law inclusion regime.

(B) *Foreign gross income items arising from a distribution with respect to an interest in a partnership*. If a partnership makes a distribution that is treated as a distribution of property for both foreign law and Federal income tax purposes, any foreign gross income item arising from the distribution (including foreign gross income attributable to a distribution from a partnership that foreign law classifies as a dividend from a corporation) is, to the extent of the U.S. capital gain amount arising from the distribution, assigned to the statutory and residual groupings to which the U.S. capital gain amount is assigned under Federal income tax law. If the foreign gross income item arising from the distribution exceeds the U.S. capital gain amount, such excess amount is assigned to the statutory and residual groupings to which a distributive share of income of the partnership in the amount of such excess would be assigned if such income were recognized for Federal income tax purposes in the U.S. taxable year in which the distribution is made. The items constituting this distributive share of income are deemed to arise in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the partnership interest or the partner's pro rata share of the partnership assets, as applicable, is assigned (or would be assigned if the partner were a United States person) for purposes of apportioning the partner's interest expense under §1.861-9(e) in the U.S. taxable year in which the distribution is made.

(C) *Foreign gross income items arising from the disposition of an interest in a partnership*. An item of foreign gross income arising from a transaction that is treated as a sale, exchange, or other disposition for both foreign law and Federal income tax purposes of an interest that is an interest in a partnership for Federal income tax purposes is assigned first, to the extent of the U.S. capital gain amount arising from the disposition, to the statutory or residual grouping (or ratably to the groupings) to which the U.S. capital gain amount is assigned. If the foreign gross income item arising from the disposition exceeds the U.S. capital gain amount, such excess amount is assigned to the statutory and residual grouping (or ratably to the groupings) to which a distributive share of income of the partnership in the amount of such excess would be assigned if such income were recognized for Federal income tax purposes in the U.S. taxable year in which the disposition occurred. The items constituting this distributive share of income are deemed to arise in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the partnership interest, or the partner's pro rata share of the partnership assets, as applicable, is assigned (or would be assigned if the partner were a United States person) for purposes of apportioning the partner's interest expense under §1.861-9(e) in the U.S. taxable year in which the disposition occurred.

* * * * *

(v) *Disregarded payments*—(A) *In general*. This paragraph (d)(3)(v) applies to assign to a statutory or residual grouping a foreign gross income item that a taxpayer includes by reason of the receipt of a disregarded payment. In the case of a taxpayer that is an individual or a domestic corporation, this paragraph (d)(3)(v) applies to a disregarded payment made between a taxable unit that is a foreign branch, a foreign branch owner, or a non-branch taxable unit, and another such taxable unit of the same taxpayer. In the case of a taxpayer that is a foreign corporation, this paragraph (d)(3)(v) applies to a disregarded payment made between taxable units that are tested units of the same taxpayer. For purposes of this paragraph (d)(3)(v), an individual or corporation is treated as the taxpayer with respect to its distributive share of foreign income taxes paid or accrued by a partnership, estate, trust or other pass-through entity. The rules of paragraph (d)(3)(v)(B) of this section apply to attribute U.S. gross income comprising the portion of a disregarded payment that is a reattribution payment to a taxable unit, and to associate the foreign gross income item arising from the receipt of the reattribution payment with the statutory and residual groupings to which that U.S. gross income is assigned. The rules

of paragraph (d)(3)(v)(C) of this section apply to assign to statutory and residual groupings items of foreign gross income arising from the receipt of the portion of a disregarded payment that is a remittance or a contribution. The rules of paragraph (d)(3)(v)(D) of this section apply to assign to statutory and residual groupings items of foreign gross income arising from disregarded payments in connection with disregarded sales or exchanges of property. Paragraph (d)(3)(v)(E) of this section provides definitions that apply for purposes of this paragraph (d)(3)(v) and paragraph (g) of this section.

(B) *Reattribution payments*—(*1*) *In general*. This paragraph (d)(3)(v)(B) assigns to a statutory or residual grouping a foreign gross income item that a taxpayer includes by reason of the receipt by a taxable unit of the portion of a disregarded payment that is a reattribution payment. The foreign gross income item is assigned to the statutory or residual groupings to which one or more reattribution amounts that constitute the reattribution payment are assigned upon receipt by the taxable unit. If a reattribution payment comprises multiple reattribution amounts and the amount of the foreign gross income item that is attributable to the reattribution payment differs from the amount of the reattribution payment, foreign gross income is apportioned among the statutory and residual groupings in proportion to the reattribution amounts in each statutory and residual grouping. The statutory or residual grouping of a reattribution amount received by a taxable unit is the grouping that includes the U.S. gross income attributed to the taxable unit by reason of its receipt of the gross reattribution amount, regardless of whether, after taking into account disregarded payments made by the taxable unit, the taxable unit has an attribution item as a result of its receipt of the reattribution amount. See paragraph (g)(13) of this section (*Example 12*).

(*2*) *Attribution of U.S. gross income to a taxable unit*. This paragraph (d)(3)(v)(B)(*2*) provides attribution rules to determine the reattribution amounts received by a taxable unit in the statutory and residual groupings in order to apply paragraph (d)(3)(v)(B)(*1*) of this section to assign foreign gross income items arising from a reattribution payment to the groupings. In the case of a taxpayer that is an individual or a domestic corporation, the attribution rules in §1.904-4(f)(2) apply to determine the reattribution amounts received by a taxable unit in the separate categories (as defined in §1.904-5(a)(4)(v)) in order to apply paragraph (d)(3)(v)(B)(*1*) of this section for purposes of §1.904-6(b)(2)(i). In the case of a taxpayer that is a foreign corporation, the attribution rules in §1.951A-2(c)(7)(ii)(B) apply to determine the reattribution amounts received by a taxable unit in the statutory and residual groupings in order to apply paragraph (d)(3)(v)(B)(*1*) of this section for purposes of §§1.951A-2(c)(3), 1.951A-2(c)(7), and 1.960-1(d)(3)(ii). For purposes of other operative sections (as described in §1.861-8(f)(1)), the principles of §1.904-4(f)(2)(vi) or §1.951A-2(c)(7)(ii)(B), as applicable, apply to determine the reattribution amounts received by a taxable unit in the statutory and residual groupings. The rules and principles of §1.904-4(f)(2)(vi) or §1.951A-2(c)(7)(ii)(B), as applicable, apply to determine the extent to which a disregarded payment made by the taxable unit is a reattribution payment and the reattribution amounts that constitute a reattribution payment, and to adjust the U.S. gross income initially attributed to each taxable unit to reflect the reattribution payments that the taxable unit makes and receives. The rules in this paragraph (d)(3)(v)(B)(*2*) limit the amount of a disregarded payment that is a reattribution payment to the U.S. gross income of the payor taxable unit that is recognized in the U.S. taxable year in which the disregarded payment is made.

(*3*) *Effect of reattribution payment on foreign gross income items of payor taxable unit*. The statutory or residual grouping to which an item of foreign gross income of a taxable unit is assigned is determined without regard to reattribution payments made by the taxable unit, and without regard to whether the taxable unit has one or more attribution items after taking into account such reattribution payments. No portion of the foreign gross income of the payor taxable unit is treated as foreign gross income of the payee taxable unit by reason of the reattribution payment, notwithstanding that U.S. gross income of the payor taxable unit that is used to assign foreign gross income of the payor taxable unit to statutory and residual groupings is reattributed to the payee taxable unit under paragraph (d)(3)(v)(B)(*1*) of this section by reason of the reattribution payment. See paragraph (e) of this section for rules reducing the amount of a foreign gross income item of a taxable unit by deductions allowed under foreign law, including deductions by reason of disregarded payments made by a taxable unit that are included in the foreign gross income of the payee taxable unit.

(C) *Remittances and contributions*—(*1*) *Remittances*—(*i*) *In general*. An item of foreign gross income that a taxpayer includes by reason of the receipt of a remittance by a taxable unit is assigned to the statutory or residual groupings of the recipient taxable unit that correspond to the groupings out of which the payor taxable unit made the remittance under the rules of this paragraph (d)(3)(v)(C)(*1*)(*i*). A remittance paid by a taxable unit is considered to be made ratably out of all of the accumulated after-tax income of the taxable unit. The accumulated after-tax income of the taxable unit that pays the remittance is deemed to have arisen in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the assets of the taxable unit are (or would be if the owner of the taxable unit were a United States person) assigned for purposes of apportioning interest expense under the asset method in §1.861-9 in the taxable year in which the remittance is made. See paragraph (g)(11) and (12) of this section (*Examples 10* and *11*). If the payor taxable unit is determined to have no assets under paragraph (d)(3)(v)(C)(*1*)(*ii*) of this section, then the foreign gross income that is included by reason of the receipt of the remittance is assigned to the residual grouping.

(*ii*) *Assets of a taxable unit*. The assets of a taxable unit are determined in accordance with §1.987-6(b), except that for purposes of applying §1.987-6(b)(2) under this paragraph (d)(3)(v)(C)(*1*)(*ii*), a taxable unit is deemed to be a section 987 QBU (within the meaning of §1.987-1(b)(2)) and assets of the taxable unit include stock held by the taxable unit, the portion of the tax book value of a reattribution asset that is assigned to the taxable unit, and the taxable unit's pro rata share of the assets of another taxable unit (other than

a corporation or a partnership), including the portion of any reattribution assets assigned to the other taxable unit, in which it owns an interest. If a taxable unit owns an interest in a taxable unit that is a partnership, the assets of the taxable unit that is the owner include its interest in the partnership or its pro rata share of the partnership assets, as applicable, determined under the principles of §1.861-9(e). The portion of the tax book value of a reattribution asset that is assigned to a taxable unit is an amount that bears the same ratio to the total tax book value of the reattribution asset as the sum of the attribution items of that taxable unit arising from gross income produced by the reattribution asset bears to the total gross income produced by the reattribution asset. The portion of a reattribution asset that is assigned to a taxable unit under this paragraph (d)(3)(v)(C)(*1*)(*ii*) is not treated as an asset of the taxable unit making the reattribution payment for purposes of applying paragraph (d)(3)(v)(C)(*1*)(*i*) of this section.

(*2*) *Contributions*. 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. See, however, §1.904-6(b)(2)(ii) (assigning certain items of foreign gross income to the foreign branch category for purposes of applying section 904 as the operative section).

(*3*) *Disregarded payment that comprises both a reattribution payment and a remittance or contribution*. If both a reattribution payment and either a remittance or a contribution result from a single disregarded payment, the foreign gross income is first attributed to the portion of the disregarded payment that is a reattribution payment to the extent of the amount of the reattribution payment, and any excess of the foreign gross income item over the amount of the reattribution payment is then to attributed to the portion of the disregarded payment that is a remittance or contribution.

(D) *Disregarded payments in connection with disregarded sales or exchanges of property*. An item of foreign gross income attributable to gain recognized under foreign law by reason of a disregarded payment received in exchange for property is characterized and assigned under the rules of paragraph (d)(2) of this section. 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 paragraph (d)(1) of this section, without regard to any reattribution of the U.S. gross income under §1.904-4(f)(2)(vi)(A) (or the principles of §1.904-4(f)(2)(vi)(A)) by reason of a disregarded payment described in §1.904-4(f)(2)(vi)(B)(*2*) (or by reason of §1.904-4(f)(2)(vi)(D)). See paragraph (d)(3)(v)(B)(*3*) of this section.

(E) *Definitions*. The following definitions apply for purposes of this paragraph (d)(3)(v) and paragraph (g) of this section.

(*1*) *Attribution item*. The term *attribution item* means the portion of an item of gross income, computed under Federal income tax law, that is attributed to a taxable unit after taking into account all reattribution payments made and received by the taxable unit.

(*2*) *Contribution*. The term *contribution* means the excess of a disregarded payment made by a taxable unit to another taxable unit that the first taxable unit owns over the portion of the disregarded payment, if any, that is a reattribution payment.

(*3*) *Disregarded entity*. The term *disregarded entity* means an entity described in §301.7701-2(c)(2) of this chapter that is disregarded as an entity separate from its owner for Federal income tax purposes.

(*4*) *Disregarded payment*. The term *disregarded payment* means an amount of property (within the meaning of section 317(a)) that is transferred to or from a taxable unit, including a transfer of property that would be a contribution to capital described in section 118 or a transfer described in section 351 if the taxable unit were a corporation under Federal income tax law, a transfer of property that would be a distribution by a corporation to a shareholder with respect to its stock if the taxable unit were a corporation under Federal income tax law, or a payment in exchange for property or in satisfaction of an account payable, in connection with a transaction that is disregarded for Federal income tax purposes and that is reflected on the separate set of books and records of the taxable unit. A disregarded payment also includes any other amount that is reflected on the separate set of books and records of a taxable unit in connection with a transaction that is disregarded for Federal income tax purposes and that would constitute an item of accrued income, gain, deduction, or loss of the taxable unit if the transaction to which the amount is attributable were regarded for Federal income tax purposes.

(*5*) *Reattribution amount*. The term *reattribution amount* means an amount of gross income, computed under Federal income tax law, that is initially assigned to a single statutory or residual grouping that includes gross income of a taxable unit but that is, by reason of a disregarded payment made by that taxable unit, attributed to another taxable unit under paragraph (d)(3)(v)(B)(*2*) of this section.

(*6*) *Reattribution asset*. The term *reattribution asset* means an asset that produces one or more items of gross income, computed under Federal income tax law, to which a disregarded payment is allocated under the rules of paragraph (d)(3)(v)(B)(*2*) of this section.

(*7*) *Reattribution payment*. The term *reattribution payment* means the portion of a disregarded payment equal to the sum of all reattribution amounts that are attributed to the recipient of the disregarded payment.

(*8*) *Remittance*. The term *remittance* means the excess of a disregarded payment, other than an amount that is treated as a contribution under paragraph (d)(3)(v)(E)(*2*) of this section, made by a taxable unit to a second taxable unit (including a second taxable unit that shares the same owner as the payor taxable unit) over the portion of the disregarded payment, if any, that is a reattribution payment.

(*9*) *Taxable unit*. In the case of a taxpayer that is an individual or a domestic corporation, the term *taxable unit* means a foreign branch, a foreign branch owner, or a non-branch taxable unit, as defined in §1.904-6(b)(2)(i)(B). In the case of a taxpayer that is a foreign corporation, the term *taxable unit* means a tested unit, as defined in §1.951A-2(c)(7)(iv)(A).

(vi) *Foreign gross income included by reason of U.S. equity hybrid instrument ownership*—(A) *Foreign gross income included by reason of an accrual*. For-

eign gross income included by reason of an accrual under foreign law with respect to a U.S. equity hybrid instrument is considered to arise from the same transaction or realization event as a distribution of property described in paragraph (d)(3)(i) or (ii) of this section and is assigned to the statutory and residual groupings by treating each amount accrued as a foreign law distribution made on the date of the accrual under foreign law.

(B) *Foreign gross income included by reason of a payment*. Foreign gross income included by reason of a payment of interest under foreign law with respect to a U.S. equity hybrid instrument is considered to arise from the same transaction or realization event as a distribution of property described in paragraph (d)(3)(i) or (ii) of this section and is assigned to the statutory and residual groupings by treating each payment as a distribution made on the date of the payment.

* * * * *

(g) * * *

(10) *Example 9: Gain on disposition of stock*—(i) *Facts*. USP owns all of the outstanding stock of CFC, which conducts business in Country A. In Year 1, USP sells all of the stock of CFC to US2 for $1,000x. For Country A tax purposes, USP's basis in the stock of CFC is $200x. Accordingly, USP recognizes $800x of gain on which Country A imposes $80x of foreign income tax based on its rules for taxing capital gains of nonresidents, which satisfy the requirement in §1.901-2(b)(5)(i)(C). For Federal income tax purposes, USP's basis in the stock of CFC is $400x. Accordingly, USP recognizes $600x of gain on the sale of the stock of CFC, of which $150x is included in the gross income of USP as a dividend under section 1248(a) that, as provided in section 1248(j), is treated as a dividend eligible for the deduction under section 245A(a). Under paragraphs (b)(20) and (21) of this section, respectively, the sale of CFC stock by USP gives rise to a $450x U.S. capital gain amount and a $150x U.S. dividend amount. Under §§1.904-4(d) and 1.904-5(c)(4), the $150x U.S. dividend amount is general category section 245A subgroup income, and the $450x U.S. capital gain amount is passive category income to USP. For purposes of allocating and apportioning its interest expense under §§1.861-9(g)(2)(i)(B) and 1.861-13, USP's stock in CFC is characterized as general category stock in the section 245A subgroup.

(ii) *Analysis*. For purposes of allocating and apportioning the $80x of Country A foreign income tax, the $800x of Country A gross income from the sale of the stock of CFC is first assigned to separate categories. Under paragraph (d)(3)(i)(D) of this section, the $800x of Country A gross income is first assigned to the separate category to which the $150x U.S. dividend amount is assigned, to the extent thereof, and is next assigned to the separate category to which the $450x U.S. capital gain amount is assigned, to the extent thereof. Accordingly, $150x of Country A gross income is assigned to the general category in the section 245A subgroup, and $450x of Country A gross income is assigned to the passive category. Under paragraph (d)(3)(i)(D) of this section, the remaining $200x of Country A gross income is assigned to the statutory and residual groupings to which earnings of CFC in that amount would be assigned if they were recognized for Federal income tax purposes in the U.S. taxable year in which the disposition occurred. These earnings are all deemed to arise in the section 245A subgroup of the general category, based on USP's characterization of its stock in CFC. Thus, under paragraph (d)(3)(i)(D) of this section the $800x of foreign gross income, and therefore the foreign taxable income, is characterized as $350x ($150x + $200x) of income in the general category section 245A subgroup and $450x of income in the passive category. This is the result even though for Country A tax purposes all $800x of Country A gross income is characterized as gain from the sale of stock, which would be passive category income under section 904(d)(2)(B)(i), because the income is assigned to a separate category based on the characterization of the gain under Federal income tax law. Under paragraph (f) of this section, the $80x of Country A tax is ratably apportioned between the general category section 245A subgroup and the passive category based on the relative amounts of foreign taxable income in each grouping. Accordingly, $35x ($80x x $350x / $800x) of the Country A tax is apportioned to the general category section 245A subgroup, and $45x ($80x x $450x / $800x) of the Country A tax is apportioned to the passive category. See also §1.245A(d)-1 for rules that may disallow a credit or deduction for the $35x of Country A tax apportioned to the general category section 245A subgroup.

(11) *Example 10: Disregarded transfer of built-in gain property*—(i) *Facts*. USP owns FDE, a disregarded entity that is treated for Federal income tax purposes as a foreign branch operating in Country A. FDE transfers Asset F, equipment used in FDE's trade or business in Country A, for no consideration to USP in a transaction that is a remittance described in paragraph (d)(3)(v)(E) of this section for Federal income tax purposes but is treated as a distribution of Asset F from a corporation to its shareholder, USP, for Country A tax purposes. At the time of the transfer, Asset F has a fair market value of $250x and an adjusted basis of $100x for both Federal and Country A income tax purposes. Country A imposes $30x of tax on FDE with respect to the $150x of built-in gain on a deemed sale of Asset F, which is recognized for Country A tax purposes by reason of the transfer to USP. If FDE had sold Asset F for $250x in a transaction that was regarded for Federal income tax purposes, FDE would also have recognized gain of $150x for Federal income tax purposes, and that gain would have been characterized as foreign branch category income under §1.904-4(f). Country A also imposes $25x of withholding tax, a separate levy, on USP by reason of the distribution of Asset F to USP.

(ii) *Analysis*—(A) *Net income tax on built-in gain*. For purposes of allocating and apportioning the $30x of Country A foreign income tax imposed on FDE by reason of the transfer of Asset F to USP for Country A tax purposes, under paragraph (c)(1) of this section the $150x of Country A gross income is first assigned to a separate category. Because the transfer does not result in a deemed sale for Federal income tax purposes, there is no corresponding U.S. item. However, FDE would have recognized gain of $150x, which would have been the corresponding U.S. item, if the deemed sale had been recognized for Federal income tax purposes. Therefore, under paragraph (d)(2)(ii) of this section, the $150x item of foreign gross income is characterized and assigned to the grouping to which such corresponding U.S. item would have been assigned if the deemed sale were recognized under Federal income tax law. Because the sale of Asset F in a regarded transaction would have resulted in foreign branch category income, the foreign gross income is characterized as foreign branch category income. Under paragraph (f) of this section, the $30x of Country A tax is also allocated to the foreign branch category, the statutory grouping to which the $150x of Country A gross income is assigned. No apportionment of the $30x of Country A tax is necessary because the class of gross income to which the foreign gross income is allocated consists entirely of a single statutory grouping.

(B) *Withholding tax on distribution*. For purposes of allocating and apportioning the $25x of Country A withholding tax imposed on USP by reason of the transfer of Asset F, under paragraph (c)(1) of this section the $250x of Country A gross income arising from the transfer of Asset F is first assigned to a separate category. For Federal income tax purposes, the transfer of Asset F is a remittance from FDE to USP, and thus there is no corresponding U.S. item. Under paragraph (d)(3)(v)(C)(*1*)(*i*) of this section, the item of foreign gross income is assigned to the groupings to which the income out of which the payment is made is assigned; the payment is considered to be made ratably out of all of the accumulated after-tax income of FDE, as computed for Federal income tax purposes; and the accumulated after-tax income of FDE is deemed to have arisen in the statutory and residual groupings in the same proportions as those in which the tax book value of FDE's assets in the groupings, determined in accordance with paragraph (d)(3)(v)(C)(*1*)(*ii*) of this section, are assigned for purposes of apportioning USP's interest expense. Because all of FDE's assets produce foreign branch category income, under paragraph (d)(3)(v)(C)(*1*) of this section the foreign gross income is characterized as foreign branch category income. Under paragraph (f) of this section, the $25x of Country A withholding tax is also allocated entirely to the foreign branch category, the statutory grouping to which the $250x of Country A gross income is assigned. No apportionment of the $25x is necessary because the class of gross income to which the foreign gross income is allocated consists entirely of a single statutory grouping.

(12) *Example 11: Disregarded payment that is a remittance*—(i) *Facts*. USP wholly owns CFC1, which is a tested unit within the meaning of §1.951A-2(c)(7)(iv)(A) (the "CFC1 tested unit"). CFC1 wholly owns FDE, a disregarded entity that is organized in Country B, which is a tested unit within the meaning of §1.951A-2(c)(7)(iv)(A) (the "FDE tested unit"). The sole assets of FDE (determined in accordance with paragraph (d)(3)(v)(C)(*1*)(*ii*) of this section) are all the outstanding stock of

CFC3, a controlled foreign corporation organized in Country B. In Year 1, CFC3 pays a $400x dividend to FDE that is excluded from CFC1's foreign personal holding company income ("FPHCI") by reason of section 954(c)(6). FDE makes no payments to CFC1 and pays no Country B tax in Year 1. In Year 2, FDE makes a $400x remittance to CFC1 as defined in paragraph (d)(3)(v)(E) of this section. Under the laws of Country B, the remittance gives rise to a $400x dividend. Country B imposes a 5% ($20x) withholding tax (which is an eligible current year tax as defined in §1.960-1(b)) on CFC1 on the dividend. In Year 2, CFC3 pays no dividends to FDE, and FDE earns no income. For Federal income tax purposes, the $400x payment from FDE to CFC1 is a disregarded payment and results in no income to CFC1. For purposes of this paragraph (g)(12) (*Example 11*), section 960(a) is the operative section and the income groups described in §1.960-1(d)(2) are the statutory and residual groupings. See §1.960-1(d)(3)(ii)(A) (applying §1.960-1 to allocate and apportion current year taxes to income groups). For Federal income tax purposes, in Year 2 the stock of CFC3 owned by FDE has a tax book value of $1,000x, $750x of which is assigned under the asset method in §1.861-9 (as applied by treating CFC1 as a United States person) to the general category tested income group described in §1.960-1(d)(2)(ii)(C), and $250x of which is assigned to a passive category FPHCI group described in §1.960-1(d)(2)(ii)(B)(*2*)(*i*).

(ii) *Analysis*. (A) The $20x Country B withholding tax on the Year 2 remittance from FDE is imposed on a $400x item of foreign gross income that CFC1 includes in foreign gross income by reason of its receipt of a disregarded payment. In order to allocate and apportion the $20x of Country B withholding tax under paragraph (c) of this section for purposes of §1.960-1(d)(3)(ii)(A), paragraph (d)(3)(v) of this section applies to assign the $400x item of foreign gross dividend income to a statutory or residual grouping. Under paragraph (d)(3)(v)(C)(*1*) of this section, the $400x item of foreign gross income is assigned to the statutory or residual groupings of the CFC1 tested unit that correspond to the statutory and residual groupings out of which FDE made the remittance.

(B) Under paragraph (d)(3)(v)(C)(*1*)(*i*) of this section, FDE is considered to have made the remittance ratably out of all of its accumulated after-tax income, which is deemed to have arisen in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of FDE's assets would be assigned (if CFC1 were a United States person) for purposes of apportioning interest expense under the asset method in Year 2, the taxable year in which FDE made the remittance. Accordingly, $300x ($400x x $750x / $1,000x) of the remittance is deemed made out of the general category tested income of the FDE tested unit, and $100x ($400x x $250x / $1,000x) of the remittance is deemed made out of the passive category FPHCI of the FDE tested unit.

(C) Under paragraph (d)(3)(v)(C)(*1*)(*i*) of this section, $300x of the $400x item of foreign gross income from the remittance, and therefore an equal amount of foreign taxable income, is assigned to the income group that includes general category tested income attributable to the CFC1 tested unit, and $100x of this foreign gross income item, and therefore an equal amount of foreign taxable income, is assigned to the income group that includes passive category FPHCI attributable to the CFC1 tested unit. Under paragraph (f) of this section, the $20x of Country B withholding tax is ratably apportioned between the income groups based on the relative amounts of foreign taxable income in each grouping. Accordingly, $15x ($20x x $300x / $400x) of the Country B withholding tax is apportioned to the CFC1 tested unit's general category tested income group, and $5x ($20x x $100x / $400x) of the Country B withholding tax is apportioned to the CFC1 tested unit's passive category FPHCI income group. See §1.960-2 for rules on determining the amount of such taxes that may be deemed paid under section 960(a) and (d).

(13) *Example 12: Disregarded payment that is a reattribution payment*—(i) *Facts*. (A) USP wholly owns CFC1, a tested unit within the meaning of §1.951A-2(c)(7)(iv)(A)(*1*) (the "CFC1 tested unit"). CFC1 wholly owns FDE1, a disregarded entity organized in Country B, that is a tested unit within the meaning of §1.951A-2(c)(7)(iv)(A)(*2*) (the "FDE1 tested unit"). Country B imposes a 20 percent net income tax on its residents. CFC1 also wholly owns FDE2, a disregarded entity organized in Country C, that is a tested unit within the meaning of §1.951A-2(c)(7)(iv)(A)(*2*) (the "FDE2 tested unit"). Country C imposes a 15 percent net income tax on its residents. The net income tax imposed by each of Country B and Country C on their tax residents is a foreign income tax within the meaning of §1.901-2(a) and a separate levy within the meaning of §1.901-2(d). For purposes of this paragraph (g)(13) (*Example 12*), the operative section is the high-tax exclusion of section 951A(c)(2)(A)(i)(III) and §1.951A-2(c)(7), and the statutory groupings are the tested income groups of each tested unit, as defined in §1.951A-2(c)(7)(iv)(A).

(B) FDE2 owns Asset A, which is intangible property with a tax book value of $12,000x that is properly reflected on the separate set of books and records of FDE2. In Year 1, pursuant to a license agreement between FDE1 and FDE2 for the use of Asset A, FDE1 makes a disregarded royalty payment to FDE2 of $1,000x that would be deductible if regarded for Federal income tax purposes. Because it is disregarded for Federal income tax purposes, the $1,000x disregarded royalty payment by FDE1 to FDE2 results in no income to CFC1 for Federal income tax purposes. Also, in Year 1, pursuant to a sub-license agreement between FDE1 and an unrelated third party for the use of Asset A, FDE1 earns $1,200x of royalty income for Federal income tax purposes (the "U.S. gross royalty") for the use of Asset A. The $1,200 of royalty income received by FDE1 from the unrelated third party is excluded from CFC1's foreign personal holding company income by reason of the active business exception in section 954(c)(2) because CFC1 satisfies the requirements of §1.954-2(d)(1). As a result, the $1,200x of royalty income that FDE1 earns from the sub-license agreement is gross tested income (as defined in §1.951A-2(c)(1)), which is properly reflected on the separate set of books and records of FDE1.

(C) Under the laws of Country B, the transaction that gives rise to the $1,200x item of U.S. gross royalty income causes FDE1 to include a $1,200x item of gross royalty income in its Country B taxable income (the "Country B gross royalty"). In addition, FDE1 deducts its $1,000x disregarded royalty payment to FDE2 for Country B tax purposes. For Country B tax purposes, FDE1 therefore has $200x ($1,200x - $1,000x) of taxable income on which Country B imposes $40x (20% x $200x) of net income tax.

(D) Under the laws of Country C, the $1,000x disregarded royalty payment from FDE1 to FDE2 causes FDE2 to include a $1,000x item of gross royalty income in its Country C taxable income (the "Country C gross royalty"). FDE2 therefore has $1,000x of taxable income for Country C tax purposes, on which Country C imposes $150x (15% x $1,000x) of net income tax.

(ii) *Analysis*—(A) *Country B net income tax*—(*1*) The Country B net income tax is imposed on foreign taxable income of FDE1 that consists of a $1,200x item of Country B gross royalty income and a $1,000x item of royalty expense. For Federal income tax purposes, the FDE1 tested unit has a $1,200x item of U.S. gross royalty income that is initially attributable to it under paragraph (d)(3)(v)(B)(*2*) of this section and §1.951A-2(c)(7)(ii)(B). The transaction that produced the $1,200x item of U.S. gross royalty income also produced the $1,200x item of Country B gross royalty income. Under paragraph (b)(2) of this section, the $1,200x item of U.S. gross royalty income is therefore the corresponding U.S. item for the $1,200x item of Country B gross royalty income of FDE1.

(*2*) The $1,000x disregarded royalty payment from FDE1 to FDE2 is allocated under paragraph (d)(3)(v)(B)(*2*) of this section and §1.951A-2(c)(7)(ii)(B) to the $1,200x of U.S. gross income of the FDE1 tested unit to the extent of that gross income. As a result, the $1,000x disregarded royalty payment causes $1,000x of the $1,200x item of U.S. gross royalty income to be reattributed from the FDE1 tested unit to the FDE2 tested unit, and results in a $1,000x reattribution amount that is also a reattribution payment.

(*3*) The $1,200x Country B gross royalty item that is included in the Country B taxable income of FDE1 is assigned under paragraph (d)(1) of this section to the statutory or residual grouping to which the $1,200x corresponding U.S. item is initially assigned under §1.951A-2(c)(7)(ii), namely, the FDE1 income group. This assignment is made without regard to the $1,000x reattribution payment from the FDE1 tested unit to the FDE2 tested unit; none of the FDE1 tested unit's $1,200x Country B gross royalty income is reattributed to the FDE2 tested unit for this purpose. See paragraph (d)(3)(v)(B)(*3*) of this section. Under paragraph (f) of this section, all of the $40x of Country B net income tax on the $200x of Country B taxable income is allocated to the FDE1 income group, the statutory grouping to which the $1,200x item of Country B gross royalty income of FDE1 is assigned. No apportionment of the $40x is necessary because the class of gross income to which the foreign gross income is allocated consists entirely of a single statutory grouping.

(B) *Country C net income tax*. The Country C net income tax is imposed on foreign taxable income of FDE2 that consists of a $1,000x item of Country C gross royalty income. For Federal income tax

purposes, under paragraph (d)(3)(v)(B)(*2*) of this section and §1.951A-2(c)(7)(ii)(B), the FDE2 tested unit has a reattribution amount of $1,000x of U.S. gross royalty income by reason of its receipt of the $1,000x reattribution payment from FDE1. The $1,000x item of U.S. gross royalty income that is included in the taxable income of the FDE2 tested unit by reason of the $1,000x reattribution payment is assigned under paragraph (d)(3)(v)(B)(*1*) of this section to the statutory or residual grouping to which the $1,000x reattribution amount of U.S. gross royalty income that constitutes the reattribution payment is assigned upon receipt by the FDE2 tested unit under §1.951A-2(c)(7)(ii), namely, the FDE2 income group. Under paragraph (d)(3)(v)(B)(*1*) of this section, the $1,000x item of Country C gross royalty income is assigned to the statutory grouping to which the $1,000x corresponding U.S. item is assigned. Accordingly, under paragraph (f) of this section, all of the $150x of Country C net income tax is allocated to the FDE2 income group, the statutory grouping to which the $1,000x item of Country C gross royalty income of FDE2 is assigned. No apportionment of the $150x is necessary because the class of gross income to which the foreign gross income is allocated consists entirely of a single statutory grouping.

(14) *Example 13: Assets of a taxable unit that owns an interest in a lower-tier taxable unit*—(i) *Facts*. USP wholly owns CFC1, a tested unit within the meaning of §1.951A-2(c)(7)(iv)(A) (the "CFC1 tested unit"). CFC1 wholly owns FDE1, a disregarded entity that is organized in Country A, and FDE2, a disregarded entity that is organized in Country B. CFC1's interests in FDE1 and FDE2 are each tested units within the meaning of §1.951A-2(c)(7)(iv)(A) (the "FDE1 tested unit" and "FDE2 tested unit," respectively). The FDE1 tested unit and FDE2 tested unit each own 50% of the interests in FDE3, a disregarded entity that is organized in Country C. CFC1's indirect interests in FDE3 are also a tested unit within the meaning of §1.951A-2(c)(7)(iv)(A) (the "FDE3 tested unit"). The FDE2 tested unit owns Asset A with a tax book value of $10,000x, and makes a reattribution payment to FDE3 that causes $5,000x of the tax book value of Asset A to be assigned to FDE3 under paragraph (d)(3)(v)(C)(*1*)(*ii*) of this section. FDE3 owns Asset B, which has a tax book value of $5,000x.

(ii) *Analysis*—(A) *Assets of the FDE3 tested unit*. The assets of the FDE3 tested unit consist of the portion of Asset A that is assigned to it under paragraph (d)(3)(v)(C)(*1*)(*ii*) of this section and any other assets determined in accordance with §1.987-6(b). The assets of the FDE3 tested unit thus consist of $5,000x of the tax book value of Asset A and all $5,000x of the tax book value of Asset B.

(B) *Assets of the FDE2 tested unit*. The assets of the FDE2 tested unit consist of the tax book value of any assets that it owns directly plus its pro rata share of the assets of the FDE3 tested unit, including the portion of reattribution assets assigned to the FDE3 tested unit. Asset A is a reattribution asset under paragraphs (d)(3)(v)(C)(*1*)(*ii*) and (d)(3)(v)(E) of this section. The assets of the FDE2 tested unit therefore consist of the portion of Asset A that it owns directly and that was not assigned to the FDE3 tested unit (or $5,000x) plus its pro rata share of the portion of Asset A that was assigned to the FDE3 tested unit, or $2,500x (50% of $5,000x). In addition, the assets of the FDE2 tested unit include its pro rata share of the tax book value of Asset B, or $2,500x (50% of $5,000x).

(C) *Assets of the FDE1 tested unit*. The assets of the FDE1 tested unit consist of its pro rata share of the assets of the FDE3 tested unit, including the portion of reattribution assets assigned to the FDE3 tested unit. Asset A is a reattribution asset under paragraphs (d)(3)(v)(C)(*1*)(*ii*) and (d)(3)(v)(E) of this section. The assets of the FDE1 tested unit therefore consist of its pro rata share of the portion of Asset A that was reattributed to the FDE3 tested unit, or $2,500x (50% of $5,000x), plus its pro rata share of the tax book value of Asset B, or $2,500x (50% of $5,000x).

(h) *Allocation and apportionment of certain foreign in lieu of taxes described in section 903*. A tax that is a foreign income tax by reason of §1.903-1(c)(1) is allocated and apportioned to statutory and residual groupings in the same proportions as the foreign taxable income that comprises the excluded income (as defined in §1.903-1(c)(1)). See paragraph (f) of this section for rules on allocating and apportioning certain withholding taxes described in §1.903-1(c)(2).

(i) *Applicability dates*. Except as provided in this paragraph (i), this section applies to taxable years beginning after December 31, 2019. Paragraphs (b)(19) and (23) and (d)(3)(i), (ii), and (v) of this section apply to taxable years that begin after December 31, 2019, and end on or after November 2, 2020. Paragraph (h) of this section applies to taxable years beginning after December 28, 2021.

Par. 23. Section 1.901-1 is amended:

1. By revising the section heading.

2. By revising paragraphs (a) through (d).

3. In paragraph (e), by removing the language "a husband and wife" and adding the language "spouses" in its place.

4. By revising paragraphs (f) and (h)(1).

5. By removing paragraph (h)(2).

6. By redesignating paragraph (h)(3) as paragraph (h)(2).

7. By revising the heading and second sentence in paragraph (j).

The revisions and additions read as follows:

§1.901-1 Allowance of credit for foreign income taxes.

(a) *In general*. Citizens of the United States, domestic corporations, certain aliens resident in the United States or Puerto Rico, and certain estates and trusts may choose to claim a credit, as provided in section 901, against the tax imposed by chapter 1 of the Internal Revenue Code (Code) for certain taxes paid or accrued to foreign countries and possessions of the United States, subject to the conditions prescribed in this section.

(1) *Citizen of the United States*. An individual who is a citizen of the United States, whether resident or nonresident, may claim a credit for—

(i) The amount of any foreign income taxes, as defined in §1.901-2(a), paid or accrued (as the case may be, depending on the individual's method of accounting for such taxes) during the taxable year;

(ii) The individual's share of any such taxes of a partnership of which the individual is a member, or of an estate or trust of which the individual is a beneficiary; and

(iii) In the case of an individual who has made an election under section 962, the taxes deemed to have been paid under section 960 (see §1.962-1(b)(2)).

(2) *Domestic corporation*. A domestic corporation may claim a credit for—

(i) The amount of any foreign income taxes, as defined in §1.901-2(a), paid or accrued (as the case may be, depending on the corporation's method of accounting for such taxes) during the taxable year;

(ii) The corporation's share of any such taxes of a partnership of which the corporation is a member, or of an estate or trust of which the corporation is a beneficiary; and

(iii) The taxes deemed to have been paid under section 960.

(3) *Alien resident of the United States or Puerto Rico*. Except as provided in a Presidential proclamation described in section 901(c), an individual who is a resident alien of the United States (as defined in section 7701(b)), or an individual who is a bona fide resident of Puerto Rico (as defined in section 937(a)) during the entire taxable year, may claim a credit for—

(i) The amount of any foreign income taxes, as defined in §1.901-2(a), paid or accrued (as the case may be, depending on the individual's method of accounting for such taxes) during the taxable year;

(ii) The individual's share of any such taxes of a partnership of which the indi-

vidual is a member, or of an estate or trust of which the individual is a beneficiary; and

(iii) In the case of an individual who has made an election under section 962, the taxes deemed to have been paid under section 960 (see §1.962-1(b)(2)).

(4) *Estates and trusts*. An estate or trust may claim a credit for—

(i) The amount of any foreign income taxes, as defined in §1.901-2(a), paid or accrued (as the case may be, depending on the estate or trust's method of accounting for such taxes) during the taxable year to the extent not allocable to and taken into account by its beneficiaries under paragraph (a)(1)(ii), (a)(2)(ii), or (a)(3)(ii) of this section (see section 642(a)); and

(ii) In the case of an estate or trust that has made an election under section 962, the taxes deemed to have been paid under section 960 (see §1.962-1(b)(2)).

(b) *Limitations*. Certain Code sections, including sections 245A(d) and (e)(3), 814, 901(e) through (m), 904, 906, 907, 908, 909, 911, 965(g), 999, and 6038, reduce, defer, or otherwise limit the credit against the tax imposed by chapter 1 of the Code for certain amounts of foreign income taxes.

(c) *Deduction denied if credit claimed*—(1) *In general*. Except as provided in paragraphs (c)(2) and (3) of this section, if a taxpayer chooses with respect to any taxable year to claim a credit under section 901 to any extent, such choice will apply to all of the foreign income taxes paid or accrued (as the case may be, depending on the taxpayer's method of accounting for such taxes) by the taxpayer in such taxable year, and no deduction from gross income is allowed for any portion of such taxes in any taxable year. See section 275(a)(4).

(2) *Exception for taxes not subject to section 275*. A deduction may be allowed under section 164(a)(3) for foreign income tax for which a credit is disallowed under any Code section and to which section 275 does not apply. See, for example, sections 901(f), 901(j)(3), 901(k)(7), 901(l)(4), 901(m)(6), and 908(b). For rules on the taxable year in which a deduction for foreign income taxes is allowed under section 164(a)(3), see §§1.446-1(c)(1)(ii), 1.461-2(a)(2), and 1.461-4(g)(6)(iii)(B).

(3) *Exception for taxes paid by an accrual basis taxpayer that relate to a prior year in which the taxpayer deducted foreign income taxes*. If a taxpayer claims a credit for foreign income taxes accrued in a taxable year (including a cash method taxpayer that elects under section 905(a) to claim a credit in the year the taxes accrue), a deduction may be claimed in that taxable year for additional foreign income taxes that are finally determined and paid as a result of a foreign tax redetermination in that taxable year if the additional foreign income taxes relate to a prior taxable year in which the taxpayer claimed a deduction, rather than a credit, for foreign income taxes paid or accrued (as the case may be, depending on the taxpayer's overall method of accounting) in that prior year.

(4) *Example*. The following example illustrates the application of paragraph (c)(3) of this section.

(i) *Facts*. USC is a domestic corporation that is engaged in a trade or business in Country X through a branch. USC uses the accrual method of accounting and a calendar year for U.S. and Country X tax purposes. For taxable Years 1 through 3, USC deducted foreign income taxes accrued in those years. In Years 4 through 6, USC claimed a credit for foreign income taxes accrued in those years. In Year 6, USC paid an additional $50x tax to Country X that relates to Year 1 because of the close of a Country X tax audit.

(ii) *Analysis*. The additional $50x Country X tax paid by USC in Year 6 that relates to Year 1 cannot be claimed by USC as a deduction on an amended return for Year 1 because the additional tax accrued in Year 6. See section 461(f) (flush language); §§1.461-1(a)(2)(i) and 1.461-2(a)(2). In addition, because the additional $50x Country X tax relates to and is considered to accrue in Year 1 for foreign tax credit purposes, USC cannot claim a credit for the additional $50x Country X tax on its Federal income tax return for Year 6. See §1.905-1(d)(1). However, pursuant to paragraph (c)(3) of this section, USC can claim a deduction for the additional $50x Country X tax that relates to Year 1 on its Federal income tax return for Year 6, even though it claims a credit for foreign income taxes that accrue in Year 6 and that relate to Year 6.

(d) *Period during which election can be made or changed*—(1) *In general*. The taxpayer may, for a particular taxable year, elect to claim a credit under section 901 (or claim a deduction in lieu of electing to claim a credit) at any time before the expiration of the period within which a claim for credit or refund of Federal income tax for such taxable year that is attributable to such credit or deduction, as the case may be, may be made (or, if longer, the period prescribed by section 6511(c) if the refund period for that taxable year is extended by an agreement to extend the assessment period under section 6501(c)(4)). Thus, an election to claim a credit for foreign income taxes paid or accrued (as the case may be, depending on the taxpayer's method of accounting for such taxes) in a particular taxable year can be made within the period prescribed by section 6511(d)(3)(A) for claiming a credit or refund of Federal income tax for that taxable year that is attributable to a credit for the foreign income taxes paid or accrued in that particular taxable year or, if longer, the period prescribed by section 6511(c) with respect to that particular taxable year. A choice to claim a deduction under section 164(a)(3), rather than a credit under section 901, for foreign income taxes paid or accrued in a particular taxable year can be made within the period prescribed by section 6511(a) or 6511(c), as applicable, for claiming a credit or refund of Federal income tax for that particular taxable year.

(2) *Manner in which election is made or changed*. A taxpayer claims a deduction or a credit for foreign income taxes paid or accrued in a particular taxable year by filing an original or amended return for that taxable year within the relevant period specified in paragraph (d)(1) of this section. A claim for a credit shall be accompanied by Form 1116 in the case of an individual, estate or trust, and by Form 1118 in the case of a corporation (and an individual, estate or trust making an election under section 962). See §§1.905-3 and 1.905-4 for rules requiring the filing of amended returns for all affected years when a timely change in the taxpayer's election to claim a deduction or credit results in U.S. tax deficiencies.

* * * * *

(f) *Taxes against which credit is allowed*. The credit for foreign income taxes is allowed only against the tax imposed by chapter 1 of the Code. The credit is not allowed against a tax that, under section 26(b)(2), is not treated as a tax imposed by such chapter.

* * * * *

(h) * * *

(1) Except as provided in paragraphs (c)(2) and (3) of this section, a taxpayer that claims a deduction for foreign income taxes paid or accrued (as the case may be,

depending on the taxpayer's method of accounting for such taxes) for that taxable year (see sections 164 and 275); and
* * * * *

(j) *Applicability date*. * * * This section applies to foreign taxes paid or accrued in taxable years beginning on or after December 28, 2021.

Par. 24. Section 1.901-2 is amended:

1. By revising paragraph (a) heading and paragraph (a)(1).

2. By revising paragraph (a)(3).

3. By revising paragraph (b).

4. By removing and reserving paragraph (c).

5. By revising paragraphs (d) and (e).

6. By revising paragraph (f)(2)(ii).

7. In paragraph (f)(3)(ii)(A), by removing the language "§1.909-2T(b)(2)(vi)" and adding the language "§1.909-2(b)(2)(vi)" in its place.

8. In paragraph (f)(3)(iii)(B)(*2*), by removing the language "§1.909-2T(b)(3)(i)" and adding the language "§1.909-2(b)(3)(i)" in its place and by removing the language "or accrued".

9. By revising paragraphs (f)(4) through (6) and adding paragraph (f)(7).

10. By revising paragraphs (g) and (h).

The revisions and additions read as follows:

§1.901-2 Income, war profits, or excess profits tax paid or accrued.

(a) *Definition of foreign income tax*—(1) *Overview and scope*. Paragraphs (a) and (b) of this section define a foreign income tax for purposes of section 901. Paragraph (c) of this section is reserved. Paragraph (d) of this section contains rules describing what constitutes a separate levy. Paragraph (e) of this section provides rules for determining the amount of foreign income tax paid by a taxpayer. Paragraph (f) of this section contains rules for determining by whom foreign income tax is paid. Paragraph (g) of this section defines the terms used in this section, and in particular provides that the term "paid" means "paid" or "accrued," depending on the taxpayer's method of accounting for foreign income taxes. Paragraph (h) of this section provides the applicability date for this section.

(i) *In general*. Section 901 allows a credit for the amount of income, war profits, and excess profits taxes paid during the taxable year to any foreign country, and section 903 provides that for purposes of Part III of subchapter N of the Code and sections 164(a) and 275(a), such taxes include a tax paid in lieu of a tax on income, war profits or excess profits that is otherwise generally imposed by a foreign country (collectively, for purposes of this section, a "foreign income tax"). Whether a foreign levy is a foreign income tax is determined independently for each separate levy. A foreign tax either is or is not a foreign income tax, in its entirety, for all persons subject to the foreign tax.

(ii) *Requirements*. A foreign levy is a foreign income tax only if—

(A) It is a foreign tax; and

(B) Either:

(*1*) The foreign tax is a net income tax, as defined in paragraph (a)(3) of this section; or

(*2*) The foreign tax is a tax in lieu of an income tax, as defined in §1.903-1(b).

(iii) *Coordination with treaties*. 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 citizen or resident of the United States (as determined under such income tax treaty) that elects benefits under the treaty. In addition, a foreign levy paid by a controlled foreign corporation that is modified by an applicable income tax treaty between the foreign jurisdiction of which the controlled foreign corporation is a resident and the foreign jurisdiction imposing the tax may qualify as a foreign income tax notwithstanding that the unmodified foreign levy does not satisfy the requirements in paragraph (b) of this section or the requirements of §1.903-1(b) if the levy, as modified by such treaty, satisfies the requirements of paragraph (b) of this section or the requirements of §1.903-1(b). See paragraph (d)(1)(iv) of this section for rules treating as a separate levy a foreign tax that is limited in its application or otherwise modified by the terms of an income tax treaty to which the foreign country imposing the tax is a party.
* * * * *

(3) *Net income tax*. A foreign tax is a net income tax only if the foreign tax meets the net gain requirement in paragraph (b) of this section.

