Key insights from the 2021 final foreign tax credit regulations

January 13, 2022

In brief

Treasury and the IRS on December 28, 2021, released final regulations (the '2021 Final Regulations') addressing various aspects of the foreign tax credit (FTC) regime. The 2021 Final Regulations were published in the Federal Register on January 4, 2022, and represent the third set of final regulations that have been issued with respect to the core provisions of the US foreign tax credit regime following the 2017 Tax Cut and Jobs Act.

The 2021 Final Regulations finalize, among other provisions, certain of the proposed FTC regulations released on September 29, 2020 (the '2020 Proposed Regulations'). The 2021 Final Regulations provide guidance in the following areas:

- the disallowance of a credit or deduction for foreign income taxes with respect to dividends eligible for a dividends-received deduction under Section 245A;
- the allocation and apportionment of foreign income taxes, interest expense, and certain deductions of life insurance companies;
- the definition of a foreign income tax and a tax in lieu of an income tax, including a new attribution requirement (previously the 'jurisdictional nexus' requirement);
- the definition of foreign branch category income; and
- the time at which foreign taxes accrue and can be claimed as a credit.

The regulations also contain clarifying rules relating to foreign-derived intangible income (FDII). The 2021 Final Regulations affect taxpayers that claim credits or deductions for foreign income taxes or that claim a deduction for FDII. Certain provisions of the 2020 Proposed Regulations were not finalized in the 2021 Final Regulations, which Treasury and the IRS continue to study.

While the 2021 Final Regulations are effective on March 7, 2022, certain provisions are applicable to periods beginning before that date. The various applicability dates are discussed further below and summarized in the table at the end of this document.

Some of the key highlights are set forth below. For additional information on the 2020 Proposed Regulations, see PwC's Tax Insight, Preliminary highlights from the 2020 final and proposed foreign tax credit regulations. Please Register for the Tax Readiness webcast on January 19 to learn more about the impacts of the 2021 Final Regulations.

The takeaway: The 2021 Final Regulations are among the most significant developments in the US FTC regime during its 100+ year existence, as they fundamentally change the definition of what is a creditable foreign income tax under Sections 901 and 903. The regulations are expected to reduce significantly the amount of FTCs that taxpayers may claim. Taxpayers should immediately re-evaluate each of the foreign taxes historically claimed as a creditable tax under the new regulatory framework to determine whether such taxes may continue to be claimed as a credit under Sections 901 or 903.

For financial statement reporting purposes, under the income tax accounting standard, companies should assess the impact, if any, of all new information in the period. This includes any impact from the issuance of regulations by the US Treasury, such as the 2021 Final Regulations. Therefore, taxpayers who are affected by the 2021 Final Regulations will need to consider their impact, if any, beginning in the financial period that includes December 28, 2021, the date the Regulations were issued.

In detail

Highlights of the 2021 Final Regulations

The 2021 Final Regulations generally follow and finalize the 2020 Proposed Regulations with certain key revisions. The content below summarizes key highlights from the 2021 Final Regulations and changes from the 2020 Proposed Regulations, as applicable.

Disallowance of certain deductions or credits for foreign income taxes under Section 245A(d)

Section 245A(d) generally denies a credit or deduction for any foreign income taxes paid or accrued with respect to a dividend for which a Section 245A deduction is allowed. The 2020 Proposed Regulations provided that taxpayers could not credit or deduct foreign income taxes paid or accrued with respect to the following: dividends for which a Section 245A deduction is allowed, hybrid dividends, subpart F inclusions attributable to tiered hybrid dividends, and distributions of Section 245A(d) previously taxed earnings and profits (PTEP). The 2020 Proposed Regulations also proposed to disallow a credit or deduction for foreign income taxes paid or accrued with respect to certain specified earnings related to Section 245A earnings and profits (E&P) where there is a foreign law distribution or pass-through inclusion under the principles of Treas. Reg. sec. 1.861-20. The proposed rules generally relied on Treas. Reg. sec. 1.861-20 to associate gross income in the foreign tax base attributable to Section 245A dividend eligible amounts. Finally, the 2020 Proposed Regulations contained an anti-avoidance rule that was proposed to apply if a transaction, series of related transactions, or arrangement was undertaken with a principal purpose of avoiding the purposes of Section 245A(d), such as by separating foreign income taxes from income or E&P to which the taxes relate, or by making distributions under foreign law in multiple years that give rise to foreign income taxes that are allocated and apportioned under the regulations using the same PTEP.

In response to comments, Treasury and the IRS agreed that there was a lack of clarity in the 2020 Proposed Regulations, particularly with respect to determining the extent to which foreign income tax imposed on a US return of capital or basis amount (e.g., arising from either a distribution from, or disposition of an interest in, a corporation or partnership) is treated as attributable to Section 245A dividend eligible amounts. As a result, Treasury and the IRS changed their approach by removing the terms 'specified distributions' and 'specified earnings and profits' and, instead, using two new terms - 'Section 245A(d) income' and 'non-inclusion' income - as the focal points of the new rules. This change in approach resulted in a significant rewrite of the regulations with a more refined scope and clarity but tethered to the same fundamental principle as the 2020 Proposed Regulations.

In this regard, the 2021 Final Regulations provide that taxpayers cannot credit or deduct foreign income taxes attributable to 'Section 245A(d) income' of a domestic corporation, a successor of a domestic corporation, or a foreign corporation, or 'non-inclusion income' of a foreign corporation (other than certain passive foreign investment companies, or PFICs). A credit or deduction for foreign income tax paid or accrued with respect to a Section 245A dividend is disallowed even if the Section 245A(a) deduction is not claimed.

For domestic corporations, Section 245A(d) income means dividends (including Section 1248 dividends) or Section 951(a)(1)(A) inclusions for which a Section 245A deduction is allowable, distributions of Section 245A(d) PTEP, hybrid dividends, and subpart F inclusions attributable to tiered hybrid dividends. For successors of domestic corporations, Section 245A income means distributions of Section 245A(d) PTEP. For foreign corporations, Section 245A income means items of subpart F income giving rise to a Section 245A(a) deduction, tiered hybrid dividends, and distributions of Section 245A(d) PTEP. Section 245A(d) PTEP is PTEP attributable to Sections 964(e)(4) and 1248 inclusions for which the US shareholder was allowed a dividends-received deduction under Section 245A, or PTEP that arose as a result of a tiered hybrid deduction that gave rise to a US shareholder’s inclusion by reason of Section 245A(e)(2). Therefore, a credit or deduction is disallowed for taxes paid or accrued with respect to certain distributions and inclusions, as well as taxes paid or accrued by reason of the receipt of a foreign law distribution with respect to stock or a foreign law disposition to the extent the taxes are attributable to Section 245A(d) income.

Non-inclusion income of a foreign corporation is income other than subpart F income, certain tested income, or items of income constituting post-1986 undistributed US earnings of a foreign corporation (generally as described in Section 245(a)(5)). Foreign income taxes are attributed to non-inclusion income of a foreign corporation in cases where such taxes are allocated and apportioned under Treas. Reg. sec. 1.861-20 to the Section 245A subgroup category of the foreign corporation’s stock by reference to the characterization of the tax book value of stock for interest expense apportionment purposes, or by reference to the income of a reverse hybrid or foreign-law CFC. Accordingly, a credit or deduction is disallowed for taxes paid or accrued by a domestic corporation that are attributable to non-inclusion income of a foreign corporation with respect to which the domestic corporation is a US shareholder, such as the US return of capital amount on a distribution from, or a disposition of an interest in, a foreign corporation, or the portion of tested income that is not included in the US shareholder’s GILTI. In addition, the definition captures foreign income taxes attributable to the return of basis portion arising from a partnership distribution or disposition of a partnership interest, as well as a disregarded distribution that is treated as a remittance.

The 2021 Final Regulations also retain the anti-avoidance rule set forth in the 2020 Proposed Regulations, and add two examples to address situations where a distribution is in part a dividend and in part a return of capital amount (i.e., part Section 245A(d) income and part ‘non-inclusion income’), as well as the application of the regulations to income of a reverse hybrid entity (treated as ‘non-inclusion income’).

