Proposed regulations provided guidance related to the foreign tax credit and foreign derived intangible income (FDII). The proposed rules on the foreign tax credit generally address the following:

1. The disallowance of a credit or deduction for foreign income taxes with respect to dividends eligible for a dividends-received deduction;
2. The allocation and apportionment of interest expense, foreign income tax expense, and certain deductions of life insurance companies;
3. The definition of a foreign income tax and a tax in lieu of an income tax;
4. Transition rules relating to the impact on loss accounts of net operating loss (NOL) carrybacks allowed by the Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136);
5. The definition of foreign branch category and financial services income; and
6. The time at which foreign taxes accrue and can be claimed as a credit.

The proposed regulations also clarify certain rules for determining FDII, such as the definition of domestic and foreign oil and gas extraction income and the definition of electronically supplied service.

Overview of the Proposed Regulations

The proposed regulations address a variety of outstanding issues, most importantly with respect to the existing definition of an income tax. The proposed rules revise aspects of this definition, specifically the net gain requirements, in light of challenges that taxpayers and the IRS have faced in applying the rules.

In addition, the proposed regulations introduce a jurisdictional limitation for purposes of determining whether a foreign tax is an income tax in the U.S. sense. The foreign tax law must require a sufficient nexus between the foreign country and the taxpayer’s activities or investment of capital or other assets that give rise to the income being taxed.

Comment: The clarifications and changes to the net gain requirement and the jurisdictional nexus requirement together are expected to restrict the creditability of foreign taxes.

Further, the proposed regulations address other issues raised in comments or resulting from legislation. For example, the proposed regulations clarify when contested taxes (that is, taxes owed to a foreign government which a taxpayer disputes) accrue for purposes of the foreign tax credit.

Comment: Overall, the proposed rules clarify which foreign taxes are creditable as income taxes, and, with respect to contested taxes, when they are creditable.

Specific Guidance Provided in the Proposed Regulations

The proposed regulations provide specific guidance regarding:

1. The determination of foreign income taxes subject to the credit and deduction disallowance provision of Code Sec. 245A(d);
2. The determination of oil and gas extraction income from domestic and foreign sources and of electronically supplied services under the Code Sec. 250 regulations;
3. The impact of the repeal of Code Sec. 902 on certain regulations issued under Code Sec. 367(b);
4. The sourcing of inclusions under Code Secs. 951, 951A, and 1293;
(5) the allocation and apportionment of interest deductions, including rules for allocating interest expense of foreign bank branches and certain regulated utility companies, an election to capitalize research and experimental expenditures and advertising expenses for purposes of calculating tax basis, and a revision to the controlled foreign corporation ("CFC") netting rule;
(6) the allocation and apportionment of Code Sec. 818(f) expenses of life insurance companies that are members of consolidated groups;
(7) the allocation and apportionment of foreign income taxes, including taxes imposed with respect to disregarded payments;
(8) the definitions of a foreign income tax and a tax in lieu of an income tax, including the addition of a jurisdictional nexus requirement and changes to the net gain requirement, the treatment of certain tax credits, the treatment of foreign tax law elections for purposes of the noncompulsory payment rules, and the substitution requirement under Code Sec. 903;
(9) the allocation of the liability for foreign income taxes in connection with certain mid-year transfers or reorganizations;
(10) transition rules to account for the effect on loss accounts of NOL carrybacks to pre-2018 tax years that are allowed under P.L. 116-136;
(11) the foreign branch category rules in Reg. §1.904-4(f) and the definition of a financial services entity for purposes of Code Sec. 904; and
(12) the time at which credits for foreign income taxes can be claimed pursuant to Code Secs. 901(a) and 905(a).

Proposed Applicability Dates

The proposed regulations generally apply to tax years beginning on or after the date the proposed regulations are published as final regulations. However, consistent with the prospective applicability date in the Code Sec. 250 regulations, the proposed FDII regulations would apply to tax years beginning on or after January 1, 2021.

Certain proposed rules, such as the proposed regulations under Code Sec. 367, among others, would apply to tax years ending on or after the date the proposed rules are filed in the Federal Register. Finally, Proposed Reg. §1.904(f)-12(j)(5) would apply to carrybacks of NOLs incurred in tax years beginning after December 31, 2017, which is consistent with the applicability date in P.L. 116-136 with respect to NOL carrybacks.

Comments and Requests for Public Hearing

Written or electronic comments and requests for a public hearing must be received within 90 days after publication of the proposed regulations in the Federal Register. 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-101657-20) 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. The Department of the Treasury (the "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 paper submissions to: CC:PA:LPD:PR (REG-101657-20), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044.

Proposed Regulations, NPRM REG-101657-20