(b) *Net gain requirement*—(1) *In general*. A foreign tax satisfies the net gain requirement only if the tax satisfies the realization, gross receipts, cost recovery, and attribution requirements in paragraphs (b)(2), (3), (4), and (5) of this section, respectively, or if the foreign tax is a surtax described in paragraph (b)(6) of this section. Paragraphs (b)(2) through (6) of this section are applied with respect to a foreign tax solely on the basis of the foreign tax law governing the calculation of the foreign taxable base, unless otherwise provided, and without any consideration of the rate of tax imposed on the foreign taxable base.

(2) *Realization requirement*—(i) *In general*. A foreign tax satisfies the realization requirement if it is imposed upon one or more of the events described in paragraphs (b)(2)(i)(A) through (C) of this section. If a foreign tax meets the realization requirement in paragraphs (b)(2)(i)(A) through (C) of this section except with respect to one or more specific and defined classes of nonrealization events (such as, for example, imputed rental income from a personal residence used by the owner), and as judged based on the application of the foreign tax to all taxpayers subject to the foreign tax, the incidence and amounts of gross receipts attributable to such nonrealization events is insignificant relative to the incidence and amounts of gross receipts attributable to events covered by the foreign tax that do meet the realization requirement, then the foreign tax is treated as meeting the realization requirement in paragraph (b)(2) of this section (despite the fact that the foreign tax is also imposed on the basis of some nonrealization events, and that some persons subject to the foreign tax may only be taxed on nonrealization events).

(A) *Realization events*. The foreign tax is imposed upon or after the occurrence of events ("realization events") that result in the realization of income under the income tax provisions of the Internal Revenue Code.

(B) *Pre-realization recapture events*. The foreign tax is imposed upon the occurrence of an event before a realization event (a "pre-realization event") that results in the recapture (in whole or part)

of a tax deduction, tax credit, or other tax allowance previously accorded to the taxpayer (for example, the recapture of an incentive tax credit if required investments are not completed within a specified period).

(C) *Pre-realization timing difference events*. The foreign tax is imposed upon the occurrence of a pre-realization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event, impose tax under the same or a separate levy (a "second tax") on the same taxpayer (for purposes of this paragraph (b)(2)(i)(C), treating a disregarded entity as defined in §301.7701-3(b)(2)(i)(C) of this chapter as a taxpayer separate from its owner), with respect to the income on which tax is imposed by reason of such pre-realization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the pre-realization event) and—

(*1*) The imposition of the tax upon such pre-realization event is based on the difference in the fair market value of property at the beginning and end of a period;

(*2*) The pre-realization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(ii) of this section) and the imposition of the tax upon the pre-realization event is based on the fair market value of such property; or

(*3*) The pre-realization event relates to a deemed distribution (for example, by a corporation to a shareholder) or inclusion (for example, under a controlled foreign corporation inclusion regime) of amounts (such as earnings and profits) that meet the realization requirement in paragraph (b)(2) of this section in the hands of the person that, under foreign tax law, is deemed to distribute such amounts.

(ii) *Readily marketable property*. Property is readily marketable if—

(A) It is stock in trade or other property of a kind that properly would be included in inventory if on hand at the close of the taxable year or if it is held primarily for sale to customers in the ordinary course of business, and

(B) It can be sold on the open market without further processing or it is exported from the foreign country.

(iii) *Examples*. The following examples illustrate the rules of paragraph (b)(2) of this section:

(A) *Example 1*. Residents of Country X are subject to a tax of 10 percent on the aggregate net appreciation in fair market value during the calendar year of all shares of stock held by them at the end of the year. In addition, all such residents are subject to a Country X tax that qualifies as a net income tax within the meaning of paragraph (a)(3) of this section. Included in the base of the net income tax are gains and losses realized on the sale of stock, and the basis of stock for purposes of determining such gain or loss is its cost. The operation of the stock appreciation tax and the net income tax as applied to sales of stock is exemplified as follows: A, a resident of Country X, purchases stock in June of Year 1 for 100u (units of Country X currency) and sells it in May of Year 3 for 160u. On December 31, Year 1, the stock is worth 120u and on December 31, Year 2, it is worth 155u. Pursuant to the stock appreciation tax, A pays 2u for Year 1 (10 percent of (120u−100u)), 3.5u for Year 2 (10 percent of (155u−120u)), and nothing for Year 3 because no stock was held at the end of that year. For purposes of the net income tax, A must include 60u (160u−100u) in his income for Year 3, the year of sale. Pursuant to paragraph (b)(2)(i)(C) of this section, the stock appreciation tax does not satisfy the realization requirement because Country X imposes a second tax upon the occurrence of a later event (that is, the sale of stock) with respect to the income that was taxed by the stock appreciation tax and no credit or comparable relief is available against such second tax for the stock appreciation tax paid.

(B) *Example 2*. The facts are the same as those in paragraph (b)(2)(iii)(A) of this section (the facts in *Example 1*), except that if stock was held on the December 31 last preceding the date of its sale, the basis of such stock for purposes of computing gain or loss under the net income tax is the value of the stock on such December 31. Thus, in Year 3, A includes only 5u (160u - 155u) as income from the sale for purposes of the net income tax. Because the net income tax imposed upon the occurrence of a later event (the sale) does not impose a tax with respect to the income that was taxed by the stock appreciation tax, under paragraph (b)(2)(i)(C) of this section, the stock appreciation tax satisfies the realization requirement. The result would be the same if, instead of a basis adjustment to reflect taxation pursuant to the stock appreciation tax, the Country X net income tax allowed a credit (or other comparable relief) to take account of the stock appreciation tax. If a credit mechanism is used, see also paragraph (e)(4)(i) of this section.

(C) *Example 3*. Country X imposes a tax on the realized net income of corporations that do business in Country X. Country X also imposes a branch profits tax on corporations organized under the law of a country other than Country X that do business in Country X. The branch profits tax is imposed when realized net income is remitted or deemed to be remitted by branches in Country X to home offices outside of Country X. Because the branch profits tax is imposed subsequent to the occurrence of events that would result in realization of income by corporations subject to such tax under the income tax provisions of the Internal Revenue Code, under paragraph (b)(2)(i)(A) of this section the branch profits tax satisfies the realization requirement.

(D) *Example 4*. Country X imposes a tax on the realized net income of corporations that do business in Country X (the "Country X corporate tax"). Country X also imposes a separate tax on shareholders of such corporations (the "Country X shareholder tax"). The Country X shareholder tax is imposed on the sum of the actual distributions received during the taxable year by such a shareholder from the corporation's realized net income for that year (that is, income from past years is not taxed in a later year when it is actually distributed) plus the distributions deemed to be received by such a shareholder. Deemed distributions are defined as a shareholder's pro rata share of the corporation's realized net income for the taxable year, less such shareholder's pro rata share of the corporation's Country X corporate tax for that year, less actual distributions made by such corporation to such shareholder from such net income. A shareholder's receipt of actual distributions is a realization event within the meaning of paragraph (b)(2)(i)(A) of this section. The deemed distributions are not realization events, but they are described in paragraph (b)(2)(i)(C)(*3*) of this section. Accordingly, the Country X shareholder tax satisfies the realization requirement.

(3) *Gross receipts requirement*—(i) *Rule*. A foreign tax satisfies the gross receipts requirement if it is imposed on the basis of the amounts described in paragraphs (b)(3)(i)(A) through (D) of this section.

(A) Actual gross receipts.

(B) In the case of either an insignificant nonrealization event described in the second sentence of paragraph (b)(2)(i) of this section or a realization event described in paragraph (b)(2)(i)(A) of this section that does not result in actual gross receipts, deemed gross receipts in an amount that is reasonably calculated to produce an amount that is not greater than fair market value.

(C) Deemed gross receipts in the amount of a tax deduction that is recaptured by reason of a pre-realization recapture event described in paragraph (b)(2)(i)(B) of this section.

(D) The amount of deemed gross receipts arising from pre-realization timing difference events described in paragraph (b)(2)(i)(C) of this section.

(ii) *Examples*. The following examples illustrate the rules of paragraph (b)(3)(i) of this section.

(A) *Example 1: Cost-plus tax—(1) Facts*. Country X imposes a "cost-plus tax" on Country X corporations that serve as regional headquarters companies for affiliated nonresident corporations, and this tax is a separate levy (within the meaning of paragraph (d)(1) of this section). A headquarters company for purposes of this tax is a corporation that performs ad-

ministrative, management or coordination functions solely for nonresident affiliated entities. Due to the difficulty of determining on a case-by-case basis the arm's length gross receipts that headquarters companies would charge affiliates for such services, gross receipts of a headquarters company are deemed, for purposes of this tax, to equal 110 percent of the business expenses incurred by the headquarters company.

(*2*) *Analysis*. Because the cost-plus tax is based on costs and not on actual gross receipts, the cost-plus tax does not satisfy the gross receipts requirement of paragraph (b)(3)(i) of this section.

(B) *Example 2: Actual gross receipts determined under appropriate transfer pricing methodology*—(*1*) *Facts*. Country X imposes a tax on resident corporations that meets the attribution requirement of paragraph (b)(5)(ii) of this section. The Country X tax is based on actual gross receipts, including gross receipts recorded on the taxpayer's books and records as due from related and unrelated persons. Corporation A, a resident of Country X, properly determines the arm's length transfer price for services provided to related persons using a cost-plus methodology, recording on its books and records receivables for the arm's length amounts due from those related persons and using those amounts to determine the realized gross receipts included in the base of the Country X tax.

(*2*) *Analysis*. Because the Country X tax is based on actual gross receipts, it satisfies the gross receipts requirement of paragraph (b)(3)(i) of this section.

(C) *Example 3: Petroleum taxed on extraction*—(*1*) *Facts*. Country X imposes a tax that is a separate levy (within the meaning of paragraph (d)(1) of this section) on income from the extraction of petroleum. Under the terms of that tax, gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted.

(*2*) *Analysis*. Because it is imposed on deemed gross receipts that exceed the fair market value of the petroleum extracted, the tax on extraction income does not satisfy the gross receipts requirement of paragraph (b)(3)(i) of this section.

(4) *Cost recovery requirement*—(i) *Costs and expenses that must be recovered*—(A) *In general*. A foreign tax satisfies the cost recovery requirement if the base of the tax is computed by reducing gross receipts (as described in paragraph (b)(3) of this section) to permit recovery of the significant costs and expenses (including significant capital expenditures) described in paragraph (b)(4)(i)(C) of this section attributable, under reasonable principles, to such gross receipts. A foreign tax need not permit recovery of significant costs and expenses, such as certain personal expenses, that are not attributable, under reasonable principles, to gross receipts included in the foreign taxable base. A foreign tax whose base is gross receipts, with no reduction for costs and expenses, satisfies the cost recovery requirement only if there are no significant costs and expenses attributable to the gross receipts included in the foreign tax base that must be recovered under the rules of paragraph (b)(4)(i)(C)(*1*) of this section. See paragraph (b)(4)(iv)(A) of this section (*Example 1*). A foreign tax that provides an alternative cost allowance satisfies the cost recovery requirement only as provided in paragraph (b)(4)(i)(B) of this section. See paragraph (b)(4)(i)(D) of this section for rules regarding principles for attributing costs and expenses to gross receipts.

(B) *Alternative cost allowances*—(*1*) *In general*. Except as provided in paragraph (b)(4)(i)(B)(*2*) of this section, if foreign tax law does not permit recovery of one or more significant costs and expenses in computing the base of the foreign tax but provides an alternative cost allowance, the foreign tax satisfies the cost recovery requirement only if the alternative allowance permits recovery of an amount that by its terms may be greater, but can never be less, than the actual amounts of such significant costs and expenses (for example, under a provision identical to percentage depletion allowed under section 613). If foreign tax law provides an optional alternative cost allowance or an election to recover costs and expenses under an alternative method, the foreign tax satisfies the cost recovery requirement if the foreign tax law also expressly provides an option to recover actual costs and expenses. See §1.901-2(e)(5) for rules limiting the amount of foreign income tax paid to the amount due under the option that minimizes the taxpayer's liability for foreign income tax over time. If foreign tax law provides an alternative cost allowance that does not by its terms permit recovery of an amount equal to or greater than the actual amounts of significant costs and expenses, the foreign tax does not satisfy the cost recovery requirement, even if, in practice, the amounts recovered under the alternative allowance equal or exceed the amount of actual costs and expenses.

(*2*) *Small business exception*. If foreign tax law provides an alternative method for determining the amount of costs and expenses allowed in computing the taxable base of small business enterprises, the foreign tax satisfies the cost recovery requirement if the foreign tax law contains reasonable limits on the maximum size of business enterprises to which the alternative cost allowance applies (for example, business enterprises having asset values or annual gross revenues below specified thresholds). See paragraph (b)(4)(iv)(B) of this section (*Example 2*).

(C) *Significant costs and expenses*—(*1*) *Amounts that must be recovered*. Whether a cost or expense is significant for purposes of this paragraph (b)(4)(i) is determined based on whether, for all taxpayers in the aggregate to which the foreign tax applies, the item of cost or expense constitutes a significant portion of the taxpayers' total costs and expenses. Costs and expenses (as characterized under foreign law) related to capital expenditures, interest, rents, royalties, wages or other payments for services, and research and experimentation are always treated as significant costs or expenses for purposes of this paragraph (b)(4)(i). Significant costs and expenses (such as interest expense) are not considered to be recovered by reason of the time value of money attributable to the acceleration of a tax benefit or other economic benefit attributable to the timing of the recovery of other costs and expenses (such as the current expensing of debt-financed capital expenditures). Foreign tax law is considered to permit recovery of significant costs and expenses even if recovery of all or a portion of certain costs or expenses is disallowed, if such disallowance is consistent with the principles underlying the disallowances required under the Internal Revenue Code, including disallowances intended to limit base erosion or profit shifting. For example, a foreign tax is considered to permit recovery of significant costs and expenses if the foreign tax law limits interest deductions so as not to exceed 10 percent of a reasonable measure of taxable income (determined either before or after depreciation and amortization) based on principles similar to those underlying section 163(j), disallows interest and royalty deductions in connection with hybrid transactions based on principles similar to those underlying section 267A, disallows deductions attributable to gross receipts that in whole or in part are excluded, exempt or eliminated from taxable income, or disallows certain expenses based on public policy considerations similar to those disallowances

contained in section 162. See paragraph (b)(4)(iv)(C) of this section (*Example 3*).

(*2*) *Amounts that need not be recovered*. A foreign tax is considered to permit recovery of significant costs and expenses even if the foreign tax law does not permit recovery of any costs and expenses attributable to wage income or to investment income that is not derived from a trade or business. In addition, in determining whether a foreign tax (the "tested foreign tax") meets the cost recovery requirement, it is immaterial whether the tested foreign tax allows a deduction for other taxes that would qualify as foreign income taxes (determined without regard to whether such other tax allows a deduction for the tested foreign tax). See paragraph (b)(4)(iv)(D) and (E) of this section (*Examples 4* and *5*).

(*3*) *Timing of recovery*. A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered earlier or later than they are recovered under the Internal Revenue Code, unless the time of recovery is so much later (for example, after the property becomes worthless or is disposed of) as effectively to constitute a denial of such recovery. The amount of costs and expenses that is recovered under the foreign tax law is neither discounted nor augmented by taking into account the time value of money attributable to any acceleration or deferral of a tax benefit resulting from the foreign law cost recovery method compared to when tax would be paid under the Internal Revenue Code. Therefore, a foreign tax satisfies the cost recovery requirement if items deductible under the Internal Revenue Code are capitalized under the foreign tax law and recovered either immediately, on a recurring basis over time, or upon the occurrence of some future event, or if the recovery of items capitalized under the Internal Revenue Code occurs more or less rapidly than under the foreign tax law.

(D) *Attribution of costs and expenses to gross receipts*. Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code (for example, principles that apply under section 265, 465 or 861(b) of the Internal Revenue Code). See also paragraph (b)(5) of this section for additional requirements relating to foreign tax law rules for attributing costs and expenses to gross receipts.

(ii) *Consolidation of profits and losses*. In determining whether a foreign tax satisfies the cost recovery requirement, one of the factors to be taken into account is whether, in computing the base of the tax, a loss incurred in one activity (for example, a contract area in the case of oil and gas exploration) in a trade or business is allowed to offset profit earned by the same person in another activity (for example, a separate contract area) in the same trade or business. If such an offset is allowed, it is immaterial whether the offset may be made in the taxable period in which the loss is incurred or only in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset the loss against profit. In determining whether a foreign tax satisfies the cost recovery requirement, it is immaterial that no such offset is allowed if a loss incurred in one such activity may be applied to offset profit earned in that activity in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset such loss against profit. In determining whether a foreign tax satisfies the cost recovery requirement, it is immaterial whether a person's profits and losses from one trade or business (for example, oil and gas extraction) are allowed to offset its profits and losses from another trade or business (for example, oil and gas refining and processing), or whether a person's business profits and losses and its passive investment profits and losses are allowed to offset each other in computing the base of the foreign tax. Moreover, it is immaterial whether foreign tax law permits or prohibits consolidation of profits and losses of related persons, unless foreign tax law requires separate entities to be used to carry on separate activities in the same trade or business. If foreign tax law requires that separate entities carry on such separate activities, the determination whether the cost recovery requirement is satisfied is made by applying the same considerations as if such separate activities were carried on by a single entity.

(iii) *Carryovers*. In determining whether a foreign tax satisfies the cost recovery requirement, it is immaterial, except as otherwise provided in paragraph (b)(4)(ii) of this section, whether losses incurred during one taxable period may be carried over to offset profits incurred in different taxable periods.

(iv) *Examples*. The following examples illustrate the rules of paragraph (b)(4) of this section.

(A) *Example 1: Tax on gross interest income of certain residents; no deductions allowed—*(*1*) *Facts.* Country X imposes a net income tax on corporations resident in Country X. Country X imposes a second tax (the "bank tax") of 1 percent on the gross amount of interest income derived by banks resident in Country X; no deductions are allowed in determining the base of the bank tax. Banks resident in Country X incur substantial costs and expenses, including interest expense, attributable to their interest income.

(*2*) *Analysis*. Because the terms of the bank tax do not permit recovery of significant costs and expenses attributable to the gross receipts included in the tax base, the bank tax does not satisfy the cost recovery requirement of paragraph (b)(4)(i) of this section.

(B) *Example 2: Small business alternative allowance—*(*1*) *Facts.* Country X imposes a tax on the income of corporations resident in Country X. Under Country X tax law, corporations are generally allowed to deduct actual costs and expenses attributable to the realized gross receipts included in the Country X tax base. However, in lieu of deductions for actual costs and expenses, businesses with gross revenues of less than the Country X currency equivalent of $500,000 are allowed a flat cost allowance of 50 percent of gross revenues.

(*2*) *Analysis*. Under paragraph (b)(4)(i)(B)(*2*) of this section, the alternative cost allowance for small businesses provided under Country X tax law satisfies the cost recovery requirement.

(C) *Example 3: Permissible deduction disallowance—*(*1*) *Facts.* Country X imposes a tax on the income of corporations resident in Country X. Under Country X tax law, deductions for the significant costs and expenses attributable to the gross receipts included in the Country X tax base are allowed, except that deductions for interest expense incurred by corporations are limited to 30 percent of the corporation's earnings before income taxes, depreciation, and amortization, and unused interest expense may be carried forward for a period of 5 years. In addition, Country X tax law contains anti-hybrid rules that deny deductions for interest, royalties, rents, and services payments made by a Country X resident to a related entity outside Country X that is treated as a transparent entity in the jurisdiction in which it is organized but as a separate entity in the jurisdiction of the entity's owners (a "reverse hybrid entity") to the extent that the payment is not included in the income of the reverse hybrid entity or its owners.

(*2*) *Analysis*. Under paragraph (b)(4)(i)(C)(*1*) of this section, costs and expenses related to interest, rents, royalties, and payments for services are treated as significant costs or expenses that must be recoverable under Country X tax law. However, because the interest expense limitation rule and the anti-hy-

brid rules in Country X tax law are consistent with the principles underlying the disallowances required under the Internal Revenue Code (namely, section 163(j) and section 267A), the Country X tax satisfies the cost recovery requirement.

(D) *Example 4: Gross basis tax on wages—(1) Facts.* A foreign country imposes payroll tax on resident employees at the rate of 10 percent of the amount of gross wages; no deductions are allowed in computing the base of the payroll tax.

(*2*) *Analysis.* Although the foreign tax law does not allow for the recovery of any costs and expenses attributable to gross receipts included in the taxable base, under paragraph (b)(4)(i)(C)(*2*) of this section, because the only gross receipts included in the taxable base are from wages, the payroll tax satisfies the cost recovery requirement.

(E) *Example 5: No deduction for another net income tax—(1) Facts.* Each of Country X and Province Y (a political subdivision of Country X) imposes a tax on resident corporations, called the "Country X income tax" and the "Province Y income tax," respectively. Each tax has an identical base, which is computed by reducing a corporation's realized gross receipts by deductions that, based on the laws of Country X and Province Y, generally permit recovery of the significant costs and expenses (including significant capital expenditures) that are attributable under reasonable principles to such gross receipts. However, the Country X income tax does not allow a deduction for the Province Y income tax for which a taxpayer is liable, nor does the Province Y income tax allow a deduction for the Country X income tax for which a taxpayer is liable.

(*2*) *Analysis.* Under paragraph (d)(1)(i) of this section, each of the Country X income tax and the Province Y income tax is a separate levy. Without regard to whether the Province Y income tax may allow a deduction for the Country X income tax, and without regard to whether the Country X income tax may allow a deduction for the Province Y income tax, both taxes would qualify as net income taxes under paragraph (a)(3) of this section. Therefore, under paragraph (b)(4)(i)(C)(*2*) of this section the fact that neither levy's base allows a deduction for the other levy is immaterial, and both levies satisfy the cost recovery requirement.

(5) *Attribution requirement*. A foreign tax satisfies the attribution requirement if the amount of gross receipts and costs that are included in the base of the foreign tax are determined based on rules described in paragraph (b)(5)(i) of this section (with respect to a separate levy imposed on nonresidents of the foreign country) or paragraph (b)(5)(ii) of this section (with respect to a separate levy imposed on residents of the foreign country).

(i) *Tax on nonresidents*. The gross receipts and costs attributable to each of the items of income of nonresidents of a foreign country that is included in the base of the foreign tax must satisfy the requirements of paragraph (b)(5)(i)(A), (B), or (C) of this section.

(A) *Income attribution based on activities*. The gross receipts and costs that are included in the base of the foreign tax are limited to gross receipts and costs that are attributable, under reasonable principles, to the nonresident's activities within the foreign country imposing the foreign tax (including the nonresident's functions, assets, and risks located in the foreign country). For purposes of the preceding sentence, attribution of gross receipts under reasonable principles includes rules similar to those for determining effectively connected income under section 864(c) but does not include rules that take into account as a significant factor the mere location of customers, users, or any other similar destination-based criterion, or the mere location of persons from whom the nonresident makes purchases in the foreign country. In addition, for purposes of the first sentence of this paragraph (b)(5)(i)(A), reasonable principles do not include rules that deem the existence of a trade or business or permanent establishment based on the activities of another person (other than an agent or other person acting on behalf of the nonresident or a pass-through entity of which the nonresident is an owner), or that attribute gross receipts or costs to a nonresident based upon the activities of another person (other than an agent or other person acting on behalf of the nonresident or a pass-through entity of which the nonresident is an owner).

(B) *Income attribution based on source*. The amount of gross income arising from gross receipts (other than gross receipts from sales or other dispositions of property) that is included in the base of the foreign tax on the basis of source (instead of on the basis of activities or the situs of property as described in paragraphs (b)(5)(i)(A) and (C) of this section) is limited to gross income arising from sources within the foreign country that imposes the tax, and the sourcing rules of the foreign tax law are reasonably similar to the sourcing rules that apply under the Internal Revenue Code. A foreign tax law's application of such sourcing rules need not conform in all respects to the application of those sourcing rules for Federal income tax purposes. For purposes of determining whether the sourcing rules of the foreign tax law are reasonably similar to the sourcing rules that apply under the Internal Revenue Code, the character of gross income arising from gross receipts is determined under the foreign tax law (except as provided in paragraph (b)(5)(i)(B)(*3*) of this section), and the following rules apply:

(*1*) *Services*. Under the foreign tax law, gross income from services must be sourced based on where the services are performed, as determined under reasonable principles (which do not include determining the place of performance of the services based on the location of the service recipient).

(*2*) *Royalties*. 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.

(*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 rules in paragraph (b)(5)(i)(A) or (C) of this section, and not on the basis of source. In the case of sales of copyrighted articles (as determined under rules similar to §1.861-18), a foreign tax satisfies the attribution requirement of paragraph (b)(5) of this section only if the transaction is treated as a sale of tangible property and not as a license of intangible property.

(C) *Attribution based on situs of property*. A foreign tax on gains of nonresidents from the sale or disposition of property, including shares in a corporation or an interest in a partnership or other pass-through entity, based on the situs of property satisfies the attribution requirement only as provided in this paragraph (b)(5)(i)(C). The amount of gross receipts from the sale or disposition of property that is included in the base of the foreign tax on the basis of the situs of real property (instead of on the basis of activities as described in paragraph (b)(5)(i)(A) of this section) may only include gross receipts that are attributable to the disposition of real property situated in the foreign country imposing the foreign tax (or an interest in a resident corporation or other entity that owns such real property) under rules reasonably similar to the rules in section 897. The amount of gross receipts from the sale or disposition of property other than shares in a corporation, including an interest in a partnership or other pass-

through entity, that is included in the base of the foreign tax on the basis of the situs of property other than real property may only include gross receipts that are attributable to property forming part of the business property of a taxable presence in the foreign country imposing the foreign tax under rules that are reasonably similar to the rules in section 864(c).

(ii) *Tax on residents*. The base of a foreign tax imposed on residents of the foreign country imposing the foreign tax may include all of the worldwide gross receipts of the resident, but must provide that any allocation to or from the resident of income, gain, deduction, or loss with respect to transactions between such resident and organizations, trades, or businesses owned or controlled directly or indirectly by the same interests (that is, any allocation made pursuant to the foreign country's transfer pricing rules) is determined under arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.

(iii) *Examples*. The following examples illustrate the rules of paragraph (b)(5) of this section.

(A) *Example 1*—(*1*) *Facts*. Country X imposes a separate levy on nonresident companies that furnish, from a location outside of Country X, specified types of electronically supplied services to users located in Country X (the "ESS tax"). The base of the ESS tax is computed by taking the nonresident company's overall net income related to supplying electronically supplied services, and deeming a portion of such net income to be attributable to a deemed permanent establishment of the nonresident company in Country X. The amount of the nonresident company's net income attributable to the deemed permanent establishment is determined on a formulary basis based on the percentage of the nonresident company's total users that are located in Country X.

(*2*) *Analysis*. The taxable base of the ESS tax is not computed based on a nonresident company's activities located in Country X, but instead takes into account the location of the nonresident company's users. Therefore, the ESS tax does not meet the requirement in paragraph (b)(5)(i)(A) of this section. The ESS tax also does not meet the requirement in paragraph (b)(5)(i)(B) of this section because it is not imposed on the basis of source, and it does not meet the requirement in paragraph (b)(5)(i)(C) of this section because it is not imposed on the sale or other disposition of property.

(B) *Example 2*—(*1*) *Facts*. The facts are the same as those in paragraph (b)(5)(iii)(A)(*1*) of this section (the facts in *Example 1*), except that instead of imposing the ESS tax by deeming nonresident companies to have a permanent establishment in Country X, Country X treats gross income from electronically supplied services provided to users located in Country X as sourced in Country X. The gross income sourced to Country X is reduced by costs that are reasonably attributed to such gross income, to arrive at the taxable base of the ESS tax. The amount of the nonresident's gross income and costs that are sourced to Country X is determined by multiplying the nonresident's total gross income and costs by the percentage of its total users that are located in Country X.

(*2*) *Analysis*. Country X tax law's rule for sourcing electronically supplied services is not based on where the services are performed and is instead based on the location of the service recipient. Therefore, the ESS tax, which is imposed on the basis of source, does not meet the requirement in paragraph (b)(5)(i)(B) of this section. The ESS tax also does not meet the requirement in paragraph (b)(5)(i)(A) of this section because it is not imposed on the basis of a nonresident's activities located in Country X, and it does not meet the requirement in paragraph (b)(5)(i)(C) of this section because it is not imposed on the sale or other disposition of property.

(6) *Surtax on net income tax*. A foreign tax satisfies the net gain requirement in this paragraph (b) if the base of the foreign tax is the amount of a net income tax. For example, if a tax (surtax) is computed as a percentage of a separate levy that is itself a net income tax, then such surtax is considered to satisfy the net gain requirement.

* * * * *

(d) *Separate levies*—(1) *In general*. Each foreign levy must be analyzed separately to determine whether it is a net income tax within the meaning of paragraph (a)(3) of this section and whether it is a tax in lieu of an income tax within the meaning of §1.903-1(b)(2). Whether a single levy or separate levies are imposed by a foreign country depends on U.S. principles and not on whether foreign tax law imposes the levy or levies pursuant to a single or separate statutes. A foreign levy is a separate levy described in this paragraph (d)(1) if it is described in paragraph (d)(1)(i), (ii), (iii), or (iv) of this section. In the case of levies that apply to dual capacity taxpayers, see also §1.901-2A(a).

(i) *Taxing authority*. A levy imposed by one taxing authority (for example, the national government of a foreign country) is always separate from a levy imposed by another taxing authority (for example, a political subdivision of that foreign country), even if the base of the levy is the same.

(ii) *Different taxable base*. 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. For example, foreign levies identical to the taxes imposed by sections 1, 11, 541, 871(a), 871(b), 881, 882, 3101 and 3111 of the Internal Revenue Code are each separate levies, because the levies are imposed on different classes of taxpayers, and the base of each of those levies contains different items than the base of each of the others. A taxable base of a separate levy may consist of a particular type of income (for example, wage income, investment income, or income from self-employment). The taxable base of a separate levy may also consist of an amount unrelated to income (for example, wage expense or assets). A separate levy may provide that items included in the base of the tax are computed separately merely for purposes of a preliminary computation and are then combined as a single taxable base. Income included in the taxable base of a separate levy may also be included in the taxable base of another levy (which may or may not also include other items of income); separate levies are considered to be imposed if the taxable bases are not combined as a single taxable base, even if the taxable bases are determined using the same computational rules. For example, a foreign levy identical to the tax imposed by section 1 is a separate levy from a foreign levy identical to the tax imposed by section 1411, because tax is imposed under each levy on a separate taxable base that is not combined with the other as a single taxable base. Where foreign tax law imposes a levy that is the sum of two or more separately computed amounts of tax, and each such amount is computed by reference to a different base, separate levies are considered to be imposed. Levies are not separate merely because different rates apply to different classes of taxpayers that are subject to the same provisions in computing the base of the tax. For example, a foreign levy identical to the tax imposed on U.S. citizens and resident alien individuals by section 1 of the Internal Revenue Code is a single levy notwithstanding that the levy has graduated rates and applies different rate schedules to unmarried individuals, married individuals who file separate returns, and married individuals who file joint returns. In addition, in general, levies are not separate merely because some provisions determining the base of the

levy apply, by their terms or in practice, to some, but not all, persons subject to the levy. For example, a foreign levy identical to the tax imposed by section 11 of the Internal Revenue Code is a single levy even though some provisions apply by their terms to some but not all corporations subject to the section 11 tax (for example, section 465 is by its terms applicable to corporations described in sections 465(a)(1)(B), but not to other corporations), and even though some provisions apply in practice to some but not all corporations subject to the section 11 tax (for example, section 611 does not, in practice, apply to any corporation that does not have a qualifying interest in the type of property described in section 611(a)).

(iii) *Tax imposed on nonresidents*. A foreign levy imposed on nonresidents is always treated as a separate levy from that imposed on residents, even if the base of 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. In addition, a withholding tax (as defined in section 901(k)(1)(B)) that is imposed on gross income of nonresidents is treated as a separate levy as to each separate class of income described in section 61 (for example, interest, dividends, rents, or royalties) subject to the withholding tax. If two or more subsets of a separate class of income are subject to a withholding tax based on different income attribution rules (for example, 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), separate levies are considered to be imposed with respect to each subset of that separate class of income.

(iv) *Foreign levy modified by an applicable income tax treaty*. A foreign levy that is limited in its application by, or is otherwise modified by, an income tax treaty to which the foreign country imposing the levy is a party is a separate levy from the levy imposed under the domestic law (without regard to the treaty) of the foreign country, and is also a separate levy from the foreign levy as modified by a different income tax treaty to which the foreign country imposing the levy is a party, even if the two treaties modify the foreign levy in exactly the same manner. Accordingly, a foreign levy paid by taxpayers that qualify for and claim benefits under an income tax treaty is a separate levy from the levy as applied to taxpayers that are ineligible for, or that do not claim, benefits under that treaty, even if the two foreign levies would apply in the same manner to a particular taxpayer, and regardless of whether the unmodified foreign levy is a foreign income tax within the meaning of paragraph (a)(1)(ii) of this section.

(2) *Contractual modifications*. Notwithstanding paragraph (d)(1) of this section, if foreign tax law imposing a levy is modified for one or more persons subject to the levy by a contract entered into by such person or persons and the foreign country, then the foreign tax law is considered for purposes of sections 901 and 903 to impose a separate levy for all persons to whom such contractual modification of the levy applies, as contrasted to the levy as applied to all persons to whom such contractual modification does not apply.

(3) *Examples*. The following examples illustrate the rules of paragraph (d)(1) of this section.

(i) *Example 1: Separate taxable bases*—(A) *Facts*. A foreign statute imposes a levy on corporations equal to the sum of 15% of the corporation's realized net income plus 3% of its net worth.

(B) *Analysis*. As the levy is the sum of two separately computed amounts, each of which is computed by reference to a separate base, under paragraph (d)(1)(ii) of this section each of the portion of the levy based on income and the portion of the levy based on net worth is considered, for purposes of sections 901 and 903, to be a separate levy.

(ii) *Example 2: Separate taxable bases*—(A) *Facts*. A foreign statute imposes a levy on nonresident alien individuals analogous to the taxes imposed by section 871 of the Internal Revenue Code.

(B) *Analysis*. As the levy is imposed on separately computed amounts, each of which is computed by reference to a separate taxable base and portions of which comprise withholding tax on gross income of nonresidents, under paragraphs (d)(1)(ii) and (iii) of this section, each of the portions of the foreign levy imposed on each separate class of gross income analogous to the tax imposed by section 871(a) and the portion of the foreign levy analogous to the tax imposed by sections 871(b) and 1 is considered, for purposes of sections 901 and 903, to be a separate levy.

(iii) *Example 3: Separate taxable bases*—(A) *Facts*—(*1*) A single foreign statute or separate foreign statutes impose a foreign levy that is the sum of the products of specified rates applied to specified bases, as follows:

Table 1 to paragraph (d)(3)(iii)(A)(*1*)

Base	Rate (percent)
Net income from mining	45
Net income from manufacturing	50
Net income from technical services	50
Net income from other services	45
Net income from investments	15
All other net income	50

(*2*) In computing each such base, deductible expenditures are allocated to the type of income they generate. If allocated deductible expenditures exceed the gross amount of a specified type of income, the excess may not be applied against income of a different specified type.

(B) *Analysis*. The levy is the sum of several separately computed amounts, each of which is computed by reference to a separate base. Accordingly, under paragraph (d)(1)(ii) of this section, each of the levies on mining net income, manufacturing net income, technical services net income, other services net income, investment net income and other net income is considered, for purposes of sections 901 and 903, to be a separate levy.

(iv) *Example 4: Combined taxable base after preliminary separate computation*—(A) *Facts*. The facts are the same as those in paragraph (d)(3)(iii)(A) of this section (the facts in *Example 3*), except that excess deductible expenditures allocated to one type of income are applied against other types of income to which the same rate applies.

(B) *Analysis*. Under paragraph (d)(1)(ii) of this section, the levies on mining net income and other services net income together are considered, for purposes of sections 901 and 903, to be a single levy since, despite a separate preliminary computation of

the bases, by reason of the permitted application of excess allocated deductible expenditures the bases are not separately computed. For the same reason, the levies on manufacturing net income, technical services net income and other net income together are considered, for purposes of sections 901 and 903, to be a single levy. The levy on investment net income is considered, for purposes of sections 901 and 903, to be a separate levy. These results are not dependent on whether the application of excess allocated deductible expenditures to a different type of income is permitted in the same taxable period in which the expenditures are taken into account for purposes of the preliminary computation, or only in a different (for example, later) taxable period.

(v) *Example 5: Combined taxable base with income subject to different rates*—(A) *Facts*. The facts are the same as those in paragraph (d)(3)(iii)(A) of this section (the facts in *Example 3*), except that excess deductible expenditures allocated to any type of income other than investment income are applied against the other types of income (including investment income) according to a specified set of priorities of application. Excess deductible expenditures allocated to investment income are not applied against any other type of income.

(B) *Analysis*. For the same reasons as those set forth in paragraph (d)(3)(iv)(B) of this section (the analysis in *Example 4*), all of the levies are together considered, for purposes of sections 901 and 903, to be a single levy.

(vi) *Example 6: Minimum Tax*—(A) *Facts*. Country X imposes a net income tax ("Income Tax") and a minimum tax ("Minimum Tax") on its residents. Under Country X tax law, alternative minimum taxable income for purposes of the Minimum Tax equals the taxable income under the Income Tax increased by certain disallowed deductions. The Minimum Tax equals the excess, if any, of the alternative minimum taxable income times the Minimum Tax rate over the amount of the Income Tax.

(B) *Analysis*. Under paragraph (d)(1)(ii) of this section, the Minimum Tax is a separate levy from the Income Tax, because the taxable base of each levy is separately computed and not combined as a single taxable base. The result would be the same if under Country X tax law the Minimum Tax equaled the alternative minimum taxable income times the Minimum Tax rate, and residents of Country X were required to pay the greater of the Income Tax or the Minimum Tax (rather than the Income Tax plus the excess, if any, of the Minimum Tax over the Income Tax).

(vii) *Example 7: Diverted Profits Tax*—(A) *Facts*. Country X imposes a 20% net income tax ("Income Tax") and a 25% "Diverted Profits Tax" on nonresident corporations. Under Country X tax law, taxable income under the Diverted Profits Tax is determined first by attributing gross receipts of the nonresident corporation to a hypothetical permanent establishment in Country X. Country X applies the same computational rules that apply under the Income Tax to determine the taxable income attributable to a hypothetical permanent establishment under the Diverted Profits Tax.

(B) *Analysis*. Under paragraph (d)(1)(ii) of this section, the Diverted Profits Tax is a separate levy from the Income Tax, because the taxable income under the Diverted Profits Tax is not combined with the taxable income under the Income Tax as a single taxable base.

(viii) *Example 8: Modified Income Tax*—(A) *Facts*. Country X imposes a net income tax ("Income Tax") on nonresident corporations that carry on a trade or business in Country X through a permanent establishment. Under Country X tax law, the taxable base of the Income Tax as initially enacted is determined by attributing profits of the nonresident corporation to its permanent establishment in Country X based upon rules similar to Articles 5 and 7 of the 2016 U.S. Model Income Tax Convention. However, Country X later amends the Income Tax to provide that nonresident corporations that are engaged in certain digital transactions in Country X and earning revenues above certain thresholds are deemed to have a permanent establishment; under the Income Tax as originally enacted, such activities would not have created a permanent establishment in Country X.

(B) *Analysis*. Under paragraph (d)(1)(ii) of this section, the Income Tax as applied to nonresident corporations engaged in digital transactions and deemed to have a permanent establishment under the modified Income Tax is not a separate levy from the Income Tax as applied to the same or other nonresident corporations that would have permanent establishments under the Income Tax as originally enacted, because income attributable to both actual and deemed permanent establishments is combined as a single taxable base.

(ix) *Example 9: Disallowed deductions*—(A) *Facts*. Country X imposes a net income tax ("Income Tax") on resident corporations. In determining the taxable base for the Income Tax, Country X tax law has a cap on allowed interest deductions for companies engaged in the extraction, production, or refinement of oil or natural gas.

(B) *Analysis*. Under paragraph (d)(1)(ii) of this section, the Income Tax as applied to corporations engaged in the extraction, production, or refinement of oil or natural gas is not a separate levy from the Income Tax as applied to other corporations subject to the levy. The Income Tax is a single levy even though the cap on allowed interest expense deductions applies by its terms to some, but not all, corporations subject to the Income Tax.

(x) *Example 10: Different taxable base for class of taxpayers*—(A) *Facts*. Country X imposes a net income tax ("Income Tax") and an oil tax. The oil tax applies only to resident corporations engaged in the extraction, production, or refinement of oil, and resident corporations subject to the oil tax are not subject to the Income Tax. The taxable base under the oil tax is the taxable income under the Income Tax increased by disallowed interest expense.

(B) *Analysis*. Under paragraph (d)(1)(ii) of this section, the oil tax is a separate levy from the Income Tax, because the taxable income under the oil tax is not combined with the taxable income under the Income Tax as a single taxable base. The levies are imposed on different classes of taxpayers (resident taxpayers engaged in the extraction, production, or refinement of oil, in the case of the oil tax, and all other resident corporations, in the case of the Income Tax), and the base of each of those levies contains different items.

(e) *Amount of foreign income tax that is creditable*—(1) *In general*. Credit is allowed under section 901 for the amount of foreign income tax that is paid by the taxpayer. Under paragraph (g) of this section, the term "paid" means "paid" or "accrued," depending on the taxpayer's method of accounting for such taxes. The amount of foreign income tax paid by the taxpayer is determined separately for each taxpayer under the rules in this paragraph (e).

(2) *Refunds and credits*—(i) *Refundable amounts*. An amount remitted to a foreign country is not an amount of foreign income tax paid to the extent that it is reasonably certain that the amount will be refunded, rebated, abated, or forgiven. It is reasonably certain that an amount will be refunded, rebated, abated, or forgiven to the extent the amount exceeds a reasonable approximation of final foreign income tax liability to the foreign country. See section 905(c) and §1.905-3 for the required redeterminations if amounts claimed as a credit (on either the cash or accrual basis) exceed the amount of the final foreign income tax liability.

(ii) *Credits*. Except as provided in paragraph (e)(2)(iii) of this section, an amount of foreign income tax liability is not an amount of foreign income tax paid to the extent the foreign income tax liability is reduced, satisfied, or otherwise offset by a tax credit, including a tax credit that under the foreign tax law is payable in cash only to the extent it exceeds the taxpayer's liability for foreign income tax or a tax credit acquired from another taxpayer.

(iii) *Exception for overpayments and other fully refundable credits*. An amount of foreign income tax paid is not reduced (or treated as constructively refunded) solely by reason of the fact that a credit is allowed (or may be allowed) for the amount paid to reduce the amount of a different separate levy owed by the taxpayer. See paragraphs (e)(2)(ii) and (e)(4) of this section. However, under paragraph (e)(2)(i) of this section (and taking into account any redetermination required under section 905(c) and §1.905-3), an amount remitted with respect to a separate levy for a foreign taxable period that constitutes an overpayment of the taxpayer's final liability for that levy for that period, and that is refundable in cash at the taxpay-

er's option, is not an amount of tax paid. Therefore, if such an overpayment of one tax is applied as a credit against a different foreign income tax liability of the taxpayer for the same or a different taxable period, the credited amount of the overpayment may qualify as an amount paid of that different foreign income tax, if the credited amount does not exceed a reasonable approximation of the taxpayer's final foreign income tax liability for the taxable period to which the overpayment is applied. Similarly, if under the foreign tax law, the full amount of a tax credit is payable in cash at the taxpayer's option, the taxpayer's choice to apply all or a portion of the tax credit in satisfaction of a foreign income tax liability of the taxpayer is treated as a constructive payment of cash to the taxpayer in the amount so applied, followed by a constructive payment of the foreign income tax liability against which the credit is applied. An overpayment or other tax credit that under the foreign tax law is otherwise fully payable in cash at the taxpayer's option and that is applied in part in satisfaction of a foreign income tax liability is treated as an amount of foreign income tax paid notwithstanding that a portion of the amount otherwise payable in cash to the taxpayer is subject to a lien or otherwise seized in order to satisfy a different, pre-existing liability of the taxpayer to the foreign government or to a third party.

(iv) *Examples*. The following examples illustrate the rules of paragraph (e)(2) of this section.

(A) *Example 1*. The domestic law of Country X imposes a 25 percent tax described in §1.903-1(b) on the gross amount of interest from sources in Country X that is received by a nonresident of Country X. Country X imposes the tax on the nonresident recipient and requires any resident of Country X that pays such interest to a nonresident to withhold and pay over to Country X 25 percent of such interest, which is applied to offset the recipient's liability for the 25 percent tax. A tax treaty between the United States and Country X modifies domestic law of Country X and provides that Country X may not tax interest received by a resident of the United States from a resident of Country X at a rate in excess of 10 percent of the gross amount of such interest. A resident of the United States may claim the benefit of the treaty only by applying for a refund of the excess withheld amount (15 percent of the gross amount of interest income) after the end of the taxable year. A, a resident of the United States, receives a gross amount of 100u (units of Country X currency) of interest income from a resident of Country X from sources in Country X in Year 1, from which 25u of Country X tax is withheld. A files a timely claim for refund of the 15u excess withheld amount. 15u of the amount withheld (25u-10u) is reasonably certain to be refunded; therefore, under paragraph (e)(2)(i) of this section 15u is not considered an amount of foreign income tax paid to Country X.

(B) *Example 2*. A's initial foreign income tax liability under Country X tax law is 100u (units of Country X currency). However, under Country X tax law A's initial income tax liability is reduced in order to compute A's final tax liability by an investment credit of 15u and a credit for charitable contributions of 5u. Under paragraph (e)(2)(ii) of this section, the amount of foreign income tax paid by A is 80u.

(C) *Example 3*. A computes foreign income tax liability in Country X for Year 1 of 100u (units of Country X currency), files a tax return on that basis, and remits 100u of tax. The day after A files that return, A files a claim for refund of 90u. The difference between the 100u of liability reflected in A's original return and the 10u of liability reflected in A's refund claim depends on whether a particular expenditure made by A is nondeductible or deductible, respectively. Based on an analysis of the Country X tax law, A's Country X tax advisors have advised A that it is not clear whether or not that expenditure is deductible. In view of the uncertainty as to the proper treatment of the item in question under Country X tax law, no portion of the 100u paid by A is reasonably certain to be refunded. If A receives a refund, A must treat the refund as required by section 905(c) of the Internal Revenue Code.

(D) *Example 4*. A levy of Country X, which qualifies as a foreign income tax within the meaning of paragraph (a)(1)(ii) of this section, provides that each person who makes payment to Country X pursuant to the levy will receive a bond to be issued by Country X with an amount payable at maturity equal to 10 percent of the amount paid pursuant to the levy. A remits 38,000u (units of Country X currency) to Country X and is entitled to receive a bond with an amount payable at maturity of 3,800u. It is reasonably certain that a refund in the form of property (the bond) will be made. The amount of that refund is equal to the fair market value of the bond. Therefore, only the portion of the 38,000u payment in excess of the fair market value of the bond is an amount of foreign income tax paid.

(3) *Subsidies*—(i) *General rule*. An amount of foreign income tax is not an amount of foreign income tax paid by a taxpayer to a foreign country to the extent that—

(A) The amount is used, directly or indirectly, by the foreign country imposing the tax to provide a subsidy by any means (including, but not limited to, a rebate, a refund, a credit, a deduction, a payment, a discharge of an obligation, or any other method) to the taxpayer, to a related person (within the meaning of section 482), to any party to the transaction, or to any party to a related transaction; and

(B) The subsidy is determined, directly or indirectly, by reference to the amount of the tax or by reference to the base used to compute the amount of the tax.

(ii) *Subsidy*. The term "subsidy" includes any benefit conferred, directly or indirectly, by a foreign country to one of the parties enumerated in paragraph (e)(3)(i)(A) of this section. Substance and not form shall govern in determining whether a subsidy exists. The fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists.

(iii) *Official exchange rate*. A subsidy described in paragraph (e)(3)(i)(B) of this section does not include the actual use of an official foreign government exchange rate converting foreign currency into dollars where a free exchange rate also exists if—

(A) The economic benefit represented by the use of the official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit;

(B) The economic benefit of the official exchange rate applies to a broad range of international transactions, in all cases based on the total payment to be made without regard to whether the payment is a return of principal, gross income, or net income, and without regard to whether it is subject to tax; and

(C) Any reduction in the overall cost of the transaction is merely coincidental to the broad structure and operation of the official exchange rate.

(iv) *Examples*. The following examples illustrate the rules of paragraph (e)(3) of this section.

(A) *Example 1—(1) Facts*. Country X imposes a 30 percent tax on nonresident lenders with respect to interest which the nonresident lenders receive from borrowers who are residents of Country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of §1.903-1(b). Country X provides the nonresident lenders with receipts upon their payment of the 30 percent tax. Country X remits to resident borrowers an incentive payment for engaging in foreign loans, which payment is an amount equal to 20 percent of the interest paid to nonresident lenders.