The above rules apply to taxable years of a foreign corporation that begin after December 31, 2019, and end on or after November 2, 2020, and with respect to a US person’s taxable years in which or with which such taxable years of the foreign corporation end.

Observation: Treasury and the IRS effectively rewrote the 2020 Proposed Regulations with respect to Section 245A(d) by replacing the key terms of the 2020 Proposed Regulations with two new key terms (‘Section 245A(d) Income’ and ‘non-inclusion income’), adding 23 new defined terms, and adding two new examples. Considering this, it is somewhat surprising that Treasury and the IRS did not choose to re-propose these regulations to allow for further public comment on the scope and application of the rules, which apply retroactively. That approach would have been consistent with the cautious approach that was taken with respect to much of the 2020 Proposed

Regulations under Treas. Reg. sec. 1.861-20 related to disregarded payments, which effectively re-proposed many rules originally proposed in 2019. In any event, the 2021 Final Regulations appear to incorporate much of the complexity contained in other FTC-related regulations, such as the provisions of Treas. Reg. sec. 1.861-20 related to determining the assignment of foreign gross income and allocation and apportionment of foreign income taxes in the context of disregarded payments. Taxpayers will need to consider carefully the application of the new regulations when considering all of the transactions involved in their structure that give rise to a foreign tax liability, even where no dividends-received deduction under Section 245A has been claimed previously or presently.

Allocation and apportionment of foreign income taxes

The 2020 Proposed Regulations provided more detailed and comprehensive guidance regarding the assignment of foreign gross income, and the allocation and apportionment of associated foreign income taxes, to the relevant statutory and residual groupings in certain cases. This guidance included rules for dispositions of stock and partnership interests, and rules for transactions that are distributions with respect to a partnership interest. It also included new rules addressing the allocation and apportionment of foreign income taxes imposed by reason of disregarded payments. With certain limited additions and clarifications, the 2021 Final Regulations finalized the provisions of the 2020 Proposed Regulations.

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

The 2021 Final Regulations retain the rule in proposed Treas. Reg. sec.1.861-20(d)(3)(i)(D) and the corresponding rule applicable in the partnership context in proposed 1.861-20(d)(3)(ii)(B), which assigns foreign gross income arising from a partnership distribution in excess of the US capital gain amount by reference to the asset apportionment percentages of the tax book value of the partner's distributive share of the partnership's assets.

The 2021 Final Regulations provide additional detail governing the allocation and apportionment of foreign income taxes with respect to disregarded payments. In response to comments, the 2021 Final Regulations expand the assets that are considered owned by a taxable unit when applying Treas. Reg. sec. 1.861-20 with respect to a remittance made by the taxable unit. Specifically, the regulations provide that the assets of a taxable unit that makes a remittance include not only stock that it owns and the tax book value of a reattribution asset assigned to the taxable unit (as set forth in the 2020 Proposed Regulations), but the taxable unit's pro rata share of the assets of another taxable unit (other than a corporation or a partnership), including the portion of any reattribution assets assigned to the other taxable unit in which it owns an interest. Further, if a taxable unit owns an interest in a taxable unit that is a partnership, the assets of the taxable unit that is the owner include the owner's partnership interest or its pro rata share of the partnership's assets as determined under the principles of Treas. Reg. sec. 1.861-9(e). The 2021 Final Regulations define a 'taxable unit' by reference to the tested unit definition in Treas. Reg. sec. 1.951A-2(c)(7)(iv)(A) instead of by reference to the definition of a taxable unit in proposed Treas. Reg. sec. 1.954-1(d)(2).

In addition, the 2021 Final Regulations revise the definitions of the terms 'contribution' and 'remittance' in Treas. Reg. sec. 1.861-20(d)(3)(v)(E) to encompass all payments that are not reattribution payments. Finally, the 2021 Final Regulations provide a special rule that generally allocates foreign income tax on foreign gross interest income with respect to a US equity hybrid instrument to the grouping to which distributions with respect to the instrument are assigned.

These rules generally apply to taxable years that begin after December 31, 2019, and end on or after November 2, 2020.

Observation: The finalization of the remaining rules related to the allocation and apportionment of foreign gross income and foreign income taxes under Treas. Reg. sec. 1.861-20 provides taxpayers a detailed framework with respect to the treatment of foreign gross income and related foreign income taxes. It will be important for taxpayers to apply this framework to their various fact patterns and transactions, as the application will not always be clear, simple, or intuitive.

Allocation and apportionment of interest expense

The 2020 Proposed Regulations contained several special rules for the allocation and apportionment of interest expense. The 2021 Final Regulations finalize a portion of the special rules as follows:

- Interest expense on certain debt instruments issued by a regulated utility company would be directly allocated to income from assets of the utility business. This special rule applies to tax years beginning on or after December 28, 2021.

- CFC-to-CFC loans, including loans currently described in Treas. Reg. sec. 1.861-10(e)(8)(v), would not be treated as related group indebtedness (in the current year or for purposes of computing the foreign base period ratio) for purposes of applying the CFC netting rules under Treas. Reg. sec. 1.861-10(e). This special rule applies to tax years ending on or after November 2, 2020.

The 2021 Final Regulations do not provide guidance on the election included in the 2020 Proposed Regulations to capitalize and amortize R&E expenses, include rules like those in the 2020 Proposed Regulations to provide for the direct allocation of interest expense of foreign banking branches, or provide guidance relating to the definition of financial services income or a financial services entity.

Life insurance company rules under Section 818(f)

Section 818(f)(1) provides that the deduction for life insurance reserves, policyholder dividends, and death benefits, as well as certain other deductions (Section 818(f) expenses) are treated as items that cannot be definitely allocated to an item or class of gross income (but for an irrevocable election, which had to be made on or before September 15, 1985). Thus, when a life insurance company computes its Section 904 FTC limitation, its Section 818(f) expenses generally reduce its US source income and foreign source income ratably. The 2021 Final Regulations allocate and apportion Section 818(f) expenses on a life subgroup basis, but allow for a one-time election for consolidated groups to choose instead to apply a separate company approach.

The regulations relating to the allocation and apportionment of Section 818(f) expenses apply to taxable years beginning on or after December 28, 2021.

Definitions of a foreign income tax and a tax in lieu of an income tax

Section 901 allows a credit for foreign income taxes paid, and Section 903 provides that such taxes include tax in lieu of a generally imposed foreign income tax. Under the current FTC regulations, a foreign levy meets the definition of 'income tax' if it is (1) a tax; and (2) the predominant character of the tax is that of an income tax in the US sense. The predominant character of a foreign tax is that of an income tax in the US sense if it meets the net gain requirement and it is not a soak-up tax.

Jurisdictional nexus / Attribution requirement background

In response to various destination-based taxes contemplated or adopted by foreign countries, Treasury and the IRS determined it was necessary to add a jurisdictional limitation to the regulatory definition of a creditable tax. Under the 2020 Proposed Regulations, in order for a foreign tax to be an income tax in the US sense, the tax laws of the foreign country must require a sufficient nexus between the foreign country and the taxpayer's income that give rise to the tax. In general, the nexus standards are applied using the foreign tax law characterization of the income and depend on whether the taxpayer is a tax resident of the country imposing the tax or is considered a nonresident.

In the case of foreign tax imposed on tax residents of a foreign country, the 2020 Proposed Regulations provided that the foreign country may impose tax on all of the worldwide gross receipts of the resident. However, the 2020 Proposed Regulations required that the foreign tax law provide for the allocation of items of income, gain, deduction, or loss with respect to transactions between related persons using transfer pricing rules determined under arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion.

In the case of nonresidents, the 2020 Proposed Regulations generally looked to whether the foreign tax is imposed based on one of three nexus standards: activities-based nexus, source-based nexus, or property-based nexus. In general, the 2020 Proposed Regulations provided that a foreign country must impose its tax using one of these nexus standards, and that the standard being used must be reasonably similar to the US tax rules that use such principles to impose tax on nonresidents.

