

INTERNAL REVENUE BULLETIN



HIGHLIGHTS OF THIS ISSUE

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.

INCOME TAX

Announcement 2020-10, page 385.

The competent authorities of the United States of America and Switzerland hereby enter into the following arrangement ("the Arrangement") that references to North American Free Trade Agreement in the Convention between the Swiss Federation and the United States of America for the Avoidance of Double Taxation with Respect to Taxes on Income (the "Convention") shall be understood as references to the United States-Mexico-Canada Agreement ("USMCA") upon entry into force of the USMCA. The Arrangement is entered into under paragraph 3 of Article 25 (Mutual Agreement Procedure) of the Convention.

Announcement 2020-11, page 385.

This document contains corrections to TD 9900, published in Internal Revenue Bulletin 2020-30 on Monday, July 20, 2020.

REG-127732-19, page 385.

This document contains proposed regulations under the subpart F income and global intangible low-taxed income provisions of the Internal Revenue Code regarding the treatment of certain income that is subject to a high rate of foreign tax. This document also contains proposed regulations under the information reporting provisions for foreign corporations to facilitate the administration of certain rules in the proposed regulations. The proposed regulations would affect United States shareholders of controlled foreign corporations.

Rev. Proc. 2020-37, page 381.

This revenue procedure provides: (1) tables of limitations on depreciation deductions for owners of passenger automo-

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biles first placed in service by the taxpayer during calendar year 2020; and (2) a table of amounts that must be included in income by lessees of passenger automobiles first leased by the taxpayer during calendar year 2020. The tables detailing these depreciation limitations and lessee inclusion amounts reflect the automobile price inflation adjustments required by section 280F(d)(7). For purposes of this revenue procedure, the term "passenger automobiles" includes trucks and vans.

T.D. 9901, page 266.

These final regulations provide guidance on the deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income under section 250 of the Code, which was added to the Internal Revenue Code (the "Code") by the Tax Cuts and Jobs Act, Pub. L. No. 155-97 (2017). The final regulations replace previously issued proposed regulations and provide guidance on both the computation of the deductions available under section 250 and the definition and determination of FDII. In addition, the final regulations provide rules, pursuant to section 1502 of the Code, for the computation of FDII in a consolidated group. Finally, these final regulations contain amendments to regulations under sections 962, 6038 and 6038A of the Code.

T.D. 9902, page 349.

This document contains final regulations under the global intangible low-taxed income and subpart F income provisions of the Internal Revenue Code regarding the treatment of income that is subject to a high rate of foreign tax. The final regulations affect United States shareholders of foreign corporations. This guidance relates to changes made to the applicable law by the Tax Cuts and Jobs Act, which was enacted on December 22, 2017.

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

26 CFR 1.250-0, 1.250-1, 1.250(a)-1, 1.250(b)-1 through 1.250(b)-6, 1.861-8, 1.962-1, 1.1502-12, 1.1502-13, 1.1502-50, 1.6038-2, 1.6038-3, 1.6038A-2

T.D. 9901

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance regarding the deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). This document also contains final regulations coordinating the deduction for FDII and GILTI with other provisions in the Internal Revenue Code. These regulations generally affect domestic corporations and individuals who elect to be subject to tax at corporate rates for purposes of inclusions under subpart F and GILTI.

DATES: Effective Date: These regulations are effective on September 14, 2020.

Applicability Dates: For dates of applicability, see §§1.250-1(b), 1.962-1(d), 1.1502-50(g), 1.6038-2(m)(4), 1.6038-3(l), and 1.6038A-2(g).

FOR FURTHER INFORMATION CONTACT: Concerning §§1.250-1 through 1.250(b)-6, 1.6038-2, 1.6038-3, and 1.6038A-2, Brad McCormack at (202) 317-6911 and Lorraine Rodriguez at (202) 317-6726; concerning §1.962-1, Edward Tracy at (202) 317-6934; concerning

§§1.1502-12, 1.1502-13 and 1.1502-50, Michelle A. Monroy at (202) 317-5363 (not toll free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 250 was added to the Internal Revenue Code (“Code”) by the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054, 2208 (2017) (the “Act”), which was enacted on December 22, 2017. On March 6, 2019, the Department of the Treasury (“Treasury Department”) and the IRS published proposed regulations (REG-104464-18) under sections 250, 962, 1502, 6038, and 6038A in the **Federal Register** (84 FR 8188) (the “proposed regulations”). Corrections to the proposed regulations were published on April 11, 2019, and April 12, 2019, in the **Federal Register** (84 FR 14634 and 84 FR 14901, respectively). A public hearing on the proposed regulations was held on July 10, 2019. The Treasury Department and the IRS also received written comments with respect to the proposed regulations.

All written comments received in response to the proposed regulations are available at <https://www.regulations.gov> or upon request. Terms used but not defined in this preamble have the meaning provided in these final regulations.

Summary of Comments and Explanation of Revisions

I. Overview

The final regulations retain the basic approach and structure of the proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions section discusses those revisions as well as comments received in response to the solicitation of comments in the notice of proposed rulemaking. Comments outside the scope of this rulemaking are generally not addressed but may be considered in connection with future guidance projects.

II. Comments on and Revisions to Documentation Requirements and Applicability Dates

A. Documentation requirements for foreign persons, foreign use, and location outside the United States

As described in parts VII.B, C.1, and D.1 and VIII.B.1 and B.2.c of this Summary of Comments and Explanation of Revisions section, the proposed regulations provided that to establish that a recipient is a foreign person, property is for a foreign use (within the meaning of proposed §1.250(b)-4(d) and (e)), or a recipient of a general service is located outside the United States (within the meaning of proposed §1.250(b)-5(d)(2)), the taxpayer must obtain specific types of documentation described in proposed §§1.250(b)-4(c)(2), (d)(3), and (e)(3) and 1.250(b)-5(d)(3) and (e)(3). The proposed regulations also provided a transition rule whereby for taxable years beginning on or before March 4, 2019, taxpayers could use any reasonable documentation maintained in the ordinary course of the taxpayer’s business that establishes that a recipient is a foreign person, property is for a foreign use, or a recipient of a general service is located outside the United States, as applicable, in lieu of the specific documentation described in the regulations, provided that such documentation meets certain reliability requirements described in proposed §1.250(b)-3(d). See proposed §1.250-1(b). The preamble requested comments on this special transition rule.

Several comments recommended either making this transition rule permanent or extending it for a certain period after the regulations are finalized. The comments recommending that the transition rule be made permanent indicated that the documentation described in the proposed regulations may be difficult, if not impossible, to obtain in the ordinary course of business. The comments noted that customers are highly reluctant to provide some of the types of documents that the proposed regulations described. A comment noted that the documentation rules in the proposed regulations could require taxpayers to renegotiate contracts or make

inquiries of their customers that could interfere with the customer relationship. Several comments were concerned with how the documentation rules and, in particular, the reliability requirements would apply to business models with longer-term contracts, especially those entered into during the 2019 tax year.

The comments that requested extending the transition rule suggested that this would allow adequate time for the IRS to gain experience with the types of documentation taxpayers collect in the ordinary course of business, and for taxpayers to gain experience complying with such rules by developing or improving internal compliance systems. Alternatively, some comments suggested that the next issuance of regulations should be in temporary form to allow additional time to consider the reasonableness of the documentation requirements before final regulations are issued and to allow taxpayers more time to identify distortive results.

Other comments recommended changes to the documentation rules if the final regulations do not make the transition rule permanent. Several comments suggested that any list of suitable documents (for either property sales or services) should be non-exclusive and include more documents obtained in the ordinary course of business. Some comments recommended allowing the use of documentation methods similar to those for sales of fungible mass property under proposed §1.250(b)-4(d)(3)(iii) such as market research, statistical sampling, economic modeling or other similar methods to show foreign person status or foreign use.

The final regulations address these comments in several ways. First, the final regulations eliminate the requirement in the proposed regulations to obtain specific types of documents to establish foreign person status, foreign use with respect to sales of certain general property that are made directly to end users, and the location of general services provided to consumers. The Treasury Department and the IRS have determined that requiring specific documentation with respect to these requirements is difficult given the variations in industry practices and is not necessary to achieve the purpose of the statute. Accordingly, the final regula-

tions remove the specific documentation requirements to establish foreign person status and foreign use with respect to certain sales of general property and the location of a consumer of a general service. However, as explained in more detail in part II.D of this Summary of Comments and Explanation of Revisions section, as with any deduction, taxpayers claiming a deduction under section 250 bear the burden of demonstrating that they are entitled to the deduction. Therefore, the general requirement for taxpayers to substantiate their deductions will apply without any additional specific requirements as to the content of information or documents.

Second, the final regulations adopt a more flexible approach regarding the types of substantiation required for foreign use with respect to sales of general property to non-end users, foreign use with respect to sales of intangible property, and with respect to determining whether services are performed for business recipients located outside the United States. Although the substantiation requirements in the final regulations are more specific as to the nature of the information required, they are not limited to a narrow set of documents. The requirements also do not contain the specific reliability requirement set out in the proposed regulations because the reliability of documents or information can differ depending on the circumstances. For example, documents created in advance of a sales date (such as a long-term sales contract) may be as reliable as documents created at the time of the sale, depending on the facts and circumstances. Further, the final regulations continue to require that the substantiating documents be supported by credible evidence. See part II.C of this Summary of Comments and Explanation of Revisions section.

Finally, the applicability dates of the regulations have been revised, and taxpayers are permitted to rely on the proposed regulations for taxable years before the final regulations are applicable, including relying on the transition rules during the entirety of such period. See part II.F and XII of this Summary of Comments and Explanation of Revisions section.

B. Specific substantiation for certain transactions

In lieu of the documentation requirements in the proposed regulations, with respect to sales of general property to recipients other than end users, sales of intangible property, and general services provided to business recipients, the final regulations provide substantiation rules that are more flexible with respect to the types of corroborating evidence that may be used. See §1.250(b)-3(f). For these transactions, specific substantiation requirements are needed to ensure that taxpayers make sufficient efforts to determine whether the regulatory requirement is met. Therefore, with respect to these transactions, the final regulations describe the type of information necessary to meet the substantiation requirements. The specific ways a taxpayer must substantiate these elements are described in parts VII.C.9, VII.D.2, and VIII.B.2.d of this Summary of Comments and Explanation of Revisions section. The substantiation requirements are modeled after substantiation rules under section 170 (requiring substantiation through receipts for certain charitable deductions) and section 274(d) (requiring substantiation by adequate records or a taxpayer statement with corroborating evidence). The Treasury Department and the IRS have determined that requiring a taxpayer to specifically substantiate certain transactions — in particular transactions where the relevant facts needed to satisfy the rules are generally in the hands of a third party with a business relationship with the taxpayer — is necessary and appropriate for establishing “to the satisfaction of the Secretary” that property is sold for a foreign use or that services are provided to persons located outside the United States. See section 250(b)(4) and (b)(5)(C).

C. Timing to obtain, maintain, and provide specific substantiation

In general, the substantiation rules require that the substantiating documents with respect to certain transactions that give rise to foreign-derived deduction eligible income (a “FDDEI transaction”) be in existence by the time the taxpayer files its return (including extensions) with re-

spect to the FDDEI transaction (the “FDII filing date”). See §1.250(b)-3(f)(1). The final regulations do not impose additional requirements relating to when substantiating documents must be in existence. However, the timing of when substantiating documents are created may affect the credibility of the substantiating documents. For example, substantiating documents created at or near the time of the transaction generally have a higher degree of credibility as compared to substantiating documents created later in time. With respect to long-term contracts, substantiating documents created when the transaction was entered into will be more credible in later years if the taxpayer periodically confirms that the terms of the long-term contract are being adhered to.

The final regulations provide that substantiating documents must be provided to the IRS upon request, generally within 30 days or some other period agreed upon by the IRS and the taxpayer. See §1.250(b)-3(f)(1). This is necessary to allow the substantiation requirements to serve their purpose, including to allow the IRS to timely examine the taxpayer’s qualification for the FDII deduction.

D. Substantiation in all other cases

For the rules in the final regulations for which there are no specific substantiation requirements, taxpayers are already required under section 6001 to make returns, render statements, and keep the necessary records to show whether such person is liable for tax under the Code. Therefore, a taxpayer claiming a deduction under section 250 will still be required to substantiate that it is entitled to the deduction even if it is not subject to the specific substantiation requirements contained in the final regulations. See §1.6001-1(a); *INDOPCO v. Commissioner*, 503 U.S. 79, 84 (1992) (“an income tax deduction is a matter of legislative grace and . . . the burden of clearly showing the right to the claimed deduction is on the taxpayer” (internal citations omitted)).

The Treasury Department and the IRS expect that taxpayers may use a broader range of evidence to substantiate a section 250 deduction under the new substantiation requirements (and section 6001 where no specific substantiation require-

ments are provided) than they would have been able to use under the more specific documentation requirements detailed in the proposed regulations. Based on comments received, in many cases a taxpayer will be able to determine whether it meets the requirements in the final regulations using documents maintained in the ordinary course of its business, as provided in the transition rule. In some circumstances, however, it may be necessary for taxpayers to gather additional information to establish that a requirement is met. The Treasury Department and the IRS are also considering issuing additional administrative guidance on acceptable documentation to substantiate the deduction.

E. Small business exception

The final regulations include an exception for small businesses similar to the exceptions from the documentation requirements for small businesses that are in the proposed regulations. See proposed §§1.250(b)-4(c)(2)(ii)(A) and (d)(3)(ii)(A), and 1.250(b)-5(d)(3)(ii)(A) and (e)(3)(ii)(A). The exception provides that the substantiation requirements described generally in part II.B of this Summary of Comments and Explanation of Revisions section do not apply if the taxpayer and all related parties of the taxpayer, in the aggregate, receive less than \$25,000,000 in gross receipts during the prior taxable year. See §1.250(b)-3(f)(2). In response to comments that the final regulations should allow for broader application of the small business exception, the final regulations modify the threshold amount to qualify for that exception from \$10,000,000 of gross receipts received by the seller of general property or renderer of services in the prior taxable year (the standard used in the proposed regulations) to \$25,000,000 in gross receipts received by the taxpayer and all related parties. As a result of this exception, a small business will not need to satisfy the specific substantiation requirements in the regulations, although it must continue to comply with the general substantiation rules under section 6001. For example, small businesses may be able to substantiate that a sale of general property is for a foreign use by having evidence of a foreign shipping address and memorializing conversations with the

recipients explaining where the property will be resold, if sufficiently reliable, or having a copy of an export bill of lading.

F. Transition rules

The final regulations modify the applicability dates of the regulations to give taxpayers additional time to develop systems for complying with the regulations. Generally, the final regulations are applicable for taxable years beginning on or after January 1, 2021. See §1.250-1(b). This applicability date ensures that all taxpayers, regardless of whether they are fiscal- or calendar-year taxpayers, have at least three full taxable years after the Act was enacted before the final regulations become applicable. However, for taxable years beginning before January 1, 2021, taxpayers may apply the final regulations or rely on the proposed regulations, except that taxpayers that choose to rely on the proposed regulations may rely on the transition rule for documentation for all taxable years beginning before January 1, 2021 (rather than only for taxable years beginning on or before March 4, 2019, which was the limitation contained in the proposed regulations).

III. Comments on and Revisions to Proposed §1.250(a)-1 — Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income

Proposed §1.250(a)-1 provided general rules to determine the amount of a taxpayer’s section 250 deduction and associated definitions that apply for purposes of the proposed regulations.

A. Pre-Act NOLs

Several Code sections, including section 250, include limitations based on a taxpayer’s taxable income or a percentage of taxable income. The proposed regulations provided an ordering rule for applying sections 163(j) and 172 in conjunction with section 250 that provided that a taxpayer’s taxable income for purposes of applying the taxable income limitation of section 250(a)(2) is determined after all of the corporation’s other deductions are taken into account, without distinguish-

ing between pre-Act and post-Act net operating losses (“NOLs”). See proposed §1.250(a)-1(c)(4).

Several comments noted that the proposed regulations did not explicitly address the impact of pre-Act NOLs on the deduction under section 250 and recommended that pre-Act NOLs not be taken into account for purposes of determining the deduction limit under section 250(a)(2). This would allow taxpayers to take a deduction under section 250 for FDII in lieu of utilizing available pre-Act NOLs.

Section 250(a)(2) limits the FDII deduction based on “taxable income,” which is defined in section 63 to include gross income minus deductions, including NOL deductions under section 172. Section 250(a)(2) contains no language that would support ignoring pre-Act NOLs for purposes of determining the amount of taxable income for purposes of section 250(a)(2). Cf. section 965(n) (providing an election to forgo usage of a portion of pre-Act NOLs against a taxpayer’s inclusion under section 965). Therefore, the comment is not adopted.

B. Ordering rule

As discussed in the previous section, the deduction under section 250 is subject to a taxable income limitation under section 250(a)(2). Proposed §1.250(a)-1(c)(4) provided that the corporation’s taxable income is determined with regard to all items of income, deduction, or loss, except for the deduction allowed under section 250. *Example 2* in proposed §1.250(a)-1(f)(2) applied the ordering rule with respect to sections 163(j), 172, and 250.

Some comments recommended that the regulations eliminate the ordering rule in favor of an approach that used simultaneous equations to compute taxable income for each Code provision that referred to taxable income, whereas other comments expressed concern with the complexity of performing simultaneous equations. One comment recommended that the regulations not consider section 163(j) and 172(b) carryforwards or carrybacks.

The Treasury Department and the IRS have determined that further study is required to determine the appropriate rule for coordinating section 250(a)(2), 163(j), 172, and other Code provisions (including, for example, sections 170(b)(2), 246(b), 613A(d), and 1503(d)) that limit the availability of deductions based, directly or indirectly, upon a taxpayer’s taxable income. Therefore, the final regulations remove *Example 2* in proposed §1.250(a)-1(f)(2) and reserve a paragraph in §1.250(a)-1(c)(5)(ii) for coordinating section 250(a)(2) with other provisions calculated based on taxable income. The Treasury Department and the IRS are considering a separate guidance project to address the interaction of sections 163(j), 172, 250(a)(2), and other Code sections that refer to taxable income; this guidance may include an option to use simultaneous equations in lieu of an ordering rule.¹ Comments are requested in this regard.

Before further guidance is issued regarding how allowed deductions are taken into account in determining the taxable income limitation in section 250(a)(2), taxpayers may choose any reasonable method (which could include the ordering rule described in the proposed regulations or the use of simultaneous equations) if the method is applied consistently for all taxable years beginning on or after January 1, 2021.

C. Carryovers of excess FDII

Consistent with the statute, the proposed regulations did not contain any provision allowing the carryforward or carryback of a tax year’s FDII deduction in excess of the taxpayer’s taxable income limitation under section 250(b)(2) and proposed §1.250(a)-1(b)(2). One comment argued that a provision allowing the carryforward or carryback should be added because the taxable income limitation frustrates the policy goal of the FDII regime of reducing the tax incentive to locate intellectual property outside the United States. A different comment recommended that where the taxable income

limitation of the proposed regulations applies to a given tax year, the final regulations should allow for the creation of a FDII recapture account by which taxpayers can carry forward previously unused section 250 deductions to future tax years when they have enough taxable income to use these deductions. In contrast, another comment recommended that, consistent with the statute, the final regulations should not allow for carrybacks or carryforwards in order to limit the potential for abuse by taxpayers.

The section 250 deduction is an annual calculation, and nothing in the statute or legislative history contemplates the creation of carryforwards or carrybacks or a recapture account. Cf. section 163(j)(2) (providing for the carryforward of disallowed business interest). As a result, the final regulations do not adopt these recommendations.

D. Definition of GILTI

The final regulations under section 250 revise the definition of GILTI consistent with the final regulations under section 951A (“section 951A final regulations”). The term “GILTI” means, with respect to a domestic corporation for a taxable year, the corporation’s GILTI inclusion amount under §1.951A-1(c) for the taxable year. See §1.250(a)-1(c)(3).

IV. Comments on and Revisions to Proposed §1.250(b)-1 — Computation of Foreign-Derived Intangible Income

The proposed regulations provided that a taxpayer’s FDII is the taxpayer’s deemed intangible income (“DII”) multiplied by the corporation’s foreign-derived ratio. See proposed §1.250(b)-1(b). A taxpayer’s DII is the excess (if any) of the corporation’s deduction eligible income (“DEI”) over its deemed tangible income return (“DTIR”). See proposed §1.250(b)-1(c)(3). A taxpayer’s DTIR is 10 percent of the taxpayer’s qualified business asset investment (“QBAI”). See proposed §1.250(b)-1(c)(4). The foreign-derived

¹ Any separate guidance would take into account the recent addition of section 172(a)(2)(B)(ii)(I) by the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (2020). That provision provides in relevant part that, for taxable years beginning after December 31, 2020, the taxable income limitation for purposes of deducting net operating loss carrybacks and carryovers is determined without regard to the deductions under sections 172, 199A, and 250.

ratio is the taxpayer's ratio of foreign-derived deduction eligible income ("FDDEI") to DEI. See proposed §1.250(b)-1(c)(13).

A. Financial services income

Section 250(b)(3)(A)(i)(III) excludes from DEI financial services income as defined in section 904(d)(2)(D). One comment requested a clarification that income that falls outside of the definition of section 904(d)(2)(D) should be eligible for inclusion in DEI, such as leasing or financing activities outside of the active conduct of a banking, financing, or similar business.

Section 250(b)(3)(A)(i)(III) excludes only financial services income as defined in section 904(d)(2)(D). Any leasing or financing activities that are not described in section 904(d)(2)(D) will not fall within this exclusion. Therefore, no changes are necessary.

Another comment suggested that the proposed regulations do not provide enough general guidance on non-active financial services income from financial instruments (such as derivatives and hedges), and, in particular, how to characterize such income (or losses) as a FDDEI transaction. Absent such guidance, the comment asserts that taxpayers could take inconsistent positions in characterizing a derivative or hedge and characterizing the underlying transaction as FDDEI transactions. This comment recommended adding a general rule that associates the income, loss, and expenses of a derivative or hedge with the underlying transaction. Alternatively, the comment suggested that the final regulations treat the derivative or hedge transaction as a separate transaction and test it for FDDEI under the rules regarding sales of intangible property.

Consistent with the proposed regulations, the final regulations provide that, in general, financial instruments are neither general property nor intangible property, and therefore their sales cannot give rise to FDDEI. See §1.250(b)-3(b)(10) (excluding from the definition of general property a security defined under section 475(c)(2)) and §1.250(b)-3(b)(11) (intangible property has the meaning set forth in section

367(d)(4)). However, the final regulations adopt the suggestion to provide a special rule for hedges to associate the income or loss from such hedges with the underlying transaction. See §1.250(b)-4(f) and part VII.E of this Summary of Comments and Explanation of Revisions section.

B. Definition of foreign branch income

Section 250(b)(3) excludes from DEI foreign branch income as defined in section 904(d)(2)(J), which provides that foreign branch income is business profits attributable to one or more qualified business units. Proposed §1.250(b)-1(c)(11) defined foreign branch income by cross-reference to §1.904-4(f)(2), which provides that gross income is attributable to a foreign branch if the gross income is reflected on the separate set of books and records of the foreign branch. Proposed §1.250(b)-1(c)(11), however, modified this definition to also include any income from the sale, directly or indirectly, of any asset (other than stock) that produces gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or partnership interest.

Several comments requested that the final regulations remove the modification to the definition in proposed §1.904-4(f)(2). Several comments noted that the definition, as proposed, would impermissibly create a class of income that is neither DEI nor foreign branch income for section 904 foreign tax credit purposes, and therefore, asserted that the definitions must be aligned consistently. Another comment argued that the proposed regulations under section 904 already contain rules that address the types of transactions that were described in proposed §1.250(b)-1(c)(11). Multiple comments also noted that section 250(b)(3)(A)(i)(VI) cross references to section 904(d)(2)(J) without any modification to that latter provision and argued that modifying the definition in regulations exceeded the Treasury Department and IRS's regulatory authority. One comment argued that the expansion contravenes the Congressional purpose behind FDII of encouraging the repatriation of intangible property. Another comment noted

that if the definition with the modification is applied retroactively, it could adversely affect taxpayers that undertook transactions to repatriate intellectual property before the proposed regulations were issued, a problem that the comment asserted is exacerbated by the differing effective dates of the proposed foreign tax credit regulations and the FDII proposed regulations.

If the final regulations were to retain the expanded definition, one comment requested that the definition also be used for purposes of the foreign branch category definition in §1.904-4(f). Another comment requested that the final regulations provide further clarification of the treatment of the disregarded transactions, particularly with respect to the disposition of a partnership interest, and provide relevant examples of other types of transactions that the expanded definition is intended to capture. Moreover, the comment requested that the definition of foreign branch income should be modified such that it would not include any adjustments that would increase the gross income attributable to the foreign branch as a result of the transfer of intangible property from the foreign branch to the foreign branch owner.

The Treasury Department and the IRS agree that there should be one consistent definition of foreign branch income in both §§1.250(b)-1(c)(11) and 1.904-4(f)(2) to avoid the various results suggested by comments. Accordingly, the final regulations define foreign branch income by cross reference to §1.904-4(f)(2) and remove the modification to that definition in the proposed regulations that would have included as foreign branch income any income from the sale, directly or indirectly, of any asset (other than stock) that produces gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or partnership interest. See §1.250(b)-1(c)(11).²

C. Cost of goods sold allocation

The proposed regulations provided that for purposes of determining the gross income included in gross DEI and gross FDDEI, cost of goods sold is attributed to gross receipts with respect to gross DEI or

²Under §1.904-4(f)(2), a disposition of an interest in a disregarded entity could still result in foreign branch income. See §1.904-4(f)(4)(ii) Example 2.

gross FDDEI under any reasonable method. See proposed §1.250(b)-1(d)(1). The final regulations clarify that the method chosen by the taxpayer must be consistently applied.

For purposes of this rule, any cost of goods sold associated with activities undertaken in an earlier taxable year cannot be segregated into component costs and attributed disproportionately to amounts excluded from gross FDDEI or to amounts excluded from gross DEI, similar to the rules in proposed §1.199-4(b)(2)(iii)(A). The preamble to the proposed regulations requested comments on whether there are alternative approaches for dealing with timing issues, and whether additional rules should be provided for attributing cost of goods sold in determining gross DEI and gross FDDEI.

One comment recommended that the final regulations continue to allow cost of goods sold to be allocated under any reasonable method to provide flexibility to different taxpayers. Another comment agreed with the proposed regulations that cost of goods sold should be allocated between gross FDDEI and gross non-FDDEI³ regardless of whether any component of the costs was associated with activities undertaken in a prior tax year. That comment, however, recommended that for future periods taxpayers that recognized revenue under section 451 for advance payments should be permitted an election to create an imputed cost of goods sold deduction based upon the taxpayer's gross profit percentage for that particular product or service. The comment argued this election is needed because recognition of an advance payment as income without associated cost of goods sold might be required under section 451 based upon certain facts and circumstances and the election would allow the taxpayer to avoid this distortive impact.

Sections 451 and 461 provide the general rules on the timing of income recognition and taking a deduction into account, respectively. Nothing in section 250 suggests that Congress intended to change the scope of generally applicable income recognition rules. Therefore, the final regulations do not adopt the comment to per-

mit an election to create an imputed cost of goods sold deduction in the context of advance payments with respect to section 250.

D. Expense allocation

1. In General

In calculating DEI under section 250(b)(3), a taxpayer must determine the deductions that are "properly allocable" to gross DEI. Proposed §1.250(b)-1(d)(2)(i) further provided that, for purposes of calculating FDDEI, a taxpayer must determine the deductions that are "properly allocable" to gross FDDEI. Consistent with the rules for determining the foreign tax credit limitation under section 904 or qualified production activities income under former section 199, the proposed regulations provided that §§1.861-8 through 1.861-14T and 1.861-17 apply for purposes of allocating deductions to gross DEI and gross FDDEI. *Id.* Several comments supported using these general apportionment rules.

2. Research and Experimentation Expenditures

Under §1.861-17(b), an exclusive apportionment of research and experimentation ("R&E") expenditures is made if activities representing more than 50 percent of the R&E expenditures were performed in a particular geographic location, such as the United States. After this initial exclusive apportionment, the remainder of the taxpayer's R&E expenditures are apportioned under either the sales or gross income methods under §1.861-17(c) and (d). Section 1.861-17(e) provides rules for making a binding election to use either the sales or gross income method.

a. Exclusive apportionment and direct apportionment

The proposed regulations under section 250 specified that the exclusive apportionment rules in §1.861-17(b) did not apply for purposes of apportioning R&E expenses to gross DEI and gross FDDEI. See proposed §1.250(b)-1(d)(2)

(i). Several comments requested that the final regulations allow taxpayers to use exclusive apportionment for purposes of determining FDII. One comment noted that the preamble to the proposed regulations does not justify the proposed regulations omitting the exclusive apportionment method in the FDII context. Another comment asserted that allowing exclusive apportionment would mitigate a significant disincentive for taxpayers to onshore intangible property into the United States. Other comments argued that allocating R&E expenses to FDDEI may discourage taxpayers from performing R&E activities in the United States.

Several comments recommended allocating R&E expenditures based on an optional books and records method that could be used when there is a clear factual relationship between the R&E expenditures and a particular amount of income. These comments noted that some taxpayers are subject to regulatory oversight with respect to their contract pricing and costs, and therefore such taxpayers' books and records could be an accurate way of showing the relationship between R&E expenses and gross income.

Several comments also requested that the final regulations adopt special rules for expenses that are market-restricted or market-required (for example, expenses required only by the U.S. Food and Drug Administration concerning the U.S. market), including where the legally mandated rule in §1.861-17(a)(4) would not apply. One comment noted that this rule could apply in situations where U.S. law limits the realization from certain research activities to the market in which the research is performed (such as export controls) and therefore the R&E expenditures would not be expected to generate gross income outside the United States.

Several comments requested that if none of these recommendations for allocating R&E expenses are adopted, the final regulations should reserve on this provision pending the broader ongoing review of §1.861-17 by the Treasury Department.

In light of the issuance of proposed rules under §1.861-17 on December 17,

³The final regulations rename "gross non-FDDEI" as "gross RDEI" to clarify that the term includes only the residual of gross DEI that is not gross FDDEI, rather than all gross income (including income that is not gross DEI) that is not gross FDDEI. See §1.250(b)-1(c)(14).

2019 (84 FR 69124) (the “2019 FTC proposed regulations”), the final regulations remove the provision stating that the exclusive apportionment rules in §1.861-17(b) do not apply for purposes of apportioning R&E expenses to gross DEI and gross FDDEI, and generally do not provide special rules for applying §1.861-17 for purposes of section 250. Proposed §1.861-17 in the 2019 FTC proposed regulations provides that the exclusive apportionment rule applies only to section 904 as the operative section, and also proposes eliminating the special rule for legally mandated R&E. As recommended by comments to the proposed regulations under section 250, the Treasury Department and the IRS will consider the issues raised regarding the application of exclusive apportionment for purposes of section 250 as part of finalizing the 2019 FTC proposed regulations.

b. Use of sales or gross income method

Several comments requested that the final regulations include an election to allocate R&E expenses under either the sales or gross income method. Comments also requested that taxpayers should be permitted to make this election annually to give taxpayers a longer period to assess the various new regimes that rely on §1.861-17 such as section 250, and pending the finalization of the FDII regulations. Another comment suggested that the final regulations should provide that the provisions of §1.861-17(c)(3) (requiring sales to third parties by controlled foreign affiliates to be included) should not apply as it might artificially apportion more R&E expense against FDDEI.

As described in the preamble to proposed §1.861-17 in the 2019 FTC proposed regulations, the Treasury Department and the IRS are concerned that the gross income method could in some cases produce inappropriate results. See 84 FR 69124, 69129. As a result, the 2019 FTC proposed regulations proposed to eliminate the optional gross income method described in §1.861-17(d) and require R&E expenditures in excess of the amount exclusively apportioned under §1.861-17(b) to be apportioned based on gross receipts. See proposed §1.861-17(d). Comments addressing the applicability of the gross

income method will be addressed as part of finalizing the 2019 FTC proposed regulations.

Proposed §1.861-17(e)(3), published December 7, 2018 (83 FR 63200), permitted taxpayers a one-time exception to what would otherwise be a five-year binding election period under §1.861-17(e)(1) to use either the sales or the gross income method, in light of the many changes to the foreign tax credit rules made by the Act. Under proposed §1.861-17(e)(3), even if a taxpayer is subject to the binding election period, for the taxpayer’s first taxable year beginning after December 31, 2017, the taxpayer may change its apportionment method without obtaining the Commissioner’s consent. Comments to the proposed regulations under section 250 requested that this one-time exception be extended to at least a second tax year beginning after December 31, 2017, potentially at the election of the taxpayer, pending the Treasury Department’s ongoing review of §1.861-17. The final regulations under §1.861-17 issued on December 17, 2019, provide an additional year for taxpayers to change their election of the sales or gross income method. See §1.861-17(e)(3).

3. Carryovers

Comments requested additional clarification regarding whether taxpayers are required to apportion expenses incurred before the effective date of the proposed regulations. Multiple comments specifically asked for a clarification that taxpayers are not required to apportion NOLs incurred before the effective date of the proposed regulations or, in some cases, before the effective date of the Act, recommending that a clarification could be along the lines of §1.199-4(c)(2)(ii) (providing that a deduction under section 172 for a net operating loss is not allocated or apportioned to domestic production gross receipts or gross income attributable to domestic production gross receipts).

The final regulations address this comment by providing that the following provisions (which limit certain deductions and provide for the carryover of the amounts not currently allowed) do not apply when allocating and apportioning deductions to gross DEI or gross FDDEI

of a taxpayer for a taxable year: sections 163(j), 170(b)(2), 172, 246(b), and 250. See §1.250(b)-1(d)(2)(ii). The Treasury Department and the IRS considered a rule that would require expenses incurred in prior years, including in years before the effective date of the proposed regulations, to be allocated to gross DEI and gross FDDEI, but determined that the benefit of the theoretical precision of this approach would be outweighed by the burden on taxpayers and the IRS that would be associated with making retroactive determinations. Further, the approach taken in the final regulations is consistent with the premise that the section 250 deduction is calculated based on annual income and expenses.

E. Foreign-derived ratio

The proposed regulations provided rules for determining a taxpayer’s foreign-derived ratio, which is the ratio of FDDEI to DEI. See proposed §1.250(b)-1(c)(13). The preamble to the proposed regulations observed that as a result of expense apportionment or attribution of cost of goods sold to gross receipts, a taxpayer’s FDDEI could exceed its DEI, thereby resulting in a foreign-derived ratio greater than one. The preamble noted that this result would be inconsistent with section 250(b)(4), which defines FDDEI as a subset of DEI, as it would lead to having FDII in excess of DII. Therefore, the proposed regulations clarified that the foreign-derived ratio cannot exceed one.

Several comments requested that the final regulations allow the foreign-derived ratio to exceed one. The comments asserted that the foreign-derived ratio can in fact exceed one under the statute where the taxpayer has losses that cause its FDDEI to exceed its DEI, and that there is no evidence Congress intended to limit the foreign-derived ratio to no greater than one. One of the comments asserted that FDDEI and DEI are defined by the statute and that the Treasury Department and the IRS do not have the authority to define FDDEI more narrowly than the statute does. Another comment argued that section 250(a)(2) provides a separate taxable income limitation that limits the FDII deduction based on domestic losses. This comment further asserted that the foreign-derived

ratio rule of the proposed regulations reduces a taxpayer's incentive for repatriating intangible property when the foreign income from these intangibles cannot be used to offset domestic losses for purposes of applying section 250.

One comment further suggested that the final regulations allow a taxpayer to elect to determine its FDII deduction, including the various elements of the determination such as DII, QBAI, and DTIR, based on specific product lines or business lines, as determined by the taxpayer. The comment asserted that such an approach would be analogous to other provisions that calculate taxable income separately for different subsets of income such as former section 199, the foreign tax credit limitation under section 904(d), separate limitation loss recapture rules in sections 904(f) and (g), and §§1.994-1(c) and 1.994-2(b). The comment argued that such an approach to determining FDII is more consistent with the policy goal of reducing the tax incentive to locate intellectual property outside the United States, which the comment asserted would be frustrated if domestic losses reduce FDII-eligible income.

The Treasury Department and the IRS do not agree that limiting the foreign-derived ratio to no greater than one is inconsistent with the plain meaning of section 250. Specifically, the approach recommended by the comments would be inconsistent with the statutory language of section 250(b)(4), which defines FDDEI as a subset of DEI, that is, "any deduction eligible income of such taxpayer which is derived in connection with" certain transactions. Allowing the foreign-derived ratio to exceed one could also lead to anomalous results. For example, a cliff effect would arise whereby a taxpayer with significant FDDEI but only \$1 of DEI would have a significant FDII deduction, whereas if it has \$0 or less of DEI, then no FDII deduction would be allowed. This would also create further anomalous results and incentives with respect to section 163(j), which is determined taking into account the section 250 deduction.

In addition, nothing in section 250 provides for FDII to be calculated based on specific product lines or business lines, which would entail significant complexity for taxpayers and administrative burdens

for the IRS. Instead, the statute is clear that the FDII deduction is calculated as an aggregate of all FDDEI transactions. Therefore, the final regulations do not adopt this comment.

F. Partnership reporting requirements

The proposed regulations required partnership information reporting in order to administer section 250. See proposed §§1.250(b)-1(e)(2) and 1.6038-3(g)(4). One comment asserted that the partnership information reporting requirements of proposed §1.250(b)-1(e)(2) impose unnecessary administrative burdens on a partnership that reasonably believes it has no (direct or indirect) domestic corporate partners, even after the partnership has performed reasonable due diligence as to the identity of its partners and reasonably relied on information provided by the partners. The comment requested that the Treasury Department and IRS consider some form of relief from this reporting; the comment expressed the view that this limited reporting requirement would not prejudice the government's interest because the use of partnership items can only reduce the partner's tax liability. The comment further requested the addition of a reasonable cause exception (consistent with the penalty defenses available for the Form 8865 penalties).

The final regulations do not include a more limited reporting requirement because the Treasury Department and IRS are concerned that this might undermine accurate reporting at the partner level. In addition, the Treasury Department and IRS disagree with the comment's observation that reporting by the partnership of items under section 250 could only reduce a partner's tax liability—for example, a domestic corporate partner might reduce its tax liability by failing to include partnership QBAI. As to the comment's request for a reasonable cause exception, generally applicable penalty exceptions already apply to the extent information relevant to FDII is not reported on the applicable form. See section 6698(a) for filing Form 1065, section 6038(c)(4)(B) for filing Form 8865, and section 6724(a) for filing Schedule K-1 (Form 1065). For example, under §301.6724-1(a)(2)(ii) and (c)(6), a partnership may establish

reasonable cause because a payee failed to provide information necessary for the partnership to comply (or because of incorrect information provided by the payee or any other person that the partnership relied on in good faith). However, the final regulations clarify the reporting rules for tiered-partnership situations as well as provide guidance on certain computational aspects. See §1.250(b)-1(e)(2). Similar additions are made to the reporting rules with respect to controlled foreign partnerships. See §1.6038-3(g)(3).

V. Comments on and Revisions to Proposed §1.250(b)-2—Qualified Business Asset Investment

A. In general

The proposed regulations provided general rules for determining the QBAI of a taxpayer for purposes of determining its DTIR, including defining QBAI, tangible property, and specified tangible property; rules regarding dual-use property; rules for determining adjusted basis; rules regarding short tax years; rules regarding property owned through a partnership; and an anti-avoidance rule. See proposed §1.250(b)-2. Section 250(b)(2)(B) provides that QBAI, for purposes of section 250, is defined under section 951A(d), and is determined by substituting "deduction eligible income" for "tested income" and without regard to whether the corporation is a controlled foreign corporation ("CFC"). While the rules provided in §1.951A-3 for determining QBAI of a CFC for purposes of section 951A do not apply in determining QBAI for purposes of computing the deduction of a taxpayer under section 250 for its FDII, the proposed regulations under section 250 provided a similar, but not identical, determination of QBAI for purposes of FDII.

The section 951A final regulations made certain revisions and clarifications to the proposed regulations under that section ("section 951A proposed regulations"). See §1.951A-3. The preamble to the section 951A final regulations noted that, except as indicated with respect to the election to use a depreciation method other than the alternative depreciation system ("ADS") for determining the adjusted basis in specified tangible property for

assets placed in service before the enactment of section 951A (see part V.B of this Summary of Comments and Explanation of Revisions section), modifications similar to the revisions to proposed §1.951A-3 will be made to proposed §1.250(b)-2. These modifications generally clarify the QBAI computation with respect to dual-use property (§1.250(b)-2(d)) and partnerships (§1.250(b)-2(g)). Accordingly, the final regulations make conforming changes to QBAI for purposes of FDII similar to the changes made to proposed §1.951A-3 in the section 951A final regulations. See §1.250(b)-(2).

B. Determination of basis under ADS

The proposed regulations provided that, for purposes of determining QBAI, the adjusted basis in specified tangible property is determined by using ADS under section 168(g), and by allocating the depreciation deduction with respect to such property for the taxpayer's taxable year ratably to each day during the period in the taxable year to which such depreciation relates. See section 951A(d)(3)⁴ and proposed §1.250(b)-2(e)(1). ADS applies to determine the adjusted basis in property for purposes of determining QBAI regardless of whether the property was placed in service before the enactment of section 250 or section 951A, or whether the basis in the property is determined under another depreciation method for other purposes of the Code. See section 951A(d)(3) and proposed §1.250(b)-2(e).

A comment recommended that the final regulations for FDII should permit taxpayers the opportunity to follow U.S. GAAP for purposes of determining QBAI where the difference between U.S. GAAP and ADS is immaterial. The final regulations do not adopt this recommendation. Section 951A(d)(3) (and, by reference, section 250(b)(2)(B)) is clear that the adjusted basis in specified tangible property is determined using ADS under section 168(g). In addition, permitting taxpayers to elect to follow U.S. GAAP in the context of FDII will impose significant administrative burdens on the IRS to de-

termine what would be immaterial and account for different depreciation methods to compute QBAI.

C. QBAI anti-avoidance rule

In order to prevent artificial decreases to the DTIR amount, the proposed regulations disregarded certain transfers of specified tangible property by a domestic corporation to a related party where the corporation continues to use the property in production of gross DEI. In particular, proposed §1.250(b)-2(h)(1) disregarded a transfer of specified tangible property by the taxpayer to a related party if, within a two-year period beginning one year before the transfer, the taxpayer leases the same or substantially similar property from a related party and such transfer and lease occur with a principal purpose of reducing the taxpayer's DTIR. In addition, a transfer or leaseback transaction was treated as per se undertaken for a principal purpose of reducing the transferor's DTIR if the transfer and leaseback each occur within a six-month span. See proposed §1.250(b)-2(h)(3). Comments recommended that the final regulations contain a transition period for the QBAI anti-avoidance rule in proposed §1.250(b)-2(h)(3) for transactions entered into before the date that the proposed regulations were issued. The final regulations adopt this comment. See §1.250(b)-2(h)(5).

Another comment recommended that a taxpayer be able to rebut the presumption that a transfer or leaseback transaction was undertaken for a principal purpose of reducing the transferor's DTIR if the transfer and leaseback each occurred within a six-month span. The final regulations do not adopt this recommendation because a transfer and lease of the same or similar property that occurs between related parties within six months does not materially change the economic risk of the parties and is unlikely to be motivated by non-tax reasons. In addition, permitting taxpayers to rebut the presumption that such a transaction was undertaken for a principal purpose of reducing the transferor's DTIR creates significant administrative burdens.

VI. Comments on and Revisions to Proposed §1.250(b)-3 — FDDEI Transactions

The proposed regulations provided that FDDEI is the excess of gross FDDEI over deductions properly allocable to gross FDDEI. See proposed §1.250(b)-1(c)(12). The proposed regulations defined gross FDDEI as the portion of a corporation's gross DEI that is derived from all of its "FDDEI sales" and "FDDEI services." See proposed §1.250(b)-1(c)(15). The proposed regulations defined "sale" to include a lease, license, exchange, or other disposition of property, including a transfer of property resulting in gain or an income inclusion under section 367. See proposed §1.250(b)-3(b)(7).

A. Definition of "general property"

1. Treatment of Commodities

For purposes of determining what is a FDDEI sale (and relatedly, whether a sale is for a foreign use), the proposed regulations distinguished between "general property" and certain other types of property. The proposed regulations excluded any commodity (as defined in section 475(e)(2)(B) through (D)) from the definition of general property. See proposed §1.250(b)-3(b)(3). The proposed regulations did not exclude from the definition of general property a commodity described in section 475(e)(2)(A), and therefore, the sale of such a commodity may qualify as a FDDEI sale. A comment raised a concern that the sale of a physical commodity effected through certain derivative contracts (described in section 475(e)(2)(B) through (D)) might not be treated as a sale of general property under the proposed regulations. The comment recommended clarifying that the sale of a physical commodity in satisfaction of a forward contract is not excluded from the definition of general property.

The Treasury Department and the IRS generally agree that a sale of a commodity such as an agricultural commodity or a natural resource should be a sale of gener-

⁴ As enacted, section 951A(d) contains two paragraphs designated as paragraph (3). The section 951A(d)(3) discussed in this part V.B of the Summary of Comments and Explanation of Revisions section relates to the determination of the adjusted basis in property for purposes of calculating QBAI.

al property whether it is sold pursuant to a spot contract or sold pursuant to a forward or option contract, other than a section 1256 contract or similar contract that is traded and cleared like a section 1256 contract. The sale of such a commodity through a futures or option contract that is a section 1256 contract or similar contract is not treated as a sale of general property because the interposition of a clearing organization as the counterparty to such contracts severs the connection between the original selling and buying parties to the contract such that no meaningful determination can be made whether the sale through such a contract is for a foreign use. The definition of “general property” in §1.250(b)-3(b)(10) is modified accordingly. The final regulations also clarify that financial instruments or similar assets traded through futures or similar contracts do not qualify as general property.

The Treasury Department and the IRS are concerned, however, that a taxpayer could manipulate its FDDEI by selectively physically settling only its commodities forward or option contracts in which it has a gain. To prevent this manipulation, the final regulations provide that the sale of a commodity pursuant to a forward or option contract is treated as a sale of general property only to the extent that a taxpayer physically settled the contract pursuant to a consistent practice adopted for business purposes of determining whether to cash or physically settle such contracts under similar circumstances. See §1.250(b)-3(b)(10).

The proposed regulations further provided that a sale of a security (as defined in section 475(c)(2)) or a commodity (as defined in section 475(e)(2)(B) through (D)) is not a FDDEI sale. See proposed §1.250(b)-4(f). This rule is no longer necessary because the final regulations exclude such property from the definition of general property.

2. Treatment of Interests in Partnerships

The proposed regulations did not address the conditions under which the sale of a partnership interest that is not de-

scribed in section 475(c)(2) will satisfy the foreign use requirement. One comment suggested that when a taxpayer sells a partnership interest, a look-through approach should apply such that the sale of a partnership interest would be considered a sale of the partner’s proportionate share in the partnership’s assets. As such, the sale of the partnership interest could be considered a sale of general property and would qualify as a FDDEI sale so long as the other relevant requirements of the regulations were met. The same comment noted an alternative approach that would preclude looking through to the underlying assets and instead would require the foreign purchaser to determine if the acquisition of the partnership interest is for a foreign use.

The Treasury Department and the IRS have determined that, like an interest in a corporation (which is a security under section 475(c)(2)(A) and therefore not general property under §1.250(b)-3(b)(10)), interests in a partnership are not the type of property that can be subject to “any use, consumption, or disposition” outside the United States. Furthermore, a look-through approach would be inconsistent with the fact that title to the partnership’s property does not change upon the sale of an interest in a partnership and also would be difficult to administer given that the underlying property that would be tested for foreign use is not actually being transferred. Accordingly, the final regulations provide that an interest in a partnership, as well as an interest in a trust or estate, is not general property. See §1.250(b)-3(b)(10).

3. Exclusion of Intangible Property

Under the proposed regulations, the rules applicable to the determination of whether a sale of property is for a foreign use depends on whether the property sold is “general property” or “intangible property.” See proposed §1.250(b)-4(d) and (e). The proposed regulations defined general property as property other than intangible property, a security (as defined in section 475(c)(2)), or a commodity (as defined in section 475(e)(2)(B) through

(D)). See proposed §1.250(b)-3(b)(3). The proposed regulations defined intangible property by cross-reference to section 367(d)(4). See proposed §1.250(b)-3(b)(4).

Two examples in the proposed regulations suggested that a limited use license of a copyrighted article is analyzed under the rules for sales of intangible property. See proposed §1.250(b)-4(e)(4)(ii)(D) and (E) (*Example 4 and 5*). One comment recommended that if the distinction between sales of tangible and intangible property is maintained, then the final regulations should provide that software transactions involving the sale or lease of copyrighted articles are governed by the general property rules and not the intangible property rules.

The final regulations make several changes in response to this comment. Consistent with the request in the comment, the definition of “intangible property” for purposes of section 250 is clarified to not include a copyrighted article as defined in §1.861-18(c)(3). See §1.250(b)-3(b)(11). However, the rules for determining foreign use that apply to general property are not suitable for sales of digital content, including copyrighted articles, that are transferred electronically, because those rules focus on the physical transfer of property to end users. Therefore, the final regulations provide an additional rule for sales of general property that primarily contain digital content. See §1.250(b)-4(d)(1)(ii)(D). Under the final regulations, “digital content” is defined as a computer program or any other content in digital format. See §1.250(b)-3(b)(1). The determination of how a transfer of a copyrighted article is characterized (for example, as a sale or a service) for purposes of applying the final regulations is based on general U.S. tax principles, taking into account the regulations issued under section 861.⁵

Notwithstanding the final regulations’ treatment of sales of copyrighted articles for purposes of determining foreign use, no inference is intended with respect to the treatment of sales of copyrighted articles under other sections of the Code. For example, the fact that a sale of a copy-

⁵ See proposed §1.861-18(a) (84 FR 40317) (adding section 250 to the list of provisions to which §1.861-18 applies).

righted article (or other property) is treated as a FDDEI sale does not necessarily mean that the income from the sale is foreign source under section 861.

B. Foreign military sales and services

The proposed regulations provided that for purposes of section 250 a sale of property or a provision of service to the U.S. government that is governed by the Arms Export Control Act of 1976, as amended (22 U.S.C. 2751 et. seq.), is treated as a sale of property or provision of a service to a foreign government, and therefore may qualify as a FDDEI transaction if the other requirements under proposed §§1.250(b)-3 through 1.250(b)-6 are satisfied. See proposed §1.250(b)-3(c). The proposed regulations requested comments on identifying readily available documentation sufficient to demonstrate that a particular sale or service was made pursuant to the Arms Export Control Act.

Several comments requested removal of the requirement in proposed §1.250(b)-3(c) that the resale or on-service to a foreign government or agency or instrumentality thereof must be “on commercial terms.” The comments asserted that this requirement was ambiguous and observed that the taxpayer would not necessarily have access to the contract between the U.S. government and the foreign counterparty and therefore could not necessarily evaluate the commerciality of such contract. The comments also objected to the requirement that the contract between the taxpayer and the U.S. government specifically refer to the resale or on-service to the foreign government, stating that the contract may not always specify this information but that the resale or on-service could be evidenced by the taxpayer’s generally available records.

In response to the preamble’s request for comments on suitable documentation to demonstrate that a foreign military sale qualifies under this special rule, several comments noted that no one particular document will suffice to demonstrate that a given sale or service qualifies. Nevertheless, comments stated that ordinary course documentation should suffice to show that the sale or service qualifies. If the final regulations were to retain a list of particular documents required to demonstrate

that a particular sale or service was made pursuant to the Arms Export Control Act, the comments suggested various types of documents that might be available but also stated that any list of these documents should be non-exclusive since any one document may not exist for a particular sale or service, and, in any event, the Department of Defense and the State Department modify their forms frequently. One comment asked for transitional relief for any pre-existing contracts, if the final regulations were to provide an exclusive list of required documentation. Another comment requested a presumption of foreign use in the context of foreign military sales based on the high likelihood that defense articles would satisfy foreign use — sales made pursuant to the Arms Export Control Act are limited to foreign strategic partners who intend to use articles in a certain manner, such as, self-defense and internal security — and the low likelihood that a foreign person could use a defense article within the United States.

In general, the final regulations adopt the comments. Section 1.250(b)-3(c) does not include a requirement that the foreign military sale or service be “on commercial terms” or that the contract specifically refer to the resale or on-service to the foreign government. Instead, if a sale of property or a provision of a service is made pursuant to the Arms Export Control Act, then the sale of property or provision of a service is treated as a FDDEI sale or FDDEI service without needing to apply the general rules in §1.250(b)-4 or §1.250(b)-5. See §1.250(b)-3(c). The final regulations also do not require any particular documentation to substantiate that a transaction qualifies under the rule in §1.250(b)-3(c). Taxpayers will continue to be required to substantiate under section 6001 that any foreign military sale or service qualifies for a section 250 deduction.

C. Reliability of documentation and reason to know standard

The proposed regulations provided that to establish that a recipient is a foreign person, property is for a foreign use, or a recipient of a general service is located outside the United States, the taxpayer must obtain specific types of documentation described in proposed

§§1.250(b)-4(c)(2), (d)(3), and (e)(3) and 1.250(b)-5(d)(3) and (e)(3). The proposed regulations also provided that the seller or renderer must not know or have reason to know that the documentation is incorrect or unreliable. Proposed §1.250(b)-3(d)(1). One comment requested that the final regulations provide more guidance and relevant examples regarding the scope of this rule, in particular what knowledge should be imputed across a large organization and how the standard should apply when relevant information is legally protected by data privacy laws.

As described in part II of this Summary of Comments and Explanation of Revisions section, the final regulations replace the documentation requirements with substantiation rules that are more flexible with respect to the types of corroborating evidence that may be used. The knowledge or reason to know standard is retained in §§1.250(b)-3(f)(3) (treatment of certain loss transactions), 1.250(b)-4(c)(1) (foreign person requirement), (d)(1)(iii)(C) (general property incorporated into a product as a component) and (d)(2)(ii)(C)(2) (sale of intangible property consisting of a manufacturing method or process to a foreign unrelated party), and 1.250(b)-5(d)(1) (general services provided to consumers). In response to comments, the final regulations provide additional detail regarding the application of the reason to know standard in these sections. The final regulations generally provide that a taxpayer has reason to know that a transaction fails to satisfy a substantive requirement if the information that the taxpayer receives as part of the sales process contains information that indicates that the substantive requirement is not met and, after making reasonable efforts, the taxpayer cannot establish that the substantive requirement is met. See §§1.250(b)-3(f)(3), 1.250(b)-4(c)(1), (d)(1)(iii)(C) and (d)(2)(ii)(C)(2), and §1.250(b)-5(d)(1).

D. Sales or services to a partnership

For purposes of determining a taxpayer’s FDII attributable to sales of property or services to a partnership, the proposed regulations adopted an entity approach to partnerships. See proposed §1.250(b)-3(g)(1). One comment suggested that if a

seller of a good has a greater than 10 percent ownership interest in the recipient domestic partnership, the final regulations should also permit aggregate treatment of the partnership for this limited purpose. The comment observed that the proposed regulations do not permit sales to a domestic partnership to qualify as a FDDEI sale because a domestic partnership is not a foreign person under proposed §1.250(b)-3(b)(2). According to the comment, in certain industries, customers request “teaming arrangements” that require bidders to form a single domestic bidding entity that will govern the relationship between the members of the team, but most of the work is performed by the partners, under subcontract from the partnership. The comment recommended that the practice of joint bidding should not disqualify the activity for FDII purposes.

With respect to a taxpayer’s sales of property to a partnership, one comment suggested that the final regulations consider alternatives to a pure entity approach. The comment outlined two other approaches to determine if a sale to a partnership qualifies as a FDDEI sale based on whether the partnership is predominantly engaged in foreign business or a pure aggregate approach to treat the partnership as a foreign person to the extent of its ownership by direct or indirect foreign partners. With respect to a partnership engaged in multiple lines of business, each business could be viewed as a separate person for FDII purposes. While the comment did not support an aggregate approach or advocate a specific approach, the comment noted that the Treasury Department and the IRS should balance legislative intent, administrative burden, and precision.

The final regulations do not adopt these comments. The statute is clear that in the case of sales of property, the sale must be to a person that is not a United States person, and a domestic partnership is a United States person. See part VII.B of this Summary of Comments and Explanation of Revisions section. In addition, requiring taxpayers to trace the ownership, potentially through multiple tiers, of third-party partnership recipients presents significant administrative hurdles. If, alternatively, this regime were elective, it would create

the potential for abuse or uneven results for similarly situated taxpayers.

E. *Treatment of certain loss transactions*

The proposed regulations provided that if a seller or renderer knows or has reason to know that property is sold to a foreign person for a foreign use or a general service is provided to a person located outside the United States, but the seller or renderer does not satisfy the documentation requirements applicable to such sale or service, the sale of property or provision of a service is nonetheless deemed a FDDEI transaction if treating the sale or service as a FDDEI transaction would reduce a taxpayer’s FDDEI. See proposed §1.250(b)-3(f). One comment requested a clarification that taking the FDII deduction should be considered an elective action and that this rule does not impact such an election.

As described in part II of this Summary of Comments and Explanation of Revisions section, in response to comments, the final regulations adopt a more flexible approach to the FDII-specific documentation rules and instead provide specific substantiation requirements for certain elements of the regulations. Accordingly, the rule with respect to loss transactions is revised so that it only applies to transactions for which there is a specific substantiation requirement. See §1.250(b)-3(f)(3)(i). However, the fact that §1.250(b)-3(f)(3) has been narrowed in the final regulations does not mean that the allowed FDII deduction can be determined on a transaction-by-transaction basis. As provided in the final regulations, FDII is determined on a single aggregate basis, not on a transaction-by-transaction basis. See §1.250(b)-1.

The final regulations also clarify that for purposes of the loss transaction rule, whether a taxpayer has reason to know that a sale of property is to a foreign person for a foreign use, or that a general service is provided to a business recipient located outside the United States, depends on the information received as part of the sales process. If the information received as part of the sales process contains information that indicates that a sale is to a foreign person for a foreign use or that a general service is to a business recipient located

outside the United States, the requisite reason to know is present unless the taxpayer can prove otherwise. See §1.250(b)-3(f)(3)(ii). With respect to sales, the final regulations provide a non-exhaustive list of information that indicates that a recipient is a foreign person or that the sale is for a foreign use, such as a foreign address or phone number. While not all sales to a foreign person are for a foreign use (nor are all sales for a foreign use made to foreign persons), the final regulations use the same indicia for both requirements because a foreign person is more likely to make a purchase for a foreign use compared to a U.S. person. With respect to general services, information that indicates that a recipient is a business recipient include indicia of a business status, such as “LLC” or “Company,” or similar indicia under applicable law, in its name. Information that indicates that a business recipient is located outside the United States includes, but is not limited to, a foreign phone number, billing address, and evidence that the business was formed or is managed outside the United States. These rules can also apply in the case of sales made by related parties where the foreign related party is treated as the seller and the unrelated party transaction is being analyzed. See §1.250(b)-6(c)(2).

The final regulations do not include a rule specifying that a taxpayer may choose not to claim a FDII deduction. Whether an allowable deduction must be claimed is governed by general tax principles and rules on whether such deduction can be elective is beyond the scope of these regulations.

F. *Predominant character rule*

The proposed regulations provided that if a transaction includes both a sale component and a service component, the transaction is classified according to the overall predominant character of the transaction for purposes of determining whether the transaction is subject to the FDDEI sales rules of proposed §1.250(b)-4 or the FDDEI services rules of proposed §1.250(b)-5. See proposed §1.250(b)-3(e). A comment expressed support for the predominant character rule for transactions that contain both sale and service components in general but also suggested that the

final regulations allow taxpayers to elect to follow U.S. GAAP accounting, which may in certain circumstances require the disaggregation of the sale and service components of a single transaction.

For purposes of simplicity and to avoid the need for complex apportionment rules, §1.250(b)-3(d) provides a rule to determine the predominant character of the transaction when a transaction has multiple elements, such as a sale of general property and a service or sale of general property and sale of intangible property. The Treasury Department and the IRS have determined that an elective rule that allows for disaggregation would create significant complexity for taxpayers and be difficult for the IRS to administer, and could lead to whipsaw for the IRS as taxpayers elect to disaggregate when it increases the FDII deduction but not otherwise. Accordingly, the final regulations do not adopt the comment to include an election to follow U.S. GAAP to disaggregate a single transaction.

VII. Comments on and Revisions to Proposed §1.250(b)-4 – FDDEI Sales

Section 250(b)(4)(A) provides that FDDEI includes income from property the taxpayer sells to any person who is not a U.S. person and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use. Accordingly, the proposed regulations defined a FDDEI sale as a sale of property to a foreign person for a foreign use. See proposed §1.250(b)-4(b).

A. End user requirement

The proposed regulations provided that a sale of intangible property is for a foreign use to the extent the intangible property generates revenue from exploitation outside the United States, which is generally determined based on the location of end users purchasing products for which the intangible property was used in development, manufacture, sale, or distribution. See proposed §1.250(b)-4(e)(2)(i).

Several comments requested that the final regulations clarify the definition of an “end user.” One comment recommended that an “end user” be defined as any consumer or business recipient that purchases

a finished good for its own use or consumption (not for resale or further manufacture, assembly, or other processing). Another recommended that the finished good manufacturer or original equipment manufacturer, rather than the ultimate customer of the manufacturer, be treated as the end user.

The final regulations generally adopt the comment that the end user should be the consumer that purchases the property for its own consumption. See §1.250(b)-3(b)(2). Further, as discussed in part VII.C.1 of this Summary of Comments and Explanation of Revisions section, the concept of an end user is also incorporated into the rules for determining whether a sale of general property, in addition to intangible property, is for a foreign use. See §1.250-4(d). In this way, to the extent possible, the final regulations harmonize the rules for sales of general property and intangible property.

Section 1.250(b)-3(b)(2) defines the “end user” as the person that ultimately uses the property, and that a person who acquires property for resale or otherwise as an intermediary is not an end user. The definition of end user is modified for intangible property used in connection with the sale of general property, provision of services, sale of a manufacturing method or process intangible property, and for research and development as provided in §1.250(b)-4(d)(2)(ii).

The final regulations do not adopt the comments that in all cases a finished goods manufacturer may be an end user. However, as described in part VII.C.7 of this Summary of Comments and Explanation of Revisions section, the final regulations continue to provide that sales of general property for manufacturing, assembly, or other processing outside the United States are sales for a foreign use. See §1.250(b)-4(d)(1)(iii). In addition, as described in part VII.D.4 of this Summary of Comments and Explanation of Revisions section, an unrelated manufacturer (such as an original equipment manufacturer) that uses intangible property that consists of a manufacturing method or process, as provided in §1.250(b)-4(d)(2)(ii)(C), is treated as the end user if it has purchased (or licensed) the manufacturing method or process intangible property from an unrelated party.

B. Foreign person

The proposed regulations provided that a recipient is treated as a foreign person only if the seller obtains documentation of the recipient’s foreign status and does not know or have reason to know that the recipient is not a foreign person. See proposed §1.250(b)-4(c)(1). The proposed regulations provided several types of permissible documentation for this purpose, such as a written statement by the recipient indicating that the recipient is a foreign person. See proposed §1.250(b)-4(c)(2)(i).

As explained in part II of this Summary of Comments and Explanation of Revisions section, in response to comments, the final regulations remove the specific documentation requirements with respect to certain requirements, including the foreign person requirement, and further identify the substantive standards by which taxpayers must meet the requirements of the FDII regime. To address situations in which taxpayers may not be able to determine whether the recipient is a foreign person within the meaning of section 7701(a)(1), the final regulations provide that the sale of property is presumed made to a recipient that is a foreign person if the sale is as described in one of four categories: (1) foreign retail sales; (2) sales of general property that are delivered to an address outside the United States; (3) in the case of general property that is not sold in a foreign retail sale or delivered overseas, the billing address of the recipient is outside the United States; or (4) in the case of sales of intangible property, the billing address of the recipient is outside the United States. See §1.250(b)-4(c)(2)(i) through (iv). The presumption does not apply if the seller knows or has reason to know that the sale is to a recipient other than a foreign person. See §1.250(b)-4(c)(1). The final regulations also specify that a seller has reason to know that a sale is to a recipient other than a foreign person if the information received as part of the sales process contains information that indicates that the recipient is not a foreign person and the seller fails to obtain evidence establishing that the recipient is in fact a foreign person. See §1.250(b)-4(c)(1). Information that indicates that a recipient is not a foreign person includes, but is

not limited to, a United States phone number, billing address, shipping address, or place of residence; and, with respect to an entity, evidence that the entity is incorporated, formed, or managed in the United States. Id.

One comment requested that the final regulations include exceptions similar to the foreign military sales rule in the proposed regulations for other sales or licensings of property through an intermediate domestic person. The comment asserted that, for various business reasons including historic relationships with unrelated parties and efficiencies from entering into global deals to sell property to unrelated parties, certain U.S. manufacturers sell products to another U.S. entity, even though that intermediary never actually takes possession, and the product is immediately resold to a foreign person and used outside the United States. In the licensing context, a U.S. taxpayer may enter a global licensing deal with another U.S. entity whereby this intermediary is granted the authority to sub-license the intangible property to its foreign affiliates. While in both cases the transactions could potentially be restructured so that the taxpayer enters into the transactions with a foreign person that is related to the U.S. intermediary, the comment suggested that unrelated counterparties could demand compensation for any restructuring. The comment also noted that the title to section 250(b)(5)(B) references rules for “[p]roperty or services provided to domestic intermediaries,” suggesting that Congress contemplated situations where sales to a U.S. intermediary could be treated as a sale to a non-U.S. person, although the rule itself does not reference domestic intermediaries.

As explained in the preamble to the proposed regulations, section 250(b)(4)(A)(i) requires that a sale of property (which includes licenses of intangible property) be made to a person who is not a United States person. This requirement ensures that only the domestic corporation that makes the final sale to a foreign person can claim a section 250 deduction for a FDDEI sale (rather than allowing the benefit to multiple unrelated domestic corporations that all participate in a sale). Furthermore, the Treasury Department and the IRS do not agree that the heading to section 250(b)(5)(B) implies an exception

to the requirement in section 250(b)(4)(A)(i) that the sale be to a foreign person. The rule in section 250(b)(5)(B)(i) refers only to other “persons” and is not limited to domestic persons. In contrast, the Treasury Department and the IRS have determined that it is necessary and appropriate to provide a special rule for military sales in recognition that sales pursuant to the Arms Export Control Act are required to be made to the U.S. government, but are in effect sales to a foreign government. Therefore, the comment is not adopted.

C. Foreign use of general property

1. Determination of Foreign Use in General

The proposed regulations provided that the sale of general property is for a foreign use if either the property is not subject to domestic use within three years of delivery of the property or the property is subject to manufacture, assembly, or other processing outside the United States before any domestic use of the property. See proposed §1.250(b)-4(d)(2)(i). Domestic use was defined in the proposed regulations as the use, consumption, or disposition of property within the United States, including manufacture, assembly, or other processing within the United States. See proposed §1.250(b)-4(d)(2)(ii). In order to establish that general property is for a foreign use, the seller must generally obtain certain documentation with respect to the sale, such as proof of shipment of the property to a foreign address, and the seller cannot know or have reason to know that the property is not for a foreign use. See proposed §1.250(b)-4(d)(1) and (3).

Several comments noted that the definition of foreign use combined with the narrow documentation requirements make it difficult for taxpayers to satisfy the foreign use requirement. Several comments interpreted the proposed regulations as requiring taxpayers to determine whether general property that was sold would actually be subject to a domestic use within three years of the date of delivery. Other comments similarly expressed confusion regarding the obligation imposed on taxpayers to determine whether there was a reason to know that property would be subject to a domestic use. One comment

requested that the Treasury Department and the IRS treat certain types of sales, such as foreign retail sales at a physical store even where the consumer might ultimately use the property within the United States, as sales for foreign use.

As explained in part II of this Summary of Comments and Explanation of Revisions section, in response to comments on documentation, the final regulations take a more flexible approach to documentation and provide specific substantiation requirements for certain transactions (described in part VII.C.9 of this Summary of Comments and Explanation of Revisions section).

In addition, with respect to the requirement of “foreign use” for sales of general property, the final regulations clarify the meaning of that term to provide that it generally means the sale (or eventual sale) of the property to end users outside the United States or the sale of the property to a person that subjects the property to manufacture, assembly, or other processing outside the United States. See §1.250(b)-4(d)(1)(ii) and (iii). Consistent with the recommendations from comments, the Treasury Department and the IRS have determined that a more flexible definition of foreign use of general property that accounts for the possibility of some limited domestic use is more reasonable for taxpayers to apply and for the IRS to administer. Accordingly, the final regulations eliminate the requirement that the taxpayer have no “reason to know” of some domestic use for sales of general property. As described in part VII.C.2 through 8 of this Summary of Comments and Explanation of Revisions section, the final regulations generally provide that the sale of general property is for a foreign use if the seller determines that such sale is to an end user described in one of five categories. See §1.250(b)-4(d)(1)(ii)(A)-(F).

2. Delivery of Property Outside the United States

The first category of sales that are for a foreign use is sales to a recipient that are delivered by a freight forwarder or carrier to an end user if the end user receives delivery of the general property outside the United States. See §1.250(b)-4(d)(1)(ii)(A). The Treasury Department and the

IRS have determined that, in general, if an end user receives delivery of general property outside the United States, the general property will be “for a foreign use” as contemplated by section 250(b)(4)(A)(ii) and additional detail regarding the actual use of the property is unnecessary. However, it would be inappropriate to treat these sales as FDDEI sales if the seller and buyer arrange for general property to be delivered to a location outside the United States only to be redelivered for use or consumption into the United States with a principal purpose of causing what would otherwise not be a FDDEI sale to be treated as a FDDEI sale. Therefore, §1.250-4(b)(1)(ii)(A) provides an anti-abuse rule to address these concerns.

3. Location of Property Outside the United States

The second category of sales that are for a foreign use is sales of general property to an end user where the property is already located outside the United States, and includes foreign retail sales. See §1.250(b)-4(d)(1)(ii)(B). In general, sales of general property from a foreign retail sale will be used outside the United States. While it may be possible that some end users will purchase property in a foreign retail store and use it solely within the United States, the Treasury Department and the IRS have determined that requiring a determination of the actual use of these sales would be unnecessarily burdensome.

4. Resale of Property Outside the United States

The third category of sales for a foreign use is sales to a recipient such as a distributor or retailer that will resell the general property, if the seller determines that the general property will ultimately be sold to end users outside the United States. See §1.250(b)-4(d)(1)(ii)(C). This category is intended to apply to sales to distributors and retailers, but may also apply to other sales to foreign persons for resale. In addition, the final regulations provide that for purposes of this rule, the seller must substantiate the portion of sales to end users outside the United States under the rules described in parts II and VII.C.9 of this

Summary of Comments and Explanation of Revisions section.

The proposed regulations contained alternative documentation requirements for a sale of multiple items of general property that because of their fungible nature are difficult to specifically trace to a location of use (fungible mass). See proposed §1.250(b)-4(d)(3)(iii). Under the proposed regulations, a seller establishes foreign use of a fungible mass through market research, including statistical sampling, economic modeling and other similar methods. Id. The proposed regulations also provided that if a seller establishes that 90 percent or more of a fungible mass is for a foreign use, the entire fungible mass is treated as for a foreign use and if the seller cannot establish that 10 percent or more of the sale of a fungible mass is for a foreign use, then no part of the fungible mass is treated as for a foreign use. Id.

One comment stated that the fungible mass rules created overly stringent documentation requirements that were unnecessary, impractical, and unreliable because a U.S. seller would need to perform market research in order to meet the 90 percent threshold to qualify for foreign use. Conversely, the comment noted that a U.S. seller that could not meet the 10 percent threshold through market research could see their deduction eliminated in its entirety. The comment suggested instead a rebuttable presumption that fungible mass property sold outside the United States is for a foreign use unless a taxpayer knows or has reason to know that a material amount will be used within the United States.

In response to the comment, the final regulations eliminate the 10 percent and 90 percent thresholds and apply a proportionate rule. See §1.250(b)-4(d)(1)(ii)(C). Under this rule, in the case of a sale of a fungible mass of general property, if a portion of the property sold is not for a foreign use, the seller may rely on the proportion of the recipient’s resales of fungible mass to end users outside the United States to determine its proportion of ultimate sales to end users outside the United States. Id. In addition, the Treasury Department and the IRS have determined that prescribing specific methods such as market research, statistical sampling, economic modeling, and other similar meth-

ods to determine foreign use from the sale of a fungible mass of general property (or a sale of any general property) is unnecessary given the more flexible approach to documentation. It should be noted that market research or information from public data, such as general internet searches of secondary sources, is generally not a source of reliable information. In contrast, statistical sampling, economic modeling, or market research based on the taxpayer’s own data will be more reliable.

5. Electronic Transfer of Digital Content Outside the United States

The fourth category of sales for a foreign use is for sales of digital content that are transferred electronically. Sales of digital content transferred in a physical medium are for a foreign use if described in one of the first three categories. The final regulations provide that digital content that is transferred electronically is for a foreign use if it is sold to a recipient that is an end user that downloads, installs, receives, or accesses the digital content on the end user’s device outside the United States. See §1.250(b)-4(d)(1)(ii)(D). However, if this information is unavailable, such as where the device’s Internet Protocol address (“IP address”) is not available or does not serve as a reliable proxy for the end user’s location (for example, using a business headquarters’ IP address when it has employees located both within and outside the United States who use the digital content), then the sale is for a foreign use if made to an end user with a foreign billing address, but only if the gross receipts from all sales with respect to the end user (which may be a business) are in the aggregate less than \$50,000.

6. International Transportation Property

The fifth category of sales for a foreign use is sales of international transportation property. The proposed regulations provided a special rule for determining whether transportation property like aircraft, railroad rolling stock, vessels, motor vehicles or similar property that travels internationally is sold for foreign use and therefore constitutes a FDDEI sale. See proposed §1.250(b)-4(d)(2)(iv). Under this rule, such transportation property

is sold for foreign use only if during the three-year period from the date of delivery of the property the property is located outside the United States more than 50 percent of the time and more than 50 percent of the miles traversed in the use of such property will be traversed outside the United States. The seller can establish that these criteria are satisfied by obtaining a written statement from the recipient that the property is anticipated to satisfy these tests over the requisite three-year period. See proposed §1.250(b)-4(d)(3)(i) (A). With respect to air transportation, the proposed regulations provided that, for purposes of the above tests, international transportation property is deemed to be within the United States at all times during which it is engaged in transport between any two points within the United States, except where the transport constitutes uninterrupted international air transportation within the meaning of section 4262(c)(3) and the regulations under that section. See proposed §1.250(b)-4(d)(2)(iv).

One comment suggested supplementing these tests with a rebuttable presumption that any foreign-registered aircraft sold to a foreign person is for foreign use. The comment observes that “cabotage rules” significantly restrict the use of foreign registered aircraft within the United States such that a foreign registered aircraft cannot travel between two points in the United States unless the route is part of a through trip on the way to, or coming from, a foreign destination. The comment further noted that the ability of foreign persons to register aircraft in the United States is restricted. Therefore, the comment proposed that a document evidencing foreign registration of an aircraft to a foreign person should suffice to establish foreign use.

Other comments suggested changes to the thresholds in the foreign use tests in the proposed regulations. Several comments suggested reducing the thresholds from 50 percent to 20 percent and making these tests disjunctive. Another comment would retain the 50 percent threshold but eliminate the three-year period so that the foreign use test would only have to be satisfied as of the filing date of the FDII return, and that the taxpayer be permitted to elect annually to bifurcate income from foreign and domestic use based on the

percentage of actual time spent or miles traversed outside and inside the United States. A different comment suggested reducing the three-year period to one year after the date of delivery.

The Treasury Department and the IRS generally agree with the comment that place of registration is appropriate as evidence of “use.” Therefore, the final regulations provide that international transportation property used for compensation or hire is considered for a foreign use if it is sold to an end user that registers the property with a foreign jurisdiction. See §1.250(b)-4(d)(1)(ii)(E). The final regulations provide that other international transportation property is considered for a foreign use if sold to an end user that registers the property with a foreign jurisdiction *and* the property is hangared or primarily stored outside the United States. See §1.250(b)-4(d)(1)(ii)(F). This rule reflects the fact that many recipients of international transportation property will not be further using the property for the provision of international transportation services. As a result, the property will be primarily used in the place it is registered or otherwise hangared or stored. Even if such property enters the United States, because it originated in a different country, the use should not be considered domestic use because the international transportation property will generally be located outside the United States. As a result, the Treasury Department and the IRS have determined that there is no need to determine the amount of time or miles that such property is inside or outside the United States.

Finally, one comment suggested expanding the definition of transportation property to include parts of transportation property like engines, tires, electronic equipment and spare parts, even if such parts would not otherwise satisfy the foreign use tests for general property. The comment expressed concern that the sale of parts that were included within international transportation property could fail the foreign use test for general property because the parts may enter the United States as part of the transportation property. At the same time, such parts would be ineligible for the special rules for international transportation property. The comment suggested expanding the defini-

tion of transportation property to include additional parts, even if such parts would not otherwise satisfy the foreign use tests for general property.

This comment is not adopted. Such a rule would be administratively burdensome and could lead to inconsistency through the application of two sets of rules to the same transaction and property. Furthermore, the Treasury Department and the IRS have determined that the concerns that were the basis for the comment are generally addressed through the adoption of the new general rules with respect to general property and international transportation property. In particular, parts that are used outside the United States by an end user, including when incorporated into transportation property through manufacturing, assembly or other processing, would generally be considered for a foreign use under the general test for general property. As described in part VII.C.1 of this Summary of Comments and Explanation of Revisions section, this is the case even if there is the possibility of some domestic use of the property.

7. Manufacturing, Assembly, or Other Processing Outside the United States

As described in part VII.C.1 of this Summary of Comments and Explanation of Revisions section, the proposed regulations provided that the sale of general property is for a foreign use if either the property is not subject to domestic use within three years of delivery of the property or the property is subject to manufacture, assembly, or other processing outside the United States before any domestic use of the property. See proposed §1.250(b)-4(d)(2)(i). Under the proposed regulations, general property is subject to manufacturing, assembly, or other processing only if it meets either of the following two tests: (1) there is a physical and material change to the property, or (2) the property is incorporated as a component into a second product. See proposed §1.250(b)-4(d)(2)(iii)(A).

The proposed regulations clarified that a physical and material change does not include “minor assembly, packaging, or labeling.” See proposed §1.250(b)-4(d)(2)(iii)(B). Whether property has undergone a physical and material change (as

opposed to minor assembly, packaging, or labeling) is determined based on all the relevant facts and circumstances. The proposed regulations provided that general property is incorporated as a component into a second product only if the fair market value of the property when it is delivered to the recipient constitutes no more than 20 percent of the fair market value of the second product, determined when the second product is completed. See proposed §1.250(b)-4(d)(2)(iii)(C). For purposes of this rule, the proposed regulations included an aggregation rule providing that if the seller sells multiple items of property that are incorporated into the second product, all of the property sold by the seller that is incorporated into the second product is treated as a single item of property.

Several comments recommended that the final regulations provide more flexibility in satisfying the manufacturing, assembly, or other processing rule, especially in the context of sales to foreign unrelated parties where information to establish the two distinct tests may not be readily available. Several comments suggested that the “physical and material change” test should be satisfied where general property is subject to processing or manufacturing activities that are substantial in nature and that are generally considered to constitute manufacturing or production of a substantially different product. Other comments suggested that the final regulations could provide for such a “substantial in nature” rule as a third test in addition to the “physical and material change” and component tests. Comments also recommended a rebuttable presumption where a taxpayer could show that the physical and material change test had been met through reasonable documentation created in the ordinary course of its business. In addition, these comments suggested that general property sold to an unrelated party can be presumed to be sold for use, consumption, or disposition in the country of destination of the property sold, unless the taxpayer knows, or has reason to know otherwise.

With respect to the component test, comments suggested the 20 percent threshold should function as a safe harbor similar to the safe harbor under the subpart F components manufacturing rule in §1.954-3(a)(4)(iii). Another comment

suggested the addition of a facts and circumstances test. Citing concerns with lack of readily available information, comments further suggested allowing taxpayers to satisfy the 20 percent threshold through market research or other methods similar to the fungible mass rule. Another comment suggested the 20 percent threshold was too low and should be increased to 50 percent. In the case of sales of multiple components by the same seller, comments suggested that the sales should not be integrated unless actual knowledge exists as to where the products will be incorporated (such as knowledge that the product will be included in the same second product or the nature of the component compels inclusion into the second product).

Comments also noted similarities and differences with the manufacturing, assembly, or other processing requirement under FDII and the manufacturing rules under subpart F. In particular, comments pointed out that in the subpart F context, the rules address parties under common control where information is more readily available, while in the FDII context, information may not be available. A CFC’s foreign base company sales income does not include income of a CFC derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation. Notably, Treasury regulations provide two special manufacturing rules, often referred to as, the “substantial transformation” test and the “component parts” test. See §1.954-3(a)(4)(ii) and (iii). Under the first test, if property is “substantially transformed” by the CFC before sale, the property sold is considered manufactured, produced, or constructed by the selling corporation. Under the second test, a sale of property is treated as the sale of a manufactured product, rather than the sale of component parts, if the assembly or conversion of the component parts into the final product by the selling corporation involves activities that are substantial in nature and generally considered to constitute the manufacture, production, or construction of property. A CFC is deemed to have manufactured the product if its conversion costs represent 20 percent or more of the total cost of goods sold.

In response to comments, the final regulations make several changes to the rule

for manufacturing, assembly, and other processing. The final regulations clarify that general property is subject to a physical and material change if it is substantially transformed and is distinguishable from and cannot be readily returned to its original state. See §1.250(b)-4(d)(1)(iii)(B). The final regulations also provide a separate substantive rule for the component test and retain the 20 percent threshold as a safe harbor. See §1.250(b)-4(d)(1)(iii)(C). Under this substantive rule, general property is a component incorporated into another product if the incorporation of the general property into another product involves activities that are substantial in nature and generally considered to constitute the manufacture, assembly, or other processing of property based on all the relevant facts and circumstances. Id. The final regulations also clarify that general property is not considered a component incorporated into another product if it is subject only to packaging, repackaging, labeling, or minor assembly operations. See id. While the structure and some of the mechanics of the rule share similarities with the subpart F manufacturing component parts test, the rule is different in terms of purpose and substance.

Finally, in response to comments, the final regulations revise the safe harbor in the component test by specifying that the comparison should be between the fair market value of the property sold by the taxpayer and the fair market value of the final finished goods sold to consumers. See §1.250(b)-4(d)(1)(iii)(C). Because some general property could be incorporated into several different finished goods, the final regulations provide that a reliable estimate of the fair market value of the finished good could include the average fair market value of a representative range of the finished goods that could incorporate the component. An example of this is provided in §1.250(b)-4(d)(1)(v)(B)(1) (*Example 1*). The final regulations also modify the aggregation rule so that it applies only if the seller sells the property to the buyer and knows or has reason to know that the components will be incorporated into a single item of property (for example, where multiple components are sold as a kit). The final regulations specify that a seller has reason to know that the components will be incorporated into

a single item of property if the information received as part of the sales process contains information that indicates that the components will be included in the same second product or the nature of the components compels inclusion into the second product. See §1.250(b)-4(d)(1)(iii)(C).

8. Manufacturing, Assembly, or Other Processing in the United States

Section 250(b)(5)(B)(i) provides that if a seller sells property to another person (other than a related party) for further manufacture or other modification within the United States, the property is not treated as sold for a foreign use even if such other person subsequently uses such property for a foreign use. Section 250(b)(5)(B)(i) could apply in the case of a sale directly to a person that is a foreign person if the property is subject to further manufacture or other modification in the United States after the sale but before the property is delivered to the end user.

As described in the preamble to the proposed regulations, the proposed regulations did not contain specific rules corresponding to section 250(b)(5)(B)(i) because that rule is encompassed within the general rules relating to FDDEI sales in the proposed regulations. The proposed regulations generally provided that general property is not for a foreign use if the property is subject to a domestic use, which includes manufacture, assembly, or other processing within the United States. See proposed §1.250(b)-4(d)(2)(i) and (ii)(B).

Because the final regulations no longer define “foreign use” by reference to whether the property is subject to a domestic use, the rule in section 250(b)(5)(B)(i) is no longer encompassed within the general rules in the regulations relating to FDDEI sales. Accordingly, the final regulations include a rule that provides that if the seller sells general property to a recipient (other than a related party, for which separate rules apply) for manufacturing, assembly, or other processing within the United States, such property is not sold for a foreign use even if the requirements for foreign use are subsequently satisfied. See §1.250(b)-4(d)(1)(iv). For consistency, the final regulations cross reference the rules described in part VII.C.7 of this

Summary of Comments and Explanation of Revisions section for the meaning of “manufacturing, assembly, or other processing.”

9. Specific Substantiation for Foreign Use of General Property

The final regulations specifically require a taxpayer to substantiate foreign use for general property for sales of general property to resellers and manufacturers. See §1.250(b)-4(d)(3)(ii) and (iii). In the case of sales to resellers, a taxpayer must maintain and provide credible evidence upon request that the general property will ultimately be sold to end users located outside the United States. See part VII.C.4 of this Summary of Comments and Explanation of Revisions section. This requirement is satisfied if the taxpayer maintains evidence of foreign use such as the following: a binding contract that limits sales to outside of the United States, proof that the general property is suited only for a foreign market, or proof that the shipping costs would be prohibitively expensive if sold back to the United States. See §1.250(b)-4(d)(3)(ii)(A)-(C). Certain information from the recipient or a taxpayer with corroborating evidence that credibly supports the information will also suffice. See §1.250(b)-4(d)(3)(ii)(D)-(E).

With respect to manufacturing outside the United States, the substantiation requirements are met if a taxpayer maintains proof that the property is typically not sold to end users without being subject to manufacture, assembly or other processing, obtains credible information from a recipient, or, provides a statement containing certain information with corroborating evidence. See §1.250(b)-4(d)(3)(iii).

D. *Foreign use of intangible property*

1. In General

The proposed regulations provided that a sale of intangible property (which includes a license or any transfer of such property in which gain or income is recognized under section 367) is for a foreign use to the extent revenue is earned from exploiting the intangible property outside the United States. See proposed §1.250(b)-4(e)(1). Where the revenue is

considered earned is generally determined based on the location of the end user. See proposed §1.250(b)-4(e)(2). The seller of the intangible property must satisfy certain documentation requirements showing foreign use and have no knowledge, or reason to know, that the portion of the sale of the intangible property for which the seller establishes foreign use is not for foreign use. The proposed regulations also provided rules to determine foreign use for the sale of intangible property to a foreign person in exchange for periodic payments or a lump sum payment. See proposed §1.250(b)-4(e)(2).

2. Substantiating Foreign Use of Intangible Property

Several comments recommended changes to the documentation rules. In response to those comments, and as explained in part II of this Summary of Comments and Explanation of Revisions section, the final regulations adopt a more flexible approach to documentation, but require a taxpayer to specifically substantiate foreign use for sales of intangible property. See §1.250(b)-4(d)(3)(iv). A taxpayer must maintain and provide credible evidence upon request that a sale of intangible property will be used to earn revenue from end users located outside the United States. A taxpayer may satisfy the substantiation requirement by maintaining certain items as specified in the final regulations. See §1.250(b)-4(d)(3)(iv). For example, a binding contract providing that the intangible property can be exploited solely outside the United States would generally satisfy the substantiation requirements demonstrating foreign use of the intangible property. See §1.250(b)-4(d)(3)(iv)(A). Certain information from the recipient obtained or created in the ordinary course of business or corroborating evidence maintained by the taxpayer that credibly supports the information may also suffice. See §1.250(b)-4(d)(3)(iv)(B)-(C).

3. Determining Foreign Use of Intangible Property

Comments suggested that sales with respect to intangible property be divided into several subcategories. One comment

suggested dividing intangibles into production and marketing categories, with income from sales of production intangibles used in the development or manufacture of products outside the United States being FDDEI sales regardless of the location of the end user, and income from sales of marketing intangibles analyzed based on the location of the end user. Another comment suggested three subcategories of intangible sales: (i) sales of manufacturing intangibles to foreign unrelated parties, which would be considered for a foreign use if manufacturing occurs outside the United States; (ii) sales of manufacturing intangibles to related parties, which would be considered for a foreign use if the end product is sold to a foreign person for foreign use; and (iii) sales of marketing intangibles, which would be considered for a foreign use if the end user purchases the resulting product outside the United States.

Consistent with the proposed regulations, the final regulations provide that foreign use of intangible property is determined based on revenue earned from end users located within versus outside the United States. See §1.250(b)-4(d)(2)(i). The focus on the location of end users is derived from the requirement in section 250(b)(5)(A) that sales for a foreign use require “use” or “consumption” outside the United States and the end user is the person that ultimately consumes or uses the intangible property. In the case of legally protected intangible property (such as patents or trademarks), the location in which legal rights to the intangible property are granted and exploited generally determines the location of the end users. Therefore, for example, in the case of intangible property such as patents that provide rights only for markets outside the United States, the end users will generally be located solely outside the United States. In the case of intangible property that allows for worldwide exploitation (or intangible property that is not legally protected), a more specific determination of end users will generally be necessary to determine the portion of intangible property income that is for a foreign use versus not for a foreign use.

In response to the comments received, the final regulations provide more detailed guidance on determining where revenue is earned from end users of the intangible property, including rules for intangible property embedded in general property or used in connection with the sale of general property, intangible property used to provide services, and intangible property used in research and development. See §1.250(b)-4(d)(2)(ii). The final regulations also include rules for determining revenue earned from sales of a manufacturing method or process, which is similar to the separate rule for “production intangibles” or “manufacturing intangibles” that was suggested by comments.

Revenue is generally earned from intangible property used to manufacture products or provide services through sales of such products or services, or from limited use licenses of the intangible property, whether those sales, services, or limited use licenses are executed by an owner, licensee, or sub-licensee of the intangible property. Until revenue is earned from sales, services, or limited-use licenses to the end user that ultimately consumes the property or receives the service, the intangible property is generally not “exploited.” Consistent with this view, the final regulations generally place the location of use of the intangible property with the location of the end user, which is generally the person who ultimately uses the general property in which the intangible property is embedded or associated with, or, if the intangible property is used to provide a service, the service recipient. See §1.250(b)-4(d)(2)(ii)(A) and (B). These rules provide the same determination of location of end user for sales or licenses of intangible property used in research and development. See §1.250(b)-4(d)(2)(ii)(D).

4. Intangible Property Used in Manufacturing

The preamble to the proposed regulations requested comments regarding whether to adopt a rule for intangible property similar to proposed §1.250(b)-4(d)(2)

(i)(B) (treating a sale of general property as for a foreign use if the property is subject to manufacturing, assembly, or other processing outside the United States). Several comments supported a rule that treats the sale of intangible property as for a foreign use where intangibles are used in manufacturing that takes place outside the United States. Some of the comments also suggested that footnote 1522 of the Conference Report to the Act supported this position because that footnote did not specify that its application is limited to only tangible property that is subject to manufacturing, assembling, or other processing outside the United States.⁶

Based on comments received, the final regulations provide a special rule for sales to a foreign unrelated party of a manufacturing method or process or for know-how used to put the manufacturing method or process to use in manufacturing (the “manufacturing method or process rule”). See §1.250(b)-4(d)(2)(ii)(C). The final regulations provide that when this rule applies, then the foreign unrelated party is treated as an end user located outside the United States, unless the seller knows or has reason to know that the manufacturing method or process will be used in the United States, in which case the foreign unrelated party is treated as an end user located within the United States. For purposes of this rule, reason to know is determined based on the information received from the recipient during the sales process. See §1.250(b)-4(d)(2)(ii)(C)(1).

The manufacturing method or process rule does not apply to sales or licenses of a manufacturing method or process to an unrelated foreign party for purposes of manufacturing products for or on behalf of the seller of the manufacturing method or process or any of the seller’s affiliates. See §1.250(b)-4(d)(2)(ii)(C)(2). Applying the manufacturing method or process rule to determine the end user with respect to such an arrangement, such as a contract or toll manufacturing arrangement, is not appropriate because the seller or related party to the seller is using the manufacturing method or process in manufacturing for itself. Such use by the seller is effectively

⁶See H. Rept. 115-466, at 625, fn. 1522 (2017) (Conf. Rept.) (“If property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use.”).

a circular transfer of the intangible property back to the seller. However, the sale of the manufactured products by the seller of the manufacturing method or process or the seller's affiliates can still qualify as a FDDEI sale under other provisions such as §1.250(b)-4(d)(1)(ii).

The manufacturing method or process rule applies only to certain types of intangibles that are used in the manufacturing process. The distinction between the types of intangibles that qualify for this rule and other types of intangibles that may be used by manufacturers is based on a distinction between use of a patented method or process and use of other types of patented items. In all other cases, the foreign use of intangible property is determined based on revenue earned from end users located within versus outside the United States.

The manufacturing method or process rule applies only to sales to unrelated parties (including sales made through related parties that ultimately result in a sale of the manufacturing method or process to an unrelated party). Section 250(b)(5)(C) provides that sales to related parties are treated as for a foreign use only if the property is ultimately sold or used in connection with property that is sold to an unrelated party who is not a United States person. While §1.250(b)-6(c) gives effect to this rule by providing special rules for sales of general property to related parties (which apply in the case of sales of property to related parties for further manufacturing), those rules do not apply to sales of intangible property. Under the proposed regulations, a related party rule was not needed for sales of intangible property, including property consisting of a manufacturing method or process, because the proposed regulations generally provided that intangible property used in the manufacture of a product is treated as exploited at the location of the end user when the product is sold to the end user. Proposed §1.250(b)-4(e)(2)(i). Under the final regulations, limiting the manufacturing method or process rule to unrelated party sales serves the purpose of ensuring that such sales are FDDEI sales only to the extent contemplated by section 250(b)(5)(C). For example, if the taxpayer sells to a foreign related party a manufacturing method used to produce general property, then the sale of the manufacturing method is for a

foreign use to the extent that the foreign related party's sales of the general property are for a foreign use under the rules applicable to sales of general property. See §1.250(b)-4(d)(2)(ii)(A). This result is generally consistent with the result if the related party sale had instead been of general property that was used in manufacturing.

5. Bundled Intangible Property

One comment requested that where a taxpayer licenses a bundle of intangibles, it should be allowed to elect the application of the potentially applicable rules based either on the predominant feature of the bundle or using any reasonable method. The Treasury Department and the IRS recognize that intangible property is sometimes sold or licensed as a bundle, such as the license of patents, copyrights, trademarks, tradenames, and know-how in a single transaction, without specifying the amount of payment required for each item of intangible property. The final regulations provide for a predominant character determination when a transaction has multiple elements, such as a service and sale or a sale of general property and intangible property, to determine whether to apply the provisions for sales of general property, sales of intangible property, or the provision of services. See §1.250(b)-3(d).

In the case of a sale or license of bundled intangible property, the final regulations will generally base the location of exploitation on the location of the end user who ultimately uses the general property in which the intangible property is embedded or associated with, or, if the intangible property is used to provide a service, the location of the service recipient. See §1.250(b)-4(d)(2)(ii)(A)-(B), (D). Only in an unrelated party transaction involving the manufacturing method or process rule will the end user location be determined differently than a transaction involving intangible property used with general property, services, or research and development. However, the manufacturing method or process rule does not determine the location of the end user of other intangible property bundled with the manufacturing method or process. As a result, the final regulations do not provide for an

election to treat or characterize the sale or license of bundled intangible property that includes manufacturing method or process intangibles as well as other intangible property as falling entirely within one of the categories of intangible property specified in §1.250(b)-4(d)(2).