(*2*) *Analysis*. Because the incentive payment is based on the interest paid, it is determined by reference to the base used to compute the tax that is imposed on the nonresident lender. The incentive payment is a subsidy under paragraph (e)(3)(i) of this section since it is provided to a party (the borrower) to the transaction and is based on the amount of tax that is imposed on the lender with respect to the transaction. Therefore, two-thirds (20 percent/30 percent) of the amount withheld by the resident borrower from interest payments to the

nonresident lender is not an amount of foreign income tax paid.

(B) *Example 2*—(*1*) *Facts*. A U.S. bank lends money to a development bank in Country X. The development bank relends the money to companies resident in Country X. A withholding tax is imposed by Country X on the U.S. bank with respect to the interest that the development bank pays to the U.S. bank, and appropriate receipts are provided. On the date that the tax is withheld, fifty percent of the tax is credited by Country X to an account of the development bank. Country X requires the development bank to transfer the amount credited to the borrowing companies.

(*2*) *Analysis*. The amount successively credited to the account of the development bank and then to the account of the borrowing companies is determined by reference to the amount of the tax and the tax base. Since the amount credited to the borrowing companies is a subsidy provided to a party (the borrowing companies) to a related transaction and is based on the amount of tax and the tax base, under paragraph (e)(3)(i) of this section it is not an amount of foreign income tax paid.

(C) *Example 3*—(*1*) *Facts*. A U.S. bank lends dollars to a Country X borrower. Country X imposes a withholding tax on the lender with respect to the interest. The tax is to be paid in Country X currency, although the interest is payable in dollars. Country X has a dual exchange rate system, comprised of a controlled official exchange rate and a free exchange rate. Priority transactions such as exports of merchandise, imports of merchandise, and payments of principal and interest on foreign currency loans payable abroad to foreign lenders are governed by the official exchange rate which yields more dollars per unit of Country X currency than the free exchange rate. The Country X borrower remits the net amount of dollar interest due to the U.S. bank (interest due less withholding tax), pays the tax withheld in Country X currency to the Country X government, and provides to the U.S. bank a receipt for payment of the Country X taxes.

(*2*) *Analysis*. Under paragraph (e)(3)(iii) of this section, the use of the official exchange rate by the U.S. bank to determine foreign taxes with respect to interest is not a subsidy described in paragraph (e)(3)(i)(B) of this section. The official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit. The use of the official exchange rate applies to the interest paid and to the principal paid. Any benefit derived by the U.S. bank through the use of the official exchange rate is merely coincidental to the broad structure and operation of the official exchange rate.

(D) *Example 4*—(*1*) *Facts*. B, a U.S. corporation, is engaged in the production of oil and gas in Country X pursuant to a production sharing agreement among B, Country X, and the state petroleum authority of Country X. The agreement is approved and enacted into law by the Legislature of Country X. Both B and the petroleum authority are subject to the Country X income tax. Each entity files an annual income tax return and pays, to the tax authority of Country X, the amount of income tax due on its annual income. B is a dual capacity taxpayer as defined in §1.901-2(a)(2)(ii)(A). Country X has agreed to return to the petroleum authority one-half of the income taxes paid by B by allowing it a credit in calculating its own tax liability to Country X.

(*2*) *Analysis*. The petroleum authority is a party to a transaction with B and the amount returned by Country X to the petroleum authority is determined by reference to the amount of the tax imposed on B. Therefore, under paragraph (e)(3)(i) of this section the amount returned is a subsidy, and one-half of the tax imposed on B is not an amount of foreign income tax paid.

(E) *Example 5*—(*1*) *Facts*. The facts are the same as those in paragraph (e)(3)(iv)(D)(*1*) of this section (the facts in *Example 4*), except that the state petroleum authority of Country X does not receive amounts from Country X related to tax paid by B. Instead, the authority of Country X receives a general appropriation from Country X which is not calculated with reference to the amount of tax paid by B.

(*2*) *Analysis*. Because the general appropriation is not calculated with reference to the amount of tax paid by B, it is not a subsidy described in paragraph (e)(3)(i) of this section.

(4) *Multiple levies*—(i) *In general*. If, under foreign law, a taxpayer's tentative liability for one levy (the "reduced levy") is or can be reduced by the amount of the taxpayer's liability for a different levy (the "applied levy"), then the amount considered paid by the taxpayer to the foreign country pursuant to the applied levy is an amount equal to its entire liability for that applied levy (which is not considered to be reduced by the amount applied against the reduced levy), and the remainder of the total amount paid, if any, is considered paid pursuant to the reduced levy. See also paragraphs (e)(2)(ii) and (iii) of this section.

(ii) *Examples*. The following examples illustrate the rules of paragraphs (e)(2)(ii) and (iii) and (e)(4)(i) of this section.

(A) *Example 1: Tax reduced by credits*—(*1*) *Facts*. A's tentative liability for foreign income tax imposed by Country X is 100u (units of Country X currency). However, under Country X tax law, in determining A's final foreign income tax liability, its tentative liability is reduced by a 15u credit for a separate Country X levy that does not qualify as a foreign income tax and that A accrued and paid on its gross services income and is also reduced by a 5u credit for charitable contributions. Under Country X tax law, the amount of the charitable contributions credit is refundable in cash to the extent the credit exceeds the taxpayer's Country X income tax liability after applying the credit for the tax on gross services income. A timely remits the 80u due to Country X.

(*2*) *Analysis*. Under paragraphs (e)(2)(ii) and (e)(4) of this section, the amount of Country X income tax paid by A is 80u (100u tentative liability – 20u tax credits), and the amount of Country X tax on gross services income paid by A is 15u.

(B) *Example 2: Tax paid by credit for overpayment*—(*1*) *Facts*. The facts are the same as those in paragraph (e)(4)(ii)(A)(*1*) of this section (the facts in *Example 1*), except that A's final Country X income tax liability of 80u is satisfied by applying a credit for an otherwise refundable 60u overpayment from the previous taxable year of A's liability for a separate levy imposed by Country X that is also a foreign income tax and remitting the balance due of 20u.

(*2*) *Analysis*. The result is the same as in paragraph (e)(4)(ii)(A)(*2*) of this section (the analysis in *Example 1*). Under paragraph (e)(2)(iii) of this section, the portion of A's Country X income tax liability that was satisfied by applying the 60u overpayment of A's different foreign income tax liability for the previous taxable year qualifies as an amount of Country X income tax paid, because that refundable overpayment exceeded (and so is not treated as a payment of) A's different foreign income tax liability for the previous taxable year.

(5) *Noncompulsory amounts*—(i) *In general*. An amount remitted to a foreign country (a "foreign payment") is not a compulsory payment, and thus is not an amount of foreign income tax paid, to the extent that the foreign payment exceeds the amount of liability for foreign income tax under the foreign tax law (as defined in paragraph (g) of this section). A foreign payment does not exceed the amount of such liability if the foreign payment is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign tax law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign tax law for foreign income tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign income tax (including liability pursuant to a foreign tax audit adjustment). See paragraphs (e)(5)(ii) through (v) of this section. 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. However, 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. For this purpose, such costs may include an additional liability for a different foreign tax (but not U.S. taxes) that is not a foreign income tax only to the extent the amount of the additional liability is de-

termined in a manner consistent with the rules of this paragraph (e)(5). A taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for foreign income tax.

(ii) *Reasonable application of foreign tax law*. An interpretation or application of foreign tax law is not reasonable if there is actual notice or constructive notice (for example, a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. Except as provided in paragraphs (e)(5)(i) and (e)(5)(iv) of this section, voluntarily forgoing a tax benefit to which a taxpayer is entitled under the foreign tax law results in a foreign payment in excess of the taxpayer's liability for foreign income tax.

(iii) *Effect of foreign tax law elections*—(A) *In general*. Where foreign tax law includes options or elections whereby a taxpayer's foreign income tax liability may be shifted, in whole or part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in a foreign payment in excess of the taxpayer's liability for foreign income tax. Except as provided in paragraph (e)(5)(iii)(B) of this section, where foreign tax law provides a taxpayer with options or elections in computing its liability for foreign income tax whereby a taxpayer's foreign income tax liability may be permanently decreased in the aggregate over time, the taxpayer's failure to use such options or elections results in a foreign payment in excess of the taxpayer's liability for foreign income tax.

(B) *Exception for certain options or elections*—(*1*) *Entity classification elections*. If foreign tax law provides an option or election to treat an entity as fiscally transparent or non-fiscally transparent, a taxpayer's decision to use or not use such option or election is not considered to increase the taxpayer's liability for foreign income tax over time for purposes of this paragraph (e)(5).

(*2*) *Foreign consolidation, group relief, or other loss sharing regime*. If foreign tax law provides 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, a taxpayer's decision whether to file a consolidated return, whether to surrender a loss, or whether to use a surrendered loss, is not considered to increase the taxpayer's liability for foreign income tax over time for purposes of this paragraph (e)(5).

(C) *Alternative creditable levies*. If under foreign tax law a taxpayer has the option to determine its foreign income tax liability under only one of multiple separate levies, each of which qualifies as a foreign income tax, then the amount of foreign income tax paid equals the smallest liability of the amounts that would be due under each of the alternative levies, regardless of which levy the taxpayer uses to determine its foreign income tax liability.

(iv) *Exception for increase in liability in connection with anti-hybrid rules*—(A) *In general*. 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 (for example, 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, then the increase in the first taxpayer's liability is not considered to result in a foreign payment in excess of the first taxpayer's liability for foreign income tax for purposes of this paragraph (e)(5).

(B) *Definition of hybrid mismatch rule*. The term *hybrid mismatch rule* means foreign tax law rules substantially similar to sections 245A(e) and 267A and includes rules the purpose of which is to eliminate the deduction/no-inclusion outcome of hybrid and branch mismatch arrangements. Examples of such rules include rules based on, or substantially similar to, the recommendations contained in OECD/G-20, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (October 2015), and OECD/G-20, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS* (July 2017).

(v) *Exhaustion of remedies*. In determining whether a taxpayer has exhausted all effective and practical remedies, a remedy is effective and practical only if the cost of pursuing it (including the reasonably expected risk of incurring an offsetting or additional foreign income tax or other tax liability) is reasonable considering the amount at issue and the likelihood of success. An available remedy is considered effective and practical if an economically rational taxpayer would pursue it whether or not a compulsory payment of the amount at issue would be eligible for a U.S. foreign tax credit. A settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory payment.

(vi) *Examples*. The following examples illustrate the rules of paragraph (e)(5) of this section.

(A) *Example 1*. A, a corporation organized and doing business solely in the United States, owns all of the stock of B, a corporation organized in Country X. In Year 1, A buys merchandise from unrelated persons for $1,000,000, and shortly thereafter resells that merchandise to B for $600,000. Later in Year 1, B resells the merchandise to unrelated persons for $1,200,000. Under the Country X income tax, which is a net income tax within the meaning of paragraph (a)(3) of this section, all corporations organized in Country X are subject to a tax equal to 3 percent of their net income. In computing its Year 1 Country X income tax liability, B reports $600,000 ($1,200,000 - $600,000) of profit from the purchase and resale of merchandise. The Country X tax law requires that transactions between related persons be reported at arm's length prices, and a reasonable interpretation of this requirement, as it has been applied in Country X, would consider B's arm's length purchase price of the merchandise purchased from A to be $1,050,000. When it computes its Country X tax liability B is aware that $600,000 is not an arm's length price (by Country X standards). B's knowing use of a non-arm's length price (by Country X standards) of $600,000, instead of a price of $1,050,000 (an arm's length price under Country X's law), is not consistent with a reasonable interpretation and application of Country X tax law, determined in such a way as to reduce over time B's reasonably expected liability for Country X income tax. Accordingly, $13,500 (3 percent of $450,000 ($1,050,000 - $600,000)), the amount of Country X income tax remitted by B to Country X that is attributable to the purchase of the merchandise from B's parent at less than an arm's length price, is in excess of the amount of B's liability for Country X income tax, and thus is not an amount of foreign income tax paid.

(B) *Example 2*. A, a corporation organized and doing business solely in the United States, owns all of the stock of B, a corporation organized in Country X. Country X has in force an income tax treaty with the United States. The tax treaty provides that the profits of related persons shall be determined as if the persons were not related. A and B deal extensively with each other. A and B, with respect to a series of transactions involving both of them, treat A as having $300,000 of income and B as having $700,000 of income for purposes of A's United States income tax and B's Country X income tax, respectively. B has no actual or constructive notice that its treatment of these transactions under Country X tax law is likely to be erroneous. Subsequently, the Internal Revenue Service reallocates $200,000 of this income from B to A under the authority of section 482 and the tax treaty. This reallocation constitutes actual notice to A and constructive notice to B that B's interpretation and application of Country X's tax law and the tax treaty is likely to be erroneous. B does not exhaust all effective and practical remedies to obtain a refund of the amount remitted by B to Country X that is attributable to the reallocated $200,000 of income. Under paragraph (e)(5)(i) of this section, this amount is in excess of the amount of B's liability for Country X income tax and thus is not an amount of foreign income tax paid.

(C) *Example 3*. The facts are the same as those in paragraph (e)(5)(vi)(B) of this section (the facts in *Example 2*), except that B files a claim for refund (an administrative proceeding) of Country X tax and A or B invokes the competent authority procedures of the tax treaty, the cost of which is reasonable in view of the amount at issue and the likelihood of success. Nevertheless, B does not obtain any refund of Country X income tax. The cost of pursuing any judicial remedy in Country X would be unreasonable in light of the amount at issue and the likelihood of B's success, and B does not pursue any such remedy. Under paragraph (e)(5)(i) of this section, the entire amount paid by B to Country X is a compulsory payment and thus is an amount of foreign income tax paid by B.

(D) *Example 4*. The facts are the same as those in paragraph (e)(5)(vi)(B) of this section (the facts in *Example 2*), except that, when the Internal Revenue Service makes the reallocation, the Country X statute of limitations on refunds has expired, and neither the internal law of Country X nor the tax treaty authorizes the Country X tax authorities to pay a refund that is barred by the statute of limitations. B does not file a claim for refund, and neither A nor B invokes the competent authority procedures of the tax treaty. Because the Country X tax authorities would be barred by the statute of limitations from paying a refund, B has no effective and practical remedies. Under paragraph (e)(5)(i) of this section, the entire amount paid by B to Country X is a compulsory payment and thus is an amount of foreign income tax paid by B.

(E) *Example 5*. A is a U.S. person doing business in Country X. In computing its income tax liability to Country X, A is permitted, at its election, to recover the cost of machinery used in its business either by deducting that cost in the year of acquisition or by depreciating that cost on the straight-line method over a period of 2, 4, 6 or 10 years. A elects to depreciate machinery over 10 years. This election merely shifts A's tax liability to different years (compared to the timing of A's tax liability under a different depreciation period); it does not result in a payment in excess of the amount of A's liability for Country X income tax in any year since the amount of Country X income tax paid by A is consistent with a reasonable interpretation of Country X tax law in such a way as to reduce over time A's reasonably expected liability for Country X income tax. Because the standard of paragraph (e)(5)(i) of this section refers to A's reasonably expected liability, not its actual liability, events actually occurring in subsequent years (for example, whether A has sufficient profit in such years so that such depreciation deductions actually reduce A's Country X tax liability or whether the Country X tax rates change) are immaterial.

(F) *Example 6*. The domestic law of Country X imposes a 25 percent tax described in §1.903-1(b) on the gross amount of interest from sources in Country X that is received by a nonresident of Country X. Country X tax law imposes the tax on the nonresident recipient and requires any resident of Country X that pays such interest to a nonresident to withhold and pay over to Country X 25 percent of such interest, which is applied to offset the recipient's liability for the 25 percent tax. A tax treaty between the United States and Country X overrides domestic law of Country X and provides that Country X may not tax interest received by a resident of the United States from a resident of Country X at a rate in excess of 10 percent of the gross amount of such interest. A resident of the United States may claim the benefit of the tax treaty only by applying for a refund of the excess withheld amount (15 percent of the gross amount of interest income) after the end of the taxable year. A, a resident of the United States, receives a gross amount of 100u (units of Country X currency) of interest income from a resident of Country X from sources in Country X in Year 1, from which 25u of Country X tax is withheld. A does not file a timely claim for refund. Under paragraph (e)(5)(i) of this section, 15u of the amount withheld (25u-10u) is not a compulsory payment and thus is not an amount of foreign income tax paid.

(G) *Example 7: Reasonable steps to minimize creditable tax—larger noncreditable tax cost*—(*1*) *Facts*. Corporations resident in Country X are subject to a 20% generally applicable net income tax, which qualifies as a foreign income tax under paragraph (a)(1)(ii) of this section ("Income Tax"), and a separate levy equal to 25% of certain deductible payments above a specified threshold made to related parties that are not residents of Country X, which does not qualify as a foreign income tax under paragraph (a)(1)(ii) of this section ("Base Erosion Tax"). CFC, a Country X corporation, makes payments to nonresident related parties that exceed the specified threshold of the Base Erosion Tax by 100u (units of Country X currency), which if claimed as deductions would result in a Base Erosion Tax of 25u (.25 x 100u), and would also result in 300u of taxable income for purposes of the Income Tax, thus resulting in Income Tax of 60u (.20 x 300u). If in computing its liability for Income Tax CFC does not claim deductions for the 100u of excess related party payments, its liability for the Base Erosion Tax would be zero, and its liability for Income Tax would be 80u (.20 x 400u).

(*2*) *Analysis*. If CFC chooses not to deduct the 100u of excess related party payments that would subject it to the Base Erosion Tax and pays 80u of Income Tax, the amount of foreign income tax paid under paragraph (e)(5) of this section is 80u. Under paragraph (e)(5)(i) of this section, although CFC could reduce its liability for Income Tax from 80u to 60u by claiming the deductions, no portion of the Income Tax remitted is a noncompulsory payment because reducing the Income Tax by 20u would incur a Base Erosion Tax of 25u, which exceeds the amount of the potential reduction.

(H) *Example 8: Reasonable steps to minimize creditable tax—smaller noncreditable tax cost*—(*1*) *Facts*. The facts are the same as those in paragraph (e)(5)(vi)(G)(*1*) of this section (the facts in *Example 7*) except that the rate of the Base Erosion Tax is 20% and the rate of the Income Tax is 25%. Accordingly, if CFC claims the 100u of excess deductions its liability for Base Erosion Tax would be 20u (.20 x 100u), and its liability for Income Tax would be 75u (.25 x 300u). If CFC chooses not to claim the 100u of excess deductions its liability for Base Erosion Tax would be zero, and its liability for Income Tax would be 100u (.25 x 400u).

(*2*) *Analysis*. If CFC chooses not to claim the 100u of excess deductions in computing its liability for Income Tax and pays 100u of Income Tax, the amount of foreign income tax paid under paragraph (e)(5) of this section is 75u. CFC's additional payment of 25u is not an amount of Income Tax paid, because CFC could have reduced its Income Tax liability by 25u by claiming the excess deductions and paying 20u of Base Erosion Tax.

(I) *Example 9: Alternative creditable taxes*—(*1*) *Facts*. The facts are the same as those in paragraph (e)(5)(vi)(G)(*1*) of this section (the facts in *Example 7*), except that Country X does not have a Base Erosion Tax, and it allows resident corporations to elect to pay either the Income Tax or a separate levy using an alternative cost allowance (the "Alternative Tax"), which qualifies as a tax in lieu of an income tax under §1.903-1(b)(2). CFC's liability under the Income Tax is 80u, and its liability under the Alternative Tax is 100u. CFC chooses to pay the 100u of Alternative Tax rather than the 80u of Income Tax.

(*2*) *Analysis*. Under paragraph (e)(5)(iii)(C) of this section, the amount of foreign income tax paid by CFC is 80u, the smaller of the amounts due under the two alternative foreign income taxes.

(vii) *Structured passive investment arrangements*—(A) *In general*. Notwithstanding paragraph (e)(5)(i) of this section, an amount paid to a foreign country (a "foreign payment") is not a compulsory payment, and thus is not an amount of foreign income tax paid, if the foreign payment is attributable (within the meaning of paragraph (e)(5)(vii)(B)(*1*)(*ii*) of this section) to a structured passive investment arrangement (as described in paragraph (e)(5)(vii)(B) of this section).

(B) *Conditions*. An arrangement is a structured passive investment arrange-

ment if all of the following conditions are satisfied:

(*1*) *Special purpose vehicle (SPV)*. An entity that is part of the arrangement meets the following requirements:

(*i*) Substantially all of the gross income (for U.S. tax purposes) of the entity, if any, is passive investment income, and substantially all of the assets of the entity are assets held to produce such passive investment income.

(*ii*) There is a foreign payment attributable to income of the entity (as determined under the laws of the foreign country to which such foreign payment is made), including the entity's share of income of a lower-tier entity that is a branch or pass-through entity under the laws of such foreign country, that, if the foreign payment were an amount of foreign income tax paid, would be paid in a U.S. taxable year in which the entity meets the requirements of paragraph (e)(5)(vii)(B)(*1*)(*i*) of this section. A foreign payment attributable to income of an entity includes a foreign payment attributable to income that is required to be taken into account by an owner of the entity, if the entity is a branch or pass-through entity under the laws of such foreign country. A foreign payment attributable to income of the entity also includes a withholding tax (within the meaning of section 901(k)(1)(B)) imposed on a dividend or other distribution (including distributions made by a pass-through entity or an entity that is disregarded as an entity separate from its owner for U.S. tax purposes) with respect to the equity of the entity.

(*2*) *U.S. party*. A person would be eligible to claim a credit under section 901(a) (including a credit for foreign taxes deemed paid under section 960) for all or a portion of the foreign payment described in paragraph (e)(5)(vii)(B)(*1*)(*ii*) of this section if the foreign payment were an amount of foreign income tax paid.

(*3*) *Direct investment*. The U.S. party's proportionate share of the foreign payment or payments described in paragraph (e)(5)(vii)(B)(*1*)(*ii*) of this section is (or is expected to be) substantially greater than the amount of credits, if any, that the U.S. party reasonably would expect to be eligible to claim under section 901(a) for foreign income taxes attributable to income generated by the U.S. party's proportionate share of the assets owned by the SPV if the U.S. party directly owned such assets. For this purpose, direct ownership shall not include ownership through a branch, a permanent establishment or any other arrangement (such as an agency arrangement or dual resident status) that would result in the income generated by the U.S. party's proportionate share of the assets being subject to tax on a net basis in the foreign country to which the payment is made. A U.S. party's proportionate share of the assets of the SPV shall be determined by reference to such U.S. party's proportionate share of the total value of all of the outstanding interests in the SPV that are held by its equity owners and creditors. A U.S. party's proportionate share of the assets of the SPV, however, shall not include any assets that produce income subject to gross basis withholding tax.

(*4*) *Foreign tax benefit*. The arrangement is reasonably expected to result in a credit, deduction, loss, exemption, exclusion or other tax benefit under the laws of a foreign country that is available to a counterparty or to a person that is related to the counterparty (determined under the principles of paragraph (e)(5)(vii)(C)(*7*) of this section by applying the tax laws of a foreign country in which the counterparty is subject to tax on a net basis). However, a foreign tax benefit in the form of a credit is described in this paragraph (e)(5)(vii)(B)(*4*) only if the amount of any such credit corresponds to 10 percent or more of the amount of the U.S. party's share (for U.S. tax purposes) of the foreign payment referred to in paragraph (e)(5)(vii)(B)(*1*)(*ii*) of this section. In addition, a foreign tax benefit in the form of a deduction, loss, exemption, exclusion or other tax benefit is described in this paragraph (e)(5)(vii)(B)(*4*) only if such amount corresponds to 10 percent or more of the foreign base with respect to which the U.S. party's share (for U.S. tax purposes) of the foreign payment is imposed. For purposes of the preceding two sentences, if an arrangement involves more than one U.S. party or more than one counterparty or both, the aggregate amount of foreign tax benefits available to all of the counterparties and persons related to such counterparties is compared to the aggregate amount of all of the U.S. parties' shares of the foreign payment or foreign base, as the case may be. Where a U.S. party indirectly owns interests in an SPV that are treated as equity interests for both U.S. and foreign tax purposes, a foreign tax benefit available to a foreign entity in the chain of ownership that begins with the SPV and ends with the first-tier entity in the chain does not correspond to the U.S. party's share of the foreign payment attributable to income of the SPV to the extent that such benefit relates to earnings of the SPV that are distributed with respect to equity interests in the SPV that are owned directly or indirectly by the U.S. party for purposes of both U.S. and foreign tax law.

(*5*) *Counterparty*. The arrangement involves a counterparty. A counterparty is a person that, under the tax laws of a foreign country in which the person is subject to tax on the basis of place of management, place of incorporation or similar criterion or otherwise subject to a net basis tax, directly or indirectly owns or acquires equity interests in, or assets of, the SPV. However, a counterparty does not include the SPV or a person with respect to which for U.S. tax purposes the same domestic corporation, U.S. citizen or resident alien individual directly or indirectly owns more than 80 percent of the total value of the stock (or equity interests) of each of the U.S. party and such person. A counterparty also does not include a person with respect to which for U.S. tax purposes the U.S. party directly or indirectly owns more than 80 percent of the total value of the stock (or equity interests), but only if the U.S. party is a domestic corporation, a U.S. citizen or a resident alien individual. In addition, a counterparty does not include an individual who is a U.S. citizen or resident alien.

(*6*) *Inconsistent treatment*. The United States and an applicable foreign country treat one or more of the aspects of the arrangement listed in paragraph (e)(5)(vii)(B)(*6*)(*i*) through (*iv*) of this section differently under their respective tax systems, and for one or more tax years when the arrangement is in effect one or both of the following two conditions applies; either the amount of income attributable to the SPV that is recognized for U.S. tax purposes by the SPV, the U.S. party or parties, and persons related to a U.S. party or parties is materially less than the amount of income that would be recognized if the

foreign tax treatment controlled for U.S. tax purposes; or the amount of credits claimed by the U.S. party or parties (if the foreign payment described in paragraph (e)(5)(vii)(B)(*1*)(*ii*) of this section were an amount of foreign income tax paid) is materially greater than it would be if the foreign tax treatment controlled for U.S. tax purposes:

(*i*) The classification of the SPV (or an entity that has a direct or indirect ownership interest in the SPV) as a corporation or other entity subject to an entity-level tax, a partnership or other flow-through entity or an entity that is disregarded for tax purposes.

(*ii*) The characterization as debt, equity or an instrument that is disregarded for tax purposes of an instrument issued by the SPV (or an entity that has a direct or indirect ownership interest in the SPV) to a U.S. party, a counterparty or a person related to a U.S. party or a counterparty.

(*iii*) The proportion of the equity of the SPV (or an entity that directly or indirectly owns the SPV) that is considered to be owned directly or indirectly by a U.S. party and a counterparty.

(*iv*) The amount of taxable income that is attributable to the SPV for one or more tax years during which the arrangement is in effect.

(C) *Definitions*. The following definitions apply for purposes of paragraph (e)(5)(vii) of this section.

(*1*) *Applicable foreign country*. An *applicable foreign country* means each foreign country to which a foreign payment described in paragraph (e)(5)(vii)(B)(*1*)(*ii*) of this section is made or which confers a foreign tax benefit described in paragraph (e)(5)(vii)(B)(*4*) of this section.

(*2*) *Counterparty*. The term *counterparty* means a person described in paragraph (e)(5)(vii)(B)(*5*) of this section.

(*3*) *Entity*. The term *entity* includes a corporation, trust, partnership or disregarded entity described in §301.7701-2(c)(2)(i).

(*4*) *Indirect ownership*. *Indirect ownership* of stock or another equity interest (such as an interest in a partnership) shall be determined in accordance with the principles of section 958(a)(2), regardless of whether the interest is owned by a U.S. or foreign entity.

(*5*) *Passive investment income*—(*i*) *In general*. The term *passive investment income* means income described in section 954(c), as modified by this paragraph (e)(5)(vii)(C)(*5*)(*i*) and paragraph (e)(5)(vii)(C)(*5*)(*ii*) of this section. In determining whether income is described in section 954(c), paragraphs (c)(1)(H), (c)(3), and (c)(6) of section 954 shall be disregarded. Sections 954(c), 954(h), and 954(i) shall be applied at the entity level as if the entity (as defined in paragraph (e)(5)(vii)(C)(*3*) of this section) were a controlled foreign corporation (as defined in section 957(a)). For purposes of determining if sections 954(h) and 954(i) apply for purposes of this paragraph (e)(5)(vii)(C)(*5*)(*i*) and paragraph (e)(5)(vii)(C)(*5*)(*ii*) of this section, any income of an entity attributable to transactions that, assuming the entity is an SPV, are with a person that is a counterparty, or with persons that are related to a counterparty within the meaning of paragraph (e)(5)(vii)(B)(*4*) of this section, shall not be treated as qualified banking or financing income or as qualified insurance income, and shall not be taken into account in applying sections 954(h) and 954(i) for purposes of determining whether other income of the entity is excluded from section 954(c)(1) under section 954(h) or 954(i), but only if any such person (or a person that is related to such person within the meaning of paragraph (e)(5)(vii)(B)(*4*) of this section) is eligible for a foreign tax benefit described in paragraph (e)(5)(vii)(B)(*4*) of this section. In addition, in applying section 954(h) for purposes of this paragraph (e)(5)(vii)(C)(*5*)(*i*) and paragraph (e)(5)(vii)(C)(*5*)(*ii*) of this section, section 954(h)(3)(E) shall not apply, section 954(h)(2)(A)(ii) shall be satisfied only if the entity conducts substantial activity with respect to its business through its own employees, and the term "any foreign country" shall be substituted for "home country" wherever it appears in section 954(h).

(*ii*) *Income attributable to lower-tier entities; holding company exception*. Income of an upper-tier entity that is attributable to an equity interest in a lower-tier entity, including dividends, an allocable share of partnership income, and income attributable to the ownership of an interest in an entity that is disregarded as an entity separate from its owner is passive investment income unless substantially all of the upper-tier entity's assets consist of qualified equity interests in one or more lower-tier entities, each of which is engaged in the active conduct of a trade or business and derives more than 50 percent of its gross income from such trade or business, and substantially all of the upper-tier entity's opportunity for gain and risk of loss with respect to each such interest in a lower-tier entity is shared by the U.S. party (or persons that are related to a U.S. party) and, assuming the entity is an SPV, a counterparty (or persons that are related to a counterparty) ("holding company exception"). If an arrangement involves more than one U.S. party or more than one counterparty or both, then substantially all of the upper-tier entity's opportunity for gain and risk of loss with respect to its interest in any lower-tier entity must be shared (directly or indirectly) by one or more U.S. parties (or persons related to such U.S. parties) and, assuming the upper-tier entity is an SPV, one or more counterparties (or persons related to such counterparties). Substantially all of the upper-tier entity's opportunity for gain and risk of loss with respect to its interest in any lower-tier entity is not shared if the opportunity for gain and risk of loss is borne (directly or indirectly) by one or more U.S. parties (or persons related to such U.S. party or parties) or, assuming the upper-tier entity is an SPV, by one or more counterparties (or persons related to such counterparty or counterparties). Whether and the extent to which a person is considered to share in an upper-tier entity's opportunity for gain and risk of loss is determined based on all the facts and circumstances, provided, however, that a person does not share in an upper-tier entity's opportunity for gain and risk of loss if its equity interest in the upper-tier entity was acquired in a sale-repurchase transaction or if its interest is treated as debt for U.S. tax purposes. If a U.S. party owns an interest in an entity indirectly through a chain of entities, the application of the holding company exception begins with the lowest-tier entity in the chain that may satisfy the holding company exception and proceeds upward; provided, however, that the opportunity for gain and risk of loss borne by any upper-tier entity in the chain that is a counterparty shall be

disregarded to the extent borne indirectly by a U.S. party. An upper-tier entity that satisfies the holding company exception is itself considered to be engaged in the active conduct of a trade or business and to derive more than 50 percent of its gross income from such trade or business for purposes of applying the holding company exception to the owners of such entity. A lower-tier entity that is engaged in a banking, financing, or similar business shall not be considered to be engaged in the active conduct of a trade or business unless the income derived by such entity would be excluded from section 954(c)(1) under section 954(h) or 954(i) as modified by paragraph (e)(5)(vii)(C)(*5*)(*i*) of this section.

(*6*) *Qualified equity interest*. With respect to an interest in a corporation, the term *qualified equity interest* means stock representing 10 percent or more of the total combined voting power of all classes of stock entitled to vote and 10 percent or more of the total value of the stock of the corporation or disregarded entity, but does not include any preferred stock (as defined in section 351(g)(3)). Similar rules shall apply to determine whether an interest in an entity other than a corporation is a qualified equity interest.

(*7*) *Related person*. Two persons are related if—

(*i*) One person directly or indirectly owns stock (or an equity interest) possessing more than 50 percent of the total value of the other person; or

(*ii*) The same person directly or indirectly owns stock (or an equity interest) possessing more than 50 percent of the total value of both persons.

(*8*) *Special purpose vehicle (SPV)*. The term *SPV* means the entity described in paragraph (e)(5)(vii)(B)(*1*) of this section.

(*9*) *U.S. party*. The term *U.S. party* means a person described in paragraph (e)(5)(vii)(B)(*2*) of this section.

(D) *Examples*. The following examples illustrate the rules of paragraph (e)(5)(vii) of this section. No inference is intended as to whether a taxpayer would be eligible to claim a credit under section 901(a) if a foreign payment were an amount of foreign income tax paid. The examples set forth below do not limit the application of other principles of existing law to determine the proper tax consequences of the structures or transactions addressed in the regulations.

(*1*) *Example 1: U.S. borrower transaction*—(*i*) *Facts*. A domestic corporation (USP) forms a Country M corporation (Newco), contributing $1.5 billion in exchange for 100% of the stock of Newco. Newco, in turn, loans the $1.5 billion to a second Country M corporation (FSub) wholly owned by USP. USP then sells its entire interest in Newco to a Country M corporation (FP) for the original purchase price of $1.5 billion, subject to an obligation to repurchase the interest in five years for $1.5 billion. The sale has the effect of transferring ownership of the Newco stock to FP for Country M tax purposes. Assume the sale-repurchase transaction is structured in a way that qualifies as a collateralized loan for U.S. tax purposes. Therefore, USP remains the owner of the Newco stock for U.S. tax purposes. All of FSub's income is subpart F income. In Year 1, FSub pays Newco $120 million of interest. Newco pays $36 million to Country M with respect to such interest income and distributes the remaining $84 million to FP. Under Country M law, the $84 million distribution is excluded from FP's income. None of FP's stock is owned, directly or indirectly, by USP or any shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Under an income tax treaty between Country M and the United States, Country M does not impose Country M tax on interest received by U.S. residents from sources in Country M.

(*ii*) *Result*. The $36 million payment by Newco to Country M is not a compulsory payment, and thus is not an amount of foreign income tax paid because the foreign payment is attributable to a structured passive investment arrangement. First, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(iv)(C)(5) of this section; Newco's only asset, a note, is held to produce such income; the payment to Country M is attributable to such income; and if the payment were an amount of foreign income tax paid it would be paid in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(vii)(B)(*1*)(*i*) of this section. Second, if the foreign payment were treated as an amount of foreign income tax paid, USP would be deemed to pay the foreign payment under section 960(a) and, therefore, would be eligible to claim a credit for such payment under section 901(a). Third, USP would not pay any Country M tax if it directly owned Newco's loan receivable. Fourth, the distribution from Newco to FP is exempt from tax under Country M law, and the exempt amount corresponds to more than 10% of the foreign base with respect to which USP's share (which is 100% under U.S. tax law) of the foreign payment was imposed. Fifth, FP is a counterparty because FP owns stock of Newco under Country M law and none of FP's stock is owned by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, FP is the owner of 100% of Newco's stock for Country M tax purposes, while USP is the owner of 100% of Newco's stock for U.S. tax purposes, and the amount of credits claimed by USP if the payment to Country M were an amount of foreign income tax paid is materially greater than it would be if Country M tax treatment controlled for U.S. tax purposes such that FP, rather than USP, owned 100% of Newco's stock. Because the payment to Country M is not an amount of foreign income tax paid, USP is not deemed to pay any Country M tax under section 960(a). USP includes $84 million in income under subpart F with respect to Newco and also has interest expense of $84 million. FSub's income and earnings and profits are reduced by $120 million of interest expense.

(*2*) *Example 2: U.S. borrower transaction*—(*i*) *Facts*. The facts are the same as those in paragraph (e)(5)(vii)(D)(*1*)(*i*) of this section (the facts in *Example 1*), except that FSub is a wholly-owned subsidiary of Newco. In addition, assume FSub is engaged in the active conduct of manufacturing and selling widgets and derives more than 50% of its gross income from such business.

(*ii*) *Result*. The result is the same as in paragraph (e)(5)(vii)(D)(*1*)(*ii*) of this section (the result in *Example 1*), except that Newco's income is tested income rather than subpart F income, and if the $36 million foreign payment were an amount of foreign income tax paid USP would be deemed to pay a portion of the foreign payment under section 960(d), rather than 960(a). Although Newco wholly owns FSub, which is engaged in the active conduct of manufacturing and selling widgets and derives more than 50% of its income from such business, Newco's income that is attributable to Newco's equity interest in FSub is passive investment income because the sale-repurchase transaction limits FP's interest in Newco and its assets to that of a creditor, so that substantially all of Newco's opportunity for gain and risk of loss with respect to its stock in FSub is borne by USP. See paragraph (e)(5)(vii)(C)(*5*)(*ii*) of this section. Accordingly, Newco's stock in FSub is held to produce passive investment income. Thus, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(vii)(C)(*5*) of this section, Newco's assets are held to produce such income, the payment to Country M is attributable to such income, and if the payment were an amount of foreign income tax paid it would be paid in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(vii)(B)(*1*)(*i*) of this section.

(*3*) *Example 3: U.S. borrower transaction*—(*i*) *Facts*. A domestic corporation (USP) loans $750 million to its wholly-owned domestic subsidiary (Sub). USP and Sub form a Country M partnership (Partnership) to which each contributes $750 million. Partnership loans all of its $1.5 billion of capital to Issuer, a wholly-owned Country M affiliate of USP, in exchange for a note and coupons providing for the payment of interest at a fixed rate over a five-year term. Partnership sells all of the coupons to Coupon Purchaser, a Country N partnership owned by a Country M corporation (Foreign Bank) and a wholly-owned Country M subsidiary of Foreign Bank, for $300 million. At the time of the coupon sale, the fair market value of the coupons sold is $290 million and, pursuant to section 1286(b)(3), Partnership's basis allocated to the coupons sold is $290 million. Several months later and prior to any interest payments on the note, Foreign Bank and its subsidiary sell all of their interests in Coupon Purchaser to an unrelated Country O corporation for $280 million. None of Foreign Bank's stock or its subsidiary's stock is owned, directly or indirectly, by

USP or Sub or by any shareholders of USP or Sub that are domestic corporations, U.S. citizens, or resident alien individuals. Assume that both the United States and Country M respect the sale of the coupons for tax law purposes. In the year of the coupon sale, for Country M tax purposes USP's and Sub's shares of Partnership's profits total $300 million, a payment of $60 million to Country M is made with respect to those profits, and Foreign Bank and its subsidiary, as partners of Coupon Purchaser, are entitled to deduct the $300 million purchase price of the coupons from their taxable income. For U.S. tax purposes, USP and Sub recognize their distributive shares of the $10 million premium income and claim a direct foreign tax credit for their shares of the $60 million payment to Country M. Country M imposes no additional tax when Foreign Bank and its subsidiary sell their interests in Coupon Purchaser. Country M also does not impose Country M tax on interest received by U.S. residents from sources in Country M.

(*ii*) *Result*. The payment to Country M is not a compulsory payment, and thus is not an amount of foreign income tax paid, because the foreign payment is attributable to a structured passive investment arrangement. First, Partnership is an SPV because all of Partnership's income is passive investment income described in paragraph (e)(5)(vii)(C)(*5*) of this section; Partnership's only asset, Issuer's note, is held to produce such income; the payment to Country M is attributable to such income; and if the payment were an amount of foreign income tax paid, it would be paid in a U.S. taxable year in which Partnership meets the requirements of paragraph (e)(5)(vii)(B)(*1*)(*i*) of this section. Second, if the foreign payment were an amount of tax paid, USP and Sub would be eligible to claim a credit for such payment under section 901(a). Third, USP and Sub would not pay any Country M tax if they directly owned Issuer's note. Fourth, for Country M tax purposes, Foreign Bank and its subsidiary deduct the $300 million purchase price of the coupons and are exempt from Country M tax on the $280 million received upon the sale of Coupon Purchaser, and the deduction and exemption correspond to more than 10% of the $300 million base with respect to which USP's and Sub's 100% share of the foreign payments was imposed. Fifth, Foreign Bank and its subsidiary are counterparties because they indirectly acquired assets of Partnership, the interest coupons on Issuer's note, and are not directly or indirectly owned by USP or Sub or shareholders of USP or Sub that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the amount of taxable income of Partnership for one or more years is different for U.S. and Country M tax purposes, and the amount of income attributable to USP and Sub for U.S. tax purposes is materially less than the amount of income they would recognize if the Country M tax treatment of the coupon sale controlled for U.S. tax purposes. Because the payment to Country M is not an amount of foreign income tax paid, USP and Sub are not considered to pay tax under section 901. USP and Sub have income of $10 million in the year of the coupon sale.

(*4*) *Example 4: Active business; no SPV*—(*i*) *Facts*. A, a domestic corporation, wholly owns B, a Country X corporation engaged in the manufacture and sale of widgets. On January 1, Year 1, C, also a Country X corporation, loans $400 million to B in exchange for an instrument that is debt for U.S. tax purposes and equity in B for Country X tax purposes. As a result, C is considered to own stock of B for Country X tax purposes. B loans $55 million to D, a Country Y corporation wholly owned by A. In year 1, B has $166 million of net income attributable to its sales of widgets and $3.3 million of interest income attributable to the loan to D. Substantially all of B's assets are used in its widget business. Country Y does not impose tax on interest paid to nonresidents. B makes a payment of $50.8 million to Country X with respect to B's net income. Country X does not impose tax on dividend payments between Country X corporations. None of C's stock is owned, directly or indirectly, by A or by any shareholders of A that are domestic corporations, U.S. citizens, or resident alien individuals.

(*ii*) *Result*. B is not an SPV within the meaning of paragraph (e)(5)(vii)(B)(*1*) of this section because the amount of interest income received from D does not constitute substantially all of B's income and the $55 million note from D does not constitute substantially all of B's assets. Accordingly, the $50.8 million payment to Country X is not attributable to a structured passive investment arrangement.

(*5*) *Example 5: U.S. lender transaction*—(*i*) *Facts*. A Country X corporation (Foreign Bank) contributes $2 billion to a newly-formed Country X company (Newco) in exchange for 90% of the common stock of Newco and securities that are treated as debt of Newco for U.S. tax purposes and preferred stock of Newco for Country X tax purposes. A domestic corporation (USP) contributes $1 billion to Newco in exchange for 10% of Newco's common stock and securities that are treated as preferred stock of Newco for U.S. tax purposes and debt of Newco for Country X tax purposes. Newco loans the $3 billion to a wholly-owned, Country X subsidiary of Foreign Bank (FSub) in return for a $3 billion, seven-year note paying interest currently. The Newco securities held by USP represent more than 50% of the voting power in Newco and more than 50% of the value of the securities in Newco that are treated as equity for U.S. tax purposes. The Newco securities held by USP entitle the holder to fixed distributions of $4 million per year, and the Newco securities held by Foreign Bank entitle the holder to receive $82 million per year, payable only on maturity of the $3 billion FSub note in Year 7. At the end of Year 5, pursuant to a prearranged plan, Foreign Bank acquires USP's Newco stock and securities for a prearranged price of $1 billion. Country X does not impose tax on dividends received by one Country X corporation from a second Country X corporation. Under an income tax treaty between Country X and the United States, Country X does not impose Country X tax on interest received by U.S. residents from sources in Country X. None of Foreign Bank's stock is owned, directly or indirectly, by USP or any shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. In each of Years 1 through 7, FSub pays Newco $124 million of interest on the $3 billion note. Newco distributes $4 million to USP in each of Years 1 through 5. The distributions are deductible for Country X tax purposes, and Newco pays Country X $36 million with respect to $120 million of taxable income from the FSub note in each year. For U.S. tax purposes, in each year Newco's subpart F income and earnings and profits are increased by $124 million of interest income and reduced by accrued interest expense with respect to the Newco securities held by Foreign Bank.

(*ii*) *Result*. The $36 million payment to Country X is not a compulsory payment, and thus is not an amount of foreign income tax paid, because the foreign payment is attributable to a structured passive investment arrangement. First, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(vii)(C)(*5*) of this section; Newco's only asset, a note of FSub, is held to produce such income; the payment to Country X is attributable to such income; and if the payment were an amount of foreign income tax paid it would be paid in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(vii)(B)(*1*)(*i*) of this section. Second, if the foreign payment were an amount of foreign income tax paid, USP would be deemed to pay its pro rata share of the foreign payment under section 960(a) in each of Years 1 through 5 and, therefore, would be eligible to claim a credit under section 901(a). Third, USP would not pay any Country X tax if it directly owned its proportionate share of Newco's assets, a note of FSub. Fourth, for Country X tax purposes, Foreign Bank is eligible to receive a tax-free distribution of $82 million attributable to each of Years 1 through 5, and that amount corresponds to more than 10% of the foreign base with respect to which USP's share of the foreign payment was imposed. Fifth, Foreign Bank is a counterparty because it owns stock of Newco for Country X tax purposes and none of Foreign Bank's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the United States and Country X treat various aspects of the arrangement differently, including whether the Newco securities held by Foreign Bank and USP are debt or equity. The amount of credits claimed by USP if the payment to Country X were an amount of foreign income tax paid is materially greater than it would be if the Country X tax treatment controlled for U.S. tax purposes such that the securities held by USP were treated as debt or the securities held by Foreign Bank were treated as equity, and the amount of income recognized by Newco for U.S. tax purposes is materially less than the amount of income recognized for Country X tax purposes. Because the payment to Country X is not an amount of foreign income tax paid, USP is not deemed to pay any Country X tax under section 960(a). USP has a subpart F inclusion of $4 million in each of Years 1 through 5.

(*6*) *Example 6: Holding company; no SPV*—(*i*) *Facts*. A, a Country X corporation, and B, a domestic corporation, each contribute $1 billion to a newly-formed Country X entity (C) in exchange for 50% of the common stock of C. C is treated as a corporation for Country X purposes and a partnership for U.S. tax purposes. C contributes $1.95 billion to a newly-formed Country X corporation (D) in exchange for 100% of D's common stock. C loans its remaining $50 million to D. Accordingly, C's sole assets are stock and debt of D. D uses the entire $2 billion to engage in the business of manufacturing and selling widgets. In Year 1, D derives

$300 million of income from its widget business and derives $2 million of interest income. Also in Year 1, C has dividend income of $200 million and interest income of $3.2 million with respect to its investment in D. Country X does not impose tax on dividends received by one Country X corporation from a second Country X corporation. C makes a payment of $960,000 to Country X with respect to C's net income.

(*ii*) *Result*. C qualifies for the holding company exception described in paragraph (e)(5)(vii)(C)(*5*)(*ii*) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, C's interest in D constitutes substantially all of C's assets, and A and B share in substantially all of C's opportunity for gain and risk of loss with respect to D. As a result, C's dividend income from D is not passive investment income and C's stock in D is not held to produce such income. Accordingly, C is not an SPV within the meaning of paragraph (e)(5)(vii)(B)(*1*) of this section, and the $960,000 payment to Country X is not attributable to a structured passive investment arrangement.

(*7*) *Example 7: Holding company; no SPV*—(*i*) *Facts*. The facts are the same as those in paragraph (e)(5)(vii)(D)(*6*)(*i*) of this section (the facts in *Example 6*), except that instead of loaning $50 million to D, C contributes the $50 million to E in exchange for 10% of the stock of E. E is a Country Y corporation that is not engaged in the active conduct of a trade or business. Also in Year 1, D pays no dividends to C, E pays $3.2 million in dividends to C, and C makes a payment of $960,000 to Country X with respect to C's net income.

(*ii*) *Result*. C qualifies for the holding company exception described in paragraph (e)(5)(vii)(C)(*5*)(*ii*) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, C's interest in D constitutes substantially all of C's assets, and A and B share in substantially all of C's opportunity for gain and risk of loss with respect to D. As a result, less than substantially all of C's assets are held to produce passive investment income. Accordingly, C is not an SPV because it does not meet the requirements of paragraph (e)(5)(vii)(B)(*1*) of this section, and the $960,000 payment to Country X is not attributable to a structured passive investment arrangement.

