Regarding Disregarded Payments

*By Layla J. Asali**

I. Introduction

Disregarded entities have been a mainstay of U.S. international tax planning since the promulgation of the check-the-box regulations in 1997, and correspondingly, disregarded payments are prevalent in multinational financing and supply chain structures. This article considers tax policy issues raised by disregarded payments, particularly in light of the Tax Cuts and Jobs Act of 2017 ("TCJA"),[1] and examines the ways that the Treasury Department ("Treasury") and Internal Revenue Service ("IRS") have responded to these issues in TCJA regulations. In general, the TCJA and subsequent guidance have accelerated what had been a nascent trend towards giving effect to, or "regarding," disregarded payments.

A disregarded payment is a payment between a disregarded entity and its owner, or between two disregarded entities owned by the same person. A disregarded payment is generally treated as a payment between divisions of a company and therefore is not taken into account, or is "disregarded," for U.S. federal tax purposes. If the disregarded entity is treated as a corporation or other entity for foreign tax purposes, however, the disregarded payment is regarded and may give rise to items of income, gain, deduction, or loss for foreign tax purposes.

Disregarded payments raise a variety of tax policy issues. From the promulgation of the check-the-box regulations, policymakers have expressed concerns that disregarded payments permitted results under longstanding U.S. international tax rules that were inconsistent with the underlying policies of those rules.[2] For example, disregarded payments may pose tax policy challenges because the payments are regarded for foreign tax purposes, and the differing foreign tax treatment of an item may give rise to a cross-border arbitrage that is targeted by specific provisions of U.S. tax law. Disregarded payments may also pose tax policy challenges because the U.S. foreign tax credit is determined based on the incidence of foreign tax, and disregarded payments can have the effect of creating mismatches between the foreign tax base and the U.S. income tax base. While broad efforts to curb the consequences of the check-the-box rules in the international context have been unsuccessful, in some situations policymakers determined that disregarded payments should be taken into account in some way to achieve U.S. tax policy objectives.

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The TCJA has changed and raised the stakes on tax policy issues surrounding disregarded payments. These issues arise in the context of the Code Sec. 267A anti-hybrid rules, the creation of a separate foreign tax credit limitation for foreign branch category income, the exclusion of foreign branch income from the deduction for foreign-derived intangible income ("FDII"), the implementation of the repeal of Code Sec. 902 and the foreign tax credit for global intangible low-taxed income ("GILTI"), the elective provision for a GILTI high-tax exclusion, and the application of the base erosion and anti-abuse tax ("BEAT") to U.S. branches of foreign corporations. In the TCJA regulations, Treasury and IRS have addressed disregarded payments explicitly in several different contexts, and they have not necessarily taken consistent approaches.

Furthermore, in cases where it is appropriate to take disregarded payments into account, the question of how to do so raises difficult policy and design challenges.

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Part II of this article discusses selected examples of pre-TCJA rules that regard disregarded payments for some purposes. Part III addresses the treatment of disregarded payments in the anti-hybrid rules of Code Sec. 267A and potential extension of these policies to the dual consolidated loss ("DCL") rules of Code Sec. 1503(d). Part IV addresses the treatment of disregarded payments in the TCJA regulations related to the foreign tax credit (which apply for purposes of FDII as well) and GILTI. Part V addresses the treatment of internal dealings under the BEAT.

II. Examples of Pre-TCJA Rules Addressing Disregarded Payments

A. Disregarded Payments Resulting in Cross-Border Arbitrage

Disregarded payments present tax policy challenges in cases where the differing foreign tax treatment of an item may give rise to a cross-border arbitrage. Two examples of pre-TCJA rules that dealt with such situations and took differing approaches to disregarded payments are the DCL rules of Code Sec. 1503(d) and the anti-conduit rules of Reg. §1.881-3.

1. Dual Consolidated Losses

While disregarded payments are not taken into account to determine whether a DCL has been incurred in a foreign branch or disregarded entity, disregarded payments are taken into account to determine whether there has been a "foreign use" of any such DCL. The existence of a DCL is determined based on items of income and loss that are recognized for U.S. tax purposes, so disregarded payments are disregarded. However, a foreign use is determined using foreign tax principles, so the fact that the payment is disregarded for U.S. tax purposes is irrelevant.