6. Treatment of Product Intangibles as Components

One comment suggested that the final regulations include a rule that would treat certain "product intangibles" as a component of the finished product and provide a rule that is analogous to the rule for sales of general property that is incorporated as a component of another product outside the United States. See §1.250(b)-4(d)(1)(iii)(A) and (C). The final regulations do not adopt this comment. Intangible property has no physical properties, and therefore cannot be incorporated into a finished good or otherwise be a "component" of the finished good in the same way as items of general property that are considered to be components. See section 367(d)(4) (defining intangible property). For example, a patent on an article of manufacture is not a component of the finished product protected by the patent. Similarly, while a trademark design may be placed on a component of a finished product, the trademark itself is not a component of the finished product. Therefore, the final regulations do not provide a component rule for the sale or license of intangible property. Instead, the general rule that use is determined based on where the intangible property is exploited applies to these types of sales.

7. Intangible Property Used to Enhance Other Intangible Property

One comment discussed intangibles that are sold to an unrelated foreign person who enhances the intangible (for example, by adapting it to local markets) or uses the intangible property to develop other intangible property and subsequently sells such enhanced or newly created intangible property outside the United States. In these situations, the comment recommended that the sale of the original intangible property should be presumed to be for foreign use if the location of the

research and development is outside the United States and the recipient is unrelated to the original seller, and suggested that footnote 1522 of the Conference Report supports such a rule.

The final regulations do not adopt the comment. As discussed in part VII.D.3 of this Summary of Comments and Explanation of Revisions section, revenue is generally earned from intangible property used to manufacture products or provide services through sales of such products or services, or from limited use licenses of the intangible property, whether those sales, services, or limited use licenses are executed by an owner, licensee, or sub-licensee of the intangible property. Until revenue is earned from sales, services, or limited-use licenses to the end user that ultimately consumes the property or receives the service, the intangible property is generally not “exploited.” Although the final regulations provide a limited exception from this end user requirement for intangible property that consists of a manufacturing method or process (see part VII.D.4 of this Summary of Comments and Explanation of Revisions section), no exception is included for intangible property used to enhance or create other intangible property. The Treasury Department and the IRS have determined that the activities described in the comment do not constitute “use” by end users but rather are intermediate steps in the development of the intangible property before being exploited and used. In addition, nothing in the text of section 250 or footnote 1522 of the Conference Report suggests that a different definition of foreign use should apply in the case of research and development.

However, in response to comments, the final regulations clarify the rule for sales of intangible property used to develop other intangible property or to modify existing intangible property. See §1.250(b)-4(d)(2)(ii)(D). In such a case, the end user of the intangible property (primary IP) used to develop other intangible property or to modify existing intangible property (secondary IP) is the end user of the property in which the secondary IP is embedded. If the secondary IP is used to provide a service, the end user is the unrelated party recipient. If the secondary IP qualifies as a manufacturing method or pro-

cess (as described in part VII.D.4 of this Summary of Comments and Explanation of Revisions section), then the rules applicable to sales of a manufacturing method or process apply to determine if the sale of the secondary IP is for a foreign use. See §1.250(b)-4(d)(2)(ii)(C).

8. Intangible Property Used to Provide Services

One comment noted that intangible property may be sold to recipients that provide services, rather than solely to recipients that manufacture and sell goods, and that the proposed regulations did not specifically address the sale of intangible property used to provide services. For such sales, the comment recommended that the intangible property be treated as exploited in the locations in which the recipient receives legal rights to the intangible property under the terms of the contract or other applicable law. Another comment recommended that for sales of intangible property to unrelated persons for use in the provision of services, the sales should be presumed to be for foreign use if the services will be performed outside the United States without regard to the location of the person or persons receiving such services.

Revenue may be earned from intangible property through the provision of services, but until that revenue is earned, the intangible property is generally not used or “exploited.” Consistent with this view, the final regulations generally place the location of use of the intangible property with the location of the end user, which in the case of intangible property used to provide a service, is the service recipient. See §1.250(b)-4(d)(2). These rules are generally consistent with the location in which legal rights to the intangible property are granted and exploited, with exploitation generally being located where the end user ultimately consumes the property or the services the intangible property is used to provide. See §1.250(b)-4(d)(2)(i). The rules in §1.250(b)-5 for FDDEI services generally apply for purposes of determining the location of the end user. Therefore, for example, the location of the end user of intangible property that is used to provide advertising services is determined based on the location of the individuals viewing

the advertisements. See §1.250(b)-5(e)(2)(ii).

However, the regulations do not provide a presumption that a sale to a foreign unrelated party that uses that intangible property to provide services outside the United States is presumed to be for foreign use. Such a presumption could produce results that would be inconsistent with the general approach for determining the location of use of intangible property by reference to the location of exploitation (which, in the case of intangible property used to provide services, is generally the location of the person or persons receiving such services), and the Treasury Department and the IRS have determined that a departure is not warranted in this case.

9. Determination of Revenue

The proposed regulations provided that when intangible property is sold in exchange for periodic payments, the extent to which the sale qualifies for a foreign use is made annually based on actual revenue earned by the recipient. Proposed §1.250(b)-4(e)(2)(ii). In the case of a sale of intangible property in exchange for a lump sum payment, the extent to which the sale qualifies for foreign use is determined based on the ratio of total net present value the seller would have reasonably expected to earn from exploiting the intangible property outside the United States to total net present value the seller reasonably expected to earn from exploiting the intangible property worldwide. Proposed §1.250(b)-4(e)(2)(iii). However, for purposes of satisfying the documentation requirements, the proposed regulations provided that in the case of sales in exchange for periodic payments that are not contingent on the revenue or profit of a foreign unrelated party, a taxpayer may establish the extent to which a sale of intangible property is for a foreign use using the principles applicable to sales in exchange for a lump sum payment, except that the taxpayer must make projections on an annual basis. See proposed §1.250(b)-4(d)(3)(ii). This rule recognized that if the recipient of the intangible property makes periodic payments that are not contingent on the recipient’s sales or revenue, the recipient may not be willing

to provide information about the end users of the intangible property.

a. Periodic payments

Like the proposed regulations, the final regulations provide that for periodic payments (such as annual royalty payments or fixed installment payments) in exchange for rights to intangible property, other than intangible property consisting of a manufacturing method or process that is sold to a foreign unrelated party, taxpayers may estimate revenue earned by unrelated party recipients from any use of the intangible property based on the principles for determining revenue from lump sum sales, if actual revenue earned by the foreign party cannot be obtained after reasonable efforts. See §1.250(b)-4(d)(2)(iii)(A). While the proposed regulations required estimated revenue to be determined on an annual basis when a taxpayer relies on this rule, the final regulations eliminate this requirement. The Treasury Department and the IRS have determined that when estimated revenue earned by unrelated party recipients must be used, information available at the time of the sale will be more reliable than information available subsequently. In addition, eliminating the requirement to determine estimated revenue annually reduces the administrative burden on the taxpayer. See §1.250(b)-4(d)(2)(iii)(A).

b. Lump sum payments

One comment recommended that the seller be allowed to use revenue the recipient (rather than the seller) earns or expects to earn from use of the intangible property to determine the extent to which a sale of intangible property in exchange for a lump sum payment qualifies for foreign use because using the recipient's expected or actual revenue is more accurate for determining foreign use. The comment acknowledges the administrative difficulty inherent in determining foreign use in the case of sales of intangible property for a lump sum payment and in obtaining actual or expected revenue data from the recipient.

In response to the comment, the final regulations allow taxpayers to use net present values using reliable inputs, which may include net present values of revenue

that the recipient expected to earn from the exploitation of the intangible property within and outside the United States if the seller obtained such revenue data from the recipient near the time of the sale and such revenue data was used to negotiate the lump sum price paid for the intangible property. See §1.250(b)-4(d)(2)(iii)(B). In determining whether such inputs are reliable, the extent to which the inputs are used by the parties to determine the sales price agreed to between the seller and a foreign unrelated party purchasing the intangible property will be a factor. The final regulations do not allow for use of actual revenue earned by the recipient from the use of the intangible property in a lump sum sale because actual revenue earned by the recipient for all the years the recipient uses the intangible property will not be known when the seller files its tax return for the tax year in which the sale of the intangible property occurred.

c. Payments for manufacturing method or process

With respect to sales to a foreign unrelated party of intangible property consisting of a manufacturing method or process, the final regulations provide that the revenue earned from the end user is equal to the amount received from the recipient in exchange for the manufacturing method or process. See §1.250(b)-4(d)(2)(iii)(C). In the case of a bundled sale of intangible property consisting of a manufacturing method or process and other intangible property, the value of the manufacturing method or process relative to the total value of the intangible property must be determined using the principles of section 482.

E. Treatment of Certain Hedging Transactions

Several comments recommended that gain or loss from certain hedging transactions with respect to commodities be considered gain or loss from sales of general property. In support, the comments noted that the Federal income tax treatment of certain hedging transactions (for example, character and timing) corresponds to the treatment of the underlying physical transaction. Comments noted that these

rules exist, in part, because the combined value of the hedging transaction and the underlying physical transaction generally reflects a taxpayer's true economic exposure to the underlying physical commodity. Consistent with that approach and rationale, these comments recommended a similar approach for purposes of determining FDDEI sales income.

The Treasury Department and the IRS agree that certain hedging transactions should be treated in a manner that is similar to the treatment of the commodities hedged by those transactions. Furthermore, the Treasury Department and the IRS have determined that the adjustment for qualified hedging transactions should apply to all general property, rather than only commodities. Hedges of property other than commodities have the same economic effect as hedges of commodities, such that the rationale for determining FDDEI sales income from hedges by reference to hedges of commodities applies equally to other types of property. Accordingly, the final regulations generally provide that a corporation's or partnership's gross income resulting from FDDEI sales of general property is adjusted by reference to certain hedging transactions. See §1.250(b)-4(f). The hedging transaction must meet the requirements of §1.1221-2, including the identification requirement under §1.1221-2(f), the transaction must hedge price risk or currency fluctuation with respect to ordinary property, and the property being hedged must be general property that is sold in a FDDEI sale. The Treasury Department and the IRS are considering issuing more detailed guidance on hedging transactions in the form of future proposed regulations. Comments are requested on this topic.

VIII. *Comments on and Revisions to Proposed §1.250(b)-5 — FDDEI Services*

Section 250(b)(4)(B) provides that FDDEI includes income from services provided by a domestic corporation to any person, or with respect to property, not located within the United States. Section 250 does not prescribe rules for determining whether a person or property is "not located within the United States." Accordingly, proposed §1.250(b)-5 provided

rules for determining whether a service is provided to a person, or with respect to property, located outside the United States.

A. Categories of services

The proposed regulations separated all services into five mutually exclusive and comprehensive categories: general services provided to consumers, general services provided to business recipients, proximate services, property services, and transportation services. See proposed §1.250(b)-5(b). Whether a service is a FDDEI service is determined under the rules relevant to the applicable category.

One comment requested that the final regulations address how “digital services” are treated and classified under the FDDEI services regulations, although no recommendation was provided. Another comment requested more guidance on the application of the rules for general services to business recipients in the software-as-a-service context.

In response to these comments, the final regulations provide additional guidance, as described in parts VIII.B.1 and VIII.B.2.c of this Summary of Comments and Explanation of Revisions section, with respect to services that are “electronically supplied.” Services that are provided electronically typically will be categorized as general services because they will not meet the definitions of proximate services, property services, or transportation services. To provide additional guidance for determining the location of the recipients of services that are electronically supplied, the final regulations create a new category of general services defined as “electronically supplied services,” which includes general services (other than advertising services, described in the following sentence) that are delivered over the internet or an electronic network. See §1.250(b)-5(c)(5). In addition, the final regulations create a new subcategory of general services for advertising services, including advertising services to display content via the internet, and provide additional guidance with respect to these services as described in part VIII.B.2.c of this Summary of Comments and Explanation of Revisions section. See §1.250(b)-5(c)(1).

B. General services

1. General Services Provided to Consumers

The proposed regulations provided that a consumer is located where the consumer resides when the service is provided and required documentation to establish the place of residence. See proposed §1.250(b)-5(d)(2) and (3). Special rules for small transactions or small taxpayers allowed the taxpayer to establish the consumer’s location using the taxpayer’s billing address for the consumer. See proposed §1.250(b)-5(d)(3)(ii).

Comments suggested that rather than limiting taxpayers to a finite list of documentation, the rules should allow taxpayers to support the status of the consumer as a person located outside the United States using documentation that is collected in the ordinary course of the taxpayer’s trade or business.

As discussed in part II of this Summary of Comments and Explanation of Revisions section, the final regulations adopt a more flexible approach to documentation requirements compared to the proposed regulations. While the final regulations include specific substantiation requirements for certain elements of the regulations, no such rules are provided for general services to consumers. Furthermore, to minimize the burden associated with determining the residence of consumers, the final regulations provide that if the renderer does not have (or cannot after reasonable efforts obtain) the consumer’s location of residence when the service is provided, the consumer of a general service is treated as residing outside the United States if the consumer’s billing address is outside of the United States. See §1.250(b)-5(d)(1). However, this rule does not apply if the renderer knows or has reason to know that the consumer does not reside outside the United States. The final regulations clarify that “reason to know” is determined based only on whether the information received as part of the provision of the service contains information that indicates that the consumer resides in the United States. Because this rule applies to all services provided to consumers (with the modification for electronically

supplied services described in the next paragraph), the final regulations do not provide a special rule for small transactions or small taxpayers.

With respect to electronically supplied services that are provided to consumers, the final regulations provide that the consumer is deemed to reside at the location of the device used to receive the service, which may be an IP address, if available. However, if the renderer cannot determine the location of that device after reasonable efforts, the general rule based on billing address applies, subject to the renderer not knowing or having reason to know that the consumer does not reside outside the United States.

2. General Services Provided to Business Recipients

The proposed regulations determined the location of a business recipient based on the location of its operations, and the operations of any related party of the recipient, that receive a benefit (as defined in §1.482-9(l)(3)) from such service. See proposed §1.250(b)-5(e)(2) and (4). The proposed regulations provided that a service is generally provided to a business recipient located outside the United States to the extent that the renderer’s gross income from providing the service is allocated to the business recipient’s operations outside the United States. See proposed §1.250(b)-5(e)(2)(i). Where the service confers a benefit on the operations of the business recipient in specific locations, the proposed regulations provided that gross income of the renderer is allocated based on the location of the operations in specific locations that receive the benefit. See proposed §1.250(b)-5(e)(2)(i)(A). Where a service confers a benefit on the recipient’s business as a whole, or where reliable information about the particular portion of the operations that specifically receive a benefit from the service is unavailable, the proposed regulations provided that the service is deemed to confer a benefit on all of the business recipient’s operations. See proposed §1.250(b)-5(e)(2)(i)(A). For purposes of this rule, a business recipient is treated as having operations in any location where it maintains an office or other fixed place of business.

See proposed §1.250(b)-5(e)(2)(ii). The proposed regulations also required a taxpayer to obtain documentation sufficient to establish the location of a business recipient's operations that benefit from the service. See proposed §1.250(b)-5(e)(1) and (3). Under the proposed regulations, special rules for small transactions or small taxpayers allowed the taxpayer to establish the consumer's location using the taxpayer's billing address for the consumer. See proposed §1.250(b)-5(e)(3)(ii).

a. Operations of a business recipient of general services

Several comments requested clarification regarding the definition of a business recipient's operations. Some comments requested that the rule be expanded to include operations performed outside of the locations where the business recipient maintains an office or other fixed place of business. For example, where business recipients operate satellites or vessels, the comment suggested that business recipients should be treated as having operations at the location of the satellite or vessel.

The location of a business recipient's operations that benefit from a general service is based on the geographical location where the business recipient's activities are regular and continuous and is not based on the current location of mobile property such as satellites or vessels. Moreover, as noted in the next paragraph, the final regulations clarify that an office or other fixed place of business is a fixed facility through which the business recipient engages in a trade or business. See §1.250(b)-5(e)(3)(i). In the case of services performed with respect to a satellite, the location of the business recipient that receives services with respect to the satellite is based on where the business recipient remotely performs activities with respect to the satellite (which could be within the United States or in a foreign country), rather than in space. In addition, services performed with respect to a vessel owned by a business recipient may qualify as proximate services or property services, depending on the nature of the services. Therefore, no further changes to the regulations are necessary to respond to the comment.

One comment requested further clarification of the term "fixed place of business," such as whether it has the same meaning as it does for section 864(c) purposes. The comment did not specify whether using the meaning that the term has for section 864(c) purposes would be appropriate. However, the Treasury Department and the IRS have determined that it would not be appropriate to adopt the definition that applies for purposes of section 864(c). Because the final regulations define a business recipient as including all related parties of the recipient, whereas section 864(c) applies on a taxpayer-by-taxpayer basis, adopting the definition of an office or other fixed place of business that is in §1.864-7 would cause confusion. However, the final regulations clarify that an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility, through which the business recipient engages in a trade or business. See §1.250(b)-5(e)(3)(i). In addition, the final regulations provide that for purposes of determining the location of the business recipient, the renderer may make reasonable assumptions based on the information available to it. The Treasury Department and the IRS recognize that taxpayers may not be able to obtain precise information about unrelated business recipients; therefore, the final regulations allow taxpayers to make reliable assumptions based on the information available to them. See id.

One comment requested guidance on how to determine the location of operations of a business recipient that does not have an office or fixed place of business. As an example, this could occur when the business recipient is a partnership that does not itself have any offices or employees but is managed by one or more of its partners. The comment suggested that in these circumstances, the final regulations presume that the business recipient has operations where it is formed or incorporated.

To address this comment, the final regulations provide that if the business recipient does not have an identifiable office or fixed place of business (including the office of a principal manager or managing owner), the business recipient is deemed to be located at its primary billing address.

See §1.250(b)-5(e)(3)(iii). The Treasury Department and the IRS considered using place of formation or place of incorporation, but determined that a business recipient's billing address is generally available to the renderer and often bears a closer connection to the business recipient's location of actual operations.

Finally, for the sake of concision, the final regulations expand the definition of a "business recipient" to include all related parties (as defined in §1.250(b)-1(c)(19)) of the recipient. Compare §1.250(b)-5(c)(3) with proposed §1.250(b)-5(e)(4) (the latter providing, in a separate paragraph, that a reference to a business recipient includes a reference to any related party of the business recipient). However, to avoid circularity in circumstances where the business recipient is a related party of the taxpayer, in these circumstances, the term "business recipient" does not include the taxpayer. See §1.250(b)-5(c)(3).

b. The meaning of "benefit"

One comment expressed concern that the proposed regulations' reliance on the principles of §1.482-9(l)(3), which explains when an activity is considered to provide a "benefit" to a recipient, would be difficult to apply outside the related party context because the renderer may not have the information necessary to perform a detailed analysis of the recipient's operations. The comment suggests that transfer pricing standards should not be applied to evaluate transactions for purposes of section 250. The comment suggested that the term "benefit" should retain the reference to §1.482-9(l)(3), but that the regulations should include a presumption that a general service provided to a foreign person benefits operations located outside the United States.

The Treasury Department and the IRS do not intend that the reference to §1.482-9(l)(3) in the definition of "benefit" be interpreted as suggesting that taxpayers are required to perform a transfer pricing-like analysis of the recipient's operations. Rather, the reference is intended to clarify, using a concept that is based on existing tax principles, that a service confers a benefit on operations of a recipient only if an uncontrolled party with similar operations would pay for the service under

comparable circumstances. For example, if a service benefits particular operations of a business recipient so indirectly or remotely that an unrelated party with similar operations would not pay for the service, the service does not confer a benefit on those operations. See §1.482-9(l)(3)(ii). Accordingly, the final regulations retain the reference to §1.482-9(l)(3) in defining “benefit.”

One comment also requested clarification regarding the types of benefits that must be considered in determining the location of the business recipient of a general service. The comment gives the example of a U.S. financial advisor providing advice to a foreign parent that is expected to increase the value of the foreign parent’s publicly traded stock, which would also benefit any U.S. subsidiaries by making their equity-based compensation more valuable. The implication of the comment is that it is unclear whether the U.S. subsidiaries receive a compensable benefit from the service provided because their employees are also shareholders of the foreign parent.

As noted, the reference to §1.482-9(l)(3) in the definition of “benefit” is intended to provide clarity on the meaning of “benefit” using a concept that is based on existing tax principles. As described in the previous paragraph, under §1.482-9(l)(3)(ii), an activity is not considered to provide a “benefit” within the meaning of §1.482-9(l)(3) if the benefit to the recipient is “so indirect or remote” that the recipient would not be willing to pay an uncontrolled party to perform a similar activity. Accordingly, in fact patterns such as the one described in the comment (where the service potentially confers a benefit on a related party of the recipient if the employees of the related party are also shareholders of the recipient), taxpayers must determine whether a related party with employees that are shareholders of a company would generally pay a financial advisor to provide advice to the company or whether the benefit to the related party is too indirect or remote. Section 1.482-9(l) provides comprehensive guidance, including twenty-one examples, to assist taxpayers in understanding when an activity is considered to confer a benefit on a party other than the direct recipient. Accordingly, the comment is not adopted.

c. Determining the locations of the business recipient’s operations that benefit from general services

Several comments addressed the proposed regulations’ rule for determining the location of the recipient of general services that benefits from the service. See proposed §1.250(b)-5(e)(2). One comment suggested that the final regulations include language included in the preamble to the proposed regulations stating that for purposes of this rule, “the location of residence, incorporation, or formation of a business recipient is not relevant.” The final regulations adopt this comment. See §1.250(b)-5(e)(1).

Several comments indicated that it would be difficult, if not impossible, for taxpayers to obtain information regarding which of a business recipient’s locations benefits from a service. While the proposed regulations allowed taxpayers in these circumstances to assume that the services will benefit all of the business recipient’s operations ratably, several comments suggested that this simplification was not sufficient. Several comments stated that these difficulties could be alleviated by making the transition rule in proposed §1.250-1(b) permanent or by making the rules applicable to small businesses and small transactions available to all taxpayers. Several comments requested that the final regulations incorporate certain presumptions to simplify the rule, such as a presumption that any operations of the service recipient that are not known to be (or identifiable as) within the United States are presumed foreign or that services provided to a foreign person are presumed to benefit operations located outside the United States.

The final regulations retain the same general approach as the proposed regulations for determining the location of the business recipient, with some revisions for concision, by providing that a service is provided to a business recipient located outside the United States to the extent that the service confers a benefit on operations of the business recipient that are located outside the United States. See §1.250(b)-5(e)(1). Like the proposed regulations, the final regulations provide that the determination of which operations of the business recipient benefit from a general service is

made under the principles of §1.482-9. Further, the final regulations clarify that in applying these principles, (1) the taxpayer, (2) the portions of the business recipient’s operations within the United States (if any) that may benefit from the general service, and (3) the portions of the business recipient’s operations outside the United States that may benefit from the general service, are treated as if they are each one or more controlled taxpayers.

For purposes of applying the principles of §1.482-9, the final regulations provide taxpayers with flexibility to determine the extent to which a business recipient’s operations within or outside of the United States are treated as one or more separate controlled taxpayers, given that taxpayers generally will not have complete information regarding the operations of the business recipient. Any reasonable method can be used for determining the set and scope of business recipient operations that are treated as separate controlled taxpayers, for example, by segregating the operations on a per entity or per country basis, or by aggregating all of the business recipient’s operations outside the United States as one controlled taxpayer. For example, if a business recipient has operations in the United States, Country X, and Country Y, all of which may benefit from the taxpayer’s services, the business recipient’s operations in the United States, Country X, and Country Y may each be treated as separate controlled taxpayers. Alternatively, the business recipient’s operations in the United States, and the business recipient’s combined operations in Country X and Country Y, could be treated as two separate controlled taxpayers. The amount of the benefit conferred on each of the business recipient’s operations is determined under the principles of §1.482-9(k).

To simplify the rule, the final regulations remove the provision stating that if a service benefits all of the business recipient’s operations, gross income of the renderer is allocated ratably to all of the business locations of the recipient, as that provision was redundant of the general rule. The final regulations also remove the provision that gross income of the renderer is allocated ratably to all of the business locations of the recipient if the renderer is unable to obtain reliable information regarding the specific locations of

the operations of the business recipient to which a benefit is conferred. The Treasury Department and the IRS have determined that it would be inappropriate to allow a deduction that is not based on reliable information.

Comments also suggested that the final regulations should define foreign operations by negation such that a service is considered provided to a business recipient outside the United States if that service is not provided to a business recipient inside the United States. These comments asserted that this would allow mobile activity performed in outer space, international airspace, or international water to qualify as FDDEI services. The Treasury Department and the IRS have determined that evidence that services do not benefit a business recipient's operations within the United States is equivalent to demonstrating that the service benefits operations outside the United States. Therefore, no changes to the regulations are necessary. However, as explained in part VIII.B.2.a of this Summary of Comments and Explanation of Revisions section, the location of a business recipient's operations is determined based on whether its activities are regular and continuous in a particular geographical location, which generally would not include activities in outer space or international space, but may include international water (for example, in the case of a drilling rig).

Several comments requested clarity on how to determine the location of operations that benefit from general services in the case of services that are electronically supplied. In response, the final regulations modify the general rule for determining the location of the business recipient of electronically supplied services and advertising services so that location will be determined based on information that will generally be available to renderers of those types of services. See §1.250(b)-5(e)(2)(ii) and (iii).

Advertising services are different from other general services: the renderer will generally be able to determine where the advertisements are viewed because the renderer controls where the advertisements are displayed. The Treasury Department and the IRS have determined that where the advertisement is viewed serves as a reliable proxy for the locations of the

business recipient that benefit from the service. Generally, it will be in the business recipient's best interest to advertise its products or services in the locations where it does business. Therefore, the final regulations provide that with respect to advertising services, the operations of the business recipient that benefit from the advertising service are deemed to be located where the advertisements are viewed by individuals. See §1.250(b)-5(e)(2)(ii). The final regulations further provide that if advertising services are displayed via the internet, the advertising services are viewed at the location of the device on which the advertisements are viewed. See *id.* For this purpose, the IP address may be used to establish the location of that device. See *id.* The final regulations also include a new example for advertising services. See §1.250(b)-5(e)(5)(ii)(C) (*Example 3*).

Electronically supplied services are also different from other general services because the renderer will generally be able to determine where the service is accessed by using the recipient's IP address or through other means. The Treasury Department and the IRS have determined that the point of access serves as a reliable proxy for where the business recipient receives the benefit of the service. Therefore, the final regulations provide that with respect to electronically supplied services provided to a business recipient, the operations of the business recipient that benefit from the general service are deemed to be located where the general service is accessed. See §1.250(b)-5(e)(2)(iii). The final regulations also provide that if the location where the business recipient accesses the electronically supplied service is unavailable (such as where the location of access cannot be reliably determined using the location of the IP address of the device used to receive the service), and the gross receipts from all services with respect to the business recipient (or any related party to the business recipient) are in the aggregate less than \$50,000, the operations of the business recipient that benefit from the general service provided by the renderer are deemed to be located at the recipient's billing address. *Id.* The final regulations also include new examples for electronically supplied services. See §1.250(b)-5(e)(5)(ii)(E) and (F) (*Example 5* and *6*).

d. Substantiating general services provided to business recipients

As discussed in part II of this Summary of Comments and Explanation of Revisions section, the final regulations replace the documentation requirements with new substantiation requirements for certain transactions, including general services provided to business recipients. The final regulations provide that a general service provided to a business recipient is a FDDEI service only if the taxpayer maintains sufficient substantiation to support its determination of the extent to which the service benefits a business recipient's operations outside the United States. See §1.250(b)-5(e)(4). A taxpayer satisfies this requirement by either obtaining credible evidence establishing the extent to which operations of the business recipient benefit from the service or preparing a statement that supports its determination with corroborating evidence. See §1.250(b)-5(e)(4). The final regulations explain that the determination of the portion of the service that will benefit the business recipient's operations located outside the United States may be based on evidence obtained from the business recipient, such as statements made by the recipient regarding the need for the service or data on the sales of the business recipient's operations, or the taxpayer's own records, such as time spent working with the business recipient's different offices. See §1.250(b)-5(e)(4)(ii).

As explained in part VII.C.4 of this Summary of Comments and Explanation of Revisions section, the Treasury Department and the IRS have determined that it is unnecessary to delineate which specific methods satisfy substantiation. If the taxpayer substantiates its determination with evidence provided by the business recipient, the final regulations do not specify what information must be included in the statement beyond requiring that it must establish the extent to which the service benefits operations located outside the United States. See §1.250(b)-5(e)(4)(i). The Treasury Department and the IRS understand that service recipients may not be willing to provide information about their business to taxpayers. Accordingly, the final regulations do not require the evidence to specify which of a business recipient's

locations benefit from a service (for example, the business recipient's European operations rather than its Asian operations), just the portion of the service that benefits operations outside the United States generally.

C. Proximate services

The proposed regulations provided that the provision of a proximate service to a recipient located outside the United States is a FDDEI service. See proposed §1.250(b)-5(f). The proposed regulations defined a proximate service as a service, other than a property service or transportation service, substantially all of which is performed in the physical presence of the recipient or, in the case of a business recipient, its employees. See proposed §1.250(b)-5(c)(6).

Comments requested that the final regulations expand the definition of a proximate service in proposed §1.250(b)-5(c)(6) to include services performed in the physical presence of additional persons working for a business recipient, including that business's own employees, the employees of a related party of the recipient, or the recipient's contract workers or agents. In response to these comments, the final regulations expand the definition of a proximate service to provide that it means a service, other than a property service or a transportation service, provided to a recipient, but only if substantially all of the service is performed in the physical presence of the recipient or persons working for the recipient such as employees, contractors, or agents. See §1.250(b)-5(c)(8).

Comments also recommended that the final regulations provide that income received for the provision of proximate services, which must be performed outside the United States to qualify as a FDDEI service, is not treated as foreign branch income for purposes of section 250. The comments explained that taxpayers providing such services may potentially be deemed to operate a branch in the country in which the service occurs. The comments asserted that it is contrary to the purpose of section 250 for income from a FDDEI service (a proximate service provided outside the United States) to be excluded from FDDEI because the income is also foreign branch income. The

comments made similar arguments with respect to property services, and one comment suggested that this concern applies to all services.

As explained in part IV.B of this Summary of Comments and Explanation of Revisions section, in response to comments, the final regulations confirm that there is one consistent definition of foreign branch income in both §§1.250(b)-1(c)(11) and 1.904-4(f)(2). The fact that the regulations under section 250 otherwise would treat certain income as eligible for FDII is irrelevant for purposes of determining whether the income is foreign branch income under section 904(d)(2)(J). Further, as acknowledged by the comments, providing a proximate service (or any other service) outside the United States does not necessarily create a foreign branch; therefore, not all income from proximate services performed outside the United States will be foreign branch income. Accordingly, the final regulations do not adopt these comments.

D. Property services

The proposed regulations provided that a property service is a FDDEI service if it is provided with respect to tangible property located outside the United States, but only if the property is located outside the United States for the duration of the period the service is performed. See proposed §1.250(b)-5(g).

1. Qualification of Property Services as FDDEI Services

Several comments recommended that the final regulations remove the mutually exclusive categories of services in proposed §1.250(b)-5(b) because, according to the comments, they are inconsistent with section 250(b)(4)(B), which treats as FDDEI services those provided to any person, or with respect to property, not located within the United States. Comments asserted that the statute is disjunctive and requires that a service with respect to property gives rise to FDDEI if the service is provided to a person located outside the United States, regardless of the location of the serviced property.

The final regulations do not adopt these comments. Section 250(b)(4)(B) refers to

persons and property disjunctively, which indicates that Congress intended for there to be a category of services provided with respect to persons located outside the United States that would be FDDEI services and a separate category of services provided with respect to property located outside the United States that would be FDDEI services. The proposed regulations gave effect to this intent. The statute and legislative history are ambiguous, however, as to whether Congress intended for *all* services provided with respect to persons located outside the United States and *all* services provided with respect to property located outside the United States to be included within the scope of the statute.

The Treasury Department and the IRS have determined that property services must be provided with respect to property located outside the United States in order to qualify as FDDEI services. The purpose of the section 250 deduction is to help neutralize the role that tax considerations play when a taxpayer chooses the location of intangible income attributable to foreign-market activity, that is, whether to earn such income through its U.S.-based operations or through its CFCs. See Senate Committee on the Budget, 115th Cong., "Reconciliation Recommendations Pursuant to H. Con. Res. 71," at 375 (Comm. Print 2017). Providing a FDII deduction for all property services performed in the United States with respect to property with owners located outside the United States, regardless of the property's connection to foreign markets, would not further that purpose. Furthermore, even if the statute required that property services provided to any person located outside the United States could qualify as FDDEI services, the statute does not specify how to determine the location of such person. In the case of property services, the Treasury Department and the IRS have determined that basing the location of such person on the location of the property that the person owns is most consistent with the nature of a property service and the location of the benefit that is being provided. Therefore, even under the comment's alternative reading of section 250(b)(4)(B), the Treasury Department and the IRS have determined that property services should be limited to those services provided to property located outside the United States.

However, in recognition of the fact that some property services performed within the United States may nonetheless be connected to foreign markets, as discussed in part VIII.D.2 of this Summary of Comments and Explanation of Revisions section, the final regulations expand the circumstances under which property services may qualify as FDDEI services notwithstanding the fact that the services are performed in the United States.

Several comments suggested that the final regulations clarify that the property services rules apply only to services that the taxpayer provides with respect to completed property that is in use by the property's owner, and thus, that manufacturing-related services (such as toll manufacturing) are not property services, but rather general services. The comments suggested that if manufacturing services are treated as property services, manufacturing services performed in the United States will never give rise to FDDEI even if the sale of the same property to a foreign person for a foreign use would have been a FDDEI sale. In response to the comments, the final regulations specify that manufacturing services *are* property services but allow property services performed in the United States to qualify as FDDEI services under some circumstances. See §1.250(b)-5(c)(7) and (g)(2). These changes are described in part VIII.D.2 of this Summary of Comments and Explanation of Revisions section. Taken together, these changes allow manufacturing services performed in the United States to be FDDEI services in some circumstances.

In addition, one comment suggested that the definition of "property service" should be modified to remove the condition that only tangible property can be the subject of a property service. The comment states that services can be provided with respect to intangible property located outside the United States, and notes that the statute does not distinguish between services provided with respect to tangible and intangible property. The final regulations do not adopt this recommendation. Intangible property cannot be "located" outside the United States given that intangible property, by definition, does not have physical properties. Accordingly, the Treasury Department and the IRS determined that the general services rules,

which look to the location of the recipient, are a more appropriate framework for analyzing these types of services.

2. Services Provided with Respect to Property Temporarily Located in the United States

The proposed regulations provided that a property service is a FDDEI service only if the tangible property with respect to which the service is performed is located outside the United States for the duration of the period of performance, but requested comments regarding the treatment of property that is located in the United States only temporarily.

Comments requested that the final regulations provide that a property service is still a FDDEI service in part (or in full) if the property enters the United States temporarily while the services are performed, and included various recommendations for a safe harbor, including treating a property service as a FDDEI service if the property is present in the United States for a particular period while the property is out of commercial service. Some comments also requested that the types of property services that are FDDEI services should be expanded to include toll manufacturing arrangements for foreign persons. The comments pointed out that section 250(b)(4)(B) does not specify when property must be located outside the United States. The comments suggested that a special rule for property temporarily in the United States would be consistent with Congress's objective in enacting section 250, which they assert was to incentivize taxpayers to serve the foreign market. In addition, one comment asserted that the proposed regulations penalize a seller for entering into a services arrangement (such as toll manufacturing) instead of a sales arrangement.

The final regulations generally adopt the comments. The Treasury Department and the IRS agree that in certain circumstances, treating property services as FDDEI services is appropriate even if the service is provided within the United States. Accordingly, the final regulations include an exception for property services performed with respect to property that is temporarily located in the United States and treats those services as being provided

with respect to tangible property located outside the United States if several conditions are satisfied. See §1.250(b)-5(g)(2). Those conditions are that the property must be temporarily located in the United States for the purpose of receiving the property service; after the completion of the service, the property will be primarily hangared, docked, stored, or used outside the United States; the property is not used to generate revenue in the United States at any point during the duration of the service; and the property is owned by a foreign person that resides or primarily operates outside the United States.

E. Transportation services

The proposed regulations provided that the provision of a transportation service is a FDDEI service if both the origin and the destination of the service are outside the United States. See proposed §1.250(b)-5(h). Where either the origin or destination (but not both) are outside the United States, then 50 percent of the transportation service is considered a FDDEI service. The proposed regulations defined a transportation service as a service to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle, or any similar mode of transportation. See proposed §1.250(b)-5(c)(7).

Comments requested that the final regulations include elections with respect to cross-border transportation services, including an election for taxpayers to choose either (i) the 50-percent FDDEI treatment provided in the proposed regulations, or (ii) a bifurcation method under which the FDDEI treatment of income from the service is based on actual time or mileage, or (iii) a predominant location method in which all of the income from the service is FDDEI if the taxpayer can demonstrate that more than 50-percent of the services were provided to a person or with respect to property outside the United States on a mileage basis. A comment also requested clarification on whether intermediate domestic stops can be disregarded for purposes of determining the origin and destination of a transportation service.

The final regulations retain the rule in the proposed regulations. See §1.250(b)-5(h). The Treasury Department and the IRS have determined that the primary

benefit of the service relates to servicing the origin or destination market. A 50/50 allocation rule thus provides a simpler and more administrable rule for reflecting the value of each market when the origin or destination is in the United States. In addition, the Treasury Department and the IRS have determined that an elective rule that allows different taxpayers to choose the rule most favorable to their business models would result in inconsistent treatment of similarly situated taxpayers and lead to whipsaw for the IRS. In addition, the rule in the proposed regulations is clear that only the locations of the origin and destination, and not intermediate stops, are relevant to the determination. Accordingly, the final regulations do not adopt these comments. However, the final regulations clarify that freight forwarding and similar services are included within the definition of “transportation services.” See §1.250(b)-5(c)(9).

IX. Comments on and Revisions to Proposed §1.250(b)-6—Related Party Transactions

In the case of a sale of general property or a provision of a general service to a related party, proposed §1.250(b)-6 provided additional requirements that must be satisfied for the transaction to qualify as a FDDEI sale or FDDEI service. These requirements must be satisfied in addition to the general requirements that apply to such sales and services as provided in proposed §§1.250(b)-3 through 1.250(b)-5.

A. Related party sales

1. Amended Return Requirement

The proposed regulations provided two distinct rules for determining whether a sale of property to a related party (related party sale) is a FDDEI transaction. One rule applied when the related party *resells* the purchased property in an unrelated party transaction, either without modification or where the related party incorporates the purchased property as a component of property that is then resold in an unrelated transaction. See proposed §1.250(b)-6(c)(1)(i). A different rule applied when the related party *uses* the prop-

erty in an unrelated transaction, either in connection with the sale of altogether different property or to provide a service. See proposed §1.250(b)-6(c)(1)(ii).

The rule for resales in proposed §1.250(b)-6(c)(1)(i) required that an unrelated party transaction actually occur before the taxpayer can treat the original sale to the related party as a FDDEI transaction. If an unrelated party transaction has not occurred by the filing date of the return that includes the original sale (FDII filing date), the taxpayer cannot immediately treat the sale to the related party as a FDDEI transaction. Instead, in the subsequent year when the unrelated party transaction occurs, the taxpayer can file an amended return for the tax year of the original related party sale treating that sale as a FDDEI transaction and determine its modified FDII benefit accordingly, assuming the period of limitations provided by section 6511 remains open when the unrelated party transaction occurs.

In contrast to the resale rule of proposed §1.250(b)-6(c)(1)(i), where a related party uses the property in an unrelated party transaction (rather than resells that property), the taxpayer was permitted under proposed §1.250(b)-6(c)(1)(ii) to treat that related party sale as a FDDEI transaction so long as the taxpayer reasonably expected, as of the FDII filing date, that one or more unrelated party transactions will occur with respect to the property sold to the related party and that more than 80 percent of the revenue earned by the foreign related party will be earned from such unrelated party transaction or transactions.

Several comments noted administrative difficulties with the amended return requirement for resale transactions in proposed §1.250(b)-6(c)(1)(i). Many comments questioned the requirement of filing an amended return, arguing that it was administratively burdensome (for taxpayers, the IRS, and even state tax authorities) to file or process multiple amended returns. Some comments noted that because of long production or sales cycles, an unrelated party transaction will often not occur by the FDII filing date and might not occur until after the period of limitations under section 6511 has closed so taxpayers would no longer have the ability to treat

the related party sale as a FDDEI transaction. Other comments observed that a taxpayer cannot always trace whether any particular sale to a related party leads to a particular unrelated party transaction given that taxpayers often sell products of a fungible nature or rely on accounting systems that track inventory flows broadly rather than specifically identifying transactions item by item. For such taxpayers, it would be impractical to require tracing, whether at the FDII filing date or any other time.

The preamble to the proposed regulations invited comments on the procedure for amending returns or suggestions for other alternatives for accounting for information relating to foreign use acquired only after the filing of a corporation’s original return. In response, several comments suggested allowing taxpayers to treat the sale to a related party as a FDDEI transaction in the year the related party sale occurred and, if an unrelated party transaction did not in fact occur in a later year, the taxpayer could adjust its FDDEI in that later year to recapture the FDII benefit it should not have claimed. Other comments responded with a range of other alternatives to the amended return requirement such as an election to defer the FDII benefit until the tax year of the unrelated party transaction or a carryforward mechanism for the amount of the original FDII benefit to the later year when the unrelated party transaction occurs (which would be based on the FDII that would have been available in the year of the related party sale and could either take the form of a deduction or a credit in the year of the unrelated transaction).

Some comments pointed out the different treatment of related party sales and the related party use rules of proposed §1.250(b)-6(c)(1)(ii). Under the related party use rules, a taxpayer could treat a sale to a related party as a FDDEI transaction so long as the taxpayer reasonably expected that an unrelated party transaction would later occur, which would alleviate the administrative burdens of the amended return requirement. Under this approach, a taxpayer need not wait until the subsequent unrelated party transaction actually occurred to claim a FDII benefit in the year of the original sale. One com-

ment noted that because the U.S. parent controls the process and all the sellers are related, the taxpayers would generally be in a position to know what products would be sold to foreign unrelated buyers for foreign use. Comments suggested similar treatment for both related party sales and related party use.

Comments further provided suggestions for how a taxpayer could demonstrate it had a reasonable expectation as of the FDII filing date that an unrelated party transaction would occur. Several comments requested the ability to use market research such as inventory turnover, statistical sampling, economic modelling or other similar methods, with one comment suggesting that the fungible mass rule in proposed §1.250(b)-4(d)(3)(iii) also be adopted in this context. One comment suggested that an unrelated party transaction exists whenever the product sold is specifically designed for a foreign market or can only be used outside of the United States. Another noted that in some cases the related party buyer is contractually obligated to sell products only to unrelated foreign parties. Comments also noted that past practice could inform the reasonable expectation of unrelated party transactions.

The Treasury Department and the IRS agree with the concerns expressed by the comments about the administrative burdens that the amended return requirement can cause for both taxpayers and tax administrators. Therefore, the final regulations modify the resale rule in proposed §1.250(b)-6(c)(1)(i) to allow a taxpayer to treat a sale to a related party as a FDDEI transaction in the tax year of the related party sale provided that an unrelated party transaction has occurred or will occur in the ordinary course of business with respect to the property sold to the related party, whether the property is a completed product or a component of a different product. The unrelated party sale can occur at any time in the future so that taxpayers with long production or sales cycles are not unduly prevented from claiming FDII benefits based on the period of limitations for filing an amended return under section 6511. The condition that the unrelated party transaction must be in the ordinary course of business is intended to exclude situations in which the resale is tangential

to the business of the taxpayer and related party (for example, if the taxpayer sells a machine to a related party for the related party's consumption, and the machine is later sold by the related party for scrap or recycling).

The final regulations also remove the requirement that the FDII filing date is determinative with respect to related party sales and use of property in an unrelated party transaction. Taxpayers that engage in related party transactions should generally be able to obtain information after the FDII filing date that will confirm whether a related party sale is in fact a FDDEI sale or service. A rule that depends on the FDII filing date would create uncertainty during examinations if the FDII filing date is inconsistent with actual post-FDII filing date transactions. Therefore, if in fact, an unrelated party transaction does not actually occur in a future year, the related party sale would not be a FDDEI sale. This could also apply to related party services where a substantially similar service that occurs in a future year should be taken into account. See part IX.B.1. of this Summary of Comments and Explanation of Revisions section.

The final regulations also include guidance on how a taxpayer can demonstrate that an unrelated party sale will later occur. Taxpayers can rely on contractual restrictions or historical practices indicating that the related party only sells products to unrelated foreign customers. Moreover, if the design of a product indicates that it is destined only for foreign customers, taxpayers can establish that an unrelated party sale will occur with respect to that product.

In light of the more flexible approach to demonstrate that an unrelated party transaction will occur, the final regulations do not include a de minimis rule such as treating the entire fungible mass of sales as for a foreign use if a seller obtains documentation establishing that 90 percent or more of the fungible mass is for a foreign use (or conversely, no portion of the fungible mass is treated as for a foreign use if the seller does not obtain documentation establishing that 10 percent or more of the fungible mass is for a foreign use) as explained in part VII.C.4 of this Summary of Comments and Explanation of Revisions section.

2. Intermediate Sales to a U.S. Related Party before Eventual Sale to an Unrelated Party

The proposed regulations provided that for purposes of determining whether a related party sale is for a foreign use, all foreign related parties of the seller are treated as if they were a single foreign related party. Proposed §1.250(b)-6(c)(3). This rule gave effect to section 250(b)(5)(C)(I) (providing that a sale to a foreign related party may be for a foreign use if the property is ultimately sold by "a" foreign party to a foreign unrelated party) and allowed a sale to a foreign related party to be a FDDEI sale even if the property is resold to one or more other foreign related parties before the sale to an unrelated foreign person.

One comment requested that the final regulations clarify how the related party resale rule operates when the foreign related party buyer purchases a semi-finished product from the U.S. parent (or another domestic related party), finishes that product, and resells it to the U.S. parent (or another domestic related party) for ultimate sale to an unrelated person for a foreign use. The comment requested that the related party sale rule should apply notwithstanding the intermediate sale so long as the taxpayer can substantiate the ultimate sale of property to the unrelated foreign party. The comment argued that such a clarification would eliminate unwarranted disparate treatment for U.S. companies that engage in multiple related-party sales as compared to those that engage in just one step.

The Treasury Department and the IRS generally agree with this comment and have modified §1.250(b)-6(c)(3) to provide that a U.S. person (either the seller itself or another U.S. person that is a related party of the seller) is treated as part of a single foreign related party. This rule only applies for purposes of determining whether the related party sale is for a foreign use; it does not modify or eliminate the requirement that a seller must sell property to a foreign person for the sale to be a FDDEI sale. However, the Treasury Department and the IRS are concerned that U.S. persons that are members of the same modified affiliated group, but not members of a consolidated group, could

use this rule to avoid the requirement that a sale be made to a foreign person by inserting a foreign person, such as a foreign partnership, as an intermediary in the sale from one U.S. person to another U.S. person. The Treasury Department and the IRS have determined that it would be inappropriate to use the related party sales rules to expand the types of sales that are eligible to be treated as FDDEI sales in this way. Therefore, the rule does not treat a U.S. person as related to the seller if the U.S. person is not related to the seller under the 80 percent or more standard for vote or value in section 1504(a). See §1.250(b)-6(c)(3).

3. Rule for Use of Property in an Unrelated Party Transaction

For transactions other than the resale of purchased property, such as where the foreign related party uses the purchased property to produce other property that is sold in unrelated party transactions, or where the foreign related party uses the property in the provision of a service in an unrelated party transaction, the proposed regulations provided that the sale of property does not qualify as a FDDEI sale unless, as of the FDII filing date, the seller reasonably expects that more than 80 percent of the revenue earned by the foreign related party from the use of the property in all transactions will be earned from unrelated party transactions that are FDDEI transactions (determined without regard to the documentation requirements in §1.250(b)-4 or §1.250(b)-5). See proposed §1.250(b)-6(c)(1)(ii). One comment expressed concern with the 80 percent rule of the proposed regulations creating a cliff effect whereby a taxpayer would derive no FDII benefit if its revenues fell below this threshold. That comment suggested either lowering the threshold or replacing it with a sliding scale upon a certain minimum level of revenues. It also noted that it is unclear how revenue should be measured for purposes of this 80 percent rule, such as whether it should be based on the price of all sales to end user customers and whether it should just include sales to unrelated customers or also related party sales.

The Treasury Department and the IRS agree with the comment that the relat-

ed party sale and related party use rules should have similar standards. To make this rule consistent with the standard in §1.250(b)-6(c)(1)(i), the final regulations modify the rule to require that one or more unrelated party transactions occurs with respect to the property. The Treasury Department and the IRS expect that taxpayers have sufficient control over the supply chain involving controlled transactions to make this determination. In addition, to eliminate the potential cliff effect described in the comment, the final regulations remove the 80 percent rule and instead require the seller in the related party transaction to allocate the buyer's revenues ratably between related and unrelated party transactions based on revenues reasonably expected to be earned as of the FDII filing date. The final regulations also adopt the suggested clarification that revenue should be measured for this purpose based on the price of all transactions with unrelated parties.

Other comments requested clarifications and relevant examples concerning the definition of a component under proposed §1.250(b)-6(b)(5)(ii) and how a component can be distinguished from a sale of property for use in connection with property sold to an unrelated party under proposed §1.250(b)-6(b)(5)(iii). Several comments noted that the preamble to the proposed regulations stated that the component rule of proposed §1.250(b)-4(d)(2)(iii)(C) did not apply for purposes of determining what is a component for purposes of proposed §1.250(b)-6(b)(5)(ii) and requested that this clarification be included in the text of the final regulations. In response to the comments, the final regulations remove the reference to "component" in §1.250(b)-6(b)(5)(ii) and replace it with "constituent part" to avoid any implication that the component rule of §1.250(b)-4(d)(1)(iii)(C) may apply. Further, the final regulations modify the rule for a related party use transaction in §1.250(b)-6(b)(3)(iii) to clarify that it does not include transactions in which the purchased property is a constituent part of the product sold, to eliminate any potential overlap with §1.250(b)-6(b)(5)(ii). Lastly, the final regulations modify the example in §1.250(b)-6(c)(4) to clarify that property that is used in connection with a sale to an unrelated party means property

that is not a constituent part of the product that is ultimately sold.

B. Related party services

1. In General

The proposed regulations generally provided that a provision of a general service to a business recipient that is a related party qualifies as a FDDEI service only if the service is not substantially similar to a service provided by the related party to persons located within the United States. See proposed §1.250(b)-6(d)(1). One comment noted that, unlike the related party sales rule, the related party services rules of proposed §1.250(b)-6(d) did not specify whether the substantially similar service needs to be provided before the FDII filing date for the rule to apply. The comment recommended a rule that is consistent with the related party sales rules. It suggested that the final regulations provide that the service to the related party is treated as a FDDEI transaction in the year provided to the related party if the substantially similar service test was not implicated in that year, but that taxpayers should be required to amend that return to reverse the FDII benefit if a substantially similar service occurs in a later year.

As discussed in part IX.A.1. of this Summary of Comments and Explanation of Revisions section, the final regulations eliminate the amended return requirement for related party sales and allow such sales to be FDDEI sales as long as an unrelated party transaction will occur. Accordingly, the final regulations do not adopt the suggestion to treat a service as not being subject to the substantially similar service test as long as there is no substantially similar service in the year of the related party transaction. However, the Treasury Department and the IRS agree with the recommendation that the related party sales and services rules should be made consistent with respect to the timing element of the unrelated transaction. Therefore, the final regulations provide that a related party service is a FDDEI service only if the related party service is not substantially similar to a service that has been or will be provided by the related party to a person located within the United States. The fact that a substantially similar ser-

vice will occur in a future year does not prevent that substantially similar service from being considered in the determination of whether a related party service is a FDDEI service.

2. Clarifications Related to Benefit and Price Tests

Under the proposed regulations, a service provided by a renderer to a related party is “substantially similar” to a service provided by the related party to a person located within the United States if the renderer’s service (or “related party service”) is used by the related party to provide a service to a person located within the United States and either the “benefit test” of proposed §1.250(b)-6(d)(2)(i) or the “price test” of proposed §1.250(b)-6(d)(2)(ii) is satisfied. The benefit test is satisfied if 60 percent or more of the benefits conferred by the related party service are to persons located within the United States. See proposed §1.250(b)-6(d)(2)(i). Under the price test, a service provided by a renderer to a related party is “substantially similar” to a service provided by the related party to a person located within the United States if the renderer’s service is used by the related party to provide a service to a person located within the United States and 60 percent or more of the price that persons located within the United States pay for the service provided by the related party is attributable to the renderer’s service. See proposed §1.250(b)-6(d)(2)(ii).

One comment supported these bright line tests for substantially similar services as practicable but asserted it would be burdensome for taxpayers to have to apply both tests, and therefore requested that the final regulations only retain the price test, or alternatively should apply the tests conjunctively so that only if both tests are met is a service considered substantially similar to a service provided by a related party to a person in the United States.

The Treasury Department and the IRS have determined that these two tests consider distinct factors, both of which are relevant, and therefore the final regulations do not adopt the suggestion that the benefit test be eliminated or that the tests be made conjunctive. Both tests address concerns with “round tripping” arrange-

ments where the provision of services primarily benefits persons within the United States, but a related party located outside the United States is interposed in order to qualify the initial transaction as a FDDEI transaction. While the two tests may overlap, they also serve different purposes and address different concerns. One example that implicates the benefit test is when a related party bundles its own services that provide minimal benefit to persons located outside the United States with other services that primarily benefit persons located within the United States. The price test addresses situations such as when a taxpayer provides a broad range of services to a related party located outside the United States but one component of the service is provided unchanged to persons located within the United States and this is reflected in the price charged to the U.S. customer compared to the price charged to the related party. Consequently, in the absence of the price test, a related party service that satisfies the benefit test could qualify as a FDDEI transaction even if the related party service accounts for 60 percent or more of the total price charged to customers located within the United States. However, the final regulations clarify that the benefit test is met only if 60 percent or more of the benefits conferred by the related party service are directly used by the related party to confer benefits on consumers or business recipients within the United States. See §1.250(b)-6(d)(2)(i). For example, if a business recipient located in the United States hires the related party to provide a consulting service, and the related party hires the taxpayer to perform research that is used by the related party in performing the consulting service, the related party will have directly used the taxpayer’s research in performing the consulting service for the business recipient located within the United States. Services provided to the related party that will only indirectly benefit the related party’s service recipients (generally, when the related party’s service recipients would not be willing to pay for the related party service) are not “substantially similar” to the services provided by the related party. See §1.482-9(l)(3)(ii) for an explanation of indirect or remote benefits.

Proposed §1.250(b)-6(d)(3) provided that for purposes of applying the price and

benefit tests, the location of a consumer or business recipient with respect to a related party service is determined under the principles that apply to FDDEI services. One comment requested the addition of a clarifying sentence to proposed §1.250(b)-6(d)(3) indicating that the benefits conferred and price paid for the related party service that is provided to persons located in the United States must be allocated based on the locations of the business recipients that benefit from these services provided by the related party. In response to this comment, the final regulations clarify that if the related party provides a service to a business recipient, the business recipient is treated as a person located within the United States to the extent that the service confers a benefit on the business recipient’s operations located within the United States. The price paid to the related party is allocated proportionally based on the locations of the business recipient that benefit from the services provided by the related party. See §1.250(b)-6(d)(3)(i). The final regulations also clarify that for purposes of applying the price test, if the benefits conferred by the related party service are to persons located in the United States and outside the United States, the price paid by the related party for the related party service is allocated proportionally based on the locations of the business recipient that benefit from the services provided by the related party. See §1.250(b)-6(d)(3)(ii). In addition, the examples have been revised to clarify the application of the rules. See §1.250(b)-6(d)(4).

X. Comments on and Revisions to Proposed §1.962-1

Proposed §1.962-1(b)(1)(i) allowed individuals making an election under section 962 to take into account the deduction for GILTI under section 250. Specifically, proposed §1.962-1(b)(1)(i)(A)(2) provided that “taxable income” for purposes of section 962 includes GILTI inclusions, and proposed §1.962-1(b)(1)(i)(B)(3) specified that the section 250 deduction for GILTI is permitted as a deduction to arrive at “taxable income.” The final regulations retain these rules without change.

One comment noted that the reference to section 960(a)(1) in §1.962-1(b)(2) was obsolete after the revisions to section 960

made by the Act, and that the regulations lacked any reference to foreign tax credits with respect to GILTI inclusions. The Treasury Department and the IRS agree with this comment. Accordingly, §1.962-1(a)(2), (b)(2), and (c) have been updated to replace obsolete cross-references to section 960(a)(1) with cross-references to section 960(a); §1.962-1(b)(2) has been updated to clarify that foreign tax credits with respect to GILTI inclusions under section 960(d) are available to individuals making section 962 elections (subject to the limitations of section 904(c) and 904(d)(1)(A)); and §1.962-1(c) has been updated to provide a revised example illustrating the application of §1.962-1. The limitation on the section 11(c) surtax exemption (repealed in 1978⁷) provided in §1.962-1(b)(1)(ii) has also been struck from §1.962-1.

Finally, the Treasury Department and the IRS understand that there is uncertainty regarding the situations in which individuals may make a section 962 election on an amended return. The Treasury Department and the IRS are considering issuing further guidance under section 962. Until further guidance on this issue is published, individuals may make an otherwise valid section 962 election on an amended return for the 2018 tax year and subsequent years, regardless of circumstance, provided the interests of the government are not prejudiced by the delay, as described in §301.9100-3(c). For example, the interests of the government could be prejudiced when a section 962 election is made on an amended return resulting in an overpayment in a year for which the period to file a claim for refund is open under section 6511 and simultaneously increasing the amount of U.S. tax due in years for which the assessment period under section 6501 has expired.

XI. *Comments on and Revisions to Proposed §§1.1502-12, 1.1502-13, and 1.1502-50 — Consolidated Section 250*

Proposed §1.1502-50 provided that the section 250 deduction of a member of a consolidated group (member) is determined by reference to the relevant items of all members of the same consolidated

group (single-entity treatment). Single-entity treatment ensures that the aggregate amount of section 250 deductions allowed to members appropriately reflects the income, expenses, gains, losses, and property of the consolidated group as a whole. To effectuate single-entity treatment, proposed §1.1502-50 aggregated the DEI, FDDEI, DTIR, and GILTI of all members, the amounts of which are used to calculate an overall deduction amount for the consolidated group. See proposed §1.1502-50(e) (providing definitions). The aggregate deduction amount for the consolidated group is then allocated among the members on the basis of their respective contributions to consolidated FDDEI and consolidated GILTI. See proposed §1.1502-50(b).

A. *Single-entity treatment*

Two comments addressed the computation of a member's section 250 deduction. The comments generally supported single-entity treatment. However, one comment recommended permitting a taxpayer to elect out of single-entity treatment with respect to the section 250 deduction attributable to GILTI. The comment expressed concern about applying the taxable income limitation in section 250(a)(2) to companies with pre-Act NOLs while also arguing that the NOLs of a consolidated group should not affect the section 250 deduction attributable to GILTI of a member that has not contributed to the NOLs. The Treasury Department and the IRS decline to adopt this recommendation because single-entity treatment ensures that a consolidated group's income tax liability is clearly reflected, as required by section 1502. Permitting taxpayers to elect out of single-entity treatment would incentivize inappropriate planning with respect to the location of CFCs within the consolidated group and undermine the policy behind the enactment of section 250.

B. *Life-nonlife consolidated groups*

The second comment raised concerns that the proposed regulations may be incompatible with the rules and framework of §1.1502-47 for life-nonlife consoli-

dated groups. The comment asserted that single-entity treatment could result in an inappropriate permanent disallowance of the section 250 deduction in a life-nonlife consolidated group if the allocation of the section 250 deduction among members is made on a subgroup basis. The comment recommended applying the section 250 deduction based on the life-nonlife consolidated group's consolidated taxable income, rather than taking the deduction into account at the subgroup-level. Under the comment's recommended approach, the section 250 deduction would be treated as a consolidated deduction to determine whether it can be used against consolidated taxable income before being allocated to a member. The Treasury Department and the IRS are studying these concerns and request comments on this topic.

C. *Qualified business asset investment*

Proposed §1.1502-50(c)(1) provided that, for purposes of determining a member's QBAI, the basis of specified tangible property does not include an amount equal to any gain or loss realized with respect to such property by another member in an intercompany transaction, whether or not such gain or loss is deferred. This rule was intended to negate the impact (whether positive or negative) of an intercompany sale of property on the computation of DII, in accordance with single-entity treatment. However, in most relevant cases, once an intercompany item has been included in income, there are real, external consequences to the group. For example, if gain has been included in consolidated taxable income (and in the tax system), the group should take the associated increase in tax basis into account. Therefore, these final regulations limit the application of the rule negating the impact of intercompany sales of property to the period during which the intercompany gain or loss remains deferred under §1.1502-13. See §1.1502-50(c)(1)(i).

The Treasury Department and the IRS are also concerned that single-entity treatment is not achieved in certain intercompany transactions involving the transfer of a partnership interest if such transfers result in an increase or decrease in the basis

⁷Pub. L. No. 95-600, 92 Stat 2763 (1978).

of specified tangible property under section 743(b) and thus impact the computation of DII. The final regulations therefore provide that a member's partner-specific QBAI basis includes a basis adjustment under section 743(b) resulting from an intercompany transaction only when, and to the extent, gain or loss, if any, is recognized in the transaction and no longer deferred under §1.1502-13. See §1.1502-50(c)(1)(ii).

XII. Applicability Dates

As proposed, proposed §§1.250(a)-1 through 1.250(b)-6 would apply to taxable years ending on or after March 4, 2019. However, the proposed regulations also provided that, for taxable years beginning on or before March 4, 2019, taxpayers may use any reasonable documentation maintained in the ordinary course of the taxpayer's business that establishes that a recipient is a foreign person, property is for a foreign use (within the meaning of proposed §1.250(b)-4(d) and (e)), or a recipient of a general service is located outside the United States (within the meaning of proposed §1.250(b)-5(d)(2) and (e)(2)), as applicable, in lieu of the documentation required in proposed §§1.250(b)-4(c)(2), (d)(3), and (e)(3) and 1.250(b)-5(d)(3) and (e)(3), provided that such documentation meets the reliability requirements described in proposed §1.250(b)-3(d). The proposed regulations also provided that taxpayers may rely on proposed §§1.250(a)-1 through 1.250(b)-6 for taxable years ending before March 4, 2019.

The final regulations modify the applicability dates in proposed §§1.250(a)-1 through 1.250(b)-6 as follows. Except for §1.250(b)-2(h), the rules in §§1.250(a)-1 through 1.250(b)-6 apply to taxable years beginning on or after January 1, 2021. Section 1.250(b)-2(h), which contains an anti-abuse rule for certain transfers of property, applies to taxable years ending on or after March 4, 2019, consistent with the applicability date in the proposed regulations. See, however, part V.C of this Summary of Comments and Explanation of Revisions section for a transition rule relating to transfers that occur before March 4, 2019.

However, taxpayers may choose to apply the final regulations to taxable years

beginning before January 1, 2021, provided that they apply the final regulations in their entirety (other than the special substantiation requirements in §1.250(b)-3(f) and the applicable provisions in §1.250(b)-4(d)(3) or §1.250(b)-5(e)(4)). See section 7805(b)(7). Taxpayers will be required to substantiate under section 6001 that any sale or service qualifies for a section 250 deduction. Alternatively, taxpayers may rely on proposed §§1.250(a)-1 through 1.250(b)-6 in their entirety for taxable years beginning before January 1, 2021, except that taxpayers relying on the proposed regulations may rely on the transition rule for documentation for all taxable years beginning before January 1, 2021 (rather than only for taxable years beginning on or before March 4, 2019). See also part II of this Summary of Comments and Explanation of Revisions section.

Section 1.962-1(b)(1)(i)(B)(3), which allows individuals making an election under section 962 to take into account the section 250 deduction, applies to taxable years of a foreign corporation ending on or after March 4, 2019, and with respect to a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends.

Proposed §1.962-1(b)(1)(i)(A)(2), which updated the regulations to conform to the enactment of section 951A by providing that "taxable income" for purposes of section 962 includes GILTI inclusions, is proposed to apply beginning with the last taxable year of a foreign corporation beginning before January 1, 2018, and with respect to a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends. The final regulations provide that §1.962-1(b)(1)(i)(A)(2) applies to taxable years of a foreign corporation ending on or after March 4, 2019, and with respect to a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends. Under section 951A(f)(1)(A), GILTI inclusions are treated in the same manner as amounts included under section 951(a)(1)(A) for purposes of section 962. Accordingly, individuals making an election under section 962 were required to include GILTI in "taxable income" for purposes of section 962 irrespective of this update to the regulations.

Section 1.962-1(a)(2), (b)(1)(ii), (b)(2)(i) through (iii), and (c), which update obsolete cross-references to former section 960(a)(1), strike the section 11(c) surtax exemption limitation, update rules on the allowance of foreign tax credits to individuals making an election under section 962 (including with respect to the carry-back and carryover of such credits), and provide an updated example illustrating the application of §1.962-1, apply to taxable years of a foreign corporation ending on or after July 15, 2020, and with respect to a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends. With respect to foreign tax credits, section 960(d) provides domestic corporations (which includes individuals making an election under section 962) a credit for taxes attributable to tested income, and section 904(c) and 904(d)(1)(A) prohibit taxpayers from carrying back or carrying over any excess foreign taxes attributable to tested income as a credit in their first preceding taxable years and in any of their first 10 succeeding taxable years. Accordingly, individuals making an election under section 962 that claimed foreign tax credits attributable to tested income were subject to the limitations of sections 960(d), 904(c), and 904(d)(1)(A) irrespective of the updates to the regulations.

One comment requested clarification that proposed §1.962-1 can be applied for taxable years beginning in 2018. With respect to taxable years before the relevant final regulations are applicable, the final regulations provide that taxpayers may choose to apply the provisions of §1.962-1(a)(2), (b)(1)(i)(A)(2), (b)(1)(i)(B)(3), (b)(1)(ii), (b)(2)(i) through (iii), and (c) for taxable years of a foreign corporation beginning on or after January 1, 2018, and with respect to a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends.

Proposed §1.1502-50 was proposed to apply to consolidated return years ending on or after July 15, 2020. The final regulations provide that §1.1502-50 applies to consolidated return years beginning on or after January 1, 2021. Taxpayers that choose to apply the final regulations under §§1.250(a)-1 through 1.250(b)-6 to taxable years beginning before January 1, 2021, must also apply the provisions in

§1.1502-50 to such years. Similarly, taxpayers that rely on proposed §§1.1250(a)-1 through 1.1250(b)-6 for taxable years beginning before January 1, 2021, must also follow proposed §1.1502-50.

Proposed §§1.6038-2(f)(15) and 1.6038A-2(b)(5)(iv) are proposed to apply with respect to information for annual accounting periods beginning on or after March 4, 2019. See sections 6038(a)(3) and 7805(b)(1)(B). Proposed §1.6038-3(g)(4) is proposed to apply to taxable years of a foreign partnership beginning on or after March 4, 2019. See section 7805(b)(1)(B). No changes were made to the proposed applicability date in the final regulations.

XIII. Comment Regarding Special Analyses

One comment asserted that in issuing the proposed regulations, the Treasury Department and the IRS did not comply with Executive Orders 12866 and 13563 because the costs and benefits analysis required under the executive orders did not quantify the burden imposed by the documentation requirements for larger business entities that were ineligible for the small business and small transaction exceptions.

The Treasury Department and the IRS complied with the applicable requirements under Executive Orders 12866 and 13563 when issuing the proposed regulations. See 84 FR 8188, Special Analyses section. In addition, an economic analysis of the impact of the substantiation requirements of the final regulations is contained in part I.C.1.a.i of the Special Analyses section. As required by the Regulatory Flexibility Act, an analysis of the impact of the final regulations on small businesses is contained in part III of the Special Analyses section.

Special Analyses

I. Regulatory Planning and Review — Economic Analysis

Executive Orders 13771, 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, of reducing costs, of harmonizing rules, and of promoting flexibility. For purposes of Executive Order 13771, this final rule is regulatory.

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

A. Background

The Tax Cuts and Jobs Act (the “Act”) introduced new section 250 of the Internal Revenue Code, which provides a deduction for (1) a portion of profits attributable to U.S. activities that serve foreign markets and (2) a portion of profits of controlled foreign corporations (“CFCs”). The deduction has the effect of reducing the role that U.S. tax considerations play in a domestic corporation’s decision about whether to service foreign markets directly or through a CFC, and also of protecting the U.S. tax base against base erosion incentives created by the new participation exemption system established under section 245A.⁸

At the most basic level, the section 250 deduction is available to domestic corporations with respect to their “excess return” (that is, their return in excess of a fixed return on tangible assets) derived from serving foreign markets. This deduction results in a lower effective rate of U.S. tax on the corporations’ foreign-derived intangible income (“FDII”)

and global intangible low-taxed income (“GILTI”). FDII is the portion of the “excess return” derived from serving foreign markets directly from the United States, while GILTI is the portion of the “excess return” derived through foreign affiliates. FDII and GILTI are calculated based on formulas set out in sections 250 and 951A, respectively. For taxable years between 2018 and 2025, section 250 generally allows a deduction equal to the sum of 37.5 percent of the corporation’s FDII plus 50 percent of its GILTI (thereafter, these deductions are reduced to 21.875 percent and 37.5 percent, respectively). These deduction rates are intended to produce comparable tax rates on income earned from serving foreign markets, regardless of whether such income is earned directly by a domestic corporation or by its CFCs.⁹

On March 6, 2019, the Treasury Department and the IRS published proposed regulations relating to section 250 (“proposed regulations”).

B. Need for final regulations

Regulations are needed to aid taxpayers in determining the amount of their section 250 deduction. The final regulations are also needed to respond to comments received on the proposed regulations.

C. Baseline

The economic analysis that follows compares the final regulations to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of the final regulations. This no-action baseline reflects the current environment including the existing international tax regulations pursuant to the Act, prior to any amendment by the final regulations.

D. Economic analysis

The final regulations provide certainty and clarity to taxpayers regarding the section 250 deduction. In the absence of such guidance, the chance that different taxpayers would interpret the statute differently would be exacerbated. Similarly situated

⁸See Senate Explanation, at 370 (“[O]ffering similar ... rates for intangible income derived from markets, whether through U.S.-based operations or through CFCs, reduces or eliminates the tax incentive to locate or move intangible income abroad, thereby limiting one margin where the Code distorts business investment decisions.”).

⁹See Joint Comm. on Taxation, General Explanation of Public Law 115-97, at 377-383.

taxpayers might interpret the statutory rules pertaining to the treatment of particular sales or services differently, with one taxpayer pursuing a sale that another taxpayer might decline to make because of different interpretations of how the income would be treated under section 250. If this second taxpayer's activity were more profitable, an economic loss is generated. Such situations are more likely to arise in the absence of guidance. While no guidance can curtail all differential or inaccurate interpretations of the statute, the final regulations significantly mitigate the chance for differential or inaccurate interpretations and thereby increase economic efficiency.

The Treasury Department and the IRS expect that in the absence of this guidance taxpayers would undertake fewer eligible sales and services. Thus, the final regulations will generally enhance sales and services across certain eligible activities relative to the no-action baseline. Because of the scale of U.S. economic activity generally associated with foreign use (independent of any specific definition of foreign use) and because of the general responsiveness of economic activity to effective tax rates, which may be affected by the section 250 deduction, we project that the final regulations will have annual economic effects greater than \$100 million (2020 dollars) relative to the no-action baseline.

The Treasury Department and the IRS have not made quantitative estimates of the effects of these final regulations on the volume of eligible sales and services or on the overall size or composition of U.S. economic activity relative to the no-action baseline or regulatory alternatives. The Treasury Department and the IRS have not undertaken these estimates because we do not have sufficiently detailed data or models for: (i) the costs to taxpayers of establishing that particular transactions are eligible for the section 250 deduction ("substantiation requirements") under various standards of substantiation; (ii) the effect of differences in substantiation requirements on economic activity, including both activities that are eligible for the section 250 deduction and activities

not eligible for the section 250 deduction under the final regulations versus regulatory alternatives; and (iii) the economic effects of other clarifications in the final regulations, including the treatment of military sales, relative to the no-action baseline and regulatory alternatives. Each of these items would be needed to provide sufficiently precise estimates of the effects of these final regulations.

The Treasury Department and the IRS project that as many as 350,000 taxpayers may be potentially affected by the final regulations. This estimate is based on International Trade Administration ("ITA") statistics of the number of companies engaged in export activities.¹⁰ No data derived from tax forms were available to provide an estimate of potentially affected taxpayers because the section 250 deduction is new and the transactions that would now give rise to a section 250 deduction were not previously separately reported on tax forms. No comments were received on estimates of the number of affected taxpayers provided in the proposed regulations. The Treasury Department and the IRS plan to include estimates of the number of affected taxpayers in analysis of any future regulatory guidance when possible.

The economic effects of major provisions of these final regulations are discussed qualitatively in Part I.C and are separately categorized depending on whether the provisions have been significantly revised from the proposed regulations or are largely unchanged from the proposed regulations.

The Treasury Department and the IRS solicit comments on the economic effects of the regulations.

1. Economic Effects of Provisions Substantially Revised From the 2019 Section 250 Proposed Regulations

a. Documentation requirements

The statute provides a section 250 deduction for certain income derived by the taxpayer from serving foreign markets but it does not provide detail regarding what it means to "serve foreign markets" or how

to document that fact. Many of the calculations needed for the section 250 deduction are based on Foreign Derived Deduction Eligible Income (FDDEI), which is certain income derived from sales of property to foreign persons for "foreign use" and from the provision of services to persons, or with respect to property, located outside the United States. The statute is likewise silent on the meaning of "foreign use."

The proposed regulations defined terms and prescribed specific documents that taxpayers were required to hold to establish that such income was derived from serving foreign markets. Comments to the proposed regulations, however, noted that the documentation requirements were prohibitively burdensome because, contrary to the original understanding of the Treasury Department and the IRS, taxpayers frequently do not have ready access to those types of documentation. Therefore, comments argued, the proposed regulations frequently created compliance costs that were high relative to the value of the deduction. In addition, comments explained that for taxpayers that enter into long term contracts, it was difficult to simultaneously satisfy the proposed regulations' requirements that the documentation be obtained by the FDII filing date and also that it be obtained no earlier than one year before the date of the sale or the service. Commenters also noted that the Regulatory Flexibility Act analysis for the proposed regulations provide an estimate of the compliance burden for small entities but did not provide a comparable estimate for larger entities, which could have had a considerably higher burden.

Because of these difficulties, the Treasury Department and the IRS adopt a different approach in the final regulations for the substantiation of foreign use for purposes of the section 250 deduction. This approach is described in sections 3.a.i – 3.a.iii. For each of the items in 3.a.i – 3.a.iii, the approach in the final regulations is significantly more flexible than the specific documentation requirements in the proposed regulations.

The Treasury Department and the IRS have determined that the substantiation requirements in the final regulations provide

¹⁰ ITA data was accessed at <http://tse.export.gov/EDB>SelectReports.aspx?DATA=ExporterDB> in December, 2018.

a reasonable balance of compliance costs and the administrative burden of ensuring that the transactions are consistent with the intent and purpose of the statute.

i. General Substantiation Versus Specific Substantiation

The statute generally provides a section 250 deduction for income that is for foreign use and specifies that the Secretary should issue regulations to specify how foreign use should be substantiated for purposes of tax administration. To address the substantiation issue, the Treasury Department and the IRS considered: (i) which types of transactions should be subject (only) to the general substantiation rules that apply to all deductions, versus requiring specific substantiation, and (ii) for those transactions for which more specific substantiation will be required, what forms specific substantiation should take.

The final regulations specify that for many types of sales and services, eligibility for the section 250 deduction is subject only to the general requirement under the Code that eligibility for deductions must be supported by sufficient substantiation, including through the use of available business records. The final regulations provide substantiation requirements that are generally similar to the substantiation requirements for other types of deductions, which helps standardize deduction-related benefits in the Code and thereby minimizes the risk of unintended complications across provisions of the Code.

The Treasury Department and the IRS considered allowing general substantiation for all types of transactions. However, the Treasury Department and the IRS determined that certain types of transactions pose a higher risk of being treated as eligible transactions (FDDEI transactions) without the taxpayer having generated revenue from serving foreign markets. For these certain transactions, the final regulations provide specific substantiation requirements. These requirements involve either (i) a specific document, (ii) information from the recipient obtained or created in the ordinary course of business, or (iii) a taxpayer statement with corroborating evidence (where the taxpayer chooses the form of corroborating evidence). In general, these requirements are substan-

tially more flexible than the documentation requirements set forth in the proposed regulations because they allow taxpayers to choose the method of substantiation among a set of options and because this set includes options that are less onerous than in the proposed regulations. In addition, to further reduce compliance burdens relative to the proposed regulations, and in response to comments, the final regulations remove the requirement in the proposed regulations that the substantiating documents must be obtained no earlier than one year before the date of the sale or service.

The main categories of transactions for which specific substantiation is required are: (i) sales of intangible property; (ii) sales of general property to resellers and manufacturers; and (iii) the provision of general services to business recipients. These types of transactions generally have a higher potential for mischaracterization than other transactions for which general substantiation is required; for example, intangible property is often used both within and without of the United States, and without some specific substantiation documenting its use, the foreign portion could easily be overstated. Similarly, if a U.S. person sells a finished good to a foreign reseller, the final regulations require the taxpayer to provide evidence that the reseller will not immediately sell the property back into the United States; otherwise, the taxpayer could claim the section 250 deduction for what is effectively a sale for domestic use. The Treasury Department and the IRS have determined that this latter activity would not be consistent with the intent and purpose of the statute. In addition, in the case of general services (such as consulting or accounting services) provided to a business recipient that is an integrated multinational company with operations within and outside the United States, without substantiation the IRS would have difficulty verifying the extent to which the business recipient's operations outside the United States benefited from the service. Thus, the Treasury final regulations impose more thorough substantiation requirements for such types of transactions.

The specific substantiation requirements provide that a taxpayer may substantiate that a sale of general property

to a distributor is for a foreign use by maintaining proof that property is specifically designed, labeled, or adapted for a foreign market or proof that the cost of shipping the property back to the United States relative to the value of the property makes it impractical that the property will be resold in the United States. Furthermore, in recognition of the fact that some taxpayers may not be able to substantiate their deductions with information already available to them, the specific substantiation requirements do not apply to taxpayer years beginning before January 1, 2021. In addition, the specific substantiation requirements do not apply to businesses with less than \$25 million in gross receipts.

The Treasury Department and the IRS do not have readily available data or models to provide sufficiently precise estimates of the difference in compliance costs for these provisions between the final regulations and regulatory alternatives such as the proposed regulations.

ii. Removal of Specific References to Market Research

The proposed regulations contained specific rules regarding appropriate methods of documenting foreign use for: (i) fungible mass property and (ii) general services provided to a business recipient located outside the United States. In particular, the proposed regulations provided that a seller could establish certain foreign use through market research, including statistical sampling, economic modeling and other similar methods. In light of the more flexible and less prescriptive approach to documentation generally taken by the final regulations relative to the proposed regulations, the Treasury Department and the IRS have determined that prescribing specific methods (such as market research) for determining the use of these types of property is not necessary and have further determined that general market research based on secondary sources could be misleading in this circumstance.

The Treasury Department and the IRS do not have readily available data or models to provide sufficiently precise estimates of the difference in compliance costs for these items between the final reg-

ulations and regulatory alternatives such as the proposed regulations.

iii. Digital Content, Electronically Supplied Services, and Advertising Services

The final regulations also clarify how to establish foreign use for sales of digital content and how to establish a recipient's location outside of the United States with respect to electronically supplied services and advertising services. As noted in comments, the proposed regulations did not clearly explain how foreign use should be established for transfers of copyrighted articles that are delivered electronically rather than on a physical medium. To clarify the treatment of these sales, the final regulations specify that a sale of a copyrighted article is evaluated under the general property rules rather than the rules for foreign use of intangible property regardless of how the copyrighted article is transferred. In addition, the final regulations provide new rules for establishing whether a sale of digital content, which may include a sale of a copyrighted article, is for a foreign use. The final regulations define "digital content" as a computer program or any other content in digital format. A sale of general property that primarily contains digital content is generally a FDDEI sale if the end user downloads or accesses the content on a device located outside the United States.

In response to comments, the final regulations provide two new subcategories of general services and provide more detailed guidance regarding how to establish the location of recipients of these services. First, the final regulations also provide a new subcategory of general services for electronically supplied services. An electronically supplied service is a general service (other than an advertising service) that is delivered primarily over the internet or an electronic network. As in the case of a digital content sale, an electronically supplied service qualifies for the section 250 deduction if the recipient accesses the service from a location outside the United States. Thus, under the final regulations, the structure of otherwise similar

transactions (the sale of digital content and the provision of an electronically supplied service) should generally not affect whether the transaction qualifies for the section 250 deduction. Second, the final regulations provide a new subcategory of general services for advertising services. The final regulations assign the location of the recipient of advertising services at the location where the advertisements are viewed, since that location serves as a reliable proxy for the location of the business recipient that benefits from the service.

The Treasury Department and the IRS project that because taxpayers typically know where digital content, electronically supplied services, and advertising services are accessed or viewed, these provisions will reduce taxpayer compliance costs relative to the proposed regulations.

The Treasury Department and the IRS do not have readily available data or models to provide sufficiently precise estimates of the difference in compliance costs for these items, between the final regulations and regulatory alternatives such as the proposed regulations.

b. Foreign military sales

Section 250 conditions eligibility on sales being made to a foreign person and services being provided to a person located outside the United States but does not include specific rules applicable to foreign military sales or services. This silence may lead to inefficient decisions by taxpayers because many sales of military equipment and services by U.S. defense contractors to foreign governments are structured (pursuant to the Arms Export Control Act) as sales and services provided to the U.S. government. The equipment or services are then sold or provided by the U.S. government to the foreign government; in effect, the contractor is selling goods and services to a foreign person but the sale is technically made to the U.S. government. The Treasury Department and the IRS recognize that the statute is unclear as to whether such sales and services can qualify for the section 250 deduction.

The Treasury Department and the IRS considered several options for treating

these sales and services. One option was not addressing this issue in the final regulations. This option was rejected because the Treasury Department and the IRS determined that it would perpetuate uncertainty about the application of section 250 to foreign military sales and services made through the U.S. government and could thus result in inefficient economic activity if some taxpayers took the position that these sales and services qualify for a section 250 deduction but other similarly-situated taxpayers took the position that they do not qualify. Furthermore, to the extent that some taxpayers took the position that these sales and services do not qualify, their economic decisions would be inefficient when evaluated under the intent and purpose of the statute.

A second option was to clarify that a foreign military sale or service through the U.S. government does not qualify for a section 250 deduction. This option was rejected because the Treasury Department and the IRS determined that this treatment would be inconsistent with the intent and purpose of the statute, and thus economic activity would be inefficient when evaluated under this standard.¹¹

A third option was to allow any sale or service to a U.S. person that acts as an intermediary and does not take on the benefits and burdens of ownership to generally qualify for a section 250 deduction if there is an ultimate foreign recipient. This option was rejected because the Treasury Department and the IRS determined that such a broad exception could allow multiple section 250 deductions for the same transaction if both the seller and the intermediary buyer were U.S. taxpayers. Furthermore, determining whether a party is an "intermediary" for this purpose would require a complex facts-and-circumstances analysis of whether the party had the benefits and burdens of ownership.

A fourth option was the approach adopted in the proposed regulations, which provided that sales of property or the provision of a service to the U.S. government under the Arms Export Control Act is treated as a sale of property or provision of a service to a foreign government and

¹¹ See Joint Comm. on Taxation, General Explanation of Public Law 115-97, at, at 380 n. 1740.

thus generally eligible for the section 250 deduction.

The final regulations adopt the approach provided in the proposed regulations but relax the proposed regulations' documentation requirements. Instead, under the final regulations only the general substantiation requirements apply to these transactions. Thus, the final regulations provide that foreign military sales or services to the U.S. government under the Arms Export Control Act are treated as an eligible sale or service. This rule provides uniform tax treatment between the defense sector and other sectors of the U.S. economy with respect to sales and services that are clearly meant for a foreign use. The final rule also results in lower compliance costs than the proposed regulations because it requires no further substantiation beyond compliance with the Arms Export Control Act rules.

The Treasury Department projects that this reduction in compliance costs will increase foreign military sales and services. The Treasury Department and the IRS have not estimated either the reduction in compliance costs under the final regulations relative to the no-action baseline or regulatory alternatives including the proposed regulations or the change in foreign military sales and services that would result from this reduction. They have not undertaken this estimation because they do not have sufficiently detailed data or models of the costs to taxpayers of establishing that particular transactions are eligible for the section 250 deduction, or the responsiveness of such transactions to compliance costs.

c. Additional issues and changes

The final regulations contain several additional changes that will generally expand the situations in which a transaction will be a FDDEI transaction relative to the proposed regulations.

The final regulations add an exception to the rule in the proposed regulations that a property service is a FDDEI service only if the property is located outside the United States for the duration of the period the service is performed. The exception provides that a property service may be a FDDEI service if it is provided with respect to property that is temporar-

ily located in the United States. This will increase the number of property services that constitute FDDEI services relative to the proposed regulations. The final regulations also clarify that the toll manufacturing services are treated as property services. Because of the new exception for property services with respect to property temporarily in the United States, this clarification should increase the number of toll manufacturing and repair, maintenance, and overhaul services that will constitute FDDEI services relative to the proposed regulations. This rule will also mitigate incentives to restructure service contracts into sale contracts (for example by having the property owner sell and buy back the property that requires service) in order to qualify for FDII benefits despite the lack of any economic efficiency gains from doing so. The Treasury Department and the IRS have not estimated the effect of these changes on compliance costs or on the volume of property services or specifically toll manufacturing services that U.S. businesses may undertake relative to the proposed regulations.

The final regulations revise the definition of transportation services to include freight forwarding services because such services are economically similar to the types of shipping services that are already described in the definition of transportation services; this will provide greater certainty to taxpayers that provide these services because the test for determining whether a transportation service is a FDDEI service (based on the origin and destination of the service) will generally be clearer than the test for general services (based on the location of the recipient). The Treasury Department and the IRS have not estimated the effect of this clarification on compliance costs or on the volume of freight forwarding services that U.S. businesses may undertake relative to the proposed regulations.

The final regulations add an exception to the general rule in the proposed regulations that intangible property used in manufacturing is treated as for a foreign use outside the United States only to the extent that the end users of the manufactured property are located outside the United States. The exception allows that a sale of a manufacturing method or process intangible to a foreign unrelated party is for foreign use based on the location of manufacture rather than the location of the ultimate end user. This provides a meaningful reduction in compliance burden relative to the proposed regulations because it does not require the seller to track the product to its end user and instead relies on information immediately knowable to the seller. The Treasury Department and the IRS have not estimated the effect of this exception on compliance costs or more generally on U.S. economic activity relative to the proposed regulations because we do not have sufficiently precise data on the number of potentially affected taxpayers or the volume of affected activity.

The final regulations eliminate the requirement in the proposed regulations that for sales of international transportation property to be eligible for the section 250 deduction, the property must be located outside the country more than 50 percent of the time and used outside the country for more than 50 percent of the miles for the three-year period after delivery. In the final regulations, the sale of international transportation property is defined to be for a foreign use depending on where it is registered (and in the case of international transportation property not used for compensation or hire, also taking into account where it is primarily hangared or stored). This change in the definition eases the burden of compliance relative to the proposed regulations. The Treasury Department and the IRS have not undertaken quantitative estimates of the effect of this change on compliance costs or on sales of transportation property relative to the proposed regulations.

In response to comments, the final regulations clarify that the definition of general property includes physical commodities that are sold pursuant to derivative contracts. This revision addresses a concern raised in comments that some physical commodities may be sold pursuant to a forward or option contract that itself would not be general property. Also in response to comments, the final regulations provide that the amount of a taxpayer's income from a transaction that is eligible for the section 250 deduction is increased by any gain, or decreased by any loss, taken into account with respect to certain hedging transactions related to

the sales. This treatment more accurately reflects the overall economic gain or loss realized with respect to the hedged transactions, and will ensure that similarly-situated taxpayers take consistent positions with respect to these types of transactions. The Treasury Department and the IRS have not estimated the effects of these clarifications relative to the proposed regulations.

Finally, the final regulations remove a special rule from the proposed regulations that a sale of an interest in a foreign branch is treated as giving rise to foreign branch income, which would preclude any income from these sales from giving rise to FDDEI. This change respects the functional difference between income derived by a branch (which generally reflects business activity of the branch) versus income derived by the branch owner from selling the branch (which generally reflects the owner's gain from appreciation in value of the branch), and will allow more transactions to qualify as FDDEI transactions. The Treasury Department and the IRS have not estimated the effects of this change relative to the proposed regulations.

d. Ordering rule

The Act introduced multiple Code provisions that simultaneously limit the availability of a deduction based, directly or indirectly, upon a taxpayer's taxable income. Because the deductions themselves affect taxable income, the order in which taxpayers calculate deduction limitations matters. The proposed regulations contained an example outlining a possible approach to an ordering rule for these Code provisions. Several comments suggested alternative ordering rules. The Treasury Department and the IRS have decided to further study the most appropriate ordering rule for computations across various provisions that are based upon a taxpayer's taxable income. Therefore, the example from the proposed regulations has been removed and the Treasury Department and the IRS reserve on a final determination of the ordering rule at this time. For now, taxpayers can generally use any reasonable method to determine the ordering of rules that limit deductions based upon taxable income. Because we have decided

to study this issue further, we have not yet estimated the economic effects of different potential ordering rules.

2. Economic Effects of Provisions Not Substantially Revised from the 2019 Section 250 Proposed Regulations

a. Computation of the ratio of FDDEI to DEI

The Act defines a corporation's FDII based on a set of calculations that includes the ratio of its FDDEI to its Deduction Eligible Income ("foreign-derived ratio"). The final regulations specify that, for purposes of determining the numerator of the foreign-derived ratio, the domestic corporation must allocate expenses to its gross FDDEI. The Treasury Department and the IRS deemed this approach the most consistent with the statute by providing what the Treasury Department and the IRS have determined to be the most accurate measure of the corporation's income that is "foreign-derived," through matching of expenses to gross income. In addition, the use of existing expense allocation rules potentially reduces the burden on taxpayers and the IRS relative to adopting a new set of expense allocation rules.

The Treasury Department and the IRS considered two other approaches; one, in which the foreign-derived ratio would be computed as the ratio of foreign versus U.S. gross receipts and another in which the ratio would be computed as foreign versus U.S. gross income. The Treasury Department and the IRS have determined that both of these approaches would result in a less accurate measure of foreign-derived net income. The Treasury Department and the IRS have determined that these alternative approaches could also reward low margin (or even loss-leading) sales or services to foreign markets by allowing a section 250 deduction due to positive gross receipts or income from foreign sources, even if the net income from foreign sources after allocated expenses is zero or negative.

The Treasury Department and the IRS have determined that the chosen alternative generally provides the most accurate computation of FDII. We have not estimated the economic effects of including

these alternative, less accurate computations of FDII in the calculation of taxpayers' foreign-derived ratios.

b. Section 962

The section 250 deduction for FDII and GILTI is available only to domestic corporations. However, Congress enacted section 962 in Public Law No. 89-834 (1962) to ensure that individuals' tax burdens with respect to undistributed foreign earnings of their CFCs are comparable with their tax burdens if they had held their CFCs through a domestic corporation. See S. Rept. 1881, 87th Cong., 2d Sess. 92 (1962).

To address this divergence, the Treasury Department and the IRS considered two options with respect to extending the section 250 deduction to individuals (which include, for this purpose, individual partners in partnerships and individual shareholders in S corporations) that make an election under section 962. The first option was to not allow the deduction for individuals. Not allowing the section 250 deduction would require that individuals that currently own their CFCs directly (or indirectly through a partnership or S corporation) transfer the stock of their CFCs to new U.S. corporations in order to obtain the benefit of the section 250 deduction. The Treasury Department and the IRS determined that such reorganization would be economically costly, both in terms of legal fees and substantive economic costs related to organizing and operating new corporate entities with no general economic benefit relative to the second option.

The second option was to allow individuals to claim a section 250 deduction with respect to their GILTI if they make the section 962 election. The Treasury Department and the IRS determined that allowing individuals the section 250 deduction would improve economic efficiency by preventing the need for costly legal restructuring solely for the purpose of tax savings. Allowing a section 250 deduction with respect to GILTI of an individual (including an individual that is a shareholder of an S corporation or a partner in a partnership) that makes an election under section 962 provides comparable treatment for this income.

This is the option adopted by the Treasury Department and the IRS in the final regulations.

The Treasury Department and the IRS have not estimated the difference in economic effects between these two regulatory alternatives.

II. Paperwork Reduction Act

The regulations provide the authority for the IRS to require taxpayers to file certain forms with the IRS to obtain the benefit of the section 250 deduction. Pursuant to the regulations, all taxpayers with a section 250 deduction are required to file one new form (Form 8993). The reg-

ulations also authorize the IRS to request additional information on several existing forms (Forms 1065 (Schedule K-1), 5471, 5472, 8865, and other forms as needed) if the filer of the form has a deduction under section 250. In 2018, the IRS released and invited comments on drafts of these forms in order to give members of the public advance notice and an opportunity to submit comments. The IRS received no comments on the portions of the forms that relate to section 250 during the comment period. Consequently, the IRS made the forms available in late 2018 for use by the public.

The information collection burdens under the Paperwork Reduction Act, 44

U.S.C. 3501 et seq. (“PRA”) from these final regulations are in §§1.250(a)-1(d), 1.250(b)-1(e)(2), 1.6038-2(f)(15), 1.6038-3(g)(4), and 1.6038A-2(b)(5)(iv). For purposes of the PRA, the reporting burden associated with these collections of information will be reflected in the PRA submission for Form 8993, Form 1065, Form 5471, Form 8865, and Form 5472 (see chart at the end of this part II for OMB control numbers).

The tax forms that were created or revised as a result of the information collections in these final regulations, as well as the estimated number of respondents, are as follows:

Related New or Revised Tax Forms			
	New	Revision of existing form	Number of respondents (estimated)
<i>Form 8993</i>	✓		75,000 - 350,000
<i>Form 1065, Schedule K-1 (for corporate partners only, revision starting TY2021)</i>		✓	15,000 - 45,000
<i>Form 5471</i>		✓	10,000 - 20,000
<i>Form 8865</i>		✓	<10,000
<i>Form 5472</i>		✓	50,000 - 80,000

Source: RAAS:CDW and ITA

The numbers of respondents in the Related New or Revised Tax Forms table were estimated by the Research, Applied Analytics and Statistics Division (“RAAS”) of the IRS from the Compliance Data Warehouse (“CDW”), using tax years 2014 through 2017; as well as based on export data from the International Trade Administration (“ITA”) for 2015 and 2016. Tax data for 2018 are not yet available due to extended filing dates. Data for Form 8993 represent preliminary estimates of the total number of taxpayers that may be required to file the new Form 8993. Data for each of the Forms 1065, 5471, 5472, and 8865 represent preliminary estimates of the total number of taxpayers that are expected to file these revised forms regardless of whether that taxpayer must also file Form 8993.

The current status of the PRA submissions related to the tax forms that will

be revised as a result of the information collections in the section 250 regulations is provided in the accompanying table. The reporting burdens associated with the information collections in the regulations are included in the aggregated burden estimates for OMB control numbers 1545-0123 (which represents a total estimated burden time for all forms and schedules for corporations of 3.344 billion hours and total estimated monetized costs of \$61.558 billion (\$2019)), 1545-0074 (which represents a total estimated burden time, including all other related forms and schedules for individuals, of 1.717 billion hours and total estimated monetized costs of \$33.267 billion (\$2019)), and 1545-1668 (which represents a total estimated burden time for all related forms and schedules for other filers, in particular trusts and estates, of 281,974 hours and total estimated mon-

etized costs of \$25.107 million (\$2018)). The overall burden estimates provided for the OMB control numbers below are aggregate amounts that relate to the entire package of forms associated with the applicable OMB control number and will in the future include, but not isolate, the estimated burden of the tax forms that will be created or revised as a result of the information collections in the regulations. These numbers are therefore unrelated to the calculations needed to assess the burden imposed by the regulations. These burdens have been reported for other regulations related to the taxation of cross-border income and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overestimating the burden of the international tax provisions. No burden estimates specific to the forms affected by the regulations

are currently available. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the regulations. The Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Those estimates would capture both

changes made by the Act and those that arise out of discretionary authority exercised in the final regulations.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the final regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for

each relevant form and ways for the IRS to minimize the paperwork burden. Proposed revisions (if any) to these forms that reflect the information collections contained in these final regulations will be made available for public comment at <http://www.irs.gov/draftforms> and will not be finalized until after these forms have been approved by OMB under the PRA.