The 'jurisdictional nexus' requirements of the 2020 Proposed Regulations were the most controversial aspect of the 2020 Proposed Regulations, and Treasury and the IRS responded to the numerous comments that were received. While some helpful modifications were made in response to the comments, Treasury and the IRS were not willing to delay the application of or remove the rules when finalizing the regulations. The lone exception to this was with respect to certain taxes imposed by Puerto Rico, which were provided a one-year delayed effective date.

Attribution requirement changes in the 2021 Final Regulations

The 2021 Final Regulations include the 'jurisdictional nexus' requirement as part of the 'net gain requirement' (discussed below) and change the name to an 'attribution' requirement to reflect that the rule provides limits on the scope of the gross receipts and costs that are attributable to a taxpayer's activities, source, or situs and included in the base of the foreign tax.

Treas. Reg. sec. 1.901-2(b)(5)(i)(A) generally provides the activities-based attribution standard. This standard states that in the case of a foreign country imposing tax on nonresidents, the foreign tax law may determine the amount of income subject to tax based on the nonresident's activities within the foreign country. This includes its functions, assets, and risks located in the foreign country. Examples of rules that would meet this requirement are those that are consistent with Section 864(c) of the Code or Articles 5 and 7 of US Model Income Tax Treaty.

By contrast, foreign countries that consider destination-based criterion a significant factor in allocating profit (e.g. by deeming a taxable presence based on the location of customers in the foreign country) will not meet the activities-based attribution standard and so the foreign tax imposed on such income will not be a creditable income tax if paid or accrued by a US taxpayer.

If foreign tax law imposes tax on a nonresident based on the income arising from sources within the foreign country (i.e., the source-based attribution standard), Treas. Reg. sec. 1.901-2(b)(5)(i)(B) requires that the sourcing rules under the foreign tax law must be reasonably similar to those that apply for US Federal income tax purposes. The 2020 Proposed Regulations explicitly provided that in the case of income from services, such income is sourced based on the place of performance of the service, not the location of the recipient of the service. This provision was retained in the 2021 Final Regulations. Additionally, the 2021 Final Regulations specify that royalty income must be sourced where the use of, or the right to use, the intangible property is located, and sales income cannot be attributed based on source.

If a foreign tax law imposes tax on a nonresident's income from dispositions of property that does not meet the activities requirement then the attribution requirement will be satisfied only with respect to gains from the disposition of (1) real property in the foreign country (or an interest in a resident corporation or other entity that owns such property) under rules reasonably similar to those under Section 897 (FIRPTA); or (2) property forming part of the business property of a taxable presence in the foreign country or an interest in a partnership or other passthrough entity to the extent that it owns such property.

Observation: By restricting situs-based attribution to gains on direct and indirect dispositions of real property, gains on direct dispositions of other business property, and gains on indirect dispositions of other business property through noncorporate entities, the 2021 Final Regulations call into question the creditability of nonresident capital gain taxes that are common in many foreign countries, particularly in Asia and Latin America. The 2021 Final Regulations materially depart from the 2020 Proposed Regulations in this respect. Taxpayers should immediately evaluate the potential impact of these changes on current and planned transactions.

A separate attribution requirement applies to taxes imposed on tax residents of the foreign taxing jurisdiction. Such a levy satisfies the attribution requirement if, in allocating items of income, gain, deduction or loss, applicable transfer pricing rules are consistent with arm's length principles without taking into account destination-based criteria as a significant factor. Examples of arm's length transfer pricing rules include the Section 482 regulations, or the OECD's Transfer Pricing Guidelines. Treasury and the IRS requested comments in the preamble to the 2020 Proposed Regulations on whether special rules are needed to address transfer pricing rules that are formulary, rather than arm's length based, but the 2021 Final Regulations do not mention, and make no changes regarding, such formulary rules.

The 2021 Final Regulations make clear that the attribution requirement will not be violated if a foreign country imposes tax on the worldwide income of a taxpayer resident in such foreign country. Treas. Reg. sec. 1.901-2(g)(6) defines 'resident' and 'nonresident' for these purposes.

***Observation*:** The Organisation for Economic Co-operation and Development (OECD), as part of its overall work to address Base Erosion and Profit Shifting (BEPS), is developing rules that include: (1) a new international tax framework with respect to taxing rights to market jurisdictions on part of the residual profits earned by large and profitable multinational entities (known as 'Pillar One') and (2) a global minimum tax implemented through a proposed income inclusion rule and undertaxed payment rule (known as 'Pillar Two'). The new attribution requirement raises significant questions about the creditability of novel taxes imposed under Pillar One or Pillar Two. It is expected that certain aspects of the attribution requirement would need to be revisited in the event the United States adopts Pillar One or Two.

Net gain requirement

Under the existing regulations, the net gain requirement is met if, upon evaluation of empirical data, a foreign tax reaches the net gain of a taxpayer in the 'normal circumstances' in which it applies. The net gain requirement consists of realization, gross receipt, and cost recovery requirements. Treasury and IRS determined that both taxpayers and IRS have historically had difficulty and uncertainty in applying these rules. As a result, the 2020 Proposed Regulations provided rules that stated that the determination of whether a foreign tax satisfies the net gain requirement would be based on whether the terms of the foreign tax laws governing computation of the tax base meet the realization, gross receipts, and cost recovery requirements which comprise the net gain requirement.

The 2021 Final Regulations also include the attribution requirement (discussed above) as part of the net gain requirement along with the realization, gross receipts, and cost recovery requirements.

Realization requirement

Under the prior regulations, a foreign tax generally satisfied the realization requirement if it is imposed at the same time or after an event which, under the Code, would result in the realization of income, or in certain instances, if it is imposed before a realization event (e.g. a foreign mark-to-market regime). Treasury and IRS have determined that amounts that are included in the foreign tax base but are not a result of 'realization events' should not prevent an otherwise-qualifying foreign tax from qualifying as an income tax.

Accordingly, Treas. Reg. sec. 1.901-2(b)(2) states that the foreign tax may still be treated as meeting the realization requirement if the portion of the foreign tax base that is the result of nonrealization events is minimal relative to the portion of the foreign tax base that is the result of realization events. This determination is not made on a taxpayer-by-taxpayer basis. Rather, the determination is based on the application of the foreign tax to all taxpayers subject to such foreign tax.

Under the prior regulations, foreign taxes imposed on a shareholder on a deemed distribution of income realized by the distributing entity satisfied the realization requirement as long as a second tax was not imposed on the shareholder on the same income when such income was actually distributed. Treas. Reg. sec. 1.901-2(b)(2)(i)(C) clarifies the rules relating to such pre-realization events. Under the 2021 Final Regulations, because a shareholder-level tax on a distribution from a corporation is imposed on a different taxpayer (i.e., the shareholder and not the corporation), it is not treated as a second tax imposed on the corporation’s income.

Gross receipts requirement

The prior regulations provided that a tax satisfies the gross receipts requirement if it is imposed on the basis of (1) gross receipts; or (2) gross receipts computed under a method that is likely to produce an amount that is not greater than the fair market value of actual gross receipts ('the alternative gross receipts test').

Consistent with the 2020 Proposed Regulations, the 2021 Final Regulations remove the provision of the prior regulations referring to the gross receipts computed under a method 'likely' to produce an amount not greater than fair market value. Under Treas. Reg. sec. 1.901-2(b)(3), the gross receipts requirement will be satisfied only if the foreign tax is imposed based on actual gross receipts or deemed gross receipts on insignificant non-realization events or pre-realization timing difference events. In the case of an insignificant non-realization event or a realization event that does not result in actual gross receipts, the gross receipts requirements may also be met by foreign taxes imposed on deemed gross receipts in an amount that is reasonably calculated to produce an amount that is not greater than the fair market value.