Congress enacted the DCL rules to prevent the "double dipping" of losses, based on a determination that "[l]osses that a corporation uses to offset foreign tax on income that the United States does not subject to tax should not also be used to reduce any other corporation's U.S. tax."[3] The DCL rules depend on the application of both U.S. tax principles and foreign tax principles. U.S. tax principles are relevant because the limitation on the use of a DCL to reduce U.S. tax (the "domestic use limitation rule") applies if a foreign branch recognizes a loss for U.S. tax purposes that is made available to offset income of a domestic affiliate.[4] Foreign tax principles are relevant because the exceptions to the domestic use limitation rule depend in part on whether there is (or can be) a "foreign use" of a DCL.[5] A foreign use is defined by reference to foreign tax principles; it occurs "when any portion of a deduction or loss taken into account in computing the DCL is made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws and that is, or would be, considered under U.S. tax principles to be an item of" a foreign corporation.[6]

Under the current DCL regulations, U.S. tax principles apply and disregarded payments are not taken into account in determining whether a DCL exists.[7] In determining whether there is a DCL attributable to a disregarded entity, the relevant items of income, gain, deduction, and loss are those reflected on the books and records of the entity, "as adjusted to conform to U.S. tax principles."[8] Therefore, even though a payment between

a foreign disregarded entity and its foreign owner is reflected on the books and records of the entity (and presumably taken into account for foreign tax purposes), the books and records must be adjusted to disregard the disregarded payment for purposes of determining whether there is a DCL.[9]

However, once it is established that there is a DCL, disregarded payments are taken into account in determining whether there has been a "foreign use" of such DCL. A disregarded payment may give rise to an indirect foreign use if the items resulting from the disregarded payment have the effect of making an item of deduction composing the DCL available for foreign use.[10] The rules for indirect foreign use do not apply in the case of ordinary course transactions that do not have a principal purpose of avoidance of Code Sec. 1503(d), but the regulations provide that a disregarded interest payment that is regarded for foreign tax purposes "shall be deemed to have been incurred, or taken into account, with a principal purpose of avoiding the provisions of section 1503(d)."[11]

2. Reg. §1.881-3 Anti-Conduit Rules

The anti-conduit rules were promulgated pursuant to Code Sec. 7701(l) to address the use of multiple-party financing arrangements to avoid U.S. withholding tax that would have been due on a direct financing arrangement between the ultimate provider and ultimate U.S. recipient of the financing. In general, the rules ignore the participation of an intermediate entity where: (1) there are two or more financing transactions linked by the intermediate entity, (2) the participation of the intermediate entity reduces U.S. withholding tax, and (3) the participation of the intermediate entity was pursuant to a tax avoidance plan. The rules are intended to address back-to-back financings through an intermediate entity that is eligible for a lower rate of withholding tax than the ultimate provider of the financing on U.S. source payments under a tax treaty or otherwise. The policy objective of these rules is to prevent foreign persons that are not eligible for a reduced rate of withholding tax from routing payments through an intermediate entity that is so eligible. An underlying premise of the rules is that the use of an intermediate entity is inappropriate in cases where the intermediate entity is not subject to meaningful local tax on the payment it receives from U.S. sources because it is permitted a deduction for an offsetting payment on a second financing transaction.

Regulations issued in 2011 generally regard a disregarded entity as a person for purposes of the anti-conduit rules, thereby giving effect to otherwise disregarded financing transactions and payments between a disregarded entity and its owner.[12] These regulations were aimed at fact patterns in which U.S. source payments were routed through a hybrid entity that was a tax resident in a treaty jurisdiction, and therefore eligible for benefits under a U.S. tax treaty, but was disregarded for U.S. tax purposes.[13] Ignoring disregarded payments to or from disregarded entities that are effectively regarded as entities for purposes of treaty qualification would be inconsistent with the purpose of the anti-conduit rules.

B. Use of Disregarded Payments to Change the Incidence of Foreign Tax

Disregarded payments may also raise tax policy challenges because the U.S. foreign tax credit is determined based on the incidence of foreign tax, and disregarded payments can have the effect of separating foreign taxes from related income for U.S. tax purposes. This concern arose in the context of foreign tax credit splitter transactions, targeted by Congress in 2010 with the enactment of Code Sec. 909.

1. Partnership Inter-Branch Splitter Arrangements

Pursuant to prior regulations under Code Sec. 704(b), disregarded payments between disregarded entities owned by a partnership could be used to allocate foreign taxes to a partner other than the partner to which the related income was allocated. In particular, former Reg. §1.704-1(b)(4)(viii)(d)(3) provided that if a branch of a partnership was required to include in income under foreign law a disregarded payment from another branch of the partnership, foreign taxes (*i.e.*, creditable foreign tax expenditures or CFTEs) imposed with respect to the disregarded payment were considered related to the income in the CFTE category of the recipient branch. Because the inter-branch payment was disregarded for U.S. federal income tax purposes, however, the income related to the CFTEs imposed on the disregarded payment remained for U.S. tax purposes in the income of the payor branch. By permitting CFTEs and related income to be allocated to different CFTE categories, the rule had the potential effect of permitting an allocation of CFTEs and related income to the partners "in a manner that separates the CFTEs from the related income" and thereby could result

in foreign income taxes being allocated to a different partner than the partner to whom the related income is allocated.[14]