Form	Type of Filer	OMB Number(s)	Status
Form 8993 (NEW)	Business (NEW Model)	1545-0123	Published in the Federal Register Notice (FRN) on 9/30/19. Public Comment period closed on 11/29/19. Approved by OMB through 12/31/20. Link: https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s
	Individual (NEW Model)	1545-0074	Published in the Federal Register on 9/30/19. Public Comment period closed on 11/29/19. Approved by OMB through 12/31/20. Link: https://www.federalregister.gov/documents/2019/09/30/2019-21066/proposed-collection-comment-request-for-form-1040-form-1040nr-form-1040nr-ez-form-1040x-1040-sr-and-u
	Business (NEW Model)	1545-0123	Published in the Federal Register on 9/30/19. Public Comment period closed on 11/29/19. Approved by OMB through 12/31/20. Link: https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s
	Business (NEW Model)	1545-0123	Published in the Federal Register on 9/30/19. Public Comment period closed on 11/29/19. Approved by OMB through 12/31/20. Link: https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s
Form 5471	All other filers (mainly trusts and estates) (Legacy system)	1545-1668	Published in the Federal Register on 10/01/18. Public Comment period closed on 11/30/18. Approved by OMB through 12/31/21. Link: https://www.federalregister.gov/documents/2018/10/01/2018-21288/proposed-collection-comment-request-for-regulation-project
	Business (NEW Model)	1545-0123	Published in the Federal Register on 9/30/19. Public Comment period closed on 11/29/19. Approved by OMB through 12/31/20. Link: https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s
Form 5472	Business (NEW Model)	1545-0123	Published in the Federal Register on 9/30/19. Public Comment period closed on 11/29/19. Approved by OMB through 12/31/20. Link: https://www.federalregister.gov/documents/2019/09/30/2019-21068/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s

III. Regulatory Flexibility Act

It is hereby certified that this final regulation 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). The Treasury Department and the IRS have determined that the regulations may affect a substan-

tial number of small entities, but have also concluded that the economic impact on small entities as a result of the collections of information in this regulation is not expected to be significant.

The small business entities that are subject to section 250 and these final regulations are small domestic corporations claiming a deduction under section 250 based on their FDII and GILTI. Pursuant to §1.250(a)-1(d), taxpayers are required to file new Form 8993 to compute the amount of the eligible deduction for FDII and GILTI under section 250. The Treasury Department and the IRS estimate that there are between 75,000 and 350,000 respondents of all sizes that are likely to file Form 8993. Additionally, under §1.250(b)-1(e), a partnership that has one or more direct or indirect partners that are domestic corporations and that is required to file a return under section 6031 must furnish on Schedule K-1 (Form 1065) certain information that would allow the partner to accurately calculate its FDII. The Treasury Department and the IRS estimate the number of domestic corporations that are direct or indirect partners in a partnership affected by §1.250(b)-1(e) is between 15,000 and 45,000.

As discussed in the Summary of Comments and Explanation of Revisions section of this preamble, the Treasury Department and the IRS have determined that requiring specific documentation in every case is challenging given the variations in industry practices. Accordingly, the final regulations adopt a more flexible approach to the documentation requirements in the proposed regulations and, for certain of these regulatory requirements, instead provide substantiation rules that are more flexible with respect to the types of corroborating evidence that may be used to determine that a transaction is a FDDEI transaction. A transaction is a FDDEI transaction only if the taxpayer substantiates its determination of foreign use (in the case of sales of general property to non-end users and sales of intangible property) or location outside the United States (in the case of general services provided to a business recipient) as described in the applicable paragraph of §1.250(b)-4(d)(3) or §1.250(b)-5(e)(4). Similar to the exception for small businesses from the documentation requirements in the proposed regulations, the final regulations provide that the new specific substantiation requirements do not apply to a taxpayer if the taxpayer and all related parties of the taxpayer received less than \$25,000,000

in gross receipts in the prior taxable year. The Treasury Department and the IRS anticipate that a substantial share of small entities claiming a section 250 deduction will qualify for the small business exception, thereby significantly reducing the overall burden of the final regulations on small entities. Although the rule will alleviate burden on many small entities, the Small Business Administration's small business size standards (13 CFR part 121) identify as small entities several industries with annual revenues above \$25 million.

For the rules in the final regulations for which there are no specific substantiation requirements, taxpayers will continue to be required to substantiate deductions under section 250 pursuant to section 6001. Small business entities are expected to experience 0 to 5 minutes, with an average of 2.5 minutes, of recordkeeping per transaction recipient. The hourly estimates include all associated activities: recordkeeping, tax planning, learning about the law, gathering tax materials, form completion and submissions, and time with a tax preparer or use of tax software. The estimated monetized burden for small business entities for compliance is \$53.12 per hour, a figure computed from the IRS Business Taxpayer Burden model which assigns each firm in the micro data a monetization rate based on total revenue and assets reported on their tax return. See "Tax Compliance Burden" (John Guyton et al., July 2018) at <https://www.irs.gov/pub/irs-soi/d13315.pdf>. The assigned monetization rates include, in addition to wages, employer non-wage costs such as employment taxes, benefits, and overhead. The reporting burden for completing Form 8993 is estimated to average 21 hours for all affected entities, regardless of size. The reporting burden on small entities (those with receipts below \$25 million in RAAS calculations) is estimated to average 17.1 hours. Based on the monetized hourly burden reported above, the annual per-entity reporting burden for small entities will be \$908.

For these reasons, the Treasury Department and the IRS have determined that the requirements in §§ 1.250(a)-1(d), 1.250(b)-4(d)(3), and 1.250(b)-5(e)(4) will not have a significant economic impact on a substantial number of small entities.

The small business entities that are subject to §1.6038-2(f)(15), §1.6038-3(g)(4), or §1.6038A-2(b)(5)(iv) are domestic small business entities that claim a deduction under section 250 by reason of having FDII that are either controlling U.S. shareholders of a foreign corporation, controlling fifty-percent partners or controlling ten-percent partners of a foreign partnership, or at least 25-percent foreign-owned, by vote or value, respectively. The data to assess the number of small entities potentially affected by §1.6038-2(f)(15), §1.6038-3(g)(4), or §1.6038A-2(b)(5)(iv) are not readily available. However, businesses that are controlling U.S. shareholders of a foreign corporation, controlling fifty-percent partners or controlling ten-percent partners of a foreign partnership, or at least 25-percent foreign-owned, by vote or value are generally not small businesses for the reasons described in part III of the Special Analyses section in the proposed regulation (REG-104464-18, 84 FR 8188 (March 6, 2019)). Consequently, the Treasury Department and the IRS have determined that §§1.6038-2(f)(15), 1.6038-3(g)(4), and 1.6038A-2(b)(5)(iv) will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses. No comments were received.

IV. 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. This 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.

V. 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. These 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.

VI. Congressional Review Act

The Administrator of the Office of Information and Regulatory Affairs of 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(a)(3) of the CRA, a major rule generally may not take effect until 60 days after the rule is published in the **Federal Register**. Accordingly, the Treasury Department and IRS are adopting these final regulations with the delayed effective date generally prescribed under the Congressional Review Act.

Drafting Information

The principal authors of the regulations are Kenneth Jeruchim, Brad McCormack, and Lorraine Rodriguez of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in the development of the regulations.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, Notices, and other guidance cited in this document are published in the Internal Revenue Bulletin and are 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 in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

Adoption of 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 entries in numerical order for §§1.250-0, 1.250-1, 1.250(a)-1, 1.250(b)-1, 1.250(b)-2, 1.250(b)-3, 1.250(b)-4, 1.250(b)-5, 1.250(b)-6, and §1.1502-50 and revising the entries for §§1.1502-12 and 1.1502-13 to read in part as follows:

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

* * * * *

Section 1.250-0 also issued under 26 U.S.C. 250(c).

Section 1.250-1 also issued under 26 U.S.C. 250(c).

Section 1.250(a)-1 also issued under 26 U.S.C. 250(c) and 6001.

Section 1.250(b)-1 also issued under 26 U.S.C. 250(c) and 6001.

Section 1.250(b)-2 also issued under 26 U.S.C. 250(c).

Section 1.250(b)-3 also issued under 26 U.S.C. 250(c).

Section 1.250(b)-4 also issued under 26 U.S.C. 250(c).

Section 1.250(b)-5 also issued under 26 U.S.C. 250(c).

Section 1.250(b)-6 also issued under 26 U.S.C. 250(c).

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Section 1.1502-12 also issued under 26 U.S.C. 250(c) and 1502.

Section 1.1502-13 also issued under 26 U.S.C. 250(c) and 1502.

* * * * *

Section 1.1502-50 also issued under 26 U.S.C. 250(c) and 1502.

* * * * *

Par. 2. Sections 1.250-0, 1.250-1, 1.250(a)-1, and 1.250(b)-1 through 1.250(b)-6 are added to read as follows:

Sec.

* * * * *

1.250-0 *Table of contents.*

1.250-1 *Introduction.*

1.250(a)-1 *Deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI).*

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

1.250(b)-2 *Qualified business asset investment (QBAI).*

1.250(b)-3 *Foreign-derived deduction eligible income (FDDEI) transactions.*

1.250(b)-4 *Foreign-derived deduction eligible income (FDDEI) sales.*

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

1.250(b)-6 *Related party transactions.*

* * * * *

§1.250-0 Table of contents.

This section contains a listing of the headings for §§1.250-1, 1.250(a)-1, and 1.250(b)-1 through 1.250(b)-6.

§1.250-1 Introduction.

- (a) Overview.
- (b) Applicability dates.

§1.250(a)-1 Deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI).

- (a) Scope.
- (b) Allowance of deduction.
- (1) In general.
- (2) Taxable income limitation.
- (3) Reduction in deduction for taxable years after 2025.
- (4) Treatment under section 4940.
- (c) Definitions.
 - (1) Domestic corporation.
 - (2) Foreign-derived intangible income (FDII).
 - (3) Global intangible low-taxed income (GILTI).
 - (4) Section 250(a)(2) amount.
 - (5) Taxable income.
 - (i) In general.
 - (ii) [Reserved]
 - (d) Reporting requirement.
 - (e) Determination of deduction for consolidated groups.
 - (f) Example: Application of the taxable income limitation.

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

- (a) Scope.

- (b) Definition of FDII.
 (c) Definitions.
 (1) Controlled foreign corporation.
 (2) Deduction eligible income.
 (3) Deemed intangible income.
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 (10) FDDEI transaction.
 (11) Foreign branch income.
 (12) Foreign-derived deduction eligible income.
 (13) Foreign-derived ratio.
 (14) Gross RDEI.
 (15) Gross DEI.
 (16) Gross FDDEI.
 (17) Modified affiliated group.
 (i) In general.
 (ii) Special rule for noncorporate entities.
 (iii) Definition of control.
 (18) Qualified business asset investment.
 (19) Related party.
 (20) United States shareholder.
 (d) Treatment of cost of goods sold and allocation and apportionment of deductions.
 (1) Cost of goods sold for determining gross DEI and gross FDDEI.
 (2) Deductions properly allocable to gross DEI and gross FDDEI.
 (i) In general.
 (ii) Determination of deductions to allocate.
 (3) Examples.
 (e) Domestic corporate partners.
 (1) In general.
 (2) Reporting requirement for partnership with domestic corporate partners.
 (3) Examples.
 (f) Determination of FDII for consolidated groups.
 (g) Determination of FDII for tax-exempt corporations.
- §1.250(b)-2 Qualified business asset investment (QBAI).*
- (a) Scope.
 (b) Definition of qualified business asset investment.
 (c) Specified tangible property.
 (1) In general.
 (2) Tangible property.
 (d) Dual use property.
 (1) In general.
 (2) Definition of dual use property.
 (3) Dual use ratio.
 (4) Example.
 (e) Determination of adjusted basis of specified tangible property.
 (1) In general.
 (2) Effect of change in law.
 (3) Specified tangible property placed in service before enactment of section 250.
 (f) Special rules for short taxable years.
 (1) In general.
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 (3) Determination of partner adjusted basis.
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 (ii) Sole use partnership property.
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 (iii) Dual use partnership property.
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 (4) Determination of proportionate share of the partnership's adjusted basis in partnership specified tangible property.
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 (h) Anti-avoidance rule for certain transfers of property.
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 (4) Definitions related to anti-avoidance rule.
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 (ii) FDII-eligible related party.
 (iii) Specified related party.
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- §1.250(b)-3 Foreign-derived deduction eligible income (FDDEI) transactions.*
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 (7) Foreign retail sale.
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 (9) Fungible mass of general property.
 (10) General property.
 (11) Intangible property.
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- (B) Sales to an end user without the use of a carrier or freight forwarder.
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 - (E) Sales of international transportation property used for compensation or hire.
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 - (v) Examples.
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 - (f) FDDEI sales hedging transactions.
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 - (2) FDDEI sales hedging transaction.
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 - (b) Definition of FDDEI service.
 - (c) Definitions.
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 - (3) Business recipient.
 - (4) Consumer.
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 - (6) General service.
 - (7) Property service.
 - (8) Proximate service.
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 - (e) General services provided to business recipients.
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 - (5) Examples.
 - (f) Proximate services.
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 - (2) Exception for service provided with respect to property temporarily in the United States.
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- §1.250-1 Introduction.*
- (a) *Overview.* Sections 1.250(a)-1 and 1.250(b)-1 through 1.250(b)-6 provide rules to determine a domestic corporation's section 250 deduction. Section 1.250(a)-1 provides rules to determine the amount of a domestic corporation's deduction for foreign-derived intangible income and global intangible low-taxed income. Section 1.250(b)-1 provides general rules and definitions regarding the computation of foreign-derived intangible income. Section 1.250(b)-2 provides rules for determining a domestic corporation's qualified business asset investment. Section 1.250(b)-3 provides general rules and definitions regarding the determination of gross foreign-derived deduction eligible income. Section 1.250(b)-4 provides rules regarding the determination of gross foreign-derived deduction eligible income from the sale of property. Section 1.250(b)-5 provides rules regarding the determination of gross foreign-derived deduction eligible income from the provision of a service. Section 1.250(b)-6 provides rules regarding the sale of property or provision of a service to a related party.
 - (b) *Applicability dates.* Except as provided in the next sentence, §§1.250(a)-1 and 1.250(b)-1 through 1.250(b)-6 apply to taxable years beginning on or after January 1, 2021. Section 1.250(b)-2(h) applies to taxable years ending on or af-

ter March 4, 2019. However, taxpayers may choose to apply §§1.250(a)-1 and 1.250(b)-1 through 1.250(b)-6 for taxable years beginning on or after January 1, 2018, and before January 1, 2021, provided they apply the regulations in their entirety (other than §1.250(b)-3(f) and the applicable provisions in §1.250(b)-4(d)(3) or §1.250(b)-5(e)(4)).

§1.250(a)-1 Deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI).

(a) *Scope.* This section provides rules for determining the amount of a domestic corporation's deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). Paragraph (b) of this section provides general rules for determining the amount of the deduction. Paragraph (c) of this section provides definitions relevant for determining the amount of the deduction. Paragraph (d) of this section provides reporting requirements for a domestic corporation claiming the deduction. Paragraph (e) of this section provides a rule for determining the amount of the deduction of a member of a consolidated group. Paragraph (f) of this section provides examples illustrating the application of this section.

(b) *Allowance of deduction—(1) In general.* A domestic corporation is allowed a deduction for any taxable year equal to the sum of—

(i) 37.5 percent of its foreign-derived intangible income for the year; and

(ii) 50 percent of—

(A) Its global intangible low-taxed income for the year; and

(B) The amount treated as a dividend received by the corporation under section 78 which is attributable to its GILTI for the year.

(2) *Taxable income limitation.* In the case of a domestic corporation with a section 250(a)(2) amount for a taxable year, for purposes of applying paragraph (b)(1) of this section for the year—

(i) The corporation's FDII for the year (if any) is reduced (but not below zero) by an amount that bears the same ratio to the corporation's section 250(a)(2) amount that the corporation's FDII for the year bears to the sum of the corporation's FDII and GILTI for the year; and

(ii) The corporation's GILTI for the year (if any) is reduced (but not below zero) by the excess of the corporation's section 250(a)(2) amount over the amount of the reduction described in paragraph (b)(2)(i) of this section.

(3) *Reduction in deduction for taxable years after 2025.* For any taxable year of a domestic corporation beginning after December 31, 2025, paragraph (b)(1) of this section applies by substituting—

(i) 21.875 percent for 37.5 percent in paragraph (b)(1)(i) of this section; and

(ii) 37.5 percent for 50 percent in paragraph (b)(1)(ii) of this section.

(4) *Treatment under section 4940.* For purposes of section 4940(c)(3)(A), a deduction under section 250(a) is not treated as an ordinary and necessary expense paid or incurred for the production or collection of gross investment income.

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

(1) *Domestic corporation.* The term *domestic corporation* has the meaning set forth in section 7701(a), but does not include a regulated investment company (as defined in section 851), a real estate investment trust (as defined in section 856), or an S corporation (as defined in section 1361).

(2) *Foreign-derived intangible income (FDII).* The term *foreign-derived intangible income* or *FDII* has the meaning set forth in §1.250(b)-1(b).

(3) *Global intangible low-taxed income (GILTI).* The term *global intangible low-taxed income* or *GILTI* means, with respect to a domestic corporation for a taxable year, the corporation's GILTI inclusion amount under §1.951A-1(c) for the taxable year.

(4) *Section 250(a)(2) amount.* The term *section 250(a)(2) amount* means, with respect to a domestic corporation for a taxable year, the excess (if any) of the sum of the corporation's FDII and GILTI (determined without regard to section 250(a)(2) and paragraph (b)(2) of this section), over the corporation's taxable income. For a corporation that is subject to the unrelated business income tax under section 511, taxable income is determined only by reference to that corporation's unrelated business taxable income defined under section 512.

(5) *Taxable income—(i) In general.* The term *taxable income* has the meaning

set forth in section 63(a) determined without regard to the deduction allowed under section 250 and this section.

(ii) [Reserved]

(d) *Reporting requirement.* Each domestic corporation (or individual making an election under section 962) that claims a deduction under section 250 for a taxable year must make an annual return on Form 8993, "Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)" (or any successor form) for such year, setting forth the information, in such form and manner, as Form 8993 (or any successor form) or its instructions prescribe. Returns on Form 8993 (or any successor form) for a taxable year must be filed with the domestic corporation's (or in the case of a section 962 election, the individual's) income tax return on or before the due date (taking into account extensions) for filing the corporation's (or in the case of a section 962 election, the individual's) income tax return.

(e) *Determination of deduction for consolidated groups.* A member of a consolidated group (as defined in §1.1502-1(h)) determines its deduction under section 250(a) and this section under the rules provided in §1.1502-50(b).

(f) *Example: Application of the taxable income limitation.* The following example illustrates the application of this section. For purposes of the example, it is assumed that DC is a domestic corporation that is not a member of a consolidated group and the taxable year of DC begins after 2017 and before 2026.

(1) *Facts.* For the taxable year, without regard to section 250(a)(2) and paragraph (b)(2) of this section, DC has FDII of \$100x and GILTI of \$300x. DC's taxable income (without regard to section 250(a) and this section) is \$300x.

(2) *Analysis.* DC has a section 250(a)(2) amount of \$100x, which is equal to the excess of the sum of DC's FDII and GILTI of \$400x (\$100x + \$300x) over its taxable income of \$300x. As a result, DC's FDII and GILTI are reduced, in the aggregate, by \$100x under section 250(a)(2) and paragraph (b)(2) of this section for purposes of calculating DC's deduction allowed under section 250(a)(1) and paragraph (b)(1) of this section. DC's FDII is reduced by \$25x, the amount that bears the same ratio to the section 250(a)(2) amount (\$100x) as DC's FDII (\$100x) bears to the sum of DC's FDII and GILTI (\$400x). DC's GILTI is reduced by \$75x, which is the remainder of the section 250(a)(2) amount (\$100x - \$25x). Therefore, for purposes of calculating its deduction under section 250(a)(1) and paragraph (b)(1) of this section, DC's FDII is \$75x (\$100x - \$25x) and its

GILTI is \$225x (\$300x - \$75x). Accordingly, DC is allowed a deduction for the taxable year under section 250(a)(1) and paragraph (b)(1) of this section of \$140.63x (\$75x x 0.375 + \$225x x 0.50).

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

(a) *Scope.* This section provides rules for computing FDII. Paragraph (b) of this section defines FDII. Paragraph (c) of this section provides definitions that are relevant for computing FDII. Paragraph (d) of this section provides rules for computing gross income and allocating and apportioning deductions for purposes of computing deduction eligible income (DEI) and foreign-derived deduction eligible income (FDDEI). Paragraph (e) of this section provides rules for computing the DEI and FDDEI of a domestic corporate partner. Paragraph (f) of this section provides a rule for computing the FDII of a member of a consolidated group. Paragraph (g) of this section provides a rule for computing the FDII of a tax-exempt corporation.

(b) *Definition of FDII.* Subject to the provisions of this section, the term *FDII* means, with respect to a domestic corporation for a taxable year, the corporation's deemed intangible income for the year multiplied by the corporation's foreign-derived ratio for the year.

(c) *Definitions.* This paragraph (c) provides definitions that apply for purposes of this section and §§1.250(b)-2 through 1.250(b)-6.

(1) *Controlled foreign corporation.* The term *controlled foreign corporation* has the meaning set forth in section 957(a) and §1.957-1(a).

(2) *Deduction eligible income.* The term *deduction eligible income* or *DEI* means, with respect to a domestic corporation for a taxable year, the excess (if any) of the corporation's gross DEI for the year over the deductions properly allocable to gross DEI for the year, as determined under paragraph (d)(2) of this section.

(3) *Deemed intangible income.* The term *deemed intangible income* means, with respect to a domestic corporation for a taxable year, the excess (if any) of the corporation's DEI for the year over the corporation's deemed tangible income return for the year.

(4) *Deemed tangible income return.* The term *deemed tangible income return*

means, with respect to a domestic corporation and a taxable year, 10 percent of the corporation's qualified business asset investment for the year.

(5) *Dividend.* The term *dividend* has the meaning set forth in section 316, and includes any amount treated as a dividend under any other provision of subtitle A of the Internal Revenue Code or the regulations in this part (for example, under section 78, 356(a)(2), 367(b), or 1248).

(6) *Domestic corporation.* The term *domestic corporation* has the meaning set forth in §1.250(a)-1(c)(1).

(7) *Domestic oil and gas extraction income.* The term *domestic oil and gas extraction income* means income described in section 907(c)(1), substituting "within the United States" for "without the United States."

(8) *FDDEI sale.* The term *FDDEI sale* has the meaning set forth in §1.250(b)-4(b).

(9) *FDDEI service.* The term *FDDEI service* has the meaning set forth in §1.250(b)-5(b).

(10) *FDDEI transaction.* The term *FDDEI transaction* means a FDDEI sale or a FDDEI service.

(11) *Foreign branch income.* The term *foreign branch income* has the meaning set forth in section 904(d)(2)(J) and §1.904-4(f)(2).

(12) *Foreign-derived deduction eligible income.* The term *foreign-derived deduction eligible income* or *FDDEI* means, with respect to a domestic corporation for a taxable year, the excess (if any) of the corporation's gross FDDEI for the year, over the deductions properly allocable to gross FDDEI for the year, as determined under paragraph (d)(2) of this section.

(13) *Foreign-derived ratio.* The term *foreign-derived ratio* means, with respect to a domestic corporation for a taxable year, the ratio (not to exceed one) of the corporation's FDDEI for the year to the corporation's DEI for the year. If a domestic corporation has no FDDEI for a taxable year, the corporation's foreign-derived ratio is zero for the taxable year.

(14) *Gross RDEI.* The term *gross RDEI* means, with respect to a domestic corporation or a partnership for a taxable year, the portion of the corporation or partnership's gross DEI for the year that is not included in gross FDDEI.

(15) *Gross DEI.* The term *gross DEI* means, with respect to a domestic corporation or a partnership for a taxable year, the gross income of the corporation or partnership for the year determined without regard to the following items of gross income—

(i) Amounts included in gross income under section 951(a)(1);

(ii) GILTI (as defined in §1.250(a)-1(c)(3));

(iii) Financial services income (as defined in section 904(d)(2)(D) and §1.904-4(e)(1)(ii));

(iv) Dividends received from a controlled foreign corporation with respect to which the corporation or partnership is a United States shareholder;

(v) Domestic oil and gas extraction income; and

(vi) Foreign branch income.

(16) *Gross FDDEI.* The term *gross FDDEI* means, with respect to a domestic corporation or a partnership for a taxable year, the portion of the gross DEI of the corporation or partnership for the year which is derived from all of its FDDEI transactions.

(17) *Modified affiliated group—(i) In general.* The term *modified affiliated group* means an affiliated group as defined in section 1504(a) determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears, and without regard to section 1504(b)(2) and (3).

(ii) *Special rule for noncorporate entities.* Any person (other than a corporation) that is controlled by one or more members of a modified affiliated group (including one or more persons treated as a member or members of a modified affiliated group by reason of this paragraph (c)(17)(ii)) or that controls any such member is treated as a member of the modified affiliated group.

(iii) *Definition of control.* For purposes of paragraph (c)(17)(ii) of this section, the term *control* has the meaning set forth in section 954(d)(3).

(18) *Qualified business asset investment.* The term *qualified business asset investment* or *QBAI* has the meaning set forth in §1.250(b)-2(b).

(19) *Related party.* The term *related party* means, with respect to any person, any member of a modified affiliated group that includes such person.

(20) *United States shareholder*. The term *United States shareholder* has the meaning set forth in section 951(b) and §1.951-1(g).

(d) *Treatment of cost of goods sold and allocation and apportionment of deductions*—(1) *Cost of goods sold for determining gross DEI and gross FDDEI*. For purposes of determining the gross income included in gross DEI and gross FDDEI of a domestic corporation or a partnership, the cost of goods sold of the corporation or partnership is attributed to gross receipts with respect to gross DEI or gross FDDEI under any reasonable method that is applied consistently. Cost of goods sold must be attributed to gross receipts with respect to gross DEI or gross FDDEI regardless of whether certain costs included in cost of goods sold can be associated with activities undertaken in an earlier taxable year (including a year before the effective date of section 250). A domestic corporation or partnership may not segregate cost of goods sold with respect to a particular product into component costs and attribute those component costs disproportionately to gross receipts with respect to amounts excluded from gross DEI or gross FDDEI, as applicable.

(2) *Deductions properly allocable to gross DEI and gross FDDEI*—(i) *In general*. For purposes of determining a do-

mestic corporation's deductions that are properly allocable to gross DEI and gross FDDEI, the corporation's deductions are allocated and apportioned to gross DEI and gross FDDEI under the rules of §§1.861-8 through 1.861-14T and 1.861-17 by treating section 250(b) as an operative section described in §1.861-8(f). In allocating and apportioning deductions under §§1.861-8 through 1.861-14T and 1.861-17, gross FDDEI and gross RDEI are treated as separate statutory groupings. The deductions allocated and apportioned to gross DEI equal the sum of the deductions allocated and apportioned to gross FDDEI and gross RDEI. All items of gross income described in paragraphs (c)(15)(i) through (vi) of this section are in the residual grouping.

(ii) *Determination of deductions to allocate*. For purposes of determining the deductions of a domestic corporation for a taxable year properly allocable to gross DEI and gross FDDEI, the deductions of the corporation for the taxable year are determined without regard to sections 163(j), 170(b)(2), 172, 246(b), and 250.

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

(i) *Assumed facts*. The following facts are assumed for purposes of the examples—

(A) DC is a domestic corporation that is not a member of a consolidated group.

(B) All sales and services are provided to persons that are not related parties.

(C) All sales and services to foreign persons qualify as FDDEI transactions.

(ii) *Examples*—

(A) *Example 1: Allocation of deductions*—(1) *Facts*. For a taxable year, DC manufactures products A and B in the United States. DC sells products A and B and provides services associated with products A and B to United States and foreign persons. DC's QBAI for the taxable year is \$1,000x. DC has \$300x of deductible interest expense allowed under section 163. DC has assets with a tax book value of \$2,500x. The tax book value of DC's assets used to produce products A and B and services is split evenly between assets that produce gross FDDEI and assets that produce gross RDEI. DC has \$840x of supportive deductions, as defined in §1.861-8(b) (3), attributable to general and administrative expenses incurred for the purpose of generating the class of gross income that consists of gross DEI. DC apportions the \$840x of deductions on the basis of gross income in accordance with §1.861-8T(c) (1). For purposes of determining gross FDDEI and gross DEI under paragraph (d)(1) of this section, DC attributes \$200x of cost of goods sold to Product A and \$400x of cost of goods sold to Product B, and then attributes the cost of goods sold for each product ratably between the gross receipts of such product sold to foreign persons and the gross receipts of such product sold to United States persons. The manner in which DC attributes the cost of goods sold is a reasonable method. DC has no other items of income, loss, or deduction. For the taxable year, DC has the following income tax items relevant to the determination of its FDII:

Table 1 to paragraph (d)(3)(ii)(A)(1)

	Product A	Product B	Services	Total
Gross receipts from U.S. persons	\$200x	\$800x	\$100x	\$1,100x
Gross receipts from foreign persons	\$200x	\$800x	\$100x	\$1,100x
Total gross receipts	\$400x	\$1,600x	\$200x	\$2,200x
Cost of goods sold for gross receipts from U.S. persons	\$100x	\$200x	\$0	\$300x
Cost of goods sold for gross receipts from foreign persons	\$100x	\$200x	\$0	\$300x
Total cost of goods sold	\$200x	\$400x	\$0	\$600x
Gross income	\$200x	\$1,200x	\$200x	\$1,600x
Tax book value of assets used to produce products/services	\$500x	\$500x	\$1,500x	\$2,500x

(2) *Analysis*—(i) *Determination of gross FDDEI and gross RDEI*. Because DC does not have any income described in section 250(b)(3)(A)(i)(I) through (VI) and paragraphs (c)(15)(i) through (vi) of this section, none of its gross income is excluded from gross DEI. DC's gross DEI is \$1,600x (\$2,200x total gross receipts less \$600x total cost of goods sold). DC's gross FDDEI is \$800x (\$1,100x of gross receipts from foreign persons minus attributable cost of goods sold of \$300x).

(ii) *Determination of foreign-derived deduction eligible income*. To calculate its FDDEI, DC must

determine the amount of its deductions that are allocated and apportioned to gross FDDEI and then subtract those amounts from gross FDDEI. DC's interest deduction of \$300x is allocated and apportioned to gross FDDEI on the basis of the average total value of DC's assets in each grouping. DC has assets with a tax book value of \$2,500x split evenly between assets that produce gross FDDEI and assets that produce gross RDEI. Accordingly, an interest expense deduction of \$150x is apportioned to DC's gross FDDEI. With respect to DC's supportive deductions of \$840x that are related to DC's gross DEI,

DC apportions such deductions between gross FDDEI and gross RDEI on the basis of gross income. Accordingly, supportive deductions of \$420x are apportioned to DC's gross FDDEI. Thus, DC's FDDEI is \$230x, which is equal to its gross FDDEI of \$800x less \$150x of interest expense deduction and \$420x of supportive deductions.

(iii) *Determination of deemed intangible income*. DC's deemed tangible income return is \$100x, which is equal to 10 percent of its QBAI of \$1,000x. DC's DEI is \$460x, which is equal to its gross DEI of \$1,600x less \$300x of interest ex-

pense deductions and \$840x of supportive deductions. Therefore, DC's deemed intangible income is \$360x, which is equal to the excess of its DEI of \$460x over its deemed tangible income return of \$100x.

(iv) *Determination of foreign-derived intangible income.* DC's foreign-derived ratio is 50 percent, which is the ratio of DC's FDDEI of \$230x to DC's DEI of \$460x. Therefore, DC's FDII is \$180x, which is equal to DC's deemed intangible income of \$360x multiplied by its foreign-derived ratio of 50 percent.

(B) *Example 2: Allocation of deductions with respect to a partnership—(1) Facts—(i) DC's operations.* DC is engaged in the production and sale of products consisting of two separate product groups in three-digit Standard Industrial Classification (SIC) Industry Groups, hereafter referred to as Group AAA and Group BBB. All of the gross income of DC is included in gross DEI. DC incurs \$250x of research and experimental (R&E) expenditures in the United States that are deductible under section 174. None of the R&E is included in cost of goods sold. For purposes of determining gross FDDEI and gross DEI

under paragraph (d)(1) of this section, DC attributes \$210x of cost of goods sold to Group AAA products and \$900x of cost of goods sold to Group BBB products, and then attributes the cost of goods sold with respect to each such product group ratably between the gross receipts with respect to such product group sold to foreign persons and the gross receipts with respect to such product group not sold to foreign persons. The manner in which DC attributes the cost of goods sold is a reasonable method. For the taxable year, DC has the following income tax items relevant to the determination of its FDII:

Table 2 to (d)(3)(ii)(B)(I)(i)

	Group AAA Products	Group BBB Products	Total
Gross receipts from U.S. persons	\$200x	\$800x	\$1,000x
Gross receipts from foreign persons	\$100x	\$400x	\$500x
Total gross receipts	\$300x	\$1,200x	\$1,500x
Cost of goods sold for gross receipts from U.S. persons	\$140x	\$600x	\$740x
Cost of goods sold for gross receipts from foreign persons	\$70x	\$300x	\$370x
Total cost of goods sold	\$210x	\$900x	\$1,110x
Gross income	\$90x	\$300x	\$390x
R&E deductions	\$40x	\$210x	\$250x

(ii) *PRS's operations.* In addition to its own operations, DC is a partner in PRS, a partnership that also produces products described in SIC Group AAA. DC is allocated 50 percent of all income, gain, loss, and deductions of PRS. During the taxable year, PRS sells Group AAA products solely to foreign persons, and all of its gross income is included in gross DEI. PRS has \$400 of gross receipts from sales of Group AAA products for the taxable year and incurs \$100x of research and experimental (R&E) expenditures in the United States that are deductible under section 174. None of the R&E is included in cost of goods sold. For purposes of determining gross FDDEI and gross DEI under paragraph (d)(1) of this section, PRS attributes \$200x of cost of goods sold to Group AAA products, and then attributes the cost of goods sold with respect to such product group ratably between the gross receipts with respect to such product group sold to foreign persons and the gross receipts with respect to such product group not sold to foreign persons. The manner in which PRS attributes the cost of goods sold is a reasonable method. DC's distributive share of PRS taxable items is \$100x of gross income and \$50x of R&E deductions, and DC's share of PRS's gross receipts from sales of Group AAA products for the taxable year is \$200x under §1.861-17(f)(3).

(iii) *Application of the sales method to allocate and apportion R&E.* DC applies the sales method to apportion its R&E deductions under §1.861-17. Neither DC nor PRS licenses or sells its intangible property to controlled or uncontrolled corporations in a manner that necessitates including the sales by such corporations for purposes of apportioning DC's R&E deductions.

(2) *Analysis—(i) Determination of gross DEI and gross FDDEI.* Under paragraph (e)(1) of this section, DC's gross DEI, gross FDDEI, and deductions allocable to those amounts include its distributive share

of gross DEI, gross FDDEI, and deductions of PRS. Thus, DC's gross DEI for the year is \$490x (\$390x attributable to DC and \$100x attributable to DC's interest in PRS). DC's gross income from sales of Group AAA products to foreign persons is \$30x (\$100x of gross receipts minus attributable cost of goods sold of \$70x). DC's gross income from sales of Group BBB products to foreign persons is \$100x (\$400x of gross receipts minus attributable cost of goods sold of \$300x). DC's gross FDDEI for the year is \$230x (\$30x from DC's sale of Group AAA products plus \$100x from DC's sale of Group BBB products plus DC's distributive share of PRS's gross FDDEI of \$100x).

(ii) *Allocation and apportionment of R&E deductions.* To determine FDDEI, DC must allocate and apportion its R&E expense of \$300x (\$250x incurred directly by DC and \$50x incurred indirectly through DC's interest in PRS). In accordance with §1.861-17, R&E expenses are first allocated to a class of gross income related to a three-digit SIC group code. DC's R&E expenses related to products in Group AAA are \$90x (\$40x incurred directly by DC and \$50x incurred indirectly through DC's interest in PRS) and its expenses related to Group BBB are \$210x. See paragraph (d)(2)(i) of this section. Accordingly, all R&E expense attributable to a particular SIC group code is apportioned on the basis of the amounts of sales within that SIC group code. Total sales within Group AAA were \$500x (\$300x directly by DC and \$200x attributable to DC's interest in PRS), \$300x of which were made to foreign persons (\$100x directly by DC and \$200x attributable to DC's interest in PRS). Therefore, the \$90x of R&E expense related to Group AAA is apportioned \$54x to gross FDDEI (\$90x x \$300x/\$500x) and \$36x to gross RDEI (\$90x x \$200x/\$500x). Total sales within Group BBB were \$1,200x, \$400x of which were made to foreign persons. Therefore, the \$210x of R&E expense related

to products in Group BBB is apportioned \$70x to gross FDDEI (\$210x x \$400x/\$1,200x) and \$140x to gross RDEI (\$210x x \$800x/\$1,200x). Accordingly, DC's FDDEI for the tax year is \$106x (\$230x gross FDDEI minus \$124x of R&E (\$54x + \$70x) allocated and apportioned to gross FDDEI).

(e) *Domestic corporate partners—(1) In general.* A domestic corporation's DEI and FDDEI for a taxable year are determined by taking into account the corporation's share of gross DEI, gross FDDEI, and deductions of any partnership (whether domestic or foreign) in which the corporation is a direct or indirect partner. For purposes of the preceding sentence, a domestic corporation's share of each such item of a partnership is determined in accordance with the corporation's distributive share of the underlying items of income, gain, deduction, and loss of the partnership that comprise such amounts. See §1.250(b)-2(g) for rules on calculating the increase to a domestic corporation's QBAI by the corporation's share of partnership QBAI.

(2) *Reporting requirement for partnership with domestic corporate partners.* A partnership that has one or more direct partners that are domestic corporations and that is required to file a return under section 6031 must furnish to each such partner on or with such partner's Schedule K-1 (Form 1065 or any successor form)

by the due date (including extensions) for furnishing Schedule K-1 the partner's share of the partnership's gross DEI, gross FDDEI, deductions that are properly allocable to the partnership's gross DEI and gross FDDEI, and partnership QBAI (as determined under §1.250(b)-2(g)) for each taxable year in which the partnership has gross DEI, gross FDDEI, deductions that are properly allocable to the partnership's gross DEI or gross FDDEI, or partnership specified tangible property (as defined in §1.250(b)-2(g)(5)). In the case of tiered partnerships where one or more partners of an upper-tier partnership are domestic corporations, a lower-tier partnership must report the amount specified in this paragraph (e)(2) to the upper-tier partnership to allow reporting of such information to any partner that is a domestic corporation. To the extent that a partnership cannot determine the information described in the first sentence of this paragraph (e)(2), the partnership must instead furnish to each partner its share of the partnership's attributes that a partner needs to determine the partner's gross DEI, gross FDDEI, deductions that are properly allocable to the partner's gross DEI and gross FDDEI, and the partner's adjusted bases in partnership specified tangible property.

(3) *Examples.* The following examples illustrate the application of this paragraph (e).

(i) *Assumed facts.* The following facts are assumed for purposes of the examples—

(A) DC, a domestic corporation, is a partner in PRS, a partnership.

(B) FP and FP2 are foreign persons.

(C) FC is a foreign corporation.

(D) The allocations under PRS's partnership agreement satisfy the requirements of section 704.

(E) No partner of PRS is a related party of DC.

(F) DC, PRS, and FC all use the calendar year as their taxable year.

(G) PRS has no items of income, loss, or deduction for its taxable year, except the items of income described.

(ii) *Examples—*

(A) *Example 1: Sale by partnership to foreign person—(I) Facts.* Under the terms of the partnership agreement, DC is allocated 50 percent of all income, gain, loss, and deductions of PRS. For the taxable year, PRS recognizes \$20x of gross income on the sale of general property (as defined in

§1.250(b)-3(b)(10)) to FP, a foreign person (as determined under §1.250(b)-4(c)), for a foreign use (as determined under §1.250(b)-4(d)). The gross income recognized on the sale of property is not described in section 250(b)(3)(A)(I) through (VI) or paragraphs (c)(15)(i) through (vi) of this section.

(2) *Analysis.* PRS's sale of property to FP is a FDDEI sale as described in §1.250(b)-4(b). Therefore, the gross income derived from the sale (\$20x) is included in PRS's gross DEI and gross FDDEI, and DC's share of PRS's gross DEI and gross FDDEI (\$10x) is included in DC's gross DEI and gross FDDEI for the taxable year.

(B) *Example 2: Sale by partnership to foreign person attributable to foreign branch—(I) Facts.* The facts are the same as in paragraph (e)(3)(ii)(A)(1) of this section (the facts in *Example 1*), except the income from the sale of property to FP is attributable to a foreign branch of PRS.

(2) *Analysis.* PRS's sale of property to FP is excluded from PRS's gross DEI under section 250(b)(3)(A)(VI) and paragraph (c)(15)(vi) of this section. Accordingly, DC's share of PRS's gross income of \$10x from the sale is not included in DC's gross DEI or gross FDDEI for the taxable year.

(C) *Example 3: Partnership with a loss in gross FDDEI—(I) Facts.* The facts are the same as in paragraph (e)(3)(ii)(A)(1) of this section (the facts in *Example 1*), except that in the same taxable year, PRS also sells property to FP2, a foreign person (as determined under §1.250(b)-4(c)), for a foreign use (as determined under §1.250(b)-4(d)). After taking into account both sales, PRS has a gross loss of \$30x.

(2) *Analysis.* Both the sale of property to FP and the sale of property to FP2 are FDDEI sales because each sale is described in §1.250(b)-4(b). DC's share of PRS's gross loss (\$15x) from the sales is included in DC's gross DEI and gross FDDEI.

(D) *Example 4: Sale by partnership to foreign related party of the partnership—(I) Facts.* Under the terms of the partnership agreement, DC has 25 percent of the capital and profits interest in the partnership and is allocated 25 percent of all income, gain, loss, and deductions of PRS. PRS owns 100 percent of the single class of stock of FC. In the taxable year, PRS has \$20x of gain on the sale of general property (as defined in §1.250(b)-3(b)(10)) to FC, and FC makes a physical and material change to the property within the meaning of §1.250(b)-4(d)(1)(iii)(B) outside the United States before selling the property to customers in the United States.

(2) *Analysis.* The sale of property by PRS to FC is described in §1.250(b)-4(b) without regard to the application of §1.250(b)-6, since the sale is to a foreign person (as determined under §1.250(b)-4(c)) for a foreign use (as determined under §1.250(b)-4(d)). However, FC is a foreign related party of PRS within the meaning of section 250(b)(5)(D) and §1.250(b)-3(b)(6), because FC and PRS are members of a modified affiliated group within the meaning of paragraph (c)(17) of this section. Therefore, the sale by PRS to FC is a related party sale within the meaning of §1.250(b)-6(b)(1). Under section 250(b)(5)(C)(i) and §1.250(b)-6(c), because FC did not sell the property, or use the property in connection with other property sold or the provision of a service, to a foreign unrelated party before the property was subject to a domestic use, the sale by PRS to FC is not a

FDDEI sale. See §1.250(b)-6(c)(1). Accordingly, the gain from the sale (\$20x) is included in PRS's gross DEI but not its gross FDDEI, and DC's share of PRS's gain (\$5x) is included in DC's gross DEI but not gross FDDEI. This is the result notwithstanding that FC is not a related party of DC because FC and DC are not members of a modified affiliated group within the meaning of paragraph (c)(17) of this section.

(f) *Determination of FDII for consolidated groups.* A member of a consolidated group (as defined in §1.1502-1(h)) determines its FDII under the rules provided in §1.1502-50.

(g) *Determination of FDII for tax-exempt corporations.* The FDII of a corporation that is subject to the unrelated business income tax under section 511 is determined only by reference to that corporation's items of income, gain, deduction, or loss, and adjusted bases in property, that are taken into account in computing the corporation's unrelated business taxable income (as defined in section 512). For example, if a corporation that is subject to the unrelated business income tax under section 511 has tangible property used in the production of both unrelated business income and gross income that is not unrelated business income, only the portion of the basis of such property taken into account in computing the corporation's unrelated business taxable income is taken into account in determining the corporation's QBAI. Similarly, if a corporation that is subject to the unrelated business income tax under section 511 has tangible property that is used in both the production of gross DEI and the production of gross income that is not gross DEI, only the corporation's unrelated business income is taken into account in determining the corporation's dual use ratio with respect to such property under §1.250(b)-2(d)(3).

§1.250(b)-2 Qualified business asset investment (QBAI)

(a) *Scope.* This section provides general rules for determining the qualified business asset investment of a domestic corporation for purposes of determining its deemed tangible income return under §1.250(b)-1(c)(4). Paragraph (b) of this section defines qualified business asset investment (QBAI). Paragraph (c) of this section defines tangible property and specified tangible property. Paragraph (d)

of this section provides rules for determining the portion of property that is specified tangible property when the property is used in the production of both gross DEI and gross income that is not gross DEI.

Paragraph (e) of this section provides rules for determining the adjusted basis of specified tangible property. Paragraph (f) of this section provides rules for determining QBAI of a domestic corporation with a short taxable year. Paragraph (g) of this section provides rules for increasing the QBAI of a domestic corporation by reason of property owned through a partnership. Paragraph (h) of this section provides an anti-avoidance rule that disregards certain transfers when determining the QBAI of a domestic corporation.

(b) *Definition of qualified business asset investment.* The term *qualified business asset investment (QBAI)* means the average of a domestic corporation's aggregate adjusted bases as of the close of each quarter of the domestic corporation's taxable year in specified tangible property that is used in a trade or business of the domestic corporation and is of a type with respect to which a deduction is allowable under section 167. In the case of partially depreciable property, only the depreciable portion of the property is of a type with respect to which a deduction is allowable under section 167.

(c) *Specified tangible property—(1) In general.* The term *specified tangible property* means, with respect to a domestic corporation for a taxable year, tangible property of the domestic corporation used in the production of gross DEI for the taxable year. For purposes of the preceding sentence, tangible property of a domestic corporation is used in the production of gross DEI for a taxable year if some or all of the depreciation or cost recovery allowance with respect to the tangible property is either allocated and apportioned to the gross DEI of the domestic corporation for the taxable year under §1.250(b)-1(d)(2) or capitalized to inventory or other property held for sale, some or all of the gross income or loss from the sale of which is taken into account in determining DEI of the domestic corporation for the taxable year.

(2) *Tangible property.* The term *tangible property* means property for which the depreciation deduction provided by sec-

tion 167(a) is eligible to be determined under section 168 without regard to section 168(f)(1), (2), or (5), section 168(k)(2)(A)(i)(II), (IV), or (V), and the date placed in service.

(d) *Dual use property—(1) In general.* The amount of the adjusted basis in dual use property of a domestic corporation for a taxable year that is treated as adjusted basis in specified tangible property for the taxable year is the average of the domestic corporation's adjusted basis in the property multiplied by the dual use ratio with respect to the property for the taxable year.

(2) *Definition of dual use property.* The term *dual use property* means, with respect to a domestic corporation and a taxable year, specified tangible property of the domestic corporation that is used in both the production of gross DEI and the production of gross income that is not gross DEI for the taxable year. For purposes of the preceding sentence, specified tangible property of a domestic corporation is used in the production of gross DEI and the production of gross income that is not gross DEI for a taxable year if less than all of the depreciation or cost recovery allowance with respect to the property is either allocated and apportioned to the gross DEI of the domestic corporation for the taxable year under §1.250(b)-1(d)(2) or capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the DEI of the domestic corporation for the taxable year.

(3) *Dual use ratio.* The term *dual use ratio* means, with respect to dual use property, a domestic corporation, and a taxable year, a ratio (expressed as a percentage) calculated as—

(i) The sum of—

(A) The depreciation deduction or cost recovery allowance with respect to the property that is allocated and apportioned to the gross DEI of the domestic corporation for the taxable year under §1.250(b)-1(d)(2); and

(B) The depreciation or cost recovery allowance with respect to the property that is capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the DEI of the domestic corporation for the taxable year; divided by

(ii) The sum of—

(A) The total amount of the domestic corporation's depreciation deduction or cost recovery allowance with respect to the property for the taxable year; and

(B) The total amount of the domestic corporation's depreciation or cost recovery allowance with respect to the property capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the income or loss of the domestic corporation for the taxable year.

(4) *Example.* The following example illustrates the application of this paragraph (d).

(i) *Facts.* DC, a domestic corporation, owns a machine that produces both gross DEI and income that is not gross DEI. The average adjusted basis of the machine for the taxable year in the hands of DC is \$4,000x. The depreciation with respect to the machine for the taxable year is \$400x, \$320x of which is capitalized to inventory of Product A, gross income or loss from the sale of which is taken into account in determining DC's gross DEI for the taxable year, and \$80x of which is capitalized to inventory of Product B, gross income or loss from the sale of which is not taken into account in determining DC's gross DEI for the taxable year. DC also owns an office building for its administrative functions with an average adjusted basis for the taxable year of \$10,000x. DC does not capitalize depreciation with respect to the office building to inventory or other property held for sale. DC's depreciation deduction with respect to the office building is \$1,000x for the taxable year, \$750x of which is allocated and apportioned to gross DEI under §1.250(b)-1(d)(2), and \$250x of which is allocated and apportioned to income other than gross DEI under §1.250(b)-1(d)(2).

(ii) *Analysis—(A) Dual use property.* The machine and office building are property for which the depreciation deduction provided by section 167(a) is eligible to be determined under section 168 (without regard to section 168(f)(1), (2), or (5), section 168(k)(2)(A)(i)(II), (IV), or (V), and the date placed in service). Therefore, under paragraph (c)(2) of this section, the machine and office building are tangible property. Furthermore, because the machine and office building are used in the production of gross DEI for the taxable year within the meaning of paragraph (c)(1) of this section, the machine and office building are specified tangible property. Finally, because the machine and office building are used in both the production of gross DEI and the production of gross income that is not gross DEI for the taxable year within the meaning of paragraph (d)(2) of this section, the machine and office building are dual use property. Therefore, under paragraph (d)(1) of this section, the amount of DC's adjusted basis in the machine and office building that is treated as adjusted basis in specified tangible property for the taxable year is determined by multiplying DC's adjusted basis in the machine and office building by DC's dual use ratio with respect to the machine and office building determined under paragraph (d)(3) of this section.

(B) Depreciation not capitalized to inventory.

Because none of the depreciation with respect to the office building is capitalized to inventory or other property held for sale, DC's dual use ratio with respect to the office building is determined entirely by reference to the depreciation deduction with respect to the office building. Therefore, under paragraph (d)(3) of this section, DC's dual use ratio with respect to the office building for Year 1 is 75 percent, which is DC's depreciation deduction with respect to the office building that is allocated and apportioned to gross DEI under §1.250(b)-1(d)(2) for Year 1 (\$750x), divided by the total amount of DC's depreciation deduction with respect to the office building for Year 1 (\$1000x). Accordingly, under paragraph (d)(1) of this section, \$7,500x (\$10,000x x 0.75) of DC's average adjusted bases in the office building is taken into account under paragraph (b) of this section in determining DC's QBAI for the taxable year.

(C) Depreciation capitalized to inventory. Because all of the depreciation with respect to the machine is capitalized to inventory, DC's dual use ratio with respect to the machine is determined entirely by reference to the depreciation with respect to the machine that is capitalized to inventory and included in cost of goods sold. Therefore, under paragraph (d)(3) of this section, DC's dual use ratio with respect to the machine for the taxable year is 80 percent, which is DC's depreciation with respect to the machine that is capitalized to inventory of Product A, the gross income or loss from the sale of which is taken into account in determining DC's DEI for the taxable year (\$320x), divided by DC's depreciation with respect to the machine that is capitalized to inventory, the gross income or loss from the sale of which is taken into account in determining DC's income for Year 1 (\$400x). Accordingly, under paragraph (d)(1) of this section, \$3,200x (\$4,000x x 0.8) of DC's average adjusted basis in the machine is taken into account under paragraph (b) of this section in determining DC's QBAI for the taxable year.

(e) Determination of adjusted basis of specified tangible property—(1) In general. The adjusted basis in specified tangible property for purposes of this section is determined by using the cost capitalization methods of accounting used by the domestic corporation for purposes of determining the gross income and deductions of the domestic corporation and the alternative depreciation system under section 168(g), and by allocating the depreciation deduction with respect to such property for the domestic corporation's taxable year ratably to each day during the period in the taxable year to which such depreciation relates. For purposes of the preceding sentence, the period in the taxable year to which such depreciation relates is determined without regard to the applicable convention under section 168(d).

(2) Effect of change in law. The adjusted basis in specified tangible property is determined without regard to any provi-

sion of law enacted after December 22, 2017, unless such later enacted law specifically and directly amends the definition of QBAI under section 250 or section 951A.

(3) Specified tangible property placed in service before enactment of section 250. The adjusted basis in specified tangible property placed in service before December 22, 2017, is determined using the alternative depreciation system under section 168(g), as if this system had applied from the date that the property was placed in service.

(f) Special rules for short taxable years—(1) In general. In the case of a domestic corporation that has a taxable year that is less than twelve months (a *short taxable year*), the rules for determining the QBAI of the domestic corporation under this section are modified as provided in paragraphs (f)(2) and (3) of this section with respect to the taxable year.

(2) Determination of when the quarter closes. For purposes of determining when the quarter closes, in determining the QBAI of a domestic corporation for a short taxable year, the quarters of the domestic corporation for purposes of this section are the full quarters beginning and ending within the short taxable year (if any), determining quarter length as if the domestic corporation did not have a short taxable year, plus one or more short quarters (if any).

(3) Reduction of qualified business asset investment. The QBAI of a domestic corporation for a short taxable year is the sum of—

(i) The sum of the domestic corporation's aggregate adjusted bases in specified tangible property as of the close of each full quarter (if any) in the domestic corporation's taxable year divided by four; plus

(ii) The domestic corporation's aggregate adjusted bases in specified tangible property as of the close of each short quarter (if any) in the domestic corporation's taxable year multiplied by the sum of the number of days in each short quarter divided by 365.

(4) Example. The following example illustrates the application of this paragraph (f).

(i) **Facts.** A, an individual, owns all of the stock of DC, a domestic corporation. A owns DC from the

beginning of the taxable year. On July 15 of the taxable year, A sells DC to USP, a domestic corporation that is unrelated to A. DC becomes a member of the consolidated group of which USP is the common parent and as a result, under §1.1502-76(b)(2)(ii), DC's taxable year is treated as ending on July 15. USP and DC both use the calendar year as their taxable year. DC's aggregate adjusted bases in specified tangible property for the taxable year are \$250x as of March 31, \$300x as of June 30, \$275x as of July 15, \$500x as of September 30, and \$450x as of December 31.

(ii) **Analysis—(A) Determination of short taxable years and quarters.** DC has two short taxable years during the year. The first short taxable year is from January 1 to July 15, with two full quarters (January 1 through March 31 and April 1 through June 30) and one short quarter (July 1 through July 15). The second taxable year is from July 16 to December 31, with one short quarter (July 16 through September 30) and one full quarter (October 1 through December 31).

(B) Calculation of qualified business asset investment for the first short taxable year. Under paragraph (f)(2) of this section, for the first short taxable year, DC has three quarter closes (March 31, June 30, and July 15). Under paragraph (f)(3) of this section, the QBAI of DC for the first short taxable year is \$148.80x, the sum of \$137.50x ((\\$250x + \\$300x)/4) attributable to the two full quarters and \$11.30x (\$275x x 15/365) attributable to the short quarter.

(C) Calculation of qualified business asset investment for the second short taxable year. Under paragraph (f)(2) of this section, for the second short taxable year, DC has two quarter closes (September 30 and December 31). Under paragraph (f)(3) of this section, the QBAI of DC for the second short taxable year is \$217.98x, the sum of \$112.50x (\$450x/4) attributable to the one full quarter and \$105.48x (\$500x x 77/365) attributable to the short quarter.

(g) Partnership property—(1) In general. If a domestic corporation holds an interest in one or more partnerships during a taxable year (including indirectly through one or more partnerships that are partners in a lower-tier partnership), the QBAI of the domestic corporation for the taxable year (determined without regard to this paragraph (g)(1)) is increased by the sum of the domestic corporation's partnership QBAI with respect to each partnership for the taxable year.

(2) Determination of partnership QBAI. For purposes of paragraph (g)(1) of this section, the term *partnership QBAI* means, with respect to a partnership, a domestic corporation, and a taxable year, the sum of the domestic corporation's partner adjusted basis in each partnership specified tangible property of the partnership for each partnership taxable year that ends with or within the taxable year. If a partnership taxable year is less than twelve months, the principles of paragraph (f) of

this section apply in determining a domestic corporation's partnership QBAI with respect to the partnership.

(3) *Determination of partner adjusted basis*—(i) *In general*. For purposes of paragraph (g)(2) of this section, the term *partner adjusted basis* means the amount described in paragraph (g)(3)(ii) of this section with respect to sole use partnership property or paragraph (g)(3)(iii) of this section with respect to dual use partnership property. The principles of section 706(d) apply to this determination.

(ii) *Sole use partnership property*—(A) *In general*. The amount described in this paragraph (g)(3)(ii), with respect to sole use partnership property, a partnership taxable year, and a domestic corporation, is the sum of the domestic corporation's proportionate share of the partnership adjusted basis in the sole use partnership property for the partnership taxable year and the domestic corporation's partner-specific QBAI basis in the sole use partnership property for the partnership taxable year.

(B) *Definition of sole use partnership property*. The term *sole use partnership property* means, with respect to a partnership, a partnership taxable year, and a domestic corporation, partnership specified tangible property of the partnership that is used in the production of only gross DEI of the domestic corporation for the taxable year in which or with which the partnership taxable year ends. For purposes of the preceding sentence, partnership specified tangible property of a partnership is used in the production of only gross DEI for a taxable year if all the domestic corporation's distributive share of the partnership's depreciation deduction or cost recovery allowance with respect to the property (if any) for the partnership taxable year that ends with or within the taxable year is allocated and apportioned to the domestic corporation's gross DEI for the taxable year under §1.250(b)-1(d)(2) and, if any of the partnership's depreciation or cost recovery allowance with respect to the property is capitalized to inventory or other property held for sale, all the domestic corporation's distributive share of the partnership's gross income or loss from the sale of such inventory or other property for the partnership taxable year that ends with or within the taxable

year is taken into account in determining the DEI of the domestic corporation for the taxable year.

(iii) *Dual use partnership property*—(A) *In general*. The amount described in this paragraph (g)(3)(iii), with respect to dual use partnership property, a partnership taxable year, and a domestic corporation, is the sum of the domestic corporation's proportionate share of the partnership adjusted basis in the property for the partnership taxable year and the domestic corporation's partner-specific QBAI basis in the property for the partnership taxable year, multiplied by the domestic corporation's dual use ratio with respect to the property for the partnership taxable year determined under the principles of paragraph (d)(3) of this section, except that the ratio described in paragraph (d)(3) of this section is determined by reference to the domestic corporation's distributive share of the amounts described in paragraph (d)(3) of this section.

(B) *Definition of dual use partnership property*. The term *dual use partnership property* means partnership specified tangible property other than sole use partnership property.

(4) *Determination of proportionate share of the partnership's adjusted basis in partnership specified tangible property*—(i) *In general*. For purposes of paragraph (g)(3) of this section, the domestic corporation's proportionate share of the partnership adjusted basis in partnership specified tangible property for a partnership taxable year is the partnership adjusted basis in the property multiplied by the domestic corporation's proportionate share ratio with respect to the property for the partnership taxable year. Solely for purposes of determining the proportionate share ratio under paragraph (g)(4)(ii) of this section, the partnership's calculation of, and a partner's distributive share of, any income, loss, depreciation, or cost recovery allowance is determined under section 704(b).

(ii) *Proportionate share ratio*. The term *proportionate share ratio* means, with respect to a partnership, a partnership taxable year, and a domestic corporation, the ratio (expressed as a percentage) calculated as—

(A) The sum of—

(1) The domestic corporation's distributive share of the partnership's depreciation deduction or cost recovery allowance with respect to the property for the partnership taxable year; and

(2) The amount of the partnership's depreciation or cost recovery allowance with respect to the property that is capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the domestic corporation's distributive share of the partnership's income or loss for the partnership taxable year; divided by

(B) The sum of—

(1) The total amount of the partnership's depreciation deduction or cost recovery allowance with respect to the property for the partnership taxable year; and

(2) The total amount of the partnership's depreciation or cost recovery allowance with respect to the property capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the partnership's income or loss for the partnership taxable year.

(5) *Definition of partnership specified tangible property*. The term *partnership specified tangible property* means, with respect to a domestic corporation, tangible property (as defined in paragraph (c)(2) of this section) of a partnership that is—

(i) Used in the trade or business of the partnership;

(ii) Of a type with respect to which a deduction is allowable under section 167; and

(iii) Used in the production of gross income included in the domestic corporation's gross DEI.

(6) *Determination of partnership adjusted basis*. For purposes of this paragraph (g), the term *partnership adjusted basis* means, with respect to a partnership, partnership specified tangible property, and a partnership taxable year, the amount equal to the average of the partnership's adjusted basis in the partnership specified tangible property as of the close of each quarter in the partnership taxable year determined without regard to any adjustments under section 734(b) except for adjustments under section 734(b)(1)(B) or section 734(b)(2)(B) that are attributable to distributions of tangible proper-

ty (as defined in paragraph (c)(2) of this section) and for adjustments under section 734(b)(1)(A) or 734(b)(2)(A). The principles of paragraphs (e) and (h) of this section apply for purposes of determining a partnership's adjusted basis in partnership specified tangible property and the proportionate share of the partnership's adjusted basis in partnership specified tangible property.

(7) *Determination of partner-specific QBAI basis.* For purposes of this paragraph (g), the term *partner-specific QBAI basis* means, with respect to a domestic corporation, a partnership, and partnership specified tangible property, the amount that is equal to the average of the basis adjustment under section 743(b) that is allocated to the partnership specified tangible property of the partnership with respect to the domestic corporation as of the close of each quarter in the partnership taxable year. For this purpose, a negative basis adjustment under section 743(b) is expressed as a negative number. The principles of paragraphs (e) and (h) of this section apply for purposes of determining the partner-specific QBAI basis with respect to partnership specified tangible property.

(8) *Examples.* The following examples illustrate the rules of this paragraph (g).

(i) *Assumed facts.* Except as otherwise stated, the following facts are assumed for purposes of the examples:

(A) DC, DC1, DC2, and DC3 are domestic corporations.

(B) PRS is a partnership and its allocations satisfy the requirements of section 704.

(C) All properties are partnership specified tangible property.

(D) All persons use the calendar year as their taxable year.

(E) There is no partner-specific QBAI basis with respect to any property.

(ii) *Example 1: Sole use partnership property—(A) Facts.* DC is a partner in PRS. PRS owns two properties, Asset A and Asset B. The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset A is \$100x and in Asset B is \$500x. In Year 1, PRS's section 704(b) depreciation deduction is \$10x with respect to Asset A and \$5x with respect to Asset B, and DC's section 704(b) distributive share of the depreciation deduction is \$8x with respect to Asset A and \$1x with respect to Asset B. None of the depreciation with respect to Asset A or Asset B is capitalized to inventory or other property held for sale. DC's entire distributive share

of the depreciation deduction with respect to Asset A and Asset B is allocated and apportioned to DC's gross DEI for Year 1 under §1.250(b)-1(d)(2).

(B) *Analysis—(1) Sole use partnership property.* Because all of DC's distributive share of the depreciation deduction with respect to Asset A and B is allocated and apportioned to gross DEI for Year 1, Asset A and Asset B are sole use partnership property within the meaning of paragraph (g)(3)(ii)(B) of this section. Therefore, under paragraph (g)(3)(ii)(A) of this section, DC's partner adjusted basis in Asset A and Asset B is equal to the sum of DC's proportionate share of PRS's partnership adjusted basis in Asset A and Asset B for Year 1 and DC's partner-specific QBAI basis in Asset A and Asset B for Year 1, respectively.

(2) *Proportionate share.* Under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset A and Asset B is PRS's partnership adjusted basis in Asset A and Asset B for Year 1, multiplied by DC's proportionate share ratio with respect to Asset A and Asset B for Year 1, respectively. Because none of the depreciation with respect to Asset A or Asset B is capitalized to inventory or other property held for sale, DC's proportionate share ratio with respect to Asset A and Asset B is determined entirely by reference to the depreciation deduction with respect to Asset A and Asset B. Therefore, DC's proportionate share ratio with respect to Asset A for Year 1 is 80 percent, which is the ratio of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset A for Year 1 (\$8x), divided by the total amount of PRS's section 704(b) depreciation deduction with respect to Asset A for Year 1 (\$10x). DC's proportionate share ratio with respect to Asset B for Year 1 is 20 percent, which is the ratio of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset B for Year 1 (\$1x), divided by the total amount of PRS's section 704(b) depreciation deduction with respect to Asset B for Year 1 (\$5x). Accordingly, under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset A is \$80x (\$100x x 0.8), and DC's proportionate share of PRS's partnership adjusted basis in Asset B is \$100x (\$500x x 0.2).

(3) *Partner adjusted basis.* Because DC has no partner-specific QBAI basis with respect to Asset A and Asset B, DC's partner adjusted basis in Asset A and Asset B is determined entirely by reference to its proportionate share of PRS's partnership adjusted basis in Asset A and Asset B. Therefore, under paragraph (g)(3)(ii)(A) of this section, DC's partner adjusted basis in Asset A is \$80x, DC's proportionate share of PRS's partnership adjusted basis in Asset A, and DC's partner adjusted basis in Asset B is \$100x, DC's proportionate share of PRS's partnership adjusted basis in Asset B.

(4) *Partnership QBAI.* Under paragraph (g)(2) of this section, DC's partnership QBAI with respect to PRS is \$180x, the sum of DC's partner adjusted basis in Asset A (\$80x) and DC's partner adjusted basis in Asset B (\$100x). Accordingly, under paragraph (g)(1) of this section, DC increases its QBAI for Year 1 by \$180x.

(iii) *Example 2: Dual use partnership property—(A) Facts.* DC owns a 50 percent interest in PRS.

All section 704(b) and tax items are identical and are allocated equally between DC and its other partner. PRS owns three properties, Asset C, Asset D, and Asset E. PRS sells two products, Product A and Product B. All of DC's distributive share of the gross income or loss from the sale of Product A is taken into account in determining DC's DEI, and none of DC's distributive share of the gross income or loss from the sale of Product B is taken into account in determining DC's DEI.

(1) *Asset C.* The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset C is \$100x. In Year 1, PRS's depreciation is \$10x with respect to Asset C, none of which is capitalized to inventory or other property held for sale. DC's distributive share of the depreciation deduction with respect to Asset C is \$5x (\$10x x 0.5), \$3x of which is allocated and apportioned to DC's gross DEI under §1.250(b)-1(d)(2).

(2) *Asset D.* The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset D is \$500x. In Year 1, PRS's depreciation is \$50x with respect to Asset D, \$10x of which is capitalized to inventory of Product A and \$40x is capitalized to inventory of Product B. None of the \$10x depreciation with respect to Asset D capitalized to inventory of Product A is capitalized to ending inventory. However, of the \$40x capitalized to inventory of Product B, \$10x is capitalized to ending inventory. Therefore, the amount of depreciation with respect to Asset D capitalized to inventory of Product A that is taken into account in determining DC's distributive share of the income or loss of PRS for Year 1 is \$5x (\$10x x 0.5), and the amount of depreciation with respect to Asset D capitalized to inventory of Product B that is taken into account in determining DC's distributive share of the income or loss of PRS for Year 1 is \$15x (\$30x x 0.5).

(3) *Asset E.* The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset E is \$600x. In Year 1, PRS's depreciation is \$60x with respect to Asset E. Of the \$60x depreciation with respect to Asset E, \$20x is allowed as a deduction, \$24x is capitalized to inventory of Product A, and \$16x is capitalized to inventory of Product B. DC's distributive share of the depreciation deduction with respect to Asset E is \$10x (\$20x x 0.5), \$8x of which is allocated and apportioned to DC's gross DEI under §1.250(b)-1(d)(2). None of the \$24x depreciation with respect to Asset E capitalized to inventory of Product A is capitalized to ending inventory. However, of the \$16x depreciation with respect to Asset E capitalized to inventory of Product B, \$10x is capitalized to ending inventory. Therefore, the amount of depreciation with respect to Asset E capitalized to inventory of Product A that is taken into account in determining DC's distributive share of the income or loss of PRS for Year 1 is \$12x (\$24x x 0.5), and the amount of depreciation with respect to Asset E capitalized to inventory of Product B that is taken into account in determining DC's distributive share of the income or loss of PRS for Year 1 is \$3x (\$6x x 0.5).

(B) *Analysis.* Because Asset C, Asset D, and Asset E are not used in the production of only gross DEI in Year 1 within the meaning of paragraph (g)(3)(ii)(B) of this section, Asset C, Asset D, and Asset E are dual use partnership property within the mean-

ing of paragraph (g)(3)(iii)(B) of this section. Therefore, under paragraph (g)(3)(iii)(A) of this section, DC's partner adjusted basis in Asset C, Asset D, and Asset E is the sum of DC's proportionate share of PRS's partnership adjusted basis in Asset C, Asset D, and Asset E, respectively, for Year 1, and DC's partner-specific QBAI basis in Asset C, Asset D, and Asset E, respectively, for Year 1, multiplied by DC's dual use ratio with respect to Asset C, Asset D, and Asset E, respectively, for Year 1, determined under the principles of paragraph (d)(3) of this section, except that the ratio described in paragraph (d)(3) of this section is determined by reference to DC's distributive share of the amounts described in paragraph (d)(3) of this section.

(1) *Asset C—(i) Proportionate share.* Under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset C is PRS's partnership adjusted basis in Asset C for Year 1, multiplied by DC's proportionate share ratio with respect to Asset C for Year 1. Because none of the depreciation with respect to Asset C is capitalized to inventory or other property held for sale, DC's proportionate share ratio with respect to Asset C is determined entirely by reference to the depreciation deduction with respect to Asset C. Therefore, DC's proportionate share ratio with respect to Asset C is 50 percent, which is the ratio calculated as the amount of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset C for Year 1 (\$5x), divided by the total amount of PRS's section 704(b) depreciation deduction with respect to Asset C for Year 1 (\$10x). Accordingly, under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset C is \$50x (\$100x x 0.5).

(ii) *Dual use ratio.* Because none of the depreciation with respect to Asset C is capitalized to inventory or other property held for sale, DC's dual use ratio with respect to Asset C is determined entirely by reference to the depreciation deduction with respect to Asset C. Therefore, DC's dual use ratio with respect to Asset C is 60 percent, which is the ratio calculated as the amount of DC's distributive share of PRS's depreciation deduction with respect to Asset C that is allocated and apportioned to DC's gross DEI under §1.250(b)-1(d)(2) for Year 1 (\$3x), divided by the total amount of DC's distributive share of PRS's depreciation deduction with respect to Asset C for Year 1 (\$5x).

(iii) *Partner adjusted basis.* Because DC has no partner-specific QBAI basis with respect to Asset C, DC's partner adjusted basis in Asset C is determined entirely by reference to DC's proportionate share of PRS's partnership adjusted basis in Asset C, multiplied by DC's dual use ratio with respect to Asset C. Under paragraph (g)(3)(iii)(A) of this section, DC's partner adjusted basis in Asset C is \$30x, DC's proportionate share of PRS's partnership adjusted basis in Asset C for Year 1 (\$50x), multiplied by DC's dual use ratio with respect to Asset C for Year 1 (60 percent).

(2) *Asset D—(i) Proportionate share.* Under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset D is PRS's partnership adjusted basis in Asset D for Year 1, multiplied by DC's proportionate share ratio with respect to Asset D for Year 1. Because all

of the depreciation with respect to Asset D is capitalized to inventory, DC's proportionate share ratio with respect to Asset D is determined entirely by reference to the depreciation with respect to Asset D that is capitalized to inventory and included in cost of goods sold. Therefore, DC's proportionate share ratio with respect to Asset D is 50 percent, which is the ratio calculated as the amount of PRS's section 704(b) depreciation with respect to Asset D capitalized to Product A and Product B that is taken into account in determining DC's section 704(b) distributive share of PRS's income or loss for Year 1 (\$20x), divided by the total amount of PRS's section 704(b) depreciation with respect to Asset D capitalized to Product A and Product B that is taken into account in determining PRS's section 704(b) income or loss for Year 1 (\$40x). Accordingly, under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset D is \$250x (\$500x x 0.5).

(ii) *Dual use ratio.* Because all of the depreciation with respect to Asset D is capitalized to inventory, DC's dual use ratio with respect to Asset D is determined entirely by reference to the depreciation with respect to Asset D that is capitalized to inventory and included in cost of goods sold. Therefore, DC's dual use ratio with respect to Asset D is 25 percent, which is the ratio calculated as the amount of depreciation with respect to Asset D capitalized to inventory of Product A and Product B that is taken into account in determining DC's DEI for Year 1 (\$5x), divided by the total amount of depreciation with respect to Asset D capitalized to inventory of Product A and Product B that is taken into account in determining DC's income or loss for Year 1 (\$20x).

(iii) *Partner adjusted basis.* Because DC has no partner-specific QBAI basis with respect to Asset D, DC's partner adjusted basis in Asset D is determined entirely by reference to DC's proportionate share of PRS's partnership adjusted basis in Asset D, multiplied by DC's dual use ratio with respect to Asset D. Under paragraph (g)(3)(iii)(A) of this section, DC's partner adjusted basis in Asset D is \$62.50x, DC's proportionate share of PRS's partnership adjusted basis in Asset D for Year 1 (\$250x), multiplied by DC's dual use ratio with respect to Asset D for Year 1 (25 percent).

(3) *Asset E—(i) Proportionate share.* Under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset E is PRS's partnership adjusted basis in Asset E for Year 1, multiplied by DC's proportionate share ratio with respect to Asset E for Year 1. Because the depreciation with respect to Asset E is partly deducted and partly capitalized to inventory, DC's proportionate share ratio with respect to Asset E is determined by reference to both the depreciation that is deducted and the depreciation that is capitalized to inventory and included in cost of goods sold. Therefore, DC's proportionate share ratio with respect to Asset E is 50 percent, which is the ratio calculated as the sum (\$25x) of the amount of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset E for Year 1 (\$10x) and the amount of PRS's section 704(b) depreciation with respect to Asset E capitalized to inventory of Product A and Product B that is taken into account in determining DC's section 704(b) distributive share of PRS's income or loss for Year 1 (\$15x), divided by the sum (\$50x) of the total amount of PRS's section 704(b) depreciation deduction with respect to Asset E for Year 1 (\$20x) and the total amount of PRS's section 704(b) depreciation with respect to Asset E capitalized to inventory of Product A and Product B that is taken into account in determining PRS's section 704(b) income or loss for Year 1 (\$30x). Accordingly, under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset E is \$300x (\$600x x 0.5).

(ii) *Dual use ratio.* Because the depreciation with respect to Asset E is partly deducted and partly capitalized to inventory, DC's dual use ratio with respect to Asset E is determined by reference to the depreciation that is deducted and the depreciation that is capitalized to inventory and included in cost of goods sold. Therefore, DC's dual use ratio with respect to Asset E is 80 percent, which is the ratio calculated as the sum (\$20x) of the amount of DC's distributive share of PRS's depreciation deduction with respect to Asset E that is allocated and apportioned to DC's gross DEI under §1.250(b)-1(d)(2) for Year 1 (\$8x) and the amount of depreciation with respect to Asset E capitalized to inventory of Product A and Product B that is taken into account in determining DC's DEI for Year 1 (\$12x), divided by the sum (\$25x) of the total amount of DC's distributive share of PRS's depreciation deduction with respect to Asset E for Year 1 (\$10x) and the total amount of depreciation with respect to Asset E capitalized to inventory of Product A and Product B that is taken into account in determining DC's income or loss for Year 1 (\$15x).

(iii) *Partner adjusted basis.* Because DC has no partner-specific QBAI basis with respect to Asset E, DC's partner adjusted basis in Asset E is determined entirely by reference to DC's proportionate share of PRS's partnership adjusted basis in Asset E, multiplied by DC's dual use ratio with respect to Asset E. Under paragraph (g)(3)(iii)(A) of this section, DC's partner adjusted basis in Asset E is \$240x, DC's proportionate share of PRS's partnership adjusted basis in Asset E for Year 1 (\$300x), multiplied by DC's dual use ratio with respect to Asset E for Year 1 (80 percent).

(4) *Partnership QBAI.* Under paragraph (g)(2) of this section, DC's partnership QBAI with respect to PRS is \$332.50x, the sum of DC's partner adjusted basis in Asset C (\$30x), DC's partner adjusted basis in Asset D (\$62.50x), and DC's partner adjusted basis in Asset E (\$240x). Accordingly, under paragraph (g)(1) of this section, DC increases its QBAI for Year 1 by \$332.50x.

(iv) *Example 3: Sole use partnership specified tangible property; section 743(b) adjustments—(A) Facts.* The facts are the same as in paragraph (g)(8)(ii)(A) of this section (the facts in *Example 1*), except that there is an average of \$40x positive adjustment to the adjusted basis in Asset A as of the close of each quarter of PRS's taxable year with respect to DC under section 743(b) and an average of \$20x negative adjustment to the adjusted basis in Asset B as of the close of each quarter of PRS's taxable year with respect to DC under section 743(b).

(B) *Analysis.* Under paragraph (g)(3)(ii)(A) of this section, DC's partner adjusted basis in Asset A is \$120x, which is the sum of \$80x (DC's proportionate share of PRS's partnership adjusted basis in Asset

A as illustrated in paragraph (g)(8)(ii)(B)(2) of this section (the analysis in *Example 1*) and \$40x (DC's partner-specific QBAI basis in Asset A). Under paragraph (g)(3)(i)(A) of this section, DC's partner adjusted basis in Asset B is \$80x, the sum of \$100x (DC's proportionate share of the partnership adjusted basis in the property as illustrated in paragraph (g)(8)(ii)(B)(2) of this section (the analysis in *Example 1*) and (-\$20x) (DC's partner-specific QBAI basis in Asset B). Therefore, under paragraph (g)(2) of this section, DC's partnership QBAI with respect to PRS is \$200x (\$120x + \$80x). Accordingly, under paragraph (g)(1) of this section, DC increases its QBAI for Year 1 by \$200x.

(v) *Example 4: Sale of partnership interest before close of taxable year—(A) Facts.* DC1 owns a 50 percent interest in PRS on January 1 of Year 1. PRS does not have an election under section 754 in effect. On July 1 of Year 1, DC1 sells its entire interest in PRS to DC2. PRS owns Asset G. The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset G is \$100x. DC1's section 704(b) distributive share of the depreciation deduction with respect to Asset G is 25 percent with respect to PRS's entire year. DC2's section 704(b) distributive share of the depreciation deduction with respect to Asset G is also 25 percent with respect to PRS's entire year. Both DC1's and DC2's entire distributive shares of the depreciation deduction with respect to Asset G are allocated and apportioned under §1.250(b)-1(d)(2) to DC1's and DC2's gross DEI, respectively, for Year 1. PRS's allocations satisfy section 706(d).

(B) *Analysis—(1) DC1.* Because DC1 owns an interest in PRS during DC1's taxable year and receives a distributive share of partnership items of the partnership under section 706(d), DC1 has partnership QBAI with respect to PRS in the amount determined under paragraph (g)(2) of this section. Under paragraph (g)(3)(i) of this section, DC1's partner adjusted basis in Asset G is \$25x, the product of \$100x (the partnership's adjusted basis in the property) and 25 percent (DC1's section 704(b) distributive share of depreciation deduction with respect to Asset G). Therefore, DC1's partnership QBAI with respect to PRS is \$25x. Accordingly, under paragraph (g)(1) of this section, DC1 increases its QBAI by \$25x for Year 1.

(2) DC2. DC2's partner adjusted basis in Asset G is also \$25x, the product of \$100x (the partnership's adjusted basis in the property) and 25 percent (DC2's section 704(b) distributive share of depreciation deduction with respect to Asset G). Therefore, DC2's partnership QBAI with respect to PRS is \$25x. Accordingly, under paragraph (g)(1) of this section, DC2 increases its QBAI by \$25x for Year 1.

(vi) *Example 5: Partnership adjusted basis; distribution of property in liquidation of partnership interest—(A) Facts.* DC1, DC2, and DC3 are equal partners in PRS, a partnership. DC1 and DC2 each has an adjusted basis of \$100x in its partnership interest. DC3 has an adjusted basis of \$50x in its partnership interest. PRS has a section 754 election in effect. PRS owns Asset H with a fair market value of \$50x and an adjusted basis of \$0, Asset I with a fair market value of \$100x and an adjusted basis of \$100x, and Asset J with a fair market value of \$150x and an adjusted basis of \$150x. Asset H and Asset J

are tangible property, but Asset I is not tangible property. PRS distributes Asset I to DC3 in liquidation of DC3's interest in PRS. None of DC1, DC2, DC3, or PRS recognizes gain on the distribution. Under section 732(b), DC3's adjusted basis in Asset I is \$50x. PRS's adjusted basis in Asset H is increased by \$50x to \$50x under section 734(b)(1)(B), which is the amount by which PRS's adjusted basis in Asset I immediately before the distribution exceeds DC3's adjusted basis in Asset I.

(B) *Analysis.* Under paragraph (g)(6) of this section, PRS's adjusted basis in Asset H is determined without regard to any adjustments under section 734(b) except for adjustments under section 734(b)(1)(B) or section 734(b)(2)(B) that are attributable to distributions of tangible property and for adjustments under section 734(b)(1)(A) or 734(b)(2)(A). The adjustment to the adjusted basis in Asset H is under section 734(b)(1)(B) and is attributable to the distribution of Asset I, which is not tangible property. Accordingly, for purposes of applying paragraph (g)(1) of this section, PRS's adjusted basis in Asset H is \$0.

(h) *Anti-avoidance rule for certain transfers of property—(1) In general.* If, with a principal purpose of decreasing the amount of its deemed tangible income return, a domestic corporation transfers specified tangible property (*transferred property*) to a specified related party of the domestic corporation and, within the disqualified period, the domestic corporation or an FDII-eligible related party of the domestic corporation leases the same or substantially similar property from any specified related party, then, solely for purposes of determining the QBAI of the domestic corporation under paragraph (b) of this section, the domestic corporation is treated as owning the transferred property from the later of the beginning of the term of the lease or date of the transfer of the property until the earlier of the end of the term of the lease or the end of the recovery period of the property.

(2) *Rule for structured arrangements.* For purposes of paragraph (h)(1) of this section, a transfer of specified tangible property to a person that is not a related party or lease of property from a person that is not a related party is treated as a transfer to or lease from a specified related party if the transfer or lease is pursuant to a structured arrangement. A structured arrangement exists only if either paragraph (h)(2)(i) or (ii) of this section is satisfied.

(i) The reduction in the domestic corporation's deemed tangible income return is priced into the terms of the arrangement with the transferee.

(ii) Based on all the facts and circumstances, the reduction in the domestic corporation's deemed tangible income return is a principal purpose of the arrangement. Facts and circumstances that indicate the reduction in the domestic corporation's deemed tangible income return is a principal purpose of the arrangement include—

(A) Marketing the arrangement as tax-advantaged where some or all of the tax advantage derives from the reduction in the domestic corporation's deemed tangible income return;

(B) Primarily marketing the arrangement to domestic corporations which earn FDDEI;

(C) Features that alter the terms of the arrangement, including the return, in the event the reduction in the domestic corporation's deemed tangible income return is no longer relevant; or

(D) A below-market return absent the tax effects or benefits resulting from the reduction in the domestic corporation's deemed tangible income return.

(3) *Per se rules for certain transactions.* For purposes of paragraph (h)(1) of this section, a transfer of property by a domestic corporation to a specified related party (including a party deemed to be a specified related party under paragraph (h)(2) of this section) followed by a lease of the same or substantially similar property by the domestic corporation or an FDII-eligible related party from a specified related party (including a party deemed to be a specified related party under paragraph (h)(2) of this section) is treated per se as occurring pursuant to a principal purpose of decreasing the amount of the domestic corporation's deemed tangible income return if both the transfer and the lease occur within a six-month period.

(4) *Definitions related to anti-avoidance rule.* The following definitions apply for purpose of this paragraph (h).

(i) *Disqualified period.* The term *disqualified period* means, with respect to a transfer, the period beginning one year before the date of the transfer and ending the earlier of the end of the remaining recovery period (under the system described in section 951A(d)(3)(A)) of the property or one year after the date of the transfer.

(ii) *FDII-eligible related party.* The term *FDII-eligible related party* means, with respect to a domestic corporation, a

member of the same consolidated group as the domestic corporation or a partnership with respect to which at least 80 percent of the interests in partnership capital and profits are owned, directly or indirectly, by the domestic corporation or one or more members of the consolidated group that includes the domestic corporation.

(iii) *Specified related party*. The term *specified related party* means, with respect to a domestic corporation, a related party other than an FDII-eligible related party.

(iv) *Transfer*. The term *transfer* means any disposition, exchange, contribution, or distribution of property, and includes an indirect transfer. For example, a transfer of an interest in a partnership is treated as a transfer of the assets of the partnership. In addition, if paragraph (h)(1) of this section applies to treat a domestic corporation as owning specified tangible property by reason of a lease of property, the termination or lapse of the lease of the property is treated as a transfer of the specified tangible property by the domestic corporation to the lessor.

(5) *Transactions occurring before March 4, 2019*. Paragraph (h)(1) of this section does not apply to a transfer of property that occurs before March 4, 2019.

(6) *Examples*. The following examples illustrate the application of this paragraph (h).

(i) *Example 1: Sale-leaseback with a related party—(A) Facts*. DC, a domestic corporation, owns Asset A, which is specified tangible property. DC also owns all the single class of stock of DS, a domestic corporation, and FS1 and FS2, each a controlled foreign corporation. DC and DS are members of the same consolidated group. On January 1, Year 1, DC sells Asset A to FS1. At the time of the sale, Asset A had a remaining recovery period of 10 years under the alternative depreciation system. On February 1, Year 1, FS2 leases Asset B, which is substantially similar to Asset A, to DS for a five-year term ending on January 31, Year 6.

(B) *Analysis*. Because DC transfers specified tangible property (Asset A), to a specified related party of DC (FS1), and, within a six month period (January 1, Year 1 to February 1, Year 1), an FDII-eligible related party of DC (DS) leases a substantially similar property (Asset B) from a specified related party (FS2), DC's transfer of Asset A and lease of Asset B are treated as per se occurring pursuant to a principal purpose of decreasing the amount of its deemed tangible income return. Accordingly, for purposes of determining DC's QBAI, DC is treated as owning Asset A from February 1, Year 1, the later of the date of the transfer of Asset A (January 1, Year 1) and the beginning of the term of the lease of Asset B (February 1, Year 1), until January 31, Year 6, the earlier of

the end of the term of the lease of Asset B (January 31, Year 6) or the remaining recovery period of Asset A (December 31, Year 10).

(ii) *Example 2: Sale-leaseback with a related party; lapse of initial lease—(A) Facts*. The facts are the same as in paragraph (h)(6)(i)(A) of this section (the facts in *Example 1*). In addition, DS allows the lease of Asset B to expire on February 1, Year 6. On June 1, Year 6, DS and FS2 renew the lease for a five-year term ending on May 31, Year 11.

(B) *Analysis*. Because DC is treated as owning Asset A under paragraph (h)(1) of this section, the lapse of the lease of Asset B is treated as a transfer of Asset A to FS2 on February 1, Year 6, under paragraph (h)(4)(iv) of this section. Further, because DC is deemed to transfer specified tangible property (Asset A) to a specified related party (FS2) upon the lapse of the lease, and within a six month period (February 1, Year 6 to June 1, Year 6), an FDII-eligible related party of DC (DS) leases a substantially similar property (Asset B), DC's deemed transfer of Asset A under paragraph (h)(4)(iv) of this section and lease of Asset B are treated as per se occurring pursuant to a principal purpose of decreasing the amount of its deemed tangible income return. Accordingly, for purposes of determining DC's QBAI, DC is treated as owning Asset A from June 1, Year 6, the later of the date of the deemed transfer of Asset A (February 1, Year 6) and the beginning of the term of the lease of Asset B (June 1, Year 6), until December 31, Year 10, the earlier of the end of the term of the lease of Asset B (May 31, Year 11) or the remaining recovery period of Asset A (December 31, Year 10).

§1.250(b)-3 Foreign-derived deduction eligible income (FDDEI) transactions.

(a) *Scope*. This section provides rules related to the determination of whether a sale of property or provision of a service is a FDDEI transaction. Paragraph (b) of this section provides definitions related to the determination of whether a sale of property or provision of a service is a FDDEI transaction. Paragraph (c) of this section provides rules regarding a sale of property or provision of a service to a foreign government or an agency or instrumentality thereof. Paragraph (d) of this section provides a rule for characterizing a transaction with both sales and services elements. Paragraph (e) of this section provides a rule for determining whether a sale of property or provision of a service to a partnership is a FDDEI transaction. Paragraph (f) of this section provides rules for substantiating certain FDDEI transactions.

(b) *Definitions*. This paragraph (b) provides definitions that apply for purposes of this section and §§1.250(b)-4 through 1.250(b)-6.

(1) *Digital content*. The term *digital content* means a computer program or any other content in digital format. For example, digital content includes books in digital format, movies in digital format, and music in digital format. For purposes of this section, a computer program is a set of statements or instructions to be used directly or indirectly in a computer or other electronic device in order to bring about a certain result, and includes any media, user manuals, documentation, data base, or similar item if the media, user manuals, documentation, data base, or other similar item is incidental to the operation of the computer program.

(2) *End user*. Except as modified by §1.250(b)-4(d)(2)(ii), the term *end user* means the person that ultimately uses or consumes property or a person that acquires property in a foreign retail sale. A person that acquires property for resale or otherwise as an intermediary is not an end user.

(3) *FDII filing date*. The term *FDII filing date* means, with respect to a sale of property by a seller or provision of a service by a renderer, the date, including extensions, by which the seller or renderer is required to file an income tax return (or in the case of a seller or renderer that is a partnership, a return of partnership income) for the taxable year in which the gross income from the sale of property or provision of a service is included in the gross income of the seller or renderer.

(4) *Finished goods*. The term *finished goods* means general property that is acquired by an end user.

(5) *Foreign person*. The term *foreign person* means a person (as defined in section 7701(a)(1)) that is not a United States person and includes a foreign government or an international organization.

(6) *Foreign related party*. The term *foreign related party* means, with respect to a seller or renderer, any foreign person that is a related party of the seller or renderer.

(7) *Foreign retail sale*. The term *foreign retail sale* means a sale of general property to a recipient that acquires the general property at a physical retail location (such as a store or warehouse) outside the United States.

(8) *Foreign unrelated party*. The term *foreign unrelated party* means, with respect to a seller, a foreign person that is not a related party of the seller.

(9) *Fungible mass of general property.* The term *fungible mass of general property* means multiple units of property for sale with similar or identical characteristics for which the seller does not know the specific identity of the recipient or the end user for a particular unit.

(10) *General property.* The term *general property* means any property other than: intangible property (as defined in paragraph (b)(11) of this section); a security (as defined in section 475(c)(2)); an interest in a partnership, trust, or estate; a commodity described in section 475(e)(2)(A) that is not a physical commodity; or a commodity described in section 475(e)(2)(B) through (D). A physical commodity described in section 475(e)(2)(A) is treated as general property, including if it is sold pursuant to a forward or option contract (including a contract described in section 475(e)(2)(C), but not a section 1256 contract as defined in section 1256(b) or other similar contract that is traded on a U.S. or non-U.S. regulated exchange and cleared by a central clearing organization in a manner similar to a section 1256 contract) that is physically settled by delivery of the commodity (provided that the taxpayer physically settled the contract pursuant to a consistent practice adopted for business purposes of determining whether to cash or physically settle such contracts under similar circumstances).

(11) *Intangible property.* The term *intangible property* has the meaning set forth in section 367(d)(4). For purposes of section 250, intangible property does not include a copyrighted article as defined in §1.861-18(c)(3).

(12) *International transportation property.* The term *international transportation property* means aircraft, railroad rolling stock, vessel, motor vehicle, or similar property that provides a mode of transportation and is capable of traveling internationally.

(13) *IP address.* The term *IP address* means a device's Internet Protocol address.

(14) *Recipient.* The term *recipient* means a person that purchases property or services from a seller or renderer.

(15) *Renderer.* The term *renderer* means a person that provides a service to a recipient.

(16) *Sale.* The term *sale* means any sale, lease, license, sublicense, exchange, or other disposition of property, and includes any transfer of property in which gain or income is recognized under section 367. In addition, the term *sell* (and any form of the word *sell*) means any transfer by sale.

(17) *Seller.* The term *seller* means a person that sells property to a recipient.

(18) *United States.* The term *United States* has the meaning set forth in section 7701(a)(9), as expanded by section 638(1) with respect to mines, oil and gas wells, and other natural deposits.

(19) *United States person.* The term *United States person* has the meaning set forth in section 7701(a)(30), except that the term does not include an individual that is a bona fide resident of a United States territory within the meaning of section 937(a).

(20) *United States territory.* The term *United States territory* means American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands.

(c) *Foreign military sales and services.* If a sale of property or a provision of a service is made to the United States or an instrumentality thereof pursuant to 22 U.S.C. 2751 et seq. under which the United States or an instrumentality thereof purchases the property or service for resale or on-service to a foreign government or agency or instrumentality thereof, then the sale of property or provision of a service is treated as a FDDEI sale or FDDEI service without regard to §1.250(b)-4 or §1.250(b)-5.

(d) *Transactions with multiple elements.* A transaction is classified according to its overall predominant character for purposes of determining whether the transaction is a FDDEI sale under §1.250(b)-4 or a FDDEI service under §1.250(b)-5. For example, whether a transaction that includes both a sales component and a service component is subject to §1.250(b)-4 or §1.250(b)-5 is determined based on whether the overall predominant character, taking into account all relevant facts and circumstances, is a sale or service. In addition, whether a transaction that includes both a sale of general property and a sale of intangible property is subject to §1.250(b)-4(d)(1) or §1.250(b)-4(d)(2) is

determined based on whether the overall predominant character, taking into account all relevant facts and circumstances, is a sale of general property or a sale of intangible property.

(e) *Treatment of partnerships—(1) In general.* For purposes of determining whether a sale of property to or by a partnership or a provision of a service to or by a partnership is a FDDEI transaction, a partnership is treated as a person. Accordingly, for example, a partnership may be a seller, renderer, recipient, or related party, including a foreign related party (as defined in paragraph (b)(6) of this section).

(2) *Examples.* The following examples illustrate the application of this paragraph (e).

(i) *Example 1: Domestic partner sale to foreign partnership with a foreign branch—(A) Facts.* DC, a domestic corporation, is a partner in PRS, a foreign partnership. DC and PRS are not related parties. PRS has a foreign branch within the meaning of §1.904-4(f)(3)(iii). DC and PRS both use the calendar year as their taxable year. For the taxable year, DC recognizes \$20x of gain on the sale of general property to PRS for a foreign use (as determined under §1.250(b)-4(d)). During the same taxable year, PRS recognizes \$20x of gain on the sale of other general property to a foreign person for a foreign use (as determined under §1.250(b)-4(d)). PRS's income on the sale of the property is attributable to its foreign branch.