(*8*) *Example 8: Holding company; no SPV*—(*i*) *Facts*. The facts are the same as those in paragraph (e)(5)(vii)(D)(*6*)(*i*) of this section (the facts in *Example 6*), except that B's $1 billion investment in C consists of 30% of C's common stock and 100% of C's preferred stock. A's $1 billion investment in C consists of 70% of C's common stock. B sells its preferred stock to F, a Country X corporation, subject to a repurchase obligation. Assume that under Country X tax law, but not U.S. tax law, F is treated as the owner of the preferred shares and receives a distribution in Year 1 of $50 million. The remaining earnings are distributed 70% to A and 30% to B.

(*ii*) *Result*. C qualifies for the holding company exception described in paragraph (e)(5)(vii)(C)(*5*)(*ii*) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, and C's interest in D constitutes substantially all of C's assets. Additionally, although F does not share in C's opportunity for gain and risk of loss with respect to C's interest in D because F acquired its interest in C in a sale-repurchase transaction, B (the U.S. party) and in the aggregate A and F (who would be counterparties assuming C were an SPV) share in substantially all of C's opportunity for gain and risk of loss with respect to D and such opportunity for gain and risk of loss is not borne exclusively either by B or by A and F in the aggregate. Accordingly, C's shares in D are not held to produce passive investment income and the $200 million dividend from D is not passive investment income. C is not an SPV within the meaning of paragraph (e)(5)(vii)(B)(*1*) of this section, and the $960,000 payment to Country X is not attributable to a structured passive investment arrangement.

(*9*) *Example 9: Asset holding transaction*—(*i*) *Facts*. A domestic corporation (USP) contributes $6 billion of Country Z debt obligations to a Country Z entity (DE) in exchange for all of the class A and class B stock of DE. DE is a disregarded entity for U.S. tax purposes and a corporation for Country Z tax purposes. A corporation unrelated to USP and organized in Country Z (FC) contributes $1.5 billion to DE in exchange for all of the class C stock of DE. DE uses the $1.5 billion contributed by FC to redeem USP's class B stock. The terms of the class C stock entitle its holder to all income from DE, but FC is obligated immediately to contribute back to DE all distributions on the class C stock. USP and FC enter into a contract under which USP agrees to buy after five years the class C stock for $1.5 billion and an agreement under which USP agrees to pay FC periodic payments on $1.5 billion. The transaction is structured in such a way that, for U.S. tax purposes, there is a loan of $1.5 billion from FC to USP, and USP is the owner of the class C stock and the class A stock. In Year 1, DE earns $400 million of interest income on the Country Z debt obligations. DE makes a payment to Country Z of $100 million with respect to such income and distributes the remaining $300 million to FC. FC contributes the $300 million back to DE. None of FC's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Assume that Country Z imposes a withholding tax on interest income derived by U.S. residents. Country Z treats FC as the owner of the class C stock. Pursuant to Country Z tax law, FC is required to report the $400 million of income with respect to the $300 million distribution from DE, but is allowed to claim credits for DE's $100 million payment to Country Z. For Country Z tax purposes, FC is entitled to current deductions equal to the $300 million contributed back to DE.

(*ii*) *Result*. The payment to Country Z is not a compulsory payment, and thus is not an amount of foreign income tax paid, because the payment is attributable to a structured passive investment arrangement. First, DE is an SPV because all of DE's income is passive investment income described in paragraph (e)(5)(vii)(C)(*5*) of this section; all of DE's assets are held to produce such income; the payment to Country Z is attributable to such income; and if the payment were an amount of tax paid it would be paid in a U.S. taxable year in which DE meets the requirements of paragraph (e)(5)(vii)(B)(*1*)(*i*) of this section. Second, if the payment were an amount of foreign income tax paid, USP would be eligible to claim a credit for such amount under section 901(a). Third, USP's proportionate share of DE's foreign payment of $100 million is substantially greater than the amount of credits USP would be eligible to claim if it directly held its proportionate share of DE's assets, excluding any assets that would produce income subject to gross basis withholding tax if directly held by USP. Fourth, FC is entitled to claim a credit under Country Z tax law for the payment and recognizes a deduction for the $300 million contributed to DE under Country Z law. The credit claimed by FC corresponds to more than 10% of USP's share (for U.S. tax purposes) of the foreign payment and the deductions claimed by FC correspond to more than 10% of the base with respect to which USP's share of the foreign payment was imposed. Fifth, FC is a counterparty because FC is considered to own equity of DE under Country Z law and none of FC's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the United States and Country Z treat certain aspects of the transaction differently, including the proportion of equity owned in DE by USP and FC, and the amount of credits claimed by USP if the Country Z payment were an amount of tax paid is materially greater than it would be if the Country Z tax treatment controlled for U.S. tax purposes such that FC, rather than USP, owned the class C stock. Because the payment to Country Z is not an amount of foreign income tax paid, USP is not considered to pay tax under section 901. USP has $400 million of interest income.

(*10*) *Example 10: Loss surrender*—(*i*) *Facts*. The facts are the same as those in paragraph (e)(5)(vii)(D)(9)(*i*) of this section (the facts in *Example 9*), except that the deductions attributable to the arrangement contribute to a loss recognized by FC for Country Z tax purposes, and pursuant to a group relief regime in Country Z FC elects to surrender the loss to its Country Z subsidiary.

(*ii*) *Result*. The results are the same as in paragraph (e)(5)(vii)(D)(*9*)(*ii*) of this section (the results in *Example 9*). The surrender of the loss to a related party is a foreign tax benefit that corresponds to the base with respect to which USP's share of the foreign payment was imposed.

(*11*) *Example 11: Joint venture; no foreign tax benefit*—(*i*) *Facts*. FC, a Country X corporation, and USC, a domestic corporation, each contribute $1 billion to a newly-formed Country X entity (C) in exchange for stock of C. FC and USC are entitled to equal 50% shares of all of C's income, gain, expense and loss. C is treated as a corporation for Country X purposes and a partnership for U.S. tax purposes. In Year 1, C earns $200 million of net passive investment income, makes a payment to Country X of $60 million with respect to that income, and distributes $70 million to each of FC and USC. Country X does not impose tax on dividends received by one Country X corporation from a second Country X corporation.

(*ii*) *Result*. FC's tax-exempt receipt of $70 million, or its 50% share of C's profits, is not a foreign tax benefit within the meaning of paragraph (e)(5)(vii)(B)(*4*) of this section because it does not corre-

spond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Accordingly, the $60 million payment to Country X is not attributable to a structured passive investment arrangement.

(*12*) *Example 12: Joint venture; no foreign tax benefit*—(*i*) *Facts*. The facts are the same as those in paragraph (e)(5)(vii)(D)(*11*)(*i*) of this section (the facts in *Example 11*), except that C in turn contributes $2 billion to a wholly-owned and newly-formed Country X entity (D) in exchange for stock of D. D is treated as a corporation for Country X purposes and disregarded as an entity separate from its owner for U.S. tax purposes. C has no other assets and earns no other income. In Year 1, D earns $200 million of passive investment income, makes a payment to Country X of $60 million with respect to that income, and distributes $140 million to C.

(*ii*) *Result*. C's tax-exempt receipt of $140 million is not a foreign tax benefit within the meaning of paragraph (e)(5)(vii)(B)(*4*) of this section because it does not correspond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Fifty percent of C's foreign tax exemption is not a foreign tax benefit within the meaning of paragraph (e)(5)(vii)(B)(*4*) of this section because it relates to earnings of D that are distributed with respect to an equity interest in D that is owned indirectly by USC under both U.S. and foreign tax law. The remaining 50% of C's foreign tax exemption, as well as FC's tax-exempt receipt of $70 million from C, is also not a foreign tax benefit because it does not correspond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Accordingly, the $60 million payment to Country X is not attributable to a structured passive investment arrangement.

(6) *Soak-up taxes*—(i) *In general*. An amount remitted to a foreign country is not an amount of foreign income tax paid to the extent that liability for the foreign income tax is dependent (by its terms or otherwise) on the availability of a credit for the tax against income tax liability to another country. Liability for foreign income tax is dependent on the availability of a credit for the foreign income tax against income tax liability to another country only if and to the extent that the foreign income tax would not be imposed but for the availability of such a credit.

(ii) *Examples*. The following examples illustrate the application of paragraph (e)(6)(i) of this section.

(A) *Example 1: Tax rates dependent on availability of credit*—(*1*) *Facts*. Country X imposes a tax on the receipt of royalties from sources in Country X by nonresidents of Country X. The tax is 15% of the gross amount of such royalties unless the recipient is a resident of the United States or of country A, B, C, or D, in which case the tax is 20% of the gross amount of such royalties. Like the United States, each of countries A, B, C, and D allows its residents a credit against the income tax otherwise payable to it for income taxes paid to other countries.

(*2*) *Analysis*. Because the 20% rate applies only to residents of countries that allow a credit for taxes paid to other countries and the 15% rate applies to residents of countries that do not allow such a credit, one-fourth of the Country X tax would not be imposed on residents of the United States but for the availability of such a credit. One-fourth of the Country X tax imposed on residents of the United States who receive royalties from sources in Country X is dependent on the availability of a credit for the Country X tax against income tax liability to another country and, accordingly, under paragraph (e)(6)(i) of this section that amount is not an amount of foreign income tax paid.

(B) *Example 2: Tax not dependent on availability of credit*—(*1*) *Facts*. Country X imposes a net income tax on the realized net income of nonresidents of Country X from carrying on a trade or business in Country X. Although Country X tax law does not prohibit other nonresidents from carrying on business in Country X, United States persons are the only nonresidents of Country X that carry on business in Country X. The Country X tax would be imposed in its entirety on a nonresident of Country X irrespective of the availability of a credit for the Country X tax against income tax liability to another country.

(*2*) *Analysis*. Because no portion of the Country X tax liability is dependent on the availability of a credit for such tax in another country, under paragraph (e)(6)(i) of this section no portion of the Country X tax is a soak-up tax.

(C) *Example 3: Tax holiday denied to corporations with shareholders eligible for credit*—(*1*) *Facts*. Country X imposes a net income tax on the realized net income of all corporations incorporated in Country X. Country X allows a tax holiday to qualifying corporations incorporated in Country X that are owned by nonresidents of Country X, pursuant to which no Country X tax is imposed on the net income of a qualifying corporation for the first 10 years of its operations in Country X. A corporation qualifies for the tax holiday if it meets certain minimum investment criteria and if the development office of Country X certifies that in its opinion the operations of the corporation will be consistent with specified development goals of Country X. The development office will not issue this certification to any corporation owned by persons resident in countries that allow a credit to shareholders (such as a deemed paid credit under section 960) for Country X tax paid by a corporation incorporated in Country X. In practice, tax holidays are granted to a large number of corporations, but the Country X net income tax is imposed on a significant number of other corporations incorporated in Country X (for example, those owned by Country X persons and those which have had operations for more than 10 years) in addition to corporations denied a tax holiday because their shareholders qualify for a credit for the Country X tax against income tax liability to another country.

(*2*) *Analysis*. Under paragraph (e)(6)(i) of this section, no portion of the Country X tax paid by Country X corporations denied a tax holiday because they have U.S. shareholders is dependent on the availability of a credit for the Country X tax against income tax liability to another country, because a significant number of other Country X corporations pay the Country X tax irrespective of the availability of a credit to their shareholders.

(D) *Example 4: Tax deferral allowed for corporations with shareholders eligible for credit* —(*1*) *Facts*. The facts are the same as those in paragraph (e)(6)(ii)(C)(*1*) of this section (the facts of *Example 3*), except that Country X corporations owned by persons resident in countries that allow a credit for Country X tax when dividends are distributed by the corporations are granted a provisional tax holiday. Under the provisional tax holiday, instead of relieving such a corporation from Country X tax for 10 years, liability for such tax is deferred until the Country X corporation distributes dividends.

(*2*) *Analysis*. Because a significant number of other Country X corporations pay the Country X tax irrespective of the availability of a credit to their shareholders, the result is the same as in paragraph (e)(6)(ii)(C)(*2*) of this section.

(E) *Example 5: Tax based on greater of tax in lieu of income tax or amount eligible for credit*—(*1*) *Facts*. Pursuant to a contract with Country X, A, a domestic corporation engaged in manufacturing activities in Country X, must pay tax to Country X equal to the greater of 5u (units of Country X currency) per item produced, or the maximum amount creditable by A against its U.S. income tax liability for that year with respect to income from its Country X operations. Also pursuant to the contract, A is exempted from Country X's otherwise generally-imposed net income tax. The contractual tax is a tax in lieu of income tax as defined in §1.903-1(b). In Year 1, A produces 16 items, which would result in Country X tax of 16 x 5u = 80u, and taking into account the section 904 limitation, the maximum amount of Country X tax that A can claim as a credit against its U.S. income tax liability is 125u. Accordingly, A's contractual liability for Country X tax in lieu of income tax is 125u, the greater of the two amounts.

(*2*) *Analysis*. Under paragraph (e)(6)(i) of this section, the amount of tax paid by A that is dependent on the availability of a credit against income tax of another country is 125u – 80u = 45u, the amount that would not be imposed but for the availability of a credit.

(f) * * *

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(ii) *Examples*. The following examples illustrate the rules of paragraphs (f)(1) and (2)(i) of this section.

(A) *Example 1*. Under a loan agreement between A, a resident of Country X, and B, a United States person, A agrees to pay B a certain amount of interest net of any tax that Country X may impose on B with respect to its interest income. Country X imposes a 10 percent tax on the gross amount of interest income received by nonresidents of Country X from sources in Country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of §1.903-1(b). Under the law of Country X this tax is imposed on the nonresident recipient, and any resident of Country X that pays such interest to a nonresident is required to withhold and pay over to Country X 10 percent of the amount of such interest, which is applied to offset the recipient's liability for the tax. Because legal liability for the tax is imposed on the recipient of such interest income, B is the tax-

payer with respect to the Country X tax imposed on B's interest income from B's loan to A. Accordingly, B's interest income for Federal income tax purposes includes the amount of Country X tax that is imposed on B with respect to such interest income and that is paid on B's behalf by A pursuant to the loan agreement, and, under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by B.

(B) *Example 2*. The facts are the same as those in paragraph (f)(2)(ii)(A) of this section (the facts in *Example 1*), except that in collecting and receiving the interest B is acting as a nominee for, or agent of, C, who is a United States person. Because C (not B) is the beneficial owner of the interest, legal liability for the tax is imposed on C, not B (C's nominee or agent). Thus, C is the taxpayer with respect to the Country X tax imposed on C's interest income from C's loan to A. Accordingly, C's interest income for Federal income tax purposes includes the amount of Country X tax that is imposed on C with respect to such interest income and that is paid on C's behalf by A pursuant to the loan agreement. Under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by C. No such tax is considered paid by B.

(C) *Example 3*. Country X imposes a tax called the "Country X income tax." A, a United States person engaged in construction activities in Country X, is subject to that tax. Country X has contracted with A for A to construct a naval base. A is a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) and, in accordance with paragraphs (a)(1) and (c)(1) of §1.901-2A, A has established that the Country X income tax as applied to dual capacity persons and the Country X income tax as applied to persons other than dual capacity persons together constitute a single levy. A has also established that that levy is a net income tax within the meaning of paragraph (a)(3) of this section. Pursuant to the terms of the contract, Country X has agreed to assume any Country X tax liability that A may incur with respect to A's income from the contract. For Federal income tax purposes, A's income from the contract includes the amount of tax liability that is imposed by Country X on A with respect to its income from the contract and that is assumed by Country X; and for purposes of section 901 the amount of such tax liability assumed by Country X is considered to be paid by A. By reason of paragraph (f)(2)(i) of this section, Country X is not considered to provide a subsidy, within the meaning of paragraph (e)(3) of this section, to A.

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(4) *Taxes imposed on partnerships and disregarded entities*—(i) *Partnerships*. If foreign law imposes tax at the entity level on the income of a partnership, the partnership is considered to be legally liable for such tax under foreign law and therefore is considered to pay the tax for Federal income tax purposes. The rules of this paragraph (f)(4)(i) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid. See §§1.702-1(a)(6) and 1.704-1(b)(4)(viii) for rules relating to the determination of a partner's distributive share of such tax.

(ii) *Disregarded entities*. If foreign law imposes tax at the entity level on the income of an entity described in §301.7701-2(c)(2)(i) of this chapter (a *disregarded entity*), the person (as defined in section 7701(a)(1)) who is treated as owning the assets of the disregarded entity for Federal income tax purposes is considered to be legally liable for such tax under foreign law. Such person is considered to pay the tax for Federal income tax purposes. The rules of this paragraph (f)(4)(ii) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid.

(5) *Allocation of taxes in the case of certain ownership or classification changes*—(i) *In general*. If a partnership, disregarded entity, or corporation undergoes one or more covered events during its foreign taxable year that do not result in a closing of the foreign taxable year, then a portion of the foreign income tax (other than a withholding tax described in section 901(k)(1)(B)) paid by a person under paragraphs (f)(1) through (4) of this section with respect to the continuing foreign taxable year in which such covered event or events occur is allocated to and among all persons that were predecessor entities or prior owners during such foreign taxable year. The allocation is made based on the respective portions of the taxable income (as determined under foreign law) for the continuing foreign taxable year that are attributable under the principles of §1.1502-76(b) to the period of existence or ownership of each predecessor entity or prior owner during the continuing foreign taxable year. Foreign income tax allocated to a person that is a predecessor entity is treated (other than for purposes of section 986) as paid by the person as of the close of the last day of its last U.S. taxable year. Foreign income tax allocated to a person that is a prior owner, for example a transferor of a disregarded entity, is treated (other than for purposes of section 986) as paid by the person as of the close of the last day of its U.S. taxable year in which the covered event occurred.

(ii) *Covered event*. For purposes of this paragraph (f)(5), a covered event is a partnership termination under section 708(b)(1), a transfer of a disregarded entity, or a change in the entity classification of a disregarded entity or a corporation.

(iii) *Predecessor entity and prior owner*. For purposes of this paragraph (f)(5), a predecessor entity is a partnership or a corporation that undergoes a covered event as described in paragraph (f)(5)(ii) of this section. A prior owner is a person that either transfers a disregarded entity or owns a disregarded entity immediately before a change in the entity classification of the disregarded entity as described in paragraph (f)(5)(ii) of this section.

(iv) *Partnership variances*. In the case of a change in any partner's interest in the partnership (a variance), except as otherwise provided in section 706(d)(2) (relating to certain cash basis items) or 706(d)(3) (relating to tiered partnerships), foreign tax paid by the partnership during its U.S. taxable year in which the variance occurs is allocated between the portion of the U.S. taxable year ending on, and the portion of the U.S. taxable year beginning on the day after, the day of the variance. The allocation is made under the principles of this paragraph (f)(5) as if the variance were a covered event.

(6) *Allocation of foreign taxes in connection with elections under section 336(e) or 338 or §1.245A-5(e)*. For rules relating to the allocation of foreign taxes in connection with elections made pursuant to section 336(e), see §1.336-2(g)(3)(ii). For rules relating to the allocation of foreign taxes in connection with elections made pursuant to section 338, see §1.338-9(d). For rules relating to the allocation of foreign taxes in connection with elections made pursuant to §1.245A-5(e)(3)(i), see §1.245A-5(e)(3)(i)(B).

(7) *Examples*. The following examples illustrate the rules of paragraphs (f)(3) through (6) of this section.

(i) *Example 1*—(A) *Facts*. A, a United States person, owns 100 percent of B, an entity organized in Country X. B owns 100 percent of C, also an entity organized in Country X. B and C are corporations for U.S. and foreign tax purposes that use the "u" as their functional currency. Pursuant to a consolidation regime, Country X imposes a net income tax described

in paragraph (a)(3) of this section on the combined income of B and C within the meaning of paragraph (f)(3)(ii) of this section. In year 1, C pays 25u of interest to B. If B and C did not report their income on a combined basis for Country X tax purposes, the interest paid from C to B would result in 25u of interest income to B and 25u of deductible interest expense to C. For purposes of reporting the combined income of B and C, Country X first requires B and C to determine their own income (or loss) on a separate schedule. For this purpose, however, neither B nor C takes into account the 25u of interest paid from C to B because the income of B and C is included in the same combined base. The separate income of B and C reported on their Country X schedules for year 1, which do not reflect the 25u intercompany payment, is 100u and 200u, respectively. The combined income reported for Country X purposes is 300u (the sum of the 100u separate income of B and 200u separate income of C).

(B) *Result*. On the separate schedules described in paragraph (f)(3)(iii)(A) of this section, B's separate income is 100u and C's separate income is 200u. Under paragraph (f)(3)(iii)(B)(*1*) of this section, the 25u interest payment from C to B is taken into account for purposes of determining B's and C's portions of the combined income under paragraph (f)(3)(iii) of this section, because B and C would have taken the items into account if they did not compute their income on a combined basis. Thus, B's portion of the combined income is 125u (100u plus 25u) and C's portion of the combined income is 175u (200u less 25u). The result is the same regardless of whether the 25u interest payment from C to B is deductible for U.S. Federal income tax purposes. See paragraph (f)(3)(iii)(B)(*2*) of this section.

(ii) *Example 2*—(A) *Facts*. A, a United States person, owns 100 percent of B, an entity organized in Country X. B is a corporation for Country X tax purposes, and a disregarded entity for U.S. income tax purposes. B owns 100 percent of C and D, entities organized in country X that are corporations for both U.S. and Country X tax purposes. B, C, and D use the "u" as their functional currency and file on a combined basis for Country X income tax purposes. Country X imposes a net income tax described in paragraph (a)(3) of this section at the rate of 30 percent on the taxable income of corporations organized in Country X. Under the Country X combined reporting regime, income (or loss) of C and D is attributed to, and treated as income (or loss) of, B. B has the sole obligation to pay Country X income tax imposed with respect to income of B and income of C and D that is attributed to, and treated as income of, B. Under Country X tax law, Country X may proceed against B, but not C or D, if B fails to pay over to Country X all or any portion of the Country X income tax imposed with respect to such income. In year 1, B has income of 100u, C has income of 200u, and D has a net loss of (60u). Under Country X tax law, B is considered to have 240u of taxable income with respect to which 72u of Country X income tax is imposed. Country X does not provide mandatory rules for allocating D's loss.

(B) *Result*. Under paragraph (f)(3)(ii) of this section, the 72u of Country X tax is considered to be imposed on the combined income of B, C, and D. Because Country X tax law does not provide mandatory rules for allocating D's loss between B and C, under paragraph (f)(3)(iii)(C) of this section D's (60u) loss is allocated pro rata: 20u to B ((100u/300u) × 60u) and 40u to C ((200u/300u) × 60u). Under paragraph (f)(3)(i) of this section, the 72u of Country X tax must be allocated pro rata among B, C, and D. Because D has no income for Country X tax purposes, no Country X tax is allocated to D. Accordingly, 24u (72u × (80u/240u)) of the Country X tax is allocated to B, and 48u (72u × (160u/240u)) of such tax is allocated to C. Under paragraph (f)(4)(ii) of this section, A is considered to have legal liability for the 24u of Country X tax allocated to B under paragraph (f)(3) of this section.

(g) *Definitions*. For purposes of this section and §§1.901-2A and 1.903-1, the following definitions apply.

(1) *Foreign country and possession (territory) of the United States*. The term *foreign country* means any foreign state, any possession (territory) of the United States, and any political subdivision of any foreign state or of any possession (territory) of the United States. The term *possession* (or *territory*) *of the United States* means American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, and the U.S. Virgin Islands.

(2) *Foreign levy*. The term *foreign levy* means a levy imposed by a foreign country.

(3) *Foreign tax*. The term *foreign tax* means a foreign levy that is a tax as defined in paragraph (a)(2) of this section.

(4) *Foreign tax law*. The term *foreign tax law* means the laws of the foreign country imposing a foreign tax, including a separate levy that is modified by an applicable income tax treaty. The 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.

(5) *Paid, payment, and paid by*. The term *paid* means "paid" or "accrued"; the term *payment* means "payment" or "accrual"; and the term *paid by* means "paid by" or "accrued by or on behalf of," depending on the taxpayer's method of accounting for foreign income taxes. In the case of a taxpayer that claims a foreign tax credit, 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 §1.905-1(d)) during the taxable year. The term *paid* does not include foreign taxes deemed paid under section 904(c) or section 960.

(6) *Resident and nonresident*. The terms *resident* and *nonresident*, when used in the context of the foreign tax law of a foreign country, have the meaning provided in paragraphs (g)(6)(i) and (ii) of this section.

(i) *Resident*. An individual is a resident of a foreign country if the individual is liable to income tax in such country by reason of the individual's residence, domicile, citizenship, or similar criterion under such country's foreign tax law. An entity (including a corporation, partnership, trust, estate, or an entity that is disregarded as an entity separate from its owner for Federal income tax purposes) is a resident of a foreign country if the entity is liable to tax on its income (regardless of whether tax is actually imposed) under the laws of the foreign country by reason of the entity's place of incorporation or place of management in that country (or in a political subdivision or local authority thereof), or by reason of a criterion of similar nature, or if the entity is of a type that is specifically identified as a resident in an income tax treaty with the United States to which the foreign country is a party.

(ii) *Nonresident*. A nonresident with respect to a foreign country is any individual or entity that is not a resident of such foreign country.

(7) *Taxpayer*. The term *taxpayer* has the meaning set forth in paragraph (f)(1) of this section.

(h) *Applicability dates*. Except as otherwise provided in this paragraph (h), this section applies to foreign taxes paid (within the meaning of paragraph (g) of this section) in taxable years beginning on or after December 28, 2021. For foreign taxes paid to Puerto Rico by reason of section 1035.05 of the Puerto Rico Internal Revenue Code of 2011, as amended (13 L.P.R.A. §30155) (treating certain income, gain or loss as effectively connected with the active conduct of a trade or business with Puerto Rico), this section applies to foreign taxes paid (within the meaning of paragraph (g) of this section) in taxable years beginning on or after January 1, 2023. For foreign taxes described in the preceding sentence that are paid in taxable years beginning before January

1, 2023, see §1.901-2 as contained in 26 CFR part 1 revised as of April 1, 2021.

Par. 25. Section 1.903-1 is revised to read as follows:

§1.903-1 Taxes in lieu of income taxes.

(a) *Overview*. Section 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. Paragraphs (b) and (c) of this section define a tax described in section 903. Paragraph (d) of this section provides examples illustrating the application of this section. Paragraph (e) of this section sets forth the applicability date of this section. For purposes of this section and §§1.901-2 and 1.901-2A, a tax described in section 903 is referred to as a "tax in lieu of an income tax" or an "in lieu of tax" and the definitions in §1.901-2(g) apply for purposes of this section. Determinations of the amount of a tax in lieu of an income tax that is paid by a person and determinations of the person by whom such tax is paid are made under §1.901-2(e) and (f), respectively. Section 1.901-2A contains additional rules applicable to dual capacity taxpayers (as defined in §1.901-2(a)(2)(ii)(A)).

(b) *Definition of tax in lieu of an income tax*—(1) *In general*. Paragraphs (b)(2) and (c) of this section provide the requirements for a foreign levy to qualify as a tax in lieu of an income tax. The rules of this section are applied independently to each separate levy (within the meaning of §§1.901-2(d) and 1.901-2A(a)). A foreign tax either is or is not a tax in lieu of an income tax in its entirety for all persons subject to the tax. It is immaterial whether the base of the in lieu of tax bears any relation to realized net gain. The base of the foreign tax may, for example, be gross income, gross receipts or sales, or the number of units produced or exported. The foreign country's reason for imposing a foreign tax on a base other than net income (for example, because of administrative difficulty in determining the amount of income that would otherwise be subject to a net income tax) is immaterial, although paragraph (c)(1) of this section generally requires a showing that the foreign country made a deliberate and cognizant choice to impose the in lieu of tax instead of a net income tax (see paragraph (c)(1)(iii) of this section).

(2) *Requirements*. 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 of paragraph (c) of this section.

(c) *Substitution requirement*—(1) *In general*. A foreign tax (the "tested foreign tax") satisfies the substitution requirement if, based on the foreign tax law, the requirements in paragraphs (c)(1)(i) through (iv) of this section are satisfied with respect to the tested foreign tax, or the tested foreign tax is a covered withholding tax described in paragraph (c)(2) of this section.

(i) *Existence of generally-imposed net income tax*. A separate levy that is a net income tax (as described in §1.901-2(a)(3)) is generally imposed by the same foreign country (the "generally-imposed net income tax") that imposes the tested foreign tax.

(ii) *Non-duplication*. Neither the generally-imposed net income tax nor any other separate levy that is a net income tax is also imposed, in addition to the tested foreign tax, by the same foreign country on any persons with respect to any portion of the income to which the amounts (such as sales or units of production) that form the base of the tested foreign tax relate (the "excluded income"). Therefore, a tested foreign tax does not meet the requirement of this paragraph (c)(1)(ii) if a net income tax imposed by the same foreign country applies to the excluded income of any persons that are subject to the tested foreign tax, even if not all persons subject to the tested foreign tax are subject to the net income tax.

(iii) *Close connection to excluded income*. But for the existence of the tested foreign tax, the generally-imposed net income tax would otherwise have been imposed on the excluded income. The requirement in the preceding sentence is met only if the imposition of such tested foreign tax bears a close connection to the failure to impose the generally-imposed net income tax on the excluded income; the relationship cannot be merely incidental, tangential, or minor. 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 must be based on foreign tax law, or the legislative history of either the tested foreign tax or the generally-imposed net income tax that describes the provisions excluding taxpayers subject to the tested foreign tax from the generally-imposed net income tax. Thus, 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, and the tested foreign tax is enacted contemporaneously with the generally-imposed net income tax. A close connection also exists if the generally-imposed net income tax by its terms does not apply to, but does not expressly exclude, the excluded income, and the tested foreign tax is enacted contemporaneously with the generally-imposed net income tax. Where the tested foreign tax is not enacted contemporaneously with the generally-imposed net income tax and the generally-imposed net income tax is not amended contemporaneously with the enactment of the tested foreign tax to exclude the excluded income or to narrow the scope of the generally-imposed net income tax so as not to apply 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). Not all income derived by persons subject to the tested foreign tax need be excluded income, provided the tested foreign tax applies only to amounts that relate to the excluded income.

(iv) *Jurisdiction to tax excluded income*. 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 §1.901-2(b)(5).

(2) *Covered withholding tax*. A tested foreign tax is a covered withholding tax if, based on the foreign tax law, the requirements in paragraphs (c)(1)(i) and (c)(2)(i) through (iii) of this section are met with respect to the tested foreign tax. See also §1.901-2(d)(1)(iii) for rules treating withholding taxes as separate levies with respect to each class of income subject to

the tax or with respect to each subset of a class of income that is subject to different income attribution rules.

(i) *Withholding tax on nonresidents*. The tested foreign tax is a withholding tax (as defined in section 901(k)(1)(B)) that is imposed on gross income of persons who are nonresidents of the foreign country imposing the tested foreign tax. It is immaterial whether the tested foreign tax is withheld by the payor or is imposed directly on the nonresident taxpayer.

(ii) *Non-duplication*. The tested foreign tax is not in addition to any net income tax that is imposed by the foreign country on any portion of the net income attributable to the gross income that is subject to the tested foreign tax. Therefore, a tested foreign tax does not meet the requirement of this paragraph (c)(2)(ii) if by its terms it applies to gross income of nonresidents that are also subject to a net income tax imposed by the same foreign country on the same income, even if not all nonresidents subject to the tested foreign tax are also subject to the net income tax.

(iii) *Source-based attribution requirement*. The income subject to the tested foreign tax satisfies the attribution requirement described in §1.901-2(b)(5)(i)(B).

(d) *Examples*. The following examples illustrate the rules of this section.

(1) *Example 1: Tax on gross income from services; non-duplication requirement*—(i) *Facts.* Country X imposes a tax at the rate of 3 percent on the gross receipts of companies, wherever resident, from furnishing specified types of electronically supplied services to customers located in Country X (the "ESS tax"). No deductions are allowed in determining the taxable base of the ESS tax. In addition to the ESS tax, Country X imposes a net income tax within the meaning of §1.901-2(a)(3) on resident companies (the "resident income tax") and also imposes a net income tax within the meaning of §1.901-2(a)(3) on the income of nonresident companies that is attributable, under reasonable principles, to the nonresident's permanent establishment within Country X (the "nonresident income tax"). Under Country X tax law, a permanent establishment is defined in the same manner as under the 2016 U.S. Model Income Tax Convention. Both the resident income tax and the nonresident income tax, which are separate levies under §1.901-2(d)(1)(iii), qualify as generally-imposed net income taxes. Under Country X tax law, the ESS tax applies to both resident and nonresident companies regardless of whether the company is also subject to the resident income tax or the nonresident income tax, respectively.

(ii) *Analysis.* Under §1.901-2(d)(1)(iii), the ESS tax comprises two separate levies, one imposed on resident companies (the "resident ESS tax"), and one imposed on nonresident companies (the "nonresident ESS tax"). Under paragraph (c)(1)(ii) of this section, neither the resident ESS tax nor the nonresident ESS tax satisfies the substitution requirement, because by its terms the income to which the gross receipts subject to the ESS tax relate is also subject to one of the two generally-imposed net income taxes imposed by Country X. Similarly, under paragraph (c)(2)(ii) of this section, the nonresident ESS tax is not a covered withholding tax because by its terms it is imposed in addition to the nonresident income tax. The fact that nonresident taxpayers that do not have a permanent establishment in Country X are in practice subject to the nonresident ESS tax but not to the nonresident income tax on the gross receipts included in the base of the nonresident ESS tax is not relevant to the determination of whether the ESS tax meets the substitution requirement under paragraph (c)(1) of this section. Therefore, neither the resident ESS tax nor the nonresident ESS tax is a tax in lieu of an income tax.

(2) *Example 2: Tax on gross income from services; attribution of income*—(i) *Facts*. The facts are the same as those in paragraph (d)(1)(i) of this section (the facts in *Example 1*), except that under Country X tax law, the nonresident ESS tax is imposed only if the nonresident company does not have a permanent establishment in Country X. If the nonresident company has a Country X permanent establishment, the nonresident income tax applies to the profits attributable to that permanent establishment. In addition, the statutory language and legislative history to the nonresident ESS tax demonstrate that Country X made a cognizant and deliberate choice to impose the nonresident ESS tax instead of the nonresident income tax with respect to the gross receipts that are subject to the nonresident ESS tax.

(ii) *Analysis*—(A) *General application of substitution requirement*. The nonresident ESS tax meets the requirements in paragraphs (c)(1)(i) and (ii) of this section because Country X has two generally-imposed net income taxes and neither generally-imposed net income tax nor any other separate levy that is a net income tax is imposed by Country X on a nonresident's income to which gross receipts that form the base of the nonresident ESS tax relate (which is the excluded income). The statutory language and legislative history to the nonresident ESS tax demonstrate that Country X made a cognizant and deliberate choice not to impose the nonresident income tax on the excluded income. Therefore, the nonresident ESS tax meets the requirement in paragraph (c)(1)(iii) of this section because, but for the existence of the tested foreign tax, the nonresident income tax would otherwise have been imposed on the excluded income. However, the nonresident ESS tax does not meet the requirement in paragraph (c)(1)(iv) of this section, because if Country X had chosen to apply the nonresident income tax (rather than the nonresident ESS tax) to the excluded income, the modified nonresident income tax would fail the attribution requirement in §1.901-2(b)(5). First, the modified tax would not satisfy the requirement in §1.901-2(b)(5)(i)(A) because the modified tax would not apply to income attributable under reasonable principles to the nonresident's activities within the foreign country, since the modified tax is determined by taking into account the location of customers. Second, the modified tax would not satisfy the requirement in §1.901-2(b)(5)(i)(B) because the excluded income is from services performed outside of Country X. Third, the modified tax would not satisfy the requirement in §1.901-2(b)(5)(i)(C) 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. Because the Country X nonresident income tax as applied to the excluded income would fail to meet the attribution requirement in §1.901-2(b)(5), as required by paragraph (c)(1)(iv) of this section, the nonresident ESS tax does not satisfy the substitution requirement in paragraph (c)(1) of this section.

(B) *Covered withholding tax analysis*. The nonresident ESS tax meets the requirement in paragraph (c)(1)(i) of this section because there exists a generally-imposed net income tax. It also meets the requirements in paragraphs (c)(2)(i) and (ii) of this section because it is a withholding tax on gross receipts of nonresidents and the income attributable to those gross receipts is not subject to a net income tax. However, the nonresident ESS tax does not meet the requirement in paragraph (c)(2)(iii) of this section because the services income subject to the nonresident ESS tax is from electronically supplied services performed outside of Country X. See §1.901-2(b)(5)(i)(B). Therefore, the nonresident ESS tax is not a covered withholding tax under paragraph (c)(2) of this section. Because the nonresident ESS tax does not satisfy the substitution requirement of paragraph (c) of this section, it is not a tax in lieu of an income tax.

(3) *Example 3: Withholding tax on royalties; attribution requirement*—(i) *Facts*. YCo, a resident of Country Y, is a controlled foreign corporation wholly-owned by USP, a domestic corporation. In Year 1, YCo grants a license to XCo, a resident of Country X unrelated to YCo or USP, for the right to use YCo's intangible property (IP) throughout the world, including in Country X. Under Country X's domestic tax law, all royalties paid by a resident of Country X to a nonresident are sourced in Country X and are subject to a 30% withholding tax on the gross income, regardless of whether the nonresident payee has a taxable presence in Country X. Country X's withholding tax on royalties is a separate levy under §1.901-2(d)(1)(iii). In Year 1, XCo withholds 30u (units of Country X currency) tax from 100u of royalties owed and paid to YCo under the licensing arrangement, of which 50u is attributable to XCo's use of the YCo IP in Country X and 50u is attributable to use of the YCo IP outside Country X. The United States and Country X have an income tax treaty (U.S.-Country X treaty); under the royalties article of the treaty, Country X agreed to impose its withholding tax on royalties paid to a U.S. resident only on royalties paid for IP used in Country X. Country X and Country Y do not have an income tax treaty.

(ii) *Analysis*. Under §1.901-2(d)(1)(iv), the Country X withholding tax on royalties, as modified by the U.S.-Country X treaty, is a separate levy from the unmodified Country X withholding tax to which YCo was subject (because YCo is not a U.S. resident eligible for benefits under the U.S.-Country X treaty). The Country X withholding tax on royalties, unmodified by the U.S.-Country X treaty, does not meet the attribution requirement in §1.901-2(b)(5)

(i)(B) because Country X's source rule for royalties (based upon residence of the payor) is not reasonably similar to the sourcing rules that apply under the Internal Revenue Code. Thus, under paragraph (c)(2)(iii) of this section, the Country X withholding tax paid by YCo is not a covered withholding tax, and none of the 30u of Country X withholding tax paid by YCo with respect to the 100u of royalties for the use of the IP is a payment of foreign income tax.

(4) *Example 4: Withholding tax on royalties; attribution requirement*—(i) *Facts*. The facts are the same as in paragraph (d)(3)(i) of this section (the facts of *Example 3*), except that XCo only uses the IP in Country X and the 100u of royalties paid to YCo in Year 1 is all attributable to XCo's use of the IP in Country X.

(ii) *Analysis*. The result is the same as in paragraph (d)(3) of this section (the analysis of *Example 3*). Because Country X's source rule for royalties (based upon residence of the payor) is not reasonably similar to the sourcing rules that apply under the Internal Revenue Code, the withholding tax paid by YCo does not meet the attribution requirement in §1.901-2(b)(5)(i)(B). Under paragraph (c)(2)(iii) of this section, the Country X withholding tax paid by YCo is not a covered withholding tax, and none of the 30u of Country X withholding tax paid by YCo with respect to the 100u of royalties for IP used in Country X is a payment of foreign income tax.

(5) *Example 5: Multiple in-lieu-of taxes*—(i) *Facts*. Country X imposes a net income tax within the meaning of §1.901-2(a)(3) on the income of nonresident companies that is attributable, under reasonable principles, to the nonresident's activities within Country X (the "trade or business tax"). The trade or business tax applies to all nonresident corporations that engage in business in Country X except for nonresident corporations that engage in insurance activities, which are instead subject to two different taxes ("insurance taxes"). The insurance taxes apply to nonresident corporations that engage in insurance activities that are attributable, under reasonable principles, to the nonresident's activities within Country X. The insurance taxes do not satisfy the cost recovery requirement in §1.901-2(b)(4). The trade or business tax and the two insurance taxes were enacted contemporaneously, and the statutory language of the trade or business tax expressly excludes gross income derived by nonresident corporations engaged in insurance activities from the trade or business tax.

(ii) *Analysis*. The insurance taxes meet the requirements in paragraphs (c)(1)(i) and (ii) of this section because Country X has a generally-imposed net income tax, the trade or business tax, and neither the trade or business tax nor any other separate levy that is a net income tax is imposed by Country X on a nonresident's gross income to which the amounts that form the base of the insurance taxes (the "excluded income") relate. The Country X tax law expressly provides that the trade or business tax does not apply to nonresident corporations engaged in insurance activities. In addition, the two insurance taxes were enacted contemporaneously with the trade or business tax. Therefore, it is demonstrated that Country X made a cognizant and deliberate choice to impose the insurance taxes in lieu of the generally-imposed trade or business tax, and the insurance taxes meet the requirement in paragraph (c)(1)(iii) of this section. If the trade or business tax also applied to the excluded income, the trade or business tax would meet the requirement in §1.901-2(b)(5)(i)(A), because it would apply only to income attributable, under reasonable principles, to the nonresident's activities within the foreign country. Thus, the insurance taxes meet the requirement in paragraph (c)(1)(iv) of this section. Therefore, the insurance taxes satisfy the substitution requirement in paragraph (c)(1) of this section.

(6) *Example 6: Later-enacted in-lieu-of tax; close connection requirement*—(i) *Facts*. The facts are the same as those in paragraph (d)(5)(i) of this section (the facts in *Example 5*), except that one of the two insurance taxes applies only to nonresident corporations engaged in the life insurance business in Country X and was enacted five years after the enactment of the trade or business tax and the other insurance tax enacted contemporaneously with the trade or business tax. The legislative history to the later-enacted insurance tax shows that Country X intended to increase the tax imposed on nonresident corporations engaged in life insurance activities and, instead of amending the first insurance tax to increase the rate applicable to life insurance companies, it enacted the second insurance tax that only applies to life insurance corporations.

(ii) *Analysis*. The later-enacted insurance tax meets the requirements in paragraphs (c)(1)(i) and (ii) of this section because Country X has a generally-imposed net income tax, the trade or business tax, and neither the trade or business tax nor any other separate levy that is a net income tax is imposed by Country X on the income attributable to the activities that form the base of the later-enacted insurance tax. The later-enacted insurance tax meets the requirement in paragraph (c)(1)(iii) of this section because the legislative history to the later-enacted insurance tax demonstrates that Country X made a cognizant and deliberate choice to impose the later-enacted insurance tax on life insurance companies instead of the trade or business tax. The later-enacted insurance tax also meets the requirement of paragraph (c)(1)(iv) of this section for the reasons set forth in paragraph (d)(5)(ii) of this section. Therefore, the later-enacted insurance tax satisfies the substitution requirement in paragraph (c)(1) of this section.

(7) *Example 7: Excise tax creditable against net income tax*—(i) *Facts*. Country X imposes an excise tax that does not satisfy the cost recovery requirement in §1.901-2(b)(4), and a net income tax within the meaning of §1.901-2(a)(3). The excise tax, which is payable independently of the net income tax, is allowed as a credit against the net income tax. In Year 1, A has a tentative net income tax liability of 100u (units of Country X currency) but is allowed a credit for 30u of excise tax that it paid that year.

(ii) *Analysis*. Pursuant to §1.901-2(e)(4), the amount of excise tax A has paid to Country X is 30u and the amount of net income tax A has paid to Country X is 70u. The excise tax paid by A does not satisfy the substitution requirement set forth in paragraph (c)(1) of this section because the excise tax is imposed in addition to, and not in substitution for, the generally-imposed net income tax.

(e) *Applicability dates*. Except as otherwise provided in this paragraph (e), this section applies to foreign taxes paid (within the meaning of §1.901-2(g)(5)) in taxable years beginning on or after December 28, 2021. For foreign taxes paid to Puerto Rico under section 3070.01 of the Puerto Rico Internal Revenue Code of 2011, as amended (13 L.P.R.A. §31771) (imposing an excise tax on a controlled group member's acquisition from another group member of certain personal property manufactured or produced in Puerto Rico and certain services performed in Puerto Rico), this section applies to foreign taxes paid (within the meaning of §1.901-2(g)(5)) in taxable years beginning on or after January 1, 2023. For foreign taxes described in the preceding sentence that are paid in taxable years beginning before January 1, 2023, see §1.903-1 as contained in 26 CFR part 1 revised as of April 1, 2021.

Par. 26. Section 1.904-4 is amended:

1. By revising paragraph (b)(2)(i)(A).

2. By revising the last sentence of paragraph (c)(4).

3. In paragraph (f)(1)(i) introductory text, by removing the language "paragraph (f)(1)(ii) of this section" and adding in its place the language "paragraph (f)(1)(ii), (iii), or (iv) of this section".

4. By adding paragraphs (f)(1)(iii) and (iv).

5. By removing and reserving paragraphs (f)(2)(ii) and (iii).

6. By revising paragraphs (f)(2)(vi)(A) and (f)(2)(vi)(B)(*1*)(*ii*).

7. By adding paragraph (f)(2)(vi)(G).

8. By revising paragraph (f)(3)(v).

9. In the second sentence of paragraph (f)(3)(vii)(B), by removing the language "treated as carried out pursuant to" and adding in its place the language "carried out constitute".

10. By redesignating paragraphs (f)(3)(viii) and (ix) as paragraphs (f)(3)(ix) and (xii), respectively.

11. By adding a new paragraph (f)(3)(viii).

12. In newly redesignated paragraph (f)(3)(ix), by removing the language "paragraph (f)(3)(viii)" and adding the language "paragraph (f)(3)(ix)" in its place.

13. By redesignating paragraph (f)(3)(x) as paragraph (f)(3)(xiii).

14. By adding new paragraphs (f)(3)(x) and (xi).

15. In paragraphs (f)(4)(i)(B)(*1*) and (*2*), by removing the language "paragraph

(f)(3)(viii)" and adding the language "paragraph (f)(3)(ix)" in its place.

16. In paragraphs (f)(4)(iv)(B)(*1*) and (f)(4)(v)(B)(*2*), by removing the language "paragraph (f)(3)(x)" and adding the language "paragraph (f)(3)(xiii)" in its place.

17. By adding paragraphs (f)(4)(xiii) through (xvi) and (q)(3).

The additions and revisions read as follows:

§1.904-4 Separate application of section 904 with respect to certain categories of income.

* * * * *

(b) * * *

(2) * * *

(i) * * *

(A) Income received or accrued by any person that is of a kind that would be foreign personal holding company income (as defined in section 954(c), taking into account any exceptions or exclusions to section 954(c), including, for example, section 954(c)(3), (c)(6), (h), or (i)) if the taxpayer were a controlled foreign corporation, including any amount of gain on the sale or exchange of stock in excess of the amount treated as a dividend under section 1248;

* * * * *

(c) * * *

(4) * * * The grouping rules of paragraphs (c)(3)(i) through (iv) of this section also apply separately to income attributable to each tested unit, as defined in §1.951A-2(c)(7)(iv), of a controlled foreign corporation, and to each foreign QBU of a noncontrolled 10-percent owned foreign corporation or any other look-through entity defined in §1.904-5(i), or of any United States person.

* * * * *

(f) * * *

(1) * * *

(iii) *Income arising from U.S. activities excluded from foreign branch category income*. Gross income that is attributable to a foreign branch and that arises from activities carried out in the United States by any foreign branch, including income that is reflected on a foreign branch's separate books and records, is not assigned to the foreign branch category. Instead, such income is assigned to the general category or a specified separate category under the rules of this section. However, under paragraph (f)(2)(vi) of this section, gross income (including U.S. source gross income) attributable to activities carried on outside the United States by the foreign branch may be assigned to the foreign branch category by reason of a disregarded payment to a foreign branch from a foreign branch owner or another foreign branch that is allocable to income recorded on the books and records of the payor foreign branch or foreign branch owner.

(iv) *Income arising from stock excluded from foreign branch category income*—(A) *In general*. Except as provided in paragraph (f)(1)(iv)(B) of this section, gross income that is attributable to a foreign branch and that comprises items of income arising from stock of a corporation (whether foreign or domestic), including gain from the disposition of such stock or any inclusion under section 951(a), 951A(a), 1248, or 1293(a), is not assigned to the foreign branch category. Instead, such income is assigned to the general category or a specified separate category under the rules of this section.

(B) *Exception for dealer property*. Paragraph (f)(1)(iv)(A) of this section does not apply to gain recognized from dispositions of stock of a corporation, if the stock would be dealer property (as defined in §1.954-2(a)(4)(v)) if the foreign branch were a controlled foreign corporation.