Temporary regulations issued in connection with the enactment of Code Sec. 909 revised the regulations under Code Sec. 704(b) to remove the prior rule regarding inter-branch payments and to prevent allocations that would result in a "separation of taxes and related income from satisfying the safe harbor" for allocations deemed to be in accordance with the partners' interest in the partnership.[15]

Treasury and IRS issued additional temporary regulations in 2016 and final regulations in 2019 addressing the allocation of CFTEs, including in relation to disregarded payments. Under these regulations, if a partnership makes allocations to give economic regard to disregarded payments between branches, the income related to the CFTEs (*i.e.*, income in a CFTE category) is similarly allocated. Under the 2019 final regulations, CFTEs are allocated to categories of net income of the partnership.[16] A partnership's net income in a CFTE category is determined by assigning partnership items attributable to its activities within the relevant CFTE category.[17] The regulations provide specifically with respect to disregarded payments:

> An item of gross income is assigned to the activity that generates the item of income that is recognized for U.S. Federal income tax purposes. Consequently, disregarded payments are not taken into account in determining the amount of net income attributable to an activity, although a special allocation of income used to make a disregarded payment may result in the subdivision of an activity into two divisible parts.[18]

The final regulations further provide that "income from a divisible part of a single activity is treated as income from a separate activity if necessary to prevent separating CFTEs from the related foreign income, such as when income from divisible parts of a single activity is subject to different allocations."[19]

These regulations can be thought of as regarding disregarded payments, but the preamble disavows this characterization. The preamble notes that a comment requested that the rules be clarified to provide more explicitly that "disregarded payments between CFTE categories are taken into account in computing the net income in a CFTE category."[20] Although such an approach might have been a more straightforward way of ensuring that foreign taxes relating to partnership disregarded payments are not separated from income, as noted above, the final regulations state explicitly that disregarded payments are not taken into account in determining net income. Under the approach taken in the final regulations, disregarded payments can result in an activity "being subdivided and the subdivided portions being assigned to different CFTE categories."[21] The preamble observes:

> In other words, while the 2016 temporary regulations do not literally provide that a disregarded payment "reduces" the net income in a CFTE category in that case, the 2016 temporary regulations provide for a result similar to the result suggested by the comment by instead subdividing an activity and then assigning one sub-activity to a different CFTE category. This approach is more consistent with the fact that income items are determined based on regarded items and not disregarded items, including disregarded payments.[22]

2. Loss-Sharing Splitter Arrangements

The regulations under Code Sec. 909 also apply to disregarded payments to the extent those payments create foreign tax losses that can be shared outside the "U.S. combined income group" of the payor with the effect that foreign taxes are separated from related income for U.S. tax purposes.[23] Under these regulations, a loss-sharing splitter arrangement occurs "to the extent that a shared loss of a U.S. combined income group could have been used to offset income of that group in the current or in a prior foreign taxable year (usable shared loss) but is used instead to offset income of another U.S. combined income group."[24] A U.S. combined income group is an individual or a corporation and all disregarded entities or partnerships whose income and deductions are combined with the income and deductions of the individual or corporation.[25] For this purpose, a branch is treated as an entity.[26] The income and loss of a U.S. combined income group is determined using foreign tax principles.[27]

Because a shared loss is determined using foreign tax principles, a disregarded transaction can give rise to a shared loss for purposes of Code Sec. 909. A shared loss might occur if, for example: CFC1 owns DRE1 and DRE2, DRE1 lends funds to DRE2, and DRE2 uses the loan proceeds to equity fund a subsidiary, CFC2. In this example, DRE2's interest expense generates a local country loss and DRE1 generates an offsetting amount

of income in the local country. For U.S. tax purposes, CFC1 is considered to pay the tax imposed on DRE1. If DRE2 could under foreign law share its loss with DRE1, a member of its U.S. combined income group, the loss would be a usable shared loss. If instead DRE2 shares its loss with CFC2, which is outside its U.S. combined income group, the loss sharing would give rise to a foreign tax credit splitting event.

From a U.S. tax perspective, the local law loss of DRE2 does not exist; it results from a disregarded payment. The foreign tax credit splitter rules, however, take this loss into account because it has been used to change the incidence of foreign tax (from CFC1 to CFC2 in the example) in a way that separates the foreign tax from the related income.

3. Deductible Disregarded Payments

The Code Sec. 909 regulations also include a rule that taxes paid or accrued with respect to a disregarded payment that is deductible under foreign law are subject to Code Sec. 909 if the payor of the disregarded payment is subject to foreign tax on related income from a splitter arrangement.[28] This rule prevents a taxpayer that engages in a splitter arrangement from reducing the amount of split tax by making a disregarded deductible payment that results in the recipient of the disregarded payment paying a withholding tax. In such a case, the withholding tax acts as a substitute for a portion of the foreign income tax that is subject to Code Sec. 909, and the disregarded payment was used to shift the incidence of the split tax to the recipient of the disregarded payment.