(B) *Analysis.* DC's sale of property to PRS, a foreign partnership, is a FDDEI sale because it is a sale to a foreign person for a foreign use. Therefore, DC's gain of \$20x on the sale to PRS is included in DC's gross DEI and gross FDDEI. However, PRS's gain of \$20x is not included in the gross DEI or gross FDDEI of PRS because the gain is foreign branch income within the meaning of §1.250(b)-1(c)(11). Accordingly, none of PRS's gain on the sale of property is included in DC's gross DEI or gross FDDEI under §1.250(b)-1(e)(1).

(ii) *Example 2: Domestic partner sale to domestic partnership without a foreign branch—(A) Facts.* The facts are the same as in paragraph (e)(2)(i)(A) of this section (the facts in *Example 1*), except PRS is a domestic partnership that does not have a foreign branch within the meaning of §1.904-4(f)(3)(iii).

(B) *Analysis.* DC's sale of property to PRS, a domestic partnership, is not a FDDEI sale because the sale is to a United States person. Therefore, the gross income from DC's sale to PRS is included in DC's gross DEI but is not included in its gross FDDEI. However, PRS's sale of other general property is a FDDEI sale, and therefore the gain of \$20x is included in the gross DEI and gross FDDEI of PRS. Accordingly, DC includes its distributive share of PRS's gain from the sale in determining DC's gross DEI and gross FDDEI for the taxable year under §1.250(b)-1(e)(1).

(f) *Substantiation for certain FDDEI transactions—(1) In general.* Except as

provided in paragraph (f)(2) of this section, for purposes of §1.250(b)-4(d)(1)(ii)(C) (foreign use for sale of general property for resale), §1.250(b)-4(d)(1)(iii) (foreign use for sale of general property subject to manufacturing, assembly, or processing outside the United States), §1.250(b)-4(d)(2) (foreign use for sale of intangible property), and §1.250(b)-5(e) (general services provided to business recipients located outside the United States), a transaction is a FDDEI transaction only if the taxpayer substantiates its determination of foreign use (in the case of sales of property) or location outside the United States (in the case of general services provided to a business recipient) as described in the applicable paragraph of §1.250(b)-4(d)(3) or §1.250(b)-5(e)(4). The substantiating documents must be in existence as of the FDII filing date with respect to the FDDEI transaction, and a taxpayer must provide the required substantiating documents within 30 days of a request by the Commissioner or another period as agreed between the Commissioner and the taxpayer.

(2) *Exception for small businesses.*

Paragraph (f)(1) of this section, and the specific substantiation requirements described in the applicable paragraph of §1.250(b)-4(d)(3) or §1.250(b)-5(e)(4), do not apply to a taxpayer if the taxpayer and all related parties of the taxpayer, in the aggregate, receive less than \$25,000,000 in gross receipts during the taxable year prior to the FDDEI transaction. If the taxpayer's prior taxable year was less than 12 months (a short period), gross receipts are annualized by multiplying the gross receipts for the short period by 365 and dividing the result by the number of days in the short period.

(3) *Treatment of certain loss transactions—(i) In general.* If a domestic corporation fails to satisfy the substantiation requirements described in the applicable paragraph of §1.250(b)-4(d)(3) or §1.250(b)-5(e)(4) with respect to a transaction (including in connection with

a related party transaction described in §1.250(b)-6), the gross income from the transaction will be treated as gross FDDEI if—

(A) In the case of a sale of property, the seller knows or has reason to know that property is sold to a foreign person for a foreign use (within the meaning of §1.250(b)-4(d)(1) or (2));

(B) In the case of the provision of a general service to a business recipient, the renderer knows or has reason to know that a service is provided to a business recipient located outside the United States; and

(C) Not treating the transaction as a FDDEI transaction would increase the amount of the corporation's FDDEI for the taxable year relative to its FDDEI that would be determined if the transaction were treated as a FDDEI transaction.

(ii) *Reason to know—(A) Sales to a foreign person for a foreign use.* For purposes of paragraph (f)(3)(i)(A) of this section, a seller has reason to know that a sale is to a foreign person for a foreign use if the information received as part of the sales process contains information that indicates that the recipient is a foreign person or that the sale is for a foreign use, and the seller fails to obtain evidence establishing that the recipient is not in fact a foreign person or that the sale is not in fact for a foreign use. Information that indicates that a recipient is a foreign person or that the sale is for a foreign use includes, but is not limited to, a foreign phone number, billing address, shipping address, or place of residence; and, with respect to an entity, evidence that the entity is incorporated, formed, or managed outside the United States.

(B) *General services provided to a business recipient located outside the United States.* For purposes of paragraph (f)(3)(i)(B) of this section, a renderer has reason to know that the provision of a general service is to a business recipient located outside the United States if the information received as part of the sales process contains information that indicates that the re-

cipient is a business recipient located outside the United States and the seller fails to obtain evidence establishing that the recipient is not in fact a business recipient located outside the United States. Information that indicates that a recipient is a business recipient includes, but is not limited to, indicia of a business status (such as "LLC" or "Company," or similar indicia under applicable domestic or foreign law, in the name) or statements by the recipient indicating that it is a business. Information that indicates that a business recipient is located outside the United States includes, but is not limited to, a foreign phone number, billing address, and evidence that the entity or business is incorporated, formed, or managed outside the United States.

(iii) *Multiple transactions.* If a seller or renderer engages in more than one transaction described in paragraph (f)(3)(i) of this section in a taxable year, paragraph (f)(3)(i) of this section applies by comparing the corporation's FDDEI if each such transaction were not treated as a FDDEI transaction to its FDDEI if each such transaction were treated as a FDDEI transaction.

(iv) *Example.* The following example illustrates the application of this paragraph (f)(3).

(A) *Facts.* During a taxable year, DC, a domestic corporation, manufactures products A and B in the United States. DC sells product A and product B to Y, a foreign person that is a distributor, for \$200x and \$800x, respectively. DC knows or has reason to know that all of its sales of product A and product B will ultimately be sold to end users located outside the United States. Y provides DC with a statement that satisfies the substantiation requirement of paragraph (f)(1) of this section and §1.250(b)-4(d)(3)(ii) that establishes that its sales of product B are for a foreign use but does not obtain substantiation establishing that any sales of product A are for a foreign use. DC's cost of goods sold is \$450x. For purposes of determining gross FDDEI, under §1.250(b)-1(d)(1) DC attributes \$250x of cost of goods sold to product A and \$200x of cost of goods sold to product B, and then attributes the cost of goods sold for each product ratably between the gross receipts of such product sold to foreign persons and the gross receipts of such product not sold to foreign persons. The manner in which DC attributes the cost of goods sold is a reasonable method. DC has no other items of income, loss, or deduction.

Table 1 to paragraph (f)(3)(iv)(A)

	Product A	Product B	Total
Gross receipts	\$200x	\$800x	\$1,000x
Cost of Goods Sold	\$250x	\$200x	\$450x
Gross Income (Loss)	(\$50x)	\$600x	\$550x

(B) *Analysis.* By not treating the sales of product A as FDDEI sales, the amount of DC's FDDEI would increase by \$50x relative to its FDDEI if the sales of product A were treated as FDDEI sales. Accordingly, because DC knows or has reason to know that its sales of product A are to foreign persons for a foreign use, the sales of product A constitute FDDEI sales under paragraph (f)(3) of this section, and thus the \$50x loss from the sale of product A is included in DC's gross FDDEI.

§1.250(b)-4 Foreign-derived deduction eligible income (FDDEI) sales.

(a) *Scope.* This section provides rules for determining whether a sale of property is a FDDEI sale. Paragraph (b) of this section defines a FDDEI sale. Paragraph (c) of this section provides rules for determining whether a recipient is a foreign person. Paragraph (d) of this section provides rules for determining whether property is sold for a foreign use. Paragraph (e) of this section provides a special rule for the sale of interests in a disregarded entity. Paragraph (f) of this section provides a rule regarding certain hedging transactions with respect to FDDEI sales.

(b) *Definition of FDDEI sale.* Except as provided in §1.250(b)-6(c), the term *FDDEI sale* means a sale of general property or intangible property to a recipient that is a foreign person (see paragraph (c) of this section for presumption rules relating to determining foreign person status) and that is for a foreign use (as determined under paragraph (d) of this section). A sale of any property other than general property or intangible property is not a FDDEI sale.

(c) *Presumption of foreign person status—(1) In general.* The sale of property is presumed to be to a recipient that is a foreign person for purposes of paragraph (b) of this section if the sale is described in paragraph (c)(2) of this section. However, this presumption does not apply if the seller knows or has reason to know that the sale is not to a foreign person. A seller has reason to know that a sale is not to a foreign person if the information received as part of the sales process contains information that indicates that the recipient is not a foreign person and the seller fails to obtain evidence establishing that the recipient is in fact a foreign person. Information that indicates that a recipient is not a foreign person includes, but is not limited to, a United States phone number, billing address, shipping address, or place of residence; and, with respect to an enti-

ty, evidence that the entity is incorporated, formed, or managed in the United States.

(2) *Sales of property.* A sale of a property is described in this paragraph (c)(2) if:

(i) The sale is a foreign retail sale;

(ii) In the case of a sale of general property that is not a foreign retail sale and the general property is delivered (such as through a commercial carrier) to the recipient or an end user, the shipping address of the recipient or end user is outside the United States;

(iii) In the case of a sale of general property that is not described in either paragraph (c)(2)(i) or (ii) of this section, the billing address of the recipient is outside the United States; or

(iv) In the case of a sale of intangible property, the billing address of the recipient is outside the United States.

(d) *Foreign use—(1) Foreign use for general property—(i) In general.* The sale of general property is for a foreign use for purposes of paragraph (b) of this section if the seller determines that the sale is for a foreign use under the rules of paragraph (d)(1)(ii) or (iii) of this section and the exception in paragraph (d)(1)(iv) of this section does not apply.

(ii) *Rules for determining foreign use—(A) Sales that are delivered to an end user by a carrier or freight forwarder.* Except as otherwise provided in this paragraph (d)(1)(ii)(A), a sale of general property (other than a sale of general property described in paragraphs (d)(1)(ii)(D) through (F) of this section) that is delivered through a carrier or freight forwarder to a recipient that is an end user is for a foreign use if the end user receives delivery of the general property outside the United States. However, a sale described in the preceding sentence is not treated as a sale to an end user for a foreign use if the sale is made with a principal purpose of having the property transported from its location outside the United States to a location within the United States for ultimate use or consumption.

(B) *Sales to an end user without the use of a carrier or freight forwarder.* With respect to sales that are not delivered through the use of a carrier or freight forwarder, a sale of general property (other than a sale of general property described in paragraphs (d)(1)(ii)(D) through (F) of

this section) to a recipient that is an end user is for a foreign use if the property is located outside the United States at the time of the sale (including as part of foreign retail sales).

(C) *Sales for resale.* A sale of general property (other than a sale of general property described in paragraphs (d)(1)(ii)(D) through (F) of this section) to a recipient (such as a distributor or retailer) that will resell the general property is for a foreign use if the general property will ultimately be sold to end users outside the United States (including in foreign retail sales) and such sales to end users outside the United States are substantiated under paragraph (d)(3)(ii) of this section. In the case of sales of a fungible mass of general property, the taxpayer may presume that the proportion of its sales that are ultimately sold to end users outside the United States is the same as the proportion of the recipient's resales of that fungible mass to end users outside the United States.

(D) *Sales of digital content.* A sale of general property that primarily contains digital content that is transferred electronically rather than in a physical medium 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 (see §1.250(b)-5(d)(2) and (e)(2)(iii) for rules that apply in the case of digital content that is not purchased in a sale but is electronically supplied as a service). If information about where the digital content is downloaded, installed, received, or accessed (such as the device's IP address) is unavailable, and the gross receipts from all sales with respect to the end user (which may be a business) are in the aggregate less than \$50,000, a sale of general property described in the preceding sentence is for a foreign use if it is to an end user that has a billing address located outside the United States.

(E) *Sales of international transportation property used for compensation or hire.* A sale of international transportation property used for compensation or hire is for a foreign use if the end user registers the property with a foreign jurisdiction.

(F) *Sales of international transportation property not used for compensation or hire.* A sale of international transportation property not used for compensation

or hire is for a foreign use if the end user registers the property in a foreign jurisdiction and hangs or stores the property primarily outside the United States.

(iii) *Sales for manufacturing, assembly, or other processing*—(A) *In general*. A sale of general property is for a foreign use if the sale is to a foreign unrelated party that subjects the property to manufacture, assembly, or other processing outside the United States and such manufacturing, assembly, or other processing outside the United States is substantiated under paragraph (d)(3)(iii) of this section. Property is subject to manufacture, assembly, or other processing only if the property is physically and materially changed (as described in paragraph (d)(1)(iii)(B) of this section) or the property is incorporated as a component into another product (as described in paragraph (d)(1)(iii)(C) of this section).

(B) *Property subject to a physical and material change*. The determination of whether general property is subject to a physical and material change is made based on all the relevant facts and circumstances. General property is subject to a physical and material change if it is substantially transformed and is distinguishable from and cannot be readily returned to its original state.

(C) *Property incorporated into a product as a component*. General property is a component incorporated into another product if the incorporation of the general property into another product involves activities that are substantial in nature and generally considered to constitute the manufacture, assembly, or processing of property based on all the relevant facts and circumstances. However, general property is not considered a component incorporated into another product if it is subject only to packaging, repackaging, labeling, or minor assembly operations. In addition, general property is treated as a component if the seller expects, using reliable estimates, that the fair market value of the property when it is delivered to the recipient will constitute no more than 20 percent of the fair market value of the finished good into which the general property is directly or indirectly incorporated when the finished good is sold to end users (the “20-percent rule”). If the property could be incorporated into a number of different finished goods, a reliable estimate of the

fair market value of the finished good may include the average fair market value of a representative range of such goods. For purposes of the 20-percent rule, all general property that is sold by the seller and incorporated into the finished good is treated as a single item of property if the seller sells the property to the recipient and the seller knows or has reason to know that the components will be incorporated into a single item of property (for example, where multiple components are sold as a kit). A seller knows or has reason to know that the components will be incorporated into a single item of property if the information received as part of the sales process indicates that the components will be included in the same second product or the nature of the components compels inclusion into the second product and the seller fails to obtain evidence to the contrary.

(iv) *Sales of property subject to manufacturing, assembly, or other processing in the United States*. If the seller sells general property to a recipient (other than a related party) for manufacturing, assembly, or other processing within the United States, such property is not sold for a foreign use even if the requirements of paragraph (d)(1)(ii) or (iii) of this section are subsequently satisfied. See §1.250(b)-6(c) for rules governing sales of general property to a foreign person that is a related party. Property is subject to manufacture, assembly, or other processing only if the property is physically and materially changed (as described in paragraph (d)(1)(iii)(B) of this section) or the property is incorporated as a component into another product (as described in paragraph (d)(1)(iii)(C) of this section).

(v) *Examples*. The following examples illustrate the application of this paragraph (d)(1).

(A) *Assumed facts*. The following facts are assumed for purposes of the examples—

(1) DC is a domestic corporation.

(2) FP is a foreign person that is a foreign unrelated party with respect to DC.

(3) To the extent a sale is for a foreign use, any applicable substantiation requirements described in paragraph (d)(3)(ii) or (iii) of this section are satisfied.

(B) *Examples*—

(1) *Example 1: Manufacturing outside the United States*—(i) *Facts*. DC sells batteries for \$18x to

FP. DC expects that FP will insert the batteries into tablets as part of the process of assembling tablets outside the United States. While the tablets are manufactured in a way that end users would not easily be able to remove the batteries, the batteries could be removed from the tablets and would resemble their original state following the removal. The finished tablets will be sold to end users within and outside the United States. DC’s batteries are used in two types of tablets, Tablet A and Tablet B. Based on an economic analysis, DC determines that the fair market value of Tablet A is \$90x and the fair market value of Tablet B is \$110x. FP informs DC that the number of sales of Tablet A is approximately equal to the number of sales of Tablet B.

(ii) *Analysis*. Because the batteries could be removed from the tablets and be returned to their original state, the insertion of the batteries into the tablets does not constitute a physical and material change described in paragraph (d)(1)(iii)(B) of this section. However, the average fair market value of a representative range of tablets that incorporate the batteries is \$100x (the average of \$90x for Tablet A and \$110x for Tablet B because their sales are approximately equal), and \$18x is less than 20 percent of \$100x. Therefore, the batteries are considered components of the tablets and treated as subject to manufacture, assembly, or other processing outside the United States. See paragraphs (d)(1)(iii)(A) and (C) of this section. As a result, notwithstanding that some tablets incorporating the batteries may be sold to an end user in the United States, DC’s sale of batteries is considered for a foreign use. Accordingly, DC’s sale of batteries to FP is for a foreign use under paragraph (d)(1)(iii)(A) and (C) of this section, and the sale is a FDDEI sale.

(2) *Example 2: Manufacturing outside the United States*—(i) *Facts*. The facts are the same as in paragraph (d)(1)(v)(B)(1) of this section (the facts in *Example 1*), except FP purchases the batteries from DC for \$25x. In addition, FP purchased other components of tablets from other parties. FP has a substantial investment in machinery and tools that are used to assemble tablets.

(ii) *Analysis*. Even though the fair market value of the batteries that FP purchases from DC and incorporates into the tablets exceeds 20 percent of the fair market value of the tablets, because the batteries are used by FP in activities that are substantial in nature and generally considered to constitute the manufacture, assembly or other processing of property, the batteries are components of the tablets. As a result, DC’s sale of property to FP is still for a foreign use under paragraph (d)(1)(iii)(A) and (C) of this section, and the sale is a FDDEI sale.

(3) *Example 3: Sale of products to distributor outside the United States*—(i) *Facts*. DC sells smartphones to FP, a distributor of electronics located within Country A. The sales contract between DC and FP provides that FP may sell the smartphones it purchases from DC only to specified retailers located within Country A. The specified retailers only sell electronics, including smartphones, in foreign retail sales.

(ii) *Analysis*. Although FP does not sell the smartphones it purchases from DC to end users, FP sells to retailers that sell the smartphones in foreign retail sales. All of the sales of smartphones from DC to FP

are sales of general property for a foreign use under paragraph (d)(1)(ii)(C) of this section because FP is only allowed to sell the smartphones to retailers who sell such property in foreign retail sales. As a result, DC's sales of smartphones to FP are FDDEI sales.

(4) *Example 4: Sale of a fungible mass of products—(i) Facts.* DC and persons other than DC sell multiple units of printer paper that is considered fungible general property to FP during the taxable year. FP is a distributor that sells paper to retail stores within and outside the United States. FP informs DC that approximately 25 percent of FP's sales of the paper are to retail stores located outside of the United States for foreign retail sales.

(ii) *Analysis.* The sale of paper to FP is for a foreign use to the extent that the paper will be sold to end users located outside the United States under paragraph (d)(1)(ii)(C) of this section. Because a portion of DC's sales to FP are not for a foreign use, DC must determine the amount of paper that is sold for a foreign use. Based on the information provided by FP about its own sales, DC determines under paragraph (d)(1)(ii)(C) of this section that 25 percent of the total units of paper that is fungible general property that FP purchased from all persons in the taxable year will ultimately be sold to end users located outside the United States. Accordingly, DC satisfies the test for a foreign use under paragraph (d)(1)(ii)(C) of this section with respect to 25 percent of its sales of the paper to FP.

(5) *Example 5: Limited use license of copyrighted computer software—(i) Facts.* DC provides FP with a limited use license to copyrighted computer software in exchange for an annual fee of \$100x. The limited use license restricts FP's use of the computer software to 100 of FP's employees, who download the software onto their computers. The limited use license prohibits FP from using the computer software in any way other than as an end user, which includes prohibiting sublicensing, selling, reverse engineering, or modifying the computer software. All of FP's employees download the software onto computers that are physically located outside the United States.

(ii) *Analysis.* The software licensed to FP is digital content as defined in §1.250(b)-3(b)(1), and is downloaded by an end user as defined in §1.250(b)-3(b)(2). Accordingly, because the software is downloaded solely onto computers outside the United States, DC's license to FP is for a foreign use and therefore a FDDEI sale under paragraph (d)(1)(ii)(D) of this section. The entire \$100x of the license fee is included in DC's gross FDDEI for the taxable year.

(6) *Example 6: Limited use license of copyrighted computer software used within and outside the United States—(i) Facts.* The facts are the same as in paragraph (d)(1)(v)(B)(5) of this section (the facts in *Example 5*), except that FP has offices both within and outside the United States, and DC's internal records indicates that 50 percent of the downloads of the software are onto computers located outside the United States.

(ii) *Analysis.* Because 50 percent of the downloads of the software are onto computers located outside the United States, a portion of DC's license to FP is for a foreign use and therefore such portion is a FDDEI sale. The \$50x of license fee derived with respect to such portion is included in DC's gross FDDEI for the taxable year.

(7) *Example 7: Sale of a copyrighted article—(i) Facts.* DC sells copyrighted music available for download on its website. Once downloaded, the recipient listens to the music on electronic devices that do not need to be connected to the internet. DC has data that an individual accesses the website to purchase a song for download on a device located outside the United States. The terms of the sale permit the recipient to use the song for personal use, but convey no other rights to the copyrighted music to the recipient.

(ii) *Analysis.* The music acquired through download is digital content as defined in §1.250(b)-3(b)(1). Because the recipient acquires no ownership in copyright rights to the music, the sale is considered a sale of a copyrighted article, and thus is a sale of general property. See §1.250(b)-3(b)(10) and (11). As a result, the sale is considered for a foreign use under paragraph (d)(1)(ii)(D) of this section because the digital content was installed, received, or accessed on the end user's device outside the United States. The income derived with respect to the sale of the music is included in DC's gross FDDEI for the taxable year. See §1.250(b)-5(d)(3) for an example of digital content provided to consumers as a service rather than as a sale.

(2) *Foreign use for intangible property—(i) In general.* A sale of rights to exploit intangible property solely outside the United States is for a foreign use. A sale of rights to exploit intangible property solely within the United States is not for a foreign use. A sale of rights to exploit intangible property worldwide is partially for a foreign use and partially not for a foreign use. Whether intangible property is exploited within versus outside the United States is determined based on revenue earned from end users located within versus outside the United States. Therefore, a sale of rights to exploit intangible property both within and outside the United States is for a foreign use in proportion to the revenue earned from end users located outside the United States over the total revenue earned from the exploitation of the intangible property. A sale of intangible property will be treated as a FDDEI sale only if the substantiation requirements of paragraph (d)(3)(iv) of this section are satisfied. For rules specific to determining end users and revenue earned from end users for intangible property used in sales of general property, provision of services, research and development, or consisting of a manufacturing method or process, see paragraph (d)(2)(ii) of this section.

(ii) *Determination of end users and revenue earned from end users—(A) Intangible property embedded in general property or used in connection with the*

sale of general property. If intangible property is embedded in general property that is sold, or used in connection with a sale of general property, then the end user of the intangible property is the end user of the general property. Revenue is earned from the end user of the general property outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1)(ii) of this section.

(B) *Intangible property used in providing a service.* If intangible property is used to provide a service, then the end user of that intangible property is the recipient, consumer, or business recipient of the service or, in the case of a property service or a transportation service that involves the transportation of property, the end user is the owner of the property on which such service is being performed. Such end users are treated as located outside the United States only to the extent the service qualifies as a FDDEI service under §1.250(b)-5. Therefore, in the case of a recipient of a sale of intangible property that uses such intangible property to provide a property service that qualifies as a FDDEI service to another person, that person is the end user and is treated as located outside the United States.

(C) *Intangible property consisting of a manufacturing method or process—(1) In general.* Except as provided in paragraph (d)(2)(ii)(C)(2) of this section, if intangible property consists of a manufacturing method or process (as defined in paragraph (d)(2)(ii)(C)(3) of this section) and is sold to a foreign unrelated party (including in a sale by a foreign related party), then the foreign unrelated party is treated as an end user located outside the United States, unless the seller knows or has reason to know that the manufacturing method or process will be used in the United States, in which case the foreign unrelated party is treated as an end user located within the United States. A seller has reason to know that the manufacturing method or process will be used in the United States if the information received from the recipient as part of the sales process contains information that indicates that the recipient intends to use the manufacturing method or process in the United States and the seller fails to obtain evidence establishing that the recipient does not intend to use the

manufacturing method or process in the United States.

(2) *Exception for certain manufacturing arrangements.* A sale of intangible property consisting of a manufacturing method or process (including a sale by a foreign related party) to a foreign unrelated party for use in manufacturing products for or on behalf of the seller or any person related to the seller does not qualify as a sale to a foreign unrelated party for purposes of determining the end user under paragraph (d)(2)(ii)(C)(I) of this section.

(3) *Manufacturing method or process.* For purposes of this section, a manufacturing method or process consists of a sequence of actions or steps that comprise an overall method or process that is used to manufacture a product or produce a particular manufacturing result, which may be in the form of a patent or know-how. Intangible property consisting of the right to make and sell an item of property is not a manufacturing method or process, whereas intangible property consisting of the right to apply a series of actions or steps to be performed to achieve a particular manufacturing result is a manufacturing method or process. For example, a utility or design patent on an article of manufacture, machine, composition of matter, design, or providing the right to sell equipment to perform a process is not a manufacturing method or process, whereas a utility patent covering a method or process of manufacturing is a manufacturing method or process for purposes of this section.

(D) *Intangible property used in research and development.* If intangible property (primary IP) is used to develop new or modify other intangible property (secondary IP), then the end user of the primary IP is the end user (applying paragraph (d)(2)(ii)(A), (B), or (C) of this section) of the secondary IP.

(iii) *Determination of revenue for periodic payments versus lump sums—(A) Sales in exchange for periodic payments.* In the case of a sale of intangible property, other than intangible property consisting of a manufacturing method or process that is sold to a foreign unrelated party, to a recipient in exchange for periodic payments, the extent to which the sale is for a foreign use is determined annually based on the actual revenue earned by the recipient

from any use of the intangible property for the taxable year in which a periodic payment is received. If actual revenue earned by the recipient cannot be obtained after reasonable efforts, then estimated revenue earned by a recipient that is not a related party of the seller from the use of the intangible property may be used based on the principles of paragraph (d)(2)(iii)(B) of this section.

(B) *Sales in exchange for a lump sum.* In the case of a sale of intangible property, other than intangible property consisting of a manufacturing method or process that is sold to a foreign unrelated party, for a lump sum, the extent to which the sale is for a foreign use is determined based on the ratio of the total net present value of revenue the seller would have expected to earn from the exploitation of the intangible property outside the United States to the total net present value of revenue the seller would have expected to earn from the exploitation of the intangible property. In the case of a recipient that is a foreign unrelated party, net present values of revenue that the recipient expected to earn from the exploitation of the intangible property within and outside the United States may also be used if the seller obtained such revenue data from the recipient near the time of the sale and such revenue data was used to negotiate the lump sum price paid for the intangible property. Net present values must be determined using reliable inputs including, but not limited to, reliable revenue, expenses, and discount rates. The extent to which the inputs are used by the parties to determine the sales price agreed to between the seller and a foreign unrelated party purchasing the intangible property will be a factor in determining whether such inputs are reliable. If the intangible property is sold to a foreign related party, the reliability of the inputs used to determine net present values and the net present values are determined under section 482.

(C) *Sales to a foreign unrelated party of intangible property consisting of a manufacturing method or process.* In the case of a sale to an unrelated foreign party of intangible property consisting of a manufacturing method or process, the revenue earned from the end user is equal to the amount received from the recipient in exchange for the manufacturing meth-

od or process. In the case of a bundled sale of intangible property consisting of a manufacturing method or process and intangible property not consisting of a manufacturing method or process, the revenue earned from the intangible property consisting of the manufacturing method or process equals the total amount paid for the bundled sale multiplied by the proportion that the value of the manufacturing method or process bears to the total value of the intangible property. The value of the manufacturing method or process to the total value of the intangible property must be determined using the principles of section 482.

(iv) *Examples.* The following examples illustrate the application of this paragraph (d)(2).

(A) *Assumed facts.* The following facts are assumed for purposes of the examples—

(1) DC is a domestic corporation.

(2) Except as otherwise provided, FP and FP2 are foreign persons that are foreign unrelated parties with respect to DC.

(3) All of DC's income is DEI.

(4) Except as otherwise provided, the substantiation requirements described in paragraph (d)(3)(iv) of this section are satisfied.

(5) Except as otherwise provided, inputs used to determine the net present values of the revenue are reliable.

(B) *Examples—*

(i) *Example 1: License of worldwide rights with actual revenue data from recipient—(i) Facts.* DC licenses to FP worldwide rights to the copyright to composition A in exchange for annual royalties of 60 percent of revenue from FP's sales of composition A. FP sells composition A to customers through digital downloads from servers. In the taxable year, FP earns \$100x in revenue from sales of copies of composition A to customers, of which \$60x is from customers located in the United States and the remaining \$40x is from customers located outside the United States. FP provides DC with reliable records showing the amount of revenue earned in the taxable year from sales of composition A to establish the royalties owed to DC. These records also provide DC with the amount of revenue earned from sales of composition A to customers located within the United States.

(ii) *Analysis.* FP is not the end user of the copyright to composition A under paragraph (d)(2)(ii)(A) of this section because the copyright is used in the sale of general property (the sale of copyrighted articles to customers). The customers that purchase a copy of composition A from FP are the end users (as defined in §1.250(b)-3(b)(2) and paragraph (d)(2)(ii)(A) of this section) because those custom-

ers are the recipients of composition A when sold as general property. Based on the actual revenue earned by FP from sales of composition A, 40 percent ($\$40x/\$100x$) of the revenue generated by the copyright during the taxable year is earned outside the United States. Accordingly, a portion of DC's license to FP is for a foreign use under paragraph (d)(2) of this section and therefore such portion is a FDDEI sale. The $\$24x$ of royalty ($0.40 \times \$60x$ of total royalties owed to DC during the taxable year) derived with respect to such portion is included in DC's gross FDDEI for the taxable year.

(2) *Example 2: Fixed annual payments for worldwide rights without actual revenue data from recipient—(i) Facts.* The facts are the same as in paragraph (d)(2)(iv)(B)(1)(i) of this section (the facts in *Example 1*), except FP pays DC a fixed annual payment of $\$60x$ each year for the worldwide rights to the copyright to composition A and does not provide DC with data showing how much revenue FP earned from sales of composition A, even after DC requests that FP provide it with such information. DC also is unable to determine how much revenue FP earned from sales of composition A to customers within the United States from the data it has with respect to FP and publicly available data with respect to FP. However, DC's economic analysis of the revenue DC expected it could earn annually from use of composition A as part of determining the annual payments DC would receive from FP from the license of composition A supports a determination that 40 percent of sales of composition A during the tax year would be to customers located outside the United States. During an examination of DC's return for the taxable year, DC provides the IRS with data explaining the economic analysis, inputs, and results from its valuation of composition A used in determining the amount of annual payments agreed to by DC and FP.

(ii) *Analysis.* For the same reasons provided in paragraph (d)(2)(iv)(B)(1)(ii) of this section (the analysis in *Example 1*), the customers that purchase copies of composition A from FP are the end users. DC is allowed to use reliable economic analysis to estimate revenue earned by FP from the use of the copyright to composition A under paragraph (d)(2)(iii)(A) of this section because DC was unable to obtain actual revenue earned by FP from use of the copyright to composition A during the taxable year after reasonable efforts to obtain the actual revenue data. Based on DC's economic analysis, a portion of DC's license to FP is for a foreign use under paragraph (d)(2) of this section and therefore such portion is a FDDEI sale. $\$24x$ of the $\$60x$ fixed payment to DC ($0.40 \times \$60x$) is included in DC's gross FDDEI for the taxable year.

(3) *Example 3: Sale of patent rights protected in the United States and other countries; use of financial projections in sale to foreign unrelated party—(i) Facts.* DC owns a patent for an active pharmaceutical ingredient ("API") approved for treatment of disease A ("indication A") in the United States and in Countries A, B, and C. The patent is registered in the United States and in Countries A, B, and C. DC sells to FP all of its patent rights to the API for indication A for a lump sum payment of $\$1,000x$. DC has no basis in the patent rights. To determine the sales price for the patent rights, DC projected that the net present value of the revenue it would earn from selling

a pharmaceutical product incorporating the API for indication A was $\$5,000x$, with 15 percent of the net present value of revenue earned from sales within the United States and 85 percent of the net present value of revenue earned from sales outside the United States. DC did not obtain revenue projections from the recipient.

(ii) *Analysis.* FP is not the end user of the patent under paragraph (d)(2)(ii)(A) of this section because the patent is used in the sale of general property (the sale of pharmaceutical products to customers) and FP is not the recipient of that general property. The unrelated party customers that purchase the finished pharmaceutical product from FP are the end users (as defined in §1.250(b)-3(b)(2) and paragraph (d)(2)(ii)(A) of this section) because those customers are the unrelated party recipients of the pharmaceutical product when sold as general property. Based on the financial projections DC used to determine the sales price of the patent that FP purchased, a portion of DC's sale to FP is for a foreign use under paragraph (d)(2) of this section and such portion is a FDDEI sale. The $\$850x$ (85 percent $\times \$1,000x$) of gain derived with respect to such portion is included in DC's gross FDDEI for the taxable year.

(4) *Example 4: Sale of patent rights protected in the United States and other countries; use of financial projections in sale to foreign related party—(i) Facts.* The facts are the same as in paragraph (d)(2)(iv)(B)(3)(i) of this section (the facts in *Example 3*), except that FP is a foreign related party with respect to DC, and DC projected that the net present value of the revenue it would earn from selling a pharmaceutical product incorporating the API for indication A would result in 1 percent of the revenue earned from sales within the United States and 99 percent of the revenue earned from sales outside the United States. During the examination of DC's return for the taxable year, the IRS determines that DC's substantiation allocating the projected revenue from sales within the United States and outside the United States does not reflect reliable inputs to determine the net present values of revenues under section 482, but determines that the total lump sum price FP paid for DC's patent rights is an arm's length price. The IRS determines that the most reliable net present values of revenue DC would have earned from sales within the United States and outside the United States is $\$750x$ and $\$4250x$, respectively.

(ii) *Analysis.* For the same reasons provided in paragraph (d)(2)(iv)(B)(3)(ii) of this section (the analysis in *Example 3*), the customers that purchase the finished pharmaceutical product from FP are the end users. Under paragraph (d)(2)(iii)(B) of this section, the reliability of the inputs DC used to determine the net present values and the net present values are determined under section 482. Based on the sales price of the patent that FP purchased and the IRS-determined net present values of revenue DC would have earned from sales within the United States and outside the United States, a portion of DC's sale to FP is for a foreign use under paragraph (d)(2) of this section and such portion is a FDDEI sale. DC is allowed to include $\$850x$ ($\$4250x$ divided by $\$5000x$) $\times \$1,000x$) of gain in DC's gross FDDEI for the taxable year.

(5) *Example 5: Sale of patent of manufacturing method or process protected in the United States and*

other countries; foreign unrelated party—(i) Facts. DC owns the worldwide rights to a patent covering a process for refining crude oil. DC sells to FP the right to DC's patented process for refining crude oil for a lump sum payment of $\$100x$. DC has no basis in the patent rights. DC does not know or have reason to know that FP will use the patented process to refine crude oil within the United States or will sell or license the rights to the patent to a person to refine crude oil within the United States.

(ii) *Analysis.* DC's patent covering a process for refining crude oil is a manufacturing method or process as defined in paragraph (d)(2)(ii)(C)(3) of this section. Under paragraph (d)(2)(ii)(C)(1) of this section, FP is treated as the end user of the patent, and is treated as located outside the United States because FP is a foreign unrelated party and DC does not know or have reason to know that the patented process will be used in the United States. As a result, all of the sale to FP is for a foreign use under paragraph (d)(2) of this section and therefore is a FDDEI sale. The entire $\$100x$ lump sum payment is included in DC's gross FDDEI for the taxable year.

(6) *Example 6: License of intangible property that includes a patented manufacturing method or process protected in the United States and other countries; foreign unrelated party—(i) Facts.* DC owns worldwide rights to patents, know-how, and a trademark and tradename for product Z. The patents consist of: a patent covering the right to make, use, and sell product Z (article of manufacture), a patent covering the rights to make, use, and sell a composition of substances used in certain components of product Z (composition of matter), and a patent covering the right to use a manufacturing process consisting of a series of manufacturing steps to manufacture product Z (manufacturing method or process as defined in paragraph (d)(2)(ii)(C)(3) of this section) and to sell the product Z that FP manufactures using the manufacturing method or process. The know-how consists entirely of manufacturing know-how used to implement the manufacturing steps that comprise the manufacturing method or process. DC licenses the worldwide rights to the patents, know-how, and the trademark and tradename for product Z to FP in exchange for annual royalties of 60 percent of revenue from sales of product Z. FP manufactures product Z in country X and sells product Z to DC2, a domestic corporation and unrelated party to DC and FP, for resale to customers located within the United States. FP also sells product Z to FP2, a foreign unrelated party with respect to DC and FP, for resale to customers located outside the United States. During the taxable year, FP sells to DC2 $\$140x$ of product Z. Also, during the taxable year, FP sells to FP2 $\$60x$ of product Z. DC determines under the principles of section 482 that the licensed know-how and the patented manufacturing method or process comprise 10 percent of the arm's length price of the intangible property DC licenses to FP.

(ii) *Analysis—(A) End users.* Under paragraph (d)(2)(ii)(C)(1) of this section, FP is treated as the end user of the patent covering the right to use the manufacturing process and the manufacturing know-how used to implement the manufacturing method or process, and is treated as located outside the United States because FP is a foreign unrelated party and DC does not know or have reason to know that the

patented process and know-how will be used in the United States. DC2, FP, and FP2 are not the end users of the remaining intangible property under paragraph (d)(2)(ii)(A) of this section because that intangible property is used in the sale of general property (the sale of product Z) and DC2, FP, and FP2 are not the end users of that general property. The unrelated party customers that purchase product Z from DC2 and FP2 are the end users (as defined in §1.250(b)-3(b)(2) and paragraph (d)(2)(ii)(A) of this section) because those customers are the unrelated party recipients of product Z.

(B) *Foreign use*. Under paragraph (d)(2)(ii)(A) of this section, revenue from royalties paid for the intangible property other than the manufacturing method or process is earned from end users outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1) of this section. FP2 is a reseller of product Z to end users outside the United States, so all sales of product Z to FP2 are for a foreign use under paragraph (d)(1)(ii)(C) of this section. Because DC has determined that 10 percent of the value of the intangible property consists of a manufacturing method or process (as defined in paragraph (d)(2)(ii)(C)(3) of this section) used to manufacture product Z, \$12x of the \$120x royalty FP pays to DC during the taxable year is for foreign use (\$120x total royalty x 0.10) based on the location of FP's manufacturing utilizing the know-how or all of the sequence of actions that comprise the manufacturing method or process under paragraph (d)(2)(ii)(C)(3) of this section. Based on the sales of product Z within and outside the United States, \$32.4x of the royalties FP pays DC for rights to the licensed intangible property during the taxable year ((\\$60x of revenue from sales to FP2 for resale to customers located outside the United States divided by \\$200x total worldwide sales revenue FP receives from DC2 and FP2) x (\\$120x total royalties less \\$12 of those royalties attributable to the manufacturing method or process)) qualifies as income earned from the sale of intangible property for a foreign use under paragraph (d)(2) of this section and therefore such portion is a FDDEI sale. As a result, \$44.40x of royalties (\$12x + \$32.40x) is included in DC's gross FDDEI for the taxable year.

(7) *Example 7: License of intangible property that includes a patented manufacturing method or process protected in the United States and other countries; foreign related party with third-party manufacturer—(i) Facts*. The facts are the same as in paragraph (d)(2)(iv)(B)(6)(i) of this section (the facts in *Example 6*), except that FP is a foreign related party with respect to DC and FP engages FP2, a foreign unrelated party, to manufacture product Z. FP sublicenses to FP2 the rights to the intangible property FP licenses from DC solely to manufacture product Z and sell product Z to FP. FP2 manufactures product Z in country Y and sells all of product Z it manufactures to FP. During the taxable year, FP sold \$80x of product Z to DC2, which DC2 resold to customers located within the United States. Also, during the taxable year, FP sold \$120x of product Z to customers located outside the United States.

(ii) *Analysis—(A) End users*. Under paragraph (d)(2)(ii)(C)(1) of this section, FP is not treated as the end user of the patent covering the right to use the manufacturing process and the manufacturing know-

how used to implement the manufacturing method or process because FP is a foreign related party with respect to DC. Under paragraph (d)(2)(ii)(C)(2) of this section, FP2 is also not treated as the end user of the patent covering the right to use the manufacturing process and the manufacturing know-how used to implement the manufacturing method or process because FP2 is using that intangible property to manufacture product Z for FP. DC2 is also not treated as the end user of the patent covering the right to use the manufacturing process and the manufacturing know-how used to implement the manufacturing method or process because DC2 does not use the patent or know-how in manufacturing. DC2, FP, and FP2 are not the end users of the remaining intangible property under paragraph (d)(2)(ii)(A) of this section because that intangible property is used in the sale of general property (the sale of product Z) and DC2, FP, and FP2 are not the end users of that general property. The unrelated party customers that purchase the Product Z from DC2 and FP are the end users (as defined in §1.250(b)-3(b)(2) and paragraph (d)(2)(ii)(A) of this section) of the intangible property because those customers are the persons that ultimately use or consume product Z.

(B) *Foreign use*. Based on the sales of product Z to customers located within and outside the United States, \$72x of the royalties FP pays DC for rights to the licensed intangible property during the taxable year ((\\$120x of revenue from sales to customers located outside the United States divided by \\$200x total worldwide sales revenue) x \\$120x total royalties) qualifies as income earned from the sale of intangible property for a foreign use under paragraph (d)(2) of this section and therefore such portion is a FDDEI sale. As a result, \$72x of royalties is included in DC's gross FDDEI for the taxable year.

(8) *Example 8: Deemed sale in exchange for contingent payments under section 367(d)—(i) Facts*. DC owns 100 percent of the stock of FP, a foreign related party with respect to DC. FP manufactures and sells product A. For the taxable year, DC contributes to FP exclusive worldwide rights to patents, trademarks, know-how, customer lists, and goodwill and going concern value (collectively, intangible property) related to product A in an exchange described in section 351. DC is required to report an annual income inclusion on its Federal income tax return based on the productivity, use, or disposition of the contributed intangible property under section 367(d). DC includes a percentage of FP's revenue in its gross income under section 367(d) each year. In the current taxable year, FP earns \$1,000x of revenue from sales of product A. Based on reliable sales records kept by FP for the taxable year, \$300x of FP's revenue is earned from sales of product A to customers within the United States, and \$700x of its revenue is earned from sales of product A to customers outside the United States.

(ii) *Analysis*. DC's deemed sale of the intangible property to FP in exchange for payments contingent upon the productivity, use, or disposition of the intangible property related to product A under section 367(d) is a sale for purposes of section 250 and this section. See §1.250(b)-3(b)(16). Based on FP's sales records for the taxable year, 70 percent of DC's deemed sale to FP is for a foreign use, and 70 percent of DC's income inclusion under section 367(d) de-

rived with respect to such portion is included in DC's gross FDDEI for the taxable year.

(9) *Example 9: License of intangible property followed by a sale of general property in which the intangible property is embedded; unrelated parties—(i) Facts*. DC owns the worldwide rights to a patent on a silicon chip used in computers, tablets, and smartphones. The patent does not qualify as a manufacturing method or process (as defined in paragraph (d)(2)(ii)(C)(3) of this section). DC licenses the worldwide rights to the patent to FP in exchange for annual royalties of 30 percent of revenue from sales of the silicon chips. During the taxable year, FP manufactures silicon chips protected by the patent and sells all of those chips to FP2 for \$1,000x. FP2 also purchases similar silicon chips from other suppliers. FP2 uses the silicon chips in computers, tablets, smartphones, and motherboards that FP2 manufactures in country X and sells to its customers located within the United States and foreign countries. For purposes of this example, FP2's manufacturing qualifies as subjecting the silicon chips to manufacture, assembly, or other processing outside the United States as provided in paragraph (d)(1)(iii) of this section.

(ii) *Analysis*. FP is not the end user or treated as an end user (as defined in §1.250(b)-3(b)(2) and paragraph (d)(2)(ii)(A) of this section) because FP is not the unrelated party recipient of the general property in which the patent is embedded, and the patent does not qualify as a manufacturing method or process. Under paragraph (d)(2)(ii)(A) of this section, revenue from royalties paid for the patent is earned from end users outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1) of this section. Because FP2 is subjecting the silicon chips to manufacture, assembly, or other processing outside the United States, the revenue from royalties FP pays to DC qualifies for foreign use based on the location of FP2's manufacturing and qualifies as a FDDEI sale. As a result, the entire \$300x of annual royalties paid by FP to DC during the taxable year is included in DC's gross FDDEI for the taxable year.

(10) *Example 10: License of intangible property followed by a sale of general property in which the intangible property is embedded; related parties—(i) Facts*. The facts are the same as in paragraph (d)(2)(iv)(B)(9)(i) of this section (the facts in *Example 9*), except that FP and FP2 are foreign related parties with respect to DC. FP2 sells and ships computers, tablets, and smartphones it manufactures with the silicon chips it purchases from FP to unrelated party wholesalers located within and outside the United States. The wholesalers within the United States only sell to retailers located within the United States and the wholesalers outside the United States only sell to retailers located outside the United States. The retailers within the United States only sell to customers located within the United States and the retailers located outside the United States only sell to customers located outside the United States. FP2 earns \$15,000x of revenue from sales to unrelated party wholesalers located outside the United States and \$10,000x of revenue from sales to unrelated party wholesalers located within the United States. FP2 also sells and ships motherboards with the silicon chips it purchases from FP to unrelated party

manufacturers located outside the United States. FP2 does not sell motherboards with the silicon chips it purchases from FP to unrelated party manufacturers located within the United States. FP2 earns \$5,000x of revenue from the sales of these motherboards to manufacturers located outside the United States. For purposes of this example, these manufacturers subject the motherboards to manufacture, assembly, or other processing outside the United States as provided in paragraph (d)(1)(iii) of this section.

(ii) *Analysis.* FP is not the end user or treated as an end user (as defined in §1.250(b)-3(b)(2) and paragraph (d)(2)(ii)(A) of this section) of the intangible property because FP is not the end user of the general property in which the patent is embedded (the silicon chips). FP2 is also not the end user (as defined in §1.250(b)-3(b)(2) and paragraph (d)(2)(ii)(A) of this section) of the intangible property because FP2 is not the end user of the silicon chips. Under paragraph (d)(2)(ii)(A) of this section, the customers of the retailers that purchase from the unrelated party wholesalers are the end users. Because the wholesalers located outside the United States only sell to retailers located outside the United States that sell to end users located outside the United States, the location of the wholesalers is a reliable basis for determining the location of the end users. Revenue from royalties paid for the patent is earned from end users outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1) of this section. A portion of the sales to the unrelated party wholesalers qualify as foreign use under paragraph (d)(1) of this section and the sales to the unrelated party manufacturers qualify as foreign use under paragraph (d)(1)(iii) of this section. Accordingly, revenue from royalties FP pays to DC is from a FDDEI sale to the extent of such sales to the unrelated party manufacturers and such portion of sales to unrelated party wholesalers that qualify for foreign use. As a result, \$200x of annual royalties paid by FP to DC during the taxable year (((\$15,000x of sales to wholesalers located outside the United States plus \$5,000x of sales to manufacturers located outside the United States) divided by \$30,000x total sales) x \$300x) is included in DC's gross FDDEI for the taxable year.

(II) *Example 11: License of intangible property followed by a sale of general property that incorporates the intangible property; unrelated parties with manufacturing within the United States—(i) Facts.* The facts are the same as in paragraph (d)(2)(iv)(B)(9)(i) of this section (the facts in *Example 9*), except that FP2 manufactures its computers, tablets, smartphones, and motherboards in the United States.

(ii) *Analysis.* FP is not the end user or treated as an end user (as defined in §1.250(b)-3(b)(2) and paragraph (d)(2)(ii)(A) of this section) because FP is not the unrelated party recipient of the general property in which the patent is embedded (the silicon chips) and the patent does not qualify as a manufacturing method or process. Under paragraph (d)(2)(ii)(A) of this section, revenue from royalties paid for the patent is earned from end users outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1) of this section. Because FP2 is subjecting the silicon chips to manufacture, assembly, or other processing within the United States, the revenue from royalties FP pays

to DC does not qualify as foreign use based on the location of FP2's manufacturing and therefore does not qualify as a FDDEI sale. As a result, none of the \$300x of annual royalties paid by FP to DC during the taxable year is included in DC's gross FDDEI for the taxable year.

(12) *Example 12: License of intangible property used to provide a service—(i) Facts.* DC licenses to FP worldwide rights to the copyrights on movies in exchange for an annual royalty of \$100x. FP also licenses copyrights on movies from persons other than DC. FP provides a streaming service that meets the definition of an electronically supplied service in §1.250(b)-5(c)(5) to its customers within the United States and foreign countries. FP's streaming service provides its customers a catalog of movies to choose to stream. These movies include the copyrighted movies FP licenses from DC. FP does not provide DC with data showing how much revenue FP earned from streaming services during the taxable year, even after DC requests that FP provide it with such information. DC also is unable to determine how much revenue FP earned from streaming services to customers within the United States from the data it has with respect to FP and publicly available data with respect to FP. However, DC's economic analysis of the revenue DC expected it could earn annually from use of the copyrights as part of determining the annual payments DC would receive from FP from the license of the copyrights supports a determination that \$10,000x of revenue would be earned during the taxable year from customers worldwide, and that 40 percent of that revenue would be earned from customers located outside the United States. During an examination of DC's return for the taxable year, DC provides the IRS with data explaining the economic analysis, inputs, and results from its valuation of the copyrights used in determining the amount of annual payments agreed to by DC and FP.

(ii) *Analysis.* Under paragraph (d)(2)(ii)(B) of this section, FP's customers are the end users of the copyrights FP licenses from DC because FP uses those copyrights to provide the general service to FP's customers. Under paragraph (d)(2)(ii)(B) of this section, revenue from royalties paid for the copyrights is earned from end users outside the United States to the extent the service qualifies as a FDDEI service under §1.250(b)-5. DC is allowed to use reliable economic analysis to estimate revenue earned by FP from streaming the licensed movies under paragraph (d)(2)(iii)(A) of this section because DC was unable to obtain actual revenue earned by FP from use of the copyrights during the taxable year after reasonable efforts to obtain the actual revenue data. Based on DC's reliable economic analysis, \$40x of the annual royalty payment to DC (0.40 x \$100x total annual royalty payment) is included in DC's gross FDDEI for the taxable year.

(13) *Example 13: License of intangible property used in research and development of other intangible property—(i) Facts.* DC owns a patent ("patent A") for an active pharmaceutical ingredient ("API") approved for treatment of disease A in the United States and in foreign countries. DC licenses to FP worldwide rights to patent A for an annual royalty of \$100x. FP uses patent A in research and development of a new API for treatment of disease B. Patent A does not consist of a manufacturing method or

process (as defined in paragraph (d)(2)(ii)(C)(3) of this section). FP's research and development is successful, resulting in FP obtaining both a patent for the new API for treatment of disease B and approval for use in the United States and foreign countries. FP does not earn any revenue from sales of finished pharmaceutical products containing the API during years 1 through 4 of the license of patent A. In year 5 of the license of patent A, FP earns \$800x of revenue from sales of finished pharmaceutical products containing the API to customers located within the United States and \$200x of revenue from sales to customers located in foreign countries.

(ii) *Analysis.* FP is not the end user (as defined in §1.250(b)-3(b)(2) and paragraph (d)(2)(ii)(D) of this section) of patent A because FP is not the end user described in paragraph (d)(2)(ii)(A) of this section of the product in which the API that was developed from patent A is embedded. The unrelated party customers that purchase the finished pharmaceutical product from FP are the end users (as defined in §1.250(b)-3(b)(2) and paragraph (d)(2)(ii)(D) of this section) because those customers are the end users described in paragraph (d)(2)(ii)(A) of this section of the pharmaceutical product in which the newly developed patent is embedded. During the taxable years that include years 1 through 4 of the license of patent A, FP earns no revenue from sales of the API to a foreign person for a foreign use. Under paragraph (d)(2)(ii)(D) of this section, none of the \$100x annual royalty payments to DC for each of the tax years that include years 1 through 4 of the license of patent A is included in DC's gross FDDEI. Based on FP's sales of the API during the tax year that includes year 5 of the license of patent A, \$20x of the annual royalty payment to DC (\$200x of revenue from sales of API to customers located outside the United States divided by \$1,000x total worldwide revenue earned from sales of the API) x \$100x annual royalty) is included in DC's gross FDDEI for the taxable year.

(3) *Foreign use substantiation for certain sales of property—(i) In general.* Except as provided in §1.250(b)-3(f)(3) (relating to certain loss transactions), a sale of property described in paragraphs (d)(1)(ii)(C) of this section (foreign use for sale of general property for resale), (d)(1)(iii) of this section (foreign use for sale of general property subject to manufacturing, assembly, or processing outside the United States), or (d)(2) of this section (foreign use for sale of intangible property) is a FDDEI transaction only if the taxpayer satisfies the substantiation requirements described in paragraphs (d)(3)(ii), (iii), or (iv) of this section, as applicable.

(ii) *Substantiation of foreign use for resale.* A seller satisfies the substantiation requirements with respect to a sale of property described in paragraph (d)(1)(ii)(C) of this section (sales of general property for resale) only if the seller maintains one or more of the following items—

(A) A binding contract that specifically limits subsequent sales to sales outside the United States;

(B) Proof that property is specifically designed, labeled, or adapted for a foreign market;

(C) Proof that the cost of shipping the property back to the United States relative to the value of the property makes it impractical that the property will be resold in the United States;

(D) Credible evidence obtained or created in the ordinary course of business from the recipient evidencing that property will be sold to an end user outside the United States (or, in the case of sales of fungible mass property, stating what portion of the property will be sold to end users outside the United States); or

(E) A written statement prepared by the seller containing the information described in paragraphs (d)(3)(ii)(E)(1) through (7) of this section corroborated by evidence that is credible and sufficient to support the information provided.

(1) The name and address of the recipient;

(2) The date or dates the property was shipped or delivered to the recipient;

(3) The amount of gross income from the sale;

(4) A full description of the property subject to resale;

(5) A description of the method of sales to the end users, such as direct sales by the recipient or sales by the recipient to retail stores;

(6) If known, a description of the end users; and

(7) A description of how the seller determined that property will be ultimately sold to an end user outside the United States (or, in the case of sales of fungible mass property, of how the taxpayer determined what portion of the property that will ultimately be sold to end users outside the United States).

(iii) *Substantiation of foreign use for manufacturing, assembly, or other processing outside the United States.* A seller satisfies the substantiation requirements with respect to a sale of property described in paragraph (d)(1)(iii) of this section (sales of general property subject to manufacturing, assembly, or other processing outside the United States) if the

seller maintains one or more of the following items—

(A) Credible evidence that the property has been sold to a foreign unrelated party that is a manufacturer and such property generally cannot be sold to end users without being subject to a physical and material change (for example, the sale of raw materials that cannot be used except in a manufacturing process);

(B) Credible evidence obtained or created in the ordinary course of business from the recipient to support that the product purchased will be subject to manufacture, assembly, or other processing outside the United States within the meaning of paragraph (d)(1)(iii) of this section; or

(C) A written statement prepared by the seller containing the information described in paragraphs (d)(3)(iii)(C)(1) through (7) of this section corroborated by evidence that is credible and sufficient to support the information provided.

(1) The name and address of the manufacturer of the property;

(2) The date or dates the property was shipped or delivered to the recipient;

(3) The amount of gross income from the sale;

(4) A full description of the general property sold and the type or types of finished goods that will incorporate the general property the taxpayer sold;

(5) A description of the manufacturing, assembly, or other processing operations, including the location or locations of manufacture, assembly, or other processing; how the general property will be used in the finished good; and the nature of the finished good's manufacturing, assembly, or other processing operations as compared to the process used to make the general property used to make the finished good;

(6) A description of how the seller determined the general property was substantially transformed or the activities were substantial in nature within the meaning of paragraph (d)(1)(iii)(B) or (C) of this section, whichever the case may be; and,

(7) If the seller is relying on the rule described in paragraph (d)(1)(iii)(C) of this section (that the fair market value of the general property be no more than twenty percent of the fair market value when incorporated into the finished goods sold

to end users), an explanation of how the seller satisfies the requirements in that paragraph.

(iv) *Substantiation of foreign use of intangible property.* A taxpayer satisfies the substantiation requirements with respect to a sale of property described in paragraph (d)(2) of this section (foreign use for intangible property) if the seller maintains one or more of the following items—

(A) A binding contract that specifically provides that the intangible property can be exploited solely outside the United States;

(B) Credible evidence obtained or created in the ordinary course of business from the recipient establishing the portion of its revenue for a taxable year that was derived from exploiting the intangible property outside the United States; or

(C) A written statement prepared by the seller containing the information described in paragraphs (d)(3)(iv)(C)(1) through (9) of this section corroborated by evidence that is credible and sufficient to support the information provided.

(1) The name and address of the recipient;

(2) The date of the sale;

(3) The amount of gross income from the sale;

(4) A description of the intangible property;

(5) An explanation of how the intangible property will be used by the recipient (embedded in general property, used to provide a service, used as a manufacturing method or process, or used in research and development);

(6) An explanation of how the seller determined what portion of the sale is a FDDEI sale;

(7) If the intangible property consists of a manufacturing method or process, an explanation of how the elements of paragraph (d)(2)(ii)(C) of this section are satisfied;

(8) If the sale is for periodic payments, an explanation of how the seller determined the extent of foreign use based on the actual revenue earned by the recipient from the use of the intangible property for the taxable year in which a periodic payment is received as required by paragraph (d)(2)(iii)(A) of this section, or, if actual revenue cannot be obtained after reasonable efforts, an explanation of why actual

revenue is unavailable and how the seller determined the extent of foreign use based on estimated revenue; and

(9) If the sale is for a lump sum, an explanation of how the seller determined the total net present value of revenue it expected to earn from the exploitation of the intangible property outside the United States and the total net present value of revenue it expected to earn from the exploitation of the intangible property as required by paragraph (d)(2)(iii)(B) of this section.

(v) *Examples.* The following examples illustrate the application of this paragraph (d)(3).

(A) *Assumed facts.* The following facts are assumed for purposes of the examples—

(1) DC is a domestic corporation.

(2) FP is a foreign person located within Country A that is a foreign unrelated party with respect to DC.

(3) All of DC's income is DEI.

(4) Except as otherwise provided, the substantive rule for foreign use as described in paragraphs (d)(1) and (2) of this section are satisfied.

(B) *Examples—*

(i) *Example 1: Substantiation by seller of sale of products to distributor outside the United States with taxpayer statement and corroborating evidence—(i) Facts.* DC sells smartphones to FP, a distributor of electronics that sells property to end users. As part of their regular business process and pursuant to DC's terms and conditions of sales, DC issues commercial invoices to FP that contain a condition that any subsequent sales must be to end users outside the United States. At or near the time of the FDII filing date, DC prepares a statement containing the information required in paragraph (d)(3)(ii)(E) of this section. During an examination of DC's return for the taxable year, the IRS requests substantiation information of foreign use. DC submits the commercial invoices issued to FP as supporting information that FP's customers are end users outside the United States and all other corroborating evidence to the IRS.

(ii) *Analysis.* DC's sale to FP is a sale of general property for resale subject to the substantiation requirements of paragraph (d)(3)(ii) of this section. DC satisfies the substantiation requirement by providing the statement that satisfies the requirements of paragraph (d)(3)(ii)(E) of this section. The commercial invoices issued pursuant to the terms and conditions of sales sufficiently corroborate DC's statement that the smartphones will ultimately be sold to end users outside of the United States.

(2) *Example 2: Substantiation of sale of products to distributor outside the United States with recipient provided information—(i) Facts.* DC sells cameras to FP, a distributor of electronics that sells property to end users outside the United States. FP issues sales invoices to its end users. The invoices contain de-

tailed information about the nature of the subsequent sales of the cameras and the location of the end users for value added tax (VAT) purposes. DC is able to obtain copies of FP's VAT invoices with respect to the camera sales that were maintained and submitted pursuant to Country A law. Rather than prepare a statement described in paragraph (d)(3)(ii)(E) of this section, DC submits FP's invoices to the IRS as substantiation of foreign use.

(ii) *Analysis.* DC's sale to FP is a sale of general property for resale subject to the substantiation requirements of paragraph (d)(3)(ii) of this section. DC satisfies the substantiation requirements by providing the invoices that satisfy the requirements of paragraph (d)(3)(ii)(D) of this section. The VAT invoices issued by FP pursuant to Country A law constitute credible evidence from FP that ultimate sales are to end users located outside the United States.

(e) *Sales of interests in a disregarded entity.* Under Federal income tax principles, the sale of any interest in an entity that is disregarded for Federal income tax purposes is considered the sale of the assets of that entity, and this section applies to the sale of each such asset that is general property or intangible property for purposes of determining whether such sale qualifies as a FDDEI sale.

(f) *FDDEI sales hedging transactions—(1) In general.* The amount of a corporation's or partnership's gross FDDEI from FDDEI sales of general property in a taxable year is increased by any gain, or decreased by any loss, taken into account in that taxable year with respect to any FDDEI sales hedging transactions (determined by taking into account the applicable Federal income tax accounting rules, including §1.446-4).

(2) *FDDEI sales hedging transaction—*The term *FDDEI sales hedging transaction* means a transaction that meets the requirements of §1.1221-2(a) through (e) and that is identified in accordance with the requirements of §1.1221-2(f), except that the transaction must manage risk of price changes or currency fluctuations with respect to ordinary property, as provided in §1.1221-2(b)(1), and the ordinary property whose price risk is being hedged must be general property that is sold in a FDDEI sale.

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

(a) *Scope.* This section provides rules for determining whether a provision of a service is a FDDEI service. Paragraph (b) of this section defines a FDDEI service. Paragraph (c) of this section pro-

vides definitions relevant for determining whether a provision of a service is a FDDEI service. Paragraph (d) of this section provides rules for determining whether a general service is provided to a consumer located outside the United States. Paragraph (e) of this section provides rules for determining whether a general service is provided to a business recipient located outside the United States. Paragraph (f) of this section provides rules for determining whether a proximate service is provided to a recipient located outside the United States. Paragraph (g) of this section provides rules for determining whether a service is provided with respect to property located outside the United States. Paragraph (h) of this section provides rules for determining whether a transportation service is provided to a recipient, or with respect to property, located outside the United States.

(b) *Definition of FDDEI service.* Except as provided in §1.250(b)-6(d), the term *FDDEI service* means a provision of a service described in any one of paragraphs (b)(1) through (5) of this section. If only a portion of a service is treated as provided to a person, or with respect to property, outside the United States, the provision of the service is a FDDEI service only to the extent of the gross income derived with respect to such portion.

(1) The provision of a general service to a consumer located outside the United States (as determined under paragraph (d) of this section).

(2) The provision of a general service to a business recipient located outside the United States (as determined under paragraph (e) of this section).

(3) The provision of a proximate service to a recipient located outside the United States (as determined under paragraph (f) of this section).

(4) The provision of a property service with respect to tangible property located outside the United States (as determined under paragraph (g) of this section).

(5) The provision of a transportation service to a recipient, or with respect to property, located outside the United States (as determined under paragraph (h) of this section).

(c) *Definitions.* This paragraph (c) provides definitions that apply for purposes of this section and §1.250(b)-6.

(1) *Advertising service*. The term *advertising service* means a general service that consists primarily of transmitting or displaying content (including via the internet) to consumers with a purpose to generate revenue based on the promotion of a product or service.

(2) *Benefit*. The term *benefit* has the meaning set forth in §1.482-9(l)(3).

(3) *Business recipient*. The term *business recipient* means a recipient other than a consumer and includes all related parties of the recipient. However, if the recipient is a related party of the taxpayer, the term does not include the taxpayer.

(4) *Consumer*. The term *consumer* means a recipient that is an individual that purchases a general service for personal use.

(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. Electronically supplied services include the provision of access to digitized products (such as streaming content without downloading the 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); services automatically generated from a computer via the internet or other network in response to data input by the recipient; the provision of information electronically; and similar services.

(6) *General service*. The term *general service* means any service other than a property service, proximate service, or transportation service. The term *general service* includes advertising services and electronically supplied services.

(7) *Property service*. The term *property service* means a service, other than a transportation service, provided with respect to tangible property, but only if substantially all of the service is performed at the location of the property and results in physical manipulation of the property such as through manufacturing, assembly, maintenance, or repair. Substantially all of a service is performed at the location of property only if the renderer spends more than 80 percent of the time providing the service at or near the location of the property.

(8) *Proximate service*. The term *proximate service* means a service, other than a property service or a transportation service, provided to a consumer or business recipient, but only if substantially all of the service is performed in the physical presence of the consumer or, in the case of a business recipient, substantially all of the service is performed in the physical presence of persons working for the business recipient such as employees, contractors, or agents. Substantially all of a service is performed in the physical presence of a consumer or persons working for a business recipient only if the renderer spends more than 80 percent of the time providing the service in the physical presence of such persons.

(9) *Transportation service*. The term *transportation service* means a service to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle, or any other mode of transportation. Transportation services include freight forwarding and similar services.

(d) *General services provided to consumers*—(1) *In general*. A general service is provided to a consumer located outside the United States if the consumer of a general service resides outside of the United States when the service is provided. Except as provided in paragraph (d)(2) of this section, if the renderer does not have or cannot after reasonable efforts obtain the consumer's location of residence when the service is provided, the consumer of a general service is treated as residing at the location of the consumer's billing address. However, the rule in the preceding sentence allowing for the use of a consumer's billing address does not apply if the renderer knows or has reason to know that the consumer does not reside outside the United States. A renderer has reason to know that the consumer does not reside outside the United States if the information received as part of the provision of the service indicates that the consumer resides in the United States and the renderer fails to obtain evidence establishing that the consumer resides outside the United States.

(2) *Electronically supplied services*. The consumer of an electronically supplied service is deemed to reside at the location of the device used to receive the service. Such location may be determined

based on the location of the IP address when the electronically supplied service is provided. However, if the renderer does not have or cannot after reasonable efforts obtain the consumer's device location, then the location of the device is treated as being outside the United States if the renderer's billing address for the consumer is outside of the United States, subject to the knowledge and reason to know standards described in paragraph (d)(1) of this section.

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

(i) *Facts*. DC, a domestic corporation, provides a streaming movie service on its website. The terms of the service allow consumers to watch movies over the internet. The terms of the service permit the consumer to view the movies for personal use, but convey no ownership of movies to the consumers.

(ii) *Analysis*. The streaming service is a FDDEI service under paragraph (d)(1) of this section to the extent that the service is provided to consumers that reside outside the United States. The service that DC provides is a general service, provided to consumers that is an electronically supplied service under paragraph (c)(5) of this section. Therefore, the consumers are deemed to reside at the location of the devices used to receive the service under paragraph (d)(2) of this section. However, if the renderer cannot reasonably obtain the consumers' device location (such as IP addresses), the device location is treated as being outside the United States if their billing addresses are outside the United States. See §1.250(b)-4(d)(1)(v)(B)(7) for an example of digital content provided to consumers as a sale rather than a service.

(e) *General services provided to business recipients*—(1) *In general*. A general service is provided to a business recipient located outside the United States to the extent that the service confers a benefit on the business recipient's operations outside the United States under the rules in paragraph (e)(2) of this section. The location of residence, incorporation, or formation of a business recipient is not relevant to determining the location of the business recipient's operations that benefit from a general service.

(2) *Determination of business operations that benefit from the service*—(i) *In general*. Except as otherwise provided in paragraph (e)(2)(ii) and (iii) of this section, the determination of which operations of the business recipient located outside the United States benefit from a general service, and the extent to which such operations benefit, is made under the principles of §1.482-9 by treating the taxpayer as one controlled taxpayer, the por-

tions of the business recipient's operations within the United States (if any) that may benefit from the general service as one or more controlled taxpayers, and the portions of the business recipient's operations outside the United States (if any) that may benefit from the general service, each as one or more controlled taxpayers. The extent to which a business recipient's operations within or outside of the United States are treated as one or more separate controlled taxpayers is determined under any reasonable method (for example, separate controlled taxpayers may be determined on a per entity or per country basis, or by aggregating all of the business recipient's operations outside the United States as one controlled taxpayer). The determination of the amount of the benefit conferred on the business recipient's operations that are treated as controlled taxpayers is determined under a reasonable method consistent with the principles of §1.482-9(k), treating the renderer's gross income from the services provided to the business recipient as if it were a "cost" as that term is used in §1.482-9(k). Reasonable methods may include, for example, allocations based on time spent or costs incurred by the renderer or sales, profits, or assets of the business recipient. The determination is made when the service is provided based on information obtained from the business recipient or on the renderer's own records (such as time spent working with the business recipient's offices located outside the United States).

(ii) *Advertising services.* With respect to advertising services, the operations of the business recipient that benefit from the advertising service provided by the renderer are deemed to be located where the advertisements are viewed by individuals. If advertising services are displayed via the internet, the advertising services are viewed at the location of the device on which the advertisements are viewed. For this purpose, the IP address may be used to establish the location of a device on which an advertisement is viewed.

(iii) *Electronically supplied services.* With respect to an electronically supplied service, the operations of the business recipient that benefit from that service provided by the renderer are deemed to be located where the business recipient (including employees, contractors, or agents)

accesses the service. If it cannot be determined whether the location is within or outside the United States (such as where the location of access cannot be reliably determined using the location of the IP address of the device used to receive the service), and the gross receipts from all services with respect to the business recipient are in the aggregate less than \$50,000 for the renderer's taxable year, the operations of the business recipient that benefit from the service provided by the renderer are deemed to be located at the recipient's billing address; otherwise, the operations of the business recipient that benefit are deemed to be located in the United States. If the renderer provides a service that is partially an electronically supplied service and partially a general service that is not an electronically supplied service (such as a service that is performed partially online and partially by mail or in person), the location of the business recipient is determined using the rule for electronically supplied services in this paragraph (e)(2)(iii) if the primary purpose of the service is to provide electronically supplied services; otherwise, the rule for general services described in paragraph (e)(2)(i) of this section applies.

(3) *Identification of business recipient's operations—(i) In general.* For purposes of this paragraph (e), except with respect to advertising services and electronically supplied services, a business recipient is treated as having operations where it maintains an office or other fixed place of business. In general, an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility, through which the business recipient engages in a trade or business. For purposes of making the determination in this paragraph (e)(3)(i), the renderer may make reliable assumptions based on the information available to it.

(ii) *Advertising services and electronically supplied services.* The location of a business recipient that receives advertising services or electronically supplied services will be determined under the rules of paragraph (e)(2)(ii) and (iii) of this section, respectively, even if the business recipient does not maintain an office or other fixed place of business in the locations where the advertisements are viewed (in the case of advertising services) or where

the general service is accessed (in the case of electronically supplied services).

(iii) *No office or fixed place of business.* In the case of general services other than advertising services and other than electronically supplied services, if the business recipient does not have an identifiable office or fixed place of business (including the office of a principal manager or managing owner), the business recipient is deemed to be located at its primary billing address.

(4) *Substantiation of the location of a business recipient's operations outside the United States.* Except as provided in §1.250(b)-3(f)(3) (relating to certain loss transactions), a general service provided to a business recipient is treated as a FDDEI service only if the renderer substantiates its determination of the extent to which the service benefits a business recipient's operations outside the United States. A renderer satisfies the preceding sentence if the renderer maintains one or more of the following items—

(i) Credible evidence obtained or created in the ordinary course of business from the business recipient establishing the extent to which operations of the business recipient outside the United States benefit from the service; or

(ii) A written statement prepared by the renderer containing the information described in paragraphs (e)(4)(ii)(A) through (F) of this section corroborated by evidence that is credible and sufficient to support the information provided.

(A) The name of the business recipient;
(B) The date or dates of the service;
(C) The amount of gross income from the service;

(D) A full description of the service;
(E) A description of how the service will benefit the business recipient; and

(F) An explanation of how the renderer determined what portion of the service will benefit the business recipient's operations located outside the United States.

(5) *Examples.* The following examples illustrate the application of this paragraph (e).

(i) *Assumed facts.* The following facts are assumed for purposes of the examples—

(A) DC is a domestic corporation.
(B) A and R are not related parties of DC.

(C) Except as otherwise provided, the substantiation requirements described in paragraph (e)(4) of this section are satisfied.

(ii) *Examples*—

(A) *Example 1: Determination of business operations that benefit from the service—(I) Facts.* For the taxable year, DC provides a consulting service to R, a company that operates restaurants within and outside of the United States, in exchange for \$150x. Fifty percent of the sales earned by R and its related parties are from customers located outside of the United States. However, the consulting service that DC provides relates specifically to a single chain of fast food restaurants that R operates. Sales information that R provides to DC indicates that 70 percent of the sales of the fast food restaurant chain are from locations within the United States and 30 percent of the sales are from Country X. DC determines that the use of sales is a reasonable method under the principles of §1.482-9(k) to allocate the benefit of the consulting service among R's fast food operations.

(2) *Analysis.* Under paragraph (e)(1) of this section, DC's service is provided to a person located outside the United States to the extent that DC's service confers a benefit to R's operations outside the United States. Under paragraph (e)(2)(i) of this section, DC, R's fast food operations within the United States, and R's fast food operations in Country X, are treated as if they were controlled taxpayers because only these operations may benefit from DC's service. The principles of §1.482-9(k) apply to determine the amount of DC's service that benefits R's operations outside the United States. DC's gross income is allocated based on the sales of the fast food chain of restaurants that benefits from DC's service because using sales is a reasonable method. Therefore, 30 percent of the provision of the consulting service is treated as the provision of a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, \$45x (\$150x x 0.30) of DC's gross income from the provision of the consulting service is included in DC's gross FDDEI for the taxable year.

(B) *Example 2: Determination of business operations that benefit from the service; alternative facts—(I) Facts.* The facts are the same as in paragraph (e)(5)(ii)(A)(1) of this section (the facts in Example 1), except that DC provides an information technology service to R that benefits R's entire business. DC determines that the use of sales is a reasonable method under the principles of §1.482-9(k) to allocate the benefit of the information technology service among R's entire business.

(2) *Analysis.* DC, R's operations within the United States, and R's operations in Country X, are treated as if they were controlled taxpayers because the service that DC provides relates to R's entire business. DC's gross income is allocated based on sales of the entire business because using sales is a reasonable method to determine the amount of DC's service that benefits R's operations outside the United States under the principles of §1.482-9(k). Therefore, 50 percent of the provision of the information technology service is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, \$75x

(\$150x x 0.50) of DC's gross income from the provision of the information technology service is included in DC's gross FDDEI for the taxable year.

(C) *Example 3: Advertising services—(I) Facts.* The facts are the same as in paragraph (e)(5)(ii)(A)(1) of this section (the facts in Example 1), except that DC provides an advertising service to R. DC displays advertisements for R's restaurant chain on its social media website and smartphone application. Based on the IP addresses of the devices on which the advertisements are viewed, 20 percent of the views of the advertisements were from devices located outside the United States.

(2) *Analysis.* Because the service that DC provides is an advertising service, under paragraph (e)(2)(i) of this section, as modified by paragraph (e)(2)(ii) of this section, R's operations that benefit from DC's advertising service are deemed to be where the advertisements are viewed. Therefore, 20 percent of the provision of the advertising service is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, \$30x (\$150x x 0.20) of DC's gross income from the provision of the advertising service is included in DC's gross FDDEI for the taxable year.

(D) *Example 4: No reliable information about which operations benefit from the service or publicly available information—(I) Facts.* For the taxable year, DC provides a consulting service to R, a business-facing company that does not advertise its business. All of DC's interaction with R is through R's employees that report to an office in the United States. Statements made by R's employees indicate that the service will benefit R's business operations located within and outside the United States, but do not provide information that would allow DC to reliably determine the extent to which its service will confer a benefit on R's business operations located outside the United States.

(2) *Analysis.* DC is unable to determine the extent to which its service will confer a benefit on R's business operations located outside the United States under paragraph (e)(2)(i) of this section. Accordingly, DC cannot substantiate a determination of the extent to which the service benefits a business recipient's operations outside the United States under paragraph (e)(4) of this section. Therefore, no portion of DC's service is a FDDEI service.

(E) *Example 5: Electronically supplied services that are accessed by the business recipient's employees—(I) Facts.* DC provides payroll services for R. As part of this service, DC maintains a website through which R can enter payroll information for its employees and through which R's employees can enter and change their personal information. DC also causes R's employees' paychecks to be directly deposited into their bank accounts and pays R's employment taxes on R's behalf. The primary purpose of the service is to pay R's employees. R has 100 user accounts that access DC's website. Sixty of the user accounts that access DC's website access the website from devices that are located outside the United States and forty of the user accounts access the website from devices that are located inside the United States.

(2) *Analysis.* Under paragraph (e)(1) of this section, DC's service is provided to a person located

outside the United States to the extent that DC's service confers a benefit to R's operations outside the United States. The service that DC provides to R is an electronically supplied service under paragraph (c)(5) of this section. Accordingly, under paragraph (e)(2)(i) of this section, as modified by paragraph (e)(2)(iii) of this section, R's operations that benefit from DC's services are deemed to be located where R accesses the service, which is where R's employees access the website. See paragraph (e)(2)(iii) of this section. Accordingly, the portion of the payroll service that is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section is determined based on the extent to which the locations where R accesses the website are located outside the United States. Because 60 percent (60/100) of user accounts access DC's website from locations outside the United States, 60 percent of the provision of the payroll service is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section.

(F) *Example 6: Electronically supplied services that are accessed by the business recipient's customers—(I) Facts.* DC maintains a website for R, a company that sells consumer goods online. R's offices are in the United States, but R sells its products to customers both within and outside the United States. Based on the IP addresses of the devices on which the website is accessed, 30 percent of the devices that accessed the website during the taxable year were located outside the United States.

(2) *Analysis.* Under paragraph (e)(1) of this section, DC's service is provided to a person located outside the United States to the extent that DC's service confers a benefit to R's operations outside the United States. The service that DC provides to R is an electronically supplied service under paragraph (c)(5) of this section. Accordingly, under paragraph (e)(2)(i) of this section, as modified by paragraph (e)(2)(iii) of this section, R's operations that benefit from DC's services are deemed to be located where the service is accessed, which is where R's website is accessed in this example. Therefore, 30 percent of the provision of the website maintenance service is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section.

(G) *Example 7: Service provided to a domestic person—(I) Facts.* A, a domestic corporation that operates solely in the United States, enters into a services agreement with R, a company that operates solely outside the United States. Under the agreement, A agrees to perform a consulting service for R. A hires DC to provide a service to A that A will use in the provision of a consulting service to R.

(2) *Analysis.* Because DC provides a service to A, a person located within the United States, DC's provision of the service to A is not a FDDEI service under paragraph (b)(2) of this section, even though the service is used by A in providing a service to R, a person located outside the United States. See also section 250(b)(5)(B)(ii). However, A's provision of the consulting service to R may be a FDDEI service, in which case A's gross income from the provision of such service would be included in A's gross FDDEI.

(f) *Proximate services.* A proximate service is provided to a recipient located outside the United States if the proximate service is performed outside the United States. In the case of a proximate service performed partly within the United States and partly outside of the United States, a proportionate amount of the service is treated as provided to a recipient located outside the United States corresponding to the portion of time the renderer spends providing the service outside of the United States.

(g) *Property services—(1) In general.* Except as provided in paragraph (g)(2) of this section, a property service is provided with respect to tangible property located outside the United States only if the property is located outside the United States for the duration of the period the service is performed.

(2) *Exception for services provided with respect to property temporarily in the United States.* A property service is deemed to be provided with respect to tangible property located outside the United States if the following conditions are satisfied—

(i) The property is temporarily in the United States for the purpose of receiving the property service;

(ii) After the completion of the service, the property will be primarily hangared, stored, or used outside the United States;

(iii) The property is not used to generate revenue in the United States at any point during the duration of the service; and

(iv) The property is owned by a foreign person that resides or primarily operates outside the United States.

(h) *Transportation services.* Except as provided in this paragraph (h), a transportation service is provided to a recipient, or with respect to property, located outside the United States only if both the origin and the destination of the service are outside of the United States. However, in the case of a transportation service provided to a recipient, or with respect to property, where either the origin or the destination of the service is outside of the United States, but not both, then 50 percent of the gross income from the transportation service is considered derived from services provided to a recipient, or with respect to property, located outside the United States.

§1.250(b)-6 Related party transactions.

(a) *Scope.* This section provides rules for determining whether a sale of property or a provision of a service to a related party is a FDDEI transaction. Paragraph (b) of this section provides definitions relevant for determining whether a sale of property or a provision of a service to a related party is a FDDEI transaction. Paragraph (c) of this section provides rules for determining whether a sale of general property to a foreign related party is a FDDEI sale. Paragraph (d) of this section provides rules for determining whether the provision of a general service to a business recipient that is a related party is a FDDEI service.

(b) *Definitions.* This paragraph (b) provides definitions that apply for purposes of this section.

(1) *Related party sale.* The term *related party sale* means a sale of general property to a foreign related party. See §1.250(b)-1(e)(3)(ii)(D) (*Example 4*) for an illustration of a related party sale in the case of a seller that is a partnership.

(2) *Related party service.* The term *related party service* means a provision of a general service to a business recipient that is a related party of the renderer and that is described in §1.250(b)-5(b)(2) without regard to paragraph (d) of this section.

(3) *Unrelated party transaction.* The term *unrelated party transaction* means, with respect to property purchased by a foreign related party (the “purchased property”) in a related party sale from a seller—

(i) A sale of the purchased property by the foreign related party in the ordinary course of its business to a foreign unrelated party with respect to the seller;

(ii) A sale of property by the foreign related party to a foreign unrelated party with respect to the seller, if the purchased property is a constituent part of the property sold to the foreign unrelated party;

(iii) A sale of property by the foreign related party to a foreign unrelated party with respect to the seller, if the purchased property is not a constituent part of the product sold to the foreign unrelated party but rather is used in connection with producing the property sold to the foreign unrelated party; or

(iv) A provision of a service by the foreign related party to a foreign unrelated

party with respect to the seller, if the purchased property was used in connection with the provision of the service.

(c) *Related party sales—(1) In general.* A related party sale of general property is a FDDEI sale only if the requirements described in either paragraph (c)(1)(i) or (ii) of this section are satisfied with respect to the related party sale. This paragraph (c) does not apply in determining whether a sale of intangible property to a foreign related party is a FDDEI sale.

(i) *Sale of property in an unrelated party transaction.* A related party sale is a FDDEI sale if an unrelated party transaction described in paragraph (b)(3)(i) or (ii) of this section occurs with respect to the property purchased in the related party sale and such unrelated party transaction is described in §1.250(b)-4(b) (definition of FDDEI sale). The seller in the related party sale may establish that an unrelated party transaction will occur with respect to the property, or what portion of the property will be sold in an unrelated party transaction in the case of sale of a fungible mass of general property, based on contractual terms (including, for example, that the related party is contractually bound to only sell the product to foreign unrelated parties), past practices of the foreign related party (such as practices to only sell products to foreign unrelated parties), a showing that the product sold is designed specifically for a foreign market, or books and records otherwise evidencing that sales will be made to foreign unrelated parties.

(ii) *Use of property in an unrelated party transaction.* A related party sale is a FDDEI sale if one or more unrelated party transactions described in paragraph (b)(3)(iii) or (iv) of this section occurs with respect to the property purchased in the related party sale and such unrelated party transaction or transactions would be described in §1.250(b)-4(b) or §1.250(b)-5(b) (definition of FDDEI service). If the property purchased in the related party sale will be used in unrelated party transactions described in the preceding sentence and other transactions, the amount of gross income from the related party sale that is attributable to a FDDEI sale is equal to the gross income from the related party sale multiplied by a fraction, the numerator of which is the revenue that the related

party reasonably expects (as of the FDII filing date) to earn from all unrelated party transactions with respect to the property purchased in the related party sale that would be described in §1.250(b)-4(b) or §1.250(b)-5(b) and the denominator of which is the total revenue that the related party reasonably expects (as of the FDII filing date) to earn from all transactions with respect to the property purchased in the related party sale.

(2) *Treatment of foreign related party as seller or renderer.* For purposes of determining whether a sale of property or provision of a service by a foreign related party is, or would be, described in §1.250(b)-4(b) or §1.250(b)-5(b), the foreign related party that sells the property or provides the service is treated as a seller or renderer, as applicable, and the foreign unrelated party is treated as the recipient.

(3) *Transactions between related parties.* For purposes of determining whether an unrelated party sale has occurred and satisfies the requirements of paragraphs (c)(1) or (2) of this section with respect to a sale to a foreign related party (and not for purposes of determining whether a sale is to a foreign person as required by §1.250(b)-4(b)), all related parties of the seller are treated as if they are part of a single foreign related party. For purposes of the preceding sentence, in determining whether a United States person is a member of the seller's modified affiliated group, and therefore a related party of the seller, the definition of the term *modified affiliated group* in §1.250(b)-1(c)(17) applies without the substitution of "more than 50 percent" for "at least 80 percent" each place it appears. Accordingly, if a foreign related party sells or uses property purchased in a related party sale in a transaction with a second related party of the seller, transactions between the second related party and an unrelated party may be treated as an unrelated party transaction for purposes of applying paragraph (c)(1) of this section to a related party sale.

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

(i) *Facts.* DC, a domestic corporation, sells a machine to FC, a foreign related party of DC in a transaction described in §1.250(b)-4(b) (without regard to this paragraph (c)). FC uses the machine solely to manufacture product A. As of the FDII filing date for the taxable year, 75 percent of fu-

ture revenue from sales by FC to unrelated parties of product A will be from sales that would be described in §1.250(b)-4(b).

(ii) *Analysis.* The sale by DC to FC is a related party sale. Because FC uses the machine to make product A, but the machine is not a constituent part of product A because FC does not undertake further manufacturing with respect to the machine itself, FC's sale of product A is an unrelated party transaction described in paragraph (b)(3)(iii) of this section. Therefore, DC's sale of the machine is only a FDDEI sale if the requirements of paragraph (c)(1)(ii) of this section are satisfied. Because 75 percent of the revenue from future sales of product A will be from unrelated party transactions that would be described in §1.250(b)-4(b), 75 percent of the revenues from DC's sale of the machine to FC constitute FDDEI sales.

(d) *Related party services—(1) In general.* Except as provided in this paragraph (d)(1), a related party service is a FDDEI service only if the related party service is not substantially similar to a service that has been provided or will be provided by the related party to a person located within the United States. However, if a related party service is substantially similar to a service provided (in whole or in part) by the related party to a person located in the United States solely by reason of paragraph (d)(2)(ii) of this section, the amount of gross income from the related party service attributable to a FDDEI service is equal to the difference between the gross income from the related party service and the amount of the price paid by persons located within the United States that is attributable to the related party service. Section 250(b)(5)(C)(ii) and this paragraph (d)(1) apply only to a general service provided to a related party that is a business recipient and are not applicable with respect to any other service provided to a related party.

(2) *Substantially similar services.* A related party service is substantially similar to a service provided by the related party to a person located within the United States only if the related party service is used by the related party in whole or part to provide a service to a person located within the United States and either—

(i) 60 percent or more of the benefits conferred by the related party service are directly used by the related party to confer benefits on consumers or business recipients located within the United States; or

(ii) 60 percent or more of the price paid by consumers or business recipients located within the United States for the service

provided by the related party is attributable to the related party service.

(3) *Special rules.* For purposes of paragraph (d) of this section, the rules in paragraphs (d)(3)(i) and (ii) of this section apply.

(i) *Rules for determining the location of and price paid by recipients of a service provided by a related party.* The location of a consumer or business recipient with respect to services provided by the related party is determined under §1.250(b)-5(d) and (e)(2), respectively, but treating the related party as the renderer. Accordingly, if the related party provides a service to a business recipient, the related party is treated as conferring benefits on a person located within the United States to the extent that the service confers a benefit on the business recipient's operations located within the United States. Similarly, for purposes of applying paragraph (d)(2)(ii) of this section with respect to business recipients, the price paid by a business recipient to the related party for services is allocated proportionally based on the locations of the business recipient that benefit from the services provided by the related party.

(ii) *Rules for allocating the benefits provided by and price paid to the renderer of a related party service.* For purposes of applying paragraph (d)(2)(i) of this section with respect to benefits that are directly used by the related party to confer benefits on its recipients, the benefits provided by the renderer to the related party are allocated to the related party's consumers or business recipients within the United States based on the proportion of benefits conferred by the related party on consumers or business recipients located within the United States. For purposes of determining the amount of the price paid by persons located within the United States that is attributable to the related party service in applying paragraph (d)(2)(ii) of this section, if the related party provides services that confer benefits on persons located within the United States and outside the United States, the price paid for the related party service by the related party to the renderer is allocated proportionally based on the benefits conferred on each location by the related party to its recipients.

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

(i) *Assumed facts.* The following facts are assumed for purposes of the examples—

(A) DC is a domestic corporation.

(B) FC is a foreign corporation and a foreign related party of DC that operates solely outside the United States.

(C) The service DC provides to FC is a general service provided to a business recipient located outside the United States as described in §1.250(b)-5(b)(2) without regard to the application of paragraph (d) of this section.

(D) The benefits conferred by DC's service to FC's customers are not indirect or remote within the meaning of §1.482-9(l)(3)(ii).

(ii) *Examples—*

(A) *Example 1: Services that are substantially similar services under paragraph (d)(2)(i) of this section—(I) Facts.* FC enters into a services agreement with R, a company that operates restaurant chains within and outside the United States. Under the agreement, FC agrees to furnish a design for the renovation of a chain of restaurants that R owns; the design will include architectural plans. FC hires DC to provide an architectural service to FC that FC will use in the provision of its design service to R. The architectural service that DC provides to FC will serve no other purpose than to enable FC to provide its service to R. The service that FC provides will benefit only R's operations within the United States. FC pays an arm's length price of \$50x to DC for the architectural service and DC recognizes \$50x of gross income from the service. FC incurs additional costs to add additional design elements to the plans and charges R a total of \$100x for its service.

(2) *Analysis.* All of the service that DC provides to FC is directly used in the provision of a service to R because FC uses DC's architectural service to provide its design service to R, and the architectural service that DC provides to FC will serve no purpose other than to enable FC to provide its service to R. In addition, FC is treated as conferring benefits only to persons located within the United States under paragraph (d)(3)(i) of this section because only R's operations within the United States benefit from the service provided by FC that used the service provided by DC. Therefore, the service provided by DC to FC is substantially similar to the service provided by FC to R under paragraph (d)(2)(i) of this section. Accordingly, DC's provision of the architectural service to FC is not a FDDEI service under paragraph (d)(1) of this section, and DC's gross income from the architectural service (\$50x) is not included in its gross FDDEI.

(B) *Example 2: Services that are not substantially similar services under paragraph (d)(2)(i) of this section—(I) Facts.* The facts are the same as paragraph (d)(4)(ii)(A)(1) of this section (the facts in *Example 1*), except that 90 percent of R's operations

that will benefit from FC's service are located outside the United States.

(2) *Analysis—(i) Analysis under paragraph (d)(2)(i) of this section.* All of the service that DC provides to FC is directly used in the provision of a service to R. However, because 90 percent of R's operations that will benefit from FC's service are located outside the United States under paragraph (d)(3)(i) of this section, only 10 percent of the benefits of FC's service are conferred on persons located within the United States. Further, because FC's service confers a benefit on R's operations located within and outside the United States, the benefit provided by DC to FC is allocated proportionately based on the locations of R that benefit from the services provided by FC under paragraph (d)(3)(ii) of this section. Therefore, only 10 percent of DC's architectural service are directly used by FC to confer benefits on persons located within the United States under paragraph (d)(3)(ii) of this section. Therefore, the architectural service provided by DC to FC is not substantially similar to the design service provided by FC to persons located within the United States under paragraph (d)(2)(i) of this section.

(C) *Example 3: Services that are substantially similar services under paragraph (d)(2)(ii) of this section—(I) Facts.* The facts are the same as paragraph (d)(4)(ii)(B)(1) of this section (the facts in *Example 2*), except that FC pays an arm's length price of \$75x to DC for the architectural service and DC recognizes \$75x of gross income from the service. As in paragraph (d)(4)(ii)(A)(1) and (d)(4)(ii)(B)(1) of this section (the facts in *Example 1* and *Example 2*), FC charges R a total of \$100x for its service.

(2) *Analysis—(i) Price paid by persons located within the United States.* Under paragraph (d)(3)(i) of this section, FC is treated as conferring benefits on a person located within the United States to the extent that R's operations that will benefit from FC's service are located within the United States. Further, because FC's service confers a benefit on R's operations located within and outside the United States, the price paid by R to FC (\$100x) is allocated proportionately based on the locations of R that benefit from the services provided by FC under paragraph (d)(3)(i) of this section. Accordingly, because 10 percent of R's operations that will benefit from FC's services are located within the United States, persons located within the United States are treated as paying \$10x (\$100x x 0.10) for FC's services for purposes of applying the test in paragraph (d)(2)(ii) of this section.

(ii) *Amount attributable to the related party service.* The service that FC provides to R is attributable in part to DC's service because FC uses the architectural plans that DC provides to provide a service to R. Under paragraph (d)(3)(ii) of this section, because the benefits of the service provided by FC are conferred on persons located within the United States and outside the United States, a proportionate amount (10 percent) of the price paid to DC for the related party service (\$75x), or \$7.5x, is treated as attributable to the services provided to persons located within the United States.

(iii) *Application of test in paragraph (d)(2)(ii) of this section.* For purposes of applying the test described in paragraph (d)(2)(ii) of this section, the price paid by persons located within the United

States for the service provided by the related party (FC) is \$10x, as determined in paragraph (d)(4)(ii)(C)(2)(i) of this section (the analysis of this *Example 3*). The amount of the price that is attributable to DC's service is \$7.5x, as determined in paragraph (d)(4)(ii)(C)(2)(ii) of this section (the analysis of this *Example 3*). Accordingly, of the price treated as paid to FC by persons located within the United States, 75 percent (\$7.5x/\$10x) is attributable to the related party service. Because more than 60 percent of the price treated as paid by persons within the United States for FC's service is attributable to DC's service, the service provided by DC to FC is substantially similar to the design service provided by FC to persons located within the United States under paragraph (d)(2)(ii) of this section.

(iv) *Conclusion.* Under paragraph (d)(1) of this section, because the related party service provided by DC is substantially similar to the service provided by FC to a person located in the United States solely by reason of paragraph (d)(2)(ii) of this section, the difference between DC's gross income from the related party service and the amount of the price paid by persons located within the United States that is attributable to the related party service is treated as a FDDEI service. Accordingly, \$67.5x (\$75x - \$7.5x) of DC's gross income from the provision of the service to FC is treated as a FDDEI service.

Par. 3. Section 1.861-8 is amended by revising the last sentence of paragraph (d)(2)(ii)(C)(1) and adding paragraph (f)(1)(vi)(N) as follows:

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

* * * * *

(d) * * *

(2) * * *

(ii) * * *

(C) * * *

(1) * * * The term *gross foreign-derived deduction eligible income*, or *gross FDDEI*, has the meaning provided in §1.250(b)-1(c)(16).

* * * * *

(f) * * *

(1) * * *

(vi) * * *

(N) Deduction eligible income and foreign-derived deduction eligible income under section 250(b).

* * * * *

Par. 4. Section 1.962-1 is amended by:

1. Revising paragraph (a)(2).

2. Adding paragraphs (b)(1)(i)(A)(2) and (b)(1)(i)(B)(3).

3. Removing and reserving paragraph (b)(1)(ii).

4. Revising paragraphs (b)(2)(i) through (iii), (c), and (d)

The revisions and additions read as follows:

§1.962-1 Limitation of tax for individuals on amounts included in gross income under section 951(a).

(a) * * *

(2) For purposes of applying sections 960(a) and 960(d) (relating to foreign tax credit) such amounts shall be treated as if received by a domestic corporation (as provided in paragraph (b)(2) of this section).