Cost recovery requirement (formerly ‘net income test’)

The net income requirement under the prior regulations generally required that a foreign tax, judged on the basis of its predominant character, provide that the base of the tax is computed by reducing gross receipts by significant costs and expenses that are attributable, under reasonable principles, to such gross receipts, or permit the recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses. A foreign tax law permits the recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be under the Code, unless the time of recovery is such that under the circumstances there is effectively a denial of recovery. Further, under the 'nonconfiscatory gross basis tax rule' in the prior regulations, a foreign tax that is imposed on a gross basis could satisfy the net income requirement only in the 'rare situation' when the tax is almost certain to reach some net gain in the normal circumstances in which it applies. Such a situation would be when costs and expenses will almost never be so high as to offset gross receipts or gross income, and the rate of tax is such that, after the tax is paid, taxpayers subject to the tax are almost certain to have net gain. The general principles set forth in the prior regulations were carried over to the 2021 Final Regulations, with certain key clarifications and changes.

Under the 2021 Final Regulations, the ‘net income’ requirement was renamed as the ‘cost recovery requirement’, and the predominant character standard was removed. For a foreign tax to satisfy the cost recovery requirement described in Treas. Reg. sec. 1.901-2(b)(4) of the 2021 Final Regulations, the tax base must be computed by reducing gross receipts by significant costs and expenses (including significant capital expenditures) that are attributable under reasonable principles to such gross receipts. In general, whether a cost or expense is significant is determined based on whether, for all taxpayers in the aggregate to which the foreign tax applies, the item of cost or expense constitutes a significant portion of the taxpayers’ total costs and expenses. When considering whether the foreign tax law permits the recovery of the significant costs and expenses, the costs and expenses may be recovered at a different time than they would be under the Code (i.e., earlier or later), unless the time of recovery is so much later as to effectively constitute a denial of such recovery.

Consistent with the 2020 Proposed Regulations, the 2021 Final Regulations provide some enhanced certainty by explicitly providing that costs and expenses related to capital expenditures, interest, rents, royalties, services, and R&E will always be treated as significant. An allowance for another type of deduction in lieu of one of the aforementioned deductions is not sufficient to meet the cost recovery requirement. Additionally, a foreign levy that disallows a deduction based on principles similar to Section 163(j), 267A, or 162 may still meet the cost recovery requirement. The 2021 Final Regulations provide further clarity by stating that a foreign tax need not permit the recovery of personal expenses that are not attributable, under reasonable principles, to the gross receipts subject to tax, and that the cost recovery requirement can be met even if the foreign tax is computed without reduction for costs and expenses attributable to wages and investment income not derived from a trade or business.

In the 2021 Final Regulations, Treasury and the IRS determined that the empirical standards contemplated by the nonconfiscatory gross basis tax rule in the prior regulations create substantial compliance and administrative burdens for taxpayers and the IRS when determining whether a foreign tax is an income tax in the US sense. As a result, the 2021 Final Regulations remove the nonconfiscatory gross basis tax rule. Nevertheless, in response to comments, Treasury and the IRS did not finalize a rule in the 2020 Proposed Regulations that provided that a gross basis tax could never meet the cost recovery requirement, even if in practice there are no significant costs and expenses attributable to the gross receipts included in the foreign tax base. Instead, the 2021 Final Regulations provide that a gross basis tax will meet the cost recovery requirement if there are no significant costs and expenses attributable to the gross receipts included in the foreign tax base that must be recovered under the rules of Treas. Reg. sec. 1.901-2(b)(4)(i)(C)(1).

Under the prior regulations, an 'alternative allowance rule' provided that a foreign tax that does not permit recovery of one or more significant costs or expenses, but does provide allowances that effectively compensate for such costs or expenses, is considered to meet the net income requirement. The 2021 Final Regulations have modified this rule to treat alternative allowances as meeting the cost recovery requirement only if the foreign tax law by its terms permits the allowance in an amount that will equal or exceed actual significant costs. Also, the cost recovery requirement is satisfied with an optional alternative cost allowance only if the foreign tax law expressly provides an option to recover actual costs and expenses. In response to comments, the 2021 Final Regulations adopted an exception to the alternative cost allowance rule that provides that if the foriegn tax law provides an alternative method for determining costs and expenses taken into account in the foreign tax base for small business enterprises, the cost recovery requirement will be met, provided the law contains reasonable limits on the maximum size of the business enterprises to which the alternative cost allowance applies.

With respect to whether costs and expenses are reasonably attributable to gross receipts, the 2020 Proposed Regulations generally provided that principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Code (for example, principles that apply under Section 265, 465, or 861(b)). The 2021 Final Regulations adopted this rule without change, but added a new rule that requires consideration of the ability of a taxpayer to use losses incurred in one activity of a trade or business, either against profit earned in that activity in a different taxable year, or against profit earned in another activity conducted by the taxpayer in the same trade or business. In applying this rule, the regulations would treat the activities of separate entities as undertaken by a single entity if the foreign tax law requires separate entities to carry on separate activities.

Observation: The changes made in the 2021 Final Regulations to remove the 'predominant character' standard, and the inclusion of a per se list of significant costs or expenses have the potential to make many foreign taxes noncreditable. Taxpayers should re-examine each of the foreign taxes that have historically been treated as creditable net income taxes to ensure that the relevant foreign tax law generally provides for the recovery of each of the costs or expenses on the per se list. To the extent that one or more significant costs or expenses are not permitted, it seems unlikely that the foreign levy could be considered a net income tax under Section 901 or an in-lieu of tax under Section 903. As a result, the creditability of the foreign levy under an applicable treaty may be the sole remaining basis to claim the foreign levy as a creditable tax.

Qualifying surtax

Apart from the realization, gross receipt, cost recovery, and attribution requirements, Treas. Reg. sec. 1.901-2(b)(6) provides a rule that a foreign tax will satisfy the net gain requirement if the base of the foreign tax is the amount of a net income tax. This rule is targeted towards foreign taxes that are computed as a percentage of the tax due under a separate levy that is itself an income tax.

Soak-up taxes

The 2021 Final Regulations move the rule regarding soak-up taxes from the rules defining a creditable levy to the rules for determining the amount of creditable tax that is considered paid.

Additionally, prior regulations contained a special rule that limited the portion of a tax in lieu of an income tax that is a soak-up tax to the amount by which such tax exceeds the income tax that would have been paid had the taxpayer been subject to the generally-imposed foreign income tax. The 2021 Final Regulations withdraw this special rule as Treasury and the IRS have determined it is inconsistent with the policy of disallowing a credit for soak-up taxes.

Separate levy determination

Treasury and the IRS have determined that there is a lack of clarity in the current rules for determining whether a foreign levy is separate from another foreign levy for purposes of determining whether each levy meets the requirements of Section 901 or 903. Specifically, prior regulations stated that the key factor is whether the base of the levy is different in kind, as opposed to degree, from another levy. However, the prior regulations also stated that a levy may be separate from another levy if a different class of taxpayer is subject to each levy, regardless of whether the base of the levies is different in kind.

In general, the 2021 Final Regulations modify the regulations to identify separate levies as those that include different items of income and expense in determining the base of the tax. However, in certain cases separate levies may result even if the tax base of each levy is the same. Treas. Reg. sec. 1.901-2(d) clarifies these rules by categorizing the regulations into the following four general categories that generally give rise to separate levies: (i) taxing authority, (ii) different taxable base, (iii) tax imposed on nonresidents, and (iv) foreign levy modified by an applicable income tax treaty.

With respect to these categories, the regulations provide that a foreign levy is always separate from another foreign levy if the levy is imposed by a different foreign tax authority, even if the base of the tax is the same. Furthermore, separate levies are considered imposed on particular classes of taxpayers if the tax base is different for those taxpayers. However, a foreign tax that provides a deduction limitation (e.g., interest deduction) that applies only to one class of taxpayers subject to the tax does not cause the tax to be treated as a separate levy as to that class of taxpayers. Moreover, income included in the tax base of a separate levy may also be in the tax base of another levy. and separate levies are considered to be imposed if the tax bases are not combined as a single taxable base. For example, a foreign levy identical to the alternative minimum tax imposed by Section 55 or a foreign levy identical to the tax imposed under Section 1411 of the Code would each be considered a separate levy from a foreign levy that is identical to the tax imposed under Section 1 of the Code. In addition, the 2021 Final Regulations provide that a foreign levy imposed on nonresidents is treated as a separate levy from that imposed on residents of the taxing jurisdiction, even if the base is the same for both levies, and even if the levies are treated as a single levy under the foreign tax law.