* * * * *

(2) * * *

(vi) * * *

(A) *In general*. If a foreign branch makes a disregarded payment to its foreign branch owner or a second foreign branch, and the disregarded payment is allocable to gross income that would be attributable to the foreign branch under the rules in paragraphs (f)(2)(i) through (v) of this section, the gross income attributable to the foreign branch is adjusted downward (but not below zero) to reflect the allocable amount of the disregarded payment, and the gross income attributable to the foreign branch owner or the second foreign branch is adjusted upward by the same amount as the downward adjustment, translated (if necessary) from the foreign branch's functional currency to U.S. dollars (or the second foreign branch's functional currency, as applicable) at the spot rate (as defined in §1.988-1(d)) on the date of the disregarded payment. For rules addressing multiple disregarded payments in a taxable year, see paragraph (f)(2)(vi)(F) of this section. Similarly, if a foreign branch owner makes a disregarded payment to its foreign branch and the disregarded payment is allocable to gross income attributable to the foreign branch owner, the gross income attributable to the foreign branch owner is adjusted downward (but not below zero) to reflect the allocable amount of the disregarded payment, and the gross income attributable to the foreign branch is adjusted upward by the same amount as the downward adjustment, translated (if necessary) from U.S. dollars to the foreign branch's functional currency at the spot rate on the date of the disregarded payment. An adjustment to the amount of attributable gross income under this paragraph (f)(2)(vi) does not change the total amount, character, or source of the United States person's gross income; does not change the amount of a United States person's income in any separate category other than the foreign branch and general categories (or a specified separate category associated with the foreign branch and general categories); and has no bearing on the analysis of whether an item of gross income is eligible to be resourced under an income tax treaty.

(B) * * *

(*1*) * * *

(*ii*) Disregarded payments from a foreign branch to its foreign branch owner or to another foreign branch are allocable to gross income attributable to the payor foreign branch to the extent a deduction for that payment or any disregarded cost recovery deduction relating to that payment, if regarded, would be allocated and apportioned to gross income attributable to the payor foreign branch under the principles of §§1.861-8 through 1.861-14T and 1.861-17 (without regard to exclusive apportionment) by treating foreign source gross income and U.S. source gross income in each separate category (determined before the application of this paragraph (f)(2)(vi) to the disregarded payment at issue) each as a statutory grouping.

* * * * *

(G) *Effect of disregarded payments made and received by non-branch taxable units*—(*1*) *In general*. For purposes of determining the amount, source, and character of gross income attributable to a foreign branch and its foreign branch owner under paragraph (f)(2) of this section, the rules of paragraph (f)(2) of this section apply to a non-branch taxable unit as though the non-branch taxable unit were a foreign branch or a foreign branch owner, as appropriate, to attribute gross income to the non-branch taxable unit and to further attribute, under this paragraph (f)(2)(vi)(G), the income of a non-branch taxable unit to one or more foreign branches or to a foreign branch owner. See paragraph (f)(4)(xvi) of this section (*Example 16*).

(*2*) *Foreign branch group income*. The income of a foreign branch group is attributed to the foreign branch that owns the group. The income of a foreign branch group is the aggregate of the U.S. gross income that is attributed, under the rules of this paragraph (f)(2), to each member of the foreign branch group, determined after accounting for all disregarded payments made and received by each member of the foreign branch group.

(*3*) *Foreign branch owner group income*. The income of a foreign branch owner group is attributed to the foreign branch owner that owns the group. The income of a foreign branch owner group income is the aggregate of the U.S. gross income that is attributed, under the rules of this paragraph (f)(2), to each member of the foreign branch owner group, determined after accounting for all disregarded payments made and received by each member of the foreign branch owner group.

(3) * * *

(v) *Disregarded payment*. A disregarded payment includes an amount of property (within the meaning of section 317(a)) that is transferred to or from a non-branch taxable unit, foreign branch, or foreign branch owner, including a payment in exchange for property or in satisfaction of an account payable, or a remittance or contribution, in connection with a transaction that is disregarded for Federal income tax purposes and that is reflected on the separate set of books and records of a non-branch taxable unit (other than an individual or domestic corporation) or a foreign branch. A disregarded payment also includes any other amount that is reflected on the separate set of books and records of a non-branch taxable unit (other than an individual or a domestic corporation) or a foreign branch in connection with a transaction that is disregarded for Federal income tax purposes and that would constitute an item of accrued income, gain, deduction, or loss of the non-branch taxable unit (other than an individual or a domestic corporation) or the foreign branch if the transaction to which the amount is attributable were regarded for Federal income tax purposes.

* * * * *

(viii) *Foreign branch group*. The term *foreign branch group* means a foreign branch and one or more non-branch taxable units (other than an individual or a domestic corporation), to the extent that the foreign branch owns the non-branch taxable unit directly or indirectly through one or more other non-branch taxable units.

* * * * *

(x) *Foreign branch owner group*. The term *foreign branch owner group* means a foreign branch owner and one or more non-branch taxable units (other than an individual or a domestic corporation), to the extent that the foreign branch owner owns the non-branch taxable unit directly or indirectly through one or more other non-branch taxable units.

(xi) *Non-branch taxable unit*. The term *non-branch taxable unit* has the meaning provided in §1.904-6(b)(2)(i)(B).

* * * * *

(4) * * *

(xiii) *Example 13: Disregarded payment from domestic corporation to foreign branch*—(A) *Facts*. P, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch. FDE's functional currency is the U.S. dollar. In Year 1, P accrues and records on its books and records for Federal income tax purposes $400x of gross income from the license of intellectual property to unrelated parties that is not passive category income, all of which is U.S. source income. P also accrues $600x of foreign source passive category interest income. P compensates FDE for services that FDE performs in a foreign country with an arm's length payment of $350x, which FDE records on its books and records; the transaction is disregarded for Federal income tax purposes. Absent the application of paragraph (f)(2)(vi) of this section, the $400x of gross income earned by P from the license would be general category income that would not be attributable to FDE. If the $350x disregarded payment from P to FDE were regarded for Federal income tax purposes, the deduction for the payment would be allocated and apportioned entirely to P's $400x of general category gross licensing income under the principles of §§1.861-8 and 1.861-8T (treating U.S. source general category gross income and foreign source passive category gross income each as a statutory grouping). P and FDE incur no other expenses.

(B) *Analysis*. The $350x disregarded payment from P, a United States person, to FDE, its foreign branch, is not recorded on FDE's separate books and records (as adjusted to conform to Federal income tax principles) under paragraph (f)(2)(i) of this section because it is disregarded for Federal income tax purposes. The disregarded payment is allocable to gross income attributable to P because a deduction for the payment, if it were regarded, would be allocated and apportioned to the $400x of P's U.S. source licensing income. Accordingly, under paragraphs (f)(2)(vi)(A) and (f)(2)(vi)(B)(*3*) of this section, the amount of gross income attributable to the FDE foreign branch (and the gross income attributable to P) is adjusted in Year 1 to take the disregarded payment into account. Accordingly, $350x of P's $400x U.S. source general category gross income from the license is attributable to the FDE foreign branch for purposes of this section. Therefore, $350x of the U.S. source gross income that P earned with respect to its license in Year 1 constitutes U.S. source gross income that is assigned to the foreign branch category and $50x remains U.S. source general category income. P's $600x of foreign source passive category interest income is unchanged.

(xiv) *Example 14: Regarded payment from non-consolidated domestic corporation to a foreign branch*—(A) *Facts*. The facts are the same as those in paragraph (f)(4)(xiii)(A) of this section (the facts in *Example 13*), except P wholly owns USS, and USS (rather than P) owns FDE. P and USS do not file a consolidated return. USS has no gross income other than the $350x foreign source services income from the $350x payment it receives from P, through FDE.

(B) *Analysis*. The $350x services payment from P, a United States person, to FDE, a foreign branch of USS, is not a disregarded payment because the transaction is regarded for Federal income tax purposes. Under §§1.861-8 and 1.861-8T, P's $350x deduction for the services payment is allocated and apportioned to its U.S. source general category gross income. The payment of $350x from P to USS is services income attributable to FDE, and foreign branch category income of USS under paragraph (f)(2)(i) of this section. Accordingly, USS has $350x of foreign source foreign branch category gross income. P has $600x of foreign source passive category income and $400x of U.S. source general category gross income and a $350x deduction for the services payment, resulting in $50x of U.S. source general category taxable income to P.

(xv) *Example 15: Regarded payment from a member of a consolidated group to a foreign branch of another member of the consolidated group*—(A) *Facts*. The facts are the same as those in paragraph (f)(4)(xiv)(A) of this section (the facts in *Example 14*), except that P and USS are members of an affiliated group that files a consolidated return pursuant to section 1502 (P group).

(B) *Analysis*—(*1*) *Definitions under §1.1502-13*. Under §1.1502-13(b)(1), the $350x services payment from P to FDE, a foreign branch of USS, is an intercompany transaction between P and USS; USS is the selling member, P is the buying member, P has a deduction of $350x for the services payment that is a corresponding item, and USS has $350x of income that is an intercompany item. The payment is not a disregarded payment because the transaction is regarded for Federal income tax purposes.

(*2*) *Timing and attributes under §1.1502-13*—(*i*) *Separate entity versus single entity analysis*. Under a separate entity analysis, the result is the same as in paragraph (f)(4)(xiv)(B) of this section (the analysis in *Example 14*), whereby P has $600x of foreign source passive category income and $50x of U.S. source general category income, and USS has $350x of foreign source foreign branch category income. In contrast, under a single entity analysis, the result is the same as in paragraph (f)(4)(xiii)(B) of this section (the analysis in *Example 13*), whereby P has $600x of foreign source passive category income, $50x of U.S. source general category income, and $350x of U.S. source foreign branch category income.

(*ii*) *Application of the matching rule*. Under the matching rule in §1.1502-13(c), the timing, character, source, and other attributes of USS's $350x intercompany item and P's $350x corresponding item are redetermined to produce the effect of transactions between divisions of a single corporation, as if the services payment had been made to a foreign branch of that corporation. Accordingly, all of USS's foreign source income of $350x is redetermined to be U.S. source, rather than foreign source, income. Therefore, for purposes of §1.1502-4(c)(1), the P group has $600x of foreign passive category income, $50x of U.S. source general category income, and $350x of U.S. source foreign branch category income.

(xvi) *Example 16: Disregarded payment made from non-branch taxable unit*—(A) *Facts*. The facts are the same as those in paragraph (f)(4)(xiii)(A) of this section (the facts in *Example 13*), except that P also wholly owns FDE1, a disregarded entity that is a non-branch taxable unit. In addition, FDE1 (rather than P) is the entity that properly accrues and records on its books and records the $400x of U.S. source general category income from the license of intellectual property and the $600x of foreign source passive category interest income, and FDE1 (rather than P) is the entity that makes the $350x payment, which is disregarded for Federal income tax purposes, to FDE in compensation for services.

(B) *Analysis*. Under paragraph (f)(2)(vi)(G) of this section, the rules of paragraph (f)(2) of this section apply to attribute gross income to FDE1, a non-branch taxable unit, as though FDE1 were a foreign branch. Under these rules, the $400x of licensing income and the $600 of interest income are initially attributable to FDE1. This income is adjusted in Year 1 to account for the $350x disregarded payment, which is allocable to the $400x of licensing income of FDE1. Accordingly, $50x of the $400x of U.S. source general category licensing income is attributable to FDE1 and $350x of this income is attributable to the FDE foreign branch. To determine the income that is attributable to P, the foreign branch owner, and FDE, the foreign branch, the income that is attributed to FDE1, after taking into account all of the disregarded payments that it makes and receives, must be further attributed to one or more foreign branches or a foreign branch owner under paragraph (f)(2)(vi)(G) of this section. Under paragraph (f)(2)(vi)(G) of this section, the income of FDE1 is attributed to the foreign branch group or foreign branch owner group of which it is a member. Because FDE1 is wholly owned by P, FDE is a member solely of the foreign branch owner group that is owned by P. See definition of "foreign branch owner group" in §1.904-4(f)(3). All the income that is attributed to FDE1 under paragraph (f)(2) of this section, namely, the $50x of U.S. source general category licensing income and the $600x of foreign source passive category interest income, is further attributed to P. See §1.904-4(f)(2)(vi)(G)(*3*). Therefore, the result is the same as in paragraph (f)(4)(xiii)(B) of this section (the analysis in *Example 13*).

* * * * *

(q) * * *

(3) Paragraph (f) of this section applies to taxable years that begin after December 31, 2019, and end on or after November 2, 2020.

Par. 27. Section 1.904-6 is amended by adding paragraph (b)(2) and revising paragraph (g) to read as follows:

§1.904-6 Allocation and apportionment of foreign income taxes.

* * * * *

(b) * * *

(2) *Disregarded payments*—(i) *In general*—(A) *Assignment of foreign gross income*. Except as provided in paragraph (b)(2)(ii) of this section, if a taxpayer that is an individual or a domestic corporation includes an item of foreign gross income by reason of the receipt of a disregarded payment by a foreign branch or foreign branch owner (as those terms are defined in §1.904-4(f)(3)), or a non-branch taxable unit, the foreign gross income item is assigned to a separate category under §1.861-20(d)(3)(v).

(B) *Definition of non-branch taxable unit*. The term *non-branch taxable unit* means a person or interest that is described in paragraph (b)(2)(i)(B)(*1*) or (*2*) of this section, respectively.

(*1*) *Persons*. A non-branch taxable unit described in this paragraph (b)(2)(i)(B)(*1*) means a person that is not otherwise a foreign branch owner and that is a U.S. individual, a domestic corporation, or a foreign or domestic partnership (or other pass-through entity, as defined in §1.904-5(a)(4)) an interest in which is owned, directly or indirectly through one or more other partnerships (or other pass-through entities), by a U.S. individual or a domestic corporation.

(*2*) *Interests*. A non-branch taxable unit described in this paragraph (b)(2)(i)(B)(*2*) means an interest of a foreign branch owner or an interest of a person described in paragraph (b)(2)(i)(B)(*1*) of this section that is not otherwise a foreign branch, and that is either a disregarded entity or a branch, as defined in §1.267A-5(a)(2), including a branch described in §1.951A-2(c)(7)(iv)(A)(*3*) (modified by substituting the term "person" for "controlled foreign corporation").

(ii) *Foreign branch group contributions*—(A) *In general*. If a taxpayer includes an item of foreign gross income by reason of a foreign branch group contribution, the foreign gross income is assigned to the foreign branch category, or, in the case of a foreign branch owner that is a partnership, to the partnership's general category income that is attributable to the foreign branch. See, however, §§1.861-20(d)(3)(v)(C)(*2*), 1.960-1(d)(3)(ii)(A), and 1.960-1(e) for rules providing that foreign income tax on a disregarded payment that is a contribution from a controlled foreign corporation to a taxable unit is assigned to the residual grouping and cannot be deemed paid under section 960.

(B) *Foreign branch group contribution*. A foreign branch group contribution is a contribution (as defined in §1.861-20(d)(3)(v)(E)) made by a member of a foreign branch owner group to a member of a foreign branch group that the payor owns, made by a member of a foreign branch group to another member of that group that the payor owns, or made by a member of a foreign branch group to a member of a different foreign branch group that the payor owns. For purposes of this paragraph (b)(2)(ii)(B), the terms *foreign branch group* and *foreign branch owner group* have the meanings provided in §1.904-4(f)(3).

* * * * *

(g) *Applicability dates*. Except as otherwise provided in this paragraph (g), this section applies to taxable years that begin after December 31, 2019. Paragraph (b)(2) of this section applies to taxable years that begin after December 31, 2019, and end on or after November 2, 2020.

Par. 28. Revise 1.905-1 to read as follows:

§1.905-1 When credit for foreign income taxes may be taken.

(a) *Scope*. This section provides rules regarding when the credit for foreign income taxes (as defined in §1.901-2(a)) may be taken, based on a taxpayer's method of accounting for such taxes. Paragraph (b) of this section provides the general rule. Paragraph (c) of this section sets forth rules for determining the taxable year in which taxpayers using the cash receipts and disbursement method of accounting for income ("cash method") may claim a foreign tax credit. Paragraph (d) of this section sets forth rules for determining the taxable year in which taxpayers using the accrual method of accounting for income ("accrual method") may claim a foreign tax credit. Paragraph (e) of this section provides rules for taxpayers using the cash method to claim foreign tax credits on the accrual basis pursuant to the election provided under section 905(a). Paragraph (f) of this section provides rules for when foreign income tax expenditures of a pass-through entity can be taken as a credit by the entity's partners, shareholders, or owners. Paragraph (g) of this section provides rules for when a foreign tax credit can be taken with respect to blocked income. Paragraph (h) provides the applicability dates for this section.

(b) *General rule*. The credit for foreign income taxes provided in subpart A, part III, subchapter N, chapter 1 of the Code (the "foreign tax credit") may be taken either on the return for the year in which the foreign income taxes accrued or on the return for the year in which the foreign income taxes were paid (that is, remitted), depending on whether the taxpayer uses the accrual or the cash receipts and disbursements method of accounting for purposes of computing taxable income and filing returns. However, regardless of the year in which the credit is claimed under the taxpayer's method of accounting for foreign income taxes, the foreign tax credit is allowed only to the extent the foreign income taxes are ultimately both owed and remitted to the foreign country (in the case of a taxpayer claiming the foreign tax credit on the accrual basis, within the time prescribed by section 905(c)(2)). See section 905(b) and §§1.901-1(a) and 1.901-2(e). Because the taxpayer's liability for foreign income tax may accrue (that is, become fixed and determinable) in a different taxable year than that in which the tax is paid (that is, remitted), the taxpayer's entitlement to the credit may be perfected, or become subject to adjustment, by reason of events that occur in a taxable year after the taxable year in which the credit is allowed. See section 905(c) and §1.905-3(a) for rules relating to changes to the taxpayer's foreign income tax liability that require a redetermination of the allowable foreign tax credit and the taxpayer's U.S. tax liability.

(c) *Rules for cash method taxpayers*—(1) *Credit allowed in year paid*. Except as provided in paragraph (e) of this section, a taxpayer who uses the cash method of accounting may claim a foreign tax credit only in the taxable year in which the foreign income taxes are paid. Generally, foreign income taxes are considered paid in the taxable year in which the taxes are remitted to the foreign country. However, foreign withholding taxes described in section 901(k)(1)(B), as well as foreign net income taxes described in §1.901-2(a)(3)(i) that are withheld from the taxpayer's gross income by the payor, are treated as paid in the year in which they are withheld. Foreign income taxes that have been withheld or remitted but which are not considered an amount of tax paid for purposes of section 901 under the rules of §1.901-2(e) (for example, because the amount withheld or remitted was not a compulsory payment), however, are not eligible for a foreign tax credit. See §§1.901-2(e) and 1.905-3(b)(1)(ii)(B) (*Example 2*).

(2) *Payment of contested foreign tax liability*. Under §1.901-2(e)(2)(i), a foreign income tax liability that is contested by the taxpayer is not a reasonable approximation of the taxpayer's final foreign income tax liability and, therefore, is not considered an amount of tax paid for purposes of section 901 until the contest is resolved. Thus, except as provided in paragraph (c)(3) of this section, a foreign tax credit for a contested foreign income tax liability (or portion thereof) that has been remitted to the foreign country cannot be claimed until such time as the contest is resolved and the tax is considered paid. Once the contest is resolved and the foreign income tax liability is finally determined, the tax liability is treated as paid in the taxable year in which the foreign tax was remitted. See paragraph (c)(1) of this section; see also section 6511(d)(3) and §301.6511(d)-3 of this chapter for a special 10-year period of limitations for claiming a credit or refund of U.S. tax that is attributable to foreign income taxes for which a credit is allowed under section 901, which for taxpayers claiming credits on the cash basis runs from the unextended due date of the return for the taxable year in which the foreign income taxes are paid (within the meaning of paragraph (c) of this section).

(3) *Election to claim a provisional credit for contested taxes remitted before contest is resolved*. A taxpayer claiming foreign tax credits on the cash basis may, under the conditions provided in this paragraph (c)(3), elect to claim a foreign tax credit for a contested foreign income tax liability (or a portion thereof) in the year the contested amount (or a portion thereof) is remitted to the foreign country, notwithstanding that the liability is not finally determined and so is not considered an amount of tax paid. Such election applies only for contested foreign income taxes that are remitted in a taxable year in which the taxpayer elects under section 901(a) to claim a credit, instead of a deduction under section 164(a)(3), for taxes paid in such year. To make the election, a taxpayer must file a Form 1116 (Foreign Tax Credit (Individual, Estate, or Trust)) or Form 1118 (Foreign Tax Credit—Corporations), and the agreement described in paragraphs (d)(4)(ii) and (iii) of this section. In addition, the taxpayer must, for each subsequent taxable year up to and including the taxable year in which the contest is resolved, file the annual notice described in paragraph (d)(4)(iv) of this section. Any portion of a contested foreign income tax liability for which a provisional credit is claimed under this paragraph (c)(3) that is subsequently refunded by the foreign country results in a foreign tax redetermination under §1.905-3(a).

(4) *Adjustments to taxes claimed as a credit in the year paid*. A refund of foreign income taxes for which a foreign tax credit has been claimed on the cash basis, or a subsequent determination that the amount

paid exceeds the taxpayer's liability for foreign income tax, requires a redetermination of foreign income taxes paid and the taxpayer's U.S. tax liability pursuant to section 905(c) and §1.905-3. See §1.905-3(a) and 1.905-3(b)(1)(ii)(G) (*Example 7*). Additional foreign income taxes paid that relate back to a prior year in which foreign income taxes were claimed as a credit on the cash basis, including by reason of the settlement of a dispute with the foreign tax authority, may be claimed as a credit only in the year the additional taxes are paid (within the meaning of paragraph (c) of this section). The payment of such additional taxes does not result in a redetermination pursuant to section 905(c) or §1.905-3 of the foreign income taxes paid in any prior year, although a redetermination of U.S. tax liability may be required due, for example, to a carryback of unused foreign tax under section 904(c) and §1.904-2.

(d) *Rules for accrual method taxpayers*—(1) *Credit allowed in year accrued*—(i) *In general*. A taxpayer who uses the accrual method of accounting may claim a foreign tax credit only in the taxable year in which the foreign income taxes are considered to accrue for foreign tax credit purposes under the rules of this paragraph (d). Foreign income taxes accrue in the taxable year in which all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. See §§1.446-1(c)(1)(ii)(A) and 1.461-4(g)(6)(iii)(B). For purposes of the preceding sentence, a foreign income tax that is contingent on a future distribution of earnings does not meet the all events test until the earnings are distributed. A foreign income tax liability determined on the basis of a foreign taxable year becomes fixed and determinable at the close of the taxpayer's foreign taxable year. Therefore, foreign income taxes that are computed based on items of income, deduction, and loss that arise in a foreign taxable year accrue in the United States taxable year with or within which the taxpayer's foreign taxable year ends. Foreign withholding taxes that are paid with respect to a foreign taxable year and that represent advance payments of a foreign net income tax liability determined on the basis of that foreign taxable year accrue at the close of the foreign taxable year. Foreign withholding taxes imposed on a payment giving rise to an item of foreign gross income accrue on the date the payment from which the tax is withheld is made (or treated as made under foreign tax law).

(ii) *Relation-back rule for adjustments to taxes claimed as a credit in year accrued*. Additional tax paid as a result of a change in the foreign tax liability, including additional tax paid when a contest with a foreign tax authority is resolved, 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"). Additional withholding tax paid as a result of a change in the amount of an item of foreign gross income (such as pursuant to a foreign transfer pricing adjustment) also relates back and is considered to accrue in the year in which the payment from which the additional tax is withheld is made (or considered to have been made under foreign tax law). Foreign income taxes that are not paid within 24 months after the close of the taxable year in which they were accrued are treated as refunded pursuant to §1.905-3(a); when subsequently paid, the foreign income taxes are allowed as a credit in the relation-back year. See §1.905-3(b)(1)(ii)(E) (*Example 5*). For special rules that apply to determine when foreign income tax is considered to accrue in the case of certain ownership and entity classification changes, see §§1.336-2(g)(3)(ii), 1.338-9(d), 1.901-2(f)(5), and 1.1502-76.

(2) *Special rule for 52-53 week U.S. taxable years*. If a taxpayer has elected pursuant to section 441(f) to use a U.S. taxable year consisting of 52-53 weeks, and such U.S. taxable year closes within six calendar days of the end of the taxpayer's foreign taxable year, the determination of when foreign income taxes accrue under paragraph (d)(1) of this section is made by deeming the taxpayer's U.S. taxable year to end on the last day of its foreign taxable year.

(3) *Accrual of contested foreign tax liability*. A contested foreign income tax liability is finally determined and accrues for purposes of paragraph (d)(1) of this section when the contest is resolved. However, pursuant to section 905(c)(2), 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. Thus, except as provided in paragraph (d)(4) of this section, a foreign tax credit for a contested foreign income tax liability cannot be claimed until such time as both the contest is resolved and the tax is considered paid, even if the contested liability (or portion thereof) has previously been remitted to the foreign country. Once the contest is resolved and the foreign income tax liability is finally determined and paid, the tax liability accrues, and is considered to accrue in the relation-back year for purposes of the foreign tax credit. See paragraph (d)(1) of this section; see also section 6511(d)(3) and §301.6511(d)-3 of this chapter for a special 10-year period of limitations for claiming a credit or refund of U.S. tax that is attributable to foreign income taxes for which a credit is allowed under section 901, which for taxpayers claiming credits on the accrual basis runs from the unextended due date of the return for the taxable year in which the foreign income taxes accrued (within the meaning of this paragraph (d)).

(4) *Election to claim a provisional credit for contested taxes remitted before accrual*—(i) *Conditions of election*. A taxpayer may, under the conditions provided in this paragraph (d)(4), elect to claim a foreign tax credit for a contested foreign income tax liability (or a portion thereof) in the relation-back year when the contested amount (or a portion thereof) is remitted to the foreign country, notwithstanding that the liability is not finally determined and so has not accrued. This election is available only for contested foreign income taxes that relate to a taxable year in which the taxpayer has elected under section 901(a) to claim a credit, instead of a deduction under section 164(a)(3), for foreign income taxes that accrue in such year. If the election is made by a taxpayer with respect to contested foreign income taxes of a controlled foreign corporation, such taxes are treated as deemed paid in the relation-back year and the controlled foreign corporation may deduct the taxes in computing its taxable income in the relation-back year. To make the election, a taxpayer must file an amended return for the taxable year to which the contested tax relates, together with a Form 1116 (Foreign Tax Credit (Individual, Estate, or

Trust)) or Form 1118 (Foreign Tax Credit—Corporations), and the agreement described in paragraph (d)(4)(ii) of this section. In addition, the taxpayer must, for each subsequent taxable year up to and including the taxable year in which the contest is resolved, file the annual notice described in paragraph (d)(4)(iii) of this section. Any portion of a contested foreign income tax liability for which a provisional credit is claimed under this paragraph (d)(4) that is subsequently refunded by the foreign country results in a foreign tax redetermination under §1.905-3(a).

(ii) *Contents of provisional foreign tax credit agreement*. The provisional foreign tax credit agreement must contain the following:

(A) A statement that the document is an election and an agreement under the provisions of paragraph (d)(4) of this section;

(B) A description of the contested foreign income tax liability, including the name (or other identifier) of the foreign tax or taxes being contested, the name of the country imposing the tax, the name and identifying number of the payor of the contested tax, the amount of the contested tax, and the U.S. taxable year(s) and the income to which the contested foreign income tax liability relates;

(C) The amount of the contested foreign income tax liability in paragraph (d)(4)(ii)(B) of this section that has been remitted to the foreign country and the date of the remittance(s);

(D) An agreement by the taxpayer, for a period of three years from the later of the filing or the due date (with extensions) of the return for the taxable year in which the taxpayer notifies the Internal Revenue Service of the resolution of the contest, not to assert the statute of limitations on assessment as a defense to the assessment of additional taxes or interest related to the contested foreign income tax liability described in paragraph (d)(4)(ii)(B) of this section that may arise from a determination that the taxpayer failed to exhaust all effective and practical remedies to minimize its foreign income tax liability, so that the amount of the contested foreign income tax is not a compulsory payment and is not considered paid within the meaning of §1.901-2(e)(5);

(E) A statement that the taxpayer agrees to comply with all the conditions and requirements of paragraph (d)(4) of this section, including to provide notice to the Internal Revenue Service upon the resolution of the contest; and

(F) Any additional information as may be prescribed by the Commissioner of Internal Revenue in Internal Revenue Service forms or instructions.

(iii) *Signatory*. The provisional foreign tax credit agreement must be signed under penalties of perjury by a person authorized to sign the return of the taxpayer.

(iv) *Annual notice*. For each taxable year following the year in which an election pursuant to paragraph (d)(4) of this section is made up to and including the taxable year in which the contest is resolved, the taxpayer must include with its timely-filed return the information described in paragraphs (d)(4)(iii)(A) through (C) of this section on Form 1116 or Form 1118 or in such other form or manner prescribed by the Commissioner of Internal Revenue in Internal Revenue Service forms or instructions.

(A) A description of the contested foreign income tax liability, including the name (or other identifier) of the foreign tax or taxes, the name of the country imposing the tax, the name and identifying number of the payor of the contested tax, the amount of the contested tax, and a description of the status of the contest.

(B) With the return for the taxable year in which the contest is resolved, notification that the contest has been resolved. Such notification must include the date of final resolution and the amount of the finally determined foreign income tax liability.

(C) Any additional information, which may include a copy of the final judgment, order, settlement, or other documentation of the contest resolution, as may be prescribed by the Commissioner of Internal Revenue in Internal Revenue Service forms or instructions.

(5) *Correction of improper accruals*—(i) *In general*. The accrual of a foreign income tax expense generally involves the determination of the proper timing for recognizing the expense for Federal income tax purposes. Thus, foreign income tax expense is a material item within the meaning of section 446. See §1.446-1(e)(2)(ii). As a material item, a change in the timing of accruing a foreign income tax expense is generally a change in method of accounting. See section 446(e). A change from an improper method of accruing foreign income taxes to the proper method of accrual described in this paragraph (d) is treated as a change in a method of accounting, regardless of whether the taxpayer (or a partner or beneficiary taking into account a distributive share of foreign income taxes paid by a partnership or other pass-through entity) chooses to claim a deduction or a credit for such taxes in any taxable year. For purposes of this paragraph (d)(5), an improper method of accruing foreign income taxes includes a method under which foreign income tax is accrued in a taxable year other than the taxable year in which the requirements of the all events test in §§1.446-1(c)(1)(ii)(A) and 1.461-4(g)(6)(iii)(B) are met, or which fails to apply the relation-back rule in paragraph (d)(1) of this section that applies for purposes of the foreign tax credit, but does not include corrections to estimated accruals or errors in computing the amount of foreign income tax that is allowed as a deduction or credit in any taxable year. Taxpayers must file a Form 3115, Application for Change in Accounting Method, in accordance with Revenue Procedure 2015-13 (or any successor administrative procedure prescribed by the Commissioner) to obtain the Commissioner's permission to change from an improper method of accruing foreign income taxes to the proper method described in this paragraph (d). In order to prevent a duplication or omission of a benefit for foreign income taxes that accrue in any taxable year (whether through the double allowance or double disallowance of either a deduction or a credit, the allowance of both a deduction and a credit, or the disallowance of either a deduction or a credit, for the same amount of foreign income tax), the rules in paragraphs (d)(5)(ii) through (iv) of this section, describing a modified cut-off approach, apply if the Commissioner grants permission for the taxpayer to change to the proper method of accrual. Under the modified cut-off approach, a section 481(a) adjustment is neither required nor permitted with respect to the amounts of foreign income tax that were improperly accrued (or improperly not accrued) under the taxpayer's improper

method in taxable years before the taxable year of change.

(ii) *Adjustments required to implement a change in method of accounting for accruing foreign income taxes*. A change from an improper method of accruing foreign income taxes to the proper method described in this paragraph (d) is made under the modified cut-off approach described in this paragraph (d)(5)(ii). Under the modified cut-off approach, the amount of foreign income tax in a statutory or residual grouping (such as a separate category as defined in §1.904-5(a)(4)) that properly accrues in the taxable year of change (accounted for in the currency in which the foreign tax liability is denominated) is first adjusted upward by the amount of foreign income tax in the same grouping that properly accrued in a taxable year before the taxable year of change but which, under the taxpayer's improper method of accounting, the taxpayer failed to accrue and claim as either a credit or a deduction in any taxable year before the taxable year of change, and next, adjusted downward (but not below zero) by the amount of foreign income tax in the same grouping that the taxpayer improperly accrued in a taxable year before the year of change and for which the taxpayer claimed a credit or a deduction in such prior taxable year, but only if the improperly-accrued amount of foreign income tax did not properly accrue in a taxable year before the taxable year of change. The modified cut-off approach is applied separately with respect to amounts of foreign income tax for which the foreign tax credit is disallowed and to which section 275 does not apply. See, for example, section 901(m)(6). For purposes of the foreign tax credit, the adjusted amounts of accrued foreign income taxes, including any upward adjustment, are translated into U.S. dollars under §1.986(a)-1 as if those amounts properly accrued in the taxable year of change. To the extent that the downward adjustment in any grouping required under this modified cut-off approach exceeds the amount of foreign income tax properly accruing in that grouping in the year of change, as increased by the upward adjustment, if any, such excess will carry forward to each subsequent taxable year and reduce properly-accrued amounts of foreign income tax in the same grouping to the extent of those properly-accrued amounts, until all improperly-accrued amounts included in the downward adjustment are accounted for. See §1.861-20 for rules that apply to assign foreign income taxes to statutory and residual groupings. See paragraphs (d)(6)(v) through (d)(6)(ix) of this section for examples illustrating the application of the modified cut-off approach.

(iii) *Application of section 905(c)*—(A) *Two-year rule*. Except as otherwise provided in this paragraph (d)(5)(iii), if the taxpayer claimed a credit for improperly-accrued amounts in a taxable year before the taxable year of change, no adjustment is required under section 905(c)(2) and §1.905-3(a) solely by reason of the improper accrual. For purposes of applying section 905(c)(2) and §1.905-3(a) to improperly-accrued amounts of foreign income tax that were claimed as a credit in any taxable year before the taxable year of change, the 24-month period runs from the close of the U.S. taxable year(s) in which those amounts were accrued under the taxpayer's improper method and claimed as a credit. To the extent any improperly-accrued amounts remain unpaid as of the date 24 months after the close of the taxable year in which the amounts were improperly accrued and claimed as a credit, an adjustment is required under section 905(c)(2) and §1.905-3(a) as if the improperly-accrued amounts were refunded as of the date 24 months after the close of such taxable year. See §1.986(a)-1(c) (a refund or other downward adjustment to foreign income taxes paid or accrued on more than one date reduces the foreign income taxes paid or accrued on a last-in, first-out basis, starting with the amounts most recently paid or accrued).

(B) *Application of payments*. Amounts of foreign income tax that a taxpayer accrued and claimed as a credit or a deduction in a taxable year before the taxable year of change under the taxpayer's improper method, but that had properly accrued either in the taxable year the credit or deduction was claimed or in a different taxable year before the taxable year of change, are not included in the downward adjustment required by paragraph (d)(5)(ii) of this section. Remittances to the foreign country of such amounts (accounted for in the currency in which the foreign tax liability is denominated) are treated first as payments of the amounts of tax that had properly accrued in the taxable year claimed as a credit or deduction to the extent thereof, and then as payments of the amounts of tax that were improperly accrued in a different taxable year, on a last-in, first-out basis, starting with the most recent improperly-accrued amounts. Remittances to the foreign country of amounts of foreign income tax that properly accrue in or after the taxable year of change (accounted for in the foreign currency in which the foreign tax liability is denominated) but that are offset by the amounts included in the downward adjustment required by paragraph (d)(5)(ii) of this section are treated as payments of the amounts of tax that were improperly accrued before the taxable year of change and included in the downward adjustment on a last-in, first-out basis, starting with the most recent improperly-accrued amounts. Additional amounts of foreign income tax that first accrue in or after the taxable year of change but that relate to a taxable year before the taxable year of change are taken into account in the earlier of the taxable year of change or the taxable year or years in which they would have been considered to accrue based upon the taxpayer's improper method. Additional amounts of foreign income tax that first accrue in or after the taxable year of change and that relate to the taxable year of change or a taxable year after the year of change are taken into account in the proper relation-back year, but may then be subject to the downward adjustment required by paragraph (d)(5)(ii) of this section.

(iv) *Foreign income tax expense improperly accrued by a foreign corporation, partnership, or other pass-through entity*. Foreign income tax expense of a foreign corporation reduces both the corporation's taxable income and its earnings and profits, and may give rise to an amount of foreign taxes deemed paid under section 960 that may be claimed as a credit by a United States shareholder that is a domestic corporation or that is a person that makes an election under section 962. If the Commissioner grants permission for a foreign corporation to change its method of accounting for foreign income tax expense, the duplication or omission of those expenses (accounted for in the functional currency of the foreign corporation)

and the associated foreign income taxes (translated into dollars in accordance with §1.986(a)-1) are accounted for by applying the rules in paragraph (d)(5)(ii) of this section as if the foreign corporation were itself eligible to, and did, claim a credit under section 901 for such amounts. In the case of a partnership or other pass-through entity that is granted permission to change its method of accounting for accruing foreign income taxes to a proper method as described in this paragraph (d), such partnership or other pass-through entity must provide its partners or other owners with the information needed for the partners or other owners to properly account for the improperly-accrued or unaccrued amounts under the rules in paragraph (d)(5)(ii) of this section as if their proportionate shares of foreign income tax expense were directly paid or accrued by them.

(6) *Examples*. The following examples illustrate the application of paragraph (d) of this section. Unless otherwise stated, the local currency of Country X and Country Y, and the functional currency of any foreign branch, is the Euro (€), and at all relevant times the exchange rate is $1:€1.

(i) *Example 1: Accrual of foreign income tax*—(A) *Facts*. A, a U.S. citizen, resides and works in Country X. A uses the calendar year as the U.S. taxable year and has made an election under paragraph (e) of this section to claim foreign tax credits on an accrual basis. Country X has a tax year that begins on April 1 and ends on March 31. A's wages are subject to net income tax, at graduated rates, under Country X tax law and are subject to withholding on a monthly basis by A's employer in Country X. In the period between April 1, Year 1, and March 31, Year 2, A earns $50,000x in Country X wages, from which A's employer withholds $10,000x in tax. On December 1, Year 1, A receives a dividend distribution from a Country Y corporation, from which the corporation withheld $500x of tax. Country Y imposes withholding tax on dividends paid to nonresidents solely based on the gross amount of the dividend payment; A is not required to file a tax return in Country Y.

(B) *Analysis*. Under paragraph (d)(1) of this section, A's liability for Country X net income tax accrues on March 31, Year 2, the last day of the Country X taxable year. The Country X net income tax withheld by A's employer from A's wages is a reasonable approximation of, and represents an advance payment of, A's final net income tax liability for the year, which becomes fixed and determinable only at the close of the Country X taxable year. Thus, A cannot claim a credit for any portion of the Country X net income tax on A's Federal income tax return for Year 1, and may claim a credit for the entire Country X net income tax that accrues on March 31, Year 2, on A's Federal income tax return for Year 2. A may claim a credit for the Country Y withholding tax on A's Federal income tax return for Year 1, because the withholding tax accrued on December 1, Year 1.

(ii) *Example 2: 52-53 week taxable year*—(A) *Facts*. USC, an accrual method taxpayer, is a domestic corporation that operates in branch form in Country X. USC uses the calendar year for Country X tax purposes. For Federal income tax purposes, USC elects pursuant to §1.441-2(a) to use a 52-53 week taxable year that ends on the last Friday of December. In Year 1, USC's U.S. taxable year ends on Friday, December 25; in Year 2, USC's U.S. taxable year ends Friday, December 31. For its foreign taxable year ending December 31, Year 1, USC earns $10,000x of foreign source income through its Country X branch and incurs Country X foreign income tax of $500x; for Year 2, USC earns $12,000x and incurs Country X foreign income tax of $600x.

(B) *Analysis*. Under paragraph (d)(1) of this section, the $500x of Country X foreign income tax becomes fixed and determinable at the close of USC's foreign taxable year, on December 31, Year 1, which is after the close of its U.S. taxable year (December 25, Year 1). The $600x of Country X foreign income tax becomes fixed and determinable on December 31, Year 2. Thus, both the Year 1 and Year 2 Country X foreign income taxes accrue in USC's U.S. taxable year ending December 31, Year 2. However, pursuant to paragraph (d)(2) of this section, for purposes of determining the amount of foreign income taxes accrued in each taxable year for foreign tax credit purposes, USC's U.S. taxable year is deemed to end on December 31, the end of USC's Country X taxable year. USC may therefore claim a foreign tax credit for $500x of Country X foreign income tax on its Federal income tax return for Year 1 and a credit for $600x of Country X foreign income tax on its Federal income tax return for Year 2.

(iii) *Example 3: Contested tax*—(A) *Facts*. USC is a domestic corporation that operates in branch form in Country X. USC uses an accrual method of accounting and uses the calendar year as its U.S. and Country X taxable year. In Year 1, when the average exchange rate described in §1.986(a)-1(a)(1) is $1:€1, USC earns €20,000x = $20,000x through its Country X branch for U.S. and Country X tax purposes and accrues Country X foreign income taxes of €500x = $500x, which USC claims as a credit on its Federal income tax return for Year 1. In Year 3, when the average exchange rate is $1:€1.2, Country X asserts that USC owes additional foreign income taxes of €100x with respect to USC's Year 1 income. USC contests the liability but remits €40x to Country X with respect to the contested liability in Year 3. USC does not make an election under paragraph (d)(4) of this section to claim a provisional credit with respect to the €40x. In Year 6, after exhausting all effective and practical remedies, it is finally determined that USC is liable for €50x of additional Country X foreign income taxes with respect to its Year 1 income. USC pays an additional €10x to Country X on September 15, Year 6, when the spot rate described in §1.986(a)-1(a)(2)(i) is $1:€2.

(B) *Analysis*. Pursuant to paragraph (d)(3) of this section, the additional liability asserted by Country X with respect to USC's Year 1 income does not accrue until the contest is resolved in Year 6. USC's remittance of €40x of contested tax in Year 3 is not a payment of accrued tax, and so is not a foreign tax redetermination. Both the €40x of Country X taxes paid in Year 3 and the €10x of Country X taxes paid in Year 6 accrue in Year 6, when the contest is resolved. Once accrued and paid, the €50x relates back for foreign tax credit purposes to Year 1, and can be claimed as a credit by USC on a timely-filed amended return for Year 1. Under §1.986(a)-1(a), for foreign tax credit purposes the €40x paid in Year 3 is translated into dollars at the average exchange rate for Year 1 (€40x x $1 / €1 = $40x), and the €10x paid in Year 6 is translated into dollars at the spot rate on the date paid (€10x x $1 / €2 = $5x). Accordingly, after the €50x of Country X income tax is paid in Year 6 USC may claim an additional foreign tax credit of $45x for Year 1.

(iv) *Example 4: Provisional credit for contested tax*—(A) *Facts*. The facts are the same as those in paragraph (d)(6)(iii)(A) of this section (the facts in *Example 3*), except that USC pays the entire contested tax liability of €100x to Country X in Year 3 and elects under paragraph (d)(4) of this section to claim a provisional foreign tax credit on an amended return for Year 1. In Year 6, upon resolution of the contest, USC receives a refund of €50x from Country X.

(B) *Analysis*. In Year 3, USC may claim a provisional foreign tax credit for $100x (€100x translated at the average exchange rate for Year 1) of contested foreign tax paid to Country X by filing an amended return for Year 1, with Form 1118 attached, and a provisional foreign tax credit agreement described in paragraph (d)(4)(ii) of this section. In each year for Years 4 through 6, USC must attach the certification described in paragraph (d)(4)(iii) of this section to its timely-filed Federal income tax return. In Year 6, as a result of the €50x refund, USC must redetermine its U.S. tax liability for Year 1 and for any other affected year pursuant to §1.905-3, reducing the Year 1 foreign tax credit by $50x (from $600x to $550x), and comply with the notification requirements in §1.905-4. See §1.986(a)-1(c) (refunds of foreign income tax translated into U.S. dollars at the rate used to claim the credit).

(v) *Example 5: Improperly accelerated accrual*—(A) *Facts*—(*1*) *Foreign income tax accrued and paid*. USC is a domestic corporation that operates a foreign branch in Country X. All of USC's gross and taxable income is foreign source foreign branch category income, and all of its foreign income taxes are properly allocated and apportioned under §1.861-20 to the foreign branch category. USC uses the accrual method of accounting and uses the calendar year as its U.S. taxable year. For Country X tax purposes, USC uses a fiscal year that ends on March 31. USC accrued €200x of Country X net income tax (as defined in §1.901-2(a)(3)) for its foreign taxable year ending March 31, Year 2, for which the average exchange rate was $1:€1. It timely filed its Country X tax return and paid the €200x on January 15, Year 3. USC accrued and paid with its timely filed Country X tax returns €280x and €240x of Country X net income tax for its foreign taxable years ending on March 31 of Year 3 and Year 4, respectively, on January 15 of Year 4 and Year 5, respectively.

(*2*) *Improper accrual*. On its Federal income tax return for Year 1, USC improperly pro-rated and accelerated the accrual of Country X net income tax and claimed a credit for $150x, equal to three-fourths of the Country X net income tax of $200x that relates to

USC's foreign taxable year ending March 31, Year 2. Continuing with this improper method of accruing foreign income taxes, USC claimed a foreign tax credit of $260x on its U.S. tax return for Year 2, comprising $50x (one-fourth of the $200x of net income tax relating to its foreign taxable year ending March 31, Year 2) plus $210x (three-fourths of the $280x of net income tax relating to its foreign taxable year ending March 31, Year 3). Similarly, USC improperly accrued and claimed a foreign tax credit on its U.S. tax return for Year 3 for $250x of Country X net income tax, comprising $70x (one-fourth of the $280x that properly accrued in Year 3) plus $180x (three-fourths of the $240x that properly accrued in Year 4). In Year 4, USC realizes its mistake and, as provided in paragraph (d)(5)(i) of this section, files Form 3115 with the IRS to seek permission to change from an improper method to a proper method of accruing foreign income taxes.

Table 1 to paragraph (d)(6)(v)(A)(*2*)

Country X taxable year ending in U.S. calendar taxable year	Net income tax properly accrued ($1 = €1))	Net income tax accrued under improper method ($1 = €1))
3/31/Y1 ends in Year 1	0	¾ (200x) = 150x
3/31/Y2 ends in Year 2	200x	¼ (200x) + ¾ (280x) = 260x
3/31/Y3 ends in Year 3	280x	¼ (280x) + ¾ (240x) = 250x
3/31/Y4 ends in Year 4	240x	[year of change]

(B) *Analysis*—(*1*) *Downward adjustment*. Under paragraph (d)(5)(ii) of this section, in Year 4, the year of change, USC must reduce (but not below zero) the amount (in Euros) of Country X net income tax in the foreign branch category that properly accrues in Year 4, €240x, by the amount of foreign income tax that was accrued and claimed as either a deduction or a credit in a year before the year of change, and that had not properly accrued in either the year in which the tax was accrued under USC's improper method or in any other taxable year before the taxable year of change. For all taxable years before the taxable year of change, under its improper method USC had accrued and claimed as a credit a total of €660x = $660x of foreign income tax, of which only €480x = $480x had properly accrued. Therefore, the downward adjustment required by paragraph (d)(5)(ii) of this section is €180x (€660x - €480x = €180x). In Year 4, USC's foreign tax credit in the foreign branch category is reduced by $180x (€180x downward adjustment translated into dollars at $1:€1, the average exchange rate for Year 4), from $240x to $60x.

(*2*) *Application of section 905(c)*—(*i*) *Year 1*. Under paragraph (d)(5)(iii) of this section, the €200x USC paid on January 15, Year 3, that relates to its Country X taxable year ending on March 31, Year 2, is first treated as a payment of the €50x of that Country X net income tax liability that properly accrued and was claimed as a credit by USC in Year 2, and next as a payment of the €150x of that Country X net income tax liability that USC improperly accrued and claimed as a credit in Year 1. Because all €150x of the Country X net income tax that was improperly accrued and claimed as a credit in Year 1 was paid within 24 months of December 31, Year 1, no foreign tax redetermination occurs, and no redetermination of U.S. tax liability is required, for Year 1.

(*ii*) *Year 2*. Under paragraph (d)(5)(iii) of this section, the €280x USC paid on January 15, Year 4, that relates to its Country X taxable year ending on March 31, Year 3, is first treated as a payment of the €70x = $70x of that Country X net income tax liability that properly accrued and was claimed as a credit by USC in Year 3, and next as a payment of the €210x = $210x of that Country X net income tax liability that USC improperly accrued and claimed as a credit in Year 2. Together with the €50x = $50x of USC's Country X net income tax liability that properly accrued and was claimed as a credit in Year 2, all €260x of the Country X net income tax that was accrued and claimed as a credit in Year 2 under USC's improper method was paid within 24 months of December 31, Year 2. Accordingly, no foreign tax redetermination occurs, and no redetermination of U.S. tax liability is required, for Year 2.