* * * * *

(b) * * *

(1) * * *

(i) * * *

(A) * * *

(2) His GILTI inclusion amount (as defined in §1.951A-1(c)(1)) for the taxable year; plus

* * * * *

(B) * * *

(3) The portion of the deduction under section 250 and §1.250(a)-1 that would be allowed to a domestic corporation equal to the percentage applicable to global intangible low-taxed income for the taxable year under section 250(a)(1)(B) (including as modified by section 250(a)(3)(B)) multiplied by the sum of the amount described in paragraph (b)(1)(i)(A)(2) of this section and the amount described in paragraph (b)(1)(i)(A)(3) of this section that is attributable to the amount described in paragraph (b)(1)(i)(A)(2) of this section.

* * * * *

(2) * * *

(i) *In general.* Subject to the applicable limitation of section 904 and to the provisions of this paragraph (b)(2), there shall be allowed as a credit against the United States tax on the amounts described in paragraph (b)(1)(i) of this section the foreign income, war profits, and excess profits taxes deemed paid under section 960(a) or section 960(d) by the electing United States shareholder with respect to such amounts.

(ii) *Application of sections 960(a) and 960(d).* In applying sections 960(a) and 960(d) for purposes of this paragraph (b)(2) in the case of an electing United States shareholder, the term “domestic corporation” as used in sections 960(a), 960(d), and 78, and the term “corporation” as used in sections 901 and 960(d)(2)(A) and (B),

are treated as referring to such shareholder with respect to the amounts described in paragraph (b)(1)(i) of this section.

(iii) *Carryback and carryover of excess tax deemed paid.* For purposes of this paragraph (b)(2), other than with respect to section 951A category income (as defined in §1.904-4(g)) (including section 951A category income that is reassigned to a separate category for income resourced under a treaty), any amount by which the foreign income, war profits, and excess profits taxes deemed paid by the electing United States shareholder for any taxable year under section 960 exceed the limitation determined under paragraph (b)(2)(iv)(A) of this section is treated as a carryback and carryover of excess tax paid under section 904(c), except that in no case will excess tax paid be deemed paid in another taxable year under section 904(c) if an election under section 962 by the shareholder does not apply for such taxable year. Such carrybacks and carryovers are applied only against the United States tax on amounts described in paragraph (b)(1)(i) of this section.

* * * * *

(c) *Example.* The application of this section may be illustrated by the following example.

(1) *Facts—*(i) Individual A is a U.S. resident who owns all of the shares of the one class of stock in CFC, a controlled foreign corporation. A and CFC each use the calendar year as their U.S. and foreign taxable years and the U.S. dollar as their functional currency. A owns no direct or indirect interest in any other controlled foreign corporation.

(ii) For the 2019 taxable year, CFC has \$6,000,000 of pre-foreign tax earnings with respect to which it accrues and pays \$1,000,000 of foreign income tax, leaving \$5,000,000 of after-tax net income. Of this amount, \$3,000,000 is general category tested income as defined in section 951A(c)(2), and \$2,000,000 is passive category subpart F income described in sections 952 and 904(d)(1)(C) that is all in a single subpart F income group under §§1.954-1(c)(1)(iii) and 1.960-1(d)(2)(ii)(B)(2)(i). Of the \$1,000,000 of foreign income taxes paid or accrued by CFC, \$600,000 is allocated and apportioned to its general category tested income group and \$400,000 is allocated and apportioned to its passive category subpart F income group under §1.960-1(d)(3)(ii).

(iii) For the 2019 taxable year, A includes under section 951A(a) all \$3,000,000 of the tested income of CFC as A’s GILTI inclusion amount, as defined in §1.951A-1(c)(1). In addition, A includes under section 951(a)(1) the \$2,000,000 of passive category subpart F income of CFC.

(iv) For the 2019 taxable year, A earns \$1,000,000 of foreign source passive category gross income and \$3,000,000 of U.S. source gross income. A pays

\$100,000 of foreign withholding taxes with respect to the \$1,000,000 of foreign source passive category gross income. A incurs \$1,000,000 of deductible expenses for the 2019 taxable year that are definitely related to all of A’s gross income and are properly allocated and apportioned under §§1.861-8(b)(5) and 1.861-8T(c)(1) among the section 904 statutory and residual groupings on the basis of the relative amounts of gross income in each grouping.

(v) A elects to apply section 962 and chooses to claim credits under section 901 for the 2019 taxable year.

(2) *Analysis with respect to section 962 taxable income—*(i) Section 962(a)(1) and §1.962-1(a)(1) provide that when an individual United States shareholder elects to apply section 962 for a taxable year, the U.S. tax imposed with respect to amounts that the individual includes under section 951(a) (the “section 951(a) inclusions”) equals the tax that would be imposed under section 11 if the amounts were included by a domestic corporation under section 951(a). For purposes of section 962, an amount included under section 951A is treated as an inclusion under section 951(a). See section 951A(f)(1)(A). Therefore, A has total section 951(a) inclusions of \$5,000,000: a \$2,000,000 passive category subpart F inclusion and a \$3,000,000 GILTI inclusion amount. A is taxed at the corporate rates under section 11 with respect to these inclusions.

(ii) Section 962(a)(2), §1.962-1(a)(2), and §1.962-1(b)(2) provide that sections 960(a) and 960(d) apply to the section 951(a) inclusions of an electing individual United States shareholder as though the inclusions were received by a domestic corporation, and the electing individual United States shareholder is allowed a credit against the U.S. tax imposed with respect to the section 951(a) inclusions.

(iii) Section 960(a) deems a domestic corporation that is a United States shareholder of a controlled foreign corporation to pay the foreign income taxes paid or accrued by the foreign corporation that are properly attributable to the foreign corporation’s items of income included in the domestic corporation’s income under section 951(a). The foreign income taxes of a CFC that are properly attributable to such items are the domestic corporation’s proportionate share of the taxes that are allocated and apportioned to the relevant subpart F income group. See §1.960-1(c) and §1.960-2(b). A owns 100 percent of CFC, and includes all of its subpart F income, which is in a single subpart F income group. Therefore, all of the \$400,000 of foreign income taxes that are allocable to CFC’s subpart F income are properly attributable to the section 951(a) inclusion of A, and A is deemed to pay these taxes.

(iv) Section 960(d) provides that a domestic corporation that has an inclusion in income under section 951A is deemed to pay an amount of foreign income taxes equal to 80 percent of the product of the domestic corporation’s inclusion percentage multiplied by the sum of all tested foreign income taxes. Tested foreign income taxes are the foreign income taxes of a controlled foreign corporation that are properly attributable to its tested income that the domestic corporation takes into account under section 951A. The foreign income taxes that are properly attributable to the tested income taken into account by a domestic

corporation are the domestic corporation's proportionate share of the controlled foreign corporation's foreign income taxes that are allocated and apportioned to the relevant tested income. See §1.960-1(c) and §1.960-2(c). Because A owns 100% of CFC and takes all \$3,000,000 of CFC's tested income into account in computing A's GILTI inclusion amount, all \$600,000 of the foreign income taxes that are allocated and apportioned to the general category tested income group of CFC are tested foreign income taxes. A has an inclusion percentage of 100 percent because A's GILTI inclusion amount equals all of A's share of the tested income of CFC. A is therefore deemed to pay under section 960(d) 80 percent of the \$600,000 of tested foreign income taxes of CFC, or \$480,000 of the tested foreign income taxes.

(v) Section 1.962-1(b)(1)(A) provides that, for purposes of computing taxable income under section 962, gross income includes amounts that would be included under section 78 if the shareholder with the section 951(a) inclusions were a domestic corporation. Section 78 requires a domestic corporation to include in its gross income the foreign income taxes that it is deemed to pay under section 960, computed without regard to the 80 percent limitation under section 960(d), and to which the benefits of section 901 apply. See section 78. A therefore includes in gross income the \$600,000 of foreign income taxes that A is deemed to pay under section 960(d), computed without regard to the 80 percent limitation, and the \$400,000 of taxes that A is deemed to pay under section 960(a).

(vi) Section 1.962-1(b)(1)(B)(3) provides that, for purposes of computing taxable income under section 962, gross income is reduced only by specified deductions, which include the deduction allowed to a domestic corporation under section 250 and §1.250(a)-1 equal to 50 percent of the sum of the GILTI inclusion amount and the inclusion under section 78 with respect to the GILTI inclusion amount. See section 250(a). A is therefore allowed a deduction under section 250 equal to 50 percent of \$3,600,000 (the \$3,000,000 GILTI inclusion amount plus the \$600,000 inclusion under section 78), or \$1,800,000.

(vii) A's taxable income and pre-credit U.S. tax liability with respect to the section 951(a) inclusions are computed as follows:

Table 1 to Paragraph (c)(2)(vii)

Section 951(a) inclusions with respect to CFC	\$5,000,000
Section 78 inclusions	\$1,000,000
Deduction under section 250.....	(\$1,800,000)
Taxable income under section 962	\$4,200,000
Pre-credit U.S. tax (0.21 x \$4,200,000)	\$882,000

(viii) Section 962 and §1.962-1(b)(2) provide that, in computing the section 904 limitation on the credit for foreign income taxes that an electing individual United States shareholder is deemed to pay under sections 960(a) and (d), the individual's taxable income for a taxable year is considered to consist only of section 951(a) inclusions and the deductions allowed under section 962. Section 904 limits the credit that a taxpayer may claim for the taxes that it pays or accrues, or is deemed to pay, to the amount of its U.S. tax that is attributable to the taxpayer's

foreign source income, and applies this limitation separately with respect to each separate category of income. The limitation amount is computed by multiplying the taxpayer's total pre-credit U.S. tax by the ratio of the taxpayer's foreign source taxable income in a separate category for the taxable year to the taxpayer's total taxable income for the taxable year. See section 904(a) and §1.904-1(a).

(ix) A must compute the limitation on the credit for the foreign income taxes deemed paid under section 960(d) separately with respect to A's tax-

able income in the separate category described in section 904(d)(1)(A) (the "GILTI category"), namely, taxable income attributable to the GILTI inclusion amount. The limitation is computed using only A's 2019 taxable income under section 962 and the pre-credit U.S. tax of \$882,000 on this income. A therefore computes the limitation by multiplying \$882,000 by the ratio of A's foreign source GILTI category taxable income under section 962 to A's total taxable income under section 962, as follows:

Table 2 to Paragraph (c)(2)(ix)

GILTI inclusion amount.....	\$3,000,000
Section 78 inclusion.....	\$600,000
Section 250 deduction.....	(\$1,800,000)
Total GILTI category taxable income under section 962.....	\$1,800,000
Ratio of GILTI category taxable income to total taxable income under section 962 (\$1,800,000 / \$4,200,000).....	42.86%
Limitation amount (pre-credit U.S. tax of \$882,000 x (\$1,800,000 / \$4,200,000)).....	\$378,000

(x) A also must compute the limitation on the credit for the foreign income taxes deemed paid under section 960(a) separately with respect to the foreign source passive category taxable income under

section 962, namely, A's taxable income attributable to the subpart F inclusion. A computes the limitation by multiplying A's pre-credit U.S. tax of \$882,000 by the ratio of A's foreign source passive category

taxable income under section 962 to A's total taxable income under section 962, as follows:

Table 3 to Paragraph (c)(2)(x)

Subpart F inclusion.....	\$2,000,000
Section 78 inclusion.....	\$400,000
Total foreign source passive category taxable income.....	\$2,400,000
Ratio of foreign source passive category taxable income to total taxable income under section 962 (\$2,400,000 / \$4,200,000).....	57.14%
Limitation amount (pre-credit U.S. tax of \$882,000 x (\$2,400,000 / \$4,200,000)).....	\$504,000

(xi) A may claim a foreign tax credit for \$378,000 of the \$480,000 of foreign income taxes deemed paid under section 960(d), and a foreign tax credit for all \$400,000 of the foreign income taxes deemed paid

under section 960(a), for a total foreign tax credit of \$778,000. The U.S. tax on A's 2019 taxable income with respect to CFC under section 962 is reduced from \$882,000 to \$104,000 (\$882,000 minus \$778,000).

(3) *Analysis with respect to other income*—(i) A's taxable income and pre-credit U.S. tax liability with respect to A's other income is computed as follows:

Table 4 to Paragraph (c)(3)(i)

Gross income.....	\$4,000,000
Deductions.....	\$1,000,000
Taxable Income.....	\$3,000,000
Pre-credit U.S. tax computed under section 1(j).....	\$1,074,988

(ii) A must compute a separate limitation on the credit for the foreign withholding taxes paid with respect to A's other foreign source passive category taxable income. Under §1.962-1(b)(2)(iv)(B), A's section 904 limitation on this income is computed on the basis of A's taxable income other than the amounts taken into account under §1.962-1(b)

(1)(i). Accordingly, \$250,000 of A's deductions ($\$1,000,000 \times \$1,000,000 / \$4,000,000$) are apportioned to A's \$1,000,000 of other foreign source passive category gross income, and \$750,000 of deductions ($\$1,000,000 \times \$3,000,000 / \$4,000,000$) are apportioned to A's \$3,000,000 of U.S. source gross income, resulting in \$750,000 of other for-

ign source passive category taxable income and \$2,250,000 of U.S. source taxable income. A computes the limitation by multiplying A's pre-credit U.S. tax on A's other income of \$1,074,988 by the ratio of A's other foreign source passive category taxable income to A's other total taxable income, as follows:

Table 5 to Paragraph (c)(3)(ii)

Total other foreign source passive category taxable income.....	\$750,000
Ratio of other foreign source passive category taxable income to total other taxable income ($\$750,000 / \$3,000,000$).....	25%
Limitation amount (pre-credit U.S. tax of \$1,074,988 x ($\$750,000 / \$3,000,000$)).....	\$268,747

(iii) A may claim a foreign tax credit under section 901 for all \$100,000 of the foreign withholding taxes on the other passive income. The U.S. tax on A's \$3,000,000 of other taxable income is reduced from \$1,074,988 to \$974,988 (\$1,074,988 minus \$100,000).

(d) *Applicability dates*. Except as otherwise provided in this paragraph (d), paragraph (b)(1)(i) of this section applies beginning the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, for the taxable year in which or with which such taxable year of the foreign corporation ends. Paragraphs (b)(1)(i)(A)(2) and (b)(1)(i)(B)(3) of this section apply to taxable years of a foreign corporation that end on or after March 4, 2019, and with respect to a United States person, for the taxable year in which or with which such taxable year of the foreign corporation ends. Paragraphs (a)(2), (b)(1)(ii), (b)(2)(i) through (iii), and (c) of this section apply to taxable years of a foreign corporation that end on or after July 15, 2020, and with respect to a United States person, for the taxable year in which or with which such taxable year of the foreign corporation ends. For taxable years that precede the applicability dates described in the preceding two sentences, taxpayers may choose to apply the provisions of paragraphs (a)(2), (b)(1)(i)

(A)(2), (b)(1)(i)(B)(3), (b)(1)(ii), (b)(2)(i) through (iii), and (c) of this section for taxable years of a foreign corporation beginning on or after January 1, 2018, and with respect to a United States person, for the taxable year in which or with which such taxable year of the foreign corporation ends.

Par. 5. Section 1.1502-12 is amended by adding paragraph (t) to read as follows:

§1.1502-12 Separate taxable income.

* * * * *

(t) See §1.1502-50 for rules relating to the computation of a member's deduction under section 250.

* * * * *

Par. 6. Section 1.1502-13 is amended by:

1. In paragraph (a)(6)(ii), under the heading "Matching rule. (§1.1502-13(c)(7)(ii))", designating *Examples 1* through 17 as entries (A) through (Q).

2. In paragraph (a)(6)(ii), under the heading "Matching rule. (§1.1502-13(c)(7)(ii))", adding entry (R).

3. In paragraph (c)(7)(ii), *Examples 1* through 17 are designated as paragraphs (c)(7)(ii)(A) through (Q), respectively.

4. Redesignating newly designated paragraphs (c)(7)(ii)(A)(a) through (i) as paragraphs (c)(7)(ii)(A)(1) through (9).

5. Redesignating newly designated paragraphs (c)(7)(ii)(B)(a) and (b) as paragraphs (c)(7)(ii)(B)(1) and (2).

6. Redesignating newly designated paragraphs (c)(7)(ii)(C)(a) through (d) as paragraphs (c)(7)(ii)(C)(1) through (4).

7. Redesignating newly designated paragraphs (c)(7)(ii)(D)(a) through (e) as paragraphs (c)(7)(ii)(D)(1) through (5).

8. Redesignating newly designated paragraphs (c)(7)(ii)(E)(a) through (f) as paragraphs (c)(7)(ii)(E)(1) through (6).

9. Redesignating newly designated paragraphs (c)(7)(ii)(F)(a) through (d) as paragraphs (c)(7)(ii)(F)(1) through (4).

10. Redesignating newly designated paragraphs (c)(7)(ii)(G)(a) through (d) as paragraphs (c)(7)(ii)(G)(1) through (4).

11. Redesignating newly designated paragraphs (c)(7)(ii)(I)(a) through (e) as paragraphs (c)(7)(ii)(I)(1) through (5).

12. Redesignating newly designated paragraphs (c)(7)(ii)(J)(a) through (d) as paragraphs (c)(7)(ii)(J)(1) through (4).

13. Redesignating newly designated paragraphs (c)(7)(ii)(K)(a) through (d) as paragraphs (c)(7)(ii)(K)(1) through (4).

14. Redesignating newly designated paragraphs (c)(7)(ii)(L)(a) and (b) as paragraphs (c)(7)(ii)(L)(1) and (2).

15. Redesignating newly designated paragraphs (c)(7)(ii)(N)(a) through (c) as paragraphs (c)(7)(ii)(N)(1) through (3).
16. Redesignating newly designated paragraphs (c)(7)(ii)(O)(a) through (d) as paragraphs (c)(7)(ii)(O)(1) through (4).
17. Redesignating newly designated paragraphs (c)(7)(ii)(P)(a) and (b) as paragraphs (c)(7)(ii)(P)(1) and (2).
18. Redesignating newly designated paragraphs (c)(7)(ii)(Q)(a) through (c) as paragraphs (c)(7)(Q)(ii)(1) through (3).
19. In the table in this paragraph, for each newly redesignated paragraph listed in the “Paragraph” column, remove the text indicated in the “Remove” column and add in its place the text indicated in the “Add” column:

Paragraph	Remove	Add
(c)(7)(ii)(A)(5)	paragraph (a) of this <i>Example 1</i>	<i>Example 1</i> in paragraph (c)(7)(ii)(A)(1) of this section
(c)(7)(ii)(A)(5)	paragraphs (c) and (d) of this <i>Example 1</i>	<i>Example 1</i> in paragraphs (c)(7)(ii)(A)(3) and (4) of this section
(c)(7)(ii)(A)(6)	paragraph (a) of this <i>Example 1</i>	<i>Example 1</i> in paragraph (c)(7)(ii)(A)(1) of this section
(c)(7)(ii)(A)(7)	paragraph (a) of this <i>Example 1</i>	<i>Example 1</i> in paragraph (c)(7)(ii)(A)(1) of this section
(c)(7)(ii)(A)(8)	paragraph (a) of this <i>Example 1</i>	<i>Example 1</i> in paragraph (c)(7)(ii)(A)(1) of this section
(c)(7)(ii)(A)(9)	paragraph (a) of this <i>Example 1</i>	<i>Example 1</i> in paragraph (c)(7)(ii)(A)(1) of this section
(c)(7)(ii)(C)(3)	paragraph (a) of this <i>Example 3</i>	<i>Example 3</i> in paragraph (c)(7)(ii)(C)(1) of this section
(c)(7)(ii)(C)(4)	paragraph (c) of this <i>Example 3</i>	<i>Example 3</i> in paragraph (c)(7)(ii)(C)(3) of this section
(c)(7)(ii)(C)(4)	paragraph (b) of this <i>Example 3</i>	<i>Example 3</i> in paragraph (c)(7)(ii)(C)(2) of this section
(c)(7)(ii)(D)(5)	paragraph (a) of this <i>Example 4</i>	<i>Example 4</i> in paragraph (c)(7)(ii)(D)(1) of this section
(c)(7)(ii)(D)(5)	paragraphs (c) and (d) of this <i>Example 4</i>	<i>Example 4</i> in paragraphs (c)(7)(ii)(D)(3) and (4) of this section
(c)(7)(ii)(E)(3)	paragraph (a) of this <i>Example 5</i>	<i>Example 5</i> in paragraph (c)(7)(ii)(E)(1) of this section
(c)(7)(ii)(E)(4)	paragraph (a) of this <i>Example 5</i>	<i>Example 5</i> in paragraph (c)(7)(ii)(E)(1) of this section
(c)(7)(ii)(E)(5)	paragraph (a) of this <i>Example 5</i>	<i>Example 5</i> in paragraph (c)(7)(ii)(E)(1) of this section
(c)(7)(ii)(E)(6)	paragraph (a) of this <i>Example 5</i>	<i>Example 5</i> in paragraph (c)(7)(ii)(E)(1) of this section
(c)(7)(ii)(F)(3)	paragraph (a) of this <i>Example 6</i>	<i>Example 6</i> in paragraph (c)(7)(ii)(F)(1) of this section
(c)(7)(ii)(F)(4)	paragraph (a) of this <i>Example 6</i>	<i>Example 6</i> in paragraph (c)(7)(ii)(F)(1) of this section
(c)(7)(ii)(G)(4)	paragraph (a) of this <i>Example 7</i>	<i>Example 7</i> in paragraph (c)(7)(ii)(G)(1) of this section
(c)(7)(ii)(G)(4)	paragraph (c) of this <i>Example 7</i>	<i>Example 7</i> in paragraph (c)(7)(ii)(G)(3) of this section
(c)(7)(ii)(I)(3)	paragraph (a) of this <i>Example 9</i>	<i>Example 9</i> in paragraph (c)(7)(ii)(I)(1) of this section
(c)(7)(ii)(I)(4)	paragraph (a) of this <i>Example 9</i>	<i>Example 9</i> in paragraph (c)(7)(ii)(I)(1) of this section
(c)(7)(ii)(I)(5)	paragraph (d) of this <i>Example 9</i>	<i>Example 9</i> in paragraph (c)(7)(ii)(I)(4) of this section
(c)(7)(ii)(J)(3)	paragraph (a) of this <i>Example 10</i>	<i>Example 10</i> in paragraph (c)(7)(ii)(J)(1) of this section
(c)(7)(ii)(J)(4)	paragraph (a) of this <i>Example 10</i>	<i>Example 10</i> in paragraph (c)(7)(ii)(J)(1) of this section
(c)(7)(ii)(K)(4)	paragraph (a) of this <i>Example 11</i>	<i>Example 11</i> in paragraph (c)(7)(ii)(K)(1) of this section
(c)(7)(ii)(N)(2)	paragraph (a) of this <i>Example 14</i>	<i>Example 14</i> in paragraph (c)(7)(ii)(N)(1) of this section
(c)(7)(ii)(O)(4)	paragraph (a) of this <i>Example 15</i>	<i>Example 15</i> in paragraph (c)(7)(ii)(O)(1) of this section
(c)(7)(ii)(Q)(1)	<i>Example 16</i>	<i>Example 16</i> in paragraph (c)(7)(ii)(P) of this section
(c)(7)(ii)(Q)(2)	paragraph (f)(7), <i>Example 2</i> of this section	<i>Example 2</i> in paragraph (f)(7) of this section
(c)(7)(iii)(A)	Paragraphs (c)(6)(ii)(C), (c)(6)(ii)(D), and (c)(7)(ii), <i>Examples 16</i> and <i>17</i> of this section	Paragraphs (c)(6)(ii)(C) and (D) of this section, <i>Example 16</i> in paragraph (c)(7)(ii)(P) of this section, and <i>Example 17</i> in paragraph (c)(7)(ii)(Q) of this section

20. Adding paragraph (c)(7)(ii)(R).
The additions read as follows:

§1.1502-13 Intercompany transactions.
(a) * * *

(6) * * *
(ii) * * *
Matching rule. (§1.1502-13(c)(7)(ii))
* * * * *

(R) Example 18. Redetermination of attributes for section 250 purposes.

* * * * *
(c) * * *
(7) * * *

(ii) * * *

(R) *Example 18: Redetermination of attributes for section 250 purposes—(1) Facts.* S manufactures equipment in the United States and recognizes \$75 of gross income included in gross DEI (as defined in §1.250(b)-1(c)(15)) on the sale of Asset, which is not depreciable property, to B in Year 1 for \$100. In Year 2, B sells Asset to X for \$125 and recognizes \$25 of gross income. The sale is a FDDEI sale (as defined in §1.250(b)-1(c)(8)), and thus the \$25 of income is included in B's gross FDDEI (as defined in §1.250(b)-1(c)(16)) for Year 2.

(2) *Timing and attributes.* S's \$75 of intercompany income is taken into account in Year 2 under the matching rule to reflect the \$75 difference between B's \$25 corresponding item taken into account (based on B's \$100 cost basis in Asset) and the recomputed corresponding item (based on the \$25 basis that B would have if S and B were divisions of a single corporation and B's basis were determined by reference to S's basis). In determining whether S's gross income included in gross DEI from the sale of Asset is included in gross FDDEI, S and B are treated as divisions of a single corporation. See paragraph (a)(6) of this section. In determining the amount of income included in gross DEI that is included in gross FDDEI, the attributes of S's intercompany item and B's corresponding item may be redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. See paragraph (c)(1)(i) of this section. Applying section 250 and §1.1502-50 on a single entity basis, all \$100 of income included in gross DEI would be gross FDDEI. On a separate entity basis, S would have \$75 of gross income included in gross DEI that is included in gross RDEI (as defined in §1.250(b)-1(c)(14)) and B would have \$25 of gross income included in gross DEI that is included in gross FDDEI. Thus, on a separate entity basis, S and B would have, in the aggregate, \$100 of gross income included in gross DEI, of which only \$25 is included gross FDDEI. Accordingly, under single entity treatment, \$75 that would be treated as gross income included in gross DEI that is included in gross RDEI on a separate entity basis is redetermined to be included in gross FDDEI.

(3) *Intercompany sale for loss.* The facts are the same as in paragraph (c)(7)(ii)(R)(1) of this section (the facts in *Example 18*), except that S recognizes \$25 of loss on the sale of Asset. S's \$25 of intercompany loss is taken into account under the matching rule to reflect the \$25 difference between B's \$25 corresponding item taken into account (based on B's \$100 cost basis in Asset) and the recomputed corresponding item (based on the \$125 basis that B would have if S and B were divisions of a single corporation and B's basis were determined by reference to S's \$125 of costs). Applying section 250 and §1.1502-50 on a single entity basis, \$0 of income would be included in gross DEI. In order to reflect this result, under the matching rule, S's \$25 loss is allocated and apportioned solely to B's \$25 of gross income from the sale of Asset for purposes of determining B's DEI and FDDEI. Furthermore, B's \$25 of gross income is not taken into account for purposes of apportioning any other deductions under section 861 and the regulations under that

section for purposes of determining any member's DEI or FDDEI.

* * * *

Par. 7. Section 1.1502-50 is added to read as follows:

§1.1502-50 Consolidated section 250.

(a) *In general—(1) Scope.* This section provides rules for applying section 250 and §§1.250-1 through 1.250(b)-6 (the *section 250 regulations*) to a member of a consolidated group (*member*). Paragraph (b) of this section provides rules for the determination of the amount of the deduction allowed to a member under section 250(a)(1). Paragraph (c) of this section provides rules governing the impact of intercompany transactions on the determination of a member's qualified business asset investment (QBAI) and the effect of intercompany transactions on the determination of a member's foreign-derived deduction eligible income (FDDEI). Paragraph (d) of this section provides rules governing basis adjustments to member stock resulting from the application of paragraph (b)(1) of this section. Paragraph (e) of this section provides definitions. Paragraph (f) of this section provides examples illustrating the rules of this section. Paragraph (g) of this section provides an applicability date.

(2) *Overview.* The rules of this section ensure that the aggregate amount of deductions allowed under section 250 to members appropriately reflects the income, expenses, gains, losses, and property of all members. Paragraph (b) of this section allocates the consolidated group's overall deduction amount under section 250 to each member on the basis of its contribution to the consolidated foreign-derived deduction eligible income (consolidated FDDEI) and consolidated global intangible low-taxed income (consolidated GILTI). The definitions in paragraph (e) of this section provide for the aggregation of the deduction eligible income (DEI), FDDEI, deemed tangible income return, and global intangible low-taxed income (GILTI) of all members in order to calculate the consolidated group's overall deduction amount under section 250.

(b) *Allowance of deduction—(1) In general.* A member is allowed a deduction

for a consolidated return year under section 250. See §1.250(a)-1(b). The amount of the deduction is equal to the sum of—

(i) The product of the consolidated FDII deduction amount and the member's FDII deduction allocation ratio; and

(ii) The product of the consolidated GILTI deduction amount and the member's GILTI deduction allocation ratio.

(2) *Consolidated taxable income limitation.* For purposes of applying the limitation described in §1.250(a)-1(b)(2) to the determination of the consolidated FDII deduction amount and the consolidated GILTI deduction amount of a consolidated group for a consolidated return year—

(i) The consolidated foreign-derived intangible income (consolidated FDII) (if any) is reduced (but not below zero) by an amount which bears the same ratio to the consolidated section 250(a)(2) amount that such consolidated FDII bears to the sum of the consolidated FDII and the consolidated GILTI; and

(ii) The consolidated GILTI (if any) is reduced (but not below zero) by the excess of the consolidated section 250(a)(2) amount over the reduction described in paragraph (b)(2)(i) of this section.

(c) *Impact of intercompany transactions—(1) Impact on qualified business asset investment determination—(i) In general.* For purposes of determining a member's QBAI, the basis of specified tangible property does not include an amount equal to any gain or loss recognized with respect to such property by another member in an intercompany transaction (as defined in §1.1502-13(b)(1)) until the time that such gain or loss is no longer deferred under §1.1502-13. Thus, for example, if a selling member owns specified tangible property with an adjusted basis (within the meaning of section 1011) of \$60x and an adjusted basis (for purposes of calculating QBAI) of \$80x, and sells it for \$50x to the purchasing member (and the intercompany loss remains deferred), the basis of such property for purposes of computing the purchasing member's QBAI is \$80x.

(ii) *Partner-specific QBAI basis.* A member's partner-specific QBAI basis (as defined in §1.250(b)-2(g)(7)) includes a basis adjustment under section 743(b) resulting from an intercompany transaction

only at the time, and to the extent, gain or loss, if any, is recognized in the transaction and no longer deferred under §1.1502-13.

(2) *Impact on foreign-derived deduction eligible income characterization.* For purposes of redetermining attributes of members from an intercompany transaction as FDDEI, see §1.1502-13(c)(1)(i) and (c)(7)(ii)(R) (Example 18).

(d) *Adjustments to the basis of a member.* For adjustments to the basis of a member related to paragraph (b)(1) of this section, see §1.1502-32(b)(3)(ii)(B).

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

(1) *Consolidated deduction eligible income (consolidated DEI).* With respect to a consolidated group for a consolidated return year, the term *consolidated deduction eligible income* or *consolidated DEI* means the greater of the sum of the DEI (whether positive or negative) of all members or zero.

(2) *Consolidated deemed intangible income.* With respect to a consolidated group for a consolidated return year, the term *consolidated deemed intangible income* means the excess (if any) of the consolidated DEI, over the consolidated deemed tangible income return.

(3) *Consolidated deemed tangible income return.* With respect to a consolidated group for a consolidated return year, the term *consolidated deemed tangible income return* means the sum of the deemed tangible income return of all members.

(4) *Consolidated FDII deduction amount.* With respect to a consolidated group for a consolidated return year, the term *consolidated FDII deduction amount* means the product of the FDII deduction rate and the consolidated FDII, as adjusted by paragraph (b)(2) of this section.

(5) *Consolidated foreign-derived deduction eligible income (consolidated FDDEI).* With respect to a consolidated group for a consolidated return year, the term *consolidated foreign-derived deduction eligible income* or *consolidated FDDEI* means the greater of the sum of the FDDEI (whether positive or negative) of all members or zero.

(6) *Consolidated foreign-derived intangible income (consolidated FDII).* With respect to a consolidated group for a consolidated return year, the term *consolidated foreign-derived intangible income*

or *consolidated FDII* means the product of the consolidated deemed intangible income and the consolidated foreign-derived ratio.

(7) *Consolidated foreign-derived ratio.* With respect to a consolidated group for a consolidated return year, the term *consolidated foreign-derived ratio* means the ratio (not to exceed one) of—

- (i) The consolidated FDDEI; to
- (ii) The consolidated DEI.

(8) *Consolidated GILTI deduction amount.* With respect to a consolidated group for a consolidated return year, the term *consolidated GILTI deduction amount* means the product of the GILTI deduction rate and the sum of the consolidated GILTI, as adjusted by paragraph (b)(2) of this section, and the amounts treated as dividends received by the members under section 78 which are attributable to their GILTI for the consolidated return year.

(9) *Consolidated global intangible low-taxed income (consolidated GILTI).* With respect to a consolidated group for a consolidated return year, the term *consolidated global intangible low-taxed income* or *consolidated GILTI* means the sum of the GILTI of all members.

(10) *Consolidated section 250(a)(2) amount.* With respect to a consolidated group for a consolidated return year, the term *consolidated section 250(a)(2) amount* means the excess (if any) of the sum of the consolidated FDII and the consolidated GILTI (determined without regard to section 250(a)(2) and paragraph (b)(2) of this section), over the consolidated taxable income of the consolidated group (within the meaning of §1.1502-11).

(11) *Deduction eligible income (DEI).* With respect to a member for a consolidated return year, the term *deduction eligible income* or *DEI* means the member's gross DEI for the year (within the meaning of §1.250(b)-1(c)(15)) reduced (including below zero) by the deductions properly allocable to gross DEI for the year (as determined under §1.250(b)-1(d)(2)).

(12) *Deemed tangible income return.* With respect to a member for a consolidated return year, the term *deemed tangible income return* means an amount equal to 10 percent of the member's QBAI, as

adjusted by paragraph (c)(1) of this section.

(13) *FDII deduction allocation ratio.* With respect to a member for a consolidated return year, the term *FDII deduction allocation ratio* means the ratio of—

- (i) The member's positive FDDEI (if any); to
- (ii) The sum of the positive FDDEI of all members.

(14) *FDII deduction rate.* The term *FDII deduction rate* means 37.5 percent for consolidated return years beginning before January 1, 2026, and 21.875 percent for consolidated return years beginning after December 31, 2025.

(15) *Foreign-derived deduction eligible income (FDDEI).* With respect to a member for a consolidated return year, the term *foreign-derived deduction eligible income* or *FDDEI* means the member's gross FDDEI for the year (within the meaning of §1.250(b)-1(c)(16)) reduced (including below zero) by the deductions properly allocable to gross FDDEI for the year (as determined under §1.250(b)-1(d)(2)).

(16) *GILTI deduction allocation ratio.* With respect to a member for a consolidated return year, the term *GILTI deduction allocation ratio* means the ratio of—

- (i) The sum of the member's GILTI and the amount treated as a dividend received by the member under section 78 which is attributable to its GILTI for the consolidated return year; to

(ii) The sum of consolidated GILTI and the amounts treated as dividends received by the members under section 78 which are attributable to their GILTI for the consolidated return year.

(17) *GILTI deduction rate.* The term *GILTI deduction rate* means 50 percent for consolidated return years beginning before January 1, 2026, and 37.5 percent for consolidated return years beginning after December 31, 2025.

(18) *Global intangible low-taxed income (GILTI).* With respect to a member for a consolidated return year, the term *global intangible low-taxed income* or *GILTI* means the sum of the member's GILTI inclusion amount under §1.1502-51(b) and the member's distributive share of any domestic partnership's GILTI inclusion amount under §1.951A-5(b)(2).

(19) *Qualified business asset investment (QBAI)*. The term *qualified business asset investment* or *QBAI* has the meaning provided in §1.250(b)-2(b).

(20) *Specified tangible property*. The term *specified tangible property* has the meaning provided in §1.250(b)-2(c)(1).

(f) *Examples*. The following examples illustrate the rules of this section.

(1) *Example 1: Calculation of deduction attributable to FDII—(i) Facts*. P is the common parent of the P group and owns all of the only class of stock of subsidiaries USS1 and USS2. The consolidated return year of all persons is the calendar year. In 2018, P has DEI of \$400x, FDDEI of \$0, and QBAI of \$0; USS1 has DEI of \$200x, FDDEI of \$200x, and QBAI of \$600x; and USS2 has DEI of -\$100x, FDDEI of \$100x, and QBAI of \$400x. The P group has consolidated taxable income that is sufficient to make inapplicable the limitation in paragraph (b)(2) of this section. No member of the P group has GILTI.

(ii) *Analysis—(A) Consolidated DEI*. Under paragraph (e)(1) of this section, the P group's consolidated DEI is \$500x, the greater of the sum of the DEI (whether positive or negative) of all members (\$400x + \$200x - \$100x) or zero.

(B) *Consolidated FDDEI*. Under paragraph (e)(5) of this section, the P group's consolidated FDDEI is \$300x, the greater of the sum of the FDDEI (whether positive or negative) of all members (\$0 + \$200x + \$100x) or zero.

(C) *Consolidated deemed tangible income return*. Under paragraph (e)(12) of this section, a member's deemed tangible income return is 10 percent of its QBAI. Therefore, P's deemed tangible income return is \$0 (0.10 x \$0), USS1's deemed tangible income return is \$60x (0.10 x \$600x), and USS2's deemed tangible income return is \$40x (0.10 x \$400x). Under paragraph (e)(3) of this section, the P group's consolidated deemed tangible income return is \$100x, the sum of the deemed tangible income return of all members (\$0 + \$60x + \$40x).

(D) *Consolidated deemed intangible income*. Under paragraph (e)(2) of this section, the P group's consolidated deemed intangible income is \$400x, the excess of its consolidated DEI over its consolidated deemed tangible income return (\$500x - \$100x).

(E) *Consolidated FDII*. Under paragraph (e)(7) of this section, the P group's consolidated foreign-derived ratio is 0.60, the ratio of its consolidated FDDEI to its consolidated DEI (\$300x / \$500x). Under paragraph (e)(6) of this section, the P group's consolidated FDII is \$240x, the product of its consolidated deemed intangible income and its consolidated foreign-derived ratio (\$400x x 0.60).

(F) *Consolidated FDII deduction amount*. Under paragraph (e)(4) of this section, the P group's consolidated FDII deduction amount is \$90x, the product of the FDII deduction rate and the consolidated FDII (0.375 x \$240x).

(G) *Member's deduction attributable to consolidated FDII deduction amount*. Under paragraph (b)(1) of this section, a member is allowed a deduction equal, in part, to the product of the consolidated FDII deduction amount of the consolidated group to which the member belongs and the member's FDII deduc-

tion allocation ratio. Under paragraph (e)(13) of this section, a member's FDII deduction allocation ratio is the ratio of its positive FDDEI to the sum of each member's positive FDDEI for such consolidated return year. As a result, the FDII deduction allocation ratios of P, USS1, and USS2 are 0 (\$0 / \$300x), 2/3 (\$200x / \$300x), and 1/3 (\$100x / \$300x), respectively. Therefore, P, USS1, and USS2 are permitted deductions under paragraph (b)(1) of this section in the amount of \$0 (0 x \$90x), \$60x (2/3 x \$90x), and \$30x (1/3 x \$90x), respectively.

(2) *Example 2: Limitation on consolidated foreign-derived deduction eligible income—(i) Facts*. The facts are the same as in paragraph (f)(1)(i) of this section (the facts in *Example 1*), except that P's FDDEI is \$300x.

(ii) *Analysis—(A) Consolidated DEI and consolidated deemed tangible income return*. As in paragraphs (f)(1)(ii)(A) and (C) of this section (the analysis in *Example 1*), the P group's consolidated DEI is \$500x and the P group's consolidated deemed tangible income return is \$100x.

(B) *Consolidated FDDEI*. Under paragraph (e)(5) of this section, the P group's consolidated FDDEI is \$600x, the greater of the sum of the FDDEI (whether positive or negative) of all members (\$300x + \$200x + \$100x) or zero.

(C) *Consolidated deemed intangible income and consolidated FDII*. Under paragraph (e)(2) of this section, the P group's consolidated deemed intangible income is \$400x (\$500x - \$100x). Under paragraph (e)(7) of this section, the P group's consolidated foreign-derived ratio is 1.00 (\$600x / \$500x, but not in excess of one). Under paragraph (e)(6) of this section, the P group's consolidated FDII is \$400x (\$400x x 1.00).

(D) *Consolidated FDII deduction amount and member's deduction attributable to consolidated FDII deduction amount*. Under paragraph (e)(4) of this section, the P group's consolidated FDII deduction amount is \$150x (0.375 x \$400x). Under paragraph (e)(13) of this section, the FDII deduction allocation ratios of P, USS1, and USS2 are 1/2 (\$300 / \$600x), 1/3 (\$200x / \$600x), and 1/6 (\$100x / \$600x), respectively. Therefore, P, USS1, and USS2 are permitted deductions under paragraph (b)(1) of this section in the amounts of \$75x (1/2 x \$150x), \$50x (1/3 x \$150x), and \$25x (1/6 x \$150x), respectively.

(3) *Example 3: Member with negative FDDEI—(i) Facts*. The facts are the same as in paragraph (f)(1)(i) of this section (the facts in *Example 1*), except that P's FDDEI is -\$100x.

(ii) *Analysis—(A) Consolidated DEI and consolidated deemed tangible income return*. As in paragraphs (f)(1)(ii)(A) and (C) of this section (the facts in *Example 1*), the P group's consolidated DEI is \$500x and the P group's consolidated deemed tangible income return is \$100x.

(B) *Consolidated FDDEI*. Under paragraph (e)(5) of this section, the P group's consolidated FDDEI is \$200x, the greater of the sum of the FDDEI (whether positive or negative) of all members (-\$100x + \$200x + \$100x) or zero.

(C) *Consolidated deemed intangible income and consolidated FDII*. Under paragraphs (e)(2) and (6) of this section, the P group's consolidated deemed intangible income is \$400x (\$500x - \$100x), and

the P group's consolidated FDII is \$160x (\$400x x (\$200x / \$500x)).

(D) *Consolidated FDII deduction amount and member's deduction attributable to consolidated FDII deduction amount*. Under paragraph (e)(4) of this section, the P group's consolidated FDII deduction amount is \$60x (0.375 x \$160x). Under paragraph (e)(13) of this section, the FDII deduction allocation ratios of P, USS1, and USS2 are 0 (\$0 / \$300x), 2/3 (\$200x / \$300x), and 1/3 (\$100x / \$300x), respectively. Therefore, P, USS1, and USS2 are permitted deductions under paragraph (b)(1) of this section in the amounts of \$0 (0 x \$60x), \$40x (2/3 x \$60x), and \$20x (1/3 x \$60x), respectively.

(4) *Example 4: Calculation of deduction attributable to GILTI—(i) Facts*. The facts are the same as in paragraph (f)(1)(i) of this section (the facts in *Example 1*), except that USS1 owns CFC1 and USS2 owns CFC2. USS1 and USS2 have GILTI of \$65x and \$20x, respectively, and amounts treated as dividends received under section 78 attributable to their GILTI of \$10x and \$5x, respectively.

(ii) *Analysis—(A) Consolidated GILTI*. Under paragraph (e)(9) of this section, the P group's consolidated GILTI is \$85x, the sum of the GILTI of all members (\$0 + \$65x + \$20x).

(B) *Consolidated GILTI deduction amount*. Under paragraph (e)(8) of this section, the P group's consolidated GILTI deduction amount is \$50x, the product of the GILTI deduction rate and the sum of its consolidated GILTI and the amounts treated as dividends received by the members under section 78 which are attributable to their GILTI for the consolidated return year (0.50 x (\$85x + \$10x + \$5x)).

(C) *Member's deduction attributable to consolidated GILTI deduction amount*. Under paragraph (b)(1) of this section, a member is allowed a deduction equal, in part, to the product of the consolidated GILTI deduction amount of the consolidated group to which the member belongs and the member's GILTI deduction allocation ratio. Under paragraph (e)(16) of this section, a member's GILTI deduction allocation ratio is the ratio of the sum of its GILTI and the amount treated as a dividend received by the member under section 78 which is attributable to its GILTI for the consolidated return year to the sum of the consolidated GILTI and the amounts treated as dividends received by the members under section 78 which are attributable to their GILTI for the consolidated return year. As a result, the GILTI deduction allocation ratios of P, USS1, and USS2 are 0 (\$0 / (\$85x + \$10x + \$5x)), 3/4 ((65x + \$10x) / (\$85x + \$10x + \$5x)), and 1/4 ((20x + \$5x) / (\$85x + \$10x + \$5x)), respectively. Therefore, P, USS1, and USS2 are permitted deductions of \$0 (0 x \$50x), \$37.50x (3/4 x \$50x), and \$12.50x (1/4 x \$50x), respectively.

(D) *Member's deduction under section 250*. Under paragraph (b)(1) of this section, a member is allowed a deduction equal to the sum of the member's deduction attributable to the consolidated FDII deduction amount and the member's deduction attributable to the consolidated GILTI deduction amount. As a result P, USS1, and USS2 are entitled to deductions under paragraph (b)(1) of this section of \$0 (\$0 + \$0), \$97.50x (\$60x + \$37.50x), and \$42.50x (\$30x + \$12.50x), respectively.

(5) *Example 5: Taxable income limitation—(i) Facts*. The facts are the same as in paragraph (f)(4)

(i) of this section (the facts in *Example 4*), except that the P group's consolidated taxable income (within the meaning of paragraph (e)(10) of this section) is \$300x.

(ii) *Analysis—(A) Determination of whether the limitation described in paragraph (b)(2) of this section applies.* Under paragraph (b)(2) of this section, in the case of a consolidated group with a consolidated section 250(a)(2) amount for a consolidated year, the amount of the consolidated FDII and the consolidated GILTI otherwise taken into account in the determination of the consolidated FDII deduction amount and the consolidated GILTI deduction amount are subject to reduction. As in paragraph (f)(1)(ii)(E) of this section (the facts in *Example 1*), the P group's consolidated FDII is \$240x. As in paragraph (f)(4)(ii)(A) of this section (the analysis in *Example 4*), the P group's consolidated GILTI is \$85x. The P group's consolidated taxable income is \$300x. Under paragraph (e)(10) of this section, the P group's consolidated section 250(a)(2) amount is \$25x (($\$240x + \$85x$) - \$300x), the excess of the sum of the consolidated FDII and the consolidated GILTI, over the P group's consolidated taxable income. Therefore, the limitation described in paragraph (b)(2) of this section applies.

(B) *Allocation of reduction.* Under paragraph (b)(2)(i) of this section, the P group's consolidated FDII is reduced by an amount which bears the same ratio to the consolidated section 250(a)(2) amount as the consolidated FDII bears to the sum of the consolidated FDII and consolidated GILTI, and the P group's consolidated GILTI is reduced by the excess of the consolidated section 250(a)(2) amount over the reduction described in paragraph (b)(2)(i) of this section. Therefore, for purposes of determining the P group's consolidated FDII deduction amount and consolidated GILTI deduction amount, its consolidated FDII is reduced to \$221.54x ($\$240x - (\$25x \times (\$240x / \$325x))$) and its consolidated GILTI is reduced to \$78.46x ($\$85x - (\$25x - (\$25x \times (\$240x / \$325x)))$).

(C) *Calculation of consolidated FDII deduction amount and consolidated GILTI deduction amount.* Under paragraph (e)(4) of this section, the P group's consolidated FDII deduction amount is \$83.08x ($\$221.54x \times 0.375$). Under paragraph (e)(8) of this section, the P group's consolidated GILTI deduction amount is \$46.73x ($(\$78.46x + 10x + 5x) \times 0.50$).

(D) *Member's deduction attributable to the consolidated FDII deduction amount.* As in paragraph (f)(1)(ii)(G) of this section (the analysis in *Example 1*), the FDII deduction allocation ratios of P, USS1, and USS2 are 0, 2/3, and 1/3, respectively. Therefore, P, USS1, and USS2 are permitted deductions attributable to the consolidated FDII deduction amount of \$0 ($0 \times \$83.08x$), \$55.39x ($2/3 \times \$83.08x$), and \$27.69x ($1/3 \times \$83.08x$), respectively.

(E) *Member's deduction attributable to the consolidated GILTI deduction amount.* As in paragraph (f)(4)(ii)(C) of this section (the analysis in *Example 4*), the GILTI deduction allocation ratios of P, USS1, and USS2 are 0, 3/4, and 1/4, respectively. Therefore, P, USS1, and USS2 are permitted deductions attributable to the consolidated GILTI deduction amount of \$0 ($0 \times \$46.73x$), \$35.05x ($3/4 \times \$46.73x$), and \$11.68x ($1/4 \times \$46.73x$), respectively.

(F) *Member's deduction pursuant section 250.* Under paragraph (b)(1) of this section, a member is

allowed a deduction equal to the sum of the member's deduction attributable to the consolidated FDII deduction amount and the member's deduction attributable to the consolidated GILTI deduction amount. As a result, P, USS1, and USS2 are entitled to deductions under paragraph (b)(1) of this section of \$0 ($\$0 + \0), \$90.44x ($\$55.39x + \$35.05x$), and \$39.37x ($\$27.69x + \$11.68x$), respectively.

(g) *Applicability date.* This section applies to consolidated return years beginning on or after January 1, 2021. A taxpayer that chooses to apply the rules in §§1.250(a)-1 and 1.250(b)-1 through 1.250(b)-6 to taxable years beginning before January 1, 2021, pursuant to §1.250-1(b), must also apply the rules of this section in their entirety to consolidated return years beginning after December 31, 2017, and before January 1, 2021.

Par. 8. Section 1.6038-2 is amended by adding paragraphs (f)(15) and (m)(4) to read as follows:

§1.6038-2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations.

* * * * *

(f) * * *

(15) *Information reporting under section 250.* If the person required to file Form 5471 (or any successor form) claims a deduction under section 250(a) that is determined, in whole or part, by reference to its foreign-derived intangible income, and any amount required to be reported under paragraph (f)(11) of this section is included in its computation of foreign-derived deduction eligible income, such person will provide on Form 5471 (or any successor form) such information that is prescribed by the form, instructions to the form, publication, or other guidance published in the Internal Revenue Bulletin. To the extent that the partnership amounts described in the previous sentence cannot be determined, the controlling ten-percent partner or controlling fifty-percent partner must provide its share of the partnership's gross DEI, gross FDDEI, deductions that are properly allocable to the partnership's gross DEI and gross FDDEI, and partnership QBAI (as those terms are defined in the section 250 regulations) in the form and manner and to the extent prescribed by Form 8865 (or any successor form), instructions to the form, publication, or other guidance published in the Internal Revenue Bulletin. To the extent that the partnership amounts described in the previous sentence cannot be determined, the controlling ten-percent partner or controlling fifty-percent partner must provide its share of the partnership's attributes that the partner uses to determine the partner's gross DEI, gross FDDEI, deductions that are properly allocable to the partner's gross DEI and gross FDDEI, and the partner's adjusted bases in partnership specified tangible property.

* * * * *

(4) *Additional information required to be submitted by a controlling ten-percent or a controlling fifty-percent partner that has a deduction under section 250 by reason of FDII.* In addition to the information required pursuant to paragraphs (g)(1), (2), and (3) of this section, if, with respect to the partnership's tax year for which the Form 8865 is being filed, a controlling ten-percent partner or a controlling fifty-percent partner has a deduction under section 250 (by reason of having foreign-derived intangible income), determined, in whole or in part, by reference to the income, assets, or activities of the partnership, or transactions between the controlling-ten percent partner or controlling

fifty-percent partner and the partnership, the controlling ten-percent partner or controlling fifty-percent partner must provide its share of the partnership's gross DEI, gross FDDEI, deductions that are properly allocable to the partnership's gross DEI and gross FDDEI, and partnership QBAI (as those terms are defined in the section 250 regulations) in the form and manner and to the extent prescribed by Form 8865 (or any successor form), instructions to the form, publication, or other guidance published in the Internal Revenue Bulletin. To the extent that the partnership amounts described in the previous sentence cannot be determined, the controlling ten-percent partner or controlling fifty-percent partner must provide its share of the partnership's attributes that the partner uses to determine the partner's gross DEI, gross FDDEI, deductions that are properly allocable to the partner's gross DEI and gross FDDEI, and the partner's adjusted bases in partnership specified tangible property.

* * * * *

(l) * * * Paragraph (g)(4) of this section applies for tax years of a foreign partnership beginning on or after March 4, 2019.

Par. 10. Section 1.6038A-2 is amended by adding paragraph (b)(5)(iv) and a sentence at the end of paragraph (g) to read as follows:

§1.6038A-2 Requirement of return.

* * * * *

(b) * * *

(5) * * *

(iv) If, for the taxable year, the reporting corporation has a deduction under sec-

§1.6038-3 Information returns required of certain United States persons with respect to controlled foreign partnerships (CFPs).

* * * * *

tion 250 (by reason of having foreign-derived intangible income) with respect to any amount required to be reported under paragraph (b)(3) or (4) of this section, the reporting corporation will provide on Form 5472 (or any successor form) such information about the deduction in the form and manner and to the extent prescribed by Form 5472 (or any successor form), instructions to the form, publication, or other guidance published in the Internal Revenue Bulletin.

* * * *

(g) * * * Paragraph (b)(5)(iv) of this section applies with respect to information for annual accounting periods beginning on or after March 4, 2019.

Douglas W. O'Donnell
*Acting Deputy Commissioner for
Services and Enforcement.*

Approved: June 12, 2020.

David J. Kautter
*Assistant Secretary of the Treasury
(Tax Policy).*

(Filed by the Office of the Federal Register on July 9, 2020, 11:15 a.m., and published in the issue of the Federal Register for July 15, 2020, 85 F.R. 43042)

T.D. 9902

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Guidance under Sections 951A and 954 Regarding Income Subject to a High Rate of Foreign Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under the global intangible low-taxed income and subpart F income provisions of the Internal Revenue Code

regarding the treatment of income that is subject to a high rate of foreign tax. The final regulations affect United States shareholders of foreign corporations. This guidance relates to changes made to the applicable law by the Tax Cuts and Jobs Act, which was enacted on December 22, 2017.

DATES: *Effective date:* These regulations are effective on September 21, 2020.

Applicability dates: For dates of applicability, see §§1.951A-7(b) and 1.954-1(h)(1) and (3).

FOR FURTHER INFORMATION CONTACT: Jorge M. Oben or Larry R. Pounders at (202) 317-6934 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 951A, which contains the global intangible low-taxed income (“GILTI”) rules, was added to the Internal Revenue Code (the “Code”) by the Tax Cuts and Jobs Act, Pub. L. 115-97, 131 Stat. 2054, 2208 (December 22, 2017) (the “Act”). On October 10, 2018, the Department of the Treasury (“Treasury Department”) and the IRS published proposed regulations (REG-104390-18) under sections 951, 951A, 1502, and 6038 in the **Federal Register** (83 FR 51072). On June 21, 2019, the Treasury Department and the IRS published final regulations (T.D. 9866) in the **Federal Register** (84 FR 29288, as corrected at 84 FR 44693) under sections 951, 951A, 1502, and 6038, and proposed regulations (REG-101828-19) under sections 951, 951A, 954, 956, 958, and 1502 in the **Federal Register** (84 FR 29114, as corrected at 84 FR 37807) (“2019 proposed regulations”). Terms used but not defined in this preamble have the meaning provided in these final regulations.

The Treasury Department and the IRS received written comments with respect to the 2019 proposed regulations. A public hearing on the 2019 proposed regulations was not held because there were no requests to speak.

This rulemaking finalizes the portion of the 2019 proposed regulations under

sections 951A and 954 regarding the treatment of income subject to a high rate of foreign tax but does not finalize the portions of the 2019 proposed regulations under sections 951, 956, 958, and 1502 regarding the treatment of domestic partnerships. The Treasury Department and the IRS plan to finalize those regulations separately.

Comments outside the scope of this rulemaking are generally not addressed but may be considered in connection with future guidance projects. All written comments received in response to the 2019 proposed regulations are available at www.regulations.gov or upon request.

Summary of Comments and Explanation of Revisions

I. Overview

The 2019 proposed regulations apply the high-tax exclusion set forth in section 951A(c)(2)(A)(i)(III) (the “GILTI high-tax exclusion”), on an elective basis, to certain high-taxed income of a controlled foreign corporation (as defined in section 957) (“CFC”) regardless of whether the income would otherwise be foreign base company income (as defined in section 954) (“FBCI”) or insurance income (as defined in section 953). See proposed §1.951A-2(c)(6). The final regulations retain the basic approach and structure of the 2019 proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions discusses those revisions as well as comments received.

As discussed in part IV of this Summary of Comments and Explanation of Revisions, numerous comments recommended that the application of the GILTI high-tax exclusion be conformed with the high-tax exception of section 954(b)(4) and §1.954-1(d)(5) (the “subpart F high-tax exception”). The Treasury Department and the IRS agree that the GILTI high-tax exclusion and the subpart F high-tax exception should be conformed but have determined that the rules implementing the GILTI high-tax exclusion better reflect the policies underlying section 954(b)(4) in light of the changes made by the Act. As a result, a separate notice of proposed rulemaking published in the Proposed

Rules section of this issue of the **Federal Register** (REG-127732-19) (the “2020 proposed regulations”) proposes to generally conform the rules implementing the subpart F high-tax exception to the rules implementing the GILTI high-tax exclusion set forth in these final regulations, and provides for a single election under section 954(b)(4) for purposes of both subpart F income and tested income.

II. Calculation of Effective Foreign Tax Rate

A. QBU-by-QBU determination

The 2019 proposed regulations apply based on the effective foreign tax rate imposed on the aggregate of all items of tentative net tested income of a CFC attributable to a single qualified business unit (as defined in section 989(a)) (“QBU”) of the CFC that would be in a single tested income group. *See* proposed §1.951A-2(c)(6)(i)(B) and (c)(6)(ii)(A). The 2019 proposed regulations apply on a QBU-by-QBU basis to minimize the “blending” of income subject to different foreign tax rates and, as a result, more accurately identify income subject to a high rate of foreign tax such that low-taxed income continues to be subject to the GILTI regime in a manner consistent with its underlying policies.

The Treasury Department and the IRS received several comments regarding the determination of the effective foreign tax rate on a QBU-by-QBU basis. One comment supported the QBU-by-QBU determination. Other comments requested that the effective foreign tax rate test apply on a CFC-by-CFC basis and asserted that this approach would better align the GILTI high-tax exclusion with the subpart F high-tax exception. The comments also stated that a CFC-by-CFC approach would be consistent with the principles used to determine foreign income taxes deemed paid under proposed regulations under section 960 and would reduce complexity and compliance burdens. One comment noted that taxpayers are not required to conduct this type of QBU-level analysis for any other U.S. tax purpose and, thus, they may lack the systems, data, or personnel to do so. Other comments stated that nonconformity with the subpart

F high-tax exception would encourage taxpayers to structure into the subpart F high-tax exception and questioned the authority to adopt a QBU-by-QBU approach given the general mechanics of the GILTI regime, which compute certain items at the CFC level before aggregating such items at the United States shareholder (as defined in section 951(b)) (“U.S. shareholder”) level.

Some comments suggested that there is not a significant risk of blending foreign income subject to different tax rates and asserted that such blending should not give rise to policy concerns. Other comments stated that applying the effective foreign tax rate test on a CFC-by-CFC basis would ameliorate issues caused by differences between U.S. and foreign tax accounting methods.

Consistent with the rules set forth in the 2019 proposed regulations, the Treasury Department and the IRS have determined that calculating the effective foreign tax rate on a CFC-by-CFC basis would inappropriately allow the blending of high-taxed and low-taxed income in a manner that is inconsistent with the purpose of section 951A, which is to limit potential base erosion incentives created by a participation exemption regime. Such blending would allow low-taxed income, which poses a significant base-erosion risk, to be excluded from the GILTI regime. While the legislative history indicates that high-taxed income does not present base erosion concerns, the policy rationale underlying that view does not extend to excluding low-taxed income from GILTI merely because it may be earned by an entity that also earns high-taxed income. *See* S. Comm. on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Print. No. 115-20, at 371 (2017) (“The Committee believes that certain items of income earned by CFCs should be excluded from the GILTI [regime], either because they should be exempt from U.S. tax—as they are generally not the type of income that is the source of the base erosion concerns—or are already taxed currently by the United States. Items of income excluded from GILTI because they are exempt from U.S. tax under the bill include foreign oil and gas extraction income (which is generally immobile) and

income subject to high levels of foreign tax.”).

The QBU-by-QBU approach is also consistent with the legislative history to section 954(b)(4), which directs the Treasury Department and the IRS to allow reasonable groupings of items of income that are substantially taxed at the same rate in a single country. *See* H.R. Rep. No. 99-426, at 400-01 (1985) (“Although this rule applies separately with respect to each ‘item of income’ received by a [CFC], the committee expects that the Secretary will provide rules permitting reasonable groupings of items of income that bear substantially equal effective rates of tax in a given country. For example, all interest income received by a [CFC] from sources within its country of incorporation may reasonably be treated as a single item of income for purposes of this rule, if such interest is subject to uniform taxing rules in that country.”). Therefore, consistent with this legislative history, generally only high-taxed income, and not low- or zero-taxed income, should be excluded from gross tested income. The GILTI high-tax exclusion carries out this purpose by determining the effective rate of tax on an item of income at a granular enough level to preclude inappropriate blending without imposing undue compliance burdens on taxpayers.

Although greater blending of income subject to different rates of foreign tax may be permitted within a separate category under section 904, a section 904 separate category is not an appropriate standard for determining an item of income under section 954(b)(4) because section 904 applies, by its terms, to separate categories of income while section 954(b)(4) applies to items of income. Moreover, the purposes of sections 951A and 954(b)(4), which are primarily intended to address base erosion concerns, differ from the purposes of sections 901 and 904, which are tailored to the avoidance of double taxation of foreign source income. The ability to credit foreign taxes against a broader class of income at the U.S. shareholder level does not compel a CFC-by-CFC effective foreign tax rate computation for purposes of the GILTI high-tax exclusion. In addition, determining whether an item of income is high-taxed by grouping similar items at a QBU level has historically

been required for certain passive income under §§1.904-4(c) and 1.954-1(c)(1)(iii) (B). Consistent with the 2019 proposed regulations, §1.904-4(c) groups passive income items for purposes of determining whether they are subject to a high rate of tax on a QBU-by-QBU basis.

Finally, because the GILTI high-tax exclusion applies on an elective basis, taxpayers may choose not to make the election if the compliance burdens of the computation outweigh the benefits.

For these reasons, the final regulations do not adopt a CFC-by-CFC approach. However, the final regulations replace the QBU-by-QBU approach with a more targeted approach based on “tested units” (as discussed in part III.A of this Summary of Comments and Explanation of Revisions), permit some additional blending of income under the tested unit combination rule (as discussed in part III.B of this Summary of Comments and Explanation of Revisions), and allow taxpayers additional flexibility by permitting the GILTI high-tax exclusion election to be made on an annual basis (as discussed in part IV.C of this Summary of Comments and Explanation of Revisions). Further, as noted in part I of this Summary of Comments and Explanation of Revisions, the separate notice of proposed rulemaking published concurrently with these final regulations conforms the rules implementing the subpart F high-tax exception with the GILTI high-tax exclusion, thereby eliminating the disparity between the two elections and the incentive for taxpayers to structure into the subpart F high-tax exception.

B. CFC-level determination of foreign taxes

For purposes of the subpart F high-tax exception, the final regulations under §1.954-1(d)(3) (before modification by this Treasury decision) determined, for each U.S. shareholder, the foreign income taxes paid or accrued with respect to an item of income based on the amount of foreign income taxes that would be deemed paid under section 960 if the item of income were included in the gross income of the U.S. shareholder under section 951(a)(1)(A). The 2019 proposed regulations modify this determination, for purposes of both the subpart F high-

tax exception and the GILTI high-tax exclusion, by referencing the amounts of income and taxes at the CFC level, rather than the amount of taxes that would be deemed paid at the U.S. shareholder level. See proposed §1.954-1(d)(3)(i) and proposed §1.951A-2(c)(6)(iv). Specifically, foreign income taxes of the CFC for the current year are allocated and apportioned to the CFC’s gross income based on the rules under §1.960-1(d), which determine foreign income taxes “properly attributable” to income. The 2019 proposed regulations modify this calculation because the determination of income and taxes at the CFC level is more consistent with the text of section 954(b)(4), which refers to items of income (and tax imposed on such items) of the CFC. In addition, deemed paid credits for taxes properly attributable to tested income under section 960(d) are determined on an aggregate basis, which does not provide an accurate basis to determine the effective foreign tax rate on particular items of income of a CFC under the GILTI high-tax exclusion provided under section 954(b)(4).

A comment requested that the effective foreign tax rate test be based on the shareholder’s deemed paid credit for taxes properly attributable to tested income, as defined in section 960(d), over the shareholder’s net CFC tested income, as defined in section 951A(c). The comment asserted that such an aggregate determination, which would mirror the calculation of the GILTI inclusion, would be consistent with the GILTI legislative history, would produce more equitable results than those provided under the 2019 proposed regulations, and would significantly reduce compliance and administrative burdens for taxpayers and the government.

The Treasury Department and the IRS have concluded that this approach for calculating the effective foreign tax rate would be inconsistent with section 954(b)(4). Unlike a GILTI inclusion, which is based on the aggregate amounts of a U.S. shareholder’s pro rata shares of certain items from all the CFCs in which the shareholder is a U.S. shareholder, section 954(b)(4) applies by its terms to items of income of a single CFC. That is, section 954(b)(4) applies with respect to “any item of income received by a CFC” that is subject to a sufficiently high rate of for-

eign tax. Moreover, section 951A(c)(2)(A)(i), which provides exclusions from tested income including the high-tax exclusion, refers to “the gross income of such corporation.” Nothing in section 954(b)(4), or section 951A(c)(2)(A)(i)(III), suggests that the aggregate approach of the GILTI regime should or could apply for purposes of determining whether an item of income received by a CFC is subject to a sufficiently high level of foreign tax under section 954(b)(4). Thus, the final regulations do not adopt this comment.

C. Effective foreign tax rate

1. Threshold Rate of Tax

Consistent with section 954(b)(4), the 2019 proposed regulations apply the GILTI high-tax exclusion by comparing the effective foreign tax rate with 90 percent of the rate that would apply if the income were subject to the maximum rate of tax specified in section 11 (currently 18.9 percent, based on a maximum rate of 21 percent). See proposed §1.951A-2(c)(6)(i)(B).

Several comments requested that the GILTI high-tax exclusion instead be applied if the effective foreign tax rate is at least 13.125 percent. One comment requested that it be based on a tax rate of 13.125 percent for taxable years beginning on or before December 31, 2025, and 16.406 percent for taxable years beginning after such date. The comments asserted that using a 13.125 percent rate would be consistent with the legislative history indicating that no residual tax should be due on GILTI subject to an effective foreign tax rate in excess of 13.125 percent, which takes into account the 80 percent foreign tax credit allowance in section 960(d) and the 50 percent deduction under section 250, and that the rate should be adjusted for taxable years beginning after December 31, 2025, to correspond to the reduction in the amount of deduction allowed with respect to GILTI as provided in section 250(a)(3)(B).

The Treasury Department and the IRS disagree with these comments. The GILTI high-tax exclusion is based on section 954(b)(4), which refers to a tax rate that is greater than 90 percent of the rate that would apply if the income were subject

to the maximum rate of tax specified in section 11. The rate set forth in section 954(b)(4) does not vary depending on whether it applies for purposes of determining FBCI, insurance income, or tested income. Furthermore, the legislative history describing a 13.125 percent foreign tax rate addresses situations in which income is included in tested income and, consequently, subject to GILTI and the associated foreign tax credit rules under section 960(d).¹ Those rules do not apply to income excluded from tested income by reason of the GILTI high-tax exclusion. Accordingly, the final regulations do not adopt these comments.

2. Safe Harbors

One comment asserted that the “mechanical snapshot” rule for determining the effective foreign tax rate under the 2019 proposed regulations can produce results that are unreasonable given timing differences between the U.S. and foreign tax bases. The comment stated that if an item is accounted for in one period for U.S. tax purposes, but in another period for foreign tax purposes, the CFC may appear to have a high effective foreign tax rate in one period, and a low effective foreign tax rate in the other period, when in fact it is simply subject to a rate of tax comparable to the U.S. rate on its foreign tax base over both periods. To address these timing differences, the comment suggested that the final regulations include two new methods, in addition to the method set forth in the 2019 proposed regulations, for calculating the effective foreign tax rate, each of which could be safe harbors applied at the discretion of the taxpayer.

Under the first suggested method, the GILTI high-tax exclusion would apply if the foreign statutory income tax rate to which a QBU’s income is subject is sufficiently high and there is no special tax regime to which a material percentage of the QBU’s income is subject. In such a case, the safe harbor would apply and all the income of the QBU would be eligible for the GILTI high-tax exclusion. The comment indicated that the foreign statutory

rate could be determined by reference to publications maintained by the OECD and a special tax regime could be determined in a manner consistent with the 2016 U.S. Model Income Tax Treaty.

The second suggested method would allow taxpayers to determine a QBU’s effective foreign tax rate by reference to the average effective foreign tax rate in the current and preceding four taxable years. The comment asserted that this approach would smooth out timing differences and more accurately determine whether the QBU’s income was in fact subject to relatively high rates of tax. The comment also noted that although the GILTI regime generally operates on an annual basis, the determination of whether the income of a QBU is subject to a rate of foreign tax comparable to the U.S. rate may be better determined over a longer period based on the facts and circumstances.

The Treasury Department and the IRS have concluded that identifying special tax regimes, or determining the extent to which income would be subject to special tax regimes, would give rise to considerable complexity and administrative and compliance burdens for both taxpayers and the government. Similarly, the Treasury Department and the IRS have determined that using an average effective foreign tax rate over multiple taxable years would give rise to additional complexity and increase the burden on taxpayers and the government due, for example, to foreign tax redeterminations with respect to a QBU’s income, such as an adjustment for a loss carryback. Such adjustments would not only affect the year of the redetermination, but also every other year that took the redetermination year into account in calculating the average effective foreign tax rate, potentially resulting in multiple amended returns attributable to a foreign tax redetermination for a single taxable year. A prior year averaging approach would also lead to distortive results, such as when the CFC had losses or volatile earnings. Accordingly, the final regulations do not adopt these safe harbors. As described in Part III.B. of this Summary of Comments, the tested unit combination

rule should ameliorate some of the concerns raised by the comment.

D. Base and timing differences

1. In General

The 2019 proposed regulations generally provide that the effective rate at which taxes are imposed for a taxable year is the U.S. dollar amount of foreign income taxes paid or accrued with respect to a tentative net tested income item,² over the sum of the U.S. dollar amount of the tentative net tested income item and the amount of foreign income taxes paid or accrued with respect to the tentative net tested income item. See proposed §1.951A-2(c)(6)(iii). A tentative net tested income item is generally determined by taking into account certain items of gross income (determined under federal income tax principles) attributable to a QBU, less deductions (also determined under federal income tax principles) allocated and apportioned to such gross income. See 1.951A-2(c)(6)(ii)(A) and (B). Thus, the effective foreign tax rate is based on the amount of foreign income taxes paid or accrued on income attributable to the QBU as determined for federal income tax purposes, without regard to how the income is determined for foreign income tax purposes.

The preamble to the 2019 proposed regulations requested comments on whether additional rules are needed to properly account for cases (other than disregarded payments) in which the income base upon which foreign tax is imposed does not match the items of income reflected on the books and records of the QBU determined for federal income tax purposes. The preamble cites examples of possible adjustments to address circumstances in which QBUs are permitted to share losses or determine tax liability based on combined income for foreign tax purposes.

2. Disregarded Payments

The proposed regulations generally provide that gross income is attributable to a QBU if it is properly reflected on the

¹In addition, the assertion made by certain commenters that the law categorically provides that no residual U.S. tax is owed under GILTI at foreign effective tax rates of 13.125% is incorrect. See Joint Comm. on Tax'n, General Explanation of Public Law 115-97, at 381 & n.1753.

²The final regulations adopt the term “tentative tested income item,” instead of the term “tentative net tested income item.” See §1.951A-2(c)(7)(iii).

books and records of the QBU, determined under federal income tax principles, except that such income is adjusted to account for certain disregarded payments. *See proposed §1.951A-2(c)(6)(ii)(A)(2).* The adjustments for disregarded payments are made under the principles of §1.904-4(f)(2)(vi) (rules attributing gross income to a foreign branch), without regard to the exclusion for interest described in §1.904-4(f)(2)(vi)(C)(1). *See id.*

One comment suggested that a disregarded payment should not result in the reallocation of income between QBUs for purposes of computing the GILTI high-tax exclusion. The Treasury Department and IRS understand the comment's concern to be the potential inability to claim the GILTI high-tax exclusion in scenarios where a disregarded payment was made from a high-taxed CFC to a disregarded entity that paid no tax.

The Treasury Department and the IRS have determined that, if a tested unit³ makes a disregarded payment to another tested unit, gross income should be reallocated among the tested units to appropriately associate the income with the tested unit in which it is subject to tax. This reallocation promotes conformity between the income attributed to a tested unit and the income of that tested unit that is subject to tax in the foreign country, and, therefore, this rule results in a more accurate grouping of items of income that are generally subject to the same or similar rates of foreign tax. In addition, treating disregarded payments in this manner is consistent with the treatment of regarded payments. For example, if a tested unit of a CFC were to make a regarded deductible payment that is taken into account by another tested unit of the CFC (such as a tested unit that is an interest in a partnership), the payment would be an item of gross income of the payee tested unit that may qualify for the GILTI high-tax exclusion based on the foreign taxes attributable to that tested unit. Moreover, the regarded deduction would be reflected in a reduced tentative net tested income item (relative to the result in the absence of adjustment for disregarded payments) – and, consequently, the denominator of the effective foreign

tax rate fraction – with respect to the payor tested unit for purposes of assessing whether its gross income is subject to a high rate of foreign tax. For these reasons, the comment is not adopted.

The final regulations provide additional rules addressing disregarded payments, including providing additional detail on how the principles of §1.904-4(f)(2)(vi) should be applied. *See §1.951A-2(c)(7)(ii)(B)(2).* For example, the final regulations provide that a disregarded payment of interest is allocated and apportioned ratably to all of the gross income attributable to the tested unit that is making the disregarded payment. *See §1.951A-2(c)(7)(ii)(B)(2)(iv).* The final regulations also provide special ordering rules for reallocations with respect to multiple disregarded payments. *See §1.951A-2(c)(7)(ii)(B)(2)(iv).*

3. Foreign Net Operating Losses and Other Timing Differences

Some comments requested that the final regulations allow taxpayers to elect to adjust either the numerator or denominator of the effective foreign tax rate fraction to take into account foreign net operating loss ("NOL") carryforwards and other similar items. One comment asserted that, while the effective foreign tax rate calculation generally serves as an appropriate test, CFCs with a foreign NOL carryover may fail the test even though the rate of tax in the foreign country exceeds 18.9 percent. Another comment indicated that a CFC could fail the mechanical test in a single year although the same income is subject to a foreign tax that is substantially higher than the U.S. corporate tax rate because of timing differences (that is, differences in when income or deductions are taken into account for U.S. and foreign tax purposes).

The Treasury Department and the IRS have determined that adjusting the numerator or denominator of the effective foreign tax rate fraction for foreign NOL carryforwards or other timing differences would result in considerable complexity and would impose a significant burden on both taxpayers and the government. It

would require the application of foreign tax accounting rules, and complex coordination rules to reconcile their application with U.S. tax accounting rules, both in the current taxable year and other taxable years, to prevent an item of income, gain, deduction, loss, or credit from being duplicated or omitted. Accordingly, this comment is not adopted.

III. Adoption of Tested Unit Standard

A. In general

As discussed in part II.A of this Summary of Comments and Explanation of Revisions, the 2019 proposed regulations propose a QBU-by-QBU approach to identify the relevant items of income that may be eligible for the GILTI high-tax exclusion. For this purpose, the proposed regulations reference the definition of a QBU in section 989(a), which provides that a QBU is any separate and clearly identifiable unit of a trade or business of a taxpayer that maintains separate books and records. *See proposed 1.951A-2(c)(6)(ii)(A).* Regulations under section 989(a) provide guidance as to activities that constitute a trade or business (based on a facts-and-circumstances analysis) and the determination of separate books and records. *See §1.989(a)-1(c) and (d).* The preamble to the 2019 proposed regulations requested comments on whether the definition of a QBU should be modified for purposes of the GILTI high-tax exclusion, including the requirements to carry on activities that constitute a trade or business and to maintain books and records.

One comment asserted that it is unclear whether certain activities constitute a trade or business under the facts-and-circumstances test set forth in the regulations under section 989(a) and that making such determinations would frequently be administratively burdensome. The comment indicated that in other cases it is also difficult to determine whether certain interrelated activities constitute a single QBU or multiple QBUs (for example, different functions performed by separate divisions operating within a single CFC). In addition, the comment suggested that

³ As discussed in part III of this Summary of Comments and Explanation of Revisions, the final regulations adopt a "tested unit" standard that replaces the QBU standard used in the 2019 proposed regulations.

taxpayers may engage in affirmative tax planning to avoid the QBU rule by, for example, breaking up the operations of a single large QBU of a CFC into smaller components that would not constitute trades or businesses, or by choosing to no longer maintain books and records for such sub-lines of business. Another comment criticized the QBU approach because some taxpayers may track business activities differently than other taxpayers, which may result in the inconsistent application of the QBU rules. Finally, a comment noted that not all companies have sufficient systems in place to accurately track items at the QBU level.

The 2019 proposed regulations propose the QBU standard as a proxy for determining the type of entity, or level of activities, that would likely be subject to tax in a particular foreign country either on an entity basis or as a taxable presence, and, as a result, would likely result in items of income attributable to the QBU being subject to a different rate of foreign tax than that imposed on other income of the CFC. In response to these comments, the Treasury Department and the IRS have concluded that a more targeted approach should be applied for identifying income that is likely to be subject to foreign tax rates different from those imposed on other income earned by the CFC. This approach will generally limit the scope of the factual analysis necessary to apply these rules – for example, it does not depend on whether activities constitute a trade or business, or whether books and records are maintained – and thereby addresses many of the concerns raised in these comments. Accordingly, in lieu of the QBU standard in the 2019 proposed regulations, the final regulations generally apply the GILTI high-tax exclusion based on the gross tested income of a CFC that is attributable to a “tested unit.” *See* §1.951A-2(c)(7)(ii). Unlike the QBU standard that serves as a proxy for being subject to foreign tax, the tested unit approach generally applies to the extent an entity, or the activities of an entity, are actually subject to tax, as either a tax resident or a permanent establishment (or similar taxable presence), under the tax law of a foreign country.

The final regulations provide three categories of a tested unit. First, and consistent with the 2019 proposed regulations, a test-

ed unit includes a CFC. *See* §1.951A-2(c)(7)(iv)(A)(1). Thus, if a CFC, which itself is a tested unit, has no other tested units, the GILTI high-tax exclusion is applied with respect to all the tentative gross tested income items (determined under §1.951A-2(c)(7)(ii)) of the CFC.

Second, and also consistent with the 2019 proposed regulations, a tested unit generally includes an interest in a pass-through entity held, directly or indirectly, by a CFC. *See* §1.951A-2(c)(7)(iv)(A)(2). For this purpose, a pass-through entity is defined to include, for example, a partnership or a disregarded entity. *See* §1.951A-2(c)(7)(ix)(B).

More specifically, a CFC’s interest in a pass-through entity is a tested unit if the pass-through entity meets one of two requirements. First, the CFC’s interest in the pass-through entity is a tested unit if the pass-through entity is a tax resident of a foreign country because, in these cases, income earned by the CFC indirectly through the pass-through entity may be subject to tax at a rate different than the rate at which income earned by the CFC directly is subject to tax. *See* §1.951A-2(c)(7)(iv)(A)(2)(i). Second, the CFC’s interest in the pass-through entity is a tested unit if the pass-through entity is not subject to tax as a resident, but is treated as a corporation (or as another entity that is not fiscally transparent) for purposes of the CFC’s tax law, because in these cases income earned by the CFC indirectly through the pass-through entity may not be subject to tax in the foreign country of which the CFC is a tax resident; thus, for example, an interest in a domestic limited liability company that is a partnership for federal income tax purposes would typically be a tested unit. *See* §1.951A-2(c)(7)(iv)(A)(2)(ii). A CFC’s interest in a pass-through entity (or the activities of a branch) that is not a tested unit is a “transparent interest.” *See* §1.951A-2(c)(7)(ix)(C); see also the discussion on transparent interests in part III.C.3 of this Summary of Comments and Explanation of Revisions.

This treatment of interests in pass-through entities in the final regulations is consistent with a comment suggesting that a pass-through entity should be treated as a tested unit if the entity is treated as a separate entity for purposes of a foreign tax law, but not if the entity is fiscally

transparent (and thus not a tax resident) for purposes of the tax law of a foreign country.

An interest in an entity, rather than the entity itself, is treated as a tested unit (or a transparent interest) because the entity may have multiple owners and the characterization of the interest as a tested unit may depend on each holder’s tax treatment with respect to the interest. As a result, less than the entire entity may be characterized as a tested unit or a transparent interest. In addition, different interests in an entity held directly or indirectly by the same CFC may be characterized differently. The final regulations include an example that illustrates the application of this rule. *See* §1.951A-2(c)(8)(iii)(D) (Example 4).

Finally, a tested unit includes a branch, or a portion of a branch, the activities of which are carried on directly or indirectly by a CFC, provided that either (i) the branch gives rise to a taxable presence in the country in which the branch is located, or (ii) the branch gives rise to a taxable presence under the owner’s tax law, and the owner’s tax law provides an exclusion, exemption, or other similar relief (such as a preferential rate) for income attributable to the branch. *See* §1.951A-2(c)(7)(iv)(A)(3). In these cases, the income indirectly earned by the owner through the branch is likely subject to tax at a rate different than the rate at which income directly earned by the owner is subject to tax. The Treasury Department and the IRS have determined that this branch tested unit rule addresses blending concerns related to an owner’s taxable presence in another country in a more targeted manner than the “activities” QBU standard from the 2019 proposed regulations. In addition, the Treasury Department and the IRS have determined that the branch tested unit rule will likely reduce compliance burdens, as compared to the QBU standard from the 2019 proposed regulations, because the tested unit rule depends on how activities are treated under foreign tax law, an analysis of which in most cases would be conducted independently of the final regulations (for example, to determine whether a tax return must be filed because activities in that country give rise to a taxable presence).

For purposes of the tested unit rules, references to the tax law of a foreign coun-

try include statutes, regulations, administrative or judicial rulings, and treaties of the country. *See* §1.951A-2(c)(7)(iv)(A)(2) and (3) (cross-referencing definitions in regulations under section 267A that incorporate the definition of the tax law of a country in §1.267A-5(a)(21)).

The final regulations make clear that tested units are determined independently of one another. For example, even though a CFC is itself a tested unit, the CFC may have other tested units, such as a permanent establishment or an interest in a disregarded entity that, subject to the application of the combination rule discussed in part III.B of this Summary of Comments and Explanation of Revisions, must be treated separately for purposes of the GILTI high-tax exclusion. *See* §1.951A-2(c)(8)(iii)(D) (Example 4).

The final regulations also provide a rule that addresses cases where the same item is attributable to more than one tested unit in a tier of tested units. This may occur, for example, if an item is properly reflected both on the separate set of books and records of one tested unit, and on the separate set of books and records of a lower-tier tested that is owned (directly or indirectly) by the first tested unit, because the books and records of the two tested units were prepared under different accounting standards. In such a case, the final regulations provide that the item is considered to be attributable only to the lowest-tier tested unit. *See* §1.951A-2(c)(7)(iv)(B).

B. Combined tested units

The 2019 proposed regulations apply separately to each QBU of a CFC. *See* proposed §1.951A-2(c)(6)(ii)(A)(1). However, the preamble to the 2019 proposed regulations requested comments as to whether all of a CFC's QBUs located within a single foreign country should be combined.

Several comments recommended combining "same-country" QBUs, on an elective basis, noting it would reduce complexity and compliance burdens. Some comments asserted that a combined same-country QBU approach would be more consistent with congressional intent for the GILTI regime to target income in low- and zero-tax countries, would reduce

certain variances (for example, due to business cycle fluctuations or differences between the U.S. and foreign tax bases), and would reduce incentives for tax-motivated restructuring. Another comment recommended that the final regulations include rules that would allow taxpayers to take into account a fiscal unity or similar grouping in determining the effective foreign tax rate.

The Treasury Department and the IRS generally agree that a combination rule would reduce compliance burdens and would be consistent with the policies underlying the GILTI high-tax exclusion. Moreover, a combination rule may minimize the effect of timing and other differences between the U.S. and foreign tax bases. Accordingly, the final regulations generally provide that tested units of a CFC (including the CFC tested unit), other than certain nontaxed branch tested units, are treated as a single tested unit if the tested units are tax residents of, or located in, the same foreign country. *See* §1.951A-2(c)(7)(iv)(C)(1). In general, a nontaxed branch tested unit is a branch tested unit that does not give rise to a taxable presence under the tax law of the foreign country where the branch is located, but gives rise to a taxable presence under the tax law of the foreign country where the home office of the branch is a tax resident and such tax law provides an exclusion, exemption, or similar relief for purposes of taxing income attributable to the branch. *See* §1.951A-2(c)(7)(iv)(A)(3). The tested unit combination rule does not apply to a nontaxed branch tested unit because such a tested unit typically would not be subject to tax (or to any meaningful level of tax) in any foreign country and thus combining it with other tested units (the income of which may be subject to a meaningful level of tax) could give rise to inappropriate blending. *See* §1.951A-2(c)(7)(iv)(C)(2).

The combination rule applies without regard to whether the tested units are subject to the same foreign tax rate because it would be inconsistent with the purpose of the combination rule to require taxpayers to determine the effective foreign tax rate imposed on the tested units separately, and simply comparing the statutory foreign tax rates may not be meaningful. In addition, the combination rule is not conditioned on

the tested units having the same functional currency because the effective foreign tax rate is calculated in U.S. dollars and any differences in functional currency are unlikely to have a material effect on whether income qualifies for the GILTI high-tax exclusion. Finally, the combination rule is mandatory, and not elective, because providing an election would give rise to additional complexity, and related administrative and compliance burdens.

C. Books and records

1. In General

Under the 2019 proposed regulations, gross income is attributable to a QBU if it is properly reflected on the books and records of the QBU. *See* proposed §1.951A-2(c)(6)(ii)(A)(2). For this purpose, gross income is determined under federal income tax principles with certain adjustments to reflect disregarded payments. *Id.*

As discussed in part III.A of this Summary of Comments and Explanation of Revisions, the final regulations adopt a tested unit standard, rather than a QBU standard, for purposes of determining a tentative gross tested income item. Nevertheless, the final regulations retain the general approach set forth under the 2019 proposed regulations of relying on a separate set of books and records (as modified to apply to tested units, rather than QBUs) as the starting point for determining gross income attributable to a tested unit. The Treasury Department and the IRS have concluded that applying the books-and-records approach for tested units is appropriate because it serves as a reasonable proxy for determining the amount of gross income that the foreign country of the tested unit is likely to subject to tax. In addition, relying on a separate set of books and records is consistent with the approach taken under other provisions and, therefore, should promote administrability for both taxpayers and the government. *See*, for example, §§1.904-4(f) (foreign branch category rules), 1.987-2(b) (rules for determining items attributable to a QBU branch), and 1.1503(d)-5(c) (dual consolidated loss rules).

The final regulations generally provide that items of gross income of a CFC are

attributable to a tested unit of the CFC to the extent they are properly reflected on the separate set of books and records of the tested unit, or of the entity an interest in which is a tested unit (for example, in the case of certain partnerships). *See* §1.951A-2(c)(7)(ii)(B). This rule starts with the items of gross income of the CFC for federal income tax purposes and then attributes those items to the CFC's tested units to the extent the items are properly reflected on the separate set of books and records of the tested units (with certain adjustments, such as to account for disregarded payments). For example, if a CFC owns a partnership interest that is a tested unit, the items of gross income that the CFC derives through the partnership interest are attributed to the CFC's interest in the partnership to the extent that the items are properly reflected on the separate set of books and records of the partnership. Thus, this approach first gives effect to the rules that determine the items of gross income of the CFC, such as the rules under section 704 for purposes of determining a CFC partner's distributive share of items of a partnership, and then attributes those items to the tested units of the CFC depending on whether the items are properly reflected on the separate set of books and records. The final regulations include examples that illustrate the application of this rule. *See* §1.951A-2(c)(8)(D) (Example 4).

2. Separate Set of Books and Records

The Treasury Department and the IRS have determined that a tested unit, or an entity an interest in which is a tested unit, generally will maintain a separate set of books and records that would be readily available for purposes of the final regulations. This is expected to be the case for a branch tested unit under §1.951A-2(c)(7)(iv)(A)(3) (involving a taxable presence), for example, because a separate set of books and records would ordinarily be required to compute the foreign tax liability arising in the taxing country (or for not taking into account items attributable to the taxable presence if determined only

under the owner's tax law). Accordingly, the final regulations retain the general approach taken in the 2019 proposed regulations by defining a "separate set of books and records" by reference to §1.989(a)-1(d). *See* §1.951A-2(c)(7)(v)(A).⁴

3. Booking Rule for Transparent Interests

The final regulations provide a special booking rule that applies to a transparent interest, which, as noted in part III.A of this Summary of Comments and Explanation of Revisions, is an interest in a pass-through entity (or the activities of a branch) that is not a tested unit. This rule, which is consistent with the rule in §1.1503(d)-5(c)(3)(ii) (addressing similar interests for purposes of the dual consolidated loss rules), generally treats items properly reflected on the separate set of books and records of an entity an interest in which is a transparent interest as being properly reflected on the books and records of a tested unit that holds interests (directly or indirectly through other transparent interests) in the entity. *See* §1.951A-2(c)(7)(v)(C). This treatment is appropriate because income earned by the tested unit directly, as well as income earned by the tested unit indirectly through the transparent interest, is expected to be subject to residence-based tax in only the tested unit's country of residence (or location) and, as a result, it is unlikely that blending of income subject to different foreign tax rates would occur by reason of the tested unit's ownership of the transparent interest.

4. Tested Units that Fail to Maintain a Set of Books and Records

The final regulations include a rule that applies if a separate set of books and records is not prepared for a tested unit or transparent interest. In such a case, items required to apply the GILTI high-tax exclusion that would be reflected on a separate set of books and records of the tested unit or transparent interest must be determined and treated as properly reflected on the separate set of books and records. *See* §1.951A-2(c)(7)(v)(B). This rule is

intended to address cases where a separate set of books and records is not maintained, and to prevent the avoidance of the rules by choosing to not maintain a separate set of books and records.

5. Items of Gross Income Not Taken into Account for Financial Accounting Purposes

In some cases, items of gross income (determined under federal income tax principles) may not be properly reflected on a separate set of books and records because they are not taken into account for financial accounting purposes. This may occur when items are taken into account for federal income tax purposes and financial accounting purposes in different taxable years, or when items are taken into account for federal income tax purposes but are not taken into account for financial accounting purposes (for example, due to the mark-to-market method of accounting). To ensure that these items of gross income are attributable to a tested unit in a CFC inclusion year, the final regulations clarify that the items are treated as properly reflected on a separate set of books and records if they would be so reflected if they were taken into account for financial accounting purposes in the CFC inclusion year in which they are taken into account for federal income tax purposes. *See* §1.951A-2(c)(7)(v)(D). No inference should be drawn from this clarification with respect to other similar rules that attribute items based on books and records, including under §1.904-4(f), §1.987-2(b), or §1.1503(d)-5(c).

D. *De minimis* rules

A comment recommended that the final regulations adopt two de minimis rules to simplify the application of the QBU-by-QBU approach. First, the comment suggested that taxpayers should be permitted to elect to treat all CFCs with income below a specified threshold as a single QBU. The Treasury Department and the IRS have determined that aggregating CFCs for this purpose would be inconsis-

⁴The 2020 proposed regulations, however, replace the reference to "books and records" with a more specific standard based on items properly reflected on an "applicable financial statement," and request comments.

tent with section 954(b)(4), which applies with respect to items of income of a single CFC. Accordingly, this recommendation is not adopted.

Second, the comment suggested that taxpayers should be permitted to elect to aggregate QBUs within the same CFC that have a small amount of tested income (measured either in absolute terms or based on a percentage of the CFC's income). However, it is uncertain whether aggregating QBUs with small amounts of tested income will result in a significant amount of simplification because, for example, gross income would still have to be attributed to each QBU (taking into account disregarded payments) to determine whether the de minimis rule applies. The final regulations do not adopt the recommendation, but a de minimis rule is included in the 2020 proposed regulations to allow an opportunity for additional notice and comment.

IV. Rules Regarding the Election

A. Consistency requirement

The 2019 proposed regulations generally provide that if a CFC is a member of a controlling domestic shareholder group ("CFC group"),⁵ a GILTI high-tax exclusion election (or revocation) is either made with respect to each member of the CFC group or is not made for any member of the CFC group. *See* proposed §1.951A-2(c)(6)(v)(E)(1) and part IV.B of this Summary of Comments and Explanation of Revisions. The preamble to the 2019 proposed regulations requested comments on whether the consistency rule should be modified or removed, for example, by allowing the election to be made on an item-by-item or a CFC-by-CFC basis.

Several comments requested that the final regulations eliminate the consistency requirement such that the GILTI high-tax exclusion election can be made on a CFC-by-CFC basis, which would conform the exclusion to the subpart F high-tax exception. Some comments asserted that the consistency requirement is too restrictive because the GILTI regime generally ap-

plies to both low- and high-taxed income and the consistency requirement has the effect of applying the GILTI regime only to low-taxed income since all high-taxed income is excluded. Comments further asserted that determining whether making the election for all CFCs is beneficial, especially when involving multiple foreign countries, is a complex and difficult task and would increase taxpayers' compliance burden. Some comments stated that the elimination of the consistency requirement would enable taxpayers to minimize the unfavorable interaction between the GILTI regime and the rules for allocating and apportioning deductions. Other comments asserted that the consistency requirement would encourage taxpayers to implement structures that would convert tested income into subpart F income, which is contrary to one of the purposes of the GILTI high-tax exclusion. Finally, comments suggested that if the consistency requirement is included in the final regulations, it is likely that many taxpayers will not make the GILTI high-tax exclusion election.

The Treasury Department and the IRS have determined that the consistency requirement is necessary due to the collateral effect that the GILTI high-tax exclusion has on the allocation and apportionment of deductions. Specifically, allowing CFC-by-CFC or tested unit-by-tested unit elections would encourage the selective use of the GILTI high-tax exclusion to inappropriately manipulate the section 904 foreign tax credit limitation. In this regard, deductions allocated and apportioned to income excluded under section 954(b)(4) will be subject to section 904(b)(4), as described in Part V.A of this Summary of Comments and Explanation of Revisions, and thereby disregarded for purposes of determining a taxpayer's foreign tax credit limitation under section 904. Without a consistency requirement, taxpayers may be able to include high-taxed income in GILTI to claim foreign tax credits up to the amount of their section 904 limitation, while electing to exclude the remainder of such income under the GILTI high-tax exclusion. Consequently, the taxpayer's section 904 limitation would not take into

account all the deductions attributable to investments generating high-taxed income, resulting in a distortive application of the foreign tax credit limitation under section 904. A consistency requirement prevents this result by ensuring that a taxpayer that seeks to cross-credit the foreign tax imposed on high-taxed tentative tested income against low-taxed tentative tested income must take all of its high-taxed tentative tested income into account along with all of the deductions allocated and apportioned to that category of income. This concern does not arise with respect to other types of income that are excluded from tested income (for example, foreign oil and gas extraction income) because such items are always excluded (that is, there is no electivity as to whether they are included in tested income), and the foreign taxes attributable to that income can never be claimed as a credit against the U.S. tax imposed on section 951A inclusions.