The 2021 Final Regulations add several additional rules with respect to the determination of whether a separate levy exists that were not contained in the 2020 Proposed Regulations. The additional rules are as follows:

- a withholding tax on the gross income of nonresidents is treated as a separate levy with respect to each class of gross income (as listed in Section 61) to which the withholding tax applies;
- If two or more subsets of a separate class of income are subject to a withholding tax based on different income attribution rules, separate levies are considered to be imposed with respect to each subset of that separate class of income; and
- a foreign levy that is limited in its application by, or is otherwise modified by, an income tax treaty to which the foreign country imposing the levy is party, is a separate levy from the levy imposed under the domestic law of the foreign country and is also a separate levy form the foreign levy as modified by a different income tax treaty to which the foreign country imposing the levy is a party.

Amount of tax that is considered paid

The prior regulations at Treas. Reg. sec. 1.901-2(g)(1) and proposed Treas. Reg. sec. 1.901-2(g)(5) clarify that for purposes of determining the amount of tax considered paid and eligible for credit under Section 901, 'paid' as used in Treas. Reg. sec. 1.901-2(e) means 'paid' or 'accrued'.

Under the prior regulations, a payment to a foreign country is not treated as an amount of tax paid under Treas. Reg. sec. 1.901-2(e)(5)(i) to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven. It is not reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of the final tax liability to the foreign country. Treasury and IRS determined that the current rules governing the use of refunds and credits with respect to multiple foreign levies have led to uncertainty and inconsistency.

Treas. Reg. sec. 1.901-2(e)(2) of the 2021 Final Regulations eliminates the provision that suggests that an amount of tax is not treated as paid if it is allowed as a credit and instead provides that foreign income tax is not considered paid if it is reduced by a tax credit, regardless of whether the amount of such tax credit is refundable in cash to the extent the credit exceeds the taxpayer’s tax liability. However, the 2021 Final Regulations expand the overpayment rule contained in the 2020 Proposed Regulations that allows the portion of a credit or overpayment that is refundable in cash and that is applied as a credit against a different foreign income tax liability of the taxpayer for the same or a different tax year to be considered tax paid with respect to that different levy. Specifically, the 2021 Final Regulations provide that if, under the foreign tax law, the full amount of a tax credit is payable in cash at the taxpayer's option, the taxpayer's choice to apply all or a portion of the tax credit in satisfaction of a foreign income tax liability is treated as constructive payment of cash to the taxpayer in the amount so applied, followed by a constructive payment of the foreign income tax liability against which the credit is applied. As discussed above, the 2021 Final Regulations also provide that overpayments of tax that may be refundable in cash and are applied to the taxpayer's foreign income tax liability may qualify as an amount of tax paid for purposes of the Section 901 credit.

Finally, the 2021 Final Regulations clarify the multiple levy rule in Treas. Reg. sec. 1.901-2(e)(4) by referring to the first levy as the 'reduced levy' and the second levy as the 'applied levy'.

Observation: The addition of the special rule with respect to credits under foreign law that are fully refundable (not just refundable to the extent they exceed a foreign tax liability to which they first must be applied) is a helpful clarification in the 2021 Final Regulations.

Noncompulsory payments

In response to critical comments, Treasury and the IRS have decided that the 2007 proposed regulations regarding noncompulsory payments should be withdrawn. However, Treasury and the IRS have acknowledged that withdrawing the 2007 proposed regulations without providing additional guidance could result in a disallowance of all foreign tax credits related to loss-sharing arrangements because Treas. Reg. sec. 1.901-2(e)(5) requires taxpayers to minimize foreign income tax liability on a taxpayer-by-taxpayer basis. The 2020 Proposed Regulations addressed this issue by generally exempting from the noncompulsory payment regulations loss surrender under group relief or other loss-sharing regimes. Treasury and the IRS were concerned, however, that in certain cases loss sharing arrangements may be used to separate foreign taxes from the related income, and so Treasury and the IRS requested comments on this issue and other aspects of the treatment of loss sharing arrangements. Treasury and the IRS determined that applying the noncompulsory payment rule on a group-wide basis would be too difficult for taxpayers to comply with and for the IRS to administer, due to the difficulty of defining the related group in a way that properly accounts for differences in US and foreign tax law and prevents abuse. However, the 2021 Final Regulations at Treas. Reg. sec. 1.901-2(e)(5)(iv) include an additional limited exception for certain transactions that increase one person's foreign income tax liability but result in a reduction in another person's foreign income tax liability through the application of foreign law hybrid mismatch rules, provided that such reduction in the second person's liability is greater than the increase in the first person's liability.

Proposed Treas. Reg. sec. 1.901-2(e)(5)(ii) provided that the use or failure to use options or elections that result in an overall change in foreign income tax liability is relevant to whether a taxpayer has minimized its liability for foreign income taxes. An exception to this general rule is provided for elections to surrender losses under a foreign consolidation, group relief, or other loss-surrender regime. The 2021 Final Regulations clarify that a taxpayer must take advantage of foreign law options and elections that relate to the computation of tax liability as applied to the facts that affect the taxpayer's liability, but do not require taxpayers to modify any other conduct that may have tax consequences, including, for example, choices relating to business form or the maintenance of books and records on which income is reported, or the terms of contracts or other business arrangements.

Proposed Treas. Reg. sec. 1.901-2(e)(5)(i) made clear that the noncompulsory payment regulations require taxpayers to minimize their foreign income taxes, not their aggregate foreign taxes. Additionally, time value of money is not relevant in determining whether a taxpayer has met this obligation. The 2021 Final Regulations retain the clarification that Treas. Reg. sec. 1.901-2(e)(5) requires taxpayers to take reasonable steps to minimize their liability for foreign income taxes, including by exhausting remedies that an economically rational taxpayer would pursue whether or not the amount at issue was eligible for the foreign tax credit. However, Treasury and the IRS agree that this requirement is met if the reasonably expected, arm's-length costs of reducing foreign income tax liability would exceed the amount of the potential reduction, and that reasonably expected costs may include the cost of a reasonably anticipated offsetting foreign non-income tax liability. Treasury and the IRS determined that the reasonable cost analysis should apply not only in the exhaustion of remedies context, but also in evaluating whether a taxpayer has appropriately applied foreign tax law to minimize its foreign income tax liabilities even in the absence of a foreign tax controversy. The 2021 Final Regulations have been modified for these changes. The 2021 Final Regulations add an example in Treas. Reg. sec. 1.901-2(e)(5)(vi)(G) (Example 7) to illustrate that where a taxpayer has a choice to claim or forgo a deduction that would reduce its foreign income tax liability but increase its foreign non-income tax liability by a greater amount, the taxpayer can choose not to claim the income tax deduction without violating the noncompulsory payment requirement.

The revisions to Treas. Reg. sec. 1.901-2 under the 2021 Final Regulations apply to foreign taxes paid in tax years beginning or after December 28, 2021. For taxes paid to Puerto Rico under Section 1035.05 of the Puerto Rico Internal Revenue Code of 2011, as amended, these revisions apply to taxes paid to Puerto Rico in tax years beginning on or after January 1, 2023.

Observation: The changes made by the 2021 Final Regulations generally provide helpful clarifying guidance for taxpayers related to determining whether the payment of a tax is a compulsory payment of tax, and whether the taxpayer has exhausted all its effective and practical remedies to reduce its foreign tax liability. In this regard, the addition of the rule that allows taxpayers to consider increased costs related to offsetting non-income tax liabilities when evaluating its overall tax liability should be helpful to taxpayers. In addition, the 2021 Final Regulations provide greater clarity with respect to the interaction of the noncompulsory payment rules with loss sharing arrangements and hybrid mismatch payments.