(*iii*) *Year 3*. Under paragraph (d)(5)(iii) of this section, the €240x USC paid on January 15, Year 5, that relates to its Country X taxable year ending on March 31, Year 4, is first treated as a payment of the €60x = $60x of that Country X net income tax liability that properly accrued and was claimed as a credit by USC in Year 4, and next as a payment of the €180x = $180x of that Country X net income tax liability that USC improperly accrued and claimed as a credit in Year 3. Together with the €70x = $70x of USC's Country X net income tax liability that properly accrued and was claimed as a credit by USC in Year 3, all €250x of the Country X net income tax that was accrued and claimed as a credit in Year 3 under USC's improper method was paid within 24 months of December 31, Year 3. Accordingly, no foreign tax redetermination occurs, and no redetermination of U.S. tax liability is required, for Year 3.

(*iv*) *Year 4*. Under paragraph (d)(5)(iii) of this section, €60x = $60x of USC's January 15, Year 5 payment of €240x with respect to its Country X net income tax liability for Year 4 is treated as a payment of €60x = $60x of Country X net income tax that, after application of the downward adjustment required by paragraph (d)(5)(ii) of this section, was accrued and claimed as a credit in Year 4, the year of change.

(vi) *Example 6: Failure to pay improperly-accrued tax within 24 months*—(A) *Facts*. The facts are the same as those in paragraph (d)(6)(v) of this section (the facts in *Example 5*), except that USC does not pay its €240x tax liability for its Country X taxable year ending on March 31, Year 4, until January 15 of Year 6, when the spot rate described in §1.986(a)-1(a)(2)(i) is $1:€1.5.

(B) *Analysis*. The results are the same as in paragraphs (d)(6)(v)(B)(*2*)(*i*) and (*ii*) of this section (the analysis in *Example 5* for Year 1 and Year 2). With respect to Year 3, because the €180x = $180x of Year 4 foreign income tax that was improperly accrued and credited in Year 3 was not paid within 24 months of the end of Year 3, under section 905(c)(2) and §1.905-3(a) that €180x = $180x is treated as refunded on December 31, Year 5, requiring a redetermination of USC's Federal income tax liability for Year 3 (to reverse out the credit claimed). In Year 6, when USC pays the €240x of Country X income tax liability for Year 4, under paragraph (d)(5)(iii) of this section that payment is first treated as a payment of the €60x = $60x that was properly accrued and claimed as a credit in Year 4, and then as a payment of the €180x that was improperly accrued and claimed as a credit in Year 3 and that was treated as refunded in Year 5. Under section 905(c)(2)(B) and §1.905-3(a), that Year 6 payment of accrued but unpaid tax is a second foreign tax redetermination for Year 3 that also requires a redetermination of USC's U.S. tax liability. Under §1.986(a)-1(a)(2), the €180x of redetermined tax for Year 3 is translated into dollars at the spot rate on January 15, Year 6, when the tax is paid (€180x x $1 / €1.5 = $120x). Under §1.905-4(b)(1)(iv), USC may file one amended return accounting for both foreign tax redeterminations (which occur in two consecutive taxable years) with respect to Year 3, which taken together result in a reduction in USC's foreign tax credit for Year 3 from $250x to $190x ($250x originally accrued - $180x unpaid after 24 months + $120x paid in Year 6).

(vii) *Example 7: Additional payment of improperly-accrued tax*—(A) *Facts*. The facts are the same as those in paragraph (d)(6)(v)(A) of this section (the facts in *Example 5*), except that in Year 6, Country X assessed additional net income tax of €100x with respect to USC's Country X taxable year ending March 31, Year 3, and after exhausting all effective and practical remedies to reduce its liability for Country X income tax, USC pays the additional assessed tax on September 15, Year 7, when the spot rate described in §1.986(a)-1(a)(2)(i) is $1:€0.5.

(B) *Analysis*. Under paragraph (d)(3) of this section, the additional €100x of Country X income tax USC paid in Year 7 with respect to its foreign taxable year that ended March 31, Year 3, relates back and is considered to accrue in Year 3. However, under

its improper method of accounting USC had accrued and claimed foreign tax credits for Country X net income tax that related to Year 3 on its Federal income tax returns for both Year 2 and Year 3. Accordingly, under paragraph (d)(5)(iii)(B) of this section USC must redetermine its U.S. tax liability for both Year 2 and Year 3 (and any other affected years) to account for the additional €100x of Country X net income tax liability, using the improper method it used to accrue foreign income taxes before the year of change. Therefore, three-fourths of the €100x of additional tax, or €75x, is treated as if it accrued in Year 2, and one-fourth of the additional tax, or €25x, is treated as if it accrued in Year 3. Pursuant to §1.986(a)-1(a)(2)(i), the €75x of tax treated as if it accrued in Year 2 and the €25x of tax treated as if it accrued in Year 3 are converted into dollars using the September 15, Year 7, spot rate of $1:€0.5, to $150x and $50x, respectively. Under §1.905-4(b)(1)(iii), USC may claim a refund for any resulting overpayment of U.S. tax for Year 2 or Year 3 or any other affected year by filing an amended return within the period provided in section 6511.

(viii) *Example 8: Tax improperly accrued before year of change exceeds tax properly accrued in year of change*—(A) *Facts*. USC owns all of the stock in CFC, a controlled foreign corporation organized in Country X. Country X imposes net income tax on Country X corporations at a rate of 10% only in the year its earnings are distributed to its shareholders, rather than in the year the income is earned. Both USC and CFC use the calendar year as their taxable year for both Federal and Country X income tax purposes and CFC uses the Euro as its functional currency. In each of Years 1-3, CFC earns €1,000x for both Federal and Country X income tax purposes of general category foreign base company sales income (before reduction for foreign income taxes). CFC improperly accrues €100x of Country X net income tax with respect to €1,000x of income at the end of each of Years 1 and 2, even though no distribution is made in those years. In Year 1, for which the average exchange rate is $1:€1, USC computes and includes in income with respect to CFC $900x of subpart F income, claims a deemed paid foreign tax credit of $100x under section 960(a), and has a section 78 dividend of $100x. In Year 2, for which the average exchange rate is $1:€0.5, USC computes and includes in income with respect to CFC $1,800x of subpart F income, claims a deemed paid foreign tax credit of $200x under section 960(a), and has a section 78 dividend of $200x. In Year 2, CFC makes a distribution to USC of €400x of earnings and pays €40x of net income tax to Country X. In Year 3, for which the average exchange rate is $1:€1, CFC makes another distribution to USC of €500x of earnings and pays €50x in net income tax to Country X. In Year 3, USC realizes its mistake and seeks permission from the IRS for CFC to change to a proper method of accruing foreign income taxes. In Year 4, for which the average exchange rate is $1:€2, CFC makes a distribution of €700x of earnings and pays €70x of net income tax to Country X.

Table 2 to paragraph (d)(6)(viii)(A)

Taxable year ending:	Foreign income tax properly accrued	Foreign income tax accrued under improper method
12/31/Y1 ($1:€1)	0	€100x = $100x
12/31/Y2 ($1:€0.5)	€40x = $80x	€100x = $200x
12/31/Y3 ($1:€1)	€50x = $50x	[year of change]
12/31/Y4 ($1:€2)	€70x = $35x	

(B) *Analysis*—(*1*) *Downward adjustment*. Under paragraph (d)(5)(iv) of this section, CFC applies the rules of paragraph (d)(5) of this section as if it claimed a foreign tax credit under section 901 for Country X taxes. Under paragraph (d)(5)(ii) of this section, in Year 3, the year of change, CFC must reduce (but not below zero) the amount (in Euros) of Country X net income tax allocated and apportioned to its general category foreign base company sales income group that properly accrues in Year 3, €50x, by the amount of foreign income tax (in Euros) that was improperly accrued in that statutory grouping in a year before the year of change, and that had not properly accrued in either the year accrued or in another taxable year before the year of change. For all taxable years before the year of change, under its improper method CFC had accrued a total of €200x of foreign income tax with respect to its general category foreign base company sales income group, of which only €40x had properly accrued. Therefore, the downward adjustment required by paragraph (d)(5)(ii) of this section is €160x (€200x - €40x = €160x). In Year 3, CFC's €50x of eligible foreign income taxes in the general category foreign base company sales income group is reduced by €50x to zero. The €110x balance of the downward adjustment carries forward to Year 4, and reduces CFC's €70x of eligible foreign income taxes in the general category foreign base company sales income group by €70x to zero. The remaining €40x balance of the downward adjustment carries forward to later years and will reduce CFC's eligible foreign income taxes in the general category foreign base company sales income group until all improperly-accrued amounts are accounted for.

(*2*) *Application of section 905(c)*—(*i*) *Year 2*. Under paragraph (d)(5)(iii) of this section, CFC's payment in Year 2 of the €40x of Country X net income tax that properly accrued in Year 2, before the year of change, is treated as a payment of €40x of foreign income tax that CFC properly accrued in Year 2. The €60x of foreign income tax that CFC improperly accrued in Year 2 that remains unpaid at the end of Year 2 is not adjusted in Year 2. Under paragraph (d)(5)(iii) of this section, CFC's payment in Year 3 of €50x of Country X net income tax that properly accrued but was offset by the downward adjustment in Year 3 is treated as a payment of €50x of the remaining €60x of Country X net income tax that CFC improperly accrued in Year 2, the most recent improper accrual. In addition, CFC's payment in Year 4 of €70x of Country X net income tax that properly accrued but was offset by the downward adjustment in Year 4 is treated first as a payment of the remaining €10x of Country X net income tax that CFC improperly accrued in Year 2. Because all €100x of foreign income tax accrued in Year 2 under CFC's improper method of accounting is treated as paid within 24 months of December 31, Year 2, no foreign tax redetermination occurs, and no redetermination of CFC's foreign base company sales income, earnings and profits, and eligible foreign income taxes or of USC's $1,800x subpart F inclusion, $200x deemed paid credit, $200x section 78 dividend and U.S. tax liability is required, for Year 2.

(*ii*) *Year 1*. Because all €100x of the tax CFC improperly accrued in Year 1 remained unpaid as of December 31, Year 3, the date 24 months after the end of Year 1, under section 905(c)(2) and §1.905-3(a) that €100x is treated as refunded on December 31, Year 3. Under §1.905-3(b)(2)(ii), USC must redetermine its Federal income tax liability for Year 1 to account for the foreign tax redetermination, increasing CFC's foreign base company sales income and earnings and profits by €100x, and decreasing its eligible foreign income taxes by $100x. However, under paragraph (d)(5)(iii)(B) of this section €60x of CFC's payment in Year 4 of €70x of Country X net income tax that properly accrued but was offset by the downward adjustment in Year 4 is treated as a payment of €60x of the €100x of Country X net income tax that was improperly accrued in Year 1 and treated as refunded in Year 3. Under §1.905-4(b)(1)(iv), USC may account for the two foreign tax redeterminations that occurred in Years 3 and 4 on a single amended Federal income tax return for Year 1. CFC's foreign base company sales income (taking into account the reduction for foreign income taxes) and earnings and profits for Year 1 are recomputed as €1,000x of foreign base company sales income - €100x foreign income tax improperly accrued in Year 1 + €100x improperly accrued foreign income tax treated as refunded on December 31, Year 3 - €60x improperly accrued foreign income tax treated as paid in Year 4 = €940x. CFC's eligible foreign income taxes for Year 1 are translated into dollars at the applicable exchange rate and recomputed as $100x foreign income tax improperly accrued in Year 1 - $100x improperly accrued foreign income tax treated as refunded on December 31, Year 3 + $30x improperly accrued foreign income tax treated as paid in Year 4 = $30x. USC's subpart F inclusion with respect to CFC for Year 1 (translated at the average exchange rate for Year 1 of $1:€1) is increased from $900x to $940x

(€940x x $1 / €1), and the amount of foreign taxes deemed paid under section 960(a) and the amount of the section 78 dividend are reduced from $100x to $30x.

(*iii*) *Summary*. As of the end of Year 4, CFC and USC have been allowed a $30x foreign tax credit for Year 1, and a $200x foreign tax credit for Year 2. If in a later taxable year CFC distributes additional earnings to USC and accrues €40x of additional Country X net income tax that is offset by the balance of the €40x downward adjustment, CFC's payment of that €40x Country X net income tax liability will be treated as a payment of the remaining €40x of Country X net income tax that was improperly accrued in Year 1 and treated as refunded as of the end of Year 3.

(ix) *Example 9: Improperly deferred accrual*—(A) *Facts*—(*1*) *Foreign income tax accrued and paid*. USC is a domestic corporation that operates a foreign branch in Country X. All of USC's gross and taxable income is foreign source foreign branch category income, and all of its foreign income taxes are properly allocated and apportioned under §1.861-20 to the foreign branch category. USC uses the accrual method of accounting and uses the calendar year as its taxable year for both Federal and Country X income tax purposes. USC accrued €160x of Country X net income tax (as defined in §1.901-2(a)(3)) with respect to Year 1. USC filed its Country X tax return and paid the €160x on June 30, Year 2. USC accrued €180x, €240x, and €150x of Country X tax for Years 2, 3, and 4, respectively, and paid with its timely filed Country X tax returns these tax liabilities on June 30 of Years 3, 4, and 5, respectively. The average exchange rate described in §1.986(a)-1(a)(1) is $1:€0.5 in Year 1, $1:€1 in Year 2, $1:€1.25 in Year 3, and $1:€1.5 in Year 4.

(*2*) *Improper accrual*. On its Federal income tax return for Year 1, USC claimed no foreign tax credit. On its Federal income tax return for Year 2, USC improperly accrued and claimed a credit for $160x (€160x of Country X tax for Year 1 that it paid in Year 2, translated into dollars at the average exchange rate for Year 2). Continuing with this improper method of accounting, USC improperly accrued and claimed a credit in Year 3 for $144x (€180x of Country X tax for Year 2 that it paid in Year 3, translated into dollars at the average exchange rate for Year 3). In Year 4, USC realizes its mistake and seeks permission from the IRS to change to a proper method of accruing foreign income taxes.

Table 3 to paragraph (d)(6)(ix)(A)(*2*)

Taxable year ending:	Foreign income tax properly accrued	Foreign income tax accrued under improper method
12/31/Y1 ($1:€0.5)	€160x = $320x	0
12/31/Y2 ($1:€1)	€180x = $180x	€160x = $160x
12/31/Y3 ($1:€1.25)	€240x = $192x	€180x = $144x
12/31/Y4 ($1:€1.5)	€150x = $100x	[year of change]

(B) *Analysis*—(*1*) *Upward adjustment*. Under paragraph (d)(5)(ii) of this section, in Year 4, the year of change, USC increases the amount of Country X net income tax allocated and apportioned to its foreign branch category that properly accrues in Year 4, €150x, by the amount of foreign income tax in that same grouping that properly accrued in a taxable year before the taxable year of change, but which, under its improper method of accounting, USC failed to accrue and claim as either a credit or deduction before the taxable year of change. For all taxable years before the taxable year of change, under a proper method, USC would have accrued a total of €580x of foreign income tax, of which it accrued and claimed a credit for only €340x under its improper method. Thus, in Year 4, USC increases its €150x of properly accrued foreign income taxes in the foreign branch category by €240x (€580x - €340x), and may claim a credit in that year for the total, €390x, or $260x (translated into dollars at the average exchange rate for Year 4, as if the total amount properly accrued in Year 4).

(*2*) *Application of section 905(c)*. Under paragraph (d)(5)(iii) of this section, USC's payment in Year 2 of €160x of Country X net income tax that properly accrued in Year 1 but that USC accrued and claimed as a credit in Year 2 under its improper method of accounting is first treated as a payment of the amount of the Year 1 tax liability that properly accrued in Year 2. Since none of the €160x properly accrued in Year 2, the €160x is treated as a payment of the Year 1 tax liability that USC improperly accrued and claimed as a credit in Year 2, €160x. Because all €160x of the Country X net income tax that was improperly accrued and claimed as a credit in Year 2 was paid within 24 months of the end of Year 2, no foreign tax redetermination occurs, and no redetermination of USC's $160x foreign tax credit and U.S. tax liability is required, for Year 2. Similarly, because all €180x of the Year 2 Country X net income tax that was improperly accrued and claimed as a credit in Year 3 was paid within 24 months of the end of Year 3, no foreign tax redetermination occurs, and no redetermination of USC's $144x foreign tax credit and U.S. tax liability is required, for Year 3.

(e) *Election by cash method taxpayer to take credit on the accrual basis*—(1) *In general*. A taxpayer who uses the cash method of accounting for income may elect to take the foreign tax credit in the taxable year in which the taxes accrue in accordance with the rules in paragraph (d) of this section. Except as provided in paragraph (e)(2) of this section, an election pursuant to this paragraph (e)(1) must be made on a timely-filed original return, by checking the appropriate box on Form 1116 (Foreign Tax Credit (Individual, Estate, or Trust)) or Form 1118 (Foreign Tax Credit—Corporations) indicating the cash method taxpayer's choice to claim the foreign tax credit in the year the foreign income taxes accrue. Once made, the election is irrevocable and must be followed for purposes of claiming a foreign tax credit for all subsequent years. See section 905(a).

(2) *Exception for cash method taxpayers claiming a foreign tax credit for the first time*. If the year with respect to which an election pursuant to paragraph (e)(1) of this section to claim the foreign tax credit on an accrual basis is made (the "election year") is the first year for which a taxpayer has ever claimed a foreign tax credit, the election to claim the foreign tax credit on an accrual basis can also be made on an amended return filed within the period permitted under §1.901-1(d)(1). The election is binding in the election year and all subsequent taxable years in which the taxpayer claims a foreign tax credit.

(3) *Treatment of taxes that accrued in a prior year*. In the election year and subsequent taxable years, a cash method taxpayer that claimed foreign tax credits on the cash basis in a prior taxable year may claim a foreign tax credit not only for foreign income taxes that accrue in the election year, but also for foreign income taxes that accrued (or are considered to accrue) in a taxable year preceding the election year but that are paid in the election year or a subsequent taxable year, as applicable. Under paragraph (c) of this section, foreign income taxes paid with respect to a taxable year that precedes the election year may be claimed as a credit only in the year the taxes are paid and do not require a redetermination under section 905(c) or §1.905-3 of U.S. tax liability in any prior year.

(4) *Examples*. The following examples illustrate the application of paragraph (e) of this section.

(i) *Example 1*—(A) *Facts*. A, a U.S. citizen who is a resident of Country X, is a cash method taxpayer who uses the calendar year as the taxable year for both U.S. and Country X tax purposes. In Year 1 through Year 5, A claims foreign tax credits for Country X foreign income taxes on the cash method, in the year the taxes are paid. For Year 6, A makes a timely election to claim foreign tax credits on the accrual basis. In Year 6, A accrues $100x of Country X foreign income taxes with respect to Year 6. Also in Year 6, A pays $80x in foreign income taxes that had accrued in Year 5.

(B) *Analysis*. Pursuant to paragraph (e)(3) of this section, A can claim a foreign tax credit in Year 6 for the $100x of Country X taxes that accrued in Year 6 and for the $80x of Country X taxes that accrued in Year 5 but that are paid in Year 6.

(ii) *Example 2*—(A) *Facts*. The facts are the same as those in paragraph (e)(4)(i)(A) of this section (the facts in *Example 1*), except that in Year 7, A is assessed an additional $10x of foreign income tax by Country X with respect to A's income in Year 3. After exhausting all effective and practical remedies, A pays the additional $10x to Country X in Year 8.

(B) *Analysis*. Pursuant to paragraph (e)(3) of this section, A can claim a foreign tax credit in Year 8 for the additional $10x of foreign income tax paid to Country X in Year 8 with respect to Year 3.

(f) *Rules for creditable foreign tax expenditures of partners, shareholders, or beneficiaries of a pass-through entity*—(1) *Effect of pass-through entity's method of accounting on when foreign tax credit or deduction can be claimed*. Each partner that elects to claim the foreign tax credit for a particular taxable year may treat its distributive share of the creditable foreign tax expenditures (as defined in §1.704-1(b)(4)(viii)(*b*)) of the partnership that are paid or accrued by the partnership, under the partnership's method of accounting, during the partnership's taxable year ending with or within the partner's taxable year, as foreign income taxes paid or accrued (as the case may be, according to the partner's method of accounting for such taxes) by the partner in that particular taxable year. See §§1.702-1(a)(6) and 1.703-1(b)(2). Under §§1.905-3(a) and 1.905-4(b)(2), additional creditable foreign tax expenditures of the partnership that result from a change in the partnership's foreign tax liability for a prior taxable year, including additional taxes paid when a contest with a foreign tax authority is resolved, must be identified by the partnership as a prior year creditable foreign tax expenditure in the information reported to its partners for its taxable year in which the additional tax is actually paid. Subject to the rules in paragraphs (c) and (e) of this section, a partner using the cash method of accounting for foreign income taxes may claim a credit (or a deduction) for its distributive share of such additional taxes in the partner's taxable year with or within which the partnership's taxable year ends. Subject to the rules in paragraph (d) of this section, a partner using the accrual method of accounting for foreign income taxes may claim a credit for the partner's distributive share of such additional taxes in the relation-back year, or may claim a deduction in its taxable year with or within which the partnership's taxable year ends. The principles of this paragraph (f)(1) apply to determine the year in which a shareholder of a 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. See sections 642(a), 671, 901(b)(5), and 1373(a) and §§ 1.1363-1(c)(2)(iii) and 1.1366-1(a)(2)(iv). See §§1.905-3 and 1.905-4 for notifications and adjustments of U.S. tax liability that are required if creditable foreign tax expenditures of a partnership or S corporation, or foreign income taxes paid or accrued by a trust or estate, are refunded or otherwise reduced.

(2) *Provisional credit for contested taxes*. Under paragraph (d)(3) of this section, a contested foreign tax liability does not accrue until the contest is resolved and the amount of the liability has been finally determined. In addition, under section 905(c)(2), a foreign income tax that is not paid within 24 months of the close of the taxable year to which the tax relates may not be claimed as a credit until the tax is actually paid. Thus, a partnership or other pass-through entity cannot take the contested tax into account as a creditable foreign tax expenditure until both the contest is resolved and the tax is actually paid. However, to the extent that a partnership or other pass-through entity remits a contested foreign tax liability to a foreign country, a partner or other owner of such pass-through entity that claims foreign tax credits may, by complying with the rules in paragraph (c)(3) or (d)(4) of this section, as applicable, elect to claim a provisional credit for its distributive share of such contested tax liability in the year the pass-through entity remits the tax (for owners claiming foreign tax credits on the cash basis) or in the relation-back year (for owners claiming foreign tax credits on the accrual basis).

(3) *Example*. The following example illustrates the application of paragraph (f) of this section.

(i) *Facts*. ABC is a U.S. partnership that is engaged in a trade or business in Country X. ABC has two U.S. partners, A and B. For Federal income tax purposes, ABC and partner A both use the accrual method of accounting and utilize a taxable year ending on September 30. ABC uses a taxable year ending on September 30 for Country X tax purposes. B is a calendar year taxpayer that uses the cash method of accounting. For its taxable year ending September 30, Year 1, ABC accrues $500x in foreign income tax to Country X; each partner's distributive share of the foreign income tax is $250x. In its taxable year ending September 30, Year 5, ABC settles a contest with Country X with respect to its Year 1 tax liability and, as a result of such settlement, accrues an additional $100x in foreign income tax for Year 1. ABC remits the additional tax to Country X in January of Year 6. A and B both elect to claim foreign tax credits for their respective taxable Years 1 through 6.

(ii) *Analysis*. For its taxable year ending September 30, Year 1, A can claim a credit for its $250x distributive share of foreign income taxes paid by ABC with respect to ABC's taxable year ending September 30, Year 1. Pursuant to paragraph (f)(1) of this section, B can claim its distributive share of $250x of foreign income tax for its taxable year ending December 31, Year 1, even if ABC does not remit the Year 1 taxes to Country X until Year 2. Although the additional $100x of Country X foreign income tax owed by ABC with respect to Year 1 accrued in its taxable year ending September 30, Year 5, upon conclusion of the contest, because ABC uses the accrual method of accounting, it does not take the additional tax into account until the tax is actually paid, in its taxable year ending September 30, Year 6. See section 905(c)(2)(B) and paragraph (f)(1) of this section. Pursuant to §1.905-4(b)(2), ABC is required to notify the IRS and its partners of the foreign tax redetermination. A's distributive share of the additional tax relates back, is considered to accrue, and may be claimed as a credit for Year 1; however, A cannot claim a credit for the additional tax until Year 6, when ABC remits the tax to Country X. See §1.905-3(a). B's distributive share of the additional tax does not relate back to Year 1 and is creditable in B's taxable year ending December 31, Year 6.

(g) *Blocked income*. If, under the provisions of the regulations under section 461, an amount otherwise constituting gross income for the taxable year from sources without the United States is, owing to monetary, exchange, or other restrictions imposed by a foreign country, not includible in gross income of the taxpayer for such year, the credit for foreign income taxes imposed by such foreign country with respect to such amount shall be taken proportionately in any subsequent tax-

able year in which such amount or portion thereof is includible in gross income.

(h) *Applicability dates*. This section applies to foreign income taxes paid or accrued in taxable years beginning on or after December 28, 2021. In addition, the election described in paragraphs (c)(3) and (d)(4) of this section may be made (including by a partner or other owner of a pass-through entity described in paragraph (f)(2) of this section) with respect to amounts of contested tax that are remitted in taxable years beginning on or after December 28, 2021 and that relate to a taxable year beginning before December 28, 2021.

Par. 29. Section 1.905-3 is amended:

1. In paragraph (a), by revising the first two sentences.

2. In paragraph (b)(1)(ii)(B)(*1*), by removing the language "USC Effective" and adding the language "USC. Effective" in its place.

3. By adding paragraph (b)(4).

4. By revising paragraph (d).

The revisions and addition read as follows:

§1.905-3 Adjustments to U.S. tax liability and to current earnings and profits as a result of a foreign tax redetermination.

(a) * * * For purposes of this section and §1.905-4, the term *foreign tax redetermination* means a change in the liability for foreign income taxes (as defined in §1.901-2(a)) or certain other changes described in this paragraph (a) that may affect a taxpayer's U.S. tax liability, including by reason of a change in the amount of its foreign tax credit, a change to claim a foreign tax credit for foreign income taxes that it previously deducted, a change to claim a deduction for foreign income taxes that it previously credited, a change in the amount of its distributions or inclusions under sections 951, 951A, or 1293, a change in the application of the high-tax exception described in section 954(b)(4) (including for purposes of determining amounts excluded from gross tested income under section 951A(c)(2)(A)(i)(III) and §1.951A-2(c)(1)(iii)), or a change in the amount of tax determined under sections 1291(c)(2) and 1291(g)(1)(C)(ii). In the case of a taxpayer that claims the credit in the year the taxes are paid, a foreign tax redetermination occurs if any portion of the tax paid is subsequently refunded, or if the taxpayer's liability is subsequently determined to be less than the amount paid and claimed as a credit. * * *

(b) * * *

(4) *Change in election to claim a foreign tax credit*. A redetermination of U.S. tax liability is required to account for the effect of a timely change by the taxpayer to claim a foreign tax credit or a deduction for foreign income taxes paid or accrued in any taxable year as permitted under §1.901-1(d).

* * * * *

(d) *Applicability dates*. Except as provided in this paragraph (d), this section applies to foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019**,** and to foreign tax redeterminations of foreign corporations occurring in taxable years that end with or within a taxable year of a United States shareholder ending on or after December 16, 2019 and that relate to taxable years of foreign corporations beginning after December 31, 2017. The first two sentences of paragraph (a) of this section, and paragraph (b)(4) of this section, apply to foreign tax redeterminations occurring in taxable years beginning on or after December 28, 2021.

Par. 30. Section 1.951A-2 is amended:

1. In paragraph (c)(7)(iii)(A), by adding the language "and the rules of §1.861-20" at the end of the first sentence.

2. By removing paragraph (c)(7)(iii)(B).

3. By redesignating paragraph (c)(7)(iii)(C) as paragraph (c)(7)(iii)(B).

4. In newly redesignated paragraph (c)(7)(iii)(B), by removing the language "(c)(7)(iii)(C)" from the first sentence and adding the language "(c)(7)(iii)(B)" in its place.

5. By adding paragraph (c)(8)(ii)(M).

6. By revising paragraph (c)(8)(iii)(A)(*2*)(*ii*).

7. By removing and reserving paragraph (c)(8)(iii)(B).

8. In paragraph (c)(8)(iii)(C)(*2*)(*iii*):

i. By removing the language "the principles of §§1.960-1(d)(3)(ii) and 1.904-6(a)(1)" from the first and second sentences and adding the language "§1.861-20" in its place.

ii. By removing the language "Under these principles, the" from the third sentence and adding the language "Under §1.861-20," in its place.

The additions and revisions read as follows:

§1.951A-2 Tested income and tested loss.

* * * * *

(c) * * *

(8) * * *

(ii) * * *

(M) The same amounts of regarded items of income and deduction that are accrued under federal income tax law are also accrued under foreign law.

(iii) * * *

(A) * * *

(2) * * *

(ii) * * * Under paragraph (c)(7)(iii)(A) of this section, CFC1X's tentative tested income items are computed by treating the CFC1X tentative gross tested income item and the FDE1Y tentative gross tested income item each as income in a separate tested income group (the "CFC1X income group" and the "FDE1Y income group") and by allocating and apportioning CFC1X's deductions for current year taxes under §1.861-20 (CFC1X has no other deductions to allocate and apportion). Under paragraph (c)(7)(iii)(A) of this section and §1.861-20(d)(3)(v), the €20x deduction for Country Y income taxes is allocated and apportioned solely to the FDE1Y income group (the "FDE1Y group tax") and none of the Country Y taxes are allocated and apportioned to the CFC1X income group.

* * * * *

Par. 31. Section 1.951A-7(b) is amended:

1. By removing the language "Section" from the first sentence and adding the language "Except as otherwise provided in this paragraph (b), section," in its place.

2. Adding three sentences after the second sentence.

The addition reads as follows:

§1.951A-7 Applicability dates.

* * * * *

(b) * * * Section 1.951A-2(c)(7)(iii)(B), (c)(8)(ii), (c)(8)(iii)(A)(*2*)(*ii*), and

(c)(8)(iii)(B) apply to taxable years of foreign corporations beginning on or after December 28, 2021, and to taxable years of United States shareholders in which or with which such taxable years of the foreign corporations end. In addition, taxpayers may choose to apply the rules in §1.951A-2(c)(7)(iii)(B), (c)(8)(iii)(A)(*2*)(*ii*), and (c)(8)(iii)(B)(*2*)(*iii*) to taxable years of foreign corporations that begin after December 31, 2019, and before December 28, 2021, and to taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end. For taxable years of foreign corporations beginning before December 28, 2021, see §1.951A-2(c)(7)(iii)(B), (c)(8)(iii)(A)(*2*)(*ii*), and (c)(8)(iii)(B)(*2*)(*iii*) as contained in 26 CFR part 1 revised as of April 1, 2021.

Par. 32. Section 1.960-1 is amended:

1. By revising paragraph (b)(4).

2. By redesignating paragraphs (b)(5) through (37) as paragraphs (b)(6) through (38), respectively.

3. By adding a new paragraph (b)(5).

4. By revising newly redesignated paragraphs (b)(6) and (c)(1)(ii).

5. By redesignating paragraphs (c)(1)(iii) through (vi) as paragraphs (c)(1)(iv) through (vii).

6. By adding a new paragraph (c)(1)(iii).

7. In newly redesignated paragraph (c)(1)(iv), by removing the language "Third, current year taxes" in the first sentence and adding the language "Fourth, eligible current year taxes" in its place.

8. In newly redesignated paragraph (c)(1)(v), by removing the language "Fourth," from the first sentence and adding the language "Fifth," in its place.

9. In newly redesignated paragraph (c)(1)(vi), by removing the language "Fifth," from the first sentence and adding the language "Sixth," in its place.

10. In newly redesignated paragraph (c)(1)(vii), by removing the language "Sixth," from the first sentence and adding the language "Seventh," in its place.

11. In paragraph (d)(1), by removing the language "the U.S. dollar amount of current year taxes" from the first sentence and adding the language "the U.S. dollar amount of eligible current year taxes" in its place.

12. In paragraph (d)(3)(i) introductory text, by removing the language "current year taxes" from the second sentence and adding the language "eligible current year taxes" in its place.

13. In paragraph (d)(3)(ii)(A), by revising the last sentence.

14. In paragraph (d)(3)(ii)(B), by removing the language "a current year tax" from the first sentence and adding the language "an eligible current year tax" in its place.

15. In paragraph (f)(1)(ii), by removing the language "tax" from the fifth sentence and adding the language "eligible current year tax" in its place.

16. In paragraph (f)(2)(i):

i. By removing the language "paragraphs (c)(1)(i) through (iv)" from the third sentence and adding the language "paragraphs (c)(1)(i) through (v)" in its place.

ii. By removing the language "Under paragraph (c)(1)(v) of this section, the rules in paragraph (c)(1)(i) through (iv)" from the fourth sentence and adding the language "Under paragraph (c)(1)(vi) of this section, the rules in paragraph (c)(1)(i) through (v)" in its place.

17. In paragraph (f)(2)(ii)(B)(*1*), by removing the language "current year taxes" from the last sentence and adding the language "eligible current year taxes" in its place.

18. In paragraph (f)(2)(ii)(B)(*2*):

i. By removing the language "current year taxes" from the fifth sentence and adding the language "eligible current year taxes" in its place.

ii. By removing the last two sentences.

19. By redesignating paragraphs (f)(2)(ii)(C) through (F) as paragraphs (f)(2)(ii)(D) through (G), respectively.

20. By adding a new paragraph (f)(2)(ii)(C).

21. In newly-redesignated paragraph (f)(2)(ii)(D):

i. By removing the language "*Step 3*. Under paragraph (c)(1)(iii)" from the first sentence and adding the language "*Step 4*. Under paragraph (c)(1)(iv)" in its place.

ii. By removing the language "paragraph (c)(1)(iii)" from the fifth sentence and adding the language "paragraph (c)(1)(iv)" in its place.

22. In newly-redesignated paragraph (f)(2)(ii)(E), by removing the language "*Step 4*. Under paragraph (c)(1)(iv)" from the first sentence and adding the language "*Step 5*. Under paragraph (c)(1)(v)" in its place.

23. In newly-redesignated paragraph (f)(2)(ii)(F), by removing the language "*Step 5*. Paragraph (c)(1)(v)" and adding the language "*Step 6*. Paragraph (c)(1)(vi)" in its place.

24. In newly-redesignated paragraph (f)(2)(ii)(G), by removing the language "*Step 6*. Paragraph (c)(1)(vi)" and adding the language "*Step 7*. Paragraph (c)(1)(vii)" in its place.

The additions and revisions read as follows:

§1.960-1 Overview, definitions, and computational rules for determining foreign income taxes deemed paid under section 960(a), (b), and (d).

* * * * *

(b) * * *

(4) *Current year tax*. The term *current year tax* means a foreign income tax that is paid or accrued by a controlled foreign corporation in a current taxable year (taking into account any adjustments resulting from a foreign tax redetermination (as defined in §1.905-3(a)). See §1.905-1 for rules on when foreign income taxes are considered paid or accrued for foreign tax credit purposes; see also §1.367(b)-7(g) for rules relating to foreign income taxes associated with foreign section 381 transactions and hovering deficits.

(5) *Eligible current year tax*. The term *eligible current year tax* means a current year tax, other than a current year tax for which a credit is disallowed or suspended at the level of the controlled foreign corporation. See, for example, section 245A(e)(3) and §1.245A(d)-1(a)(2) and sections 901(k)(1), (l), and (m), 909, and 6038(c)(1)(B). An eligible current year tax, however, includes a current year tax that may be deemed paid but for which a credit is reduced or disallowed at the level of the United States shareholder. See, for example, sections 901(e), 901(j), 901(k)(2), 908, 965(g), and 6038(c)(1)(A).

(6) *Foreign income tax*. The term *foreign income tax* has the meaning provided in §1.901-2(a).

* * * * *

(c) * * *

(1) * * *

(ii) Second, deductions (other than for current year taxes) of the controlled foreign corporation for the current taxable year are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category. See paragraph (d)(3)(i) of this section. Deductions for current year taxes (other than eligible current year taxes) of the controlled foreign corporation for the current taxable year are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category. Additionally, the functional currency amounts of eligible current year taxes are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category, and to reduce earnings and profits in the PTEP groups that were increased as provided in paragraph (c)(1)(i) of this section. No deductions other than eligible current year taxes are allocated and apportioned to PTEP groups. See paragraph (d)(3)(ii) of this section.

(iii) Third, for purposes of computing foreign taxes deemed paid, eligible current year taxes that were allocated and apportioned to income groups and PTEP groups in the section 904 categories are translated into U.S. dollars in accordance with section 986(a).

* * * * *

(d) * * *

(3) * * *

(ii) * * *

(A) * * * For purposes of determining foreign income taxes deemed paid under the rules in §§1.960-2 and 1.960-3, the U.S. dollar amount of eligible current year taxes is assigned to the section 904 categories, income groups, and PTEP groups (to the extent provided in paragraph (d)(3)(ii)(B) of this section) to which the eligible current year taxes are allocated and apportioned.

* * * * *

(f) * * *

(2) * * *

(ii) * * *

(C) *Step 3*. Under paragraph (c)(1)(iii) of this section, for purposes of computing foreign taxes deemed paid under section 960, CFC1 has $600,000x of foreign income taxes in the PTEP group within the general category and $300,000x of current year taxes in the residual income group within the general category. Under paragraph (e) of this section, the United States shareholders of CFC1 cannot claim a credit with respect to the $300,000x of taxes on CFC1's income in the residual income group.

* * * * *

Par. 33. Section 1.960-2 is amended:

1. In paragraph (b)(2), by removing the language "current year taxes" and adding the language "eligible current year taxes" in its place.

2. In paragraph (b)(3)(i), by removing the language "current year taxes" each place it appears and adding the language "eligible current year taxes" in its place.

3. In paragraph (b)(5)(i), by revising the seventh sentence.

4. In paragraph (b)(5)(ii)(A), by revising the first and second sentences.

5. In paragraph (b)(5)(ii)(B), by revising the first and second sentences.

6. In paragraph (c)(4), by removing the language "current year taxes" and adding the language "eligible current year taxes" in its place.

7. In paragraph (c)(5), by removing the language "current year taxes" each place it appears and adding the language "eligible current year taxes" in its place.

8. In paragraph (c)(7)(i)(A), by revising the sixth sentence.

9. In paragraph (c)(7)(i)(B), by revising the first and second sentences.

10. In paragraph (c)(7)(ii)(A)(*1*), by revising the ninth and eleventh sentences.

11. In paragraph (c)(7)(ii)(B)(*1*)(*i*), by revising the first and second sentences.

12. In paragraph (c)(7)(ii)(B)(*1*)(*ii*), by removing the language "foreign income taxes" in the first sentence and adding the language "eligible current year taxes" in its place.

The additions and revisions read as follows:

§1.960-2 Foreign income taxes deemed paid under sections 960(a) and (d).

* * * * *

(b) * * *

(5) * * *

(i) * * * CFC has current year taxes, all of which are eligible current year taxes, translated into U.S. dollars, of $740,000x that are allocated and apportioned as follows: $50,000x to subpart F income group 1; $240,000x to subpart F income group 2; and $450,000x to subpart F income group 3. * * *

(ii) * * *

(A) * * * Under paragraphs (b)(2) and (3) of this section, the amount of CFC's foreign income taxes that are properly attributable to items of income in subpart F income group 1 to which a subpart F inclusion is attributable equals USP's proportionate share of the eligible current year taxes that are allocated and apportioned under §1.960-1(d)(3)(ii) to subpart F income group 1, which is $40,000x ($50,000x x 800,000u/1,000,000u). Under paragraphs (b)(2) and (3) of this section, the amount of CFC's foreign income taxes that are properly attributable to items of income in subpart F income group 2 to which a subpart F inclusion is attributable equals USP's proportionate share of the eligible current year taxes that are allocated and apportioned under §1.960-1(d)(3)(ii) to subpart F income group 2, which is $192,000x ($240,000x x 1,920,000u / 2,400,000u). * * *

(B) * * * Under paragraphs (b)(2) and (3) of this section, the amount of CFC's foreign income taxes that are properly attributable to items of income in subpart F income group 3 to which a subpart F inclusion is attributable equals USP's proportionate share of the eligible current year taxes that are allocated and apportioned under §1.960-1(d)(3)(ii) to subpart F income group 3, which is $360,000x ($450,000x x 1,440,000u / 1,800,000u). CFC has no other subpart F income groups within the general category. * * *

(c) * * *

(7) * * *

(i) * * *

(A) * * * CFC1 has current year taxes, all of which are eligible current year taxes, translated into U.S. dollars, of $400x that are all allocated and apportioned to the tested income group. * * *

(B) * * * Under paragraph (c)(5) of this section, USP's proportionate share of the eligible current year taxes that are allocated and apportioned under §1.960-1(d)(3)(ii) to CFC1's tested income group is $400x ($400x x 2,000u / 2,000u). Therefore, under paragraph (c)(4) of this section, the amount of foreign income taxes that

are properly attributable to tested income taken into account by USP under section 951A(a) and §1.951A-1(b) is $400x. * * *

(ii) * * *

(A) * * *

(*1*) * * * CFC1 has current year taxes, all of which are eligible current year taxes, translated into U.S. dollars, of $100x that are all allocated and apportioned to CFC1's tested income group. * * * CFC2 has current year taxes, all of which are eligible current year taxes, translated into U.S. dollars, of $20x that are allocated and apportioned to CFC2's tested income group.

* * * * *

(B) * * *

(*1*) * * *

(*i*) * * * Under paragraphs (c)(5) and (6) of this section, US1's proportionate share of the eligible current year taxes that are allocated and apportioned under §1.960–1(d)(3)(ii) to CFC1's tested income group is $95x ($100x × 285u / 300u). Therefore, under paragraph (c)(4) of this section, the amount of the foreign income taxes that are properly attributable to tested income taken into account by US1 under section 951A(a) and § 1.951A–1(b) is $95x. * * *

* * * * *

Par. 34. Section 1.960-7 is amended by revising paragraph (b) to read as follows:

§1.960-7 Applicability dates.

* * * * *

(b) Section 1.960-1(c)(2) and (d)(3)(ii) apply to taxable years of a foreign corporation beginning after December 31, 2019, and to each taxable year of a domestic corporation that is a United States shareholder of the foreign corporation in which or with which such taxable year of such foreign corporation ends. For taxable years of a foreign corporation that end on or after December 4, 2018, and also begin before January 1, 2020, see §1.960-1(c)(2) and (d)(3)(ii) as in effect on December 17, 2019.

Paragraphs (b)(4), (5), and (6), (c)(1)(ii), (iii), and (iv), and (d)(3)(ii)(A) and (B) of §1.960-1, and paragraphs (b)(2), (b)(3)(i), (b)(5)(i), (b)(5)(iv)(A), and (c)(4), (5), and (7) of §1.960-2, 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 United States shareholder of the foreign corporation in which or with which such taxable year of such foreign corporation ends. For taxable years of foreign corporations beginning before December 28, 2021, with respect to the paragraphs described in the preceding sentence, see §§1.960-1 and 1.960-2 as in effect on November 12, 2020.

Douglas W. O'Donnell,
Deputy Commissioner for Services and Enforcement.

Approved: December 9, 2021

Lily Batchelder,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 28, 2021, 4:15 p.m., and published in the issue of the Federal Register for January 4, 2022, 87 F.R. 276)

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26 CFR §1.1001-6: Transition from certain interbank offered rates

T.D. 9961

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 301

Guidance on the Transition From Interbank Offered Rates to Other Reference Rates

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance on the tax consequences of the transition away from the use of certain interbank offered rates in debt instruments, derivative contracts, and other contracts. The final regulations are necessary to address the possibility that a modification of the terms of a contract to replace such an interbank offered rate with a new reference rate could result in the realization of income, deduction, gain, or loss for Federal income tax purposes or could have other tax consequences. The final regulations will affect parties to contracts that reference certain interbank offered rates.

DATES: *Effective date*: These final regulations are effective on March 7, 2022.

Applicability date: For dates of applicability, see §§1.860A-1(b)(7), 1.1001-6(k), and 1.1275-2(m)(5).

FOR FURTHER INFORMATION CONTACT: Spence Hanemann at (202) 317-4554 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under sections 860A, 860G, 1001, 1271, 1275, and 7701(l) of the Internal Revenue Code (Code) and to the Procedure and Administration Regulations (26 CFR part 301) under section 7701 of the Code.

1. *Discontinuation of LIBOR and Tax Implications*

On July 27, 2017, the Financial Conduct Authority, the United Kingdom regulator tasked with overseeing the London Interbank Offered Rate (LIBOR), announced that publication of all currency and term variants of LIBOR, including U.S.-dollar LIBOR (USD LIBOR), may cease after the end of 2021. The administrator of LIBOR, the ICE Benchmark Administration, announced on March 5, 2021, that publication of overnight, one-month, three-month, six-month, and 12-month USD LIBOR will cease immediately following the LIBOR publication on June 30, 2023, and that publication of all other currency and tenor variants of LIBOR will cease immediately following the LIBOR publication on December 31, 2021.

On September 29, 2021, the Financial Conduct Authority announced that it will

compel the ICE Benchmark Administration to continue to publish one-month, three-month, and six-month sterling LIBOR and Japanese yen LIBOR after December 31, 2021, using a "synthetic" methodology that is not based on panel bank contributions (*synthetic GBP LIBORs* and *synthetic JPY LIBORs*, respectively). The Financial Conduct Authority has indicated that it may also require the ICE Benchmark Administration to publish one-month, three-month, and six-month USD LIBOR after June 30, 2023, using a similar synthetic methodology (*synthetic USD LIBORs*). However, these synthetic GBP LIBORs, synthetic JPY LIBORs, and synthetic USD LIBORs are expected to be published for a limited period of time.

Various tax issues may arise when taxpayers modify contracts in anticipation of the discontinuation of LIBOR or another interbank offered rate (IBOR). For example, such a modification may be treated as an exchange of property for other property differing materially in kind or extent for purposes of §1.1001-1(a), giving rise to gain or loss. Such a modification may also have consequences under the rules for integrated transactions and hedging transactions, withholding under chapter 4 of the Code, fast-pay stock, investment trusts, original issue discount, and real estate mortgage investment conduits (REMICs). To minimize potential market disruption and to facilitate an orderly transition in connection with the discontinuation of LIBOR and other IBORs, the Treasury Department and the IRS published proposed regulations (REG-118784-18) in the **Federal Register** (84 FR 54068) on October 9, 2019 (Proposed Regulations). The Proposed Regulations generally provide that modifying a debt instrument, derivative, or other contract in anticipation of an elimination of an IBOR is not treated as an exchange of property for other property differing materially in kind or extent for purposes of §1.1001-1(a). The Proposed Regulations also adjust other tax rules to minimize the collateral consequences of the transition away from IBORs.

2. *Rev. Proc. 2020-44*

The Alternative Reference Rates Committee (ARRC), whose ex officio members include the Treasury Department, was convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York in 2014. To support the transition away from USD LIBOR, the ARRC has published recommended fallback language for inclusion in the terms of certain cash products, such as syndicated loans and securitizations. The ARRC has also been actively engaged in work led by the International Swaps and Derivatives Association (ISDA) to ensure that the contractual fallback provisions in derivative contracts are sufficiently robust to prevent serious market disruptions when LIBOR is discontinued or becomes unreliable. To that end, ISDA developed the *ISDA 2020 IBOR Fallbacks Protocol* by which the parties to certain derivative contracts can incorporate certain improved fallback provisions into the terms of those contracts.

On October 9, 2020, the Treasury Department and the IRS released Rev. Proc. 2020-44, 2020-45 I.R.B. 991, in advance of finalizing the Proposed Regulations to support the adoption of the ARRC's recommended fallback provisions and the *ISDA 2020 IBOR Fallbacks Protocol*. Rev. Proc. 2020-44 provides that a modification within the scope of the revenue procedure is not treated as an exchange of property for other property differing materially in kind or extent for purposes of §1.1001-1(a). In addition, Rev. Proc. 2020-44 generally provides that a modification within the scope of the revenue procedure will not result in legging out of an integrated transaction or terminating either leg of a hedging transaction.

3. *The Final Regulations*

The Treasury Department and the IRS received public comments on the Proposed Regulations from eight commenters. Copies of these comments are available for public inspection at *https://www.regulations.gov* or upon request. No public hearing was requested, and none was held. After consideration of the public comments, the Treasury Department and the IRS adopt the Proposed Regulations as amended by this Treasury decision (Final Regulations).