The Treasury Department and the IRS agree that the GILTI high-tax exclusion election and the subpart F high-tax exception election should apply consistently and, as noted in part I of this Summary of Comments and Explanation of Revisions, have determined that the subpart F high-tax exception should be conformed to the GILTI high-tax exclusion, as discussed in the preamble to the 2020 proposed regulations. This is appropriate, in part, due to changes made by the Act. Before the Act, a consistency requirement would have had minimal effect because post-1986 earnings and profits (including income excluded from subpart F income under section 954(b)(4)) could be distributed and would be included in income of the U.S. shareholder, and foreign taxes would be deemed paid under section 902, subject to the limitations imposed by section 904, which is a result consistent with a subpart F inclusion. Further, before the Act, an amount excluded under section 954(b)(4) largely resulted only in the deferral of income and deemed paid foreign taxes, rather than an exclusion of those items from the U.S. tax base, and deductions allocated and apportioned to such income would limit a taxpayer's ability to claim foreign tax credits in the future. After the

⁵The final regulations adopt the shorter and more descriptive term "CFC group," instead of the term "controlling domestic shareholder group." *See* §1.951A-2(c)(7)(viii)(E)(2).

Act, an election under section 954(b)(4) will result in a permanent change in the treatment of high-taxed income and the associated foreign taxes and deductions, increasing the significance, from a policy perspective, of inconsistent treatment.

Thus, the Treasury Department and the IRS have determined that the policy underlying section 954(b)(4) is best furthered through a single election to exclude all high-taxed income from GILTI (and, subject to finalization of the 2020 proposed regulations, subpart F income) because that income does not pose a base erosion concern and is therefore not the type of income that Congress intended to include in tested income. However, because the application of section 954(b)(4), and the additional administrative burden associated with identifying high-taxed items of income, has always been elective, the Treasury Department and the IRS have determined that the exclusion of such income (and to the extent possible any additional burden associated with identifying such income) should continue to be limited to cases where a taxpayer elects the application of section 954(b)(4).

The Treasury Department and the IRS have determined that it would be inappropriate to allow a taxpayer to selectively exclude and include income, once it makes an election under section 954(b)(4). Section 951A generally does not permit electivity in the determination of tested income. For example, a taxpayer cannot choose to include in tested income amounts that would be subpart F income but for the application of section 954(b)(4) (regardless of whether the election is made), nor may a taxpayer choose to include foreign oil and gas extraction income in tested income. Further, contrary to some comments, the Treasury Department and the IRS anticipate that the additional electivity is more likely to increase, rather than reduce, compliance burden as a result of the need for more numerous calculations. As a result, the Treasury Department and the IRS have concluded that the consistency rule should be retained; accordingly, this recommendation is not adopted.

B. Definition of CFC group

The 2019 proposed regulations define a CFC group based on two tests. Under

the first test, a CFC group means two or more CFCs if more than 50 percent of the total combined voting power of the stock of each CFC is owned (within the meaning of section 958(a)) by the same controlling domestic shareholder (as defined in §1.964-1(c)(5)). *See* proposed §1.951A-2(c)(6)(v)(E)(2). The second test applies only if no single controlling domestic shareholder satisfies the first test. Under the second test, the 2019 proposed regulations provide that a CFC group means two or more CFCs if more than 50 percent of the total combined voting power of the stock of each CFC is owned (within the meaning of section 958(a)) by the same controlling domestic shareholders and each such shareholder owns (within the meaning of section 958(a)) the same percentage of stock in each CFC. *See id.* For purposes of both tests, a controlling domestic corporate shareholder includes a related person (within the meaning of section 267(b) or 707(b)(1)) (the “related party rule”). *See id.*

One comment raised several issues with the definition of a CFC group. For example, the comment stated that the application of the related party rule is circular because it requires the already-determined existence of a controlling domestic shareholder to apply the rule that a controlling domestic shareholder includes persons related to the controlling domestic shareholder. In addition, the comment requested clarification as to whether, for purposes of determining the CFC group, section 958(a) ownership is limited to ownership by U.S. persons. The comment also raised several issues related to changes in ownership of CFCs, including issues arising in connection with simultaneous acquisitions of CFCs and acquisitions of controlling domestic shareholders.

In response to these comments, the final regulations revise the definition of a CFC group. Under the final regulations, a CFC group is an affiliated group, as defined in section 1504(a), with certain modifications that broaden the definition. *See* §1.951A-2(c)(7)(viii)(E)(2)(i). First, the affiliated group rules in section 1504(a) apply without regard to section 1504(b)(1) through (6) (which exclude certain corporations, such as foreign corporations, from the definition of an “in-

cludible corporation”). *See id.* Second, for purposes of determining whether a CFC is a member of a CFC group, the final regulations incorporate a “more than 50 percent” threshold instead of the “at least 80 percent” threshold in section 1504(a). *See id.* Stock ownership for this purpose is determined by applying the constructive ownership rules of section 318(a), with certain modifications. *See id.* These constructive ownership rules would, for example, cause two corporations owned directly by the same U.S. individual to be part of a CFC group.

The final regulations provide that the determination of whether a CFC is included in a CFC group is made as of the close of the CFC inclusion year of the CFC that ends with or within the taxable years of the controlling domestic shareholders. *See* §1.951A-2(c)(7)(viii)(E)(2)(ii). This rule is intended to address certain changes in ownership of CFCs, such as acquisitions and dispositions. The final regulations also provide that a CFC may be a member of only one CFC group and include a special tie-breaker rule for situations in which a CFC would be a member of more than one CFC group. *See* §1.951A-2(c)(7)(viii)(E)(2)(iii).

The final regulations also clarify that if a CFC is not a member of a CFC group, a high-tax election is made (or revoked) only with respect to the CFC and the rules regarding the election apply by reference to the CFC. *See* §1.951A-2(c)(7)(viii)(A). If, however, a CFC is a member of a CFC group, a high-tax election is made (or revoked) with respect to all members of the CFC group and the rules regarding the election apply by reference to the CFC group. *See* §1.951A-2(c)(7)(viii)(E)(1).

C. Duration of election

The 2019 proposed regulations generally provide that the GILTI high-tax exclusion election is effective for the CFC inclusion year for which it is made and all subsequent CFC inclusion years, unless the election is revoked. *See* proposed §1.951A-2(c)(6)(v)(C). The 2019 proposed regulations further provide that, subject to a “change of control” exception, if an election is revoked, then the CFC cannot make a new election for any CFC inclusion year that begins within 60

months following the close of the CFC inclusion year for which the previous election was revoked (“60-month restriction”). *See* proposed §1.951A-2(c)(6)(v) (D)(2). The preamble to the 2019 proposed regulations requested comments on whether the 60-month restriction should be modified or removed.

Several comments requested that the 60-month restriction be eliminated such that taxpayers would be permitted to make the GILTI high-tax exclusion election on an annual basis. Some comments reasoned that this change would be consistent with the subpart F high-tax exception, which is an annual election. Another comment asserted that taxpayers should be permitted to make the election annually to take into account significant fluctuations in foreign income that taxpayers generate from year to year, or the likely possibility that taxpayers may be subject to differing foreign tax rates from year to year as a result of economic factors and conditions beyond their control. Finally, a comment stated that taxpayers with a mix of high-taxed and low-taxed income attributable to their QBUs must evaluate various factors to determine whether an election should be made and, as those factors change from year to year, the 60-month restriction may force taxpayers to pay additional tax under the GILTI regime if future projections are incorrect.

The Treasury Department and the IRS agree with these comments and have determined that, given that the final regulations adopt a tested unit-by-tested unit approach (in lieu of the QBU-by-QBU approach) and retain the consistency requirement set forth in the 2019 proposed regulations, the 60-month restriction is not necessary to prevent abuse. Accordingly, the final regulations do not include the 60-month restriction and, subject to the consistency requirement, taxpayers may elect the GILTI high-tax exclusion on an annual basis.

Because the final regulations eliminate the 60-month restriction, comments requesting that the restriction be clarified in certain respects are moot and therefore not discussed.

D. *Effect on non-controlling U.S. shareholders*

One comment requested that the final regulations include a notice of election and revocation requirement, which would require any U.S. shareholder that makes or revokes an election to notify the CFC of such action and require any CFC that receives an election or revocation notice from a U.S. shareholder for a taxable year to notify its other U.S. shareholders of the action taken by the U.S. shareholder and its ownership percentage.

The Treasury Department and the IRS agree that U.S. shareholders that are not controlling domestic shareholders of a CFC should be informed by the controlling domestic shareholders of the CFC if they make (or revoke) a GILTI high-tax exclusion election with respect to the CFC. Therefore, the final regulations clarify that the controlling domestic shareholders must provide notice of elections (or revocations), as required by §1.964-1(c)(3)(iii), to each U.S. shareholder that is not a controlling domestic shareholder. *See* §1.951A-2(c)(7)(viii)(A)(1)(ii), (C) and (D).

E. *Treatment of domestic partnerships as controlling domestic shareholders*

The proposed regulations under section 958 in the 2019 proposed regulations provide, as a general rule, that for purposes of sections 951 and 951A (and certain related provisions) a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of section 958(a). *See* proposed §1.958-1(d)(1). Under an exception to this general rule, a domestic partnership is treated as owning stock of a foreign corporation within the meaning of section 958(a) for purposes of determining whether any U.S. shareholder is a controlling domestic shareholder. *See* proposed §1.958-1(d)(2). The preamble to the 2019 proposed regulations requested comments on this exception. The Treasury Department and the IRS intend to address comments received in response to this request in connection with finalizing the

proposed regulations under sections 951, 956, 958, and 1502.⁶

F. *Elections made or revoked on amended tax returns*

The 2019 proposed regulations generally allow a taxpayer to make (or revoke) the GILTI high-tax exclusion election with an amended income tax return. *See* proposed §1.951A-2(c)(6)(v)(A)(1) and (c)(6)(v)(D)(1). One comment indicated that it was unclear how the binding effect of the election on all U.S. shareholders of a CFC operates when the controlling domestic shareholder makes (or revokes) the election on an amended return. In particular, the comment stated that it was unclear whether a U.S. shareholder, other than a controlling domestic shareholder, would be required to file an amended return reflecting the election (or revocation). The comment further raised concerns about the possibility that the assessment statute of limitations may limit the government’s ability to assess any additional tax due as a result of such election (or revocation). The comment recommended that the final regulations clarify whether U.S. shareholders are required to file amended income tax returns when an election is made (or revoked) on an amended return.

In general, the Treasury Department and the IRS agree with the comment that allowing the controlling domestic shareholders to make (or revoke) the GILTI high-tax exclusion election on an amended income tax return may change the amount of U.S. tax due with respect to U.S. shareholders other than the controlling domestic shareholders. Further, the election or revocation may change the amount of U.S. tax due with respect to all U.S. shareholders in intervening tax years. If the election were made (or revoked) on an amended return after some or all of these taxable years are no longer open for assessment under section 6501, it may result in the issuance of refunds for certain taxable years of shareholders when corresponding deficiencies could not be assessed or collected. As a result, the final regulations provide that

⁶Under currently applicable §1.951A-1(e)(2), a domestic partnership can be a controlling domestic shareholder—for example, for purposes of determining which party elects the GILTI high-tax exclusion under §1.951A-7(c)(7)(viii)(A), including potentially for taxable years beginning after December 31, 2017, under §1.951A-7(b), as discussed in part VIII of this Summary of Comments and Explanation of Revisions.

the election may be made (or revoked) on an amended federal income tax return only if all U.S. shareholders of the CFC file amended federal income tax returns (unless an original return has not yet been filed, in which case the original federal income tax return may be filed consistently with the election (or revocation)) for the taxable year (and for any other taxable year in which their U.S. tax liabilities would be increased by reason of that election (or revocation)) (or in the case of a partnership if any item reported by the partnership or any partnership-related item would change as a result of the election (or revocation)), within 24 months of the unextended due date of the original federal income tax return of the controlling domestic shareholder's inclusion year with or within which the CFC inclusion year, for which the election is made (or revoked), ends. See §1.951A-2(c)(7)(viii)(A)(2) and (c)(7)(viii)(C). For administrative purposes, the final regulations also provide that amended federal income tax returns for all U.S. shareholders of the CFC for the CFC inclusion year must be filed within a single 6-month period (within the 24-month period). See §1.951A-2(c)(7)(viii)(A)(2)(ii). The requirement that all amended federal income tax returns be filed within a 6-month period is to allow the IRS to timely evaluate refund claims or make additional assessments.

The final regulations also clarify how these rules operate in the case of a U.S. shareholder that is a domestic partnership. See §1.951A-2(c)(7)(viii)(A)(3) and (4). For example, the final regulations provide that in the case of a U.S. shareholder that is a partnership, the election may be made (or revoked) with an amended Form 1065 or an administrative adjustment request (as described in §301.6227-1), as applicable. See §1.951A-2(c)(7)(viii)(A)(3). The final regulations further provide that if a partnership files an administrative adjustment request, a partner that is a U.S. shareholder in the CFC is treated as having complied with these requirements (with respect to the portion of the interest held through the partnership) if the partner and the partnership timely comply with their obligations under section 6227 with respect to that administrative adjustment request. See §1.951A-2(c)(7)(viii)(A)(4).

V. Foreign Tax Credit Rules

A. Allocation and apportionment of deductions with respect to CFC stock

One comment requested that the final regulations confirm that U.S. shareholder deductions properly allocated and apportioned to income excluded under the GILTI high-tax exclusion should not be taken into account for purposes of section 904 per the application of section 904(b)(4)(B). Section 904(b)(4) applies with respect to deductions properly allocated and apportioned to income (other than amounts includable under section 951(a)(1) or 951A(a)) with respect to stock of a specified 10-percent owned foreign corporation (as defined in section 245A(b)) or to such stock to the extent income with respect to such stock is other than amounts includable under section 951(a)(1) or 951A(a). Accordingly, section 904(b)(4) applies to any deduction allocated and apportioned to dividend income for which a deduction is allowed under section 245A. See §1.904(b)-3(a)(1)(ii). Similarly, section 904(b)(4) applies to any deduction allocated and apportioned to stock of specified 10-percent owned foreign corporations in the section 245A subgroup. See §1.904(b)-3(a)(1)(iii). For purposes of characterizing stock of a CFC under §1.861-13, income excluded under the GILTI high-tax exclusion should be treated as any other foreign or U.S. source gross income described in §1.861-13(a)(1)(i)(A)(9) and (10). The portion of the value of the stock of the CFC relating to such income will be assigned to the section 245A subgroup under §1.861-13(a)(5)(ii) through (iv). As a result, the Treasury Department and the IRS have determined that the regulations are clear regarding the interaction of U.S. shareholder deductions allocated and apportioned to income excluded under the GILTI high-tax exclusion and section 904(b)(4), and no further rules are necessary.

Another comment suggested that the final regulations turn off the application of section 904(b)(4) for deductions allocated and apportioned to income or stock that relates to earnings and profits arising from CFC income that is excluded by reason of the GILTI high-tax exclusion. This comment indicated that allowing the

application of section 904(b)(4) could incentivize taxpayers to inappropriately locate deductions related to high-taxed income in the United States. The Treasury Department and the IRS do not agree that taxpayers will have a material incentive to relocate deductions relating to high-taxed income to the United States as a result of the application of section 904(b)(4) because the foreign tax rates required to qualify for the GILTI high-tax exclusion must generally be comparable to or higher than the U.S. corporate tax rate, and, thus, taxpayers will generally benefit from locating such deductions in the foreign country. In effect, the GILTI high-tax exclusion reduces the effect of federal income taxes on taxpayers' locational decisions with respect to investment and deductions, thereby increasing the likelihood that such decisions will be based on non-tax business considerations. Furthermore, section 904(b)(4) by its terms applies to income that is not includable under section 951(a)(1) or section 951A(a), and income excluded under the GILTI high-tax exclusion is not includable under either of those provisions. Accordingly, the comment is not adopted.

B. Determination of taxes paid or accrued

One comment asserted that the 2019 proposed regulations are unclear as to the determination of the foreign taxes paid or accrued and requested that the final regulations clarify that foreign income taxes include taxes imposed by a country (or countries) on the net item, as provided under current §1.954-1(d)(3)(i). The comment specifically notes, as an example, instances where two foreign countries tax the same income.

The rules provided in §1.951A-2(c)(7)(iii) and (vii) are comparable to those provided in current §1.954-1(d)(3)(i); both sets of rules generally apply §1.904-6 to allocate and apportion foreign taxes to income. Although the GILTI high-tax exclusion requires that foreign taxes be associated with income on a narrower basis — the tested unit rather than the CFC — taxes imposed on the CFC that relate to income of the tested unit will generally be associated with the appropriate income under the rules in §1.904-6, regardless of

whether such tax is imposed by one or more countries. The 2020 proposed regulations propose further conformity of the rules applicable for the computation of the effective foreign tax rate for both subpart F income and tested income.

Further, in response to this comment, as well as similar comments received in response to the 2019 proposed regulations, the final regulations (T.D. 9882) relating to foreign tax credits published in the **Federal Register** (84 FR 69022) (“the 2019 Final FTC Regulations”) and these final regulations clarify the rules for associating foreign taxes with income. In particular, these final regulations clarify that the amount of foreign income taxes paid or accrued by a CFC with respect to a tentative tested income item is the U.S. dollar amount of the controlled foreign corporation’s current year taxes that are allocated and apportioned to the related tentative gross tested income. *See* §1.951A-2(c)(7)(vii). The final regulations provide that the deductions for current year taxes are allocated and apportioned to a tentative gross tested income item under the principles of §1.960-1(d)(3), by treating each tentative gross tested income item as assigned to a separate tested income group. *See* §1.951A-2(c)(7)(iii)(A). As a result, the principles of §1.904-6(a)(1) generally apply to allocate and apportion foreign income taxes to a tentative gross tested income item. However, the principles of §1.904-6(a)(2) are applied, in lieu of the principles of §1.904-6(a)(1), to associate foreign taxes with income in the case of disregarded payments between tested units. *See* §1.960-1(d)(3) and §1.951A-2(c)(7)(iii)(B). The final regulations provide additional rules for how the principles of §1.904-6(a)(2) should be applied for purposes of the high-tax exception. *See id.* In addition, a new example illustrates how foreign income taxes are associated with income in the case of disregarded payments. *See* §1.951A-2(c)(8)(iii)(B) (Example 2). The Treasury Department and the IRS also published proposed regulations (REG-105495-19) relating to foreign tax credits in the **Federal Register** (84 FR 69124) that contain more detailed rules for associating foreign taxes with income, including in the case of disregarded payments.

C. Annual accounting periods and foreign tax accruals

The proposed regulations generally provide that the amount of foreign income taxes paid or accrued with respect to a tentative net tested income item are the CFC’s current year taxes (as defined in §1.960-1(b)(4)) that would be allocated and apportioned under the principles of §1.960-1(d)(3)(ii) to the tentative net tested income item by treating the item as in a separate tested income group. *See* proposed §1.951A-2(c)(6)(iv). Taxes accrue, and are taken into account in determining foreign taxes deemed paid under section 960(d), when 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* §1.960-1(b)(4). Therefore, withholding taxes accrue when the payment from which the tax is withheld is made, and net basis taxes on income recognized during a taxable period accrue on the last day of the taxable period. *Id.*

Comments suggested that the final regulations provide special rules to address distortions that can arise from a mismatch between the U.S. and foreign taxable years. One comment recommended a “closing of the books election” whereby a taxpayer could elect to allocate and apportion its foreign taxes accrued in one U.S. taxable year across multiple U.S. taxable years, in proportion to the income accrued in each U.S. taxable year. Other comments recommended that taxpayers be permitted to adopt various alternative methods of accounting, including the use of the foreign taxable year to determine whether income is subject to a high rate of tax, or methods of accounting required under foreign law, such as mark-to-market.

The Treasury Department and the IRS have determined that foreign taxes should be associated with U.S. income consistently for all federal income tax purposes, and that deviating from established principles for determining when income and foreign taxes are taken into account for purposes of the GILTI high-tax exclusion would be inappropriate. Allowing foreign taxes to be taken into account in applying the GILTI high-tax exclusion in a different year than the year in which the foreign taxes accrue could lead to double counting,

or double-non-counting, of the foreign taxes. This could occur, for example, if a foreign tax that accrued in one year both caused a prior year tentative tested income item to be excluded as high-taxed and was creditable in the later year under section 960(d). While some comments also recommended changes to how foreign taxes are taken into account more generally, changes to the foreign tax credit regime are beyond the scope of this rulemaking. In addition, the Treasury Department and the IRS responded to similar comments in Part V of the Summary of Comments and Explanation of Revisions in the preamble to the 2019 Final FTC Regulations.

Similar considerations would apply with respect to the adoption of alternative methods of accounting for tentative tested income items, such as the adoption of a foreign fiscal year as the testing period or mark-to-market accounting. The use of these methods would lead to potential double counting of items of income, gain, deduction, or loss in different U.S. taxable years for different purposes, or would require complex coordination rules with material changes to established rules relating to when such items accrue for federal income tax purposes. Such changes are beyond the scope of this rulemaking and, accordingly, are not adopted.

VI. Removal of Examples in §1.954-1(d)(7)

Current §1.954-1(d)(7) provides examples that illustrate the application of the rules set forth in §1.954-1(c) and (d). The Treasury Department and the IRS have determined that these examples need to be updated to properly reflect changes to current §1.954-1 made in the final regulations, and to other provisions referenced in the examples. Therefore, the final regulations remove the examples in current §1.954-1(d)(7). No inference is intended as to the removal of these examples. Additional examples will be considered in connection with the Treasury decision adopting the 2020 proposed regulations as final regulations in the **Federal Register**.

VII. Authority

The Treasury Department and the IRS are aware that questions have been raised

regarding the statutory authority for the GILTI high-tax exclusion. As described in detail in the preamble to the 2019 proposed regulations (see 84 FR 29114), the Treasury Department and the IRS have determined that the GILTI high-tax exclusion is a valid interpretation of ambiguous statutory text in section 951A(c)(2)(A)(i)(III) and, after considering assertions to the contrary, concluded that this rationale provides authority to finalize the GILTI high-tax exclusion. See *Michigan v. Environmental Protection Agency*, 135 S. Ct. 2699, 2707 (2015) (observing that a court must “accept an agency’s reasonable resolution of an ambiguity in a statute that the agency administers,” provided that such interpretation “operate[s] within the bounds of reasonable interpretation.”). Specifically, the regulation interprets the words “by reason of” in that provision as denoting independently sufficient causation. The assertion by some commenters to the contrary that the words “by reason of” unambiguously require “but for” causation is not supported by the case law. Terms such as “by reason of” have been equated with other causal terms, such as “because of” or “as a result of,” and have been interpreted flexibly based on the underlying context and purposes of the applicable provision. Several recent decisions have interpreted such terms as encompassing independently sufficient causation based on dicta in the Supreme Court’s recent opinion in *Burrage v. United States*, 134 S.Ct. 881, 890 (2014). See, e.g., *United States v. Ewing*, 749 Fed.Appx. 317, 327-28 (6th Cir. 2018); *United States v. Seals*, 915 F.3d 1203, 1206-07 (8th Cir. 2019); *United States v. Feldman*, 936 F.3d 1288, 1317-18 (11th Cir. 2019).

In addition, commenters have suggested that, based on the statutory structure of sections 954(b)(4) and 951A(c)(2)(A)(i)(III), the provisions can only apply to income that would otherwise qualify as FBCI or insurance income. The Treasury Department and the IRS disagree with this

assertion because it would require that income both qualify as FBCI or insurance income and be excluded from such categories of income for purposes of the same provision. Moreover, neither section 954(b)(4) nor 951A(c)(2)(A)(i)(III) contains any limitation on the category of income to which the provisions can apply, instead referring broadly to “any item of income” and “any gross income,” respectively.

Accordingly, the GILTI high-tax exclusion is a valid interpretation of section 951A(c)(2)(A)(i)(III) based on the statutory text and the legislative purposes and history underlying section 951A, each of which is described in detail in the preamble to the 2019 proposed regulations.

VIII. Applicability Dates

Consistent with the applicability date in the 2019 proposed regulations, the final regulations provide that the GILTI high-tax exclusion applies to taxable years of foreign corporations beginning on or after July 23, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. See §1.951A-7(b).⁷

Several comments requested that taxpayers be permitted to apply the GILTI high-tax exclusion earlier than the proposed regulations would have allowed (for example, to taxable years beginning after December 31, 2017). In response to the comments, the final regulations permit taxpayers to choose to apply the GILTI high-tax exclusion to taxable years of foreign corporations that begin after December 31, 2017, and before July 23, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end. See §1.951A-7(b). Any taxpayer that applies the GILTI high-tax exclusion retroactively must consistently apply the rules in this Treasury decision to each taxable year in which the taxpayer applies the GILTI high-tax exclusion. See *id.*

Special Analyses

I. Regulatory Planning and Review — Economic Analysis

Executive Orders 13771, 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, of reducing costs, of harmonizing rules, and of promoting flexibility. For purposes of Executive Order 13771, this final rule is regulatory.

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

A. Background

The Tax Cuts and Jobs Act (the “Act”) established a system under which certain earnings of a foreign corporation can be repatriated to a corporate U.S. shareholder without federal income tax. However, Congress recognized that, without any anti-base erosion measures, this system could incentivize taxpayers to allocate income—in particular, mobile income from intangible property that would otherwise be subject to U.S. tax—to controlled foreign corporations (“CFCs”) operating in low- or zero-tax jurisdictions. See Senate

⁷Although this applicability date applies to §1.954-1(c)(1)(iv) (clarifying the treatment of deductions and loss attributable to disqualified basis in determining a net item of foreign base company income or insurance income), the rules in §1.951A-2(c)(5) (requiring deductions or loss attributable to disqualified basis to be allocated and apportioned solely to residual gross income) apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. See §1.951A-7(a). See also proposed §1.951A-2(c)(6) (requiring deductions related to disqualified payments to be allocated and apportioned solely to residual CFC gross income), as proposed to be amended at 85 FR 19858 (April 8, 2020), which would apply to taxable years of foreign corporations ending on or after April 7, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years end. See proposed §1.951A-7(d).

Committee on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, at 365 (the “Senate Explanation”). Therefore, Congress enacted section 951A in order to subject intangible income earned by a CFC to U.S. tax on a current basis, similar to the treatment of a CFC’s subpart F income under section 951(a)(1)(A). However, in order to protect the competitive position of U.S. corporations relative to their foreign peers, the global intangible low tax income (“GILTI”) of a corporate U.S. shareholder is effectively taxed at a reduced rate by reason of the deduction under section 250 (with the resulting federal income tax further reduced by a portion of foreign tax credits under section 960(d)).

Id.

The Treasury Department and the IRS previously issued final and proposed regulations under section 951A on June 21, 2019 (“2019 proposed regulations”).

B. Need for regulations

The final regulations are needed to provide a framework for taxpayers to elect to apply the statutory high-tax exception of section 954(b)(4) and exclude certain high-taxed income from taxation under section 951A.

C. Overview of regulations

The final regulations provide that the GILTI high-tax exclusion in section 951A(c)(2)(A)(i)(III) applies to high-taxed income of a CFC that is excluded from foreign base company income (“FBCI”) or insurance income under section 954(b)(4) regardless if the income would otherwise be FBCI or insurance income.

The final regulations provide rules to determine the effective rate of tax on foreign items of income for the purposes of applying the GILTI high-tax exclusion. The final regulations provide that the effective foreign tax rate is determined on a tested unit basis. They also provide rules to determine the net amount of income (in other words, the tentative tested income item) and the foreign taxes paid or accrued with respect to such net amount of income that are used to compute the effective rate of tax. In addition, the final regulations

indicate how to make a GILTI high-tax exclusion election. The final regulations provide that the election, if made, must be made consistently for certain related CFCs. The final regulations also provide that taxpayers can make the election annually.

D. Economic analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the 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 in applying section 954(b)(4) to certain high-tax income. In the absence of this clarity, there is a higher likelihood that taxpayers will interpret the rules regarding the high-tax exclusion differently. For example, when taxpayers hold varying interpretations of statutory language, one taxpayer may undertake an investment in a particular country while another taxpayer may decline to make this investment with this difference based solely on different interpretations of how income from that investment will be treated under section 951A and related provisions. If the investment would have been more productive if undertaken by the second taxpayer, this difference in beliefs about tax treatment is economically costly. The final regulations help to minimize this outcome. Clarity and certainty over tax treatment also reduce compliance costs and the costs of tax administration.

The final regulations also work to apply the GILTI high-tax exclusion in a way that treats income similarly across all international business activity and without favoring one type of income over another. In general, such equitable treatment of income-generating activities can be expected to improve U.S. economic performance.

The Treasury Department and the IRS project that the final regulations will have annual economic effects greater than \$100 million (\$2020). This determination is

based on the fact that many of the taxpayers potentially affected by these regulations are large multinational enterprises. Because of their substantial size, even modest changes in the treatment of their foreign-source income, relative to the no-action baseline, can lead to changes in patterns of economic activity that amount to at least \$100 million per year.

The Treasury Department and the IRS project that the final regulations may increase U.S. taxpayers’ foreign investment in high-tax jurisdictions, since the final regulations may decrease the effective tax rate on high-tax foreign-source income for some U.S. taxpayers relative to the no-action baseline. The Treasury Department and the IRS have not undertaken more precise estimates of the economic effects of the regulations. We do not have readily available data or models to predict with reasonable precision the business decisions that taxpayers would make under the final regulations, such as the amount and location of their foreign business activities, versus alternative regulatory approaches, including the no-action baseline.

In the absence of 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.

3. Economic Analysis of Specific Provisions

a. Scope of the GILTI high-tax exclusion

The GILTI high-tax exclusion in section 951A permits U.S. shareholders of CFCs to elect to exclude certain high-taxed income from gross tested income. The final regulations provide guidance on which types of high-taxed income are eligible for the high-tax exclusion.

The Treasury Department and the IRS considered a number of options for defining income that is eligible for the GILTI high-tax exclusion. The options were (i) to exclude from gross tested income only income that would be subpart F income solely but for the high-tax exception of section 954(b)(4) applying to such income; (ii) in addition to excluding the

aforementioned income, to exclude from gross tested income on an elective basis an item of gross income that is excluded by reason of another exception to FBCI or insurance income, if such income is subject to an effective foreign tax rate above the statutory threshold;⁸ or (iii) to exclude from gross tested income on an elective basis any item of gross income subject to an effective foreign tax rate above the statutory threshold.

The first option excludes from gross tested income only income that would be FBCI or insurance income but for the high-tax exception of section 954(b)(4), which is the interpretation of the scope of the GILTI high-tax exclusion in the final 951A regulations. This approach is consistent with current regulations under section 954, which permit an election under section 954(b)(4) only with respect to income that is not excluded from subpart F income by reason of another exception (for example, section 954(c)(6) or 954(h)). However, under this approach, taxpayers with high-taxed gross tested income would have an incentive to structure their foreign operations in order to ensure that income that would otherwise qualify as gross tested income would instead qualify as subpart F income, to a greater degree than other regulatory approaches that provide a broader GILTI high-tax exclusion, such as the third option considered. For instance, under this option, a taxpayer could structure its operations to have a CFC purchase personal property from, or sell personal property to, a related person in order to generate foreign base company sales income described under section 954(d) (assuming certain other exceptions are not satisfied). The result would be that the CFC's income from the disposition of the property meets the definition of FBCI and hence is eligible for the high-tax exception. Because businesses are largely not currently structured in this way, such an organization would entail restructuring, which would potentially be costly and only available to certain taxpayers yet would not provide any general economic benefit. In other words, such reorganization to realize a specific tax treatment would suggest that tax instead of business

considerations are determining business structures and operations. This outcome may lead to higher compliance costs and less efficient patterns of business activity relative to a regulatory approach that provides a broader GILTI high-tax exclusion.

The second option broadens the application of the GILTI high-tax exclusion, relative to the first option, to allow taxpayers to elect to exclude items of gross income that are subject to an effective foreign tax rate above the statutory threshold, if such income was also excluded from FBCI or insurance income by reason of another exception to subpart F. Under this interpretation, income such as active financing income that is excluded from subpart F income under section 954(h), active rents or royalties that are excluded from subpart F income under 954(c)(2)(A), and related party payments that are excluded from subpart F income under section 954(c)(6) could also be excluded from gross tested income under the GILTI high-tax exclusion if such items of income are high taxed within the meaning of section 954(b)(4).

Under this approach, however, taxpayers would have the ability to exclude their CFCs' high-taxed income that would be subpart F income but for an exception (for example, active financing income), while they would not be able to exclude their CFCs' high-taxed income that is not subpart F income in the first instance (for example, active business income). This may result in differential treatment of economically similar income, which generally leads to economically inefficient decision-making. Furthermore, taxpayers with items of high-taxed income that are not subpart F income would still be incentivized to restructure their foreign operations in order to convert their high-taxed gross tested income into subpart F income, which poses the same compliance costs and inefficiencies as the first option.

The third option, which was adopted in the proposed regulations and which these regulations finalize, provides an election to broaden the scope of the high-tax exception relative to the other two options considered. Under this option, the high-tax exception under section 954(b)(4) for

purposes of the GILTI high-tax exclusion applies to any item of income that is subject to an effective foreign tax rate greater than 90 percent of the maximum corporate tax rate (currently, 18.9 percent based on a 21 percent corporate rate). The final regulations permit controlling domestic shareholders of CFCs to elect to apply the high-tax exception under section 954(b)(4) to items of gross income that would not otherwise be FBCI or insurance income. If this high-tax exception is elected, the GILTI high-tax exclusion will exclude the item of gross income from gross tested income. Under the election, an item of gross income is subject to a high rate of foreign tax if, after taking into account properly allocable expenses, the net item of income is subject to an effective foreign tax rate above the statutory threshold.

Contrary to the first two options, this approach permits similarly situated taxpayers with CFCs subject to a high rate of foreign tax to make the election to exclude such income from gross tested income and reduces the incentive for taxpayers to restructure their operations or structures to convert their high-taxed gross tested income into FBCI or insurance income for federal income tax purposes.

For taxpayers that make the election, this approach will lower U.S. tax on certain foreign income by reducing U.S. tax on a broader scope of the income of high-taxed tested units compared to the no-action baseline. If a taxpayer elects the high-tax exclusion, U.S. tax on other foreign income may increase due to complex interactions with other provisions in the corporate tax system, such as the expense allocation and foreign tax credit rules, although taxpayers will generally only make the election if this increase in tax on other foreign income is less than the decrease in tax on high-taxed income. Thus, this approach may reduce the taxpayers' cost of capital on high-taxed foreign investment, and at the margin, the lower cost of capital may increase foreign investment in high-tax jurisdictions by U.S.-parented firms relative to the baseline.

The Treasury Department and the IRS have not undertaken estimation of these effects, relative to the no-action baseline,

⁸The statutory threshold is 90 percent of the maximum U.S. corporate tax rate (18.9 percent based on the current U.S. corporate tax rate of 21 percent).

because we do not have readily available data or models to estimate with any reasonable precision: (i) the number and attributes of the taxpayers that will find it advantageous to make the election; (ii) the relationship between the marginal effective foreign tax rate at the tested unit level and foreign investment by U.S. taxpayers; and (iii) the range of marginal effective foreign tax rates at the tested unit level that taxpayers are likely to have under the final regulations versus the baseline or other regulatory approaches.

b. Aggregation of income for determination of the effective foreign tax rate

The statute provides an exclusion from tested income for high-taxed income but does not provide sufficient detail for determining how income should be aggregated for determining the effective foreign tax rate that applies to that income, such that that income would be excluded. The Treasury Department and the IRS considered four options to address this issue: (i) apply the determination of whether income is high-taxed on an item-by-item basis; (ii) apply the determination on a CFC-by-CFC basis; (iii) apply the determination on a qualified business unit (“QBU”)-by-QBU basis; and (iv) apply the determination on a tested unit-by-tested unit basis.

The first option is to determine whether income is high-taxed income on an item-by-item basis, based on the item-by-item determination that is generally applicable under the current regulations that implement the high-tax exception of section 954(b)(4) for purposes of subpart F income. However, this would entail high compliance costs for taxpayers and be difficult to administer because it would require taxpayers to analyze each item of income to determine whether, under federal tax principles, the item is subject to a sufficiently high effective foreign tax rate. The Treasury Department and the IRS have not estimated the higher compliance costs that might have been incurred under this regulatory option, relative to the final regulations.

The second option, to apply the determination based on all the items of income of the CFC, would minimize complexity and would be relatively easy to adminis-

ter. On the other hand, this approach could permit inappropriate tax planning, such as combining operations subject to different rates of tax into a single CFC. This would have the effect of “blending” the rates of foreign tax imposed on the income, which could result in low- or non-taxed income being excluded as high-taxed income by being blended with much higher-taxed income. The low-taxed income in this scenario is precisely the sort of base erosion-type income that the legislative history describes section 951A as intending to tax, and such tax motivated planning behavior is economically inefficient.

The third option, which was proposed in the proposed regulations, is to apply the high-tax exception based on the items of gross income of a QBU of the CFC. Under this approach, the net income that is taxed by the foreign jurisdiction in each QBU must be determined and the blending of different tax rates within a CFC would be minimized. While this approach would more accurately separate high-taxed and low-taxed income, compared to applying the high-tax exception on the basis of a CFC, there were several comments to the proposed regulations that noted the difficulties in compliance and administration that would arise if the QBU standard were used, such as the difficulty in determining whether a set of activities constituted a trade or business and hence a QBU.

The fourth option, which is adopted in the final regulations, is to apply the high-tax exception on the basis of the items of gross income of a tested unit of a CFC. The tested unit standard is a more targeted measure than the QBU standard and will be more easily applied to the GILTI high-tax exclusion than the QBU standard. Moreover, the tested unit standard, similarly to the QBU standard, will minimize the blending of different tax rates within a CFC. For example, if a CFC earned \$100x of tested income through a tested unit in Country A and was taxed at a 30 percent rate and earned \$100x of tested income through another tested unit in Country B and was taxed at 0 percent, the blended rate of tax on all of the CFC’s tested income is 15 percent. However, if the high-tax exception applies to each of a CFC’s tested units based on the income earned by that tested unit, then the two tax rates would not be blended together. Although

applying the high-tax exception on the basis of a tested unit, rather than the CFC as a whole, may be more complex and administratively burdensome under certain circumstances and may entail somewhat higher compliance costs (although most of the data the taxpayer would use for this purpose will likely be readily available to the taxpayer and will often overlap with data necessary to meet other compliance requirements), it more accurately pinpoints income subject to a high rate of foreign tax and therefore continues to subject to tax the low-taxed base erosion-type income that the legislative history describes section 951A as intending to tax. Accordingly, the final regulations apply the high-tax exception of section 954(b)(4) based on the items of net income of each tested unit of the CFC.

The Treasury Department and the IRS have not estimated these effects, relative to the no-action baseline, because we do not have readily available data or models to estimate with any reasonable precision the compliance costs or restructuring costs affected by these provisions relative to the no-action baseline or other regulatory alternatives.

c. Grouping of tested units in same country

The statute does not specify how items of income in the same country should be treated for the purpose of applying the GILTI high-tax exclusion. To address this issue, the final regulations provide guidance on how a CFC’s tested units in the same country should be treated in order to determine if income is high-taxed.

Under the proposed regulations, effective foreign tax rates are determined separately for each QBU, even if other QBUs of the same CFC are located in the same county. Testing each QBU separately would limit the blending of income taxed at different rates and thus limit the likelihood that that no-taxed or low-taxed income would qualify for the high-tax exclusion through aggregation with higher-taxed income. This approach is consistent with the intent to subject low-taxed base erosion-type income to tax under section 951A, as described in the legislative history. However, comments noted that separate testing for each QBU would

result in high compliance burdens for taxpayers and could result in tax rate calculations that do not reflect the rate of foreign tax on QBU income, especially in circumstances in which separate QBUs are able to share tax attributes through a fiscal unity, consolidation or similar means. If tax rate calculations do not properly reflect the rate of foreign tax on QBU, taxpayers may undertake inefficient business decisions when evaluated against the intent and purpose of the statute.

In the final regulations, all tested units of a CFC in the same country are generally grouped together to determine the effective foreign tax rate for the purpose of applying the high-tax exclusion. Under this approach, low-taxed and high-taxed income are unlikely to be blended, since tested units in the same country are likely to be subject to the same statutory tax rate. Relative to the approach in the proposed regulations, this approach will lower compliance burdens for taxpayers because taxpayers will less frequently have to allocate and apportion taxes paid by one tested unit to another tested unit. In addition, this approach may also reduce the effect of fluctuations in effective foreign tax rates observed in individual tested units relative to the regulatory alternative in the proposed regulations. Since multiple tested units are grouped together, outlying effective foreign tax rates due to timing and base differences between the U.S. and foreign tax rules will counterbalance each other. Finally, this averaging of tax rates will decrease the incentives taxpayers face to undertake inefficient planning activities to achieve certain tax rates in individual tested units relative to a regulatory approach in which effective foreign tax rates were determined separately for tested units in the same country.

The Treasury Department and the IRS have not undertaken estimation of these effects, relative to the no-action baseline, because data or models are not readily available to estimate with any reasonable precision the compliance costs or patterns of business activity affected by these provisions relative to the no-action baseline or other regulatory alternatives.

d. Foreign net operating losses

The statute provides an exclusion from tested income for income that is high-

taxed but does not specify whether or how foreign net operating loss ("NOL") carryovers should be accounted for in the computation of the effective foreign tax rate. To address this issue, the final regulations provide rules governing how foreign net operating loss carryforwards should be accounted for in the computation of the effective foreign tax rate.

The proposed regulations generally provided that the effective foreign tax rate that determines whether a tested unit's income is considered high-taxed is computed using the amount of income as determined for federal income tax purposes, without regard for how the income is determined for foreign tax purposes. Thus, under this approach, foreign NOL carryforwards do not factor into the effective foreign tax rate calculation, since foreign NOL carryforwards are not accounted for in the federal tax base under federal tax accounting principles. Some comments suggested that taxpayers should be able to make adjustments to the effective foreign tax rate calculation to account for foreign NOL carryforwards. These comments noted that NOLs carried forward to subsequent profitable tax years of a tested unit could lead to income subject to a high statutory foreign tax rate not being classified as high-taxed for the purposes of the GILTI high-tax exclusion. The effective foreign tax rate – calculated using the federal tax base – could be lower than the statutory threshold, even if the smaller foreign base is taxed at a higher rate.

The Treasury Department and the IRS decided to maintain the approach of the proposed regulations and to not provide rules that account for the use of foreign NOL carryforwards. The Treasury and IRS determined that carried forward NOLs are an example of timing differences between foreign and federal tax bases. Since there may be differences between when certain items are recognized for federal and foreign tax purposes, the effective foreign tax rate of a given tested unit calculated for the purpose of applying the high-tax exclusion may change from year to year even if the tax rate on its foreign base remains constant. Accounting for these differences would require complex rules akin to the deferred tax asset and tax liability rules used in financial accounting. Taxpayers would need to apply

rules that reconcile foreign and federal tax accounting rules over multiple years. The Treasury Department and the IRS determined that these rules would add undue complexity and impose a substantial compliance burden on taxpayers and administrative burden on the government relative to the regulatory approach of the final regulations. The Treasury Department and the IRS have not attempted to estimate the compliance burden under this alternative regulatory approach relative to the final regulations.

e. Election period

The statute provides for an election to exclude high-taxed income from gross tested income but does not specify the length of the election period. To address this issue, proposed regulations provided that the election into the high-tax exclusion would be generally made or revoked for a five-year period. The five-year election period was intended to prevent taxpayers from manipulating the timing of income, expenses, and foreign income taxes in order to achieve inappropriate results. As a simple example, under a shorter election period, a taxpayer could accelerate certain expenses that are allocable to the income of a high-taxed tested unit into a year when the taxpayer elects into the high-tax exclusion. The following year, the taxpayer could revoke its election. Thereby, in the second year, the taxpayer would be able to use the foreign income taxes paid by the high-taxed tested unit as creditable taxes against income included under section 951A without the accelerated expenses reducing the amount of the foreign tax credit that could be claimed. In order to achieve tax savings through this manipulation, taxpayers would need to manipulate a large number of items annually, and the manipulation of these items would be costly without any corresponding increase in productive economic activity.

Comments noted that the extended election period would require taxpayers to make five-year projections of a large number of variables on a tested unit-by-tested unit basis in order to determine whether to elect into the high-tax exclusion. The complexity of these projections would result in a large burden on taxpayers. More-

over, even with a shorter election period, taxpayers would likely face difficulty in engaging in tax planning by changing their election status. Existing rules limit taxpayers' discretion over the timing of recognition of income and expenses. The complexity of manipulating the timing of different items across all of a taxpayer's tested units, which is necessary under the final regulations because the election into the high-tax exclusion must be made for all related CFCs, would also create obstacles to using frequent changes in election status as part of tax reduction strategies. Therefore, the Treasury Department and IRS determined that the reduction in taxpayer compliance burdens significantly outweighed concerns about potential tax planning, and the Treasury Department and IRS adopted a one-year election period in the final regulations.

The Treasury Department and the IRS have not undertaken estimation of these effects, relative to the no-action baseline, because data or models are not readily available to estimate with any reasonable precision the compliance costs or patterns of business activity affected by these provisions relative to the no-action baseline or other regulatory alternatives.

4. Profile of Affected Taxpayers

The proposed regulations potentially affect those taxpayers that have at least one CFC with at least one tested unit (including, potentially, the CFC itself) that has high-taxed income. Taxpayers with CFCs that have only low-taxed income are not eligible to apply the high-tax exception and hence are unaffected by the proposed regulations.

The Treasury Department and the IRS estimate that there are approximately 4,000 business entities (corporations, S corporations, and partnerships) with at least one CFC that pays an effective foreign tax rate above 18.9 percent, the current high-tax statutory threshold. The Treasury Department and the IRS further estimate that, for the partnerships with at

least one CFC that pays an effective foreign tax rate greater than 18.9 percent, there are approximately 1,500 partners that have a large enough share to potentially qualify as a 10 percent U.S. shareholder of the CFC.⁹ The 4,000 business entities and the 1,500 partners provide an estimate of the number of taxpayers that could potentially be affected by guidance governing the election into the high-tax exception. The figure is approximate because the tax rate at the CFC-level will not necessarily correspond to the tax rate at the tested unit-level if there are multiple tested units within a CFC.

The Treasury Department and the IRS do not have readily available data to determine how many of these taxpayers would elect the high-tax exception as provided in these proposed regulations. Under the proposed regulations, a taxpayer that has both high-taxed and low-taxed tested units will need to evaluate the benefit of eliminating any tax under section 951 and section 951A with respect to high-taxed income against the costs of forgoing the use of foreign tax credits and, with respect to section 951A, the use of tangible assets in the computation of qualified business asset investment (QBAI).

Tabulations from the IRS Statistics of Income 2014 Form 5471 file¹⁰ further indicate that approximately 85 percent of earnings and profits are reported by CFCs incorporated in jurisdictions where the average effective foreign tax rate is less than or equal to 18.9 percent. The data indicate several examples of jurisdictions where CFCs have average effective foreign tax rates above 18.9 percent, such as France, Italy, and Japan. However, information is not readily available to determine how many tested units are part of the same CFC and what the effective foreign tax rates are with respect to such tested units. Taxpayers potentially more likely to elect the high-tax exception are those taxpayers with CFCs that only operate in high-tax jurisdictions. Data on the number or types of CFCs that operate only in high-tax jurisdictions are not readily available.

II. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) ("PRA") generally 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.

The final regulations include collections of information in §1.951A-2(c)(7)(viii)(A)(1) and (2), and §1.951A-2(c)(7)(viii)(C). The collection of information in §1.951A-2(c)(7)(viii)(A)(1) requires that each controlling domestic shareholder of a CFC file an election to exclude gross income of a CFC from tested income under the high-tax exception of section 954(b)(4), with a timely original federal income tax return or Form 1065, or, subject to certain time limitations and other requirements, with an amended federal income tax return, administrative adjustment request, or amended Form 1065, as applicable. This collection of information in the final regulations generally retains the collection of information in the proposed regulations. The final regulations clarify that a controlling domestic shareholder must make this election by filing the statement required under §1.964-1(c)(3)(ii).

The collection of information in §1.951A-2(c)(7)(viii)(A)(1)(ii) requires that each controlling domestic shareholder of a CFC that files an election to exclude gross income of a CFC from tested income under the high-tax exception of section 954(b)(4) provide any notices required under §1.964-1(c)(3)(iii). The collection of information in §1.951A-2(c)(7)(viii)(C) requires each controlling domestic shareholder that revokes an election on an amended return to provide the statement and notice described in §1.951A-2(c)(7)(viii)(A)(1)(i) and (ii), respectively.

As shown in Table 1, the Treasury Department and the IRS estimate that the number of persons potentially subject to the collections of information in §1.951A-2(c)(7)(viii)(A)(1)(i) and (ii), and §1.951A-2(c)

⁹Data are from IRS's Research, Applied Analytics, and Statistics division based on E-file data available in the Compliance Data Warehouse for tax years 2015 and 2016. The counts include Category 4 and Category 5 IRS Form 5471 filers. Category 4 filers are U.S. persons who had control of a foreign corporation during the annual accounting period of the foreign corporation. Category 5 filers are U.S. shareholders who own stock in a foreign corporation that is a CFC and who owned that stock on the last day in the tax year of the foreign corporation in that year in which it was a CFC. For full definitions, see <https://www.irs.gov/pub/irs-pdf/f5471.pdf>.

¹⁰The IRS Statistics of Income Tax Stats report on Controlled Foreign Corporations can be accessed here: <https://www.irs.gov/statistics/soi-tax-stats-controlled-foreign-corporations>.

(7)(viii)(C) is between 25,000 and 35,000. The estimate in Table 1 is based on the number of taxpayers that filed a tax return that included a Form 5471, “Information

Return of U.S. Persons With Respect to Certain Foreign Corporations.” The collections of information in §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii), and §1.951A-2(c)(7)(viii)(C)

(7)(viii)(C) can only apply to taxpayers that are U.S. shareholders (as defined in section 951(b)) and U.S. shareholders are required to file a Form 5471.

Table 1. Table of Tax Forms Impacted

Tax Forms Impacted		
Collections of information	Number of respondents (estimated)	Forms to which the information may be attached
§1.951A-2(c)(7)(viii)(A)(I)(i) and (ii), and §1.951A-2(c)(7)(viii)(C)	25,000 - 35,000	Form 990 series, Form 1120 series, Form 1040 series, Form 1041 series, and Form 1065 series

Source: MeF, DCS, and IRS’s Compliance Data Warehouse

The reporting burdens associated with the collections of information in §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C) will be reflected in the Form 14029, Paperwork Reduction Act Submission, that the Treasury Department and the IRS will submit to OMB for tax returns in the Form 990 series, Forms 1120, Forms 1040, Forms 1041, and Forms 1065. In particular, the reporting burden associated with the information collection in §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C) will be included in the burden estimates for OMB control numbers 1545-0123, 1545-0074, 1545-0092, and 1545-0047. OMB control number 1545-0123 represents a total estimated burden time for all forms and schedules for corporations of 3.344 billion hours and total estimated monetized costs of \$61.558 billion (\$2019). OMB control number 1545-0074 represents a total estimated burden time, including all other related forms and schedules for individuals, of 1.717 billion hours and total estimated monetized costs of \$33.267 billion (\$2019). OMB control number 1545-0092 represents a total estimated burden time, including all other related forms and schedules for trusts and estates, of 307,844,800 hours and total estimated monetized costs of \$9.950 billion (\$2016). OMB control number 1545-0047 represents a total estimated burden time, including all other related forms and schedules for tax-exempt organizations, of 52.450 million hours and total estimated monetized costs of \$1,496,500,000 (\$2020). Table 2 summarizes the status of the Paperwork Reduction Act submissions

of the Treasury Department and the IRS related to forms in the Form 990 series, Forms 1120, Forms 1040, Forms 1041, and Forms 1065.

The overall burden estimates provided by the Treasury Department and the IRS to OMB in the Paperwork Reduction Act submissions for OMB control numbers 1545-0123, 1545-0074, 1545-0092, and 1545-0047 are aggregate amounts related to the U.S. Business Income Tax Return, the U.S. Individual Income Tax Return, and the U.S. Income Tax Return for Estates and Trusts, along with any associated forms. The burdens included in these Paperwork Reduction Act submissions, however, do not account for any burden imposed by §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C). The Treasury Department and the IRS have not identified the estimated burdens for the collections of information in §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C) because there are no burden estimates specific to §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C) currently available. The burden estimates in the Paperwork Reduction Act submissions that the Treasury Department and the IRS will submit to the OMB will in the future include, but not isolate, the estimated burden related to the tax forms that will be revised for the collection of information in §1.951A-2(c)(7)(viii)(A)(I) and (ii) and §1.951A-2(c)(7)(viii)(C).

The Treasury Department and the IRS have included the burdens related to the Paperwork Reduction Act submissions for OMB control numbers 1545-0123, 1545-

0074, 1545-0092, and 1545-0047 in the PRA analysis for other regulations issued by the Treasury Department and the IRS related to the taxation of cross-border income. The Treasury Department and the IRS encourage users of this information to take measures to avoid overestimating the burden that the collections of information in §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C), together with other international tax provisions, impose. Moreover, the Treasury Department and the IRS also note that the Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis because an estimate based on the taxpayer-type most accurately reflects taxpayers’ interactions with the forms.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the final regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. Proposed revisions (if any) to these forms that reflect the information collections contained in §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C) will be made available for public comment at <https://apps.irs.gov/app/pick-list/list/draftTaxForms.html> and will not be finalized until after these forms have been approved by OMB under the PRA.

Table 2. Summary of Information Collection Request Submissions Related to Form 990 series, Forms 1120, Forms 1040, Forms 1041, and Forms 1065.

Form	Type of Filer	OMB Number(s)	Status
Forms 990	Tax exempt entities (NEW Model)	1545-0047	Approved by OIRA 2/12/2020 until 2/28/2021. Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201912-1545-014
	Individual (NEW Model)	1545-0074	Approved by OIRA 1/30/2020 until 1/31/2021. Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021
Form 1041	Trusts and estates	1545-0092	Approved by OIRA 5/08/2019 until 5/31/2022. Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201806-1545-014
	Business (NEW Model)	1545-0123	Approved by OIRA 1/30/2020 until 1/31/2021. Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001

III. Regulatory Flexibility Act

It is hereby certified that these 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).

Section 951A generally affects U.S. shareholders of CFCs. The reporting burdens in §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C), affect controlling domestic shareholders of a CFC that elect to apply the high-tax exception of section 954(b)(4) to gross income of a CFC. Controlling domestic shareholders are generally U.S. shareholders who, in the aggregate, own more than 50 percent of the total combined voting power of all classes of stock of the for-

ign corporation entitled to vote. As an initial matter, foreign corporations are not considered small entities. Nor are U.S. taxpayers considered small entities to the extent the taxpayers are natural persons or entities other than small entities. Thus, §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C) generally only affect small entities if a U.S. taxpayer that is a U.S. shareholder of a CFC is a small entity.

Examining the gross receipts of the e-filed Forms 5471 that is the basis of the 25,000 – 35,000 respondent estimates, the Treasury Department and the IRS have determined that the tax revenue from section 951A estimated by the Joint Committee on Taxation for businesses of all sizes is less than 0.3 percent of gross receipts as shown in the table below. Based on data

for 2015 and 2016, total gross receipts for all businesses with gross receipts under \$25 million is \$60 billion while those over \$25 million is \$49.1 trillion. Given that tax on GILTI inclusion amounts is correlated with gross receipts, this results in businesses with less than \$25 million in gross receipts accounting for approximately 0.01 percent of the tax revenue. Data are not readily available to determine the sectoral breakdown of these entities. Based on this analysis, smaller businesses are not significantly impacted by these proposed regulations. The Small Business Administration's small business size standards (13 CFR part 121) identify as small entities several industries with annual revenues above \$25 million or because of the number of employees.

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
JCT tax revenue	7.7 billion	12.5 billion	9.6 billion	9.5 billion	9.3 billion	9.0 billion	9.2 billion	9.3 billion	15.1 billion	21.2 billion
Total gross receipts	30727 billion	53870 billion	566676 billion	59644 billion	62684 billion	65865 billion	69201 billion	72710 billion	76348 billion	80094 billion
Percent	0.03	0.02	0.02	0.02	0.01	0.01	0.01	0.01	0.02	0.03

Source: Research, Applied Analytics and Statistics division (IRS), Compliance Data Warehouse (IRS) (E-filed Form 5471, category 4 or 5, C and S corporations and partnerships); Conference Report, at 689.

The data to assess the number of small entities potentially affected by §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C) are not readily available. However, businesses that are U.S. shareholders of CFCs are generally

not small businesses because the ownership of sufficient stock in a CFC in order to be a U.S. shareholder generally entails significant resources and investment. The Treasury Department and the IRS welcome comments on whether the proposed regula-

tions would affect a substantial number of small entities in any particular industry.

Regardless of the number of small entities potentially affected by §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C), the Treasury Department and

the IRS have concluded that there is no significant economic impact on such entities as a result of §1.951A-2(c)(7)(viii) (A)(I)(i) and (ii) and §1.951A-2(c)(7) (viii)(C). Furthermore, the requirements in §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C) apply only if a taxpayer chooses to make an election to apply a favorable rule. Consequently, the Treasury Department and the IRS have determined that §1.951A-2(c)(7) (viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C) will not have a significant economic impact on a substantial number of small entities. Accordingly, it is hereby certified that the collection of information requirements of §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C) would not have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS invite comments from the public on the impact of §1.951A-2(c)(7)(viii)(A)(I)(i) and (ii) and §1.951A-2(c)(7)(viii)(C) on small entities.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. § 1532) 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 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.

V. 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.

VI. 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 generally takes effect 60 days after the rule is published in the **Federal Register**. Accordingly, the Treasury Department and IRS are adopting these final regulations with the delayed effective date generally prescribed under the Congressional Review Act.

Drafting Information

The principal authors of these regulations are Jorge M. Oben and Larry R. Pounders of the Office of Associate Chief Counsel (International). 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 record-keeping requirements.

Adoption of 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 continues to read in part as follows:

Authority: 26 U.S.C. 7805.

§ 1.951A-0 [Removed]

Par. 2. Section 1.951A-0 is removed.

Par. 3. Section 1.951A-2 is amended by revising paragraph (c)(1)(iii), redesignating the text of paragraph (c)(3) as paragraph (c)(3)(i), adding a subject heading to newly redesignated (c)(3)(i), and adding paragraph (c)(3)(ii), a reserved para-

graph (c)(6), and paragraphs (c)(7) and (8) to read as follows:

§1.951A-2 Tested income and tested loss.

* * * * *

(c) * * *

(1) * * *

(iii) Gross income excluded from the foreign base company income (as defined in section 954) or the insurance income (as defined in section 953) of the corporation by reason of the exception described in section 954(b)(4) pursuant to an election under §1.954-1(d)(5), or a tentative gross tested income item of the corporation that qualifies for the exception described in section 954(b)(4) pursuant to an election under paragraph (c)(7) of this section,

* * * * *

(3) * * *

(i) *In general.* * * *

(ii) *Coordination with the high-tax exclusion*—(A) *In general.* In the case of a taxpayer that has made an election under paragraph (c)(7) of this section, in allocating and apportioning deductions under this paragraph (c)(3), the taxpayer must apply the rules of sections 861 through 865 and 904(d) (taking into account the rules of section 954(b)(5) and §1.954-1(c)) in a manner that achieves results consistent with those under paragraph (c)(7) of this section.

(B) *Application of consistency rule to deductions allocated and apportioned to the residual grouping in applying the high-tax exclusion.* Deductions that are allocated and apportioned to the residual income group under paragraph (c)(7)(iii)(A) of this section for purposes of applying the high-tax exclusion to a controlled foreign corporation’s tentative gross tested income items are allocated and apportioned for purposes of determining the controlled foreign corporation’s net income in each relevant statutory grouping using a method that provides for a consistent allocation and apportionment of deductions to gross income in the relevant groupings. See §§1.954-1(c) and 1.960-1(d)(3) for rules relating to the allocation and apportionment of expenses for purposes of determining subpart F income, which is included in the residual grouping for purposes of applying the high-tax exclusion of sections 951A(c)(2)(A)(i)(III) and 954(b)(4) and paragraph (c)(7) of this section.

Therefore, for example, interest expense that is apportioned under the modified gross income method to a tentative gross tested income item of a lower-tier corporation under paragraph (c)(7)(iii)(A)(1) of this section may be allocated and apportioned to the tested income of the upper-tier corporation or to the residual grouping, depending on whether the lower-tier corporation's tentative gross tested income item is an item of gross tested income or is excluded from gross tested income under the high-tax exclusion. *See* paragraph (c)(8)(iii)(C) (Example 3) of this section for an example illustrating the rules of this paragraph (c)(3).

(6) [Reserved]

(7) *Election to apply high-tax exception of section 954(b)(4)—(i) In general.* For purposes of section 951A(c)(2)(A)(i)(III) and paragraph (c)(1)(iii) of this section, a tentative gross tested income item of a controlled foreign corporation for a CFC inclusion year qualifies for the exception described in section 954(b)(4) only if—

(A) An election made under paragraph (c)(7)(viii) of this section is effective with respect to the controlled foreign corporation for the CFC inclusion year; and

(B) The tentative tested income item with respect to the tentative gross tested income item was subject to an effective rate of foreign tax, as determined under paragraph (c)(7)(vi) of this section, that is greater than 90 percent of the maximum rate of tax specified in section 11.

(ii) *Calculation of tentative gross tested income item—(A) In general.* A tentative gross tested income item with respect to a controlled foreign corporation for a CFC inclusion year is the aggregate of all items of gross income of the controlled foreign corporation attributable to a tested unit (as defined in paragraph (c)(7)(iv) of this section) of the controlled foreign corporation in the CFC inclusion year that would be gross tested income without regard to this paragraph (c)(7) and would be in a single tested income group (as defined in §1.960-1(d)(2)(ii)(C)). A controlled foreign corporation may have multiple tentative gross tested income items. *See* paragraphs (c)(8)(iii)(A)(2)(i) (Example 1) and (c)(8)(iii)(B)(2)(i) (Example 2) of this section for illustrations of the applica-

tion of the rule set forth in this paragraph (c)(7)(ii)(A).

(B) *Gross income attributable to a tested unit—(I) Items properly reflected on separate set of books and records.* Items of gross income of a controlled foreign corporation are attributable to a tested unit of the controlled foreign corporation to the extent they are properly reflected on the separate set of books and records of the tested unit, as modified under paragraph (c)(7)(ii)(B)(2) of this section. Each item of gross income of a controlled foreign corporation is attributable to a tested unit (and not to more than one tested unit) of the controlled foreign corporation. *See* paragraphs (c)(8)(iii)(D)(2) and (c)(8)(iii)(D)(5) (Example 4) of this section for illustrations of the application of the rule set forth in this paragraph (c)(7)(ii)(B).

(2) *Gross income determined under federal income tax principles, as adjusted for disregarded payments.* For purposes of paragraph (c)(7)(ii)(B)(1) of this section, gross income must be determined under federal income tax principles, except that the principles of §1.904-4(f)(2)(vi) apply to adjust gross income of the tested unit, to the extent thereof, to reflect disregarded payments. For purposes of this paragraph (c)(7)(ii)(B)(2), the principles of §1.904-4(f)(2)(vi) are applied taking into account the rules in paragraphs (c)(7)(ii)(B)(2)(i) through (v) of this section.

(i) The controlled foreign corporation is treated as the foreign branch owner and any other tested units of the controlled foreign corporation are treated as foreign branches.

(ii) The principles of the rules in §1.904-4(f)(2)(vi)(A) apply in the case of disregarded payments between a foreign branch and another foreign branch without regard to whether either foreign branch makes a disregarded payment to, or receives a disregarded payment from, the foreign branch owner.

(iii) The exclusion for interest and interest equivalents described in §1.904-4(f)(2)(vi)(C)(1) does not apply to the extent of the amount of a disregarded payment that is deductible in the country of tax residence (or location, in the case of a branch) of the tested unit that is the payor.

(iv) In the case of an amount described in paragraph (c)(7)(ii)(B)(2)(iii) of this section, the rules for determining how a

disregarded payment is allocated to gross income of a foreign branch or foreign branch owner in §1.904-4(f)(2)(vi)(B) are applied by treating the disregarded payment as allocated and apportioned ratably to all of the gross income attributable to the tested unit that is making the disregarded payment. If a tested unit is both a payor and payee of an amount described in paragraph (c)(7)(ii)(B)(2)(iii) of this section, gross income to which the disregarded payments are allocable include gross income allocated to the payor tested unit as a result of the receipt of amounts described in paragraph (c)(7)(ii)(B)(2)(iii) of this section, to the extent thereof. If a tested unit makes and receives payments described in paragraph (c)(7)(ii)(B)(2)(iii) of this section to and from the same tested unit, the payments are netted so that paragraph (c)(7)(ii)(B)(2)(iii) of this section and the principles of §1.904-4(f)(2)(vi) apply only to the net amount of such payments between the two tested units.

(v) In the case of multiple disregarded payments, in lieu of §1.904-4(f)(2)(vi)(F), disregarded payments are taken into account under paragraph (c)(7)(ii)(B)(2) of this section and the principles of §1.904-4(f)(2)(vi) under the rules provided in this paragraph (c)(7)(ii)(B)(2)(v). Adjustments are made with respect to a disregarded payment received by a tested unit before payments made by that tested unit. Except as provided in paragraph (c)(7)(ii)(B)(2)(iv) of this section, if a tested unit both makes and receives disregarded payments, adjustments are first made with respect to disregarded payments that would be definitely related to a single class of gross income under the principles of §1.861-8; second, adjustments are made with respect to disregarded payments that would be definitely related to multiple classes of gross income under the principles of §1.861-8, but that are not definitely related to all gross income of the tested unit; third, adjustments are made with respect to disregarded payments (other than interest described in paragraph (c)(7)(ii)(B)(2)(iii) of this section) that would be definitely related to all gross income under the principles of §1.861-8; and fourth, adjustments are made with respect to interest described in paragraph (c)(7)(ii)(B)(2)(iii) and disregarded payments that would not

be definitely related to any gross income under the principles of §1.861-8.

(iii) *Calculation of tentative tested income item*—(A) *In general*. A tentative tested income item with respect to the tentative gross tested income item described in paragraph (c)(7)(ii)(A) of this section is determined by allocating and apportioning deductions for the CFC inclusion year (including expense for current year taxes (as defined in §1.960-1(b)(4)), and not including any items described in §1.951A-2(c)(5) or (c)(6)) to the tentative gross tested income item under the principles of §1.960-1(d)(3). For purposes of this paragraph (c)(7)(iii), each tentative gross tested income item (if any) is treated as assigned to a separate tested income group, as that term is described in §1.960-1(d)(2)(ii)(C), and all other income is treated as assigned to a residual income group. For purposes of applying §§1.861-9 and 1.861-9T under the principles of §1.960-1(d)(3), the amount of interest deductions that are allocated and apportioned to the assets (or gross income, in the case of a taxpayer that has elected the modified gross income method) of a lower-tier corporation, such as a corporation the stock of which is owned by the controlled foreign corporation indirectly through the tested unit, are allocated and apportioned to the residual income category and not to any tentative gross tested income item of the controlled foreign corporation. See paragraphs (c)(8)(iii)(A)(2)(iii) (Example 1), (c)(8)(iii)(B)(2)(iv) (Example 2), and (c)(8)(iii)(C)(2)(iv) (Example 3) of this section for illustrations of the application of the rules set forth in this paragraph (c)(7)(iii)(A).

(B) *Allocation and apportionment of current year taxes imposed by reason of disregarded payments*. The principles of §1.904-6(a)(2) apply to allocate and apportion the expense for current year taxes imposed by reason of disregarded payments to a tentative gross tested income item. For purposes of this paragraph (c)(7)(iii)(B), the principles of §1.904-6(a)(2) apply by—

(1) Treating the CFC as the foreign branch owner and any other tested unit as a foreign branch;

(2) In the case of payments to a tested unit that is treated as a foreign branch under paragraph (c)(7)(iii)(B)(1) of this

section, applying the principles of §1.904-6(a)(2)(ii) and (iii) as if the tested unit receiving the payment were a foreign branch owner; and

(3) Treating any portion of a disregarded payment between individual tested units that does not result in a reallocation of gross income under paragraph (c)(7)(ii)(B)(2) of this section (because the amount of the payment exceeds the gross income of the individual tested unit making the payment) as a payment that is described in §1.904-4(f)(2)(vi)(C)(4) (to which §1.904-6(a)(2)(iii) applies). See paragraph (c)(8)(iii)(B)(2)(iii) (Example 2) of this section for illustrations of the application of the rules set forth in this paragraph (c)(7)(iii)(B).

(C) *Effect of potential and actual changes in taxes paid or accrued*. Except as otherwise provided in this paragraph (c)(7)(iii)(C), the amount of current year taxes paid or accrued by a controlled foreign corporation for purposes of this paragraph (c)(7) does not take into account any potential reduction in foreign income taxes that may occur by reason of a future distribution to shareholders of all or part of such income. However, to the extent the foreign income taxes paid or accrued by the controlled foreign corporation are reasonably certain to be returned to a shareholder by the foreign country imposing such taxes, directly or indirectly, through any means (including, but not limited to, a refund, credit, payment, discharge of an obligation, or any other method) on a subsequent distribution to such shareholder, the foreign income taxes are not treated as paid or accrued for purposes of this paragraph (c)(7). In addition, foreign income taxes that have not been paid or accrued because they are contingent on a future distribution of earnings (or other similar transaction, such as a loan to a shareholder) are not taken into account for purposes of this paragraph (c)(7). If, pursuant to section 905(c) and §1.905-3, a redetermination of U.S. tax liability is required to account for the effect of a foreign tax redetermination (as defined in §1.905-3(a)), this paragraph (c)(7) is applied in the adjusted year taking into account the adjusted amount of the redetermined foreign tax.

(iv) *Tested unit rules*—(A) *In general*. Subject to the combination rule in para-

graph (c)(7)(iv)(C) of this section, the term *tested unit* means any corporation, interest, or branch described in paragraphs (c)(7)(iv)(A)(1) through (3) of this section. See paragraph (c)(8)(iii)(D) (Example 4) of this section for an example that illustrates the application of the tested unit rules set forth in this paragraph (c)(7)(iv).

(1) A controlled foreign corporation (as defined in section 957(a)).

(2) An interest held directly or indirectly by a controlled foreign corporation in a pass-through entity that is—

(i) A tax resident (as described in §1.267A-5(a)(23)(i)) of any foreign country; or

(ii) Not treated as fiscally transparent (as determined under the principles of §1.267A-5(a)(8)) for purposes of the tax law of the foreign country of which the controlled foreign corporation is a tax resident or, in the case of an interest in a pass-through entity held by a controlled foreign corporation indirectly through one or more other tested units, for purposes of the tax law of the foreign country of which the tested unit that directly (or indirectly through the fewest number of transparent interests) owns the interest is a tax resident.

(3) A branch (as described in §1.267A-5(a)(2)) the activities of which are carried on directly or indirectly (through one or more pass-through entities) by a controlled foreign corporation. However, in the case of a branch that does not give rise to a taxable presence under the tax law of the foreign country where the branch is located, the branch is a tested unit only if, under the tax law of the foreign country of which the controlled foreign corporation is a tax resident (or, if applicable, under the tax law of a foreign country of which the tested unit that directly (or indirectly, through the fewest number of transparent interests) carries on the activities of the branch is a tax resident), an exclusion, exemption, or other similar relief (such as a preferential rate) applies with respect to income attributable to the branch. For purposes of this paragraph (c)(7)(iv)(A)(3), similar relief does not include a credit (for example, a foreign tax credit) against the tax imposed under such tax law. If a controlled foreign corporation carries on directly or indirectly (through one or more pass-through

entities) less than all of the activities of a branch (for example, if the activities are carried on indirectly through an interest in a partnership), then the rules in this paragraph apply separately with respect to the portion (or portions, if carried on indirectly through more than one chain of pass-through entities) of the activities carried on by the controlled foreign corporation. See paragraphs (c)(8)(iii)(D)(3) and (c)(8)(iii)(D)(4) (Example 4) of this section for illustrations of the application of the rules set forth in this paragraph (c)(7)(iv)(A)(3).

(B) *Items attributable to only one tested unit.* For purposes of paragraph (c)(7) of this section, if an item is attributable to more than one tested unit in a tier of tested units, the item is considered attributable only to the lowest-tier tested unit. Thus, for example, if a controlled foreign corporation directly owns a branch tested unit described in paragraph (c)(7)(iv)(A)(3) of this section, and an item of gross income is (under the rules of paragraph (c)(7)(ii)(B) of this section) attributable to both the branch tested unit and the controlled foreign corporation tested unit, then the item is considered attributable only to the branch tested unit.

(C) *Combination rule—(1) In general.* Except as provided in paragraph (c)(7)(iv)(C)(2) of this section, tested units of a controlled foreign corporation (including the controlled foreign corporation tested unit) are treated as a single tested unit if the tested units are tax residents of, or located in (in the case of a tested unit that is a branch, or a portion of the activities of a branch, that gives rise to a taxable presence under the tax law of a foreign country), the same foreign country. For purposes of this paragraph (c)(7)(iv)(C)(1), in the case of a tested unit that is an interest in a pass-through entity or a portion of the activities of a branch, a reference to the tax residency or location of the tested unit means the tax residency of the entity the interest in which is the tested unit or the location of the branch, as applicable. See paragraphs (c)(8)(iii)(D)(2) and (c)(8)(iii)(D)(5) (Example 4) of this section for illustrations of the application of the rule set forth in this paragraph (c)(7)(iv)(C)(1).

(2) *Exception for nontaxed branches.* The rule in paragraph (c)(7)(iv)(C)(1) of this section does not apply to a tested unit that is described in paragraph (c)(7)

(iv)(A)(3) of this section if the branch described in paragraph (c)(7)(iv)(A)(3) of this section does not give rise to a taxable presence under the tax law of the foreign country where the branch is located. See paragraph (c)(8)(iii)(D)(4) (Example 4) of this section for an illustration of the application of the rule set forth in this paragraph (c)(7)(v)(C)(2).

(3) *Effect of combination rule.* If, pursuant to paragraph (c)(7)(iv)(C)(1) of this section, tested units are treated as a single tested unit, then, solely for purposes of paragraph (c)(7) of this section, items of gross income attributable to such tested units, and items of deduction and foreign taxes allocated and apportioned to such gross income, are aggregated for purposes of determining the combined tested unit's tentative gross tested income item, tentative tested income item, and foreign income taxes paid or accrued with respect to such tentative tested income item.

(v) *Separate set of books and records—(A) In general.* For purposes of this paragraph (c)(7), the term *separate set of books and records* has the meaning set forth in §1.989(a)-1(d). In addition, for purposes of this paragraph (c)(7), in the case of a tested unit or a transparent interest that is an interest in a pass-through entity or a portion of the activities of a branch, a reference to the separate set of books and records of the tested unit or the transparent interest means the separate set of books and records of the entity or the branch, as applicable.

(B) *Failure to maintain separate set of books and records.* If a separate set of books and records is not maintained for a tested unit or transparent interest, the items of gross income, disregarded payments, and any other items required to apply paragraph (c)(7) of this section that would be reflected on a separate set of books and records of the tested unit or transparent interest must be determined. Such items are treated as properly reflected on the separate set of books and records of the tested unit or transparent interest for purposes of applying paragraph (c)(7) of this section.

(C) *Transparent interests.* If a tested unit of a controlled foreign corporation or an entity an interest in which is a tested unit of a controlled foreign corporation

holds a transparent interest, either directly or indirectly through one or more other transparent interests, then, for purposes of paragraph (c)(7) of this section (and subject to the rule of paragraph (c)(7)(iv)(C) of this section), items of the controlled foreign corporation properly reflected on the separate set of books and records of the transparent interest are treated as being properly reflected on the separate set of books and records of the tested unit, as modified under paragraph (c)(7)(ii)(B)(2) of this section. See paragraph (c)(8)(iii)(D)(6) (Example 4) of this section for an illustration of the application of the rule set forth in this paragraph (c)(7)(v)(C).

(D) *Items not taken into account for financial accounting purposes.* For purposes of this paragraph (c)(7), an item of gross income in a CFC inclusion year that is not taken into account in such year for financial accounting purposes, and therefore not properly reflected on a separate set of books and records of a tested unit or a transparent interest, or an entity an interest in which is a tested unit or a transparent interest, is treated as properly reflected on a separate set of books and records to the extent it would have been so reflected if the item were taken into account for financial accounting purposes in such CFC inclusion year.

(vi) *Effective rate at which foreign taxes are imposed.* For a CFC inclusion year of a controlled foreign corporation, the effective rate of foreign tax with respect to the tentative tested income items of the controlled foreign corporation is determined separately for each such item. See paragraphs (c)(8)(iii)(A)(2)(v) (Example 1), (c)(8)(iii)(B)(2)(vi) (Example 2), and (c)(8)(iii)(C)(2)(vi) (Example 3) of this section for illustrations of the application of the rules set forth in this paragraph (c)(7)(vi). The effective rate at which foreign income taxes are imposed on a tentative tested income item is—

(A) The U.S. dollar amount of foreign income taxes paid or accrued with respect to the tentative tested income item, determined by applying paragraph (c)(7)(vii) of this section; divided by

(B) The U.S. dollar amount of the tentative tested income item, increased by the amount of foreign income taxes referred to in paragraph (c)(7)(vi)(A) of this section.

(vii) *Foreign income taxes paid or accrued with respect to a tentative tested income item.* For a CFC inclusion year, the amount of foreign income taxes paid or accrued by a controlled foreign corporation with respect to a tentative tested income item of the controlled foreign corporation for purposes of this paragraph (c)(7) is the U.S. dollar amount of the controlled foreign corporation's current year taxes (as defined in §1.960-1(b)(4)) that are allocated and apportioned to the related tentative gross tested income item under the rules of paragraph (c)(7)(iii) of this section. See paragraphs (c)(8)(iii)(A)(2)(iv) (Example 1), (c)(8)(iii)(B)(2)(v) (Example 2), and (c)(8)(iii)(C)(2)(v) (Example 3) of this section for illustrations of the application of the rule set forth in this paragraph (c)(7)(vii).

(viii) *Rules regarding the high-tax election—(A) Manner—*(I) An election is made under this paragraph (c)(7)(viii) by the controlling domestic shareholders (as defined in §1.964-1(c)(5)) with respect to a controlled foreign corporation for a CFC inclusion year (*a high-tax election*) in accordance with the rules provided in forms or instructions and by—

(i) Filing the statement required under §1.964-1(c)(3)(ii) with a timely filed original federal income tax return, or with an amended federal income tax return in accordance with paragraph (c)(7)(viii)(A)(2) of this section, for the U.S. shareholder inclusion year of each controlling domestic shareholder in which or with which such CFC inclusion year ends;

(ii) Providing any notices required under §1.964-1(c)(3)(iii); and

(iii) Providing any additional information required by applicable administrative pronouncements.

(2) In the case of an election (or revocation) made with an amended federal income tax return—

(i) The election (or revocation) must be made on an amended federal income tax return duly filed within 24 months of the unextended due date of the original federal income tax return for the U.S. shareholder inclusion year with or within which the CFC inclusion year ends;

(ii) Each United States shareholder in the controlled foreign corporation as of the end of the CFC's taxable year to which the election relates must file amended fed-

eral income tax returns (or timely original federal income tax returns if a return has not yet been filed) reflecting the effect of such election (or revocation) for the U.S. shareholder inclusion year with or within which the CFC inclusion year ends as well as for any other taxable year in which the U.S. tax liability of the United States shareholder would be increased by reason of the election (or revocation) (or in the case of a partnership if any item reported by the partnership or any partnership-related item would change as a result of the election (or revocation)) within a single period no greater than six months within the 24-month period described in paragraph (c)(7)(viii)(A)(2)(i) of this section; and

(iii) Each United States shareholder in the controlled foreign corporation as of the end of the controlled foreign corporation's taxable year to which the election relates must pay any tax due as a result of such adjustments within a single period no greater than six months within the 24-month period described in paragraph (c)(7)(viii)(A)(2)(i) of this section.

(3) In the case of a United States shareholder that is a partnership, paragraphs (c)(7)(viii)(A)(1) and (2) and (c)(7)(viii)(C) of this section are applied by substituting "Form 1065 (or successor form)" for "federal income tax return" and by substituting "amended Form 1065 (or successor form) or administrative adjustment request (as described in §301.6227-1), as applicable," for "amended federal income tax return", each place that it appears.

(4) A United States shareholder that is a partner in a partnership that is also a United States shareholder in the controlled foreign corporation must generally file an amended return, as required under paragraph (c)(7)(viii)(B)(2) of this section, and must generally pay any additional tax owed as required under paragraph (c)(7)(viii)(B)(3). However, in the case of a United States shareholder that is a partner in a partnership that duly files an administrative adjustment request under paragraph (c)(7)(viii)(A)(2) of this section, the partner is treated as having satisfied the requirements of paragraphs (c)(7)(viii)(A)(2)(ii) and (iii) of this section with respect to the interest held through that partnership if:

(i) The partnership timely files an administrative adjustment request described

in paragraph (c)(7)(viii)(A)(1)(i) or (ii) of this section, as applicable; and,

(ii) Both the partnership and its partners timely comply with the requirements of section 6227 with respect to the administrative adjustment request. See §§301.6227-1 through -3 for rules relating to administrative adjustment requests.

(B) *Scope.* A high-tax election applies with respect to each tentative gross tested income item of the controlled foreign corporation for the CFC inclusion year and is binding on all United States shareholders of the controlled foreign corporation.

(C) *Revocation.* A high-tax election may be revoked by the controlling domestic shareholders of the controlled foreign corporation in the same manner as prescribed for an election made on an amended return as described in paragraph (c)(7)(viii)(A) of this section.

(D) *Failure to satisfy election requirements.* A high-tax election (or revocation) is valid only if all of the requirements in paragraph (c)(7)(viii)(A) of this section, including the requirement to provide notice under paragraph (c)(7)(viii)(A)(1)(ii) of this section, are satisfied.

(E) *Rules applicable to CFC groups—*(1) *In general.* In the case of a controlled foreign corporation that is a member of a CFC group, a high-tax election is made under paragraph (c)(7)(viii)(A) of this section, or revoked under paragraph (c)(7)(viii)(C) of this section, with respect to all controlled foreign corporations that are members of the CFC group and the rules in paragraphs (c)(7)(viii)(A) through (D) of this section apply by reference to the CFC group.

(2) *Determination of the CFC group—*(i) *Definition.* Subject to the rules in paragraphs (c)(7)(viii)(E)(2)(ii) and (iii) of this section, the term *CFC group* means an affiliated group as defined in section 1504(a) without regard to section 1504(b)(1) through (6), except that section 1504(a) is applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears, and section 1504(a)(2)(A) is applied by substituting "or" for "and." For purposes of this paragraph (c)(7)(viii)(E)(2)(i), stock ownership is determined by applying the constructive ownership rules of section 318(a), other than section 318(a)(3)(A) and (B), by applying section 318(a)(4) only to options (as defined in

§1.1504-4(d)) that are reasonably certain to be exercised as described in §1.1504-4(g), and by substituting in section 318(a)(2)(C) “5 percent” for “50 percent.

(ii) *Member of a CFC group.* The determination of whether a controlled foreign corporation is included in a CFC group is made as of the close of the CFC inclusion year of the controlled foreign corporation that ends with or within the taxable years of the controlling domestic shareholders. One or more controlled foreign corporations are members of a CFC group if the requirements of paragraph (c)(7)(viii)(E)(2) of this section are satisfied as of the end of the CFC inclusion year of at least one of the controlled foreign corporations, even if the requirements are not satisfied as of the end of the CFC inclusion year of all controlled foreign corporations. If the controlling domestic shareholders do not have the same taxable year, the determination of whether a controlled foreign corporation is a member of a CFC group is made with respect to the CFC inclusion year that ends with or within the taxable year of the majority of the controlling domestic shareholders (determined based on voting power) or, if no such majority taxable year exists, the calendar year. See paragraph (c)(8)(iii)(E) (Example 5) of this section for an example that illustrates the application of the rule set forth in this paragraph (c)(7)(viii)(E)(2)(ii).

(iii) *Controlled foreign corporations included in only one CFC group.* A controlled foreign corporation cannot be a member of more than one CFC group. If a controlled foreign corporation would be a member of more than one CFC group under paragraph (c)(7)(viii)(E)(2) of this section, then ownership of stock of the controlled foreign corporation is determined by applying paragraph (c)(7)(viii)(E)(2) of this section without regard to section 1504(a)(2)(B) or, if applicable, by reference to the ownership existing as of the end of the first CFC inclusion year of a controlled foreign corporations that would cause a CFC group to exist.

(ix) *Definitions.* The following definitions apply for purposes of this paragraph (c)(7).

(A) *Indirectly.* The term *indirectly*, when used in reference to ownership, means ownership through one or more pass-through entities.

(B) *Pass-through entity.* The term *pass-through entity* means a partnership, a disregarded entity, or any other person (whether domestic or foreign) other than a corporation to the extent that income, gain, deduction or loss of the person is taken into account in determining the income or loss of a controlled foreign corporation that owns, directly or indirectly, interests in the person.

(C) *Transparent interest.* The term *transparent interest* means an interest in a pass-through entity (or the activities of a branch) that is not a tested unit.

(8) *Examples—(i) Scope.* This paragraph (c)(8) provides examples illustrating the application of the rules in paragraph (c)(7) of this section.

(ii) *Presumed facts.* For purposes of the examples in paragraph (c)(8)(iii) of this section, except as otherwise stated, the following facts are presumed:

(A) USP is a domestic corporation.

(B) CFC1X and CFC2X are controlled foreign corporations organized in, and tax residents of, Country X.

(C) CFC3Z is a controlled foreign corporation organized in, and tax resident of, Country Z.

(D) FDEX is a disregarded entity that is a tax resident of Country X.

(E) FDE1Y and FDE2Y are disregarded entities that are tax residents of Country Y.

(F) FPSY is an entity that is organized in, and a tax resident of, Country Y but is classified as a partnership for federal income tax purposes.

(G) CFC1X, CFC2X, CFC3Z, and the interests in FDEX, FDE1Y, FDE2Y, and FPSY are tested units (the CFC1X tested unit, CFC2X tested unit, CFC3Z tested unit, FDEX tested unit, FDE1Y tested unit, FDE2Y tested unit, and FPSY tested unit, respectively).

(H) CFC1X, CFC2X, CFC3Z, FDEX, FDE1Y, and FDE2Y conduct activities in the foreign country in which they are tax resident, and properly reflect items of income, gain, deduction, and loss on separate sets of books and records.

(I) All entities have calendar taxable years (for both federal income tax purposes and for purposes of the relevant foreign country) and use the Euro (€) as their functional currency. At all relevant times €1 = \$1.

(J) The maximum rate of tax specified in section 11 for the CFC inclusion year is 21 percent.

(K) Neither CFC1X, CFC2X, nor CFC3Z directly or indirectly earns income described in section 952(b), has any items of income, gain, deduction, or loss, or makes or receives disregarded payments. In addition, no tested unit of CFC1X, CFC2X, or CFC3Z makes or receives disregarded payments.

(L) An election made under section 954(b)(4) and paragraph (c)(7)(viii) of this section is effective with respect to CFC1X and CFC2X, as applicable, for the CFC inclusion year.

(iii) *Examples—(A) Example 1: Effect of disregarded interest—(I) Facts—(i) Ownership.* USP owns all of the stock of CFC1X, and CFC1X owns all of the interests of FDE1Y.

(ii) *Gross income and deductions (other than for foreign income taxes).* In Year 1, CFC1X generates €100x of gross income from services to unrelated parties that would be gross tested income without regard to paragraph (c)(7) of this section and that is properly reflected on the books and records of FDE1Y. The €100x of services income is general category income under §1.904-4(d). In Year 1, FDE1Y accrues and pays €20x of interest to CFC1X that is deductible for Country Y tax purposes but is disregarded for federal income tax purposes. The €20x of disregarded interest income received by CFC1X from FDE1Y is properly reflected on CFC1X’s books and records, and the €20x of disregarded interest expense paid from FDE1Y to CFC1X is properly reflected on FDE1Y’s books and records.

(iii) *Foreign income taxes.* Country X imposes no tax on net income, and Country Y imposes a 25% tax on net income. For Country Y tax purposes, FDE1Y (which is not disregarded under Country Y tax law) has €80x of taxable income (€100x of services income from the unrelated parties, less a €20x deduction for the interest paid to CFC1X). Accordingly, FDE1Y incurs a Country Y income tax liability with respect to Year 1 of €20x (€80x x 25%), the U.S. dollar amount of which is \$20x.

(2) *Analysis—(i) Tentative gross tested income items.* Under paragraph (c)(7)(ii)(A) of this section, the tentative gross tested income item with respect to each of the CFC1X tested unit and the FDE1Y tested unit is the aggregate of the gross income of CFC1X that is attributable to the tested unit, that would be gross tested income (without regard to this paragraph (c)(7)), and that would be in a single tested income group. Under paragraphs (c)(7)(ii)(B)(1) and (2) of this section, items of gross income of CFC1X are attributable to the CFC1X tested unit, or the FDE1Y tested unit, to the extent properly reflected on its separate set of books and records, as determined under federal income tax principles and adjusted to take into account disregarded payments. Without regard to the €20x disregarded interest payment from FDE1Y to CFC1X, gross income attributable to the CFC1X tested unit would be €0 (that is, the €20x of interest income reflected on the books and records of CFC1X

would be reduced by €20x, the amount attributable to the payment that is disregarded for federal income tax purposes). Similarly, without regard to the €20x disregarded interest payment from FDE1Y to CFC1X, gross income attributable to the FDE1Y tested unit would be €100x (that is, €100x of services income reflected on the books and records of FDE1Y, unreduced by the €20x disregarded interest payment from FDE1Y to CFC1X). However, under paragraph (c)(7)(ii)(B)(2) of this section, the gross income attributable to each of the CFC1X tested unit and the FDE1Y tested unit is adjusted by €20x, the amount of the disregarded interest payment from FDE1Y to CFC1X that is deductible for Country Y tax purposes. Accordingly, the tentative gross tested income item attributable to the CFC1X tested unit (the “CFC1X tentative gross tested income item”) is €20x (€0 + €20x), and the tentative gross tested income item attributable to the FDE1Y tested unit (the “FDE1Y tentative gross tested income item”) is €80x (€100x - €20x).

(ii) *Foreign income tax deduction.* 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 the principles of §1.960-1(d)(3)(ii) (CFC1X has no other deductions to allocate and apportion). Under paragraph (c)(7)(iii)(A) of this section, the €20x deduction for Country Y income taxes is allocated and apportioned solely to the FDE1Y income group (the “FDE1Y group tax”). None of the Country Y taxes are allocated and apportioned to the CFC1X income group under paragraph (c)(7)(iii)(B) of this section and the principles of §1.904-6(a)(2)(ii)(A), because none of the Country Y tax is imposed solely by reason of the disregarded interest payment.

(iii) *Tentative tested income items.* Under paragraph (c)(7)(iii) of this section, the tentative tested income item with respect to the CFC1X income group (the “CFC1X tentative tested item”), is €20x. The tentative tested income item with respect to the FDE1Y income group (the “CFC1X tentative tested item”) is €60x (the FDE1Y tentative gross tested income item of €80x, less the €20x deduction for the FDE1Y group tax).

(iv) *Foreign income tax paid or accrued with respect to a tentative tested income item.* Under paragraph (c)(7)(vii) of this section, the foreign income taxes paid or accrued with respect to a tentative tested income item is the U.S. dollar amount of the current year taxes that are allocated and apportioned to the related tentative gross tested income item under the rules of paragraph (c)(7)(iii) of this section. Therefore, the foreign income taxes paid or accrued with respect to the FDE1Y tentative tested income item is \$20x, the U.S. dollar amount of the FDE1Y group tax. The foreign income tax paid or accrued with respect to the CFC1X tentative tested income item is \$0, the U.S. dollar amount of the foreign tax allocated and apportioned to the CFC1X tentative gross tested income item under paragraph (c)(7)(iii) of this section.

(v) *Effective foreign tax rate.* The effective foreign tax rate is determined under paragraph (c)(7)(vi)

of this section by dividing the U.S. dollar amount of foreign income taxes paid or accrued with respect to each respective tentative tested income item by the U.S. dollar amount of the tentative tested income item increased by the U.S. dollar amount of the relevant foreign income taxes. Therefore, the effective foreign tax rate with respect to the FDE1Y tentative tested income item is 25%, computed by dividing \$20x (the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative tested income item under paragraph (c)(7)(vii) of this section) by \$80x (the sum of \$60x, the U.S. dollar amount of the FDE1Y tentative tested income item, and \$20x, the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative tested income item). The CFC1X tentative tested income item is not subject to any foreign income tax, so is subject to an effective foreign tax rate of 0%, calculated as \$0 (the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the CFC1X tentative tested income item) divided by \$20x (the U.S. dollar amount of the CFC1X tentative tested income item).

(vi) *Gross income items excluded under sections 954(b)(4) and 951A(c)(2)(A)(i)(III).* The FDE1Y tentative tested income item is subject to an effective foreign tax rate (25%) that is greater than 18.9% (90% of the maximum rate of tax specified in section 11). Therefore, the requirement of paragraph (c)(7)(i)(B) of this section is satisfied, and the FDE1Y tentative gross tested income item qualifies under paragraph (c)(7)(i) of this section for the high-tax exception of section 954(b)(4) and is excluded from tested income under sections 951A(c)(2)(A)(i)(III) and 954(b)(4) and paragraph (c)(1)(iii) of this section. The CFC1X tentative tested income item is subject to an effective foreign tax rate of 0%. Therefore, the CFC1X tentative tested income item does not satisfy the requirement of paragraph (c)(7)(i)(B) of this section, and the CFC1X tentative gross tested income item does not qualify under paragraph (c)(7)(i) of this section for the high-tax exception of section 954(b)(4) and is not excluded from tested income under sections 951A(c)(2)(A)(i)(III) and 954(b)(4) and paragraph (c)(1)(iii) of this section.

(B) *Example 2: Disregarded payment for services—(1) Facts—(i) Ownership.* USP owns all of the stock of CFC1X. CFC1X owns all of the interests of FDE1Y. FDE1Y is a tax resident of Country Y, but is treated as fiscally transparent for Country X tax purposes, so that FDE1Y is subject to tax in Country Y and CFC1X is subject to tax in Country X with respect to FDE1Y’s activities.

(ii) *Gross income, deductions (other than for foreign income taxes), and disregarded payments.* In Year 1, CFC1X generates €1,000x of gross income from services to unrelated parties that would be gross tested income without regard to paragraph (c)(7) of this section and that is properly reflected on the books and records of CFC1X. In Year 1, CFC1X accrues and pays €480x of deductible expenses to unrelated parties, €280x of which is properly reflected on CFC1X’s books and records and is definitely related solely to CFC1X’s gross income reflected on its books and records, and €200x of which is properly reflected on FDE1Y’s books and records and is definitely related solely to FDE1Y’s gross income reflected on its books and records. Country X law

does not provide rules for the allocation or apportionment of these deductions to particular items of gross income. In Year 1, CFC1X also accrues and pays €325x to FDE1Y for support services performed by FDE1Y in Country Y; the payment is disregarded for federal income tax purposes. The €325x of disregarded support services income received by FDE1Y from CFC1X is properly reflected on FDE1Y’s books and records, and the €325x of disregarded support services expense paid from CFC1X to FDE1Y is properly reflected on CFC1X’s books and records.