Tax in lieu of income tax

For a foreign tax to be considered 'in lieu' of an income tax (a 'tested foreign tax'), it must meet the substitution requirement. The 2021 Final Regulations revise the substitution requirement by more specifically defining when a foreign tax is considered 'in lieu of' a generally imposed income tax. Additionally, the 2021 Final Regulations provide that such a tax, by virtue of the substitution requirement, must also satisfy an attribution requirement.

A foreign tax will satisfy the substitution requirement only if the tested foreign tax either satisfies a four-part test under Treas. Reg. sec. 1.903-1(c)(1) or is a ‘covered withholding tax’.

The requirements under the four-part test are as follows. First, the foreign country that imposes the tested foreign income tax must also generally impose a separate levy that is a foreign income tax.

Second, the income tax generally imposed by the foreign country may not apply to income that forms the base of the same foreign country’s tested foreign tax. The income that forms the base of the tested foreign tax is referred to as 'excluded income'.

Third, but for the existence of the tested foreign tax, the generally-imposed income tax would have been imposed on the excluded income. This ‘but for’ requirement is met only if the imposition of the tested foreign tax to the excluded income bears a 'close connection' to the failure to impose the generally-imposed income tax to the excluded income. That is, the foreign country must have made a 'cognizant and deliberate choice' to impose the tested foreign tax, rather than the generally-imposed income tax, to the excluded income. For purposes of this test, the 'close connection' requirement is satisfied if (1) the generally-imposed income tax does not apply (whether explicitly or implicitly) to the excluded income, and the tested foreign tax is enacted contemporaneously with the generally-imposed net income tax or an amendment thereto that expressly excludes the excluded income from the scope of the generally-imposed net income tax; or (2) the legislative history of the tested foreign tax (or a predecessor in lieu of tax) demonstrates the ‘close connection’ between the tested foreign tax and the generally-imposed net income tax.

Fourth, if the generally-imposed income tax or a hypothetical newly enacted separate levy with respect to the generally-imposed net income tax were to be applied to the excluded income, the income tax or separate levy would meet the 2021 Final Regulations’ attribution requirement.

Traditional source-based withholding taxes may satisfy the substitution requirement under a separate safe harbor for

'covered withholding taxes’. Similar to the general rule discussed above, a covered withholding tax must be imposed by a foreign country that also has a generally-imposed income tax, and must satisfy three additional requirements. First, the tax must be a withholding tax as defined under Section 901(k)(1)(B), that is imposed by a foreign country on gross income of nonresidents. Second, the withholding tax cannot be in addition to a net income tax that is imposed by the foreign country on any portion of the same income. Third, the withholding tax must meet the source-based attribution requirement of Treas. Reg. sec. 1.901-2(b)(5)(i)(B), under which rules for sourcing income to the foreign country must be reasonably similar to those that apply for US Federal income tax purposes.

The revisions to Treas. Reg. sec. 1.903-1 under the 2021 Final Regulations apply to foreign taxes paid in tax years beginning or after December 28, 2021. For taxes paid to Puerto Rico under Section 3070.01 of the Puerto Rico Internal Revenue Code of 2011, as amended, these revisions apply to taxes paid to Puerto Rico in tax years beginning on or after January 1, 2023.

Observation: The attribution requirement, discussed above, will pose the biggest hurdle for taxpayers to meet when considering the creditability of various foreign taxes under Section 903. That requirement states that, after considering the foreign characterization of the income subject to foreign tax, the foreign country’s source rule must be reasonably similar to the source rule that is used for similar income under the US tax law. Thus, the foreign country must impose tax using the same or very similar sourcing standards as used under the US tax law, but need not reach the same sourcing answer as would be reached under US tax law. Importantly, the regulations illustrate that even if the foreign tax law reaches an answer that is consistent with what the US views as the correct tax answer, if the foreign tax law does not impose the foreign tax based on specific principles (e.g., in the case of royalties, the use, or the right to use, intellectual property in a country versus residence of the payor) the attribution requirement is not met. Thus, the apparent flexibility of the general principle is significantly curtailed when considering the tax regimes of many countries, and taxpayers should carefully consider each foreign tax regime to determine whether the language of the foreign tax law is consistent with the standards set forth in the 2021 Final Regulations.

Observation: Further, the ‘close connection’ requirement may be difficult for taxpayers to meet in certain cases, and, in any event, requires a more detailed consideration of the genesis of each tested foreign tax and its interaction with the generally-imposed income tax. It is noteworthy that the 2021 Final Regulations do not address the circumstance where a tested foreign tax is imposed by a foreign country instead of another tax that meets the close connection requirement. In that context, it would seem that the tested foreign tax may also be considered to meet the ‘close connection’ requirement. Considering the difficulty of meeting the ‘close connection’ requirement, many taxpayers may instead rely on the less stringent requirements that the tested foreign tax be a ‘covered withholding tax,’ but that avenue will also require that the source attribution requirement be met.

Definition of foreign branch category income with intercompany payments

The 2020 Proposed Regulations contained examples in Proposed Treas. Reg. sec.1.904-4(f)(4)(xv) illustrating the application of the matching rule in Treas. Reg. sec. 1.1502-13 to a regarded intercompany payment between one affiliate group member and a foreign branch of a different member in the foreign branch category income context.

The 2021 Final Regulations finalize these examples without substantive change. However, Treasury and the IRS may address additional intercompany payment or disregarded payment issues in determining the amount and source of foreign branch category income in a future guidance project.

Timing of foreign tax credits

The 2021 Final Regulations provide additional guidance as to when cash method and accrual method taxpayers may take a credit for foreign income taxes as well as other timing issues associated with foreign tax credits.

Treas. Reg. sec 1.901-1(c)(3) provides an exception to current Treas. Reg. sec. 1.901-1(c) to allow an accrual method taxpayer, in a year in which it has elected to claim a credit for foreign income taxes that accrue in that year, also to deduct additional taxes paid in that year that, for foreign tax credit purposes, relate back and are considered to accrue in a prior year in which the taxpayer deducted foreign income taxes.

To eliminate the mismatch between the election and refund periods that exist under current regulations, the 2021 Final Regulations provide that a taxpayer must elect to claim a foreign tax credit before the expiration of the 10-year period of limitations under Section 6511(d)(3)(A); however, a taxpayer must decide to deduct foreign taxes in lieu of a credit before the expiration of the 3-year period of limitations under Section 6511(a).

The 2019 Proposed Regulations took into account the Act's amendments to Section 905(c) to require all foreign tax redeterminations to be taken into account in the year to which the redetermination of foreign taxes relate. In response to comments, the 2020 Final Regulations provided a transition rule to give taxpayers an additional year to satisfy the notification requirements in connection with foreign tax redetermination that occurred in taxable years on or after December 16, 2019, and before the date the 2020 Final Regulations were published in the Federal Register. For foreign tax redeterminations that occur with respect to pre-2018 taxable years, the 2020 Final Regulations provided that the controlling domestic shareholder may elect to account for such redeterminations as if they occurred in the foreign corporation's last taxable year beginning before January 1, 2018. The election is binding with respect to all US shareholders of the foreign corporation for the year to which the election applies as well as other members of the CFC group to which the foreign corporation is a member.

The 2021 Final Regulations expand the definition of a foreign tax redetermination to include changes to foreign income tax liability that affect a taxpayer's US tax liability even if such changes do not affect the amount of foreign tax credits claimed by the taxpayer (*e.g.*, a change that affects a GILTI or subpart F amount or affects whether a CFC is eligible for the high-tax exception under Section 954(b)(4) (including for purposes of determining amounts excluded from gross tested income)). The 2021 Final Regulations further provide that a change in a taxpayer's decision to claim a deduction or credit for foreign income taxes also constitutes a foreign tax redetermination.

The 2021 Final Regulations provide that, for cash method taxpayers, a foreign income tax is creditable when paid. For this purpose, a tax is generally considered paid when payment is remitted to the foreign tax authority or when taxes are withheld from gross income by the payor. The 2021 Final Regulations also provide rules allowing a cash method taxpayer to elect to claim foreign tax credits using the accrual method. Such election is irrevocable and generally cannot be made on an amended return. However, the 2021 Final Regulations allow taxpayers who have never claimed a foreign tax credit to make the election to claim a foreign tax credit on an accrual basis, even if the initial claim is made on an amended return. The rules further provide that taxpayers that make the election may claim a credit for all foreign taxes paid in the year even if such taxes paid relate to taxable years prior to the taxpayer making the election.