Summary of Comments and Explanation of Revisions

The Final Regulations are intended to provide special rules to help taxpayers adjust to the discontinuation of certain widely used interest rate benchmarks. To achieve this purpose, the Treasury Department and the IRS have concluded that it is appropriate in this context to depart from the ordinary tax rules to the degree and in the manner provided in the Final Regulations. One commenter recommended that the Treasury Department and the IRS supplement the rules in the Final Regulations with "rules of construction" based on the reasonableness of taxpayers' actions. The Treasury Department and the IRS decline to adopt this comment because such a principles-based rule would blur the carefully circumscribed degree and manner in which the Final Regulations authorize taxpayers to depart from the ordinary tax rules.

Although the Final Regulations and Proposed Regulations share many of the same fundamental rules, the structure of §1.1001-6 in the Final Regulations differs from that of the Proposed Regulations. These structural changes are primarily intended to simplify the operative rules, which are in §1.1001-6(b) through (g) of the Final Regulations. For example, while the Proposed Regulations separately state the rules for debt and non-debt contracts, the Final Regulations provide a single set of rules for all contracts. The Final Regulations define contract broadly to include not only debt instruments and derivative contracts but also insurance contracts, stock, leases, and other contractual relationships.

The Final Regulations also make use of defined terms, located in §1.1001-6(h), to streamline references to concepts that are frequently used in the operative rules in §1.1001-6(b) through (g). In particular, the defined term "covered modification" is the cornerstone of these rules and serves to restructure several of the fundamental rules set forth in the Proposed Regulations. For example, §1.1001-6 of the Proposed Regulations generally provides certain beneficial tax consequences when the parties to a contract modify the contract to replace an IBOR-based rate with a "qualified rate" and make certain "asso-

ciated modifications," which may include a "one-time payment." The Final Regulations unite these various elements of the Proposed Regulations (that is, modification of a contract, an IBOR-based rate, a qualified rate, associated modifications, and a one-time payment) in the single defined term "covered modification."

1. *Treatment Under Section 1001*

Section 1.1001-6(a) of the Proposed Regulations generally provides rules for applying section 1001 to a contract that is modified to replace an IBOR-based rate or IBOR-based fallback provisions or to add or amend fallback provisions that would replace an IBOR-based rate. Section 1.1001-6(a) of the Proposed Regulations generally provides that such a modification is not treated as an exchange of property under section 1001 and extends this treatment to any reasonably necessary conforming modifications. When modifications that qualify for this special treatment under proposed §1.1001-6(a) occur contemporaneously with modifications that do not qualify, the non-qualifying modifications are subject to the ordinary rules under §1.1001-1(a) or §1.1001-3 and the modifications that qualify for special treatment under proposed §1.1001-6(a) are treated as part of the existing terms of the contract. Section 1.1001-6(b) of the Final Regulations provides similar rules but makes use of the defined terms "covered modification" and "noncovered modification."

a. *Treatment of covered and noncovered modifications*

Under §1.1001-6(b)(1) of the Final Regulations, a covered modification of a contract is not treated as an exchange of property for other property differing materially in kind or in extent for purposes of §1.1001-1(a). Consequently, in the case of a debt instrument, a covered modification to which §1.1001-6(b)(1) applies is not treated as a significant modification for purposes of §1.1001-3. As defined in §1.1001-6(h)(1) of the Final Regulations, a covered modification is generally comprised of four elements: (1) a contract with an operative rate or fallback provision that references a discontinued IBOR; (2) a modification of that contract (a) to replace an operative rate that refers to a discontinued IBOR with a qualified rate and, if the parties so choose, to add an obligation for one party to make a qualified one-time payment, (b) to include a qualified rate as a fallback to an operative rate that refers to a discontinued IBOR, or (c) to replace a fallback rate that refers to a discontinued IBOR with a qualified rate; (3) any associated modifications with respect to those modifications of the operative rate or fallback provisions; and (4) satisfaction of rules in §1.1001-6(j) of the Final Regulations that exclude certain modifications from the definition of covered modification. The defined terms "discontinued IBOR," "qualified rate," "qualified one-time payment," and "associated modification" and the rules in §1.1001-6(j) of the Final Regulations that exclude certain modifications are discussed in more detail in the sections of this preamble entitled *Discontinued IBOR*, *Qualified rate*, *Qualified one-time payments*, *Associated modifications*, and *Fair market value requirement and excluded modifications*, respectively. A modification described in section 4.02 of Rev. Proc. 2020-44, as supplemented by any guidance that may be published in the Internal Revenue Bulletin, is also treated as a covered modification. Rev. Proc. 2020-44 is discussed in more detail in the section of this preamble entitled *Rev. Proc. 2020-44*. For purposes of the definition of a covered modification, the term "modification" is broadly construed to include any modification, regardless of its form. For example, a holding corporation that issued preferred stock may modify that stock for purposes of the Final Regulations by means of an exchange offer conducted by the corporation's subsidiary. The term also includes any modification regardless of whether the modification is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. For example, any agreement to make additional payments with respect to a contract is a modification of that contract, regardless of whether the parties memorialize the obligation to make those payments in an amendment to the original contract or in a new, standalone contract.

Although §1.1001-6(b)(1) of the Final Regulations generally provides that a covered modification of a contract is not treated as an exchange of property for other property differing materially in kind or in extent for purposes of §1.1001-1(a), whether a noncovered modification that occurs contemporaneously with the covered modification is an exchange of property for other property differing materially in kind or in extent is determined under the ordinary rules in §1.1001-1(a) or §1.1001-3. The Final Regulations define a noncovered modification as any modification or portion of a modification of a contract that is not a covered modification. Two commenters asked whether pairing a modification that would otherwise qualify for beneficial treatment under the Proposed Regulations with a contemporaneous modification that does not so qualify prevents both modifications from benefitting from the Proposed Regulations. The reference to a "portion of a modification" in the definitions of covered modification and noncovered modification in the Final Regulations indicates that a modification is a noncovered modification only to the extent that it fails to be a covered modification.

Two commenters requested that the Treasury Department and the IRS clarify whether, following a covered modification by which the parties add or amend fallback provisions, the change to the terms of the contract that results from the activation of the new fallback provisions must be tested separately at the time of activation to determine whether that change is an exchange of property for other property differing materially in kind or in extent for purposes of §1.1001-1(a). As is ordinarily the case, a change to the terms of the contract that results from the activation of a fallback provision must be tested at the time of activation to determine whether that change results in such an exchange under §1.1001-1(a). If the change resulting from the activation of a fallback is a covered modification under §1.1001-6(h)(1) of the Final Regulations, then the special rules provided in the Final Regulations for covered modifications apply to that change. Otherwise, whether that change is an exchange of property for other property differing materially in kind or in extent is generally determined under §1.1001-3 for debt instruments and under §1.1001-1(a) for other kinds of contracts.

b. *Discontinued IBOR*

Section 1.1001-6(h)(4) of the Final Regulations defines "discontinued IBOR," a term not used in the Proposed Regulations. Sections 1.860G-1(e) and 1.1275-2(m) of the Final Regulations also incorporate this definition. Under this new definition, a discontinued IBOR is generally an IBOR that will be discontinued, and an IBOR ceases to be a discontinued IBOR a year after the IBOR's discontinuation. The purpose of this new definition is to tailor the relief provided in the Final Regulations to better match the problem that the Final Regulations are intended to address.

One commenter requested that the Final Regulations apply when the parties to a contract modify the terms of the contract after the existing fallback provisions have already replaced all references to the IBOR with another rate. The commenter noted that, in the case of some widely held debt instruments, securing the consent of enough holders to modify the terms of the debt instrument may delay the modification so that the existing fallback provisions are triggered before the modification is complete. In such cases, the Proposed Regulations would not apply to the modification because the qualified rate would not be replacing an IBOR-based rate. The purpose of the Final Regulations is to facilitate the transition away from discontinued IBORs in order to avoid the market disruption that may occur if parties to contracts referencing discontinued IBORs fail to transition before the discontinued IBOR ceases. The change suggested by the commenter is not necessary to achieve this purpose. Moreover, the discontinuation of the most commonly used tenors of USD LIBOR has been deferred until June 30, 2023, giving parties to contracts such as those described by the commenter an additional 18 months to act. Accordingly, the Final Regulations do not adopt this comment.

As discussed in the section of this preamble entitled *Discontinuation of LIBOR and Tax Implications*, the ICE Benchmark Administration will continue to publish synthetic GBP LIBORs and synthetic JPY LIBORs for a limited time after December 31, 2021, and may publish synthetic USD LIBORs for a limited time after June 30, 2023. The Treasury Department and the IRS have determined that, for purposes of the Final Regulations, these synthetic LIBORs are a continuation of the currency and tenor variant of LIBOR that they succeed. Thus, for example, three-month sterling LIBOR became a discontinued IBOR on March 5, 2021, the date on which the ICE Benchmark Administration announced that it would permanently cease to publish three-month sterling LIBOR, and will cease to be a discontinued IBOR one year after the date on which the ICE Benchmark Administration ceases to publish the three-month tenor of synthetic GBP LIBOR.

c. *Qualified rate*

The definition of "qualified rate" in §1.1001-6(b) of the Proposed Regulations generally includes three elements: (1) the putative qualified rate must appear on a list of rates eligible to be a qualified rate in §1.1001-6(b)(1); (2) the fair market values of the contract before and after the modification involving the putative qualified rate must be substantially equivalent under §1.1001-6(b)(2); and (3) the interest rate benchmark to which the putative qualified rate refers and the relevant IBOR generally must be based on the same currency under §1.1001-6(b)(3). The fair market value requirement is addressed in more detail in the section of this preamble entitled *Fair market value requirement and excluded modifications*.

One commenter recommended streamlining the list of rates that are eligible to be a "qualified rate" in §1.1001-6(b)(1) of the Proposed Regulations. The commenter pointed out that §1.1001-6(b)(1)(x) of the Proposed Regulations generally includes qualified floating rates without regard to the limitations on multiples and that the interest rate benchmarks listed in §1.1001-6(b)(1)(i) through (viii) of the Proposed Regulations are merely examples of qualified floating rates. In response, the Treasury Department and the IRS have merged §1.1001-6(b)(1)(i) through (viii) and (x) of the Proposed Regulations into a single entry in §1.1001-6(h)(3)(ii)(A) of the Final Regulations, which includes a non-exclusive list of rates that are generally qualified floating rates, such as the Secured Overnight Financing Rate published by the Federal Reserve Bank of New York (SOFR), the Sterling Overnight Index Average, the Tokyo Overnight Average Rate, the Swiss Average Rate Overnight, and the euro short-term rate administered by the European Central Bank.

This commenter also suggested that §1.1001-6(b)(1)(xi) of the Proposed Regulations, which describes any rate determined by reference to another rate included in the list of eligible rates, is unnecessary because any rate described in that paragraph is also described in §1.1001-6(b)(1)(x) of the Proposed Regulations, which is any qualified floating rate without regard to the limitations on multiples. However, certain IBOR-based objective rates (as defined in §1.1275-5(c)) and certain IBOR-based rates on contingent payment debt instruments (within the meaning of §1.1275-4) may not be described in §1.1001-6(b)(1)(x) of the Proposed Regulations. Accordingly, the Final Regulations do not adopt this comment and retain both §1.1001-6(b)(1)(x) and (xi) of the Proposed Regulations in the list of eligible rates at §1.1001-6(h)(3)(ii)(A) and (D) of the Final Regulations, respectively.

Other commenters suggested that the list of rates that are eligible to be qualified rates in the Proposed Regulations be expanded to include any rate identified by the ARRC or ISDA as a replacement for an IBOR. The Treasury Department and the IRS have concluded that allowing any purely private organizations the authority to add to the list of rates eligible to be qualified rates would be inconsistent with the carefully circumscribed degree and manner in which the Final Regulations authorize taxpayers to depart from the ordinary tax rules. Accordingly, the Final Regulations extend such authority only to the ARRC and only for as long as the Federal Reserve Bank of New York continues to be an ex officio member of the ARRC.

One commenter recommended that the currency element of the definition of qualified rate in §1.1001-6(b)(3) of the Proposed Regulations be removed. After stating that a qualified rate under the Proposed Regulations must generally be a qualified floating rate, the commenter reasoned that the currency requirement in the definition of qualified rate is unnecessary because that requirement is already built into the

definition of qualified floating rate under §1.1275-5(b). The Final Regulations do not adopt this comment because a qualified rate under the Final Regulations is not required to be a qualified floating rate. For example, an objective rate based on a qualified floating rate may be described in §1.1001-6(h)(3)(ii)(D) of the Final Regulations but not in §1.1001-6(h)(3)(ii)(A) of the Final Regulations. Also, although the currency requirements in §1.1001-6(h)(3)(i) of the Final Regulations and §1.1275-5(b) may overlap in many cases, these requirements are not identical. The currency requirement for qualified rates in the Final Regulations requires that the discontinued IBOR and the interest rate benchmark included in the qualified rate be based on the same currency, whereas the currency requirement for qualified floating rates in §1.1275-5(b) requires that the currency on which the qualified floating rate is based match the currency in which the debt instrument is denominated.

The definition of qualified rate has also been amended in the Final Regulations in response to public comments that identify gaps in how the definition of qualified rate in the Proposed Regulations applies to covered modifications that involve the addition or amendment of fallback provisions. In particular, commenters asked how the definition of qualified rate applies when a contract is modified to include a waterfall of fallback rates, the individual tiers of which may not independently satisfy the definition of qualified rate. Commenters also asked how the definition of qualified rate applies to a fallback rate that will be determined on the date that the fallback rate is triggered and cannot be determined on the date of the modification by which that fallback rate is added to the contract.

The Final Regulations address these comments by providing a series of rules in §1.1001-6(h)(3)(i) and (iii) for determining whether a fallback rate or a collection of fallback rates meet the definition of a qualified rate. Section 1.1001-6(h)(3)(i) of the Final Regulations provides that a single qualified rate may be comprised of more than one fallback rate, such as when the parties add a fallback waterfall. In other words, this rule treats a waterfall of fallbacks as a unit and evaluates that unit to determine if it is a qualified rate. Thus, if the waterfall is designed so that each tier replaces the preceding tier when triggered (for example, when USD LIBOR ceases, USD LIBOR is replaced by the first tier of the waterfall and, if the first tier of the waterfall ceases, that first tier is replaced by the second tier), the entire waterfall is treated as a fallback to a discontinued IBOR even though, as a technical matter, only the first tier of the waterfall is a fallback to the discontinued IBOR. Section 1.1001-6(h)(3)(iii)(A) of the Final Regulations generally provides that, when a collection of fallback rates is added to the contract (for example, a fallback waterfall), that collection of fallback rates is a qualified rate only if each individual fallback rate in the collection meets the requirements to be a qualified rate. Sections 1.1001-6(h)(3)(iii)(B) and (C) of the Final Regulations apply for purposes of determining whether an individual fallback rate (regardless of whether that fallback rate was added to the contract individually or the fallback rate was added as a collection of fallback rates and is being tested individually under §1.1001-6(h)(3)(iii)(A) of the Final Regulations) meets the requirements to be a qualified rate. Under §1.1001-6(h)(3)(iii)(B) of the Final Regulations, a fallback rate is treated as not meeting the requirements to be a qualified rate if the contractual terms that comprise the fallback rate do not ensure at the time of the modification that the fallback rate will meet the requirements to be a qualified rate identified in the first sentence of §1.1001-6(h)(3)(i) of the Final Regulations when the fallback rate is triggered. Under §1.1001-6(h)(3)(iii)(C) of the Final Regulations, a fallback rate is treated as meeting the requirements to be a qualified rate if the likelihood that it will ever be triggered is remote. If §1.1001-6(h)(3)(iii)(B) and (C) of the Final Regulations both apply to a given fallback rate, the rule in §1.1001-6(h)(3)(iii)(C) takes priority over the rule in §1.1001-6(h)(3)(iii)(B). Examples in §1.1001-6(h)(3)(iv) of the Final Regulations illustrate the operation of these rules for fallback rates.

d. *Associated modifications*

The Proposed Regulations generally define an associated modification as a modification that is both associated with the replacement of an IBOR-based rate or the inclusion of fallbacks to an IBOR-based rate and that is reasonably necessary to adopt or to implement that replacement or inclusion. Section 1.1001-6(h)(5) of the Final Regulations generally defines an associated modification similarly but eliminates the requirement that an associated modification be "associated with" such a replacement or inclusion because any modification that is reasonably necessary to adopt or to implement the replacement or inclusion is necessarily associated with that replacement or inclusion.

The definition of "associated modification" in the Proposed Regulations also includes a "one-time payment," which is generally defined as a payment to offset the change in value of the contract that results from replacing an IBOR-based rate with a qualified rate. One commenter asked whether certain cash payments can qualify as associated modifications even if they do not qualify as one-time payments. For example, if the parties to an interest rate swap agree to replace USD LIBOR with a replacement rate comprised of a compounded average of SOFR (computed in arrears using a two-day observation period shift without payment lag) and a fixed adjustment spread, one party might also agree to make an incidental cash payment to compensate the counterparty for small valuation differences between the pre-modification LIBOR-based contract and the post-modification SOFR-based contract, such as the valuation differences resulting from the difference in observation period. The Treasury Department and the IRS have concluded that including such limited payments within the definition of an associated modification would further the policy goal of the Final Regulations to facilitate the transition away from discontinued IBORs. Accordingly, the definition of "associated modification" in §1.1001-6(h)(5) of the Final Regulations includes an incidental cash payment intended to compensate a counterparty for small valuation differences resulting from a modification of the administrative terms of a contract, such as the valuation differences resulting from a change in observation period. The Treasury Department and the IRS caution, however, that a payment of an amount that is not incidental cannot qualify as an associated modification.

e. *Qualified one-time payments*

The Proposed Regulations provide that a "one-time payment," generally defined as a payment to offset the change in value of the contract that results from replacing an IBOR-based rate with a qualified rate, may be an associated modification. To improve readability and clarity, the Final Regulations redesignate "one-time payments" as "qualified one-time payments" and define the new term in a standalone definition rather than as a kind of associated modification.

Commenters asked whether the Proposed Regulations cap the amount of a one-time payment and described certain abuses that may result if the amount of the payment is not limited in some way. To clarify the intent of the Proposed Regulations and to prevent excessive payments from satisfying the definition of qualified one-time payments, the Final Regulations generally limit a qualified one-time payment to the amount intended to compensate for the basis difference between the discontinued IBOR and the interest rate benchmark to which the qualified rate refers. Any portion in excess of that cap is a noncovered modification.

f. *Fair market value requirement and excluded modifications*

The Proposed Regulations generally require that the fair market value of the modified contract be substantially equivalent before and after the modification. The Proposed Regulations provide two safe harbors to the fair market value requirement: the historical average safe harbor and the arm's length safe harbor. Under the historical average safe harbor, the fair market value requirement is generally satisfied if, on the date of the modification, the historical average of the IBOR-based rate is within 25 basis points of the historical average of the putative qualified rate. To qualify for the arm's length safe harbor, the parties to the contract generally must not be related under §267(b) or §707(b)(1), must conduct bona fide, arm's length negotiations, and must determine based on those negotiations that the fair market value requirement is satisfied. The Treasury Department and the IRS received many public comments identifying practical problems and technical issues with the fair market value requirement and its two safe harbors. In response to these public comments, the Treasury Department and the IRS have replaced the fair market value requirement with rules that describe specific modifications (the excluded modifications) and exclude those modifications from the definition of covered modification. These excluded modifications are described in §1.1001-6(j)(1) through (5) of the Final Regulations.

One significant purpose of the fair market value requirement in the Proposed Regulations is to ensure that the modifications to the cash flows of an IBOR-referencing contract are intended to address the replacement of the IBOR-based rate in the contract. Because the excluded modifications replace the fair market value requirement, each of the excluded modifications described in §1.1001-6(j)(1) through (5) of the Final Regulations involves modifying the contract in a way that changes the amount or timing of contractual cash flows.

In addition to a change in cash flows, each of the excluded modifications also describes a particular purpose or intent of the parties making the modification. Section 1.1001-6(j)(1) of the Final Regulations generally describes a situation in which the parties to a contract change the contractual cash flows to induce one or more of the parties to perform any act necessary to consent to a covered modification of the contract. Example 3 in §1.1001-6(j)(6)(iii) illustrates the operation of §1.1001-6(j)(1). Section 1.1001-6(j)(2) of the Final Regulations generally describes a situation in which the parties to a contract agree to a contemporaneous noncovered modification of that contract that does not necessarily change contractual cash flows and, in consideration for that change, also agree to change contractual cash flows. Example 5 in §1.1001-6(j)(6)(v) illustrates the operation of §1.1001-6(j)(2). Section 1.1001-6(j)(3) of the Final Regulations generally describes a situation in which one party to a contract is experiencing financial distress and another party either makes a concession to or secures a concession from the distressed party in the form of a change in contractual cash flows. Example 6 in §1.1001-6(j)(6)(vi) illustrates the operation of §1.1001-6(j)(3). Section 1.1001-6(j)(4) of the Final Regulations generally describes a situation in which the parties to a contract agree to change contractual cash flows on that contract as consideration for some extra-contractual arrangement. Example 7 in §1.1001-6(j)(6)(vii) illustrates the operation of §1.1001-6(j)(4). Section 1.1001-6(j)(4) of the Final Regulations also includes a special rule that applies when the parties make an aggregate qualified one-time payment on a portfolio of modified contracts. In that case, the portion of the qualified one-time payment allocable to any one contract in the portfolio is treated as not intended to compensate for any changes in rights or obligations under any other contract in the portfolio.

In §1.1001-6(j)(5) of the Final Regulations, the Treasury Department and the IRS reserve the authority to expand this list of excluded modifications in guidance published in the Internal Revenue Bulletin. To exercise this authority, the Treasury Department and the IRS must conclude that the modification to be described in such guidance has a principal purpose of achieving a result that is unreasonable in light of the purpose of §1.1001-6. The Treasury Department and the IRS have concluded that this reservation of authority is necessary to prevent any unforeseen abuses of the significant flexibility granted to taxpayers in the Final Regulations. However, the Treasury Department and the IRS anticipate that any such guidance would be prospective in effect.

g. *Rev. Proc. 2020-44*

In Rev. Proc. 2020-44, the Treasury Department and the IRS provided rules that overlap with certain of the rules in the Final Regulations. Like §1.1001-6(b)(1) of the Final Regulations, section 5.01 of Rev. Proc. 2020-44 provides that a modification within the scope of the revenue procedure is not treated as an exchange of property for other property differing materially in kind or extent for purposes of §1.1001-1(a). And like §1.1001-6(c)(1)(iii) and (c)(2) of the Final Regulations, section 5.02 of Rev. Proc. 2020-44 generally provides that a modification within the scope of the revenue procedure will not result in legging out of an integrated transaction or terminating either leg of a

hedging transaction. Section 4.02 of Rev. Proc. 2020-44 generally limits the scope of the revenue procedure to modifications to a contract to incorporate certain fallback provisions published by the ARRC or ISDA, labeled the "ARRC Fallbacks" and the "ISDA Fallbacks" by the revenue procedure. The parties modifying a contract under Rev. Proc. 2020-44 may also deviate in certain limited ways from the ARRC and ISDA Fallbacks. The Treasury Department and the IRS noted that the scope of the revenue procedure may be expanded in subsequent guidance published in the Internal Revenue Bulletin to address developments in the transition away from IBORs. The revenue procedure applies to modifications that occur on or after October 9, 2020, and before January 1, 2023, although the parties to a contract may rely on the revenue procedure for modifications that occur before October 9, 2020.

In the definition of covered modification in §1.1001-6(h)(1), the Final Regulations generally provide that a modification described in section 4.02 of Rev. Proc. 2020-44 is treated as a covered modification. A modification described in section 4.02 of Rev. Proc. 2020-44 is treated as a covered modification even if the revenue procedure does not apply to that modification, for example, because the modification occurs after the revenue procedure's sunset date of December 31, 2022. The effect of this provision is that the rules in §§1.1001-6(b) through (g) and 1.860G-1(e), which rely on the definition of covered modification in §1.1001-6(h)(1), apply to modifications described in section 4.02 of Rev. Proc. 2020-44. Because of the substantive overlap between the rules in §1.1001-6(b) and (c) of the Final Regulations and the rules in section 5 of Rev. Proc. 2020-44, it is possible for a single modification to be subject to both sets of rules. As a practical matter, however, the rules in §1.1001-6(b) and (c) of the Final Regulations are consistent with the rules in section 5 of Rev. Proc. 2020-44, so no conflict is expected to arise.

Prior to the release of Rev. Proc. 2020-44, several commenters recommended that the Final Regulations accommodate the fallback provisions published by the ARRC and ISDA. For example, one commenter recommended that the Final Regulations provide that a modification to incorporate the ARRC's or ISDA's fallback provisions or fallback provisions substantially similar to the ARRC's or ISDA's fallback provisions is not an exchange of property under section 1001. Rev. Proc. 2020-44 and its incorporation into the definition of covered modification in the Final Regulations address these comments.

2. *Integrated Transactions and Hedging Transactions*

Section 1.1001-6(c) of the Proposed Regulations generally provides that the modification of a contract to replace an IBOR-based rate with a qualified rate is not treated as legging out of a transaction integrated under §1.1275-6, §1.988-5(a), or §1.148-4(h), provided that the components of the transaction continue to qualify for integration after the modification. That section also generally provides that the modification of a contract to replace an IBOR-based rate with a qualified rate is not treated as a disposition or termination of either leg of a hedging transaction under §1.446-4(e)(6). One commenter stated that, because §1.446-4 refers to §1.1221-2(b) for the definition of "hedging transaction" and because a hedging transaction and the hedged item must be identified as provided in §1.1221-2(f), the inclusion in the Proposed Regulations of a rule for §1.446-4 may justify a negative inference that a similar rule is required to avoid reidentification under §1.1221-2(f). The Treasury Department and the IRS have concluded that §1.1001-6(b)(1) of the Final Regulations, which provides that a covered modification of either a hedging transaction or the hedged item is not treated as an exchange of property for other property differing materially in kind or in extent for purposes of §1.1001-1(a), is sufficient to ensure that neither the hedging transaction nor the hedged item, as modified by the covered modification, needs to be reidentified under §1.1221-2(f).

The same commenter noted that §1.1001-6(c) of the Proposed Regulations does not include modifications to add or amend fallback provisions and recommended that the Final Regulations clarify whether the rules in that section apply to such modifications. The commenter further stated that, if a debt instrument and a hedge that reference the same ceasing IBOR are integrated under §1.1275-6 and the parties' covered modifications of the two instruments result in the fallback provisions being slightly mismatched either in timing (that is, the fallbacks have slightly different triggers) or amount (that is, the fallback rates are slightly different), that mismatch of the fallback provisions could cause a leg out of the integrated transaction even before either fallback provision is triggered. The commenter recommended that such mismatched fallback provisions not cause a leg out of an integrated transaction under §1.1275-6, §1.988-5(a), or §1.148-4(h). In response to these comments, §1.1001-6(c) of the Final Regulations applies to a covered modification, which is generally defined to include the addition or amendment of fallback provisions. Also, §1.1001-6(c)(2) of the Final Regulations generally provides that a covered modification that adds or amends fallback provisions is treated as not legging out of a transaction integrated under §1.1275-6, §1.988-5(a), or §1.148-4(h). The Treasury Department and the IRS caution, however, that any mismatch in the fallback provisions of the components of a transaction integrated under §1.1275-6, §1.988-5(a), or §1.148-4(h) may result in legging out when one or more of those fallback provisions are triggered. In that case, a taxpayer would first determine whether the rules in §1.1001-6(c)(1) of the Final Regulations apply to any modification that results from the triggered fallback provisions.

Several commenters raised questions about the Proposed Regulations' requirement that, to avoid legging out under §1.1275-6, §1.988-5(a), or §1.148-4(h), the integrated hedge must continue to qualify as a §1.1275-6 hedge, a §1.988-5(a) hedge, or a qualified hedge, respectively, after the modification. Two commenters asserted that certain minor mismatches between the modified terms of the components will inevitably arise (either because of minor differences in the modified terms or because the components are not modified at the same time) and that such mismatches may prevent the modified contracts from qualifying for continued integration under §1.1001-

6(c) of the Proposed Regulations. These commenters recommended that, if under the Final Regulations a modification is not treated as an exchange of property for purposes of section 1001, that modification also not be treated as legging out of an integrated transaction under §1.1275-6 or §1.988-5(a), regardless of whether the modified contracts would otherwise continue to qualify for integration. Alternatively, these commenters recommended that the Final Regulations provide a grace period during which the modified components of the integrated transaction do not have to meet the qualifications for integration. The Final Regulations adopt these commenters' alternative recommendation. Sections 1.1001-6(c)(1)(i), (ii), and (iv) of the Final Regulations provide a grace period during which a covered modification of a component of a transaction integrated under §1.1275-6, §1.988-5(a), or §1.148-4(h) does not result in legging out of that integrated transaction, notwithstanding any mismatch in timing or amount of payments that results from the covered modification during the grace period. The grace period lasts 90 days and starts on the date of the first covered modification of any component of the integrated transaction. If, however, the hedge component of the integrated transaction does not qualify as a §1.1275-6 hedge, a §1.988-5(a) hedge, or a qualified hedge under §1.148-4(h), as appropriate, by the end of the grace period, the covered modification is a legging out as of the date of the covered modification.

These commenters also observed that taxpayers may enter into temporary hedges, such as basis swaps, to manage the economic risk posed by temporary mismatches between the terms of the components of a transaction integrated under §1.1275-6 or §1.988-5(a). The commenters recommended that the Final Regulations accommodate the temporary integration of these hedges. The Final Regulations adopt this comment and provide that temporary hedges entered into to mitigate the economic effect of such temporary mismatches may be integrated during the 90-day grace period without disruption to a transaction integrated under §1.1275-6 or §1.988-5(a).

One commenter offered several comments that are specific to the rules in the Proposed Regulations on integration of tax-advantaged bonds under §1.148-4(h). This commenter recommended that the Final Regulations clarify that the rules in §1.1001-6(c) for integration of tax-advantaged bonds apply to a qualified hedge that is super-integrated under §1.148-4(h)(4). Section 1.148-4(h)(4) generally permits only negligible mismatches in timing and amount of payments on super-integrated hedges and bonds, and super-integration of taxable-index hedges, such as hedges based on IBORs, is even more strictly limited. Accordingly, the Treasury Department and the IRS do not adopt this comment, and the Final Regulations clarify that §1.1001-6(c)(1)(iv) does not apply to hedges and bonds integrated under §1.148-4(h)(4).

This commenter also requested that the Final Regulations provide that a one-time payment does not cause a hedge to fail to meet the requirements for qualification under §1.148-4(h)(3)(iv)(C), as required by §1.1001-6(c) of the Proposed Regulations. The nonperiodic nature of a one-time payment could prevent qualification under several of the requirements identified in §1.148-4(h)(3)(iv)(C), such as the requirement that the contract contain no significant investment element and the requirement that the payments on the hedge correspond closely in time to the payments on the hedged bonds. The Treasury Department and the IRS have determined that, in each case, the obstacle to qualification can be eliminated by treating the qualified one-time payment as a series of periodic payments spread over time. Accordingly, §1.1001-6(c)(1)(iv) of the Final Regulations provides that, solely for purposes of applying the qualification requirements identified in §1.148-4(h)(3)(iv)(C), a qualified one-time payment on the hedge or the hedged bonds is allocated in a manner consistent with the way in which a termination payment on a variable yield issue is allocated under §1.148-4(h)(3)(iv)(H) and the qualification requirements under §1.148-4(h)(3)(iv)(C) are applied as if the qualified one-time payment were a series of periodic payments.

3. *Fast-Pay Stock*

Section 1.7701(l)-3 provides rules that prevent the avoidance of tax by persons participating in fast-pay arrangements. A fast-pay arrangement is defined in §1.7701(l)-3(b)(1) as any arrangement in which a corporation has fast-pay stock outstanding for any part of its taxable year. Fast-pay stock is defined in §1.7701(l)-3(b)(2)(i) as stock structured so that dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment). Section 1.7701(l)-3(b)(2)(ii) provides that the determination of whether stock is fast-pay stock is based on all facts and circumstances. Stock is examined when it is issued to determine if it is fast-pay stock and, "for stock that is not fast-pay stock when issued, when there is a significant modification in the terms of the stock or the related agreements or a significant change in the relevant facts and circumstances." Id.

One commenter stated that, in certain circumstances, a covered modification of preferred stock could cause the stock to satisfy the definition of fast-pay stock despite the fact that the parties modified the stock not for the purpose of avoiding tax, but rather for the purpose of addressing the discontinuation of an IBOR. Because stock is re-examined to determine if it is fast-pay stock upon the occurrence of either "a significant modification in the terms of the stock or the related agreements" or "a significant change in the relevant facts and circumstances," the commenter recommended that the Final Regulations provide that a covered modification is neither a significant modification nor a significant change for this purpose.

The Treasury Department and the IRS have determined that such a rule would further the purpose of the Final Regulations to facilitate the transition away from IBORs that will be discontinued. In addition, the scope and operation of the recommended rule are generally consistent with the scope and operation of the rules in §§1.1001-6(b)(1) and (d) of the Final Regulations (treatment of covered modifications under section 1001 and under chapter 4, respectively). Accordingly, the Final Regulations adopt this comment and provide in §1.1001-6(e) that a covered modification of stock is not a significant modification in the terms of the stock or

the related agreements or a significant change in the relevant facts and circumstances for purposes of §1.7701(l)-3(b)(2)(ii). Unlike §§1.1001-6(b)(1) and (d) of the Final Regulations, however, §1.1001-6(e) of the Final Regulations further provides that, if a covered modification and a noncovered modification are made at the same time or as part of the same plan and the noncovered modification is a significant modification in the terms of the stock or the related agreements or a significant change in the relevant facts and circumstances, then §1.7701(l)-3(b)(2)(ii) applies and all of the facts and circumstances, including the covered modification and the noncovered modification, are considered in determining whether the stock is fast-pay stock.

4. *Investment Trusts under §301.7701-4(c)(1)*

Under §301.7701-4(c)(1), an investment trust is not classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. One commenter recommended that a covered modification of the income-apportioning terms of an ownership interest be treated as not manifesting a power to vary the investment of certificate holders in a trust under §301.7701-4(c)(1). The Final Regulations adopt this comment, providing in §1.1001-6(f) that neither a covered modification of a contract held by an investment trust nor a covered modification of an ownership interest in the investment trust manifest a power to vary the investment of the certificate holder for this purpose.

5. *Rules Regarding Qualified One-Time Payments*

The Proposed Regulations generally provide in §1.1001-6(d) that the character and source of a one-time payment made by a given payor is the same as the source and character of a payment under the contract by that payor. For example, a one-time payment by a lessee on a lease is characterized as a payment of rent and sourced accordingly. The Treasury Department and the IRS received several comments requesting clarification on how this rule applies to certain financial contracts. Several commenters also requested clarification on the timing of tax items associated with a one-time payment. One commenter requested guidance on how a one-time payment is treated for purposes of the arbitrage investment restrictions and private use restrictions that apply to tax-advantaged bonds. The Treasury Department and the IRS are still considering how best to address these issues relating to qualified one-time payments. Until the Treasury Department and the IRS publish further guidance, taxpayers may continue to rely on the rule in §1.1001-6(d) of the Proposed Regulations to determine source and character of a qualified one-time payment under the Final Regulations.

6. *REMICs*

Section 1.860G-1(e) of the Proposed Regulations provides special rules applicable to REMICs that have issued interests with an IBOR-based rate or that hold obligations with an IBOR-based rate. Section 1.860G-1(e)(4) of the Proposed Regulations provides certain rules addressing the treatment of reasonable costs incurred to effect a modification that qualifies for special treatment under §1.1001-6(a)(1), (2), or (3) of the Proposed Regulations. One commenter noted that the governing documents for a REMIC may require tax opinions and rating agency confirmations in connection with the modifications contemplated in the Proposed Regulations and recommended that the Treasury Department and the IRS confirm that the costs of obtaining these materials are "reasonable costs" within the meaning of §1.860G-1(e)(4) of the Proposed Regulations. Whether a cost is reasonable depends upon the facts and circumstances relating both to the nature of the cost and the amount of the cost. However, the Treasury Department and the IRS generally agree that the costs of obtaining tax opinions and rating agency confirmations required by the governing documents for a REMIC are reasonable in nature.

7. *Interest Expense of a Foreign Corporation*

The Proposed Regulations provide in §1.882-5(d)(5)(ii)(B) that a foreign corporation that is a bank may elect to compute interest expense attributable to excess U.S.-connected liabilities using a yearly average of SOFR. One commenter stated that a yearly average of SOFR is not an equitable substitute for 30-day USD LIBOR, the rate that foreign banks are permitted to elect for this purpose under the existing regulations, because 30-day USD LIBOR is typically a higher rate than a yearly average of SOFR. This commenter recommended that, in lieu of SOFR, the Final Regulations either refer to a widely accepted interest rate benchmark that is more similar than SOFR to 30-day USD LIBOR or add a fixed adjustment spread to the yearly average of SOFR.

The Treasury Department and the IRS continue to study the appropriate rate to replace 30-day USD LIBOR for purposes of the published rate election under §1.882-5(d)(5)(ii)(B). In evaluating the appropriate replacement rate, the Treasury Department and the IRS will continue to balance the administrative convenience of providing taxpayers an election to use the annual published rate with the need for a replacement rate that more accurately reflects the taxpayer's borrowing costs. In providing taxpayers with an election to use a published rate, the Treasury Department and the IRS must ensure that the replacement rate does not overstate the amount of interest expense allocable to income that is effectively connected with the conduct of a U.S. trade or business. Until final regulations are published that replace the 30-day USD LIBOR election provided in §1.882-5(d)(5)(ii)(B), taxpayers may continue to apply either the general rule or the annual published rate election provided under §1.882-5(d)(5)(ii) to calculate interest on excess U.S.-connected liabilities. Taxpayers may also continue to rely on the rule in §1.882-5(d)(5)(ii)(B) of the Proposed Regulations and compute interest on excess U.S.-connected liabilities by computing a yearly average SOFR based on the rates published by the Federal Bank of New York for the taxable year. Although commenters provided some ideas on a rate that could be closer to a replacement for 30-day LIBOR (for example, a widely accepted interest rate benchmark or adding a fixed adjustment spread to the yearly average of SOFR), the Treasury Department and the IRS continue to request recommendations for a specific rate that would

be an appropriate replacement to 30-day LIBOR for computing interest expense on excess U.S.-connected liabilities for purposes of §1.882-5(d)(5)(ii)(B). The Treasury Department and the IRS anticipate issuing additional guidance addressing §1.882-5(d)(5)(ii)(B) before 30-day USD LIBOR is discontinued in 2023.

8. *Change of Accounting Method*

One commenter asked the Treasury Department and the IRS to address whether changing from an IBOR-based discount rate to a discount rate based on a different interest rate benchmark for the purpose of valuing securities under the mark-to-market rules in section 475 is a change in method of accounting that requires the consent of the Secretary under section 446(e). The commenter noted that this change may occur either at the time when the relevant IBOR is discontinued or in advance of that time in anticipation of the IBOR's discontinuation. To facilitate an orderly transition in connection with the discontinuation of IBORs and to treat changes from an IBOR-based discount rate in a consistent manner, the Treasury Department and the IRS will not treat a change from a discount rate that is based on a discontinued IBOR (as defined in §1.1001-6(h)(4) of the Final Regulations) to a discount rate that is a qualified rate for the purpose of valuing securities under the mark-to-market rules in section 475 as a change in method of accounting under section 446(e).

9. *Applicability Dates*

The Proposed Regulations under §§1.860G-1(e), 1.1001-6, and 1.1275-2(m) generally propose that the Final Regulations permit taxpayers to apply the Final Regulations retroactively, as authorized under section 7805(b)(7). However, the Proposed Regulations under §1.1001-6 propose that the Final Regulations require as a condition of a taxpayer's retroactive application that all the taxpayer's related parties also apply §1.1001-6 retroactively. One commenter requested that this requirement be more clearly stated, and the Final Regulations do so in §1.1001-6(k).

Another commenter observed that sections 267(b) and 707(b)(1), under which relatedness is determined for purposes of the applicability dates in the Proposed Regulations, do not effectively address governmental entities or tax-exempt entities described in section 501(c)(3). This commenter recommended that relatedness be determined for such entities under §1.150-1(b) and (e). The Treasury Department and the IRS agree with this comment and adopt the commenter's recommendation in §§1.1001-6(k) and 1.1275-2(m)(5) of the Final Regulations.

Effect on Other Documents

Rev. Proc. 2020-44, 2020-45 I.R.B. 991, is amplified.

Special Analyses

I. Regulatory Planning and Review—Economic Analysis

Executive Orders 12866 and 13563 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including (i) potential economic, environmental, and public health and safety effects, (ii) potential distributive impacts, and (iii) equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility.

These final regulations have been designated as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) (MOA) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these final regulations as economically significant under section 1(c) of the MOA.

A. Background, Need for the Final Regulations, and Economic Analysis of Final Regulations

A very large volume of U.S. financial products and contracts include terms or conditions that reference LIBOR or, more generally, IBORs. Concern about manipulation and a decline in the volume of the funding from which LIBOR is calculated led to recommendations for the development of alternatives to LIBOR that would be based on transactions in a more robust underlying market. In addition, on July 27, 2017, the U.K. Financial Conduct Authority, the U.K. regulator tasked with overseeing LIBOR, announced that all currency and term variants of LIBOR, including USD LIBOR, may be phased out after 2021 and not be published after that timeframe. The administrator of LIBOR, the ICE Benchmark Administration, announced on March 5, 2021, that publication of overnight, one-month, three-month, six-month, and 12-month USD LIBOR will cease immediately following the LIBOR publication on June 30, 2023, and that publication of all other currency and tenor variants of LIBOR will cease immediately following the LIBOR publication on December 31, 2021.

The ARRC, a group of stakeholders affected by the cessation of the publication of USD LIBOR, was convened to identify an alternative rate and to facilitate voluntary adoption of that alternative rate. The ARRC recommended SOFR as a potential replacement for USD LIBOR. Essentially all financial products and contracts that currently contain conditions or legal provisions that rely on LIBOR and other IBORs are expected to transition to SOFR or similar alternatives in the next few years. This transition will involve changes in debt, derivatives, and other financial contracts to adopt SOFR or other alternative reference rates. The ARRC has estimated that the total exposure to USD LIBOR was close to $200 trillion in 2016, of which approximately 95 percent were in over-the-counter derivatives. ARRC further notes that USD LIBOR is also referenced in several trillion dollars of corporate loans, floating-rate mortgages, and similar financial products. In the absence of further tax guidance, the vast majority of expected changes in such contracts could lead to the recognition of gains (or losses) in these contracts for U.S. income tax purposes and to correspondingly potentially large tax liabilities for their holders. To address this issue, the final regulations provide that changes in debt instruments, derivative contracts, and other affected contracts to replace

reference rates based on discontinued IBORs in a covered modification (both as defined in the final regulations) will not result in tax realization events under section 1001 and relevant regulations thereunder. For this purpose, a covered modification is generally the replacement of a discontinued IBOR with a qualified rate, provided that the replacement is not excluded under §1.1001-6(j)(1) through (5) of these final regulations (the excluded modifications). The excluded modifications ensure that a covered modification includes only modifications to the cash flows of an IBOR-referencing contract intended to address the replacement of the IBOR-based rate in the contract and that modifications of contracts in a manner that is intended to change the amount or timing of contractual cash flows for other reasons or purposes remain subject to the general rules in section 1001 and the regulations thereunder. The final regulations also provide corresponding guidance on hedging transactions and derivatives to the effect that taxpayers may modify the components of hedged or integrated transactions to replace discontinued IBORs in a covered modification without affecting the tax treatment of the hedges or underlying transactions.

In the absence of these final regulations, parties to contracts affected by the cessation of the publication of LIBOR would either suffer tax consequences to the extent that a change to the contract results in a tax realization event under section 1001 or attempt to find alternative contracts that avoid such a tax realization event, which may be difficult as a commercial matter. Both such options would be both costly and highly disruptive to U.S. financial markets. A large number of contracts may end up being breached, which may lead to bankruptcies or other legal proceedings. The types of actions that contract holders might take in the absence of these final regulations are difficult to predict because such an event is outside recent experience in U.S. financial markets. This financial disruption would be particularly unproductive because the economic characteristics of the financial products and contracts under the new rates would be essentially unchanged. Thus, there is no underlying economic rationale for a tax realization event.

The Treasury Department and the IRS project that these final regulations would avoid this costly and unproductive disruption. The Treasury Department and the IRS further project that these final regulations, by implementing the regulatory provisions requested by ARRC and taxpayers, will help facilitate the economy's adaptation to the cessation of LIBOR in a least-cost manner.

II. Regulatory Flexibility Act

It is hereby certified that the Final Regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6).

As discussed elsewhere in this preamble, the administrator of all currency and tenor variants of LIBOR has announced that publication of overnight, one-month, three-month, six-month, and 12-month USD LIBOR will cease on June 30, 2023, and that publication of all other currency and tenor variants of LIBOR will cease on December 31, 2021. Many contracts, including financial contracts such as debt instruments and derivative contracts, refer to LIBOR or another IBOR to determine the parties' rights and obligations under the contract. When parties to IBOR-referencing contracts modify those contracts in anticipation of the discontinuation of the referenced IBOR, that modification can be a tax realization event, giving rise to gain, loss, income, or deduction. That modification can also cause other unintended tax consequences.

The number of small entities potentially affected by the Final Regulations is unknown but could be substantial because entities of all sizes are parties to contracts that reference a discontinued IBOR. Although a substantial number of small entities is potentially affected by the Final Regulations, the Treasury Department and the IRS have concluded that the Final Regulations will not have a significant economic impact on a substantial number of small entities. This is because the purpose and effect of the Final Regulations is to minimize the economic impact of the transition away from LIBOR and other discontinued IBORs by preventing many of the tax consequences that might otherwise flow when taxpayers modify IBOR-referencing contracts in anticipation of the cessation of a discontinued IBOR. Furthermore, the Final Regulations do not impose a collection of information on any taxpayers, including small entities. Accordingly, the Final Regulations will not have a significant economic impact on a substantial number of small entities.

III. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The Final Regulations do not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

IV. Executive Order 13132: Federalism

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. The Final Regulations do not have federalism implications and do not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

V. Congressional Review Act

The Administrator of the Office of Information and Regulatory Affairs of the OMB has determined that this Treasury decision is a major rule for purposes of the Congressional Review Act (5 U.S.C. 801 et seq.) ("CRA"). Under section 801(3) of the CRA, a major rule takes effect 60 days after the rule is published in the Federal Register. Accordingly, the Treasury De-

partment and IRS are adopting the Final Regulations with the delayed effective date generally prescribed under the Congressional Review Act.

Drafting Information

The principal authors of these final regulations are Caitlin Holzem and Spence Hanemann of the Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the Treasury Department and the IRS participated in their development.

Availability of IRS Documents

The revenue procedure cited in this preamble is published in the Internal Revenue Bulletin (or Cumulative Bulletin) and is available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *https://www.irs.gov*.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for §1.860G-1 and adding an entry in numerical order for §1.1001-6 to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.860G-1 also issued under 26 U.S.C. 860G(a)(1)(B), (d)(2)(E), and (e).

* * * * *

Section 1.1001-6 also issued under 26 U.S.C. 148(i), 26 U.S.C. 988(d), 26 U.S.C. 1275(d), and 26 U.S.C. 7701(l).

* * * * *

Par. 2. Section 1.860A-0 is amended by adding entries for §1.860A-1(b)(6) and (7) and §1.860G-1(e) to read as follows:

§1.860A-0 Outline of REMIC provisions.

* * * * *

§1.860A-1 Effective dates and transition rules.

* * * * *

(b) * * *

(6) Exceptions for certain modified obligations.

(7) Exceptions for certain modifications of obligations that refer to certain interbank offered rates.

* * * * *

§1.860G-1 Definition of regular and residual interests.

* * * * *

(e) Transition from certain interbank offered rates.

(1) In general.

(2) Change in reference rate for a regular interest after the startup day.

(3) Contingencies of rate on a regular interest.

(4) Reasonable expenses incurred to make covered modifications.

* * * * *

Par. 3. Section 1.860A-1 is amended by adding paragraph (b)(7) to read as follows:

§1.860A-1 Effective dates and transition rules.

* * * * *

(b) * * *

(7) *Exceptions for certain modifications of obligations that refer to certain interbank offered rates*—(i) Paragraphs (e)(2) and (4) of §1.860G-1 apply with respect to a covered modification that occurs on or after March 7, 2022. However, paragraphs (e)(2) and (4) of §1.860G-1 may be applied with respect to a covered modification that occurs before March 7, 2022. See section 7805(b)(7).

(ii) Paragraph (e)(3) of §1.860G-1 applies to a regular interest in a REMIC issued on or after March 7, 2022. However, paragraph (e)(3) of §1.860G-1 may be applied to a regular interest in a REMIC issued before March 7, 2022. See section 7805(b)(7).