(iii) *Foreign income taxes.* Country X imposes a 10% tax on net income, and Country Y imposes a 16% tax on net income. Country X allows a deduction, but not a credit, for foreign income taxes paid or accrued to another country (such as Country Y). For Country Y tax purposes, FDE1Y (which is not disregarded under Country Y tax law) has €125x of taxable income (€325x of support services income received from CFC1X, less a €200x deduction for expenses paid to unrelated parties). Accordingly, FDE1Y incurs a Country Y income tax liability with respect to Year 1 of €20x (€125x x 16%), the U.S. dollar amount of which is \$20x. For Country X tax purposes, CFC1X has €500x of taxable income (€1,000x of gross income for services, less a €480x deduction for expenses paid to unrelated parties by CFC1X and FDE1Y and a €20x deduction for Country Y taxes; Country X does not allow CFC1X a deduction for the €325x paid to FDE1Y for support services because the €325x payment is disregarded for Country X tax purposes). Accordingly, CFC1X incurs a Country X income tax liability with respect to Year 1 of €50x (€500x x 10%), the U.S. dollar amount of which is \$50x.

(2) *Analysis—(i) Tentative gross tested income item.* Under paragraph (c)(7)(ii) of this section, CFC1X has two tentative gross tested income items, one item with respect to CFC1X (the “CFC1X tentative gross tested income item”) and one item with respect to CFC1X’s interest in FDE1Y (the “FDE1Y tentative gross tested income item”). The gross income attributable to each tested unit comprises the gross income properly reflected on the books and records of each tested unit under paragraph (c)(7)(ii)(B)(1) of this section, as adjusted under paragraph (c)(7)(ii)(B)(2) of this section. Without regard to the €325x payment for support services from CFC1X to FDE1Y, the gross income attributable to the FDE1Y tested unit would be €0 (that is, the €325x of services income properly reflected on the books and records of FDE1Y, reduced by the €325x payment from CFC1X to FDE1Y that is disregarded for federal income tax purposes). Similarly, without regard to the €325x payment for support services from CFC1X to FDE1Y, the gross income attributable to the CFC1X tested unit would be €1,000x (that is, €1,000x of services income reflected on the books and records of CFC1X, unreduced by the €325x disregarded payment). However, under paragraph (c)(7)(ii)(B)(2) of this section, the gross income attributable to each of the CFC1X tested unit and the FDE1Y tested unit is adjusted by €325x, the amount of the disregarded services payment from CFC1X to FDE1Y. Accordingly, the FDE1Y tentative gross tested income item is €325x (€0 + €325x), and the CFC1X tentative gross tested income item is €675x (€1,000x - €325x).

(ii) *Deductions (other than for foreign income taxes).* Under paragraph (c)(7)(iii) of this section, CFC1X's tentative tested income items are computed by applying the principles of §1.960-1(d)(3), 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 among the income groups under federal income tax principles. For Year 1, CFC1X has deductible expense (other than foreign income tax) of €480x. This amount includes €280x of deductible expense that is definitely related solely to the services activity of the CFC1X tested unit, and another €200x of deductible expense (other than foreign income tax) that is definitely related solely to the services provided by the FDE1Y tested unit. Therefore, €280x of deductible expense (other than foreign income tax) is allocated and apportioned to the CFC1X income group, and €200x of deductible expense (other than foreign income tax) is allocated and apportioned to the FDE1Y income group.

(iii) *Foreign income tax deduction.* CFC1X accrues foreign income tax in Year 1 of €70x (€50x imposed by Country X and €20x imposed by Country Y). Under paragraph (c)(7)(iii) of this section, the deductions for foreign income taxes are allocated and apportioned under the principles of §1.960-1(d)(3)(ii) to the FDE1Y income group and the CFC1X income group. Under paragraph (c)(7)(iii)(A) of this section and §1.960-1(d)(3)(ii), the principles of §1.904-6(a)(1) generally apply to determine the amount of the foreign income tax paid or accrued with respect to each income group. However, under paragraph (c)(7)(iii)(B) of this section, foreign income taxes imposed by reason of the receipt of a disregarded payment are allocated and apportioned under the principles of §1.904-6(a)(2). The Country Y tax of €20x is imposed solely by reason of FDE1Y's receipt of a €325x disregarded payment. As a result, the entire €20x of Country Y tax is allocated and apportioned to the FDE1Y income group under the principles of §1.904-6(a)(2)(ii)(A). If Country X had allowed a deduction for the disregarded payment from CFC1X to FDE1Y and not otherwise imposed tax on CFC1X with respect to income of FDE1Y, the foreign tax imposed by Country X would relate only to the CFC1X tested income group, and no portion of it would be allocated and apportioned to the FDE1Y income group because the FDE1Y income would not be included in the Country X tax base. However, because gross income subject to tax in Country X includes gross income that for federal income tax purposes is attributable to both the FDE1Y tested unit and the CFC1X tested unit, the €50x of foreign income tax imposed by Country X is related to both the FDE1Y income group and to the CFC1X income group and must be allocated and apportioned under the principles of §1.904-6(a)(1)(i). Because Country X does not provide specific rules for the allocation or apportionment of the €500x of deductible expenses, §1.904-6(a)(1)(ii) applies the principles of §§1.861-8 through 1.861-14T to determine the foreign law net income subject to Country X tax for purposes of apportioning the €50x of Country X tax between the income groups. CFC1X has €1,000x of gross income and €500x of deductible expenses un-

der the tax laws of Country X, resulting in €500x of net foreign law income. Of the €1,000x of foreign law gross income, €325x corresponds to the gross income in the FDE1Y income group, and €675x corresponds to the gross income in the CFC1X income group. Applying federal income tax principles to allocate and apportion the foreign law deductions to foreign law gross income, €220x of the €500x foreign law deductions is allocated and apportioned to the FDE1Y income group and €280x is allocated and apportioned to the CFC1X income group. Of the total €500x of net foreign law income, €105x (€325x Country X gross income corresponding to the FDE1Y income group, less €220x allocable Country X expenses) corresponds to the FDE1Y income group and €395x (€675x Country X gross income corresponding to the CFC1X income group, less €280x allocable Country X expenses) corresponds to the CFC1X income group. Therefore, €10.5x (€50x x €105x/€500x) of Country X tax is allocated and apportioned to the FDE1Y income group, and €39.5x (€50x x €395x/€500x) is allocated and apportioned to the CFC1X income group. In total, €30.5x of foreign tax (€10.5x of Country X tax and €20x of Country Y tax) is allocated and apportioned to the FDE1Y income group (the "FDE1Y group tax"), and €39.5x of foreign tax (all of which is Country X tax) is allocated and apportioned to the CFC1X tested income group (the "CFC1X group tax").

(iv) *Tentative tested income items.* Under paragraph (c)(7)(iii) of this section, the tentative tested income item attributable to FDE1Y (the "FDE1Y tentative tested income item") is €94.5x (the FDE1Y gross tested income item of €325x, less the allocated and apportioned deductions of €230.5x (the sum of deductions (other than for foreign income tax) of €200x, Country Y tax of €20x, and Country X tax of €10.5x)). The tentative tested income item attributable to CFC1X (the "CFC1X tentative tested income item") is €355.5x (the CFC1X gross tentative tested income item of €675x, less the allocated and apportioned deductions of €319.5x (the sum of deductions (other than for foreign income tax) of €280x and Country X tax of €39.5x)).

(v) *Foreign income taxes paid or accrued with respect to a tentative tested income item.* Under paragraph (c)(7)(vii) of this section, the foreign income taxes paid or accrued with respect to a tentative tested income item is the U.S. dollar amount of the current year taxes that are allocated and apportioned to the related tentative gross tested income item under the rules of paragraph (c)(7)(iii) of this section. Therefore, the foreign income taxes paid or accrued with respect to the FDE1Y tentative tested income item is \$30.5x, the U.S. dollar amount of the FDE1Y group tax, and the foreign income taxes paid or accrued with respect to the CFC1X tentative tested income item is \$39.5x, the U.S. dollar amount of the CFC1X group tax.

(vi) *Effective foreign tax rate.* The effective foreign tax rate is determined under paragraph (c)(7)(vi) of this section by dividing the U.S. dollar amount of foreign income taxes paid or accrued with respect to each respective tentative tested income item by the U.S. dollar amount of the tentative tested income item increased by the U.S. dollar amount of the relevant foreign income taxes. Therefore, the effective foreign tax rate for the FDE1Y tentative tested in-

come item is 24.4%, computed by dividing \$30.5x (the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative tested income item), by \$125x (the sum of \$94.5x, the U.S. dollar amount of the FDE1Y tentative tested income item, and \$30.5x, the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative tested income item). Similarly, the effective foreign tax rate for the CFC1X tentative tested income item is 10%, computed by dividing \$39.5x (the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the CFC1X tentative tested income item) by \$395x (the sum of \$355.5x, the U.S. dollar amount of the CFC1X tentative tested income item, and \$39.5x, the U.S. dollar amount of the foreign taxes paid or accrued with respect to the CFC1X tentative tested income item).

(vii) *Gross income items excluded under sections 954(b)(4) and 951A(c)(2)(A)(i)(III).* The FDE1Y tentative tested income item has an effective foreign tax rate (24.4%) that is greater than 18.9% (90% of the maximum rate of tax specified in section 11). Therefore, the requirement of paragraph (c)(7)(i)(B) of this section is satisfied, and the FDE1Y tentative gross tested income item qualifies under paragraph (c)(7)(i) of this section for the high-tax exception of section 954(b)(4) and is excluded from tested income under sections 951A(c)(2)(A)(i)(III) and 954(b)(4) and paragraph (c)(1)(iii) of this section.

(C) *Example 3: Interest expense allocated and apportioned with respect to the income of a lower-tier CFC—(I) Facts—(i) Ownership.* USP owns all of the stock of CFC1X. CFC1X directly owns all the interests of FDE1Y. FDE1Y owns all of the stock of CFC3Z. Pursuant to §1.861-9(j) and §1.861-9T(j), CFC1X uses the modified gross income method to allocate and apportion its interest expense.

(ii) *Gross income and deductions (including for foreign income taxes).* During Year 1, CFC1X generates €4,000x of gross income from services that would be gross tested income without regard to paragraph (c)(7) of this section, €3,000x of which is properly reflected on the books and records of the CFC1X tested unit and €1,000x of which is properly reflected on the books and records of the FDE1Y tested unit. CFC1X also accrues €1,000x of interest expense to an unrelated person. Country X imposes €200x of income taxes with respect to the €3,000x of gross income properly reflected on the books and records of the CFC1X tested unit, and Country Y imposes €200x of income taxes with respect to the €1,000x of gross income properly reflected on the books and records of the FDE1Y tested unit. CFC3Z generates €1,000x of gross income from services that would be gross tested income without regard to paragraph (c)(7) of this section, and such gross income is properly reflected on the books and records of the CFC3Z tested unit. CFC3Z accrues no expenses, and Country Z imposes €100x of income

taxes with respect to the €1,000x of gross income generated by CFC3Z.

(2) *Analysis—(i) Tentative gross tested income items.* Under paragraph (c)(7)(ii) of this section, the €3,000x of gross income that is reflected on the books and records of the CFC1X tested unit, and the €1,000x of gross income that is reflected on the books and records of the FDE1Y tested unit, are attributable to the CFC1X tested unit and the FDE1Y tested unit, respectively. Under paragraph (c)(7)(ii) of this section, each of these amounts is a separate tentative gross tested income item of CFC1X (the “CFC1X tentative gross tested income item” and the “FDE1Y tentative gross tested income item,” respectively). Under paragraph (c)(7)(ii) of this section, the €1,000x item of tentative gross tested income that is properly reflected on the books and records of the CFC3Z tested unit is attributable to the CFC3Z tested unit. Under paragraph (c)(7)(ii) of this section, the amount attributable to the CFC3Z tested unit is a tentative gross tested income item of CFC3Z (the “CFC3Z tentative gross tested income item”).

(ii) *Allocation and apportionment of interest expense.* To compute CFC1X’s tentative tested income items, the principles of §1.960-1(d)(3) apply by treating each of CFC1X’s tentative gross tested income items as income in a separate tested income group (the “CFC1X income group” and the “FDE1Y income group”) and allocate and apportion its deductions among those income groups under federal income tax principles. Because CFC1X uses the modified gross income method under §1.861-9(j) and §1.861-9T(j) to allocate and apportion interest expense, it must allocate and apportion its interest expense between the CFC1X income group and the FDE1Y income group based on a combined gross income amount that includes both the gross income of CFC1X (including the gross income attributable to both the CFC1X tested unit and the FDE1Y tested unit) and the gross income of CFC3Z, adjusted as provided under §1.861-9(j) and §1.861-9T(j). Under §1.861-9(j) and §1.861-9T(j), the adjusted combined gross income of CFC1X comprises the CFC1X tentative gross tested income item (€3,000x), or 60% of the combined adjusted gross income amount, the FDE1Y tentative gross tested income item (€1,000x), or 20% of the combined adjusted gross income amount, and the CFC3Z gross tentative tested income item (€1,000x), or 20% of the combined adjusted gross income amount. Under paragraph (c)(7)(iii) of this section, interest expense of CFC1X that is allocated and apportioned to the gross income of CFC3Z under §1.861-9(j) and §1.861-9T(j) is not allocated and apportioned to either the CFC1X income group or the FDE1Y income group. Therefore, €600x of interest expense (60% of the €1,000x of interest expense) is allocated and apportioned to the CFC1X income group, and €200x of interest expense (20% of the €1,000x of interest expense) is allocated and apportioned to the FDE1Y income group. The €200x of interest expense that is allocated and apportioned to the €1,000x of gross tentative tested income of CFC3Z is allocated and apportioned to the residual income group for purposes of paragraph (c)(7) of this section, but can still be allocated and apportioned to a statutory grouping of tested income of CFC1X for purposes of paragraph (c)(3) of this section. See paragraph (c)(7)(iii) of this section.

(iii) *Foreign income tax deduction.* Under paragraph (c)(7)(iii) of this section, deductions for foreign

income taxes paid or accrued by CFC1X are allocated and apportioned under the principles of §§1.960-1(d)(3)(ii) and §1.904-6(a)(1) to the CFC1X income group and the FDE1Y income group. Similarly, foreign income taxes paid or accrued by CFC3Z are allocated and apportioned under the principles of §§1.960-1(d)(3)(ii) and 1.904-6(a)(1) to the tentative gross tested income item of CFC3Z (the “CFC3Z income group”). Under these principles, the €200x of Country X income taxes are allocated and apportioned to the CFC1X income group (the “CFC1X group tax”), the €200x of Country Y income taxes are allocated and apportioned to the FDE1Y income group (the “FDE1Y group tax”), and the €100x of Country Z income taxes are allocated and apportioned to the CFC3Z income group (the “CFC3Z group tax”).

(iv) *Tentative tested income items.* After the allocation and apportionment of deductions to reduce the tentative gross tested income in each income group, under paragraph (c)(7)(iii) of this section, CFC1X has a tentative tested income item with respect to the CFC1X tested unit of €2,200x (€3,000x, less €600x of interest expense and €200x of foreign income tax expense, the “CFC1X tentative tested income item”) and a tentative tested income item with respect to the FDE1Y tested unit of €600x (€1,000x, less €200x of interest expense and €200x of foreign income tax expense, the “FDE1Y tentative tested income item”). CFC3Z has a tentative tested income item of €900x (€1,000x, less €100x of foreign income tax expense, the “CFC3Z tentative tested income item”).

(v) *Foreign income taxes paid or accrued with respect to a tentative tested income item.* Under paragraph (c)(7)(vii) of this section, the foreign income taxes paid or accrued with respect to a tentative tested income item is the U.S. dollar amount of the current year taxes that are allocated and apportioned to the related tentative gross tested income item under the rules of paragraph (c)(7)(iii) of this section. Therefore, the foreign income tax paid or accrued with respect to the CFC1X tentative tested income item is \$200x, the U.S. dollar amount of the CFC1X group tax. Similarly, the foreign income tax paid or accrued with respect to the FDE1Y tentative tested income item is \$200x, the U.S. dollar amount of the FDE1Y group tax, and the foreign income tax paid or accrued with respect to the CFC3Z tentative tested income item is \$100x, the U.S. dollar amount of the CFC3Z group tax.

(vi) *Effective foreign tax rate.* The effective foreign tax rate is determined under paragraph (c)(7)(vi) of this section by dividing the U.S. dollar amount of foreign income taxes paid or accrued with respect to each respective tentative tested income item by the U.S. dollar amount of the tentative tested income item increased by the U.S. dollar amount of the relevant foreign income taxes. Therefore, the effective foreign tax rate for the CFC1X tentative tested income item is 8.3%, computed by dividing \$200x (the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the CFC1X tentative tested income item), by \$2,400x (the sum of \$2,200x, the U.S. dollar amount of the CFC1X tentative tested income item and \$200x, the U.S. dollar amount of the foreign taxes paid or accrued with respect to the CFC1X tentative tested income item). The effective foreign tax rate for the FDE1Y tentative tested income item is 25%, computed by dividing \$200x (the U.S. dollar amount of the foreign taxes paid or accrued with respect to the FDE1Y tentative tested

income item) by \$800x (the sum of \$600x, the U.S. dollar amount of the FDE1Y tentative tested income item, and \$200x, the U.S. dollar amount of the foreign taxes paid or accrued with respect to the FDE1Y tentative tested income item). The effective foreign tax rate for the CFC3Z tentative tested income item is 10%, computed by dividing \$100x (the U.S. dollar amount of the foreign taxes paid or accrued with respect to the CFC3Z tentative tested income item) by \$1,000x (the sum of \$900x, the U.S. dollar amount of the CFC3Z tentative tested income item, and \$100x, the U.S. dollar amount of the foreign taxes paid or accrued with respect to the CFC3Z tentative tested income item).

(vii) *Gross income items excluded under sections 954(b)(4) and 951A(c)(2)(A)(i)(III).* The FDE1Y tentative tested income item is subject to tax at an effective foreign tax rate (25%) that is greater than 18.9% (90% of the maximum rate of tax specified in section 11). Therefore, the requirement of paragraph (c)(7)(i)(B) of this section is satisfied, and the FDE1Y tentative gross tested income item qualifies under paragraph (c)(7)(i) of this section for the high-tax exception of section 954(b)(4) and is excluded from tested income under sections 951A(c)(2)(A)(i)(III) and 954(b)(4) and paragraph (c)(1)(iii) of this section. In computing the tested income of CFC1X under paragraph (c)(3) of this section, the deductions of CFC1X that were allocated and apportioned to the FDE1Y tentative gross tested income item (that is, the €200x of interest expense and the €200x of FDE1Y group taxes) are allocated and apportioned to this item of tentative gross tested income. As a result, the €1,000x of tentative gross tested income excluded from tested income under section 954(b)(4), as well as the €200x of interest expense and €200x of foreign tax expense allocable to that gross income, are allocated and apportioned to the residual category under paragraph (c)(3) of this section for purposes of determining the tested income of CFC1X. Under §1.960-1(d)(3), the \$200x of foreign income taxes allocated and apportioned to the excluded gross income would also be assigned to the residual income group for purposes of determining CFC1X’s tested taxes for purposes of section 960(d). The CFC1X tentative tested income item and CFC3Z tentative tested income item each have effective foreign tax rates (8.3% and 10%, respectively) that are not greater than 90% of the maximum rate of tax specified in section 11. Therefore, the CFC1X tentative gross tested income item and the CFC3Z tentative gross tested income item do not qualify under paragraph (c)(7)(i) of this section for the high-tax exception of section 954(b)(4), and are not excluded from tested income under sections 951A(c)(2)(A)(i)(III) and 954(b)(4) and paragraph (c)(1)(i) of this section. Under paragraph (c)(3) of this section, the corresponding deductions are allocated and apportioned to that gross tested income in a manner that achieves a result that is consistent the result of the allocation and apportionment of those deductions under paragraph (c)(7) of this section. Accordingly, because CFC3Z’s tentative gross tested income is not excluded from gross tested income under sections 951A(c)(2)(A)(i)(III) and 954(b)(4) and paragraph (c)(1)(i) of this section, under paragraph (c)(3) of this section the €200x of CFC1X’s interest expense that was apportioned to tentative gross tested income of CFC3Z under the modified gross income method in §1.861-9

is allocated and apportioned to gross tested income of CFC1X and therefore reduces CFC1X's tested income. In contrast, if the CFC3Z tentative gross tested item had been excluded from gross tested income under sections 951A(c)(2)(A)(i)(III) and 954(b)(4) and paragraph (c)(1)(i) of this section, then the €200x of CFC1X's interest expense that was allocated and apportioned to that income would be assigned to the residual category.

(D) *Example 4: Application of tested unit rules—(I) Facts—(i) Ownership.* USP owns all of the stock of CFC1X. CFC1X directly owns all the interests of FDEX and FDE1Y. In addition, CFC1X directly carries on activities in Country Y that constitute a branch (as described in §1.267A-5(a)(2)) and that give rise to a taxable presence under Country Y tax law and Country X tax law (such branch, "FBY").

(ii) *Items reflected on books and records.* For the CFC inclusion year, CFC1X had a €20x item of gross income (Item A), which is properly reflected on the books and records of FBY, and a €30x item of gross income (Item B), which is properly reflected on the books and records of FDEX.

(2) *Analysis—(i) Identifying the tested units of CFC1X.* Without regard to the combination rule of paragraph (c)(7)(iv)(C) of this section, CFC1X, CFC1X's interest in FDEX, CFC1X's interest in FDE1Y, and FBY would each be a tested unit of CFC1X. See paragraph (c)(7)(iv)(A) of this section. Pursuant to the combination rule, however, the FDE1Y tested unit is combined with the FBY tested unit and treated as a single tested unit because FDE1Y is a tax resident of Country Y, the same country in which FBY is located (the "Country Y tested unit"). See paragraph (c)(7)(iv)(C)(1) of this section. The CFC1X tested unit (without regard to any items attributable to the FDEX, FDE1Y, or FBY tested units) is also combined with the FDEX tested unit and treated as a single tested unit because CFC1X and FDEX are both tax residents of County X (the "Country X tested unit"). See paragraph (c)(7)(iv)(C)(1) of this section.

(ii) *Computing the items of CFC1X.* Under paragraph (c)(7)(ii)(A) of this section, a tentative gross tested income item is determined with respect to each of the Country Y tested unit and the Country X tested unit. To determine the tentative gross tested income item of each tested unit, the item of gross income that is attributable to the tested unit is determined under paragraph (c)(7)(ii)(B) of this section. Under paragraph (c)(7)(ii)(B) of this section, only Item A is attributable to the Country Y tested unit. Item A is not attributable to the Country X tested unit because it is not reflected on the separate set of books and records of the CFC1X tested unit or the FDEX tested unit, and an item of gross income is only attributable to one tested unit. See paragraph (c)(7)(ii)(B)(1) of this section. Under paragraph (c)(7)(ii)(B) of this section, only Item B is attributable to the Country X tested unit.

(3) *Alternative facts – branch does not give rise to a taxable presence in country where located—(i) Facts.* The facts are the same as in paragraph (c)(8)(iii)(D)(1) of this section (the original facts in this Example 4), except that FBY does not give rise to a taxable presence under Country Y tax law; moreover, Country X tax law does not provide an exclusion, exemption, or other similar relief with respect to income attributable to FBY.

(ii) *Analysis.* FBY is not a tested unit but is a transparent interest. See paragraphs (c)(7)(iv)(A)(3) and (c)(7)(ix)(C) of this section. CFC1X has a tested unit in Country X that includes the CFC1X tested unit (without regard to any items related to the interest in FDEX or FDE1Y, but that includes FBY since it is a transparent interest and not a tested unit) and the interest in FDEX. See paragraph (c)(7)(iv)(C) of this section. CFC1X has another tested unit in Country Y, the interest in FDE1Y.

(4) *Alternative facts – branch is a tested unit but is not combined—(i) Facts.* The facts are the same as in paragraph (c)(8)(iii)(D)(1) of this section (the original facts in this Example 4), except that FBY does not give rise to a taxable presence under Country Y tax law but Country X tax law provides an exclusion, exemption, or other similar relief (such as a preferential rate) with respect to income attributable to FBY.

(ii) *Analysis.* FBY is a tested unit. See paragraph (c)(7)(iv)(A)(3) of this section. CFC1X has two tested units in Country Y, the interest in FDE1Y and FBY. The interest in FDE1Y and FBY tested units are not combined because FBY does not give rise to a taxable presence under the tax law of Country Y. See paragraph (c)(7)(iv)(C)(2) of this section. CFC1X also has a tested unit in Country X that includes the activities of CFC1X (without regard to any items related to the interest in FDEX, the interest in FDE1Y, or FBY) and the interest in FDEX.

(5) *Alternative facts – split ownership of tested unit—(i) Facts.* The facts are the same as in paragraph (c)(8)(iii)(D)(1) of this section (the original facts in this Example 4), except that USP also owns CFC2X, CFC1X does not own FDE1Y, and CFC1X and CFC2X own 60% and 40%, respectively, of the interests of FPSY.

(ii) *Analysis for CFC1X.* Under paragraph (c)(7)(iv)(C)(1) of this section, FBY and CFC1X's 60% interest in FPSY are combined and treated as a single tested unit of CFC1X ("CFC1X's Country Y tested unit"), and CFC1X's interest in FDEX and CFC1X's other activities are combined and treated as a single tested unit of CFC1X ("CFC1X's Country X tested unit"). CFC1X's Country Y tested unit is attributed any item of CFC1X that is derived through its interest in FPSY to the extent the item is properly reflected on the books and records of FPSY. See paragraph (c)(7)(ii)(B)(1) of this section.

(iii) *Analysis for CFC2X.* Under paragraphs (c)(7)(iv)(A)(1) and (c)(7)(iv)(A)(2)(i) of this section, CFC2X and CFC2X's 40% interest in FPSY are tested units of CFC2X. CFC2X's interest in FPSY is attributed any item of CFC2X that is derived through FPSY to the extent that it is properly reflected on the books and records of FPSY. See paragraph (c)(7)(ii)(B)(1) of this section.

(iv) *Analysis for not combining CFC1X and CFC2X tested units.* None of the tested units of CFC1X are combined with the tested units of CFC2X under paragraph (c)(7)(iv)(C)(1) of this section because they are tested units of different controlled foreign corporations, and the combination rule only combines tested units of the same controlled foreign corporation.

(6) *Alternative facts – split ownership of transparent interest—(i) Facts.* The facts are the same as in paragraph (c)(8)(iii)(D)(1) of this section (the original facts in this Example 4), except that USP

also owns CFC2X, CFC1X does not own DE1Y, and CFC1X and CFC2X own 60% and 40%, respectively, of the interests in FPSY, but FPSY is not a tax resident of any foreign country and is fiscally transparent for Country X tax law purposes.

(ii) *Analysis for CFC1X.* CFC1X's interest in FPSY is not a tested unit but is a transparent interest. See paragraphs (c)(7)(iv)(A)(2) and (c)(7)(ix)(C) of this section. Under paragraph (c)(7)(v)(C) of this section, any item of CFC1X that is derived through its interest in FPSY and is properly reflected on the books and records of FPSY is treated as properly reflected on the books and records of CFC1X.

(iii) *Analysis for CFC2X.* CFC2X's interest in FPSY is not a tested unit but is a transparent interest. See paragraphs (c)(7)(iv)(A)(2) and (c)(7)(ix)(C) of this section. Under paragraph (c)(7)(v)(C) of this section, any item of CFC2X that is derived through its interest in FPSY and is properly reflected on the books and records of FPSY is treated as properly reflected on the books and records of CFC1X.

(E) *Example 5: CFC group – Controlled foreign corporations with different taxable years—(I) Facts.* USP owns all the stock of CFC1X and CFC2X. CFC2X has a taxable year ending November 30. On December 15, Year 1, USP sells all the stock of CFC2X to an unrelated party for cash.

(2) *Analysis.* The determination of whether CFC1X and CFC2X are in a CFC group is made as of the close of their CFC inclusion years that end with or within the taxable year ending December 31, Year 1, the taxable year of USP, the controlling domestic shareholder. See paragraph (c)(7)(viii)(E)(2)(ii) of this section. Under paragraph (c)(7)(viii)(E)(2)(i) of this section, USP directly owns more than 50% of the stock of CFC1X as of December 31, Year 1, the end of CFC1X's CFC inclusion year. USP also directly owns more than 50% of the stock of CFC2X as of November 30, Year 1, the end of CFC2X's CFC inclusion year. Therefore, CFC1X and CFC2X are members of a CFC group, and USP must consistently make high-tax elections, or revocations, under paragraph (c)(7)(viii) of this section with respect to CFC1X's taxable year ending December 31, Year 1, and CFC2X's taxable year ending November 30, Year 1. This is the case notwithstanding that USP does not directly own more than 50% of the stock of CFC2X as of December 31, Year 1, the end of CFC1X's CFC inclusion year. See paragraph (c)(7)(viii)(E)(2)(ii) of this section.

Par. 4. Section 1.951A-7 is amended by:

1. Designating the undesignated text as paragraph (a);

2. Adding a subject heading to newly designated paragraph (a);

3. Removing the word "Sections" and adding in its place "Except as otherwise provided in this section, sections" in newly designated paragraph (a); and

4. Adding paragraph (b).

The additions read as follows:

§1.951A-7 Applicability dates.

(a) *In general.* * * *

(b) *High-tax exception.* Section 1.951A-2(c)(1)(iii), (c)(3)(ii), and (c)(7)

and (8) apply to taxable years of foreign corporations beginning on or after July 23, 2020, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. In addition, taxpayers may choose to apply the rules in §1.951A-2(c)(1)(iii), (c)(3)(ii), and (c)(7) and (8) to taxable years of foreign corporations that begin after December 31, 2017, and before July 23, 2020, and to taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end, provided that they consistently apply those rules and the rules in §1.954-1(c)(1)(iii)(A)(3), §1.954-1(c)(1)(iv), and the first sentence of §1.954-1(d)(3)(i) to such taxable years.

§ 1.954-0 [Amended]

Par. 5. Section 1.954-0 is amended by removing and reserving paragraph (b).

Par. 6. Section 1.954-1 is amended by:

1. Adding “or” to the end of paragraph (c)(1)(iii)(A)(2)(ii);

2. Removing and reserving paragraphs (c)(1)(iii)(A)(2)(iii) and (iv);

3. Adding paragraphs (c)(1)(iii)(A)(3) and (c)(1)(iv);

4. In paragraph (d)(1) introductory text, removing the language “foreign base company oil related income, as defined in section 954(g), or” in the second sentence and adding a sentence after the fourth sentence;

5. Removing the language “imposed by a foreign country or countries” in paragraph (d)(1)(ii);

6. Removing the language “in a chain of corporations through which a distribution is made” in the first sentence in paragraph (d)(2) introductory text;

7. Removing the language “(or deemed paid or accrued)” in paragraph (d)(2)(i);

8. Revising paragraph (d)(3)(i);

9. Removing and reserving paragraph (d)(3)(ii);

10. Removing paragraph (d)(7);

11. Revising paragraph (h)(1); and

12. Adding paragraph (h)(3).

The additions and revisions read as follows:

§1.954-1 Foreign base company income.

* * * *

(c) * * *

(1) * * *

(iii) * * *

(A) * * *

(3) For purposes of paragraph (c)(1)(iii)(A) of this section, the aggregate amount from all transactions that falls within a single separate category (as defined in §1.904-5(a)(4)(v)) and is described in paragraph (c)(1)(iii)(A)(1)(i) of this section is a single item of income. Similarly, the aggregate amount from all transactions that falls within a single separate category (as defined in §1.904-5(a)(4)(v)) and is described in each one of paragraphs (c)(1)(iii)(A)(1)(ii) through (c)(1)(iii)(A)(1)(v) of this section is in each case a separate single item of income. The same principles apply for transactions described in each one of paragraphs (c)(1)(iii)(A)(2)(i) through (v) of this section.

* * * *

(iv) *Treatment of deductions or loss attributable to disqualified basis.* For purposes of paragraph (c)(1)(i) of this section (and in the case of insurance income, paragraph (a)(6) of this section), in determining the amount of a net item of foreign base company income or insurance income, deductions or loss described in §1.951A-2(c)(5) or (c)(6) are not allocated and apportioned to gross foreign base company income or gross insurance income.

(d) * * *

(1) * * * For rules concerning the application of the high-tax exception of sections 954(b)(4) and 951A(c)(2)(A)(i)(III) to tentative gross tested income items, see §1.951A-2(c)(1)(iii), (c)(3)(ii), and (c)(7) and (8). * * *

* * * *

(3) * * *

(i) *In general.* The amount of foreign income taxes paid or accrued by a controlled foreign corporation with respect to a net item of income for purposes of section 954(b)(4) and this paragraph (d) is the U.S. dollar amount of the controlled foreign corporation’s current year taxes (as defined in §1.960-1(b)(4)) that are allocated and apportioned under §1.960-1(d)(3)(ii) to the subpart F income group (as defined in §1.960-1(d)(2)(ii)(B)) that corresponds with the net item of income.

* * * *

(h) * * *

(1) *Paragraph (d)(3) of this section for taxable years ending on or after December 4, 2018, and before July 23, 2020.* For the application of paragraph (d)(3) of this section to taxable years of controlled foreign corporations ending on or after December 4, 2018, and before July 23, 2020, and to taxable years of United States shareholders in which or with which such taxable years of the controlled foreign corporations end, see §1.954-1, as contained in 26 CFR part 1 revised as of April 1, 2020.

* * * *

(3) *Paragraphs (c)(1)(iii)(A)(3), (c)(1)(iv), and (d)(3)(i) of this section for taxable years beginning on or after July 23, 2020.* Paragraphs (c)(1)(iii)(A)(3), (c)(1)(iv), and (d)(3)(i) of this section apply to taxable years of a controlled foreign corporation beginning on or after July 23, 2020, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. In addition, taxpayers may choose to apply the rules in paragraphs (c)(1)(iii)(A)(3), (c)(1)(iv), and (d)(3)(i) of this section to taxable years of controlled foreign corporations that begin after December 31, 2017, and before July 23, 2020, and to taxable years of United States shareholders in which or with which such taxable years of the controlled foreign corporations end, provided that they consistently apply those rules and the rules in §1.951A-2(c)(1)(iii), (c)(3)(ii), and (c)(7) and (8) to such taxable years.

§ 1.1502 [Amended]

Par. 7. Section 1.1502-51 is amended in paragraph (g)(1) by removing the language “§ 1.951A-7” and adding in its place “§ 1.951A-7(a)” wherever it appears.

Sunita Lough
Deputy Commissioner for Services
and Enforcement.

Approved: July 1, 2020.

David Kautter
Assistant Secretary of the Treasury
(Tax Policy).

(Filed by the Office of the Federal Register on July 29, 2020, 4:15 p.m., and published in the issue of the Federal Register for July 23, 2020, 85 F.R. 44620)

Part III

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also Part I, §§ 280F; 1.280F-7.)

Rev. Proc. 2020-37

SECTION 1. PURPOSE

This revenue procedure provides: (1) tables of limitations on depreciation deductions for owners of passenger automobiles first placed in service by the taxpayer during calendar year 2020; and (2) a table of amounts that must be included in income by lessees of passenger automobiles first leased by the taxpayer during calendar year 2020. The tables detailing these depreciation limitations and lessee inclusion amounts reflect the automobile price inflation adjustments required by § 280F(d)(7). For purposes of this revenue procedure, the term “passenger automobiles” includes trucks and vans.

SECTION 2. BACKGROUND

.01 For owners of passenger automobiles, § 280F(a) imposes dollar limitations on the depreciation deduction for the year the taxpayer places the passenger automobile in service and for each succeeding year. For passenger automobiles placed in service after 2018, § 280F(d)(7) requires the Internal Revenue Service to increase the amounts allowable as depreciation deductions by a price inflation adjustment amount that is determined using the automobile component of the Chained Consumer Price Index for all Urban Consumers published by the Department of Labor.

.02 Section 168(k)(1) provides that, in the case of qualified property, the depreciation deduction allowed under § 167(a) for the taxable year in which the property is placed in service includes an allowance equal to the applicable percentage of the property's adjusted basis (hereinafter, referred to as “§ 168(k) additional first year depreciation deduction”). Pursuant to § 168(k)(6)(A), the applicable percentage is 100 percent for qualified property acquired and placed in service after Sep-

tember 27, 2017, and placed in service before January 1, 2023, and is phased down 20 percent each year for property placed in service through December 31, 2026. Pursuant to § 168(k)(8)(D)(i), no § 168(k) additional first year depreciation deduction is allowed or allowable for qualified property acquired by the taxpayer before September 28, 2017, and placed in service by the taxpayer after 2019. For qualified property acquired and placed in service after September 27, 2017, § 168(k)(2)(F)(i) increases the first-year depreciation allowed under § 280F(a)(1)(A)(i) by \$8,000.

.03 Tables 1 and 2 of this revenue procedure provide depreciation limitations for passenger automobiles placed in service during calendar year 2020. Table 1 provides depreciation limitations for passenger automobiles acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer during calendar year 2020, for which the § 168(k) additional first year depreciation deduction applies. Table 2 provides depreciation limitations for passenger automobiles placed in service during calendar year 2020 for which no § 168(k) additional first year depreciation deduction applies. The § 168(k) additional first year depreciation deduction does not apply for 2020 if the taxpayer: (1) did not use the passenger automobile during 2020 more than 50 percent for business purposes; (2) elected out of the § 168(k) additional first year depreciation deduction pursuant to § 168(k)(7) for the class of property that includes passenger automobiles; (3) acquired the passenger automobile used and the acquisition of such property did not meet the acquisition requirements in § 168(k)(2)(E)(ii); or (4) acquired the passenger automobile before September 28, 2017, and placed it in service after 2019.

.04 Section 280F(c)(2) requires a reduction to the amount of deduction allowed to the lessee of a leased passenger automobile. Pursuant to § 280F(c)(3), the reduction must be substantially equivalent to the limitations on the depreciation deductions imposed on owners of passenger automobiles. Under § 1.280F-7(a) of the Income Tax Regulations, this reduction requires a lessee to include in

gross income an amount determined by applying a formula to the amount obtained from a table. Table 3 applies to lessees of passenger automobiles. This table shows income inclusion amounts for a range of fair market values for each taxable year after the passenger automobile is first leased.

SECTION 3. SCOPE

.01 The limitations on depreciation deductions in section 4.01(2) of this revenue procedure apply to passenger automobiles, other than leased passenger automobiles, that are placed in service by the taxpayer in calendar year 2020, and continue to apply for each taxable year that the passenger automobile remains in service.

.02 The table in section 4.02 of this revenue procedure applies to leased passenger automobiles for which the lease term begins during calendar year 2020. Lessees of these passenger automobiles must use these tables to determine the inclusion amount for each taxable year during which the passenger automobile is leased. See Rev. Proc. 2015-19, 2015-8 I.R.B. 656, as amplified and modified by section 4.03 of Rev. Proc. 2016-23, 2016-16 I.R.B. 581, for passenger automobiles first leased during calendar year 2015, Rev. Proc. 2016-23 for passenger automobiles first leased during calendar year 2016, Rev. Proc. 2017-29, 2017-14 I.R.B. 1065, for passenger automobiles first leased during calendar year 2017, Rev. Proc. 2018-25, 2018-18 I.R.B. 543, for passenger automobiles first leased during calendar year 2018, and Rev. Proc. 2019-26, 2019-24 I.R.B. 1323, for passenger automobiles first leased during calendar year 2019.

SECTION 4. APPLICATION

.01 *Limitations on Depreciation Deductions for Certain Automobiles.*

(1) *Amount of the inflation adjustment.* Under § 280F(d)(7)(B)(i), the automobile price inflation adjustment for any calendar year is the percentage (if any) by which the C-CPI-U automobile component for October of the preceding

calendar year exceeds the automobile component of the CPI (as defined in § 1(f)(4)) for October of 2017, multiplied by the amount determined under § 1(f)(3)(B). The amount determined under § 1(f)(3)(B) is the amount obtained by dividing the new vehicle component of the C-CPI-U for calendar year 2016 by the new vehicle component of the CPI for calendar year 2016, where the C-CPI-U and the CPI for calendar year 2016 means the average of such amounts as of the close of the 12-month period ending on August 31, 2016. Section 280F(d)(7)(B)(ii) defines the term “C-CPI-U automobile component” as the automobile component of the Chained Consumer Price Index for All Urban Consumers as described in § 1(f)(6). The product of the October 2017 CPI new vehicle component (144.868) and the amount deter-

mined under § 1(f)(3)(B) (0.694370319) is 100.592. The new vehicle component of the C-CPI-U released in November 2019 was 101.332 for October 2019. The October 2019 C-CPI-U new vehicle component exceeded the product of the October 2017 CPI new vehicle component and the amount determined under § 1(f)(3)(B) by 0.74 (101.332 - 100.592). The percentage by which the C-CPI-U new vehicle component for October 2019 exceeds the product of the new vehicle component of the CPI for October of 2017 and the amount determined under § 1(f)(3)(B) is 0.736 percent ($0.74/100.592 \times 100\%$), the automobile price inflation adjustment for 2020 for passenger automobiles. The dollar limitations in § 280F(a) are therefore multiplied by a factor of 0.00736, and the resulting increases, after round-

ing to the nearest \$100, are added to the 2018 limitations to give the depreciation limitations applicable to passenger automobiles for calendar year 2020. This adjustment applies to all passenger automobiles that are first placed in service in calendar year 2020.

(2) *Amount of the limitation.* Tables 1 and 2 contain the dollar amount of the depreciation limitation for each taxable year for passenger automobiles a taxpayer places in service during calendar year 2020. Use Table 1 for a passenger automobile to which the § 168(k) additional first year depreciation deduction applies that is acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer during calendar year 2020; and Table 2 for a passenger automobile for which no § 168(k) additional first year depreciation deduction applies.

REV. PROC. 2020-37 TABLE 1
DEPRECIATION LIMITATIONS FOR PASSENGER AUTOMOBILES ACQUIRED AFTER SEPTEMBER 27, 2017, AND PLACED IN SERVICE DURING CALENDAR YEAR 2020, FOR WHICH THE § 168(k) ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION APPLIES

<i>Tax Year</i>	<i>Amount</i>
1st Tax Year	\$18,100
2nd Tax Year	\$16,100
3rd Tax Year	\$9,700
Each Succeeding Year	\$5,760

REV. PROC. 2020-37 TABLE 2
DEPRECIATION LIMITATIONS FOR PASSENGER AUTOMOBILES PLACED IN SERVICE DURING CALENDAR YEAR 2020 FOR WHICH NO § 168(k) ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION APPLIES

<i>Tax Year</i>	<i>Amount</i>
1st Tax Year	\$10,100
2nd Tax Year	\$16,100
3rd Tax Year	\$9,700
Each Succeeding Year	\$5,760

.02 Inclusions in Income of Lessees of Passenger Automobiles.

A taxpayer must follow the procedures in § 1.280F-7(a) for determining the in-

come inclusion amounts for passenger automobiles first leased in calendar year 2020. In applying these procedures, les-

sees of passenger automobiles should use Table 3 of this revenue procedure.

REV. PROC. 2020-37 TABLE 3
 DOLLAR AMOUNTS FOR PASSENGER AUTOMOBILES
 WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 2020

Fair Market Value of Passenger Automobile		Tax Year During Lease				
Over	Not Over	1 st	2 nd	3 rd	4 th	5 th & later
\$50,000	\$51,000	0	1	0	2	2
51,000	52,000	2	6	9	10	13
52,000	53,000	5	11	17	20	24
53,000	54,000	7	17	24	30	35
54,000	55,000	10	22	32	39	46
55,000	56,000	12	27	41	48	57
56,000	57,000	15	32	49	58	68
57,000	58,000	17	38	56	68	79
58,000	59,000	19	44	64	77	90
59,000	60,000	22	49	72	87	100
60,000	62,000	26	56	84	102	117
62,000	64,000	30	68	99	121	139
64,000	66,000	35	78	116	139	161
66,000	68,000	40	89	131	159	183
68,000	70,000	45	99	148	177	205
70,000	72,000	50	110	163	197	227
72,000	74,000	55	121	179	215	249
74,000	76,000	60	131	195	235	271
76,000	78,000	64	142	211	254	293
78,000	80,000	69	153	227	272	315
80,000	85,000	78	172	254	306	353
85,000	90,000	90	198	295	353	408
90,000	95,000	102	225	334	401	463
95,000	100,000	114	252	373	449	518
100,000	110,000	133	292	433	520	600
110,000	120,000	157	345	513	615	710
120,000	130,000	181	399	592	710	820
130,000	140,000	206	452	671	805	931
140,000	150,000	230	506	750	901	1,040
150,000	160,000	254	559	830	996	1,150
160,000	170,000	279	612	909	1,091	1,260
170,000	180,000	303	666	988	1,186	1,370
180,000	190,000	327	720	1,067	1,281	1,480
190,000	200,000	351	773	1,147	1,377	1,589
200,000	210,000	376	826	1,227	1,471	1,700
210,000	220,000	400	880	1,306	1,566	1,810
220,000	230,000	424	934	1,385	1,661	1,920
230,000	240,000	449	987	1,464	1,757	2,029
240,000	and over	473	1,040	1,544	1,852	2,139

SECTION 5. EFFECTIVE DATE

This revenue procedure applies to passenger automobiles that a taxpayer first places in service or first leases during calendar year 2020.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is Bernard P. Harvey of the Office of Associate Chief Counsel (Income

Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Harvey at (202) 317-7005 (not a toll-free number).

Part IV

Swiss-US USMCA MAP Arrangement

Announcement 2020-10

The following is a copy of the Competent Authority Arrangement entered into by the competent authorities of the United States of America and Switzerland in which it is agreed that references to the term “North American Free Trade Agreement” in the Convention between the Swiss Federation and the United States of America for the Avoidance of Double Taxation with Respect to Taxes on Income shall be understood as references to the term “United States-Mexico-Canada Agreement” (“USMCA”) upon entry into force of the USMCA.

The text of the Competent Authority Arrangement is as follows:

COMPETENT AUTHORITY ARRANGEMENT

The competent authorities of Switzerland and the United States of America have entered into the following Competent Authority Arrangement regarding the interpretation of the term “North American Free Trade Agreement” referred to in subparagraphs a) and b) of paragraph 3 of Article 22 (Limitation on Benefits) of the Convention between the Swiss Federation and the United States of America for the Avoidance of Double Taxation with Respect to Taxes on Income, signed at Washington on October 2, 1996, as amended by the Protocol signed at Washington on October 2, 1996, as well as the Protocol signed at Washington on September 23, 2009 (the “Convention”), and referred to in paragraph 7 of the Memorandum of Understanding, introduced through the Exchange of Notes of October 2, 1996 (the “MOU”).

Pursuant to paragraph 1 of the Protocol Replacing the North American Free Trade Agreement with the Agreement between the United States of America, the United Mexican States, and Canada,

done at Buenos Aires on November 30, 2018 (the “Agreement”), as amended by the Protocol of Amendment to that Agreement, done at Mexico City on December 10, 2019 (the “Protocol of Amendment” and collectively with the Agreement, the “USMCA”), the USMCA will supersede the North American Free Trade Agreement (the “NAFTA”). The USMCA modernizes NAFTA, is entered into by the same parties, and governs the standards for trade and investment among the parties going forward.

Pursuant to Article 25 (Mutual Agreement Procedure) of the Convention, the competent authorities of the United States and Switzerland agree that the references to the NAFTA in subparagraphs a) and b) of paragraph 3 of Article 22 of the Convention and in paragraph 7 of the MOU shall be understood as references to the USMCA upon entry into force of the USMCA.

Done at Bern on June 19, 2020 For the Swiss Competent Authority: Pascal Duss	Done at Washington on June 25, 2020 For the United States Competent Authority: Douglas W. O'Donnell
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Announcement 2020-11

Correction to TD 9900, IRB 2020-30

SUMMARY: This document contains corrections to TD 9900, published in **Internal Revenue Bulletin 2020-30** on Monday, July 20, 2020. The purpose of this Treasury decision is to set forth temporary regulations that permit consolidated groups that acquire new members that were members of another consolidated group to elect in a year subsequent to the year of acquisition to waive all or part of the pre-acquisition portion of an extended carryback period under section 172 for certain losses attributable to the acquired

members if there is a retroactive statutory extension of the NOL carryback period under section 172.

Need for Correction

As published, the Treasury decision contains the following errors that need correction:

1. In **part IV of the Explanation of Provisions**, under the heading **Applicability Date**. The error consists of stating that the applicability date of these temporary regulations will expire on June 30, 2023. The correct date should be July 3, 2023.
2. In **§1.1502-21T(b)(3)(ii)(C)(6)(iii)**, under the heading **Certain taxable years beginning before January 1, 2021**. The error consists of stating that July 3, 2023 is the date (i) which the filing required under §1.1502-21T(b)(3)(ii)(C)(6)(i) must precede, and (ii) by which the amended return to which an amended statute split-waiver election statement or extended split-waiver election statement is attached must be filed. The correct date in each instance should be November 30, 2020.
3. In **§1.1502-21T(h)(9)(ii)**, under the heading **Expiration date**. The error consists of stating that the applicability of §1.1502-21T(b)(3)(ii)(C) and (D) will expire on June 30, 2023. The correct date should be July 3, 2023.

Notice of Proposed Rulemaking

Guidance under Section 954(b)(4) Regarding Income Subject to a High Rate of Foreign Tax

REG-127732-19

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under the subpart F income and global intangible low-taxed income provisions of the Internal Revenue Code regarding the treatment of certain income that is subject to a high rate of foreign tax. This document also contains proposed regulations under the information reporting provisions for foreign corporations to facilitate the administration of certain rules in the proposed regulations. The proposed regulations would affect United States shareholders of controlled foreign corporations.

DATES: Written or electronic comments and requests for a public hearing must be received by September 21, 2020. Requests for a public hearing must be submitted as prescribed in the “**Comments and Requests for a Public Hearing**” section.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-127732-19) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket.

Send hard copy submissions to:
CC:PA:LPD:PR (REG-127732-19),
Room 5203, Internal Revenue Service,
P.O. Box 7604, Ben Franklin Station,
Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jorge M. Oben or Larry R. Pounders at (202) 317-6934; concerning submissions of comments or requests for a public

hearing, Regina Johnson at (202) 317-5177 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 951(a)(1) of the Internal Revenue Code (the “Code”) provides that if a foreign corporation is a controlled foreign corporation (as defined in section 957) (“CFC”) at any time during a taxable year, every person who is a United States shareholder (as defined in section 951(b)) (a “U.S. shareholder”) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a CFC must include in gross income, for the taxable year in which or with which such taxable year of the corporation ends, the U.S. shareholder’s pro rata share of the corporation’s subpart F income for such year. Section 952 provides that subpart F income generally includes insurance income (as defined under section 953) and foreign base company income (as determined under section 954). Section 954(b)(4), however, provides that for purposes of sections 953 and 954(a), insurance income and foreign base company income do not include any item of income received by a CFC if a taxpayer establishes to the satisfaction of the Secretary that the income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum tax rate specified in section 11. Historically, §1.954-1(d) has implemented section 954(b)(4) by providing an election to exclude certain high-taxed income from the computation of subpart F income (the “subpart F high-tax exception”).

Section 951A, added to the Code by the Tax Cuts and Jobs Act, Pub. L. 115-97, 131 Stat. 2054, 2208 (December 22, 2017) (the “Act”), generally requires, for taxable years of foreign corporations beginning after December 31, 2017, that each U.S. shareholder of a CFC include in gross income its global intangible low-taxed income for the taxable year (“GILTI”). Section 951A(b) defines GILTI as a U.S. shareholder’s excess (if any) of net CFC tested income for a taxable year over the U.S. shareholder’s net deemed tangible

income return for such taxable year. Section 951A(c)(1) provides that the net CFC tested income of a U.S. shareholder is the excess of the U.S. shareholder’s aggregate pro rata share of tested income over the U.S. shareholder’s aggregate pro rata share of tested loss of each CFC. To determine the tested income of a CFC, section 951A(c)(2)(A)(i) first determines the “gross tested income” of the CFC, which is the gross income of the CFC without regard to certain items, including any gross income excluded from foreign base company income and insurance income by reason of section 954(b)(4). See section 951A(c)(2)(A)(i)(III). Tested income is then determined as the excess of gross tested income over the deductions properly allocable to such gross tested income under rules similar to the rules of section 954(b)(5). See section 951A(c)(2)(A).

On June 21, 2019, the Treasury Department and the IRS published proposed regulations (REG-101828-19) under sections 951, 951A, 954, 956, 958, and 1502 in the **Federal Register** (84 FR 29114) (the “2019 proposed regulations”). The 2019 proposed regulations under section 951A provide an election to apply section 954(b)(4) to certain high-taxed income of a CFC to which the subpart F high-tax exception does not apply, such that it can be excluded from tested income under section 951A(c)(2)(A)(i)(III) (the “GILTI high-tax exclusion”). Rules in the 2019 proposed regulations relating to sections 951A and 954, including the GILTI high-tax exclusion, are finalized, with modification, in the Final Rules section of this issue of the **Federal Register** (the “final regulations”). For rules in the final regulations relating to the GILTI high-tax exclusion, see §1.951A-2(c)(1)(iii), (c)(3), (c)(7) and (c)(8).

Terms used but not defined in this preamble have the meaning provided in these proposed regulations or the final regulations.

Explanation of Provisions

I. *Conforming the Subpart F High-Tax Exception with the GILTI High-Tax Exclusion*

As discussed in more detail in parts I and IV of the Summary of Comments and

Explanation of Revisions in the preamble to the final regulations, comments on the 2019 proposed regulations recommended that various aspects of the GILTI high-tax exclusion be conformed with the subpart F high-tax exception to ensure that the goals of the Treasury Department and the IRS in promulgating the GILTI high-tax exclusion are not undermined. For example, comments noted that the election for the subpart F high-tax exception (other than with respect to passive foreign personal holding company income) is made on an item-by-item basis with respect to each individual CFC. In contrast, the election for the GILTI high-tax exclusion is subject to a “consistency requirement,” pursuant to which an election must be made with respect to all of the CFCs that are members of a CFC group (as discussed in part III of this Explanation of Provisions). Comments asserted that the consistency requirement would make the GILTI high-tax exclusion less beneficial to taxpayers, causing them in certain cases to engage in uneconomic tax planning to convert tested income into subpart F income to avail themselves of the subpart F high-tax exception, contrary to one of the stated purposes of the GILTI high-tax exclusion (to eliminate incentives to convert tested income into subpart F income).

As discussed in the preamble to the final regulations, numerous comments recommended that the application of the GILTI high-tax exclusion be conformed with the subpart F high-tax exception. The Treasury Department and the IRS agree that the GILTI high-tax exclusion and the subpart F high-tax exception should be conformed but have determined that the rules applicable to the GILTI high-tax exclusion are appropriate and better reflect the changes made as part of the Act than the existing subpart F high-tax exception. Accordingly, to prevent inappropriate tax planning and reduce complexity, these proposed regulations revise and conform the provisions of the subpart F high-tax exception with the provisions of the GILTI high-tax exclusion in the final regulations, as modified by these proposed regulations.

Another comment on the 2019 proposed regulations suggested that section 954(b)(4) should apply consistently to all of a CFC’s items of gross income. In response to this comment, these proposed regulations provide for a single election under section 954(b)(4) for purposes of both subpart F income and tested income (the “high-tax exception”).¹ This unified rule, modeled on the GILTI high-tax exclusion in the final regulations, provides for further simplification.

II. Calculation of the Effective Tax Rate on the Basis of Tested Units

A. In general

Under §1.954-1(d), effective tax rates and the applicability of the subpart F high-tax exception are determined on the basis of net foreign base company income of a CFC.² Net foreign base company income generally means income described in §1.954-1(c)(1)(iii) reduced by deductions. See §1.954-1(c)(1). In general, single items of income tested for eligibility are determined by aggregating items of income of a certain type. See §1.954-1(c)(iii)(A) and (B). For example, the aggregate amount of a CFC’s income from dividends, interests, rents, royalties, and annuities giving rise to non-passive foreign personal holding company income constitutes a single item of income. See §1.954-1(c)(1)(iii)(A)(1)(i). In contrast, under the final regulations, effective tax rates and the applicability of the GILTI high-tax exclusion are determined by aggregating gross income that would be gross tested income (but for the GILTI high-tax exclusion) within a separate category to the extent attributable to a tested unit of a CFC. See §1.951A-2(c)(7)(ii)(A). For this purpose, the tentative tested income items and foreign taxes of multiple tested units of a CFC (including the CFC itself) that are tax residents of, or located in (in the case of certain branches), the same foreign country, generally are aggregated. See §1.951A-2(c)(7)(iv)(C)(1) and (3). As described further in the preamble to the

final regulations, applying these rules on a tested unit basis ensures that high-taxed and low-taxed items of income are not inappropriately aggregated for purposes of determining the effective rate of tax, while at the same time allowing for some level of aggregation to minimize complexity. Measuring the effective rate of foreign tax on a tested unit basis is also appropriate in light of the reduction of corporate federal income tax rates by the Act; as a result of such lower rates, it is likely that CFCs will earn more high-taxed income potentially eligible for section 954(b)(4).

For the same reasons that the GILTI high-tax exclusion applies on a tested unit basis, the Treasury Department and the IRS have determined that the subpart F high-tax exception should apply on a tested unit basis. See proposed §1.954-1(d)(1)(ii)(A) and (B). In addition, the Treasury Department and the IRS have determined that for purposes of determining the applicability of section 954(b)(4), it is appropriate to group general category items of income attributable to a tested unit that would otherwise be tested income, foreign base company income, or insurance income. See proposed §1.954-1(d)(1)(ii)(A). By grouping these items of income, taxpayers making a high-tax exception election may be able to forego the often-complex analysis required to determine whether income would meet the definition of subpart F income. For example, taxpayers will not be required to determine whether income is foreign base company sales income versus tested income if the high-tax exception applies to the income.

The proposed regulations generally group passive foreign personal holding company income in the same manner as existing §1.954-1(c)(1)(iii)(B). See proposed §1.954-1(d)(1)(ii)(C). However, the Treasury Department and the IRS may propose conforming changes to the income grouping rules in §1.904-4(c) as part of future guidance. Comments are requested on this topic.

Certain income and deductions attributable to equity transactions (for example,

¹ As a result, when the rules in these proposed regulations are adopted as final regulations, the rules in §1.951A-2(c)(7) (which provide the election specific to the GILTI high-tax exclusion) will be withdrawn.

² Similar rules apply for insurance income. See §1.954-1(d)(3)(i) and §1.954-1(a)(6).

dividends or losses attributable to stock) are also separately grouped for purposes of the high-tax exception if the income is subject to preferential rates or an exemption under the tax law of the country of residence of the recipient. *See proposed §1.954-1(d)(1)(ii)(B) and (iv)(C).* The purpose of this separate equity grouping is to separately test income or loss that is subject to foreign tax at a different rate than other general category income attributed to the tested unit and that may be susceptible to manipulation through, for example, the timing of distributions or losses.

B. Gross income attributable to tested units based on applicable financial statement

The final regulations generally use items properly reflected on the separate set of books and records (within the meaning of §1.989(a)-1(d)) as the starting point for determining gross income attributable to a tested unit. *See §1.951A-2(c)(7)(ii)(B)(1).* Books and records are used for this purpose because they serve as a reasonable proxy for determining the amount of gross income that the foreign country of the tested unit is likely to subject to tax and, given that this approach is consistent with the approach taken in other provisions, it should promote administrability.

The proposed regulations retain this general approach but replace the reference to “books and records” with a more specific standard based on items of gross income attributable to the “applicable financial statement” of the tested unit. *See proposed §1.954-1(d)(1)(iii)(A).* For this purpose, an applicable financial statement refers to a “separate-entity” (or “separate-branch,” if applicable) financial statement that is readily available, with the highest priority within a list of different types of financial statements. *See proposed §1.954-1(d)(3)(i).* These financial statements include, for example, financial statements that are audited or unaudited, and that are prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”), international financial reporting standards (“IFRS”), or the generally accepted accounting principles of the jurisdiction in which the entity is organized or the activ-

ties are located (“local-country GAAP”). *See id.*

The Treasury Department and the IRS have determined that this new standard will provide more accurate and reliable information and will promote certainty in cases where there may be various forms of readily available financial information. This standard is also expected to promote administrability because it is consistent with approaches taken under other provisions. *See section 451(b) and Rev. Proc. 2019-40, 2019-43 I.R.B. 982.* Finally, the Treasury Department and the IRS anticipate that the type of applicable financial statement will, in many cases, be the same from year to year and therefore will result in consistency and minimize opportunities for manipulation.

C. Allocation and apportionment of deductions for purposes of the high-tax exception

As explained in section II.B of this Explanation of Provisions, the final regulations generally use items properly reflected on the separate set of books and records as the starting point for determining gross income attributable to a tested unit. *See §1.951A-2(c)(7)(ii)(B)(1).* In contrast, the final regulations do not allocate and apportion deductions to those items of gross income by reference to the items of deduction that are properly reflected on the books and records of a tested unit. Instead, the final regulations apply the general allocation and apportionment rules for purposes of determining a tentative tested income item with respect to a tentative gross tested income item, such that deductions are generally allocated and apportioned under the principles of §1.960-1(d)(3) by treating each tentative gross tested income item as income in a separate tested income group, as that term is described in §1.960-1(d)(2)(ii)(C). *See §1.951A-2(c)(7)(iii).* Under those principles, certain deductions, such as interest expense, are allocated and apportioned based on a specific factor (such as assets or gross income) among the separate items of gross income of a CFC, such that deductions reflected on the books and records of a single tested unit, and generally taken into account for foreign tax purposes in computing the foreign taxable income, may not be fully

taken into account for purposes of determining a tentative tested income item.

The application of this provision of the final regulations may be illustrated by the following example. Assume that a CFC owns interests in two disregarded entities the interests in which are tested units (“TU1” and “TU2”), an equal amount of gross income is attributable to each of TU1 and TU2, and the CFC has no other activities. TU1’s income is subject to a 30 percent rate of foreign tax, and TU2’s income is subject to a 15 percent rate of foreign tax. TU1 accrues deductible interest expense payable to a third party that is allocated and apportioned to the CFC’s gross income using the modified gross income method of §1.861-9T(j)(1), such that interest expense incurred by TU1 is allocated and apportioned equally between TU1 and TU2 for purposes of the GILTI high-tax exclusion. The foreign countries in which TU1 and TU2 are tax residents allow for deductions of interest expense only to the extent that resident entities in the country actually accrue such interest expenses. Therefore, the foreign country in which TU1 is tax resident allows a full deduction for the interest accrued by TU1, and TU2’s country of tax residence does not allow an interest deduction for any interest accrued by TU1. Under the final regulations, the allocation of interest expense for federal income tax purposes may cause TU1’s gross income to fail to qualify for the high-tax exception and may cause TU2’s gross income to qualify for the high-tax exception, notwithstanding the higher tax rate in TU1’s country of residence and the lower tax rate in TU2’s country of residence.

The Treasury Department and the IRS have determined that the policy goal of section 954(b)(4) is to identify income of a CFC subject to a high effective rate of foreign tax and is better served by determining the effective foreign tax rate with respect to items of income attributable to a tested unit by reference to an amount of income that approximates taxable income as computed for foreign tax purposes, rather than federal income tax purposes. However, the use of U.S. (rather than foreign) tax accounting rules to determine the amount and timing of items of income, gain, deduction, and loss included in the high-tax exception computation remains appropri-

ate to ensure that the computation is not distorted by reason of foreign tax rules that do not conform to federal income tax principles. Therefore, these proposed regulations generally determine tentative net items by allocating and apportioning deductions, determined under federal income tax principles, to items of gross income to the extent the deductions are properly reflected on the applicable financial statement of the tested unit, consistent with the manner in which gross income is attributed to a tested unit. Under this method, a tentative net item better approximates the tax base upon which foreign tax is imposed than would be the case under the allocation and apportionment rules set forth in the regulations under section 861.

The proposed regulations allocate and apportion deductions to the extent properly reflected on the applicable financial statement only for purposes of section 954(b)(4), and not for any other purpose, such as for determining U.S. taxable income of the CFC under sections 954(b)(5) and 951A(c)(2)(A)(ii), and the associated foreign tax credits under section 960. In contrast to section 954(b)(4), under which the rules in the proposed regulations are intended to approximate the foreign tax base, taxable income and items of income for purposes of sections 954(b)(5), 951A(c)(2)(A)(ii), and 960 continue to be determined using the allocation and apportionment rules set forth in the regulations under section 861. Nevertheless, the Treasury Department and the IRS are considering whether for purposes of sections 954(b)(5), 951A(c)(2)(A)(ii), and 960 it would be appropriate, in limited cases (for example to reduce administrative and compliance burdens), to allocate and apportion deductions incurred by a CFC based on the extent to which they are properly reflected on an applicable financial statement, and request comments in this regard. For example, a rule could allocate and apportion deductions (other than foreign tax expense) only to the extent of the items of gross income attributable to the tested unit, and allocate and apportion any deductions in excess of such gross income to all gross income of the CFC. In addition, applying a method based on applicable financial statements for purposes of the high-tax exception could, in certain circumstances, affect the allocation and

apportionment of deductions for purposes of determining the amount of an inclusion with respect to gross income of the CFC that is not eligible for the high-tax exception. One approach under consideration is to provide that deductions allocated and apportioned to an item of gross income based on an applicable financial statement for purposes of calculating a tentative net item under the high-tax exception cannot be allocated and apportioned to a different item of gross income that does not qualify for the high-tax exception for purposes of calculating the inclusion under section 951(a) or section 951A. This approach would be a limited change to the traditional rules for allocating and apportioning deductions and would address concerns that, if deductions were not allocated and apportioned using a consistent method when the high-tax exception has been elected, they could be viewed as effectively being “double counted” by both reducing the tentative net item for purposes of determining whether an item of gross income is eligible for the high-tax exception and also reduce the amount of a U.S. shareholder’s inclusions under sections 951(a)(1) and 951A(a) with respect to a different item of gross income. Comments are requested on this issue.

D. *Undefined or negative foreign tax rates*

In certain cases, the effective foreign tax rate at which taxes are imposed on a tentative net item may result in an undefined value or a negative effective foreign tax rate. This may occur, for example, if foreign taxes are allocated and apportioned to the corresponding item of gross income, and the tentative net item (plus the foreign taxes) is negative because the amount of deductions allocated and apportioned to the gross income exceeds the amount of gross income (plus the foreign taxes). The proposed regulations provide that the effective rate of foreign tax with respect to a tentative net item that results in an undefined value or a negative effective foreign tax rate will be deemed to be high-taxed. See §1.954-1(d)(4)(ii). As a result, the item of gross income, and the deductions allocated and apportioned to such gross income under the rules set forth in the regulations under section 861, are

assigned to the residual grouping, and no credit is allowed for the foreign taxes allocated and apportioned to such gross income. Nevertheless, the Treasury Department and the IRS are considering whether this result is appropriate in all cases and request comments in this regard.

E. *Combination of de minimis tested units*

As discussed in the preamble to the final regulations, a comment recommended that taxpayers be permitted to aggregate QBUs within the same CFC that have a small amount of tested income. Although the final regulations did not adopt this recommendation, the proposed regulations include a rule that, subject to an anti-abuse provision, combines tested units (on a non-elective basis) that are attributed gross income less than the lesser of one percent of the gross income of the CFC, or \$250,000. See proposed §1.954-1(d)(2)(iii)(A)(2). This de minimis combination rule applies after the application of the “same foreign country” combination rule in proposed §1.954-1(d)(2)(iii)(A)(1) and, therefore, combines tested units that are not residents of (or located in) the same foreign country.

Comments are requested on this de minimis combination rule, including whether the rule could be better tailored to reduce administrative burden without permitting an excessive amount of blending of income subject to different foreign tax rates.

F. *Anti-abuse rules*

The Treasury Department and the IRS are concerned that taxpayers may include, or fail to include, items on an applicable financial statement or make, or fail to make, disregarded payments, to manipulate the application of the high-tax exception. As a result, the proposed regulations include an anti-abuse rule to address such cases if undertaken with a significant purpose of avoiding the purposes of section 951, 951A, 954(b)(4), or proposed §1.954-1(d). See proposed §1.954-1(d)(3)(v).

The Treasury Department and the IRS are also concerned that taxpayers may enter into transactions with a significant purpose of manipulating the eligibility of income for the high-tax exception. This could occur, for example, if a payment or

accrual by a CFC is deductible for federal income tax purposes but not for purposes of the tax laws of the foreign country of the payor. As a result, the deduction would reduce the tentative net items of the CFC but would not reduce the amount of foreign income taxes paid or accrued with respect to the tentative net item, which would have the effect of increasing the foreign effective tax rate imposed on the item. Accordingly, the proposed regulations include an anti-abuse rule to address transactions or structures involving certain instruments (“applicable instruments”) or reverse hybrid entities that are undertaken with a significant purpose of manipulating whether an item of income qualifies for the high-tax exception. *See* proposed §1.954-1(d)(7). The Treasury Department and the IRS continue to study other transactions and structures that may be used to inappropriately manipulate the application of the high-tax exception, including transactions and structures with hybrid entities, and may expand the application of the anti-abuse rule in the final regulations such that it is not limited to specific types of transactions or structures.

III. Mechanics of the Election

A. In general

As described in part I of this Explanation of Provisions, under current §1.954-1(d), the election for the subpart F high-tax exception is made separately with respect to each CFC, unlike the GILTI high-tax exclusion election, which must be made with respect to all of the CFCs that are members of a CFC group. As discussed in the preamble to the final regulations, the consistency requirement contained in the GILTI high-tax exclusion rules is necessary to prevent inappropriate cross-crediting with respect to high-taxed income under section 904. As a result of the changes made by the Act, a consistency requirement is also appropriate for the subpart F high-tax exception. The benefit of a CFC-specific election before the Act was to defer U.S. tax with respect to high-tax income items. After the Act, as described further in the preamble to the final regulations, the ability to exclude some high-taxed income from subpart F, while claiming foreign tax credits with respect

to other high-taxed income, can produce inappropriate results under section 904. As a result, the Treasury Department and the IRS have determined that a single high-tax exception election applicable to all income of all CFCs that are members of a CFC group better reflects the purposes of sections 904 and 954(b)(4) than a CFC-by-CFC election. Accordingly, the proposed regulations include a single unified election that applies for purposes of both subpart F and GILTI, incorporating a consistency requirement parallel to that in §1.951A-2(c)(7)(viii)(A)(1) and (c)(7)(viii)(E). *See* proposed §1.954-1(d)(6)(v).

B. Contemporaneous documentation

Neither current §1.954-1(d) nor the final regulations specify the documentation necessary for a U.S. shareholder to substantiate either the calculation of an amount excluded by reason of an election under section 954(b)(4) or that the requirements under current §1.954-1(d) or the final regulations were met. However, to facilitate the administration of the rules regarding these elections, the Treasury Department and the IRS have determined that U.S. shareholders must maintain specific contemporaneous documentation to substantiate their high-tax exception computations. Accordingly, the proposed regulations include a contemporaneous documentation requirement. *See* proposed §1.954-1(d)(6)(i)(D) and (d)(6)(vii). In addition, the proposed regulations add this information to the list of information that must be included on Form 5471 (“Information Return of U.S. Persons With Respect to Certain Foreign Corporations”). *See* proposed §1.6038-2(f)(19).

IV. Other Changes to §1.954-1

A. Coordination rules

1. Earnings and Profits Limitation

Section 1.954-1(d)(4)(ii) provides that the amount of income that is a net item of income (an input in determining whether the subpart F high-tax exception applies) is determined after the application of the earnings and profits limitation provided under section 952(c)(1). Section 952(c)(1)(A) generally limits the amount of subpart

F income of a CFC to the CFC’s earnings and profits for the taxable year. In addition, section 952(c)(2) provides that if the subpart F income of a CFC is reduced by reason of the earnings and profits limitation under section 952(c)(1)(A), any excess of the earnings and profits of the CFC for any subsequent taxable year over the CFC’s subpart F income for such taxable year is recharacterized as subpart F income under rules similar to the rules under section 904(f)(5).

The Treasury Department and the IRS have determined that this coordination rule can lead to inappropriate results. When the section 952(c)(1) limitation applies, the effective rate at which taxes are imposed under §1.954-1(d)(2) would be calculated on a smaller net item of income than if the net item of income were determined before the limitation, but the amount of foreign income taxes with respect to the net item would be unchanged. *See* §1.954-1(d)(4)(iii). This could have the effect of causing a net item of income to qualify for the subpart F high-tax exception even though the item, without regard to the limitation, would not have so qualified. In addition, amounts subject to recharacterization as subpart F income in a subsequent taxable year under section 952(c)(2) may not qualify for the subpart F high-tax exception even if the net item of income to which the recapture amount relates did so qualify. *See* §1.954-1(a)(7). As a result, the proposed regulations provide that the high-tax exception applies without regard to the limitation in section 952(c)(1). *See* proposed §1.954-1(a)(2)(i) and (5). The proposed regulations also follow current §1.951-1(a)(7), which provides that the subpart F income of a CFC is increased by earnings and profits of the CFC that are recharacterized under section 952(c)(2) and §1.952-1(f)(2)(ii) after determining the items of income of the CFC that qualify for the high-tax exception. *See* proposed §1.954-1(a)(5).

2. Full Inclusion Rule

The current regulations generally provide that, except as provided in section 953, adjusted gross foreign base company income consists of all gross income of the CFC other than gross insurance income (and amounts described

in section 952(b)), and adjusted gross insurance income consists of all gross insurance income (other than amounts described in section 952(b)), if the sum of the gross foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of gross income (the “full inclusion rule”). *See* §1.954-1(a)(3) and (b)(1)(ii). Thus, under the current regulations the full inclusion rule generally applies before the application of the subpart F high-tax exception (which occurs when adjusted net foreign base company income is determined). Under a special coordination rule, however, full inclusion foreign base company income is excluded from subpart F income if more than 90 percent of the adjusted gross foreign base company income and adjusted gross insurance company income of a CFC (determined without regard to the full inclusion rule) is attributable to net amounts excluded from subpart F income under the subpart F high-tax exception. *See* §1.954-1(d)(6).

The Treasury Department and the IRS have determined that these rules could be simplified if the determination of whether income is foreign base company income occurs before the application of the full inclusion rule. Current §1.954-1, for example, requires taxpayers to determine whether income is foreign base company income or insurance income before applying the full inclusion rule or the high tax exception. *See* §1.954-1(a)(2) through (a)(5), and (a)(6). Applying the high-tax exception first will eliminate the need to perform this factual analysis in many cases. Therefore, the proposed regulations provide that the high-tax exception applies before the full inclusion rule and, consequently, the special coordination rule in §1.954-1(d)(6) is eliminated. *See* proposed §1.954-1(a)(2)(i). In addition, the proposed regulations make conforming revisions to the coordination rule for full inclusion income and the high-tax election in the regulations under section 951A. Consequently, the proposed regulations delete §1.951A-2(c)(4)(iii)(C) and (iv)(C) (Example 3).

B. Elections on amended returns

Current §1.954-1(d)(5) generally provides that a controlling U.S. shareholder

(as defined in §1.964-1(c)(5)) may make (or revoke) a subpart F high-tax election by attaching a statement to its amended income tax return and that this election is binding on all U.S. shareholders of the CFC. In conforming the provisions of the subpart F high-tax exception with the provisions of the GILTI high-tax exclusion in the final regulations (as modified by these proposed regulations), the Treasury Department and the IRS have determined that it is also necessary to revise the rules regarding elections on amended returns. The final regulations require that amended returns for all U.S. shareholders of the CFC for the CFC inclusion year must be filed within a single 6-month period within 24 months of the unextended due date of the original income tax return of the controlling domestic shareholder’s inclusion year with or within which the relevant CFC inclusion year ends. *See* §1.951A-2(c)(7)(viii)(A)(1)(iii). As stated in the preamble to the final regulations, the Treasury Department and the IRS determined that the requirement that all amended returns be filed by the end of this period is necessary to administer the GILTI high-tax exclusion and to allow the IRS to timely evaluate refund claims or make additional assessments.

For this reason, the proposed regulations also provide that the high-tax election may be made (or revoked) on an amended federal income tax return only if all U.S. shareholders of the CFC file amended returns (unless an original federal income tax return has not yet been filed, in which case the original return may be filed consistently with the election (or revocation) for the year (and for any other tax year in which their U.S. tax liabilities would be increased by reason of that election (or revocation)), within a single 6-month period within 24 months of the unextended due date of the original federal income tax return of the controlling domestic shareholder’s inclusion year. *See* proposed §1.954-1(d)(6)(i)(B)(2). The proposed regulations provide that in the case of a U.S. shareholder that is a partnership, the election may be made (or revoked) with an amended Form 1065 or an administrative adjustment request, as applicable. Further, the proposed regulations provide that if a partnership files an

administrative adjustment request, a partner that is a U.S. shareholder in the CFC is treated as having complied with these requirements (with respect to the portion of the interest held through the partnership) if the partner and the partnership timely comply with their obligations under section 6227. *See* proposed §1.954-1(d)(6)(i)(C).

The Treasury Department and the IRS are aware that changes in circumstances occurring after the 24-month period may cause a taxpayer to benefit from making (or revoking) the election, for example, if there is a foreign tax redetermination with respect to one or more CFCs. The Treasury Department and the IRS request comments on rules that would permit a taxpayer to make (or revoke) an election after the 24-month period in cases where the taxpayer can establish that the election (or revocation) will not result in time-barred tax deficiencies.

V. Application of Section 952(c)(2) to Transactions Described in Section 381(a)

Section 952(c)(2) generally provides that if subpart F income of a CFC for a taxable year was reduced by reason of the current earnings and profits limitation in section 952(c)(1)(A), any excess of the earnings and profits of such CFC for any subsequent taxable year over the subpart F income of such foreign corporation for such taxable year is recharacterized as subpart F income under rules similar to the rules of section 904(f)(5). Section 1.904(f)-2(d)(6) generally provides, in part, that in the case of a distribution or transfer described in section 381(a), an overall foreign loss account of the distributing or transferor corporation is treated as an overall foreign loss account of the acquiring or transferee corporation as of the close of the date of the distribution or transfer.

The Treasury Department and the IRS have determined that, because of some lack of certainty whether recapture accounts carry over in transactions to which section 381(a) applies, it is appropriate to provide clarification. Therefore, the proposed regulations clarify that recapture accounts carry over to the acquiring corporation (including foreign corporations that are not CFCs) in a dis-

tribution or transfer described in section 381(a). See proposed §1.952-1(f)(4). The Treasury Department and the IRS believe that this clarification is consistent with general successor principles as may be applied under current law in certain successor transactions such as transactions described in section 381(a).

VI. Applicability Dates

The proposed regulations under §1.951A-2, 1.952-1(e), and §1.954-1 are proposed to apply to taxable years of CFCs beginning after the date the Treasury decision adopting these rules as final regulations is filed with the **Federal Register**, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

The proposed regulations under §1.952-1(f)(4) are proposed to apply to taxable years of a foreign corporation ending on or after July 20, 2020. See section 7805(b)(1)(B). As a result of this applicability date, proposed §1.952-1(f)(4) would apply with respect to recapture accounts of an acquiring corporation for taxable years of the corporation ending on or after July 20, 2020, even if the distribution or transfer described in section 381(a) occurred in a taxable year ending before July 20, 2020.

Special Analyses

I. Regulatory Planning and Review — Economic Analysis

Executive Orders 13771, 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, of reducing costs, of harmonizing rules, and of promoting flexibility. Order 13771 designation for any final rule resulting from these proposed regulations will be informed by comments received. The preliminary Executive Order 13771 designation for this proposed rule is regulatory.

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

A. Background

A foreign corporation with significant U.S. ownership may be classified as a controlled foreign corporation (“CFC”). Under section 951(a)(1)(A), each United States shareholder is required to include in gross income its pro rata share of the CFC’s subpart F income. Subpart F income consists of the sum of a CFC’s foreign base company income (as defined in section 954(a)) and insurance income (as defined in section 953(a)) and certain income described in section 952(a)(3) through (5). Section 954(b)(4), however, provides an exclusion of high-taxed items of income from foreign base company income and insurance income (the “subpart F high-tax exception”). The subpart F high-tax exception is generally governed by regulations originally issued in 1988 and significantly updated in 1995 (“current subpart F HTE regulations”).

As part of the Tax Cuts and Jobs Act, Congress enacted section 951A, which subjects certain income earned by a CFC to U.S. tax on a current basis at the United States shareholder level as global intangible low-taxed income (“GILTI”). Under section 951A(c)(2)(A)(i)(III), taxpayers may apply the high-tax exception of section 954(b)(4) in order to exclude certain high-taxed income from taxation under section 951A (the “GILTI high-tax exclusion”). The final regulations (“final GILTI HTE regulations,” referred to elsewhere in this Preamble as the final regulations) released at this same time as these proposed regulations provide provisions for the implementation of the GILTI high-tax exclusion.

B. Need for regulations

The current subpart F high-tax exception regulations and the final GILTI HTE regulations each contain guidance regarding statutory exclusions for high-taxed income that would otherwise be included in subpart F or tested income but these rules do not conform to each other. The proposed regulations are needed to conform the subpart F high-tax exception to the GILTI high-tax exclusion and to provide for a single election to exclude high-taxed income under section 954(b)(4).

C. Overview of regulations

The proposed regulations provide for a single election under section 954(b)(4) for purposes of both subpart F and GILTI, modeled on the final GILTI HTE regulations. Consistent with the final GILTI HTE regulations, the proposed regulations include the requirement that an election is generally made with respect to all CFCs that are members of a CFC group (instead of an election made on a CFC-by-CFC basis) and provide that the determination of whether income is high-taxed is made on a tested unit-by-tested unit basis. The proposed regulations would also simplify the determination of high-taxed income and often eliminate the fact intensive analysis by grouping certain income that would otherwise qualify as subpart F income together with income that would otherwise qualify as tested income for the purpose of determining the effective foreign tax rate. In addition, the proposed regulations would modify the method for allocating and apportioning deductions to items of gross income for the purposes of the high-tax exception.

D. Economic Analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed 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 proposed regulations conform the subpart F high-tax exception and GILTI high-tax exclusion by providing a single election for the purposes of both such exclusions, based on the final GILTI HTE regulations. This guidance thus reduces compliance costs and generally treats income earned across different forms of international business activity more equitably than under the no-action baseline. Based on these reasons, the Treasury Department and the IRS project that the proposed regulations will improve U.S. economic performance.

The Treasury Department and the IRS project that the proposed regulations, if finalized, would have annual economic effects greater than \$100 million (\$2020). This determination is based on the fact that many of the taxpayers potentially affected by these proposed regulations are large multinational enterprises. Because of their substantial size, even modest changes in the treatment of their foreign-source income, relative to the no-action baseline, can lead to changes in patterns of economic activity that amount to at least \$100 million per year.

The Treasury Department and the IRS have not undertaken more precise estimates of the economic effects of the proposed regulations. We do not have readily available data or models that predict with reasonable precision the business decisions that taxpayers would make under the proposed regulations, such as the amount and location of their foreign business activities and the extent to which this foreign business activity may substitute for or complement domestic business activity, versus alternative regulatory approaches, including the no-action baseline.

In the absence of quantitative estimates, the Treasury Department and the IRS have undertaken a qualitative analysis of the economic effects of the proposed regulations relative to the no-action baseline and alternative regulatory approaches.

The Treasury Department and the IRS solicit comments on the economic analysis of the proposed regulations and particularly solicit data, models, or other evidence that may be used to enhance the rigor with which the final regulations are developed.

3. Economic analysis of specific provisions

a. Single exception for all high-taxed income

The current subpart F high-tax exception regulations and the final GILTI HTE regulations each contain guidance regarding statutory exceptions for high-taxed income that would otherwise potentially be included in U.S. taxable income through a subpart F inclusion or a GILTI inclusion. These rules do not conform to each other. In addition, there currently are two elections under section 954(b)(4) with respect to distinct categories of income that are made separately. The proposed regulations provide for a single election under section 954(b)(4) of a unified high-tax exception.

Under the current subpart F high-tax exception regulations, taxpayers may elect to exclude high-taxed income from foreign base company income and insurance income on an item-by-item basis with respect to each individual CFC. Thus, taxpayers may select individual CFCs for which they elect to exclude high-taxed income from subpart F, while not making the election for other related CFCs. In contrast, the final GILTI HTE regulations contain a “consistency requirement” such that the election into the GILTI high-tax exclusion must be made for all related CFCs and with respect to all high-taxed income of those CFCs.

Comments preceding the final GILTI HTE regulations noted that the lack of conformity between the two high-tax exceptions, and particularly the ability of taxpayers to exclude items of high-taxed income from subpart F on a selective basis under the current subpart F high-tax exception regulations, may provide taxpayers with an incentive to structure activities such that certain foreign income would qualify as foreign base company income or insurance income, rather than tested income, in the absence of an election under section 954(b)(4).

To better understand this incentive and why it may be problematic, consider the following example. Under the current regulations, by structuring in a way that some of its high-taxed foreign income is treated as foreign base company sales

income (a category of foreign base company income) and electing the subpart F high-tax exception for only certain CFCs, a taxpayer may selectively exclude only a portion of its high-taxed CFC income from U.S. taxation under sections 951 and 951A. The taxpayer can then use foreign tax credits from the high-taxed income that is not excluded against its low-taxed foreign income. However, the taxpayer’s foreign tax credit limitation will not fully take into account the expenses attributable to investments giving rise to high-taxed income, since expenses allocable to excluded high-taxed income will be disregarded under section 904(b)(4). Consequently, the foreign tax limitation may be higher on a relative basis than it would have been if all high-taxed foreign income and all expenses attributable to such income were taken into account, and tax credits from non-excluded high-taxed income may more generously reduce U.S. tax liability on the taxpayer’s low-taxed income.

In contrast, under the single high-tax exception provided by these proposed regulations, the election into the high-tax exception must be made for all CFCs that are members of a CFC group. A taxpayer that wishes to use high-taxed income to cross-credit against low-taxed income would need to include all its foreign income and allocable expenses in the foreign tax credit limitation calculation. Thus, the foreign tax credit limitation will take into account all expenses attributable to foreign income and the tax credits from high-taxed foreign income will be appropriately limited. Therefore, the proposed regulations will decrease taxpayers’ incentives to inefficiently structure their foreign business activities relative to the current regulations, since such structuring would no longer be advantageous to taxpayers for purposes of the high-tax exception.

The Treasury Department and the IRS project that such structuring of foreign business activities to reclassify foreign income would be undertaken for tax-driven rather than market-driven reasons and would not provide any general economic benefit relative to the single exclusion provided in the proposed regulations. Thus, the no-action baseline may lead to higher compliance costs and less efficient patterns of business activity relative to pro-

posed regulations with a unified high-tax exception and a consistency requirement.

The Treasury Department and the IRS recognize that relative to the no-action baseline, the proposed regulations may increase U.S. tax on some foreign income earned by U.S. shareholders of CFCs since they may reduce tax planning opportunities for U.S. taxpayers. Thus, the proposed regulations may, on the margin, decrease foreign investment by some U.S. taxpayers compared to the baseline.

The Treasury Department and the IRS have not undertaken estimation of the reduction in compliance costs or the changes in the pattern of business activity under the proposed regulations, relative to the no-action baseline. We do not have readily available data or models to estimate with any reasonable precision: (i) the number and attributes of the taxpayers that will elect the unified high-tax exception under the proposed regulations or that would elect the subpart F and GILTI high-tax exceptions under the no-action baseline; (ii) the range of effective tax rates on foreign investment that taxpayers are likely to have under the proposed regulations versus the no-action baseline; and (iii) the business activities that taxpayers would undertake as a result of these effective tax rates under the proposed regulations versus the no-action baseline.

b. Grouping various categories of income into a single category

Under the current subpart F high-tax exception regulations, effective foreign tax rates are determined separately for a number of different income categories. Thus, taxpayers need to classify their income items into these categories when electing into the subpart F high-tax exception. In addition, under the final GILTI HTE regulations, taxpayers must determine whether income would otherwise qualify as tested income when electing into the GILTI high-tax exclusion. In both of these cases, to classify their income items into these various categories, taxpayers may need to undertake complex factual analyses. To simplify for taxpayers the determination of which income is subject to a high rate of foreign tax, the proposed regulations modify the categories into which income is grouped for the purpose of determining

effective foreign tax rates for the unified high-tax exception.

Under the proposed regulations, several categories of income that would otherwise qualify as subpart F income or tested income are grouped into a single category for the purpose of determining if income is high-taxed and qualifies for the high-tax exception. This grouping of income types will, in many circumstances, eliminate the need for taxpayers to determine exactly which category an income item would belong to in the absence of an election relative to the current regulations. For example, under the no-action baseline, the taxpayer may need to undertake a complex analysis to determine whether income is properly categorized as foreign base company services income or tested income. Under the proposed regulations, taxpayers could avoid such an analysis because the income would clearly fall into the new broader category that includes both foreign base company services income and potential tested income. This proposed approach will therefore result in substantial simplification and reduce the compliance burden for taxpayers electing into the high-tax exception relative to the no-action baseline.

The proposed approach will also decrease incentives for taxpayers to organize their operations solely for the purpose of ensuring that income will qualify for a certain category, relative to the no-action baseline. Under the current subpart F high-tax exception regulations, taxpayers may have an incentive to organize certain business activities to generate, for example, sales income rather than services income in order to raise (or lower) the effective foreign tax rates in the categories of foreign base company sales income and foreign base company services income. By manipulating the effective foreign tax rates of certain income categories, taxpayers may be able to maximize the tax saving they can achieve through the subpart F high-tax exception. However, organizing their activities to generate certain types of income may result in less efficient patterns of business activity relative to a regulatory approach with less specific income categories. Under the proposed regulations, because items of income will be grouped into broader categories for the purpose of determining high-taxed income, the in-

citive for taxpayers to generate specific types of income will be diminished relative to the no-action baseline.

Due to the absence of readily available data or models, the Treasury Department and the IRS have not estimated the difference in compliance costs or tax administration costs between the proposed regulations and the no-action baseline. We also have not estimated the difference in business activities that taxpayers might undertake between the proposed regulations and the no-action baseline.

c. Allocation and apportionment of deductions for purposes of the high-tax exception

The Tax Cuts and Jobs Act is silent over how deductions should be allocated and apportioned to the gross income for purposes of the high-tax exception. The allocation of these deductions can have an impact on a tested unit's effective foreign tax rate for the purposes of the high-tax exception.

Under the final GILTI HTE regulations, certain deductions are allocated and apportioned among separate items of gross income of a CFC, even if the deductions are reflected on the books and records of only one of the CFC's tested units and are likely only taken into account for the computation of foreign taxable income, as calculated for foreign tax purposes, in the jurisdiction of that tested unit. Thus, the allocation and apportionment of deductions to items of gross income may differ from how those deductions are treated by foreign jurisdictions in calculating foreign tax. For example, suppose that a CFC has an expense that for foreign jurisdictions' tax purposes is granted a full deduction against foreign taxable income in the jurisdiction of a single tested unit and is not granted deductions in any other jurisdictions where the CFC operates for the purposes of computing taxable income in these jurisdictions. Under the final GILTI HTE regulations, this deduction may nevertheless be allocated and apportioned against the gross income of multiple tested units of a CFC, some of which may not be tax resident in the same jurisdiction where the deduction is allowed for foreign tax purposes. This difference between federal and foreign tax treatment may result

in some income qualifying (or not qualifying) for the high-tax exception even when the statutory rate of foreign tax is low (or high). In addition, the difference between federal tax treatment and how taxpayers record deductions in their books and records may add to taxpayers' compliance burden and may complicate tax administration relative to alternative regulatory approaches.

To address these issues, the proposed regulations adopt an approach based on the books and records kept by the taxpayer. In particular, the proposed regulations generally provide that, for the purposes of the high-tax exception, deductions will be allocated and apportioned to items of gross income by reference to the items of deduction that are properly reflected on the books and records of a tested unit. This approach will align the method for allocating deductions to tested units with the method for attributing items of gross income to tested units, which also follows a books-and-records approach under the final GILTI HTE regulations.

Using the books-and-records approach for both gross income and deductions, tested units' income will also more closely approximate taxable income as computed by foreign jurisdictions for foreign tax purposes than it does under the final GILTI HTE regulations. The approach thus serves as a more accurate and more administrable method for determining the effective foreign tax rate paid tax than the no-action baseline.

Due to the absence of readily available data or models, the Treasury Department and the IRS have not estimated the difference in compliance costs or tax administration costs between the proposed regulations and the no-action baseline. We also have not estimated the difference in business activities that taxpayers might undertake between the proposed regulations and the no-action baseline.

4. Profile of Affected Taxpayers

The proposed regulations potentially affect those taxpayers that have at least

one CFC with at least one tested unit (including, potentially, the CFC itself) that has high-taxed income. Taxpayers with CFCs that have only low-taxed income are not eligible to elect the high-tax exception and hence are unaffected by the proposed regulations.

The Treasury Department and the IRS estimate that there are approximately 4,000 business entities (corporations, S corporations, and partnerships) with at least one CFC that pays an effective foreign tax rate above 18.9 percent, the current high-tax statutory threshold. The Treasury Department and the IRS further estimate that, for the partnerships with at least one CFC that pays an effective foreign tax rate greater than 18.9 percent, there are approximately 1,500 partners that have a large enough share to potentially qualify as a 10 percent U.S. shareholder of the CFC.³ The 4,000 business entities and the 1,500 partners provide an estimate of the number of taxpayers that could potentially be affected by guidance governing the election into the high-tax exception. The figure is approximate because the tax rate at the CFC-level will not necessarily correspond to the tax rate at the tested unit-level if there are multiple tested units within a CFC.

The Treasury Department and the IRS do not have readily available data to determine how many of these taxpayers would elect the high-tax exception as provided in these proposed regulations. Under the proposed regulations, a taxpayer that has both high-taxed and low-taxed tested units will need to evaluate the benefit of eliminating any tax under section 951 and section 951A with respect to high-taxed income against the costs of forgoing the use of foreign tax credits and, with respect to section 951A, the use of tangible assets in the computation of qualified business asset investment (QBAI).

Tabulations from the IRS Statistics of Income 2014 Form 5471 file⁴ further indicate that approximately 85 percent of earnings and profits are reported by CFCs incorporated in jurisdictions where the average effective foreign tax rate is less than

or equal to 18.9 percent. The data indicate several examples of jurisdictions where CFCs have average effective foreign tax rates above 18.9 percent, such as France, Italy, and Japan. However, information is not readily available to determine how many tested units are part of the same CFC and what the effective foreign tax rates are with respect to such tested units. Taxpayers potentially more likely to elect the high-tax exception are those taxpayers with CFCs that only operate in high-tax jurisdictions. Data on the number or types of CFCs that operate only in high-tax jurisdictions are not readily available.

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 of collections of information in the proposed regulations

The proposed regulations include new collection of information requirements in proposed §1.954-1(d)(6)(i)(A)(1) and (2), §1.954-1(d)(6)(vii)(A), and §1.6038-2(f)(19).

The collection of information in proposed §1.954-1(d)(6)(i)(A)(1) requires a statement that a controlling domestic shareholder of a CFC must file with an original or amended income tax return to elect to apply the high-tax exception in section 954(b)(4) with respect to a controlled foreign corporation. The collection of information in proposed §1.954-1(d)(6)(i)(A)(2) requires a notice that the controlling domestic shareholder must provide to other domestic shareholders who own stock of the foreign corporation to notify them of the election. The collection of information in proposed §1.954-1(d)(6)(vii)(A) requires each U.S. shareholder of a CFC that makes a

³Data are from IRS's Research, Applied Analytics, and Statistics division based on E-file data available in the Compliance Data Warehouse for tax years 2015 and 2016. The counts include Category 4 and Category 5 IRS Form 5471 filers. Category 4 filers are U.S. persons who had control of a foreign corporation during the annual accounting period of the foreign corporation. Category 5 filers are U.S. shareholders who own stock in a foreign corporation that is a CFC and who owned that stock on the last day in the tax year of the foreign corporation in that year in which it was a CFC. For full definitions, see <https://www.irs.gov/pub/irs-pdf/f5471.pdf>.

⁴The IRS Statistics of Income Tax Stats report on Controlled Foreign Corporations can be accessed here: <https://www.irs.gov/statistics/soi-tax-stats-controlled-foreign-corporations>.

high-tax election under section 954(b)(4) and §1.954-1(d)(6) to maintain certain documentation. The collection of information in proposed §1.6038-2(f)(19) requires a U.S. shareholder of a CFC that makes a high-tax election under section 954(b)(4) and §1.954-1(d)(6) to include certain information in the Form 5471 (or successor form).