With respect to accrual method taxpayers, the 2021 Final Regulations, in accordance with Treas. Reg. sec. 1.461-1(a)(2)(i), provide that foreign taxes do not accrue (and are thus not creditable) until all the events have occurred that establish the fact of liability, and the amount of the liability can be determined with reasonable accuracy. The

2021 Final Regulations also incorporate the relation-back doctrine, which provides that once the taxes have accrued, such taxes relate back and are considered to accrue in the year to which the taxes relate.

To address certain mismatches that can arise for taxpayers that use a 52-53 week taxable year, the 2021 Final Regulations provide that when such taxpayer's US taxable year closes within six days of the foreign taxable year, the taxpayer's US taxable year is deemed to end on the last day of its foreign taxable year for purposes of determining the amount of foreign income taxes that accrue.

The 2021 Final Regulations provide new rules to determine when a taxpayer may claim a credit for contested taxes paid. Historically, the IRS has ruled that—in light of the legislative history and purpose of the foreign tax credit statutory provisions (as well as past court decisions)—when a taxpayer contests a foreign tax, such contested tax does not accrue until the challenge is resolved and the liability becomes final. At that point, under the relation-back rule, the foreign tax is considered to accrue in the tax year to which it relates. The IRS also has ruled that a contested tax becomes accruable (and thus a foreign tax credit may become allowable) when paid by the taxpayer, even if the tax remains contested. The 2021 Final Regulations reverse this position and instead provide an election to allow taxpayers to claim a provisional foreign tax credit for a contested foreign income tax in the year the contested tax is remitted. The election is available for contested foreign income taxes paid directly by the taxpayer or paid by a partnership in which the taxpayer is a partner.

Under the 2021 Final Regulations, a taxpayer generally may not claim a credit for contested taxes until there is a resolution of the contest, even if the taxpayer has already remitted the taxes to the foreign tax authority. However, taxpayers may elect to claim a provisional credit for any contested taxes paid, but must agree to notify the IRS once the contest concludes, allow the IRS to examine whether the taxpayer had exhausted its remedies, and agree not to assert any statute of limitations defense if the IRS determines the tax was not compulsory. The 2021 Final Regulations provide that the provisional foreign tax credit can only be made for contested foreign income taxes that relate to a taxable year in which the taxpayer has made the election to claim a credit (instead of a deduction) for foreign income taxes that accrue in such year. The regulations also clarify that if an election is made by the US taxpayer with respect to a contested foreign income tax liability incurred by a CFC, the taxpayer may claim the deemed paid credit in the relation-back year; in addition, the CFC can take the deduction for the contested foreign income tax into account in computing its taxable income in the relation-back year.

The 2021 Final Regulations also provide rules to address issues that arise when a taxpayer establishes an improper method of accounting for foreign income taxes. The 2021 Final Regulations generally provide that taxpayers who have established an improper method of accounting must use a 'modified cut-off' approach for adjusting foreign income taxes when changing from an improper to a proper method. The 2021 Final Regulations clarify that, under the modified cut-off approach, the amount of properly accrued foreign income tax in each statutory and residual grouping is first adjusted upward and then adjusted downward (but not below zero). Any excess downward adjustment in a grouping is carried forward to reduce the properly accrued foreign income tax in that grouping in future years.

The 2021 Final Regulations provide rules regarding when partners, shareholders, or beneficiaries of pass-through entities may claim a foreign tax credit for foreign income taxes paid or accrued by such pass-through entities. The 2021 Final Regulations provide that a partner may claim its distributive share of taxes paid or accrued (as determined under the partnership's method of accounting) during the partnership's taxable year that ends with or within the partner's taxable year.

The 2021 Final Regulations make conforming changes to the regulations under Section 960 to ensure that current year taxes that are deemed paid under Sections 960(a) and 960(d) consist only of current year taxes that are eligible for a foreign tax credit. The conforming changes also clarify that foreign income taxes for which a credit is disallowed is still an item of expense that must be allocated and apportioned under the rules of Treas. Reg. sec. 1.960-1(d).

This portion of the 2021 Final Regulations applies to tax years beginning on or after December 28, 2021. The election to claim a provisional credit for contested taxes remitted before a contest is resolved may be made (including by a partner or other owner of a pass-through entity) with respect to amounts of contested tax that are remitted in taxable years beginning on or after December 28, 2021, and that relate to a tax year beginning before December 28, 2021.

Observation: The 2021 Final Regulations broaden the scope of the term 'foreign tax redetermination,' and thus further increase the circumstances where taxpayers will be required to file an amended return (or multiple amended returns) for a prior tax year. Treasury and the IRS requested and received comments with respect to alternative ways in which the IRS could administer Section 905(c) but chose not to address the issue in these regulations.

Observation: The preamble to the 2020 Proposed Regulations stated that Treasury and the IRS intended to withdraw Rev. Rul. 70-290 and Rev. Rul. 84-125 when issuing final regulations. The 2021 Final Regulations, however, did not address the withdrawal of these revenue rulings. It is expected that Treasury and the IRS may formally withdraw these rulings after the provisions of the 2021 Final Regulations apply to all taxpayers.

Other issues

Impact of the repeal of Section 902 on certain regulations issued under Section 367(b)

Consistent with the repeal of Section 902, Treasury and the IRS issued proposed regulations under Section 367(b) to clarify the treatment of foreign income taxes of a foreign surviving corporation in post-2017 taxable years. The 2021 Final Regulations provide that all foreign target corporations, foreign acquiring corporations and foreign surviving corporations are treated as non pooling corporations in post-2017 taxable years and that any amounts remaining from pre-2018 are treated as earnings and taxes in a single pre-pooling annual layer in the foreign corporation's post-2017 taxable years. This section applies to taxable years of foreign corporations ending on or after November 2, 2020, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

In addition to the proposed changes to Treas. Reg. sec. 1.367(b)-7, the 2021 Final Regulations remove references to Section 902 in other regulations issued under Section 367(b) that are no longer relevant as a result of the repeal of Section 902.

In general, the changes made to take into account the repeal of Section 902 under the regulations issued under Section 367(b) apply to taxable years of foreign corporations ending on or after November 2, 2020, and taxable years of US shareholders in which or with which such taxable years of foreign corporations end, or exchanges or distributions, as applicable, occurring after November 2, 2020.

Sourcing of inclusions under Sections 951, 951A, and 1293

Upon the removal of Treas. Reg. sec. 1.960-1(h)(1) in the final regulations released on September 29, 2020, (the '2020 Final Regulations') under Section 960, no rule specifies the source of inclusions under Section 951 before the application of Section 904(h)(1). The 2020 Proposed Regulations clarified the source of income inclusions after the removal of former Treas. Reg. sec. 1.960-1(h)(1) by treating amounts included in the gross income of a United States person under Section 951 as dividends received directly from the foreign corporation that generated the inclusion.

The 2020 Proposed Regulations rule differs from former Treas. Reg. sec. 1.960-1(h)(1) in three ways. First, the source of the inclusion is determined by reference to the lower tier-CFC and not treated as a deemed distribution through the first tier CFC. Second, instead of treating the entire amount of the inclusion under Section 951 as derived from foreign sources, the proposed rule treated dividends as being derived from US sources to the extent that the dividend is from a foreign corporation with significant income effectively connected with the conduct of a trade or business in the United States. Third, the rule in the 2020 Proposed Regulations applies for purposes of Sections 861, 862, Treas. Reg. sec. 1.861-1, and Treas. Reg. sec. 1.862-1, while former Treas. Reg. sec. 1.960-1(h)(1) applied only for purposes of Section 904.

In addition, the 2020 Proposed Regulations clarified that the source of a taxpayer's gross income from an inclusion of CFC earnings that are subject to a high rate of foreign tax should be the same, regardless of whether the taxpayer includes the income under subpart F or elects the high-taxed exception of Section 954(b)(4) and repatriates the earnings as a dividend. Finally, the 2020 Proposed Regulations also clarified that the source of Section 78 dividends associated with inclusions under Section 951 follows the rules for sourcing dividends.