Par. 4. Section 1.860G-1 is amended by:

1. Removing "paragraph (b)(3)" in paragraph (a)(5) and adding in its place "paragraphs (b)(3) and (e)(4)".

2. Adding paragraph (e).

The addition reads as follows:

§1.860G-1 Definition of regular and residual interests.

* * * * *

(e) *Transition from certain interbank offered rates*—(1) *In general*. This paragraph (e) provides rules relating to the modification of the terms of a regular interest in a REMIC or the terms of an asset held by a REMIC as part of the transition away from the London Interbank Offered Rate and certain other interbank offered rates. For purposes of this paragraph (e), *covered modification* and *discontinued IBOR* have the meanings provided in §1.1001-6(h)(1) and (4), respectively. See §1.1001-6 for additional rules that may apply to an interest in a REMIC that provides for a rate referencing a discontinued IBOR.

(2) *Change in reference rate for a regular interest after the startup day*. A covered modification of a regular interest in a REMIC that occurs after the startup day is disregarded in determining whether the modified regular interest has fixed terms on the startup day under paragraph (a)(4) of this section.

(3) *Contingencies of rate on a regular interest*. An interest in a REMIC does not fail to qualify as a regular interest solely because it is subject to a contingency whereby a rate that references a discontinued IBOR and is a variable rate permitted under paragraph (a)(3) of this section may change to a fixed rate or a different variable rate permitted under paragraph (a)(3) of this section in anticipation of the discontinued IBOR becoming unavailable or unreliable.

(4) *Reasonable expenses incurred to make covered modifications*. An interest in a REMIC does not fail to qualify as a regular interest solely because it is subject to a contingency whereby the amount of payments of principal or interest (or other similar amounts) with respect to the interest in the REMIC is reduced by reasonable costs incurred to effect a covered modification. In addition, payment by a party other than the REMIC of reasonable costs incurred to effect a covered modification is not a contribution to the REMIC for purposes of section 860G(d).

Par. 5. Section 1.1001-6 is added to read as follows:

§1.1001-6 Transition from certain interbank offered rates.

(a) *In general*. This section provides rules relating to the modification of the terms of a contract as part of the transition away from the London Interbank Offered Rate and certain other interbank offered rates. In general, paragraphs (b) through (g) of this section provide the operative rules for a covered modification. Paragraph (h) of this section defines certain terms that are used in these operative rules, such as *covered modification*, *qualified rate*, *discontinued IBOR*, *associated modification*, and *qualified one-time payment*. Paragraph (j) of this section describes certain modifications that are not covered modifications and provides examples that illustrate the operation of the rules in paragraph (j) of this section. For rules regarding original issue discount on certain debt instruments that provide for a rate referencing a discontinued IBOR, see §1.1275-2(m). For rules regarding certain interests in a REMIC that provide for a rate referencing a discontinued IBOR, see §1.860G-1(e).

(b)*Treatment under section 1001*—(1) *Covered modifications*. A covered modification of a contract is not treated as the exchange of property for other property differing materially in kind or in extent for purposes of §1.1001-1(a). For example, if the terms of a debt instrument that pays interest at a rate referencing the U.S.-dollar London Interbank Offered Rate (USD LIBOR) are modified to provide that the debt instrument pays interest at a qualified rate referencing the Secured Overnight Financing Rate published by the Federal Reserve Bank of New York (SOFR) and the modification is not described in paragraph (j) of this section, the modification is not treated as the exchange of property for other property differing materially in kind or in extent for purposes of §1.1001-1(a).

(2) *Contemporaneous noncovered modifications*. If a covered modification is made at the same time as a noncovered modification, §1.1001-1(a) or §1.1001-3, as appropriate, applies to determine whether the noncovered modification results in the exchange of property for other property differing materially in kind or in extent. In applying §1.1001-1(a) or §1.1001-3 for this purpose, the covered modification is treated as part of the terms of the contract prior to the noncovered modification. For example, if the parties to a debt instrument modify the interest rate in a manner that is a covered modification and contemporaneously extend the final maturity date of the debt instrument, which is a noncovered modification, only the extension of the final maturity date is analyzed under §1.1001-3 and, for purposes of that analysis, the modified interest rate is treated as a term of the instrument prior to the extension of the final maturity date.

(c) *Effect of a covered modification on integrated transactions and hedging transactions*—(1) *In general*. Except as otherwise provided in paragraph (c)(2) of this section, the rules in paragraphs (c)(1)(i) through (iv) of this section determine the effect of a covered modification on an integrated transaction under §1.1275-6, a qualified hedging transaction under §1.988-5(a), a hedging transaction under §1.446-4, or a qualified hedging transaction under §1.148-4(h).

(i) A covered modification of one or more contracts that are part of an integrated transaction under §1.1275-6 is treated as not legging out of the integrated transaction, provided that, no later than the end of the 90-day period beginning on the date of the first covered modification of any such contract, the financial instrument that results from any such covered modifications satisfies the requirements to be a §1.1275-6 hedge (as defined in §1.1275-6(b)(2)) with respect to the qualifying debt instrument that results from any such covered modification. If a taxpayer enters into a financial instrument intended to mitigate the economic effect of a temporary mismatch of the legs of the integrated transaction during that 90-day period (a *§1.1275-6 interim hedge*), the integration of the §1.1275-6 interim hedge with the other components of the integrated transaction during the 90-day period is treated as not legging into a new integrated transaction and the termination of the §1.1275-6 interim hedge before the end of the 90-day period is treated as not legging out of the existing integrated transaction.

(ii) A covered modification of one or more contracts that are part of a qualified hedging transaction under §1.988-5(a) is treated as not legging out of the qualified hedging transaction, provided that, no later than the end of the 90-day period beginning on the date of the first covered modification of any such contract, the financial instrument or series or combination of financial instruments that results from any such covered modifications satisfies the requirements to be a §1.988-5(a) hedge (as defined in §1.988-5(a)(4)) with respect to the qualifying debt instrument that results from any such covered modification. If a taxpayer enters into a financial instrument intended to mitigate the economic effect of a temporary mismatch of the legs of the qualified hedging transaction during that 90-day period (a *§1.988-5(a) interim hedge*), the integration of the §1.988-5(a) interim hedge with the other components of the qualified hedging transaction during the 90-day period is treated as not legging into a new qualified hedging transaction and the termination of the §1.988-5(a) interim hedge before the end of the 90-day period is treated as not legging out of the existing qualified hedging transaction.

(iii) A covered modification of one leg of a transaction subject to the hedge accounting rules in §1.446-4 is not treated as a disposition or termination (within the meaning of §1.446-4(e)(6)) of either leg of the transaction.

(iv) A covered modification of a qualified hedge or of the tax-advantaged bonds with which the qualified hedge is integrated under §1.148-4(h)(1) is treated as not terminating the qualified hedge under §1.148-4(h)(3)(iv)(B), provided that, no later than the end of the 90-day period beginning on the date of the first covered modification of either the qualified hedge or the hedged bonds, the qualified hedge

that results from any such covered modification satisfies the requirements to be a qualified hedge (determined by applying the special rules for certain modifications of qualified hedges under §1.148-4(h)(3)(iv)(C)) with respect to the hedged bonds that result from any such covered modification. Solely for purposes of determining whether the qualified hedge that results from a covered modification satisfies the requirements to be a qualified hedge with respect to the hedged bonds that result from any such covered modification in the preceding sentence, a qualified one-time payment with respect to the hedge or the hedged bonds (or both) is allocated in a manner consistent with the allocation of a termination payment for a variable yield issue under §1.148-4(h)(3)(iv)(H) and treated as a series of periodic payments. This paragraph (c)(1)(iv) does not apply if, prior to any covered modifications, the qualified hedge and the tax-advantaged bond are integrated under §1.148-4(h)(4).

(2) *Fallback rates*. If a covered modification of a contract that is part of an integrated transaction under §1.1275-6 is described in paragraph (h)(1)(ii) or (iii) of this section, that covered modification is treated as not legging out of the integrated transaction. If a covered modification of a contract that is part of a qualified hedging transaction under §1.988-5(a) is described in paragraph (h)(1)(ii) or (iii) of this section, that covered modification is treated as not legging out of the qualified hedging transaction. If a covered modification of a qualified hedge or of the tax-advantaged bonds with which the qualified hedge is integrated under §1.148-4(h) is described in paragraph (h)(1)(ii) or (iii) of this section, that covered modification is treated as not terminating the qualified hedge under §1.148-4(h)(3)(iv)(B).

(d) *Coordination with provision for existing obligations under chapter 4*. A modification of a contract is not a material modification of that contract for purposes of §1.1471-2(b)(2)(iv) to the extent the modification is a covered modification. See paragraph (b)(2) of this section for rules that apply for purposes of §1.1471-2(b)(2)(iv) when a modification to a contract includes both a covered modification and a contemporaneous noncovered modification.

(e) *Coordination with fast-pay stock rules*. A covered modification of stock is not a significant modification in the terms of the stock or the related agreements or a significant change in the relevant facts and circumstances for purposes of §1.7701(l)-3(b)(2)(ii). If a covered modification is made at the same time as, or as part of a plan that includes, a noncovered modification and the noncovered modification is a significant modification in the terms of the stock or the related agreements or a significant change in the relevant facts and circumstances, then §1.7701(l)-3(b)(2)(ii) applies to determine whether the stock is fast-pay stock, taking into account all the facts and circumstances (including both the covered and noncovered modification).

(f) *Coordination with rules for investment trusts*. A covered modification of a contract held by an investment trust does not manifest a power to vary the investment of the certificate holders for purposes of §301.7701-4(c)(1) of this chapter. Further, a covered modification of an ownership interest in an investment trust does not manifest a power to vary the investment of the certificate holder for purposes of §301.7701-4(c)(1) of this chapter.

(g) [Reserved]

(h) *Definitions*—(1) *Covered modification*. A *covered modification* is a modification or portion of a modification of the terms of a contract that is described in one or more of paragraphs (h)(1)(i) through (iii) of this section and that is not described in any of paragraphs (j)(1) through (5) of this section. Any modification of the terms of a contract described in section 4.02 of Rev. Proc. 2020-44, 2020-45 I.R.B. 991, or described in other guidance published in the Internal Revenue Bulletin that supplements the list of modifications described in section 4.02 of Rev. Proc. 2020-44 or the definitions on which that section relies (see §601.601(d)(2)(ii)(a) of this chapter) is treated as a covered modification. For purposes of this section, a modification of the terms of a contract includes any modification of the terms of the contract, regardless of the form of the modification (for example, a modification may be an exchange of one contract for another, an amendment to the existing contract, or a modification accomplished indirectly through one or more transactions with third parties) and regardless of whether the modification is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. For purposes of this section, a contract includes but is not limited to a debt instrument, a derivative contract, stock, an insurance contract, and a lease agreement.

(i) The terms of the contract are modified to replace an operative rate that references a discontinued IBOR with a qualified rate, to add an obligation for one party to make a qualified one-time payment (if any), and to make associated modifications (if any).

(ii) The terms of the contract are modified to include a qualified rate as a fallback to an operative rate that references a discontinued IBOR and to make associated modifications (if any).

(iii) The terms of the contract are modified to replace a fallback rate that references a discontinued IBOR with a qualified rate and to make associated modifications (if any).

(2) *Noncovered modification*. A *noncovered modification* is any modification or portion of a modification of the terms of a contract that is not a covered modification.

(3) *Qualified rate*—(i) *In general*. A *qualified rate* is any of the rates described in paragraph (h)(3)(ii) of this section, provided that the interest rate benchmark to which the rate refers and the discontinued IBOR identified in paragraph (h)(1)(i), (ii), or (iii) of this section are based on transactions conducted in the same currency or are otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency. For purposes of paragraphs (h)(1)(ii) and (iii) of this section, a single qualified rate may be comprised of one or more fallback rates (for example, a waterfall of fallback rates). Paragraph (h)(3)(iii) of this section provides additional rules for determining whether one or more fallback rates constitute a qualified rate, and paragraph (h)(3)(iv) of this section provides examples illustrating the operation of those rules.

(ii) *Rates*. The following rates are described in this paragraph (h)(3)(ii):

(A) A qualified floating rate, as defined in §1.1275-5(b), but without regard to the limitations on multiples set forth

in §1.1275-5(b) (examples of qualified floating rates generally include SOFR, the Sterling Overnight Index Average, the Tokyo Overnight Average Rate, the Swiss Average Rate Overnight, and the euro short-term rate administered by the European Central Bank);

(B) An alternative, substitute, or successor rate selected, endorsed, or recommended by the central bank, reserve bank, monetary authority, or similar institution (including any committee or working group thereof) as a replacement for a discontinued IBOR or its local currency equivalent in that jurisdiction;

(C) A rate selected, endorsed, or recommended by the Alternative Reference Rates Committee as a replacement for USD LIBOR, provided that the Federal Reserve Bank of New York is an ex officio member of the Alternative Reference Rates Committee at the time of the selection, endorsement, or recommendation;

(D) A rate that is determined by reference to a rate described in paragraph (h)(3)(ii)(A), (B), or (C) of this section, including a rate determined by adding or subtracting a specified number of basis points to or from the rate or by multiplying the rate by a specified number; and

(E) A rate identified for purposes of this section as a qualified rate in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(a) of this chapter).

(iii) *Rules for fallback rates*—(A) *Multiple fallback rates*. If the rate being tested as a qualified rate is comprised of more than one fallback rate, the rate is a qualified rate only if each individual fallback rate separately satisfies the requirements to be a qualified rate.

(B) *Indeterminable fallback rate*. Except as provided in paragraph (h)(3)(iii)(C) of this section, if it is not possible to determine at the time of the modification being tested as a covered modification whether a fallback rate satisfies the requirements set forth in the first sentence of paragraph (h)(3)(i) of this section (for example, the calculation agent will determine the fallback rate at the time that the fallback rate is triggered based on factors that are not guaranteed to produce a rate described in paragraph (h)(3)(ii) of this section), the fallback rate is treated as not satisfying the requirements to be a qualified rate.

(C) *Fallback rate is a remote contingency*. If the likelihood that any value will ever be determined under the contract by reference to a fallback rate is remote (determined at the time of the modification being tested as a covered modification), that fallback rate is treated as satisfying the requirements to be a qualified rate.

(iv) *Examples*. The following examples illustrate the application of the rules in paragraphs (h)(3)(i) through (iii) of this section to qualified rates comprised of one or more fallback rates.

(A) *Example 1: Addition of a single fallback rate*—(*1*) *Facts*. B is the issuer and L is the holder of a debt instrument that pays interest semiannually in U.S. dollars at a rate of six-month USD LIBOR and that contains no fallback provisions to address the pending discontinuation of six-month USD LIBOR. On July 1, 2022, B and L modify the debt instrument to add such fallback provisions (the *new fallbacks*). The new fallbacks provide that, upon the discontinuation of six-month USD LIBOR, six-month USD LIBOR will be replaced by a fallback rate equal to CME Group's forward-looking SOFR term rate of a six-month tenor (*six-month CME Term SOFR*) plus a fixed spread that will be determined at the time of six-month USD LIBOR's discontinuation. Six-month USD LIBOR will be discontinued on June 30, 2023.

(*2*) *Analysis*. The fallback rate is a qualified floating rate and is, therefore, described in paragraph (h)(3)(ii)(A) of this section. Moreover, because both six-month USD LIBOR and six-month CME Term SOFR are based on transactions conducted in U.S. dollars, the fallback rate satisfies the currency requirement in paragraph (h)(3)(i) of this section. As further provided in paragraph (h)(3)(i) of this section, B and L must also apply the rules in paragraph (h)(3)(iii)(A), (B), and (C) of this section to determine if the fallback rate is a qualified rate. Because the rate being tested as a qualified rate (*i.e.*, the fallback rate) is comprised of only one fallback rate, paragraph (h)(3)(iii)(A) of this section has no effect. As discussed elsewhere in this paragraph (h)(3)(iv)(A)(*2*), it is evident at the time of the fallback rate's addition that the fallback rate satisfies the requirements set forth in the first sentence of paragraph (h)(3)(i) of this section, so paragraph (h)(3)(iii)(B) of this section has no effect. Because it appears likely at the time of the modification that the fallback rate will be used to determine interest on the debt instrument, paragraph (h)(3)(iii)(C) of this section has no effect. In summary, the fallback rate is described in paragraph (h)(3)(ii)(A) of this section and satisfies the currency requirement in paragraph (h)(3)(i) of this section, and none of the rules in paragraph (h)(3)(iii) of this section affect the analysis. Therefore, the fallback rate is a qualified rate.

(B) *Example 2: Addition of a single indeterminable fallback rate*—(*1*) *Facts*. The facts are the same as in paragraph (h)(3)(iv)(A)(*1*) of this section (*Example 1*), except that the new fallbacks provide that, upon the discontinuation of six-month USD LIBOR, B will select a replacement for six-month USD LIBOR based on the industry standard at the time of selection.

(*2*) *Analysis*. As provided in paragraph (h)(3)(i) of this section, B and L must apply the rule in paragraph (h)(3)(iii)(B) of this section to determine whether the fallback rate is a qualified rate. Because it is not possible to determine at the time of the fallback rate's addition in 2022 whether the fallback rate (*i.e.*, the replacement rate that B will select in 2023) satisfies the requirements set forth in the first sentence of paragraph (h)(3)(i) of this section, the fallback rate is treated as not satisfying the requirements to be a qualified rate under paragraph (h)(3)(iii)(B) of this section. Therefore, the fallback rate is not a qualified rate.

(C) *Example 3: Addition of a fallback waterfall that is a qualified rate*—(*1*) *Facts*. The facts are the same as in paragraph (h)(3)(iv)(A)(*1*) of this section (*Example 1*), except that the new fallbacks provide for a fallback waterfall. The first tier of the fallback waterfall provides that, upon the discontinuation of six-month USD LIBOR, six-month USD LIBOR will be replaced by a fallback rate equal to six-month CME Term SOFR plus a fixed spread that will be determined at the time of six-month USD LIBOR's discontinuation. The second tier of the fallback waterfall provides that, upon the discontinuation of six-month CME Term SOFR, B will select a replacement for the fallback rate in the first tier of the fallback waterfall based on the industry standard at the time of selection. At the time of the fallback waterfall's addition, the likelihood that six-month CME Term SOFR will be discontinued is remote.

(*2*) *Analysis of the fallback waterfall*. As provided in paragraph (h)(3)(i) of this section, B and L must apply the rules in paragraphs (h)(3)(iii)(A), (B) and (C) of this section to determine whether the fallback waterfall is a qualified rate. Under paragraph (h)(3)(iii)(A) of this section, because the rate being tested as a qualified rate (*i.e.*, the fallback waterfall) is comprised of more than one fallback rate, the fallback waterfall is a qualified rate only if each individual fallback rate (*i.e.*, fallback rates in the first and second tiers of the fallback waterfall) separately satisfies the requirements to be a qualified rate. As concluded in paragraphs (h)(3)(iv)(C)(*3*) and (*4*) of this section, the fallback rates in the first and second tiers of the fallback waterfall separately satisfy the requirements to be a qualified rate. Therefore, the fallback waterfall is a qualified rate.

(*3*) *Analysis of the first tier of the fallback waterfall*. Because the fallback rate in the first tier of the fallback waterfall is the same as the fallback rate in paragraph (h)(3)(iv)(A)(*1*) of this section (*Example 1*), the analysis of the fallback rate in the first tier of the fallback waterfall is the same as the analysis of the fallback rate in paragraph (h)(3)(iv)(A)(*2*) of this section (*Example 1*). Accordingly, the fallback rate in the first tier of the fallback waterfall separately satisfies the requirements to be a qualified rate.

(*4*) *Analysis of the second tier of the fallback waterfall*. The fallback rate in the second tier of the fallback waterfall is the same as the fallback rate in paragraph (h)(3)(iv)(B)(*1*) of this section (*Example 2*). However, unlike the fallback rate in paragraph (h)(3)(iv)(B)(*1*) of this section (*Example 2*), the likelihood that the amount of interest on the debt instrument will ever be determined by reference to the fall-

back rate in the second tier of the fallback waterfall is remote. Accordingly, under paragraph (h)(3)(iii)(C) of this section, the fallback rate in the second tier of the fallback waterfall is treated as satisfying the requirements to be a qualified rate.

(D) *Example 4: Addition of a fallback waterfall that is not a qualified rate—*(*1*) *Facts*. The facts are the same as in paragraph (h)(3)(iv)(A)(*1*) of this section (*Example 1*), except that the new fallbacks provide for a fallback waterfall. The first tier of the fallback waterfall provides that, upon the discontinuation of six-month USD LIBOR, six-month USD LIBOR will be replaced by a stated fallback rate (*Fallback Rate X*). Fallback Rate X, which is equal to an interest rate benchmark (*Benchmark X*) plus a fixed spread, satisfies the requirements set forth in the first sentence of paragraph (h)(3)(i) of this section. The second tier of the fallback waterfall provides that, upon the discontinuation of Benchmark X, B will select a replacement for Fallback Rate X based on the industry standard at the time of selection. At the time of the fallback waterfall's addition, the likelihood that Benchmark X will be discontinued is not remote.

(*2*) *Analysis of the fallback waterfall*. As provided in paragraph (h)(3)(i) of this section, B and L must apply the rules in paragraphs (h)(3)(iii)(A), (B) and (C) of this section to determine whether the fallback waterfall is a qualified rate. Under paragraph (h)(3)(iii)(A) of this section, because the rate being tested as a qualified rate (*i.e.*, the fallback waterfall) is comprised of more than one fallback rate, the fallback waterfall is a qualified rate only if each individual fallback rate (*i.e.*, the fallback rates in the first and second tiers of the fallback waterfall) separately satisfies the requirements to be a qualified rate. As concluded in paragraph (h)(3)(iv)(D)(*3*) of this section, the fallback rate in the second tier of the fallback waterfall is treated as not satisfying the requirements to be a qualified rate. Therefore, the fallback waterfall is not a qualified rate.

(*3*) *Analysis of the second tier of the fallback waterfall*. As provided in paragraphs (h)(3)(i) and (h)(3)(iii)(A) of this section, B and L must apply the rules in paragraphs (h)(3)(iii)(B) and (C) of this section to determine whether the fallback rate in the second tier of the fallback waterfall is a qualified rate. Because the likelihood that Benchmark X will be discontinued is not remote, paragraph (h)(3)(iii)(C) of this section has no effect on the analysis of the fallback rate in the second tier of the fallback waterfall. Under paragraph (h)(3)(iii)(B) of this section, because it is not possible to determine at the time of the fallback waterfall's addition in 2022 whether the fallback rate in the second tier of the fallback waterfall (*i.e.*, the replacement rate that B will select in 2023) satisfies the requirements set forth in the first sentence of paragraph (h)(3)(i) of this section, the fallback rate in the second tier of the fallback waterfall is treated as not satisfying the requirements to be a qualified rate.

(4) *Discontinued IBOR*. A *discontinued IBOR* is any interbank offered rate described in paragraph (h)(4)(i) or (ii) of this section but only during the period beginning on the date of the announcement described in paragraph (h)(4)(i) or (ii) of this section and ending on the date that is one year after the date on which the administrator of the interbank offered rate ceases to provide the interbank offered rate.

(i) The administrator of the interbank offered rate announces that the administrator has ceased or will cease to provide the interbank offered rate permanently or indefinitely, and no successor administrator is expected as of the time of the announcement to continue to provide the interbank offered rate; or

(ii) The regulatory supervisor for the administrator of the interbank offered rate, the central bank for the currency of the interbank offered rate, an insolvency official with jurisdiction over the administrator for the interbank offered rate, a resolution authority with jurisdiction over the administrator for the interbank offered rate, a court, or an entity with similar insolvency or resolution authority over the administrator for the interbank offered rate announces that the administrator of the interbank offered rate has ceased or will cease to provide the interbank offered rate permanently or indefinitely, and no successor administrator is expected as of the time of the announcement to continue to provide the interbank offered rate.

(5) *Associated modification*. An *associated modification* is a modification of the technical, administrative, or operational terms of a contract that is reasonably necessary to adopt or to implement the modifications described in paragraph (h)(1)(i), (ii), or (iii) of this section other than associated modifications. An associated modification also includes an incidental cash payment intended to compensate a counterparty for small valuation differences resulting from a modification of the administrative terms of a contract, such as the valuation differences resulting from a change in observation period. Examples of associated modifications include a change to the definition of interest period or a change to the timing and frequency of determining rates and making payments of interest (for example, delaying payment dates on a debt instrument by two days to allow sufficient time to compute and pay interest at a qualified rate computed in arrears).

(6) *Qualified one-time payment*. A *qualified one-time payment* is a single cash payment that is intended to compensate the other party or parties for all or part of the basis difference between the discontinued IBOR identified in paragraph (h)(1)(i), (ii), or (iii) of this section and the interest rate benchmark to which the qualified rate refers.

(i) [Reserved]

(j) *Modifications excluded from the definition of covered modification*. A modification or portion of a modification described in any of paragraphs (j)(1) through (5) of this section is excluded from the definition of covered modification in paragraph (h)(1) of this section and therefore is a noncovered modification.

(1) The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is intended to induce one or more parties to perform any act necessary to consent to a modification to the contract described in paragraph (h)(1)(i), (ii), or (iii) of this section. See paragraph (j)(6)(iii) of this section (*Example 3*).

(2) The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is intended to compensate one or more parties for a modification to the contract not described in paragraph (h)(1)(i), (ii), or (iii) of this section. See paragraph (j)(6)(v) of this section (*Example 5*).

(3) The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is either a concession granted to a party to the contract because that party is experiencing financial difficulty or a concession secured by a party to the contract to account for the credit deterioration of another party to the contract. See paragraph (j)(6)(vi) of this section (*Example 6*).

(4) The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is intended to compensate one or more parties for a change in rights or obligations that are not derived from the contract being modified. See paragraph (j)(6)(vii) of this section (*Example 7*). If each contract in a given portfolio of contracts has the same parties, those parties modify more than one contract in the portfolio (each such contract is a *modified portfolio contract*), and those modifications provide for a single, aggregate qualified one-time payment with respect to all modified portfolio contracts, then the portion of the qualified one-time payment allocable to any one modified portfolio contract is treated for purposes of this paragraph (j)(4) as

not intended to compensate for a change in rights or obligations derived from any other modified portfolio contract.

(5) The terms of the contract are modified to change the amount or timing of contractual cash flows and the modification is identified for purposes of this paragraph (j)(5) in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(a) of this chapter) as having a principal purpose of achieving a result that is unreasonable in light of the purpose of this section.

(6) *Examples*. The following examples illustrate the operation of the rules in paragraphs (j)(1) through (4) of this section.

(i) *Example 1: Covered modification*—(A) *Facts*. B is the issuer and L is the holder of a debt instrument that pays interest semiannually at a rate of six-month USD LIBOR plus 100 basis points. On July 1, 2022, B and L modify the debt instrument to replace that original rate with CME Group's forward-looking SOFR term rate of a six-month tenor (*six-month CME Term SOFR*) plus an adjustment spread of 42.826 basis points plus 100 basis points (the whole modification is the *LIBOR replacement modification with basis adjustment spread*). B and L chose the adjustment spread of 42.826 basis points because that is the adjustment spread used or recommended by the International Swaps and Derivatives Association and the Alternative Reference Rates Committee for similar substitutions or replacements of six-month USD LIBOR with a tenor-adjusted variant of SOFR.

(B) *Analysis*. The parties have modified the terms of the debt instrument to replace a rate referencing a discontinued IBOR (*i.e.*, six-month USD LIBOR plus 100 basis points) with a qualified rate (*i.e.*, six-month CME Term SOFR plus 142.826 basis points). The LIBOR replacement modification with basis adjustment spread is described in paragraph (h)(1)(i) of this section and not described in any of paragraphs (j)(1) through (5) of this section. Therefore, the LIBOR replacement modification with basis adjustment spread is a covered modification of the debt instrument.

(ii) *Example 2: Covered modification with qualified one-time payment*—(A) *Facts*. The facts are the same as in paragraph (j)(6)(i)(A) of this section (*Example 1*), except that, instead of the LIBOR replacement modification with basis adjustment spread, B and L modify the debt instrument by replacing the original rate of six-month USD LIBOR plus 100 basis points with six-month CME Term SOFR plus 100 basis points and by obligating B to make a cash payment to L equal to the present value of the adjustment spread of 42.826 basis points with respect to the debt instrument (this payment is the *basis adjustment payment*, and the whole modification is the *LIBOR replacement modification with basis adjustment payment*).

(B) *Analysis*. The parties have modified the terms of the debt instrument to replace a rate referencing a discontinued IBOR (*i.e.*, six-month USD LIBOR plus 100 basis points) with a qualified rate (*i.e.*, six-month CME Term SOFR plus 100 basis points) and have added an obligation for B to make the basis adjustment payment, which is a single cash payment that is intended to compensate L for the basis difference between the discontinued IBOR identified in paragraph (h)(1)(i) of this section (*i.e.*, six-month USD LIBOR) and the interest rate benchmark to which the qualified rate refers (*i.e.*, six-month CME Term SOFR). Accordingly, the basis adjustment payment is a qualified one-time payment as defined in paragraph (h)(6) of this section, and the LIBOR replacement modification with basis adjustment payment is described in paragraph (h)(1)(i) of this section. Because it is described in paragraph (h)(1)(i) of this section and not described in any of paragraphs (j)(1) through (5) of this section, the LIBOR replacement modification with basis adjustment payment is a covered modification of the debt instrument.

(iii) *Example 3: Inducement spread*—(A) *Facts*. The facts are the same as in paragraph (j)(6)(i)(A) of this section (*Example 1*), except that the debt instrument is part of a widely held issue of debt with identical terms. Under the trust indenture applicable to the debt instrument, if B proposes a modification of the terms of the debt and all holders of the debt consent to that modification, the terms of the debt are modified as B proposed. In accordance with the trust indenture, B proposes the LIBOR replacement modification with basis adjustment spread on January 1, 2022. To induce holders such as L to perform the acts necessary to consent to the LIBOR replacement modification with basis adjustment spread, B also proposes to increase the interest rate paid to each consenting holder by an additional spread of 10 basis points (the *inducement spread*). All holders, including L, consent to B's proposed modifications by June 1, 2022. On July 1, 2022, the debt instrument is modified to implement the LIBOR replacement modification with basis adjustment spread and to increase the interest rate by the inducement spread. Once all modifications are effective, the debt instrument pays interest at a rate of six-month CME Term SOFR plus 152.826 basis points.

(B) *Analysis*. As concluded in paragraph (j)(6)(i)(B) of this section (*Example 1*), the portion of these modifications that implements the LIBOR replacement modification with basis adjustment spread is a covered modification of L's debt instrument. However, the portion of these modifications that increases the interest rate by the inducement spread changes the amount of cash flows on L's debt instrument, and that change is intended to induce L to perform the acts necessary to consent to a modification to the debt instrument described in paragraph (h)(1)(i) of this section (*i.e.*, the LIBOR replacement modification with basis adjustment spread). Therefore, the portion of the modification that increases the interest rate by the inducement spread is described in paragraph (j)(1) of this section and, consequently, is a noncovered modification of L's debt instrument. See paragraph (b)(2) of this section for the treatment of a contemporaneous noncovered modification.

(iv) *Example 4: Consent fee*—(A) *Facts*. The facts are the same as in paragraph (j)(6)(iii)(A) of this section (*Example 3*), except that, instead of proposing to increase the interest rate paid to each consenting holder by the inducement spread, B proposes to make a cash payment to each consenting holder (the *consent fee*) at the time of the modification. Thus, when the proposed modification occurs on July 1, 2022, B pays all holders, including L, the consent fee. Once all modifications are effective, the debt instrument pays interest at a rate of six-month CME Term SOFR plus 142.826 basis points.

(B) *Analysis*. As concluded in paragraph (j)(6)(i)(B) of this section (*Example 1*), the LIBOR replacement modification with basis adjustment spread is a covered modification of L's debt instrument. However, B's obligation to pay the consent fee is also a modification of L's debt instrument but is not a covered modification because it is not described in paragraph (h)(1)(i) of this section. In particular, B's obligation to pay the consent fee is not an associated modification because it is not a modification of the technical, administrative, or operational terms of L's debt instrument and is not intended to compensate for valuation differences resulting from a modification of the administrative terms of L's contract. Nor is the consent fee a qualified one-time payment because it is not intended to compensate L for any part of the basis difference between the discontinued IBOR identified in paragraph (h)(1)(i) of this section (*i.e.*, six-month USD LIBOR) and the interest rate benchmark to which the qualified rate refers (*i.e.*, six-month CME Term SOFR). See paragraph (b)(2) of this section for the treatment of a contemporaneous noncovered modification.

(v) *Example 5: Compensation for a modification to a customary financial covenant*—(A) *Facts*. The facts are the same as in paragraph (j)(6)(i)(A) of this section (*Example 1*), except that, at the same time as and for reasons unrelated to the LIBOR replacement modification with basis adjustment spread, B and L also modify customary financial covenants in the debt instrument in a manner that benefits B. In exchange for the modification of customary financial covenants, B agrees to add another 30 basis points to the rate such that, once all modifications are effective, the debt instrument pays interest at a rate of six-month CME Term SOFR plus 172.826 basis points.

(B) *Analysis*. As concluded in paragraph (j)(6)(i)(B) of this section (*Example 1*), the portion of these modifications that implements the LIBOR replacement modification with basis adjustment spread is a covered modification of the debt instrument. However, the portion of these modifications that modifies customary financial covenants is not related to the replacement of LIBOR and, therefore, is not described in any of paragraphs (h)(1)(i), (ii), or (iii) of this section and, therefore, is a noncovered modification of the debt instrument. Moreover, the portion of these modifications that adds 30 basis points to the rate changes the amount of cash flows on the debt instrument, and the parties intend that change to compensate L for a modification to the debt instrument not described in paragraph (h)(1)(i), (ii), or (iii) of this section (*i.e.*, the modification of customary financial covenants). Therefore, the portion of these modifications that adds those 30 basis points to the rate is described in paragraph (j)(2) of this section and, consequently, is a noncovered modification of the debt instrument. See paragraph (b)(2) of this section for the treatment of a contemporaneous noncovered modification.

(vi) *Example 6: Workout of distressed debt*—(A) *Facts*. The facts are the same as in paragraph (j)(6)(i)

(A) of this section (*Example 1*), except that B's financial condition has deteriorated since the issue date of the debt instrument and, to decrease the risk of B's default or bankruptcy, L agrees to subtract 50 basis points from the rate such that, once all modifications are effective, the debt instrument pays interest at a rate of six-month CME Term SOFR plus 92.826 basis points.

(B) *Analysis*. As concluded in paragraph (j)(6)(i)(B) of this section (*Example 1*), the portion of these modifications that implements the LIBOR replacement modification with basis adjustment spread is a covered modification of the debt instrument. However, the portion of these modifications that subtracts 50 basis points from the rate changes the amount of cash flows on the debt instrument, and that change is a concession granted to B because B is experiencing financial difficulty. Therefore, the portion of these modifications that subtracts those 50 basis points from the rate is described in paragraph (j)(3) of this section and, consequently, is a noncovered modification of the debt instrument. See paragraph (b)(2) of this section for the treatment of a contemporaneous noncovered modification.

(vii) *Example 7: Change in rights or obligations not derived from the modified contract*—(A) *Facts*. B is the issuer and L is the holder of a debt instrument (*Debt X*) with respect to which the facts are the same as in paragraph (j)(6)(i)(A) of this section (*Example 1*). In addition, B and L are the issuer and holder, respectively, of a second debt instrument (*Debt Y*). At the same time that the LIBOR replacement modification with basis adjustment spread occurs with respect to Debt X, B and L also modify customary financial covenants in Debt Y in a manner that benefits B. In exchange for the modification of customary financial covenants in Debt Y, B agrees to add another 30 basis points to the rate on Debt X such that, once all modifications are effective, Debt X pays interest at a rate of six-month CME Term SOFR plus 172.826 basis points.

(B) *Analysis*. As concluded in paragraph (j)(6)(i)(B) of this section (*Example 1*), the portion of these modifications that implements the LIBOR replacement modification with basis adjustment spread is a covered modification of Debt X. However, the portion of these modifications that adds 30 basis points to the rate on Debt X changes the amount of cash flows on Debt X, and the parties intend that change to compensate L for a change in rights or obligations that are not derived from Debt X (*i.e.*, the modification of customary financial covenants in Debt Y). Therefore, the portion of these modifications that adds those 30 basis points to the rate on Debt X is described in paragraph (j)(4) of this section and, consequently, is a noncovered modification of Debt X. See paragraph (b)(2) of this section for the treatment of a contemporaneous noncovered modification.

(k) *Applicability date*. This section applies to a modification of the terms of a contract that occurs on or after March 7, 2022. A taxpayer may choose to apply this section to modifications of the terms of contracts that occur before March 7, 2022, provided that the taxpayer and all related parties (within the meaning of section 267(b) or section 707(b)(1) or within the meaning of §1.150-1(b) for a taxpayer that is a State or local governmental unit (as defined in §1.103-1(a)) or a 501(c)(3) organization (as defined in section 150(a)(4))) apply this section to all modifications of the terms of contracts that occur before that date. See section 7805(b)(7).

Par. 6. Section 1.1271-0 is amended by adding entries for §1.1275-2(m) to read as follows:

§1.1271-0 Original issue discount; effective date; table of contents.

* * * * *

§1.1275-2 Special rules relating to debt instruments.

* * * * *

(m) Transition from certain interbank offered rates.

(1) In general.

(2) Single qualified floating rate.

(3) Remote contingency.

(4) Change in circumstances.

(5) Applicability date.

* * * * *

Par. 7. Section 1.1275-2 is amended by adding paragraph (m) to read as follows:

§1.1275-2 Special rules relating to debt instruments.

* * * * *

(m) *Transition from certain interbank offered rates*—(1) *In general*. This paragraph (m) applies to a variable rate debt instrument (as defined in §1.1275-5(a)) that provides both for a qualified floating rate that references a discontinued IBOR and for a methodology to change that rate referencing a discontinued IBOR to a different rate in anticipation of the discontinued IBOR becoming unavailable or unreliable. For purposes of this paragraph (m), *discontinued IBOR* has the meaning provided in §1.1001-6(h)(4). See §1.1001-6 for additional rules that may apply to a debt instrument that provides for a rate referencing a discontinued IBOR.

(2) *Single qualified floating rate*. If a debt instrument is described in paragraph (m)(1) of this section, the rate referencing a discontinued IBOR and the different rate are treated as a single qualified floating rate for purposes of §1.1275-5.

(3) *Remote contingency*. If a debt instrument is described in paragraph (m)(1) of this section, the possibility that the discontinued IBOR will become unavailable or unreliable is treated as a remote contingency for purposes of paragraph (h) of this section.

(4) *Change in circumstances*. If a debt instrument is described in paragraph (m)(1) of this section, the fact that the discontinued IBOR has become unavailable or unreliable is not treated as a change in circumstances for purposes of paragraph (h)(6) of this section.

(5) *Applicability date*. Paragraph (m) of this section applies to debt instruments issued on or after March 7, 2022. A taxpayer may choose to apply paragraph (m) of this section to debt instruments issued before March 7, 2022, provided that the taxpayer and all related parties (within the meaning of section 267(b) or section 707(b)(1) or within the meaning of §1.150-1(b) for a taxpayer that is a State or local governmental unit (as defined in §1.103-1(a)) or a 501(c)(3) organization (as defined in section 150(a)(4))) apply paragraph (m) of this section to all debt instruments issued before that date. See section 7805(b)(7).

Par. 8. Section 1.7701(l)-3 is amended by adding a sentence at the end of paragraph (b)(2)(ii) to read as follows:

§1.7701(l)-3 Recharacterizing financing arrangements involving fast-pay stock.

* * * * *

(b) * * *

(2) * * *

(ii) * * * See §1.1001-6(e) for additional rules that may apply to stock that provides for a rate referencing a discontinued IBOR, as defined in §1.1001-6(h)(4).

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

Par. 9. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 10. Section 301.7701-4 is amended by adding a sentence at the end of paragraph (c)(1) to read as follows:

§301.7701-4 Trusts.

* * * * *

(c) * * *

(1) * * * See §1.1001-6(f) of this chapter for additional rules that may apply to an investment trust that holds one or more contracts that provide for a rate referencing a discontinued IBOR, as defined in §1.1001-6(h)(4) of this chapter, and for additional rules that may apply to an investment trust with one or more ownership interests that reference a discontinued IBOR.

* * * * *

Douglas W. O'Donnell,
Deputy Commissioner for Services and Enforcement.

Approved: December 19, 2021

Lily Batchelder,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 28, 2021, 4:15 p.m., and published in the issue of the Federal Register for January 4, 2022, 87 F.R. 166)

Part III

26 CFR 54.9816-6T Methodology for calculating qualifying payment amount in 2022

Rev. Proc. 2022-11

SECTION 1. PURPOSE AND SCOPE

Pursuant to Treas. Reg. § 54.9816-6T(c), 29 CFR 2590.716-6(c), and 45 CFR 149.140(c), this revenue procedure provides the combined percentage increase for calculating the qualifying payment amount for items and services furnished during 2022 for purposes of sections 9816 and 9817 of the Internal Revenue Code (Code), sections 716 and 717 of the Employee Retirement Income Security Act of 1974 (ERISA), and sections 2799A-1 and 2799A-2 of the Public Health Service Act (PHS Act). This revenue procedure was drafted in consultation with the Departments of Labor and Health and Human Services.

SECTION 2. BACKGROUND

The No Surprises Act was enacted as Title I of Division BB of the Consolidated Appropriations Act, 2021.[1] Section 102 of the No Surprises Act added section 9816 to the Code, section 716 to ERISA, and section 2799A-1 to the PHS Act. Section 105 of the No Surprises Act added section 9817 to the Code, section 717 to ERISA, and section 2799A-2 to the PHS Act. These provisions provide protections against surprise medical bills in certain circumstances. Surprise medical bills can occur when a patient unexpectedly receives out-of-network health care, that is, health care from a provider, facility, or provider of air ambulance services that does not participate in the network of the individual's group health plan or group or individual health insurance coverage (an out-of-network or nonparticipating provider, facility, or provider of air ambulance services).[2]

Before the enactment of the No Surprises Act, when the terms of a group health plan or group or individual insurance coverage did not provide for coverage of the entire amount billed, the provider, facility, or provider of air ambulance services could balance bill the patient for the amount in excess of the amount paid by the plan or coverage and any applicable patient cost sharing (unless prohibited under applicable state law). For non-emergency services, the patient could be responsible for out-of-network cost-sharing amounts, which may be higher than in-network costs. Under the No Surprises Act, in certain circumstances, the provider, facility, or provider of air ambulance services can no longer balance bill the patient for the excess amount, and patient cost sharing is limited to in-network levels.

In July 2021, interim final regulations were issued to implement sections 9816 and 9817 of the Code, sections 716 and 717 of ERISA, and sections 2799A-1 and 2799A-2 of the PHS Act.[3] The No Surprises Act and those interim final regulations provide that, generally, in the absence of an All-Payer Model Agreement under section 1115A of the Social Security Act or specified state law,[4] a patient's cost-sharing amount is based on the qualifying payment amount.[5]

Furthermore, in the absence of an All-Payer Model Agreement or specified state law,[6] the No Surprises Act provides for negotiation between the group health plan or group or individual health insurance issuer and the provider, facility, or provider of air ambulance services to determine the amount to be paid by the plan or issuer, if any. If the parties are unable to reach an agreement through open negotiation, the No Surprises Act provides for the amount payable to be determined by a certified independent dispute resolution (IDR) entity through a federal IDR process set forth in sections 9816(c) and 9817(b) of the Code, sections 716(c) and 717(b) of ERISA, and sections 2799A-1(c) and 2799A-2(b) of the PHS Act. To the extent that the amount payable for items and services by a group health plan or group or individual health insurance issuer to an out-of-network provider, facility, or provider of air ambulance services is determined by a certified IDR entity under that federal IDR process, the statute and implementing interim final regulations issued in October 2021 provide that the certified IDR entity takes into account the qualifying payment amount for the item or service, among other additional factors and circumstances as provided for in the statute and implementing regulations.[7]

Under § 54.9816-6T(c), 29 CFR 2590.716-6(c), and 45 CFR 149.140(c), for an item or service furnished during 2022, the group health plan or group or individual health insurance issuer must calculate the qualifying payment amount by increasing the median contracted rate (as determined in accordance with § 54.9816-6T(b), 29 CFR 2590.716-6(b), and 45 CFR 149.140(b))[8] for the same or similar item or service under such plan or coverage, on January 31, 2019, by the combined percentage increase as published by the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) to reflect the percentage increase in the consumer price index for all urban consumers (U.S. city average) (CPI-U) over 2019, such percentage increase over 2020, and such percentage

[1] Pub. L. 116-260, 134 Stat. 1182 (2020).

[2] The protections against surprise billing also apply to health benefits plans offered by carriers under the Federal Employees Health Benefits (FEHB) Act. Accordingly, the guidance provided in this revenue procedure also applies to FEHB carriers. *See* 5 U.S.C. 8901(p).

[3] 86 FR 36872 (7/13/21).

[4] If an All-Payer Model Agreement or specified state law applies, the applicable Agreement or law determines the cost-sharing amount. Specified state law is defined in § 54.9816-3T, 29 CFR 2590.716-3, and 45 CFR 149.30.

[5] Qualifying payment amount is defined in § 54.9816-6T(a)(16), 29 CFR 2590.716-6(a)(16), and 45 CFR 149.140(a)(16).

[6] If an All-Payer Model Agreement or specified state law applies, the applicable Agreement or law determines the out-of-network payment amount.

[7] The applicable regulations are §§ 54.9816-8T, 54.9817-2T, 29 CFR 2590.716-8, 2590.717-2, 45 CFR 149.510, and 149.520. *See* 86 FR 55980 (10/7/21).

[8] If there is insufficient information to determine the median contracted rate, the plan or issuer generally must use data from an eligible database to determine the qualifying payment amount. The same indexing rules apply.

increase over 2021.[9] The combined percentage increase is provided in section 3 of this revenue procedure.

For an item or service furnished during 2023 or a subsequent year, a group health plan or group or individual health insurance issuer must calculate the qualifying payment amount by increasing the qualifying payment amount determined for the item or service furnished in the immediately preceding year, by the percentage increase as published by the Treasury Department and the IRS.

The annual percentage increase will be published in guidance by the IRS. The Treasury Department and the IRS must calculate the annual percentage increase using the CPI–U published by the Bureau of Labor Statistics of the Department of Labor.

This revenue procedure reflects the terms of the interim final regulations under the No Surprises Act in effect as of December 28, 2021. The Treasury Department and the IRS anticipate issuing additional guidance regarding the calculation of the qualifying payment amount to the extent that final regulations reflect different terms.

SECTION 3. PROCEDURE

For items and services provided on or after January 1, 2022, and before January 1, 2023, the combined percentage increase to adjust the median contracted rate is 1.0648523983.[10] Pursuant to this revenue procedure, group health plans and group and individual health insurance issuers may round any resulting qualifying payment amount to the nearest dollar.

Example. A group health plan sponsor calculates a median contracted rate for a service with service code X; the service is not an anesthesia service or air ambulance service. The median contracted rate for service code X is $12,480 as of January 31, 2019. For a service with service code X furnished during 2022, increasing the median contracted rate by the combined percentage increase of 1.0648523983 results in $13,289.36; rounding to the nearest dollar results in a qualifying payment amount of $13,289.

SECTION 4. EFFECTIVE DATE

The effective date of this revenue procedure is January 1, 2022.

SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is Kari DiCecco of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). For further information regarding this revenue procedure, contact Kari DiCecco at (202) 317-5500 (not a toll-free number).

[9] The calculations of the qualifying payment amount for anesthesia services, air ambulance services, and other items or services differ slightly, but all use the same formula for increasing a base rate by the combined percentage increase as published by the Treasury Department and the IRS to reflect the percentage increase in the CPI-U over 2019 and subsequent years. See § 54.9816-6T(c)(1)(iii)-(vii), 29 CFR 2590.716-6(c)(1)(iii)-(vii), and 45 CFR 149.140(c)(1)(iii)-(vii).

[10] The formula for the combined percentage increase for 2019, 2020, and 2021 is expressed as: (CPI-U 2019/CPI-U 2018) × (CPI-U 2020/CPI-U 2019) × (CPI-U 2021/CPI-U 2020). *See* § 54.9816-6T(c)(1)(i)(C), 29 CFR 2590.716-6(c)(1)(i)(C), and 45 CFR 149.140(c)(1)(i)(C).

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List[1]

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2020–27 through 2020–52 is in Internal Revenue Bulletin 2020–52, dated December 27, 2021.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2020–27 through 2020–52 is in Internal Revenue Bulletin 2020–52, dated December 27, 2021.

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