As shown in Table 1, the Treasury Department and the IRS estimate that the number of persons potentially subject to the collections of information in proposed §1.954-1(d)(6)(i)(A)(1) and (2), §1.954-1(d)(6)(vii)(A), and §1.6038-2(f)(19) is between 25,000 and 35,000. The estimate in Table 1 is based on the number of taxpayers that filed an income tax return that in-

cluded a Form 5471, “Information Return of U.S. Persons With Respect to Certain Foreign Corporations.” The collections of information in proposed §1.954-1(d)(6)(i)(A)(1) and (2), §1.954-1(d)(6)(vii)(A), and §1.6038-2(f)(19) can only apply to taxpayers that are U.S. shareholders (as defined in section 951(b)) and U.S. shareholders are required to file a Form 5471.

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
Proposed §1.954-1(d)(6)(i)(A)(1) and (2), §1.954-1(d)(6)(vii)(A), and §1.6038-2(f)(19)	25,000 - 35,000	Form 990 series, Form 1120 series, Form 1040 series, Form 1041 series, and Form 1065 series

Source: MeF, DCS, and IRS’s Compliance Data Warehouse

B. Reporting of burden related to proposed §1.954-1(d)(6)(i)(A)(1) and (2) and §1.6038-2(f)(19)

The collection of information contained in proposed §1.954-1(d)(6)(i)(A)(1) and (2) and §1.6038-2(f)(19) will be reflected in the Form 14029, Paperwork Reduction Act Submission, that the Treasury Department and the IRS will submit to OMB for income tax returns in the Form 990 series, Forms 1120, Forms 1040, Forms 1041, and Forms 1065. In particular, the reporting burden associated with the information collection in proposed §1.954-1(d)(6)(i)(A)(1) and (2) and §1.6038-2(f)(19) will be included in the burden estimates for OMB control numbers 1545-0123, 1545-0074, 1545-0092, and 1545-0047. OMB control number 1545-0123 represents a total estimated burden time for all forms and schedules for corporations of 3.344 billion hours and total estimated monetized costs of \$61.558 billion (\$2019). OMB control number 1545-0074 represents a total estimated burden time, including all other related forms and schedules for individuals, of 1.717 billion hours and total estimated monetized costs of \$33.267 billion (\$2019). OMB control number 1545-0092 represents a total estimated burden time, including all other related forms and schedules for trusts and estates, of 307,844,800 hours and total

estimated monetized costs of \$9.950 billion (\$2016). OMB control number 1545-0047 represents a total estimated burden time, including all other related forms and schedules for tax-exempt organizations, of 52.450 million hours and total estimated monetized costs of \$1,496,500,000 (\$2020). Table 2 summarizes the status of the Paperwork Reduction Act submissions of the Treasury Department and the IRS related to forms in the Form 990 series, Forms 1120, Forms 1040, Forms 1041, and Forms 1065.

The overall burden estimates provided by the Treasury Department and the IRS to OMB in the Paperwork Reduction Act submissions for OMB control numbers 1545-0123, 1545-0074, 1545-0092, and 1545-0047 are aggregate amounts related to the U.S. Business Income Tax Return, the U.S. Individual Income Tax Return, and the U.S. Income Tax Return for Estates and Trusts, along with any associated forms. The burdens included in these Paperwork Reduction Act submissions, however, do not account for any burdens imposed by proposed §1.954-1(d)(6)(i)(A)(1) and (2) and §1.6038-2(f)(19). The Treasury Department and the IRS have not identified the estimated burdens for the collections of information in proposed §1.954-1(d)(6)(i)(A)(1) and (2) and §1.6038-2(f)(19) because there are no burden estimates specific to proposed §1.954-

1(d)(6)(i)(A)(1) and (2) and §1.6038-2(f)(19) currently available. The burden estimates in the Paperwork Reduction Act submissions that the Treasury Department and the IRS will submit to the OMB will in the future include, but not isolate, the estimated burden related to the tax forms that will be revised for the collection of information in proposed §1.954-1(d)(6)(i)(A)(1) and (2) and §1.6038-2(f)(19).

The Treasury Department and the IRS have included the burdens related to the Paperwork Reduction Act submissions for OMB control numbers 1545-0123, 1545-0074, 1545-0092, and 1545-0047 in the Paperwork Reduction Act analysis for other regulations issued by the Treasury Department and the IRS related to the taxation of cross-border income. The Treasury Department and the IRS encourage users of this information to take measures to avoid overestimating the burden that the collections of information in proposed §1.954-1(d)(6)(i)(A)(1) and (2) and §1.6038-2(f)(19), together with other international tax provisions, impose. Moreover, the Treasury Department and the IRS also note that the Treasury Department and the IRS estimate Paperwork Reduction Act burdens on a taxpayer-type basis rather than a provision-specific basis because an estimate based on the taxpayer-type most accurately reflects taxpayers’ interactions with the forms.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described

above for each relevant form and ways for the IRS to minimize the paperwork burden. Any proposed revisions to these forms that reflect the information collections contained in proposed §1.954-1(d)(6)(i)(A)(1) and (2) and §1.6038-2(f)(19)

will be made available for public comment at <https://apps.irs.gov/app/picklist/list/draftTaxForms.html> and will not be finalized until after these forms have been approved by OMB under the Paperwork Reduction Act.

Table 2. Summary of Information Collection Request Submissions Related to Form 990 series, Forms 1120, Forms 1040, Forms 1041, and Forms 1065.

Form	Type of Filer	OMB Number(s)	Status
Forms 990	Tax exempt entities (NEW Model)	1545-0047	Approved by OIRA 2/12/2020 until 2/28/2021. Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201912-1545-014
Form 1040	Individual (NEW Model)	1545-0074	Approved by OIRA 1/30/2020 until 1/31/2021. Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021
Form 1041	Trusts and estates	1545-0092	Approved by OIRA 5/08/2019 until 5/31/2022. Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201806-1545-014
Form 1065 and 1120	Business (NEW Model)	1545-0123	Approved by OIRA 1/30/2020 until 1/31/2021. Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001

C. Reporting of burden related to proposed §1.954-1(d)(6)(vii)(A)

The collections of information contained in proposed §1.954-1(d)(6)(vii)(A) will not be conducted using a new or existing IRS form.

The collections of information contained in §1.954-1(d)(6)(vii)(A) have been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act. Commenters are strongly encouraged to submit public comments electronically. Comments and recommendations for the proposed information collection should be sent to www.reginfo.gov/public/do/PRAMain, with electronic copies emailed to the IRS at omb.unit@irs.gov (indicate REG-127732-19 on the subject line). Find this particular information collection by selecting “Currently under Review - Open for Public Comments” and then by using the search function. Comments can also be mailed to OMB, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington,

DC 20503, with copies mailed to the IRS, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collections of information should be received by September 21, 2020.

The likely respondents are U.S. shareholders of CFCs.

Estimated total annual reporting burden: 300,000 hours.

Estimated average annual burden per respondent: 10 hours.

Estimated number of respondents: 30,000.

Estimated frequency of responses: annually.

III. *Regulatory Flexibility Act*

When an agency issues a rulemaking proposal, the Regulatory Flexibility Act (RFA) requires the agency to “prepare and make available for public comment an initial regulatory flexibility analysis (IRFA)” which will “describe the impact of the proposed rule on small entities.” 5 U.S.C. § 603(a). Section 605 of the RFA allows an agency to certify a rule, in lieu of preparing an IRFA, if the proposed rulemaking is not expected to have a significant

economic impact on a substantial number of small entities.

These proposed regulations directly affect small entities that are a U.S. shareholder of a CFC and elect to apply the exception for high-tax income in section 954(b)(4) and proposed §1.954-1(d)(6)(i). A U.S. shareholder is a U.S. person that owns, directly, indirectly, or constructively, 10 percent or more of the vote or value of a foreign corporation. A foreign corporation is a CFC if U.S. shareholders own directly, indirectly, or constructively, more than 50 percent of the vote or value of the foreign corporation. Therefore, the proposed regulations apply only to U.S. persons that operate a foreign business in corporate form, and only if the foreign corporation is a CFC.

The Small Business Administration establishes small business size standards (13 CFR part 121) by annual receipts or number of employees. There are several industries that may be identified as small even through their annual receipts are above \$25 million or because of the number of employees. The Treasury Department and the IRS do not have data indicating

the number of small entities that will be significantly impacted by the proposed regulations. Nevertheless, for the reasons described below, the Treasury Department and the IRS do not believe that the regulations will have a significant economic impact on small entities. The proposed regulations are elective, and small entities will likely not avail of the election unless the net benefits in terms of tax liability and any consequent compliance costs are positive. Thus, the Treasury Department and the IRS hereby certify that the proposed regulations are not expected to have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses. The Treasury Department and the IRS also request comments from the public on the certifications in this Part III.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. §1532) 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. These proposed 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.

V. 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. These proposed regulations do not have federalism implica-

tions and do not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Comments and Requests for Public Hearing

Before the proposed amendments are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “**ADDRESSES**” section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. See also part II.A. of the Explanation of Provisions (requesting comments related to the income grouping rules in §1.904-4(c)), part II.C. of the Explanation of Provisions (requesting comments related to the allocation and apportionment of deductions incurred by a CFC for purposes of sections 954(b)(5), 951A(c)(2)(A)(ii), and 960 based on the extent to which they are properly reflected on an applicable financial statement), part II.D. of the Explanation of Provisions (requesting comments related to any case in which undefined or negative foreign tax rates should not be deemed high-taxed), part II.E. of the Explanation of Provisions (requesting comments related to combination of de minimis tested units to reduce administrative burden without permitting an excessive amount of blending of income subject to different foreign tax rates), and part IV.B. of the Explanation of Provisions (requesting comments related to rules that would permit a taxpayer to make (or revoke) an election after the 24-month period in cases where the taxpayer can establish that the election (or revocation) will not result in time-barred tax deficiencies). Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at www.regulations.gov or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020-4, 2020-17 IRB

1, provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

Because the Treasury Department and the IRS intend to make revisions to the rules concerning high-taxed income in §1.904-4(c) to conform them with the rules in these proposed regulations, comments are requested concerning any issues that should be taken into consideration in connection with such revisions.

Comments are requested on transition rules with respect to the application of existing §1.954-1(d), which does not contain a consistency requirement, and the final regulations in circumstances in which a U.S. shareholder’s CFCs have different taxable years.

Comments are also requested on the attribution of items to a tested unit based on an applicable financial statement in certain cases in which a CFC holds directly or indirectly more than one interest in an entity. For example, assume a CFC directly owns DEX, a disregarded entity that is a tax resident in Country X, and DEY, a disregarded entity that is a tax resident in Country Y. DEX and DEY together own all the interests in DEZ, a disregarded entity organized in Country Z that is viewed as fiscally transparent under the laws of all countries. Comments are requested on how items that are properly reflected on the applicable financial statement of DEZ, and taken into account by CFC, should be attributed to CFC’s interests in DEX and DEY, each of which is a tested unit.

Drafting Information

The principal authors of these regulations are Jorge M. Oben and Larry R. Pounders of the Office of Associate Chief Counsel (International). 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 record-keeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for §1.954-1 to read in part as follows:

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

* * * * *

Section 1.954-1 also issued under 26 U.S.C. 964(c), 6001 and 6038(a)(1).

* * * * *

§1.951A-2 [Amended]

Par. 2. Section 1.951A-2:

1. As amended in a final rule published elsewhere in this issue of the Federal Register, effective September 21, 2020, is amended by revising paragraph (c)(1)(iii), removing the paragraph (c)(3)(i) subject heading, redesignating paragraph (c)(3)(i) as paragraph (c)(3), and removing paragraph (c)(3)(ii);

2. Is amended by removing paragraphs (c)(4)(iii)(C) and (c)(4)(iv)(C); and

3. As amended in a final rule published elsewhere in this issue of the Federal Reg-

ister, effective September 21, 2020, is amended by removing paragraphs (c)(7) and (8).

The revisions read as follows:

§1.951A-2 Tested income and tested loss.

* * * * *

(c) * * *

(1) * * *

(iii) Gross income described in section 951A(c)(2)(A)(i)(III) that is excluded from the foreign base company income (as defined in section 954) or insurance income (as defined in section 953) of the corporation by reason of the exception described in section 954(b)(4) and §1.954-1(d)(1) pursuant to an election under §1.954-1(d)(6),

* * * * *

Par. 3. Section 1.951A-7, as amended in a final rule published elsewhere in this issue of the Federal Register, effective September 21, 2020, is amended by revising paragraph (b) to read as follows:

§1.951A-7 Applicability dates.

* * * * *

(b) *High-tax exception.* Section 1.951A-2(c)(1)(iii) applies to taxable years of foreign corporations beginning after [the date that final regulations are

filed for public inspection], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. For the application of §1.951A-2(c)(1)(iii) to taxable years of controlled foreign corporations beginning on or after September 21, 2020 and before [the date final regulations are filed with the **Federal Register**] and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, see §1.951A-2(c)(1)(iii), as in effect on September 21, 2020.

Par. 4. Section 1.952-1 is amended by:

1. Revising paragraph (e)(4);
2. Redesignating paragraphs (f)(4) and (5) as paragraphs (f)(5) and (6), respectively;

3. Adding a new paragraph (f)(4);

4. In newly redesignated paragraph (f)(5), designating Examples (1) through (4) as paragraphs (f)(5)(i) through (iv), respectively;

5. In newly designated paragraphs (f)(5)(i) through (iv), redesignating the paragraphs in the first column as the paragraphs in the second column in the following table:

Old paragraphs	New paragraphs
(f)(5)(i)(i) through (iii)	(f)(5)(i)(A) through (C).
(f)(5)(ii)(i) through (iii)	(f)(5)(ii)(A) through (C).
(f)(5)(iii)(i) through (iii)	(f)(5)(iii)(A) through (C).
(f)(5)(iv)(i) through (iii)	(f)(5)(iv)(A) through (C).

6. Revising newly designated paragraph (f)(6).

The revisions and addition read as follows:

§1.952-1 Subpart F income defined.

* * * * *

(e) * * *

(4) *Coordination with sections 953 and 954.* The rules of this paragraph (e) apply after the determination of net foreign base company income, as provided in §1.954-1(a)(5). This paragraph (e)(4) applies to taxable years of controlled foreign corporations beginning after [the date that final regulations are filed for public inspection], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

For taxable years before those described in the preceding sentence, see §1.952-1(e)(4), as contained in 26 CFR part 1 revised as of April 1, 2020.

* * * * *

(f) * * *

(4) *Carryover of recapture accounts in transactions to which section 381(a) applies.* In the case of a distribution or transfer described in section 381(a), any recapture accounts (as described in paragraph (f)(2)(i) of this section) of the distributor or transferor corporation are treated as recapture accounts of the acquiring corporation as of the close of the date of the distribution or transfer. If the acquiring corporation has recapture accounts in the same separate category (as defined in

§1.904-5(a)(4)(v) and §1.954-1(c)(1)(iii) (1) or (2)), the recapture accounts of the distributor or transferor corporation are added to the recapture accounts of the acquiring corporation in such category; if not, the acquiring corporation adopts the recapture accounts of the distributor or transferor corporation in such category.

* * * * *

(6) *Effective date—(i) Paragraphs (e) and (f).* Except as provided in paragraphs (e)(4) and (f)(6)(ii) of this section, paragraph (e) of this section and this paragraph (f) apply to taxable years of a controlled foreign corporation beginning after March 3, 1997.

(ii) *Paragraph (f)(4).* Paragraph (f)(4) of this section applies to taxable years of

a corporation ending on or after July 20, 2020 (even if the distribution or transfer described in section 381(a) occurred in a taxable year ending before July 20, 2020).

* * * *

Par. 5. Section 1.954-1:

1. Is amended by revising paragraphs (a)(2) and (3);
2. Is amended in paragraph (a)(4) by removing the language “term,” removing the language “means the” and adding the language “of a controlled foreign corporation is” in its place, removing the language “a” after the language “adjusted gross foreign base company income of” and adding “the” in its place;
3. Is amended by revising paragraphs (a)(5) and (6);
4. Is amended in paragraph (a)(7) by adding in the first sentence the language “and §1.952-1(f)(2)(ii) of” after the language “under section 952(c)” and revising the last sentence;
5. Is amended in paragraph (b)(1)(ii) by removing the second sentence; and

6. As amended in a final rule published elsewhere in this issue of the Federal Register, effective September 21, 2020, is amended by revising paragraphs (d) and (h)(3).

The revisions read as follows:

§1.954-1 Foreign base company income.

* * *

(2) *Gross foreign base company income*—(i) *In general*. The *gross foreign base company income* of a controlled foreign corporation, determined after the application of section 952(b) and §1.952-1(b)(2), and after the application of the high-tax exception under section 954(b)(4) and paragraph (d) of this section, consists of the categories of gross income of the controlled foreign corporation described in paragraphs (a)(2)(i)(A) through (C) of this section.

(A) Foreign personal holding company income, as defined in section 954(c).

(B) Foreign base company sales income, as defined in section 954(d).

(C) Foreign base company services income, as defined in section 954(e).

(ii) *Foreign base company income for purposes of section 954(b)*. The term foreign base company income as used in section 954(b) refers to gross foreign base company income.

(3) *Adjusted gross foreign base company income*. The *adjusted gross foreign base company income* of a controlled foreign corporation is the gross foreign base company income of the controlled foreign corporation as adjusted by the de minimis rule in section 954(b)(3)(A) and paragraph (b)(1)(i) of this section, and the full inclusion rule in section 954(b)(3)(B) and paragraph (b)(1)(ii) of this section.

* * * *

(5) *Adjusted net foreign base company income*. The *adjusted net foreign base company income* of a controlled foreign corporation is the net foreign base company income of the controlled foreign corporation, reduced by the earnings and profits limitation of section 952(c)(1) and §1.952-1(c), and increased by earnings and profits that are recharacterized as foreign base company income under section 952(c)(2) and §1.952-1(f)(2)(ii). Unless otherwise provided (for example, in paragraph (a)(2)(ii) of this section), the term foreign base company income as used in the Internal Revenue Code and elsewhere in the Income Tax Regulations means adjusted net foreign base company income.

(6) *Insurance income*. The *gross insurance income* of a controlled foreign corporation is all the gross income of the controlled foreign corporation, determined after the application of section 952(b) and §1.952-1(b)(2), and after the application of the high-tax exception under section 954(b)(4) and paragraph (d) of this section, that is taken into account to determine the insurance income of the controlled foreign corporation under section 953. The *adjusted gross insurance income* of a controlled foreign corporation is the gross insurance income of the controlled foreign corporation as adjusted by the de minimis rule in section 954(b)(3)(A) and paragraph (b)(1)(i) of this section, and the full inclusion rule in section 954(b)(3)(B)

and paragraph (b)(1)(ii) of this section. The *net insurance income* of a controlled foreign corporation is the adjusted gross insurance income of the controlled foreign corporation reduced under section 953 so as to take into account deductions (including taxes) properly allocable or apportionable to such income. The *adjusted net insurance income* of a controlled foreign corporation is the net insurance income of the controlled foreign corporation reduced

by the earnings and profits limitation of section 952(c)(1) and §1.952-1(c), and increased by earnings and profits that are recharacterized as insurance income under section 952(c)(2) and §1.952-1(f)(2)(ii). The term insurance income as used in subpart F of the Internal Revenue Code and in the regulations under that subpart means adjusted net insurance income, unless otherwise provided.

(7) *Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c)*. The earnings and profits described in this paragraph (a)(7) are not subject to the de minimis rule in section 954(b)(3)(A) and paragraph (b)(1)(i) of this section, the full inclusion rule in section 954(b)(3)(B) and paragraph (b)(1)(ii) of this section, or the high-tax exception of section 954(b)(4) and paragraph (d) of this section.

* * * *

(d) *High-tax exception*—(1) *Application*—(i) *In general*. An item of gross income of a controlled foreign corporation for a CFC inclusion year qualifies for the high-tax exception under section 954(b)(4) and this paragraph (d)(1) only if—

(A) An election made under section 954(b)(4) and paragraph (d)(6) of this section is effective with respect to the controlled foreign corporation for the CFC inclusion year; and

(B) The tentative net item with respect to the item of gross income was subject to an effective rate of foreign tax, as determined under paragraph (d)(4) of this section, that is greater than 90 percent of the maximum rate of tax specified in section 11 for the CFC inclusion year. See paragraphs (d)(9)(iii)(A)(2)(vi) (Example 1) and (d)(9)(iii)(B)(2)(vi) (Example 2) of this section for illustrations of the application of the rules set forth in this paragraph (d)(1)(i)(B).

(ii) *Item of gross income*. For purposes of this paragraph (d), an item of gross income means an item described in paragraph (d)(1)(ii)(A), (B), or (C) of this section. See paragraphs (d)(9)(iii)(A)(2)(i) (Example 1) and (d)(9)(iii)(B)(2)(i) (Example 2) of this section for illustrations of the application of the rule set forth in this paragraph (d)(1)(ii).

(A) *General gross item*. A general gross item is the aggregate amount of all gross

income, determined under federal income tax principles but without regard to items described in section 952(c)(2) and §1.952-1(f)(2)(ii), that is attributable to a single tested unit (as provided in paragraph (d)(1)(iii) of this section) of the controlled foreign corporation in the CFC inclusion year and that is—

- (1) In a single separate category (as defined in §1.904-5(a)(4)(v));
- (2) Not described in paragraph (d)(1)(ii)(B) of this section;

(3) Not passive foreign personal holding company income; and

(4) Of a type that would be treated as gross tested income, gross foreign base company income (as defined in paragraph (a)(2) of this section), or gross insurance income (as defined in paragraph (a)(6) of this section) (in all cases, determined without regard to the high-tax exception described in section 954(b)(4) and paragraph (d)(1) of this section).

(B) *Equity gross item.* An equity gross item is the sum of gross income described in paragraph (d)(1)(ii)(A) of this section, determined without regard to paragraph (d)(1)(ii)(A)(2) of this section, that is also described in either paragraph (d)(1)(ii)(B)(1) or (2) of this section.

(1) *Income or gain arising from stock.* Gross income described in this paragraph (d)(1)(ii)(B)(1) consists of dividends, income or gain recognized from dispositions of stock, and any similar items arising from stock that are taken into account by the tested unit, the entity an interest in which is the tested unit, or the branch the portion of the activities of which is the tested unit, as applicable, and subject to an exclusion, exemption, or other similar relief (such as a preferential tax rate) under the tax law of the country of tax residence of the tested unit or the entity, or the country in which the branch is located. For purposes of the preceding sentence, other similar relief does not include a deduction or credit against the tax imposed under such tax law for tax paid to another foreign country with respect to income attributable to the branch. Gross income described in this paragraph (d)(1)(ii)(B)(1) does not include gain recognized from dispositions of stock if the stock would be dealer property (as defined in §1.954-2(a)(4)(v)).

(2) *Income or gain arising from interests in pass-through entities.* Gross in-

come described in this paragraph (d)(1)(ii)(B)(2) is income or gain recognized on the disposition of, or a distribution with respect to, an interest in a pass-through entity (including an interest in a disregarded entity) that is attributable to the tested unit, the entity an interest in which is the tested unit, or the branch the portion of the activities of which is the tested unit, as applicable, and subject to an exclusion, exemption, or other similar relief (such as a preferential tax rate) under the tax law of the country of tax residence of the tested unit or the entity, or the country in which the branch is located. For purposes of the preceding sentence, other similar relief does not include a deduction or credit against the tax imposed under such tax law for tax paid to another foreign country with respect to income attributable to the branch.

(C) *Passive gross item.* A passive gross item is the sum of the gross income described in paragraph (d)(1)(ii)(A) of this section (without regard to the exclusion of passive foreign personal holding company income under paragraph (d)(1)(ii)(A)(3) of this section) that constitutes a single item of passive foreign personal holding company income described in paragraph (c)(1)(iii)(B) of this section.

(iii) *Gross income attributable to a tested unit—(A) Items properly reflected on an applicable financial statement.* Gross income of a controlled foreign corporation is attributable to a tested unit of the controlled foreign corporation to the extent it is properly reflected, as modified under paragraph (d)(1)(iii)(B) of this section, on the applicable financial statement of the tested unit. All gross income of a controlled foreign corporation is attributable to a tested unit (but no portion of the gross income is attributable to more than one tested unit) of the controlled foreign corporation. See paragraphs (d)(9)(iii)(C)(2)(ii) and (d)(9)(iii)(C)(5) (Example 3) of this section for illustrations of the application of the rule set forth in this paragraph (d)(1)(iii)(A).

(B) *Adjustments to reflect disregarded payments.* The principles of §1.904-4(f)(2)(vi) apply to adjust gross income of the tested unit, to the extent thereof, to reflect disregarded payments. For purposes of this paragraph (d)(1)(iii)(B), the principles of §1.904-4(f)(2)(vi) are applied taking

into account the rules in paragraphs (d)(1)(iii)(B)(1) through (5) of this section. See paragraphs (d)(9)(iii)(A) (Example 1) and (d)(9)(iii)(B) (Example 2) of this section for examples that illustrate the application of the adjustments set forth in this paragraph (d)(1)(iii)(B).

(1) The controlled foreign corporation is treated as the foreign branch owner and any other tested units of the controlled foreign corporation are treated as foreign branches.

(2) The principles of §1.904-4(f)(2)(vi)(A) apply in the case of disregarded payments between a foreign branch and another foreign branch without regard to whether either foreign branch makes a disregarded payment to, or receives a disregarded payment from, the foreign branch owner.

(3) The exclusion for payments described in §1.904-4(f)(2)(vi)(C)(1) (“disregarded interest”) does not apply to the extent of the amount of a disregarded payment that is deductible in the country of tax residence (or location, in the case of a branch) of the tested unit that is the payor.

(4) In the case of an amount of disregarded interest described in paragraph (d)(1)(iii)(B)(3) of this section, the rules in §1.904-4(f)(2)(vi)(B) for determining how a disregarded payment is allocated to gross income of a foreign branch or foreign branch owner are applied by treating the disregarded payment as allocated and apportioned ratably to all of the gross income attributable to the tested unit that is making the disregarded payment. However, if a tested unit is both a payor and payee of an amount of disregarded interest described in paragraph (d)(1)(iii)(B)(3) of this section, the payments made are first allocable to the gross income allocated to it as a result of the receipt of amounts of disregarded interest described in paragraph (d)(1)(iii)(B)(3) of this section, to the extent thereof. If a tested unit makes and receives payments described in paragraph (d)(1)(iii)(B)(3) of this section to and from the same tested unit, the payments are netted so that paragraph (d)(1)(iii)(B)(3) of this section and the principles of §1.904-4(f)(2)(vi) apply only to the net amount of such payments between the two tested units. If the payment described in paragraph (d)(1)(iii)(B)(3) of this section would (if regarded) be directly

allocated under the principles of §1.861-10T(b) or (c) if such payment were regarded for federal income tax purposes, then notwithstanding any other rule in this paragraph (d)(1)(iii)(B)(4), a disregarded payment is allocated to gross income of a tested unit under the principles of §1.904-4(f)(2)(vi)(B) by applying the principles of §1.861-10T.

(5) In the case of multiple disregarded payments, in lieu of the rules in §1.904-4(f)(2)(vi)(F), disregarded payments are taken into account under paragraph (d)(1)(iii)(B) of this section under the rules provided in paragraphs (d)(1)(iii)(B)(5)(i) through (iii) of this section.

(i) Adjustments are first made with respect to disregarded payments received by a payee tested unit that are not themselves attributable to disregarded payments received by the payor tested unit. Second, adjustments are made with respect to disregarded payments made by the payee tested unit that are attributable to the income of that tested unit, adjusted as described in the preceding sentence. Third, adjustments are made with respect to amounts of disregarded interest received and paid, as described in paragraph (d)(1)(iii)(B)(4) of this section. Fourth, adjustments are made with respect to any other disregarded payments made or received.

(ii) Adjustments with respect to disregarded payments made are first made with respect to disregarded payments that would be definitely related to a single class of gross income under the principles of §1.861-8; second, adjustments are made with respect to disregarded payments that would be definitely related to multiple classes of gross income under the principles of §1.861-8, but that are not definitely related to all gross income of the tested unit; third, adjustments are made with respect to disregarded payments that would be definitely related to all gross income under the principles of §1.861-8, other than payments described in paragraph (d)(1)(iii)(B)(3) of this section; and fourth, adjustments are made with respect to payments described in paragraph (d)(1)(iii)(B)(3) of this section and disregarded payments that would not be definitely related to any gross income under the principles of §1.861-8.

(iii) Adjustments can be made only to the extent there is sufficient gross income

(in the relevant income group) of the tested unit making the payment, taking into account the adjustments that increase gross income as provided in this paragraph (d)(1)(iii)(B)(5).

(iv) *Tentative net item*—(A) *In general.* Except as provided in paragraphs (d)(1)(iv)(B) and (C) of this section, a tentative net item with respect to an item of gross income described in paragraph (d)(1)(ii) of this section is determined by allocating and apportioning deductions for the CFC inclusion year (not including any items described in §1.951A-2(c)(5) or (c)(6)) to the item of gross income under the principles of §1.960-1(d)(3) by treating each single item of gross income described in paragraph (d)(1)(ii) of this section as gross income in a separate income group described in §1.960-1(d)(2)(ii) and by treating all other income as assigned to a residual income group. A deduction for current year taxes (as defined in §1.960-1(b)(4)) imposed solely by reason of a disregarded payment that gives rise to an adjustment under paragraph (d)(1)(iii)(B) of this section, however, is allocated and apportioned under the principles of §1.904-6(b)(2) in lieu of the rules under §1.861-20(d)(3)(ii). See paragraph (d)(9)(iii)(A)(2)(ii) (Example 1) and (d)(9)(iii)(B)(2)(iii) (Example 2) of this section for illustrations of the application of the rule set forth in this paragraph (d)(1)(iv)(A).

(B) *Booking rule for deductions other than current year tax expense.* Deductions (other than deductions for current year taxes) are attributable to a tested unit to the extent they are properly reflected on the applicable financial statement of the tested unit under the principles of paragraph (d)(1)(iii)(A) of this section. In applying the principles of §1.960-1(d)(3) under paragraph (d)(1)(iv)(A) of this section, deductions (other than deductions for current year taxes) attributable to a tested unit are allocated and apportioned on the basis of the income and activities to which the expense relates, but are applied only to reduce the items of gross income described in paragraph (d)(1)(ii) of this section attributable to the same tested unit (including gross income that is attributed to the tested unit by reason of disregarded payments, and regardless of whether the tested unit has gross income in the relevant income group during the CFC

inclusion year). In applying §§1.861-9 and 1.861-9T pursuant to §1.960-1(d)(3), solely for purposes of paragraph (d)(1)(iv)(A) of this section interest deductions attributable to a tested unit are allocated and apportioned only on the basis of the assets (or gross income, in the case of a taxpayer that has elected the modified gross income method) of that tested unit. No interest deductions attributable to the tested unit are allocated and apportioned to the assets or gross income of another tested unit, or of a corporation, owned by the controlled foreign corporation indirectly through the tested unit. See paragraph (d)(9)(iii)(B)(2)(ii) (Example 2) of this section for illustrations of the application of the rule set forth in this paragraph (d)(1)(iv)(B).

(C) *Deduction or loss with respect to equity.* Notwithstanding paragraph (d)(1)(iv)(A) of this section, if a tested unit takes into account a loss or deduction (including a deduction for foreign income taxes) with respect to a transaction involving stock or an interest in a pass-through entity, and income or gain with respect to the stock or interest is or would have been described in paragraph (d)(1)(ii)(B)(1) or (2) of this section, then for purposes of allocating and apportioning deductions under paragraph (d)(1)(iv)(A) of this section, the deduction or loss is allocated and apportioned solely to the item of gross income described in paragraph (d)(1)(ii)(B)(1) or (2) of this section, as applicable, with respect to such tested unit, regardless of whether there is any gross income included in such item during the CFC inclusion year.

(D) *Effect of potential and actual changes in taxes paid or accrued.* Except as otherwise provided in this paragraph (d)(1)(iv)(D), the amount of current year taxes paid or accrued with respect to an item of gross income (as described in paragraph (d)(1)(ii) of this section) does not take into account any potential reduction in foreign income taxes that may occur by reason of a future distribution to shareholders of all or part of such income. However, to the extent the foreign income taxes paid or accrued by the controlled foreign corporation are reasonably certain to be returned to a shareholder by the foreign country imposing such taxes, directly or indirectly, through any means (including, but not limited to, a refund, credit, payment, discharge of an obligation, or

any other method) on a subsequent distribution to such shareholder, the foreign income taxes are not treated as paid or accrued for purposes of paragraphs (d)(1)(iv) or (d)(5) of this section. In addition, foreign income taxes that have not been paid or accrued because they are contingent on a future distribution of earnings (or other similar transaction, such as a loan to a shareholder) are not taken into account for purposes of paragraph (d)(1)(iv) or (d)(5) of this section. If, pursuant to section 905(c) and §1.905-3, a redetermination of U.S. tax liability is required to account for the effect of a foreign tax redetermination (as defined in §1.905-3(a)), paragraph (d)(1)(iv) and (d)(5) of this section are applied in the adjusted year taking into account the adjusted amount of the redetermined foreign tax.

(v) *Portfolio interest and treatment of certain income under foreign tax credit rules.* Portfolio interest, as described in section 881(c), does not qualify for the high-tax exception under section 954(b)(4) and this paragraph (d). For rules concerning the treatment for foreign tax credit purposes of distributions of passive income excluded from foreign base company income, insurance income or tested income under section 954(b)(4) and this paragraph (d), see section 904(d)(3)(E) and §1.904-4(c)(7)(iii).

(2) *Tested unit rules—(i) In general.* Subject to the combination rule in paragraph (d)(2)(iii) of this section, the term *tested unit* means any corporation, interest, or branch described in paragraphs (d)(2)(i)(A) through (C) of this section. See paragraph (d)(9)(iii)(C) of this section for an example that illustrates the application of the tested unit rules set forth in this paragraph (d)(2).

(A) A controlled foreign corporation (as defined in section 957(a)).

(B) An interest held directly or indirectly by a controlled foreign corporation in a pass-through entity that is—

(I) A tax resident (as described in §1.267A-5(a)(23)(i)) of any foreign country; or

(2) Not treated as fiscally transparent (as determined under the principles of §1.267A-5(a)(8)) for purposes of the tax law of the foreign country of which the controlled foreign corporation is a tax resident or, in the case of an interest in a

pass-through entity held by a controlled foreign corporation indirectly through one or more other tested units, for purposes of the tax law of the foreign country of which the tested unit that directly (or indirectly through the fewest number of transparent interests) owns the interest is a tax resident.

(C) A branch (as described in §1.267A-5(a)(2)) the activities of which are carried on directly or indirectly (through one or more pass-through entities) by a controlled foreign corporation. However, in the case of a branch that does not give rise to a taxable presence under the tax law of the foreign country where the branch is located, the branch is a tested unit only if, under the tax law of the foreign country of which the controlled foreign corporation is a tax resident (or, if applicable, under the tax law of a foreign country of which the tested unit that directly (or indirectly, through the fewest number of transparent interests) carries on the activities of the branch is a tax resident), an exclusion, exemption, or other similar relief (such as a preferential rate) applies with respect to income attributable to the branch. For purposes of this paragraph (d)(2)(i)(C), similar relief does not include a deduction or credit against the tax imposed under such tax law for tax paid to another foreign country with respect to income attributable to the branch. If a controlled foreign corporation carries on directly or indirectly less than all of the activities of a branch (for example, if the activities are carried on indirectly through an interest in a partnership), then the rules in this paragraph (d)(2)(i)(C) apply separately with respect to the portion (or portions, if carried on indirectly through more than one chain of pass-through entities) of the activities carried on by the controlled foreign corporation. See paragraphs (d)(9)(iii)(C)(3) and (d)(9)(iii)(C)(4) (Example 3) of this section for illustrations of the application of the rules set forth in this paragraph (d)(2)(i)(C).

(ii) *Items attributable to only one tested unit.* For purposes of paragraph (d) of this section, if an item is attributable to more than one tested unit in a tier of tested units, the item is considered attributable only to the lowest-tier tested unit. Thus, for example, if a controlled foreign corporation directly owns a branch tested unit described

in paragraph (d)(2)(i)(C) of this section, and an item of gross income is (under the rules of paragraph (d)(1)(iii) of this section) attributable to both the branch tested unit and the controlled foreign corporation tested unit, then the item is considered attributable only to the branch tested unit.

(iii) *Combination rule—(A) In general.* Except as provided in paragraph (d)(2)(iii)(B) of this section, tested units of a controlled foreign corporation (including the controlled foreign corporation tested unit) that meet the requirements in paragraph (d)(2)(iii)(A)(1) of this section are treated as a single tested unit, and tested units that meet the requirements of paragraph (d)(2)(iii)(A)(2) of this section (after taking into account the application of paragraph (d)(2)(iii)(A)(1) of this section) are also treated as a single tested unit.

(1) *Subject to tax in same foreign country.* The tested units are tax residents of, or located in (in the case of a tested unit that is branch, or a portion of the activities of a branch, that gives rise to a taxable presence under the tax law of a foreign country), the same foreign country. For purposes of this paragraph (d)(2)(iii)(A)(1), in the case of a tested unit that is an interest in a pass-through entity or a portion of the activities of a branch, a reference to the tax residency or location of the tested unit means the tax residency of the entity the interest in which is the tested unit or the location of the branch, as applicable. See paragraphs (d)(9)(iii)(C)(2)(i) and (d)(9)(iii)(C)(5) (Example 3) for illustrations of the application of the rule set forth in this paragraph (d)(2)(iii)(A)(1).

(2) *De minimis gross income.* The gross income attributable to the tested unit (determined under paragraph (d)(1)(iii) of this section and translated into U.S. dollars, if necessary, at the appropriate exchange rate under section 989(b)(3)) is less than the lesser of one percent of gross income of the controlled foreign corporation, or \$250,000. Appropriate adjustments are made for purposes of applying this paragraph (d)(2)(iii)(A)(2) if assets, including assets of or interests in a tested unit or a transparent entity, are transferred, including by issuance, contribution or distribution, if a significant purpose of the transfer is to qualify for the rule in this paragraph (d)(2)(iii), or if the rule is otherwise availed of with a significant pur-

pose of avoiding the purposes of section 951, 951A, or 954(b)(4). A purpose may be a significant purpose even though it is outweighed by other purposes (taken together or separately). See paragraph (d)(9)(iii)(D) (Example 4) of this section for an example that illustrates the application of the rule set forth in this paragraph (d)(2)(iii)(A)(2).

(B) *Exception for nontaxed branches.* The rule in paragraph (d)(2)(iii)(A) of this section does not apply to a tested unit that is described in paragraph (d)(2)(i)(C) of this section if the branch described in paragraph (d)(2)(i)(C) of this section does not give rise to a taxable presence under the tax law of the foreign country where the branch is located. See paragraph (d)(9)(iii)(C)(4) (Example 4) of this section for an illustration of the application of the rule set forth in this paragraph (d)(2)(iii)(B).

(C) *Effect of combination rule.* If, pursuant to paragraph (d)(2)(iii)(A) of this section, tested units are treated as a single tested unit, then, solely for purposes of paragraph (d) of this section, items of gross income attributable to such tested units, and items of deduction and foreign taxes allocated and apportioned to such gross income, are aggregated for purposes of determining the combined tested unit's tentative net items, and foreign income taxes paid or accrued with respect to such tentative net items.

(3) *Applicable financial statement rules—(i) In general.* For purposes of this paragraph (d), the term *applicable financial statement* means a statement or information described in paragraphs (d)(3)(i)(A) through (H) of this section. A statement or information described in one of these paragraphs qualifies as an applicable financial statement only if the statement or information described in all preceding paragraphs is not readily available. For example, the statement or information described in paragraph (d)(3)(i)(C) of this section qualifies as an applicable financial statement only if the statement or information described in paragraphs (d)(3)(i)(A) and (B) of this section is not readily available. For purposes of paragraphs (d)(3)(i)(A) through (H) of this section, the term “separate-entity” includes the term “separate-branch,” as applicable. For purposes of paragraph (d) of this section, in the case of a tested unit or a transparent

interest that is an interest in a pass-through entity or a portion of the activities of a branch, a reference to the applicable financial statement of the tested unit or the transparent interest means the applicable financial statement of the entity or the branch, as applicable.

(A) An audited separate-entity financial statement that is prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”).

(B) An audited separate-entity financial statement that is prepared on the basis of international financial reporting standards (“IFRS”).

(C) An audited separate-entity financial statement that is prepared on the basis of the generally accepted accounting principles of the jurisdiction in which the entity is organized or the activities are located (“local-country GAAP”).

(D) An unaudited separate-entity financial statement that is prepared in accordance with U.S. GAAP.

(E) An unaudited separate-entity financial statement that is prepared on the basis of IFRS.

(F) An unaudited separate-entity financial statement that is prepared on the basis of local-country GAAP.

(G) Separate-entity records used for tax reporting.

(H) Separate-entity records used for internal management controls or regulatory or other similar purposes.

(ii) *Failure to prepare an applicable financial statement.* If an applicable financial statement is not prepared for a tested unit or a transparent interest, the items of gross income, deduction, disregarded payments, and any other items required to apply paragraph (d) of this section that would be properly reflected on an applicable financial statement of the tested unit or transparent interest must be determined. Such items are treated as properly reflected on the applicable financial statement of the tested unit or transparent interest for purposes of applying paragraph (d) of this section.

(iii) *Transparent interests.* If a tested unit of a controlled foreign corporation or an entity an interest in which is a tested unit of a controlled foreign corporation holds a transparent interest, either directly or indirectly through one or more other transparent interests, then, for purposes of

paragraph (d) of this section (and subject to the rule of paragraph (d)(2)(iii) of this section), items of the controlled foreign corporation properly reflected on the applicable financial statement of the transparent interest are treated as being properly reflected on the applicable financial statement of the tested unit, as modified under paragraph (d)(1)(iii)(B) of this section. See paragraph (d)(9)(iii)(C)(6) (Example 3) of this section for an illustration of the application of the rule set forth in this paragraph (d)(3)(iii).

(iv) *Items not taken into account for financial accounting purposes.* For purposes of this paragraph (d), an item in a CFC inclusion year that is not taken into account in such year for financial accounting purposes, and therefore not properly reflected on an applicable financial statement of a tested unit or a transparent interest, is treated as properly reflected on such applicable financial statement to the extent it would have been so reflected if the item were taken into account for financial accounting purposes in such CFC inclusion year.

(v) *Adjustments to items reflected on the applicable financial statement—(A) In general.* Appropriate adjustments are made if an item is included or not included on an applicable financial statement, or if a disregarded payment described in paragraph (d)(1)(iii)(B) of this section is made or not made, with a significant purpose of avoiding the purposes of section 951, 951A, 954(b)(4), or paragraph (d) of this section. Adjustments pursuant to this paragraph (d)(3)(v) include attributing all or a portion of the item to one or more tested units or transparent interests in a manner that reflects the substance of the transaction, or segregating all or a portion of the item and treating it as attributable to a separate item of gross income described in paragraph (d)(1)(ii) of this section. The combination rule of paragraph (d)(2)(iii)(A)(I) of this section does not apply to an item that is segregated and treated as a separate item of gross income under this paragraph (d)(3)(v). See also §1.904-4(f)(2)(vi)(E) for rules relating to the determination of the amount of disregarded payments taken into account under paragraph (d)(1)(iii)(B) of this section.

(B) *Factually unrelated items—(I) Gross income.* Without limiting the scope

of a significant avoidance purpose as described in paragraph (d)(3)(v)(A) of this section, gross income generally is treated as included on an applicable financial statement with a significant purpose of avoiding the purposes of section 951, 951A, 954(b)(4), or paragraph (d) of this section if it is factually unrelated to the other activities of the relevant entity or branch and is subject to tax at a materially different effective rate of foreign tax than the other activities of the tested unit (or entity, an interest in which is a tested unit) to which the item would otherwise be attributable, or is subject to a withholding tax imposed by a foreign country other than the country of residence of the tested unit. For purposes of this paragraph (d)(3)(v)(B)(1), an effective rate of foreign tax is materially different than the effective rate of foreign tax on other activities if it differs by at least 10 percentage points.

(2) *Deductions*. Without limiting the scope of a significant avoidance purpose as described in paragraph (d)(3)(v)(A) of this section, a deduction generally is treated as included on an applicable financial statement with a significant purpose of avoiding the purposes of section 951, 951A, 954(b)(4), or paragraph (d) of this section if it is not incurred in connection with funding, or in the ordinary course of, the preexisting activities of the relevant entity or branch and is not deductible, in whole or in part, in the country of residence or location of the tested unit (or entity, an interest in which is a tested unit) to which the item would otherwise be attributable.

(4) *Effective rate at which foreign taxes are imposed*—(i) *In general*. For a CFC inclusion year of a controlled foreign corporation, the effective rate of foreign tax with respect to the tentative net items of the controlled foreign corporation is determined separately for each such item. The effective foreign tax rate at which taxes are imposed on a tentative net item is—

(A) The U.S. dollar amount of foreign income taxes paid or accrued with respect to the tentative net item under paragraph (d)(5) of this section; divided by

(B) The U.S. dollar amount of the tentative net item, increased by the amount of foreign income taxes described in paragraph (d)(4)(i)(A) of this section.

(ii) *Undefined value or negative effective foreign tax rate*. If the amount described in paragraph (d)(4)(i)(A) of this section is positive and the amount described in paragraph (d)(4)(i)(B) of this section is zero or negative, the effective rate of foreign tax with respect to the tentative net item is deemed to be greater than 90 percent of the rate that would apply if the income were subject to the maximum rate of tax specified in section 11.

(5) *Foreign income taxes paid or accrued with respect to a tentative net item*. For a CFC inclusion year, the amount of foreign income taxes paid or accrued by a controlled foreign corporation with respect to a tentative net item (as described in paragraph (d)(1)(iv) of this section) for purposes of section 954(b)(4) and this paragraph (d) is the amount of the controlled foreign corporation's current year taxes (as defined in §1.960-1(b)(4)) that are allocated and apportioned to the related item of gross income under the rules of paragraph (d)(1)(iv) of this section. See paragraphs (d)(9)(iii)(A)(2)(iv) (Example 1) and (d)(9)(iii)(B)(2)(v) (Example 2) of this section for illustrations of the application of this paragraph (d)(5).

(6) *Rules regarding the high-tax election*—(i) *Manner*—(A) *In general*. An election is made under this paragraph (d)(6) by the controlling domestic shareholders (as defined in paragraph (d)(8)(iii) of this section) with respect to a controlled foreign corporation for a CFC inclusion year (a *high-tax election*) in accordance with the rules provided in forms or instructions and by—

(1) Filing the statement required under paragraph (d)(6)(vi)(A) of this section with a timely filed original federal income tax return, or with an amended federal income tax return for the U.S. shareholder inclusion year of each controlling domestic shareholder in which or with which such CFC inclusion year ends;

(2) Providing any notices required under paragraph (d)(6)(vi)(B) of this section;

(3) Substantiating, as described in paragraph (d)(6)(vii) of this section, its determination as to whether, with respect to each item of gross income, the requirement set forth in paragraph (d)(1)(i)(B) of this section is satisfied; and

(4) Providing any additional information required by applicable administrative pronouncements.

(B) *Election (or revocation) made with an amended income tax return*. In the case of an election (or revocation) made with an amended federal income tax return—

(1) The election (or revocation) must be made on an amended federal income tax return duly filed within 24 months of the unextended due date of the original federal income tax return for the U.S. shareholder inclusion year with or within which the CFC inclusion year ends;

(2) Each United States shareholder of the controlled foreign corporation as of the end of the controlled foreign corporation's taxable year to which the election relates must file amended federal income tax returns (or timely original income tax returns if a return has not yet been filed) reflecting the effect of such election (or revocation) for the U.S. shareholder's inclusion year with or within which the CFC inclusion year ends as well as for any other taxable year in which the U.S. tax liability of the United States shareholder would be increased by reason of the election (or revocation) (or in the case of a partnership if any item reported by the partnership or any partnership-related item would change as a result of the election (or revocation)) within a single period no greater than six months within the 24-month period described in paragraph (d)(6)(i)(B)(1) of this section; and

(3) Each United States shareholder of the controlled foreign corporation as of the end of the controlled foreign corporation's taxable year to which the election relates must pay any tax due as a result of such adjustments within a single period no longer than six months within the 24-month period described in paragraph (d)(6)(i)(B)(1) of this section;

(C) *Special rules for United States shareholders that are domestic partnerships*. In the case of a United States shareholder that is a domestic partnership, paragraphs (d)(6)(i)(A) and (B) and (d)(6)(iii) of this section are applied by substituting "Form 1065 (or successor form)" for "federal income tax return" and by substituting "amended Form 1065 (or successor form)" or administrative adjustment request (as described in §301.6227-1), as applicable,"

for “amended federal income tax return”, each place that it appears.

(D) *Special rules for United States shareholders that hold an interest in the controlled foreign corporation through a partnership.* A United States shareholder that is a partner in a partnership that is also a United States shareholder in the controlled foreign corporation must generally file an amended return, as required under paragraph (d)(6)(i)(B)(2) of this section, and must generally pay any additional tax owed as required under paragraph (d)(6)(i)(B)(3) of this section. However, in the case of a United States shareholder that is a partner in a partnership that duly files an administrative adjustment request under paragraph (d)(6)(i)(B)(1) or (2) of this section, the partner is treated as having satisfied the requirements of paragraphs (d)(6)(i)(B)(2) and (3) of this section with respect to the interest held through that partnership if:

(I) The partnership files an administrative adjustment request within the time described in paragraph (d)(6)(i)(B); and,

(2) The partnership and the partners comply with the requirements of section 6227. See §§301.6227-1 through 301.6227-3 for rules relating to administrative adjustment requests.

(ii) *Scope.* A high-tax election applies with respect to each item of gross income described in paragraph (d)(1)(ii) of this section of the controlled foreign corporation for the CFC inclusion year and is binding on all United States shareholders of the controlled foreign corporation.

(iii) *Revocation.* A high-tax election may be revoked by the controlling domestic shareholders of the controlled foreign corporation in the same manner as prescribed for an election made on an amended federal income tax return as described in paragraph (d)(6)(i) of this section.

(iv) *Failure to satisfy election requirements.* A high-tax election (or revocation) is valid only if all of the requirements in paragraph (d)(6)(i)(A) of this section, including the requirement to provide notice under paragraph (d)(6)(i)(A)(2) of this section, are satisfied.

(v) *Rules applicable to CFC groups—*(A) *In general.* In the case of a controlled foreign corporation that is a member of a CFC group, a high-tax election is made under paragraph (d)(6)(i) of this section,

or revoked under paragraph (d)(6)(iii) of this section, with respect to all controlled foreign corporations that are members of the CFC group, and the rules in paragraphs (d)(6)(i) through (iv) of this section apply by reference to the CFC group.

(B) *Determination of the CFC group—*(1) *Definition.* Subject to the rules in paragraphs (d)(6)(v)(B)(2) and (3) of this section, the term *CFC group* means an affiliated group as defined in section 1504(a) without regard to section 1504(b)(1) through (6), except that section 1504(a) is applied by substituting “more than 50 percent” for “at least 80 percent” each place it appears, and section 1504(a)(2)(A) is applied by substituting “or” for “and.” For purposes of this paragraph (d)(6)(v)(B), stock ownership is determined by applying the constructive ownership rules of section 318(a), other than section 318(a)(3)(A) and (B), by applying section 318(a)(4) only to options (as defined in §1.1504-4(d)) that are reasonably certain to be exercised as described in §1.1504-4(g), and by substituting in section 318(a)(2)(C) “5 percent” for “50 percent.”

(2) *Member of a CFC group.* The determination of whether a controlled foreign corporation is included in a CFC group is made as of the close of the CFC inclusion year of the controlled foreign corporation that ends with or within the taxable years of the controlling domestic shareholders. One or more controlled foreign corporations are members of a CFC group if the requirements of paragraph (d)(6)(v)(B)(1) of this section are satisfied as of the end of the CFC inclusion year of at least one of the controlled foreign corporations, even if the requirements are not satisfied as of the end of the CFC inclusion year of all controlled foreign corporations. If the controlling domestic shareholders do not have the same taxable year, the determination of whether a controlled foreign corporation is a member of a CFC group is made with respect to the CFC inclusion year that ends with or within the taxable year of the majority of the controlling domestic shareholders (determined by voting power) or, if no such majority taxable year exists, the calendar year. See paragraph (d)(9)(iii)(E) (Example 5) of this section for an example that illustrates the application of the rule set forth in this paragraph (d)(6)(v)(B)(2).

(3) *Controlled foreign corporations included in only one CFC group.* A controlled foreign corporation cannot be a member of more than one CFC group. If a controlled foreign corporation would be a member of more than one CFC group under paragraph (d)(6)(v)(E)(2) of this section, then ownership of stock of the controlled foreign corporation is determined by applying paragraph (d)(6)(v)(B) of this section without regard to section 1504(a)(2)(B) or, if applicable, by reference to the ownership existing as of the end of the first CFC inclusion year of a controlled foreign corporation that would cause a CFC group to exist.

(vi) *Rules regarding the statement and the notice requirements.* The following rules apply for purposes of the statement and notice requirements in this paragraph (d)(6).

(A) *Statement required to be filed with a tax return.* The statement required by paragraph (d)(6)(i)(A)(1) of this section must set forth the name, country of organization, and U.S. employer identification number (if applicable) of the foreign corporation, the name, address, stock interests, and U.S. employer identification number of each controlling domestic shareholder (or, if applicable, the agent described in §1.1502-77(a) with respect to the consolidated group of which the controlling domestic shareholder is a member) approving the action, and the names, addresses, U.S. employer identification numbers, and stock interests of all other domestic shareholders notified of the action taken. Such statement must describe the nature of the action taken on behalf of the foreign corporation and the taxable year for which made, and identify a designated shareholder who retains a jointly executed consent confirming that such action has been approved by all of the controlling domestic shareholders and containing the signature of a principal officer of each such shareholder (or the agent described in §1.1502-77(a), if applicable).

(B) *Notice.* On or before the filing date described in paragraph (d)(6)(i)(A)(1) of this section (or paragraph (d)(6)(i)(B)(1) of this section if filing an amended income tax return), the controlling domestic shareholders must provide written notice of the election made to all other persons known by them to be domestic sharehold-

ers who own (within the meaning of section 958(a)) stock of the foreign corporation. Such notice must set forth the name, country of organization and U.S. employer identification number (if applicable) of the foreign corporation, and the names, addresses, and stock interests of the controlling domestic shareholders. Such notice must describe the nature of the action taken on behalf of the foreign corporation and the taxable year for which made, and identify a designated shareholder who retains a jointly executed consent confirming that such action has been approved by all of the controlling domestic shareholders and containing the signature of a principal officer of each such shareholder (or the agent described in §1.1502-77(a), if applicable).

(vii) *Substantiation requirements*—(A) *In general.* If an election under section 954(b)(4) and paragraph (d)(6) of this section is in effect for a controlled foreign corporation for a CFC inclusion year, then each United States shareholder of that controlled foreign corporation with respect to the CFC inclusion year is required to maintain sufficient documentation (as described in paragraph (d)(6)(vii)(B) of this section) to establish that the taxpayer reasonably concluded that each item of gross income of the controlled foreign corporation satisfied (or did not satisfy) the requirement set forth in paragraph (d)(1)(i)(B) of this section. The substantiating documents must be in existence as of the filing date of the income tax return described in paragraph (d)(6)(i)(A) of this section (or paragraph (d)(6)(i)(B)(I) of this section if filing an amended income tax return) and must be provided to the Commissioner within 30 days of being requested by the Commissioner (unless otherwise agreed between the Commissioner and the taxpayer).

(B) *Sufficient documentation.* For purposes of paragraph (d)(6)(vii)(A) of this section, the term sufficient documentation means documentation that accurately and completely describes the computations related to the high-tax exception under section 954(b)(4) and this paragraph (d)(6) with respect to each item of gross income of the controlled foreign corporation. Sufficient documentation must include the information described in paragraphs (d)(6)(vii)(B)(I) through (5) of this section.

(1) A description of each of the tested units and transparent interests of the controlled foreign corporation, including a detailed explanation of any tested units that are combined either under the same-country combination rule, or the de minimis combination rule.

(2) A detailed list of the items of gross income and deductions attributable to each tested unit and the applicable financial statement of each tested unit and transparent interest.

(3) A list of disregarded payments taken into account under paragraph (d)(1)(iii)(B) of this section for purposes of determining the gross income attributable to a tested unit.

(4) A list of current year foreign taxes paid or accrued with respect to each item of gross income, as described in paragraph (d)(5) of this section.

(5) The effective tax rate calculation for each item of gross income attributable to a tested unit, as described in paragraph (d)(4)(i) of this section.

(7) *Anti-abuse rule.* Appropriate adjustments are made if an applicable instrument is issued or acquired, or a reverse hybrid is formed or availed of, with a significant purpose of avoiding the purposes of section 951, 951A, 954(b)(4), or paragraph (d) of this section. Adjustments pursuant to this paragraph (d)(7) include adjustments to foreign income taxes paid or accrued with respect to a tentative net item as determined under paragraph (d)(5) of this section, and adjustments to the tentative net item as determined under paragraph (d)(1)(iv) of this section. See paragraph (d)(9)(iii)(F) (Example 6) of this section for an example that illustrates the application of the anti-abuse rule set forth in this paragraph (d)(7).

(8) *Definitions.* The following definitions apply for purposes of this paragraph (d).

(i) *Applicable instrument.* The term *applicable instrument* means an instrument or arrangement described in paragraph (d)(8)(i)(A) or (B) of this section. For purposes of this paragraph (d)(8)(i), an instrument or arrangement includes a sale-repurchase transaction (including as described in §1.861-2(a)(7)), or other similar transaction or series of related transactions in which legal title to property is transferred and the property (or similar

property, such as securities of the same class and issue) is reacquired or expected to be reacquired.

(A) *Deductions to issuer.* An instrument or arrangement is described in this paragraph (d)(8)(i)(A) if, for federal income tax purposes, the instrument or arrangement gives rise to deductions to the issuer but, under the tax law of a foreign country, does not give rise to deductions (or gives rise to deductions that are disallowed), in whole or in part, to the issuer.

(B) *Income to holder.* An instrument or arrangement is described in this paragraph (d)(8)(i)(B) if, under the tax law of a foreign country, the instrument or arrangement gives rise to income included in the holder's income but, for federal income tax purposes, does not give rise to income to the holder.

(ii) *CFC inclusion year.* The term *CFC inclusion year* has the meaning provided in §1.951A-1(f)(1).

(iii) *Controlling domestic shareholders.* The term *controlling domestic shareholders* of a controlled foreign corporation means the United States shareholders (as defined in section 951(b) or 953(c)) who, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such foreign corporation entitled to vote and who undertake to act on its behalf. If United States shareholders of the controlled foreign corporation do not, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such foreign corporation entitled to vote, the controlling United States shareholders of the controlled foreign corporation are all those United States shareholders who own (within the meaning of section 958(a)) stock of such corporation.

(iv) *Disregarded entity.* The term *disregarded entity* means an entity that is disregarded as an entity separate from its owner, as described in §301.7701-2(c)(2)(i) of this chapter.

(v) *Disregarded payment.* The term *disregarded payment* means any amount described in paragraph (d)(8)(v)(A) or (B) of this section.

(A) *Transfers to or from a disregarded entity.* An amount described in this paragraph (d)(8)(iv)(A) is any amount that is

transferred to or from a disregarded entity in connection with a transaction that is disregarded for federal income tax purposes and that is properly reflected on the applicable financial statement of a tested unit or a transparent interest.

(B) *Other disregarded amounts*. An amount described in this paragraph (d)(8)(iv)(B) is any amount properly reflected on the applicable financial statement of a tested unit or transparent interest that would constitute an item of income, gain, deduction, or loss (other than an amount described in paragraph (d)(8)(iv)(A) of this section), a distribution to or contribution from the owner of the tested unit, transparent interest or entity, or a payment in exchange for property if the transaction to which the amount is attributable were regarded for federal income tax purposes.

(vi) *Indirectly*. The term *indirectly*, when used in reference to ownership, means ownership through one or more pass-through entities.

(vii) *Pass-through entity*. The term *pass-through entity* means a partnership, a disregarded entity, or any other person (whether domestic or foreign) other than a corporation to the extent that income, gain, deduction, or loss of the person is taken into account in determining the income or loss of a controlled foreign corporation that owns, directly or indirectly, interests in the person.

(viii) *Reverse hybrid*. The term *reverse hybrid* has the meaning provided in §1.909-2(b)(1)(iv).

(ix) *Transparent interest*. The term *transparent interest* means an interest in a pass-through entity (or the activities of a branch) that is not a tested unit.

(x) *U.S. shareholder inclusion year*. The term *U.S. shareholder inclusion year* has the meaning provided in §1.951A-1(f)(7).

(9) *Examples—(i) Scope*. This paragraph (d)(9) provides presumed facts and examples illustrating the application of the rules in paragraph (d) of this section.

(ii) *Presumed facts*. For purposes of the examples in paragraph (d)(9)(iii) of this section, except as otherwise stated, the following facts are presumed:

(A) USP is a domestic corporation.

(B) CFC1X and CFC2X are controlled foreign corporations organized in, and tax residents of, Country X.

(C) FDEX is a disregarded entity that is a tax resident of Country X.

(D) FDE1Y and FDE2Y are disregarded entities that are tax residents of Country Y.

(E) FPSY is an entity that is organized in, and a tax resident of, Country Y but is classified as a partnership for federal income tax purposes.

(F) CFC1X, CFC2X, and the interests in FDEX, FDE1Y, FDE2Y, and FPSY are tested units (the CFC1X tested unit, CFC2X tested unit, FDEX tested unit, FDE1Y tested unit, FDE2Y tested unit, and FPSY tested unit, respectively).

(G) CFC1X, CFC2X, FDEX, FDE1Y and FDE2Y conduct activities in the foreign country in which they are tax resident, and properly reflect items of income, gain, deduction, and loss on separate applicable financial statements.

(H) All entities have calendar taxable years (for both federal income tax purposes and for purposes of the relevant foreign country) and use the Euro (€) as their functional currency. At all relevant times €1 = \$1.

(I) The maximum rate of tax specified in section 11 for the CFC inclusion year is 21 percent.

(J) Neither CFC1X nor CFC2X directly or indirectly earns income described in section 952(b), or has any items of income, gain, deduction, or loss. In addition, no tested unit of CFC1X or CFC2X makes or receives disregarded payments.

(K) No tested unit is eligible for the de minimis combination rule of paragraph (d)(2)(iii)(A)(2) of this section.

(L) An election made under section 954(b)(4) and paragraph (d)(6) of this section is effective with respect to CFC1X and CFC2X, as applicable, for the CFC inclusion year.

(iii) *Examples—(A) Example 1: Effect of disregarded interest—(I) Facts—(i) Ownership*. USP owns all of the stock of CFC1X, and CFC1X owns all of the interests of FDE1Y.

(ii) *Gross income and deductions (other than foreign income taxes)*. In Year 1, CFC1X generates €100x of gross income from services performed for unrelated parties and properly reflects that gross income on the applicable financial statement of FDE1Y. The €100x of services income is general category income under §1.904-4(d). In Year 1, FDE1Y accrues and pays €20x of interest to CFC1X that is deductible for Country Y tax purposes but is disregarded for federal income tax purposes. The €20x of disregarded interest income received by CFC1X from FDE1Y is properly reflected on CFC1X's applicable financial statement, and the €20x of disregarded interest expense paid from FDE1Y to CFC1X is properly reflected on FDE1Y's applicable financial statement.

(iii) *Foreign income taxes*. Country X imposes no tax on net income, and Country Y imposes a 25% tax on net income. For Country Y tax purposes, FDE1Y (which is not disregarded under Country Y tax law) has €80x of taxable income (€100x of services income from the unrelated parties, less a €20x deduction for the interest paid to CFC1X). Accordingly, FDE1Y incurs a Country Y income tax liability of €20x ((€100x - €20x) x 25%) with respect to Year 1, the U.S. dollar amount of which is \$20x.

(2) *Analysis—(i) Items of gross income*. Under paragraph (d)(1)(ii) of this section, CFC1X has €100x of general category gross income that is divided into two general gross items, one item that is attributable to the CFC1X tested unit and one item that is attributable to the FDE1Y tested unit under paragraph (d)(1)(iii) of this section. Without regard to the €20x interest payment from FDE1Y to CFC1X, the gross income attributable to the CFC1X tested unit would be €0 (that is, the €20x of interest income properly reflected on the applicable financial statement of CFC1X would be reduced by €20x, the amount attributable to the payment that is disregarded for federal income tax purposes). Similarly, without regard to the €20x interest payment from FDE1Y to CFC1X, the gross income attributable to the FDE1Y tested unit would be €100x (that is, the €100x of services income properly reflected on the applicable financial statement of FDE1Y, unreduced by the €20x disregarded payment made from FDE1Y to CFC1X). However, under paragraph (d)(1)(iii)(B) of this section, the gross income attributable to each of the CFC1X tested unit and the FDE1Y tested unit is adjusted by €20x, the amount of the disregarded interest payment from FDE1Y to CFC1X that is deductible for Country Y tax purposes. Accordingly, the item of gross income attributable to the CFC1X tested unit (the “CFC1X general gross item”) is €20x (€0 + €20x) and the item of gross income attributable to the FDE1Y tested unit (the “FDE1Y general gross item”) is €80x (€100x - €20x), both of which are general gross items under paragraph (d)(1)(ii)(A) of this section.

(ii) *Foreign income tax deduction*. Under paragraph (d)(1)(iv) of this section, CFC1X's tentative net items are computed by treating the CFC1X general gross item and the FDE1Y general gross item each as in a separate income group (the “CFC1X income group” and the “FDE1Y income group”) and by allocating and apportioning CFC1X's deductions for current year taxes between the income groups under the principles of §1.960-1(d)(3) (CFC1X has no other deductions to allocate and apportion). Under paragraph (d)(1)(iv)(A) of this section, the €20x deduction for Country Y income taxes is allocated and apportioned solely to the FDE1Y income group (the “FDE1Y group tax”). None of the Country Y taxes are allocated and apportioned to the CFC1X income group under paragraph (d)(1)(iv) of this section and the principles of §1.904-6(b)(2), because none of the Country Y tax is imposed solely by reason of the disregarded interest payment.

(iii) *Tentative net items*. Under paragraph (d)(1)(iv)(A) of this section, the tentative net item with respect to the FDE1Y income group (the “FDE1Y ten-

tative net item") is €60x (the FDE1Y general gross item of €80x, less the €20x deduction for the FDE1Y group tax). The tentative net item with respect to the CFC1X income group (the "CFC1X tentative net item") is €20x.

(iv) *Foreign income taxes paid or accrued with respect to a tentative net item.* Under paragraph (d)(5) of this section, the foreign income taxes paid or accrued with respect to a tentative net item is the U.S. dollar amount of the current year taxes that are allocated and apportioned to the item of gross income under the rules of paragraph (d)(1)(iv) of this section. Therefore, the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item is \$20x, the U.S. dollar amount of the FDE1Y group tax. The foreign income taxes paid or accrued with respect to the CFC1X tentative net item is \$0, the U.S. dollar amount of the foreign tax allocated and apportioned to the CFC1X general gross item under paragraph (d)(1)(iv) of this section.

(v) *Effective foreign tax rate.* The effective foreign tax rate is determined under paragraph (d)(4) of this section by dividing the U.S. dollar amount of foreign income taxes paid or accrued with respect to each respective tentative net item by the U.S. dollar amount of the tentative net item increased by the U.S. dollar amount of the relevant foreign income taxes. Therefore, the effective foreign tax rate with respect to the FDE1Y tentative net item is 25%, calculated by dividing \$20x (the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item under paragraph (d)(5) of this section) by \$80x (the sum of \$60x, the U.S. dollar amount of the FDE1Y tentative net item, and \$20x, the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item). The CFC1X tentative net item is not subject to any foreign income tax, so is subject to an effective foreign tax rate of 0%, calculated as \$0 (the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the CFC1X tentative net item), divided by \$20x (the U.S. dollar amount of the FDE1Y tentative net item).

(vi) *Qualification for the high-tax exception.* The FDE1Y tentative net item is subject to an effective foreign tax rate (25%) that is greater than 18.9% (90% of the 21% maximum rate of tax specified in section 11). Therefore, the requirement of paragraph (d)(1)(i)(B) of this section is satisfied, and the FDE1Y general gross item qualifies under paragraph (d)(1)(i) of this section for the high-tax exception of section 954(b)(4) and, under paragraphs (a)(2) and (a)(6) of this section, is excluded from the gross foreign base company income and gross insurance income, respectively, of CFC1X; in addition, the FDE1Y general gross item is excluded from gross tested income under section 951A(c)(2)(A)(i)(III) and §1.951A-2(c)(1)(iii). The CFC1X tentative net item is subject to an effective foreign tax rate of 0%. Therefore, the CFC1X tentative net item does not satisfy the requirement of paragraph (d)(1)(i)(B) of this section, and the CFC1X general gross item does not qualify under paragraph (d)(1)(i) of this section for the high-tax exception of section 954(b)(4) and, under paragraphs (a)(2) and (a)(6) of this section, is not excluded from the gross foreign base company income and gross insurance income of CFC1X; in addition, the CFC1X general gross item is not ex-

cluded from gross tested income under section 951A(c)(2)(A)(i)(III) and §1.951A-2(c)(1)(iii).

(B) *Example 2: Effect of disregarded payment for services—(I) Facts—(i) Ownership.* USP owns all of the stock of CFC1X. CFC1X owns all of the interests of FDE1Y. FDE1Y is a tax resident of Country Y, but is treated as fiscally transparent for Country X tax purposes, so that FDE1Y is subject to tax in Country Y and that CFC1X is subject to tax in Country X with respect to FDE1Y's activities.

(ii) *Gross income, deductions (other than for foreign income taxes), and disregarded payments.* In Year 1, CFC1X generates €1,000x of gross income from services to unrelated parties that would be gross tested income or gross foreign base company income without regard to paragraph (d)(1) of this section and that is properly reflected on the applicable financial statement of CFC1X. The €1,000x of gross income for services is general category income under §1.904-4(d). In Year 1, CFC1X accrues and pays €480x of deductible expenses to unrelated parties, €280x of which is properly reflected on CFC1X's applicable financial statement and is definitely related solely to CFC1X's gross income reflected on its applicable financial statement, and €200x of which is properly reflected on FDE1Y's applicable financial statement and is definitely related solely to FDE1Y's gross income reflected on its applicable financial statement. Country X law does not provide rules for the allocation or apportionment of these deductions to particular items of gross income. In Year 1, CFC1X also accrues and pays €325x to FDE1Y for support services performed by FDE1Y in Country Y; the payment is disregarded for federal income tax purposes. The €325x of disregarded support services income received by FDE1Y from CFC1X is properly reflected on FDE1Y's applicable financial statement, and the €325x of disregarded support services expense paid from CFC1X to FDE1Y is properly reflected on CFC1X's applicable financial statement.

(iii) *Foreign income taxes.* Country X imposes a 10% tax on net income, and Country Y imposes a 16% tax on net income. Country X allows a deduction, but not a credit, for foreign income taxes paid or accrued to another country (such as Country Y). For Country Y tax purposes, FDE1Y (which is not disregarded under Country Y tax law) has €125x of taxable income (€325x of support services income received from CFC1X, less a €200x deduction for expenses paid to unrelated parties). Accordingly, FDE1Y incurs a Country Y income tax liability with respect to Year 1 of €20x (€125x x 16%), the U.S. dollar amount of which is \$20x. For Country X tax purposes, CFC1X has €500x of taxable income (€1,000x of gross income for services, less a €480x deduction for expenses paid to unrelated parties by CFC1X and FDE1Y and a €20x deduction for Country Y taxes; Country X does not allow CFC1X a deduction for the €325x paid to FDE1Y for support services because the €325x payment is disregarded for Country X tax purposes). Accordingly, CFC1X incurs a Country X income tax liability with respect to Year 1 of €50x (€500x x 10%), the U.S. dollar amount of which is \$50x.

(2) *Analysis—(i) Items of gross income.* Under paragraph (d)(1)(ii) of this section, CFC1X has €1,000x of general category gross income that is divided into two general gross items, one item that is

attributable to the CFC1X tested unit and one item that is attributable to the FDE1Y tested unit under paragraph (d)(1)(iii) of this section. Without regard to the €325x payment for support services from CFC1X to FDE1Y, the gross income attributable to the CFC1X tested unit would be €1,000x (that is, the €1,000x of gross income from services properly reflected on the applicable financial statement of CFC1X, unreduced by the €325x payment from CFC1X to FDE1Y that is disregarded for federal income tax purposes). Similarly, without regard to the €325x payment for support services from CFC1X to FDE1Y, the gross income attributable to the FDE1Y tested unit would be €0 (that is, the €325x of services income properly reflected on the applicable financial statement of FDE1Y, reduced by the €325x disregarded payment). However, under paragraph (d)(1)(iii)(B) of this section, the gross income attributable to each of the CFC1X tested unit and the FDE1Y tested unit is adjusted by €325x, the amount of the disregarded services payment from CFC1X to FDE1Y. Accordingly, the item of gross income attributable to the CFC1X tested unit (the "CFC1X general gross item") is €675x (€1,000x - €325x), and the item of gross income attributable to the FDE1Y tested unit (the "FDE1Y general gross item") is €325x (€0 + €325x), both of which are general gross items under paragraph (d)(1)(ii)(A) of this section.

(ii) *Deductions (other than for foreign income taxes).* Under paragraph (d)(1)(iv) of this section, CFC1X's tentative net items are computed by applying the principles of §1.960-1(d)(3), treating the CFC1X general gross item and the FDE1Y general gross item each as in a separate income group (the "CFC1X income group" and the "FDE1Y income group") and by allocating and apportioning CFC1X's deductions among the income groups. Under paragraph (d)(1)(iv)(B) of this section, the €280x of deductible expenses properly reflected on the applicable financial statement of the CFC1X tested unit are allocated and apportioned to the CFC1X income group, and the €200x of deductible expenses properly reflected on the applicable financial statement of the FDE1Y tested unit are allocated and apportioned to the FDE1Y income group.

(iii) *Foreign income tax deduction.* CFC1X accrues foreign income tax in Year 1 of €70x (€50x imposed by Country X and €20x imposed by Country Y). Under paragraph (d)(1)(iv)(A) of this section, the €70x of foreign income tax is allocated and apportioned under the principles of §1.960-1(d)(3)(ii) (or under the principles of §1.904-6(b)(2) in the case of tax imposed solely by reason of a disregarded payment that gives rise to an adjustment under paragraph (d)(1)(iii)(B) of this section) to the FDE1Y income group and the CFC1X income group. The Country Y tax of €20x is imposed solely by reason of FDE1Y's receipt of a €325x disregarded payment. As a result, the €20x of Country Y tax is allocated and apportioned to the FDE1Y income group under the principles of §1.904-6(b)(2). If Country X had allowed a deduction for the disregarded payment from CFC1X to FDE1Y and not otherwise imposed tax on CFC1X with respect to income of FDE1Y, the foreign tax imposed by Country X would relate only to the CFC1X income group, and no portion of it would be allocated and apportioned to the FDE1Y income group because the FDE1Y income would

not be included in the Country X tax base. However, because gross income subject to tax in Country X corresponds to gross income that for federal income tax purposes is attributable to both the FDE1Y income group and the CFC1X income group, the €50x of foreign income tax imposed by Country X is allocated to both the FDE1Y income group and the CFC1X income group and must be apportioned between the two income groups under §1.861-20(e). Because Country X does not provide specific rules for the allocation or apportionment of the €500x of deductible expenses, §1.861-20(e) applies the principles of the section 861 regulations to determine the foreign law net income subject to Country X tax for purposes of apportioning the €50x of Country X tax between the income groups. CFC1X has €1,000x of gross income and €500x of deductible expenses under the tax laws of Country X, resulting in €500x of net foreign law income. Of the €1,000x of foreign law gross income, €325x corresponds to the gross income in the FDE1Y income group, and €675x corresponds to the gross income in the CFC1X income group. Applying federal income tax principles to allocate and apportion the foreign law deductions to foreign law gross income, €220x of the €500x foreign law deductions is allocated and apportioned to the FDE1Y income group and €280x is allocated and apportioned to the CFC1X income group. Of the total €500x of net foreign law income, €105x (€325x Country X gross income corresponding to the FDE1Y income group, less €220x allocable Country X expenses) corresponds to the FDE1Y income group and €395x (€675x Country X gross income corresponding to the CFC1X income group, less €280x allocable Country X expenses) corresponds to the CFC1X income group. Therefore, €10.5x (€50x x €105x/€500x) of Country X tax is allocated and apportioned to the FDE1Y income group, and €39.5x (€50x x €395x/€500x) is allocated and apportioned to the CFC1X income group. In total, €30.5x of foreign income tax (€10.5x of Country X tax and €20x of Country Y tax) is allocated and apportioned to the FDE1Y income group (the “FDE1Y group tax”) and €39.5x of foreign income tax (all of which is Country X tax) is allocated and apportioned to the CFC1X income group (the “CFC1X group tax”).

(iv) *Tentative net items.* Under paragraphs (d)(1)(iv)(A) and (B) of this section, the tentative net item in the FDE1Y income group (the “FDE1Y tentative net item”) is €94.5x (the general gross item of €325x, less the allocated and apportioned deductions of €230.5x (the sum of deductions (other than for foreign income tax) of €200x and the FDE1Y group taxes of €30.5x)). The tentative net item in the CFC1X income group (the “CFC1X tentative net item”) is €355.5x (the general gross item of €675x, less the allocated and apportioned deductions of €319.5x (the sum of deductions (other than for foreign income tax) of €280x and the CFC1X group tax of €39.5x)).

(v) *Foreign income taxes paid or accrued with respect to a tentative net item.* Under paragraph (d)(5) of this section, the foreign income taxes paid or accrued with respect to a tentative net item is the U.S. dollar amount of the current year taxes that are allocated and apportioned to the item of gross income under the rules of paragraph (d)(1)(iv) of this section. Therefore, the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item is

\$30.5x, the U.S. dollar amount of the FDE1Y group tax. The foreign income tax paid or accrued with respect to the CFC1X tentative net item is \$39.5x, the U.S. dollar amount of the CFC1X group tax.

(vi) *Effective foreign tax rate.* The effective foreign tax rate is determined under paragraph (d)(4) of this section by dividing the U.S. dollar amount of foreign income taxes with respect to each respective tentative net item by the U.S. dollar amount of the tentative net item increased by the U.S. dollar amount of the relevant foreign income taxes. Therefore, the effective foreign tax rate with respect to the FDE1Y tentative net item is 24.4%, calculated by dividing \$30.5x (the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item under paragraph (d)(5)) by \$125x (the sum of \$94.5x, the U.S. dollar amount of the FDE1Y tentative net item, and \$30.5x, the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item). The effective foreign tax rate with respect to the CFC1X tentative net item is 10%, calculated by dividing \$39.5x (the U.S. dollar amount of the CFC1X group tax) by \$395x (the sum of \$355.5x, the U.S. dollar amount of the CFC1X tentative net item and \$39.5x, the U.S. dollar amount of the foreign income tax paid or accrued with respect to the CFC1X tentative net item).

(vii) *Qualification for the high-tax exception.* The FDE1Y tentative net item is subject to an effective foreign tax rate (24.4%) that is greater than 18.9% (90% of the maximum rate of tax specified in section 11). Therefore, the requirement of paragraph (d)(1)(i)(B) of this section is satisfied, and the FDE1Y general gross item qualifies for the high-tax exception of section 954(b)(4) and, under paragraphs (a)(2) and (a)(6) of this section, is excluded from the gross foreign base company income and the gross insurance income, respectively, of CFC1X; in addition, the FDE1Y general gross item is excluded from gross tested income under section 951A(c)(2)(A)(i)(III) and §1.951A-2(c)(1)(iii). The CFC1X tentative net item is subject to an effective foreign tax rate (10%) that is not greater than 18.9%. Therefore, the CFC1X general gross item does not satisfy the requirement of paragraph (d)(1)(i)(B) of this section, does not qualify for the high-tax exception of section 954(b)(4) and, under paragraphs (a)(2) and (a)(6) of this section, is not excluded from the gross foreign base company income and gross insurance income of CFC1X; in addition, the CFC1X general gross item is not excluded from gross tested income under section 951A(c)(2)(A)(i)(III) and §1.951A-2(c)(1)(iii).

(C) *Example 3: Application of tested unit rules—(1) Facts—(i) Ownership.* USP owns all of the stock of CFC1X. CFC1X directly owns all of the interests of FDEX and FDE1Y. In addition, CFC1X directly carries on activities in Country Y that constitute a branch (as described in §1.267A-5(a)(2)) and that give rise to a taxable presence under Country Y tax law and Country X tax law (such branch, “FBY”).

(ii) *Items reflected on applicable financial statement.* For the CFC inclusion year, CFC1X has a €20x item of gross income (Item A), which is properly reflected on the applicable financial statement of FBY, and a €30x item of gross income (Item B), which is properly reflected on the applicable financial statement of FDEX.

(2) *Analysis—(i) Identifying the tested units of CFC1X.* Without regard to the combination rule of paragraph (d)(2)(iii) of this section, CFC1X, CFC1X’s interest in FDEX, CFC1X’s interest in FDE1Y, and FBY would each be a tested unit of CFC1X. See paragraph (d)(2)(i) of this section. Pursuant to the combination rule, however, the FDE1Y tested unit is combined with the FBY tested unit and treated as a single tested unit because FDE1Y is a tax resident of Country Y, the same country in which FBY is located (the “Country Y tested unit”). See paragraph (d)(2)(iii)(A)(I) of this section. The CFC1X tested unit (without regard to any items attributable to the FDEX, FDE1Y, or FBY tested units) is also combined with the FDEX tested unit and treated as a single tested unit because CFC1X and FDEX are both tax residents of County X (the “Country X tested unit”). See paragraph (d)(2)(iii)(A)(I) of this section.

(ii) *Computing the items of CFC1X.* Under paragraph (d)(1)(ii) of this section, an item of gross income is determined with respect to each of the Country Y tested unit and the Country X tested unit. To determine the item of gross income of each tested unit, the gross income that is attributable to the tested unit is determined under paragraph (d)(1)(iii) of this section. Under paragraph (d)(1)(iii)(A) of this section, only Item A is attributable to the Country Y tested unit, and only Item B is attributable to the Country X tested unit. Item A is not attributable to the Country X tested unit because it is not reflected on the applicable financial statement of the CFC1X tested unit or the FDEX tested unit, and an item of gross income is only attributable to one tested unit. See paragraph (d)(1)(iii)(A) of this section.

(3) *Alternative facts – branch does not give rise to a taxable presence in country where located—(i) Facts.* The facts are the same as in paragraph (d)(9)(iii)(C)(I) of this section (the original facts in this Example 3), except that FBY does not give rise to a taxable presence under Country Y tax law; moreover, Country X tax law does not provide an exclusion, exemption, or other similar relief with respect to income attributable to FBY.

(ii) *Analysis.* FBY is not a tested unit but is a transparent interest. See paragraphs (d)(2)(i)(C) and (d)(8)(ix) of this section. CFC1X has a tested unit in Country X that includes the CFC1X tested unit (without regard to any items related to the interest in FDEX or FDE1Y, but that includes FBY since it is a transparent interest and not a tested unit) and the interest in FDEX. See paragraph (d)(2)(iii) of this section. CFC1X has another tested unit in Country Y, the interest in FDE1Y.

(4) *Alternative facts – branch is a tested unit but is not combined—(i) Facts.* The facts are the same as in paragraph (d)(9)(iii)(C)(I) of this section (the original facts in this Example 3), except that FBY does not give rise to a taxable presence under Country Y tax law but Country X tax law provides an exclusion, exemption, or other similar relief (such as a preferential rate) with respect to income attributable to FBY.

(ii) *Analysis.* FBY is a tested unit. See paragraph (d)(2)(i)(C) of this section. CFC1X has two tested units in Country Y, the interest in FDE1Y and FBY. The interest in FDE1Y and FBY tested units are not combined because FBY does not give rise to a tax-

able presence under the tax law of Country Y. See paragraph (d)(2)(iii)(B) of this section. CFC1X also has a tested unit in Country X that includes the activities of CFC1X (without regard to any items related to the interest in FDEX, the interest in FDE1Y, or FBY) and the interest in FDEX.

(5) *Alternative facts – split ownership of tested unit—(i) Facts.* The facts are the same as in paragraph (d)(9)(iii)(C)(1) of this section (the original facts in this *Example 3*), except that USP also owns CFC2X, CFC1X does not own FDE1Y, and CFC1X and CFC2X own 60% and 40%, respectively, of the interests of FPSY.

(ii) *Analysis for CFC1X.* Under paragraph (d)(2)(iii)(A)(1) of this section, FBY and CFC1X's 60% interest in FPSY are combined and treated as a single tested unit of CFC1X ("CFC1X's Country Y tested unit"), and CFC1X's interest in FDEX and its other activities are combined and treated as a single tested unit of CFC1X ("CFC1X's Country X tested unit"). CFC1X's Country Y tested unit is attributed any item of CFC1X that is derived through its interest in FPSY to the extent the item is properly reflected on the applicable financial statement of FPSY. See paragraph (d)(1)(iii)(A) of this section.

(iii) *Analysis for CFC2X.* Under paragraphs (d)(2)(i)(A) and (d)(2)(i)(B)(1) of this section, CFC2X and CFC2X's 40% interest in FPSY are tested units of CFC2X. CFC2X's interest in FPSY is attributed any item of CFC2X that is derived through FPSY to the extent that it is properly reflected on the applicable financial statement of FPSY. See paragraph (d)(1)(iii)(A) of this section.

(iv) *Analysis for not combining CFC1X and CFC2X tested units.* None of the tested units of CFC1X are combined with the tested units of CFC2X under paragraph (d)(2)(iii)(A)(1) of this section because they are tested units of different controlled foreign corporations, and the combination rule only combines tested units of the same controlled foreign corporation.

(6) *Alternative facts – split ownership of transparent interest—(i) Facts.* The facts are the same as in paragraph (d)(9)(iii)(C)(1) of this section (the original facts in this *Example 3*), except that USP also owns CFC2X, CFC1X does not own FDE1Y, and CFC1X and CFC2X own 60% and 40%, respectively, of the interests in FPSY, but FPSY is not a tax resident of any foreign country and is fiscally transparent for Country X tax law purposes.

(ii) *Analysis for CFC1X.* CFC1X's interest in FPSY is not a tested unit but is a transparent interest. See paragraphs (d)(2)(i)(B) and (d)(8)(ix) of this section. Under paragraph (d)(3)(iii) of this section, any item of CFC1X that is derived through its interest in FPSY and is properly reflected on the applicable financial statement of FPSY is treated as properly reflected on the applicable financial statement of CFC1X.

(iii) *Analysis for CFC2X.* CFC2X's interest in FPSY is not a tested unit but is a transparent interest. See paragraphs (d)(2)(i)(B) and (d)(8)(ix) of this section. Under paragraph (d)(3)(iii) of this section, any item of CFC2X that is derived through its interest in FPSY and is properly reflected on the applicable financial statement of FPSY is treated as properly reflected on the applicable financial statement of CFC2X.

(D) *Example 4: Application of de minimis combination rule—(1) Facts—(i) Ownership.* USP owns all of the stock of CFC1X, and CFC1X directly owns all of the interests of FDEW, FDEX, FDE1Y, FDE2Y, and FDEZ. FDEW and FDEZ are disregarded entities that are tax residents of Country W and Country Z, respectively.

(ii) *Gross income attributable to tested units.* Without regard to the combination rule of paragraph (d)(2)(iii) of this section, CFC1X, and CFC1X's interests in each of FDEW, FDEX, FDE1Y, FDE2Y, and FDEZ, would each be a tested unit of CFC1X. For the CFC inclusion year, and without regard to the combination rule of paragraph (d)(2)(iii) of this section, the U.S. dollar amount of the gross income attributable to the tested units of CFC1X (determined under paragraph (d)(1)(iii) of this section, and without regard to the combination rule in paragraph (d)(2)(iii) of this section) is as follows:

Table 1 to paragraph (d)(9)(iii)(D)(1)(ii).

Tested Unit	Gross Income
CFC1X	\$19,500,000
FDEW	\$100,000
FDEX	\$100,000
FDE1Y	\$175,000
FDE2Y	\$50,000
FDEZ	\$75,000
Total:	\$20,000,000

(2) *Analysis—(i) Same country combination rule.* Pursuant to the same country combination rule in paragraph (d)(2)(iii)(A)(1) of this section, which applies before the de minimis combination rule in paragraph (d)(2)(iii)(A)(2) of this section, the CFC1X tested unit (without regard to any items attributed to other tested units) is combined with CFC1X's interest in FDEX and treated as a single tested unit because CFC1X and FDEX are both tax residents of Country X (the "Country X tested unit"). CFC1X's interests in FDE1Y and FDE2Y are also combined under the same country combination rule and treated as a single tested unit because FDE1Y and FDE2Y are both tax residents of Country Y (the "Country Y tested unit").

(ii) *De minimis combination rule.* Pursuant to the de minimis combination rule in paragraph (d)(2)(iii)(A)(2) of this section, CFC1X's interests in FDEW and FDEZ are combined and treated as a single tested unit because the gross income attributable to each of these tested units (\$100,000 attributable to CFC1X's interest in FDEW, and \$75,000 attributable to CFC1X's interest in FDEZ) is less than \$200,000, which is the lesser of 1% of CFCX's total gross income (\$200,000) or \$250,000. The Country X tested unit and the Country Y tested unit are not combined under the de minimis combination rule because the gross income attributable to these tested units (\$19,600,000 attributable to the Country X tested unit, and \$225,000 attributable to the Country Y tested unit) is not less than \$200,000.

(E) *Example 5: CFC group - Controlled foreign corporations with different taxable years—(1) Facts.* USP owns all of the stock of CFC1X and CFC2X. CFC2X has a taxable year ending November 30. On

December 15, Year 1, USP sells all the stock of CFC2X to an unrelated party for cash.

(2) *Analysis.* The determination of whether CFC1X and CFC2X are in a CFC group is made as of the close of their CFC inclusion years that end with or within the taxable year ending December 31, Year 1, the taxable year of USP, the controlling domestic shareholder under paragraph (d)(8)(iii) of this section. See paragraph (d)(6)(v)(B)(2) of this section. Under paragraph (d)(6)(v)(B)(1) of this section, USP directly owns more than 50% of the stock of CFC1X as of December 31, Year 1, the end of CFC1X's CFC inclusion year. USP also directly owns more than 50% of the stock of CFC2X as of November 30, Year 1, the end of CFC2X's CFC inclusion year. Therefore, CFC1X and CFC2X are members of a CFC group and USP must consistently make high-tax elections, or revocations, under paragraph (d)(6) of this section with respect to CFC1X's taxable year ending December 31, Year 1, and CFC2X's taxable year ending November 30, Year 1. This is the case notwithstanding that USP does not directly own more than 50% of the stock of CFC2X as of December 31, Year 1, the end of CFC1X's CFC inclusion year. See paragraph (d)(6)(v)(B)(2) of this section.

(F) *Example 6: Application of anti-abuse rule to applicable instrument—(1) Facts—(i) Ownership.* USP owns all the stock of CFC1X. CFC1X owns all the stock of CFCY, a controlled foreign corporation organized in Country Y. Under paragraph (d)(2)(i)(A) of this section, CFCY is a tested unit.

(ii) *Applicable instrument.* With a significant purpose of causing an item of gross income of CFCY to qualify for the high-tax exception described in section 954(b)(4) and paragraph (d)(1) of this section, CFCY issues an instrument to CFC1X. The instrument is treated as indebtedness that gives rise to deductible interest for federal income tax purposes and under the tax law of Country X, but payments or accruals with respect to the instrument are not deductible under the tax law of Country Y. During Year 1, CFCY accrues and pays €20x with respect to the instrument held by CFC1X. For federal income tax purposes, the €20x accrual is deductible interest expense. For Country Y tax purposes, neither the payment nor accrual is deductible. For Country X tax purposes, the €20x payment is interest and included in income. CFCY has a general gross item that after taking into account the €20x interest deduction on the instrument, but before taking into account the anti-abuse rule under paragraph (d)(7) of this section, would qualify for the high-tax exception in section 954(b)(4) and paragraph (d)(1) of this section; but for the €20x interest deduction (for federal income tax purposes), the general gross item of CFCY would not qualify for the high-tax exception.

(2) *Analysis.* Under paragraph (d)(8)(i)(A) of this section, the instrument CFCY issues to CFC1X is an applicable instrument because it gives rise to deductions for federal income tax purposes but not, in whole or in part, under the tax law of Country Y. In addition, CFCY issues the instrument with a significant purpose of avoiding the purposes of section 951, 951A, or 954(b)(4) or paragraph (d)(1) of this section. As a result, appropriate adjustments are made pursuant to the anti-abuse rule in paragraph (d)(7) of this section. The adjustments in this case would be an increase in the amount of the tentative net item

described in paragraph (d)(1)(iv) of this section by €20x, the amount of the payment on the applicable instrument that is deductible for federal income tax purposes, but not for Country Y tax purposes, such that CFCY's item of gross income does not qualify for the high-tax exception described in section 954(b)(4) and paragraph (d)(1) of this section.

* * * *

(h) * * *

(3) *Paragraphs (a)(2) through (a)(7), (b)(1)(ii), (c)(1)(iii)(A)(3), (c)(1)(iv), and (d) of this section.* Paragraphs (c)(1)(iii)(A)(3) and (c)(1)(iv) of this section apply to taxable years of a controlled foreign corporation beginning on or after July 23, 2020, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. Paragraphs (a)(2) through (7), (b)(1)(ii), and (d) of this section apply to taxable years of controlled foreign corporations beginning on or after [the date that final regulations are filed for public inspection], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. For the application of paragraphs (a)(2) through (7), (b)(1)(ii), and (d) (excluding paragraphs (d)(3)(i) and (d)(3)(ii)) of this section to taxable years of controlled foreign corporations beginning before [the date that final regulations are filed for public inspection], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, see §1.954-1, as con-

tained in 26 CFR part 1 revised as of April 1, 2020. For the application of paragraphs (d)(3)(i) and (ii) of this section to taxable years of controlled foreign corporations beginning on or after July 23, 2020 and before [the date final regulations are filed with the **Federal Register**], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, see §1.954-1(d)(3)(i) and (ii), as in effect on September 21, 2020.

§1.954-3 [Amended]

Par. 6. Section 1.954-3 is amended by removing the second sentence in paragraph (b)(3).

§§ 1.954-6, 1.954-7, and 1.954-8 [Removed]

Par. 7. Sections 1.954-6 through 1.954-8 are removed.

Par. 8. Section 1.6038-2, as amended July 15, 2020, at 85 FR 43042, effective September 14, 2020, is further amended by:

1. Adding reserved paragraphs (f)(16) through (18);
2. Adding paragraph (f)(19);
3. Adding reserved paragraph (m)(5); and
4. Adding paragraph (m)(6).

The additions read as follows:

§1.6038-2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations.

* * * *

(f) * * *

(16) – (18) [Reserved]

(19) *High-tax election documentation requirement.* If for the annual accounting period of a corporation a United States shareholder makes a high-tax election under section 954(b)(4) and §1.954-1(d)(6), then Form 5471 (or successor form) must contain such information related to the high-tax election in the form and manner and to the extent prescribed by the form, instructions to the form, publication, or other guidance published in the Internal Revenue Bulletin.

* * * *

(m) * * *

(5) [Reserved]

(6) *Special rule for paragraph (f)(19) of this section.* Paragraph (f)(19) of this section applies to taxable years of controlled foreign corporations beginning on or after [the date that final regulations are filed for public inspection], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

Sunita Lough

*Deputy Commissioner for Services
and Enforcement.*

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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.

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¹A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2019–27 through 2019–52 is in Internal Revenue Bulletin 2019–52, dated December 27, 2019.

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¹ A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2019–27 through 2019–52 is in Internal Revenue Bulletin 2019–52, dated December 27, 2019.

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