The 2021 Final Regulations finalize the sourcing of inclusions provisions included in the 2020 Proposed Regulations without substantive change. The above sourcing rules apply to taxable years ending on or after November 2, 2020.

Oil and gas extraction income from domestic and foreign sources

Treasury and the IRS are concerned that taxpayers with both domestic oil and gas extraction income (DOGEI) and foreign oil and gas extraction income (FOGEI) would be incentivized to minimize their DOGEI in order to maximize their potential Section 250 deduction attributable to FDII while maximizing their FOGEI in order to minimize their gross tested income. Accordingly, language has been added to Treas. Reg. sec. 1.250(b)-1(c)(7) to provide that taxpayers must use a consistent method for purposes of determining both DOGEI and FOGEI. The change set forth in the 2021 Final Regulations is the same as was set forth in the 2020 Proposed Regulations.

The revisions to Treas. Reg. sec. 1.250(b)-1(c)(7) apply to taxable years beginning on or after January 1, 2021.

Electronically supplied services under the Section 250 regulations

Treasury and the IRS determined that the definition of 'electronically supplied services' as currently defined in the regulations applying to foreign-derived deduction eligible income (FDDEI) services could be interpreted in a manner that includes services that were not primarily electronic and automated in nature but rather where the renderer applies human effort or judgment, such as professional services that are provided through the internet or an electric network. The 2020 Proposed Regulations provided a revised definition that the value of the services to the end user must be derived primarily from the service's automation or electronic delivery in order to be an electronically supplied service and specifically excludes legal, accounting, medical or teaching services 'delivered electronically and synchronously'. The 2021 Final Regulations remove the reference to 'and synchronously' from the definition to clarify that the timing of the provision of a service, relative to when the service is accessed by the end user, is not a determinative factor.

Mid-year transfers or reorganizations

The 2021 Final Regulations expand the existing rule under Treas. Reg. sec. 1.901-2(f)(4) that allocates taxes between different technical taxpayers when there is a change in the ownership of a partnership or DRE to cover any entity classification change under US tax law that does not cause the entity's foreign taxable year to close. Furthermore, the rule clarifies that the allocation rules apply not just in the case of multiple covered events of the same type within a continuing foreign taxable year, but also in the case of any combination of covered events.

The 2021 Final Regulations also clarify that withholding taxes paid in the foreign taxable year of a covered event are not subject to allocation. Treasury and the IRS determined that an allocation approach would be inappropriate because it may separate withholding taxes from income that accrues when paid and not achieve the appropriate matching of withholding taxes and related income.

Finally, the 2021 Final Regulations clarify that in the case of a Section 338 election, the allocation of foreign tax between old target and new target is made using the principles of Treas. Reg. sec. 1.1502-76(b). The 2021 Final Regulations also clarify how the allocation is made if there are multiple Section 338 elections during the foreign taxable year with respect to multiple transfers of the stock of target and provide that if a Section 338 election is made for a target that holds an interest in a disregarded entity or partnership, the rules of Treas. Reg. sec. 1.901-2(f)(4) and (5) apply to determine the technical taxpayer. Conforming changes were made with respect to Section 336(e) elections including the proposed rule that withholding taxes are not subject to allocation.

The 2021 Final Regulations finalize the provisions included in the 2020 Proposed Regulations without substantive change. The above provisions apply to foreign income taxes paid or accrued in taxable years beginning on or after December 28, 2021.

Observation: Consistent with the final regulations in which they replace, the methodology for allocating taxes under the 2021 Final Regulations as a result of changes in entity classification or the ownership of a disregarded entity or partnership is based on the respective portions of the taxable income (as determined under foreign law) that are attributable under the principles of Treas. Reg. sec.1502-76(b) to the period of existence or ownership of a predecessor entity or prior owner during the continuing foreign tax year. Under those principles, generally a closing of the books or a pro-rata method may be used. However, taxpayers should consider foreign gross income that is subject to foreign income tax that arises by reason of transactions that are specifically excluded from being considered under a pro-rata method (e.g., 'extraordinary transactions'), as well as withholding taxes, as such taxes are not subject to the new allocation rules.

As noted above, the 2021 Final Regulations did not provide guidance with respect to the following provisions included in the 2020 Proposed Regulations:

- Election to capitalize certain expenses in determining tax book value of assets (i.e., research and experimentation and advertising expenses);
- Direct allocation of interest expense in the case of certain foreign banking branches;
- Definition of financial services income or financial services entity.

Treasury and the IRS are continuing to study the comments received in connection with those provisions.

Treasury and the IRS previously finalized the transition rules contained in the 2020 Proposed Regulations relating to the impact on loss accounts of net operating loss carrybacks to pre-2018 taxable years under Coronavirus Aid, Relief, and Economic Security Act ('CARES' Act). Treas. Reg. sec. 1.904(f)-12(j) was finalized without change in TD 9956, published in the Federal Register (86 FR 52971) on September 24, 2021.

Key applicability dates

Tax years beginning on or after December 28, 2021

- **§ 1.164-2(d).** Disallowance of deduction
- **§ 1.336-2.** Allocation of foreign taxes relating to Section 336(e) election.
- **§ 1.338-9.** International aspects of Section 338
- **§ 1.861-9(g)(3).** Asset method for interest expense with respect to disregarded payments
- **§ 1.861-10(f).** Indebtedness of certain regulated utilities
- **§ 1.861-14(h).** Section 818(f)(1) items of life insurance company for consolidated groups
- **§ 1.861-20(h).** Allocation and apportionment of foreign income taxes
- **§ 1.901-1.** Allowance of credit for foreign income taxes
- **§ 1.901-2.** Creditable foreign income taxes
  - For certain Puerto Rico income tax - tax year beginning on or after 1/1/2023
- **§ 1.903-1.** Taxes in lieu of income taxes
  - For Puerto Rico Excise Tax - tax year beginning on or after 1/1/2023
- **§ 1.905-1.** Timing of FTC claims, provisional credit for contested taxes, correction of improper accrual
- **§ 1.905-3.** Foreign tax redetermination; Change in election to claim a FTC
- **§ 1.951A-2.** Definition of tested income
  - May choose to apply certain paragraphs to tax years beginning after December 31, 2019 and before December 28, 2021
- **§ 1.960-1.** Rules for determining foreign income taxes deemed paid under Section 960
  - For paragraphs (b)(4), (5), and (6), (c)(1), and (d)(3)
- **§ 1.960-2.** Foreign income taxes deemed paid under Sections 960
  - For paragraphs (b)(5) and (c)(7)

Tax years beginning after December 31, 2019, and ending on or after November 2, 2020

- **§ 1.245A(d)-1.** Disallowance of foreign tax credit or deduction in connection with Section 245A DRD
- **§ 1.861-20(d).** Allocation and apportionment of foreign taxes on disposition of stock, partnerships and disregarded payments
- **§ 1.904-4(f).** US activities excluded from foreign branch, and other revisions to coordinate with Section 1.861-20
- **§1.904-6.** Allocation and apportionment of foreign income taxes

Tax years ending on or after November 2, 2020

- **§ 1.367(b)-2, -3, -4(b)(2), -7(g), -10.** Revisions to account for the repeal of Section 902
- **§ 1.861-3(d).** Sourcing of Sections 951, 951A, and 1293 inclusions and 78 gross-ups
- **§ 1.861-8(e)(4)(i).** Expenses attributable to controlled services
- **§ 1.861-10(e)(8).** Withdrawal of CFC netting 'haven' rule

Tax years beginning after December 31, 2017 and ending on or after December 4, 2018.

- **§ 1.904-4(b)(2)(i)(A).** Definition of passive category income

See also

- Tax Readiness Webcast: Impacts of the 2021 final foreign tax credit regulations (January 19, 2022)
- Preliminary highlights from the 2020 final and proposed foreign tax credit regulations (October 12, 2020)

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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