III. TCJA Anti-Hybrid Rules and Disregarded Payments

The Code Sec. 267A anti-hybrid rules disallow a U.S. deduction for interest or royalties paid in connection with a hybrid transaction. These rules address cross-border arbitrage in the form of double deduction or deduction/no inclusion scenarios identified by Action 2 of the OECD's Base Erosion and Profit Shifting ("BEPS") project. Because disregarded payments can be used to achieve these double deduction and deduction/no inclusion outcomes, the final regulations promulgated under Code Sec. 267A in 2020 (the "Final Section 267A Regulations") provide specific rules targeting the use of disregarded payments to achieve hybrid deductions that are disallowed under Code Sec. 267A.[29]

A. Hybrid Transactions Resulting from Disregarded Payments

Code Sec. 267A(c) defines a "hybrid transaction" as one in which payments are treated as interest or royalties for U.S. federal tax purposes but "which are not so treated for purposes [of] the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax." The statute thereby compels the identification of transactions that are treated in one way for purposes of foreign tax law and a different way for purposes of U.S. tax law. The regulations under Code Sec. 267A include specific rules addressing disregarded payments, but these rules generally refer to payments that constitute "disregarded payments" from a foreign law perspective, not from a U.S. perspective, because in order for Code Sec. 267A to apply, there must be a deduction for U.S. federal tax purposes. A payment that is a disregarded payment from a U.S. perspective does not give rise to a deduction for U.S. tax purposes.

Specifically, the Final Section 267A Regulations define a "disregarded payment" as "a specified payment to the extent that, under the tax law of a tax resident or taxable branch to which the payment is made, the payment is not regarded (for example, because under such tax law it is a payment involving a single taxpayer or members of a group) and, were the payment to be regarded (and treated as interest or a royalty, as applicable) under such tax law, the tax resident or taxable branch would include the payment in income …."[30] As such, a disregarded payment results in a deduction/no inclusion outcome.[31] As a result, a disregarded payment can give rise to a disqualified hybrid amount that results in deduction disallowance under Code Sec. 267A.[32]

The Final Section 267A Regulations include an example illustrating the disregarded payment rule. In the example, a domestic corporation, US1, is, for foreign tax purposes, a disregarded entity of its owner, a Country X corporation, FX. US1 is regarded as a domestic corporation for U.S. federal tax purposes. US1 pays an amount that is treated as interest for U.S. federal tax purposes to FX, but the payment is disregarded for Country X tax purposes "as a transaction involving a single taxpayer."[33] The example concludes that the interest payment is a disregarded payment and the U.S. tax deduction is subject to disallowance under Code Sec. 267A as a disqualified hybrid amount.[34]

The preamble to the Final Section 267A Regulations also characterizes "interest-free loans" as an example of a disregarded payment under the Proposed Section 267A

Regulations. An interest-free loan is an instrument that is treated as debt for both U.S. and foreign tax purposes but provides no stated interest. If the issuer is allowed an imputed interest deduction under its tax law, but the holder is not required to take into account imputed interest income under its tax law, the result is a deduction/no inclusion outcome. The preamble to the Final Section 267A Regulations states that the disregarded payment rule of the proposed regulations was intended to apply to such an instrument "[b]ecause the imputed interest deduction is not regarded under the tax law of the holder of the instrument."[35] In fact, however, there is no payment in these arrangements so it is difficult to characterize them as disregarded payments. Perhaps recognizing that the disregarded payment rule is not well suited to apply to interest-free loans, the Final Section 267A Regulations define imputed interest on interest-free loans as hybrid transactions and do not apply the disregarded payment rule to such transactions.[36]

B. Reconsideration of Treatment of Disregarded Payments in DCL Rules

The approach taken towards disregarded payments in the Final Section 267A Regulations caused Treasury and IRS to reconsider the approach previously taken towards disregarded payments in the DCL rules. The preamble to the Proposed Section 267A Regulations observes that a deduction/no inclusion outcome could result from "similar structures involving payments to domestic corporations that are regarded for foreign tax purposes but disregarded for U.S. tax purposes."[37] In raising this concern, the preamble to the Proposed Section 267A Regulations describes the following example. USP (the domestic parent of a consolidated group) borrows from a bank to fund the acquisition of FT, a foreign corporation that is tax resident of Country X. USP contributes the loan proceeds to USS, a newly formed member of the USP consolidated group. USS forms FDE, a disregarded entity that is tax resident of Country X. USS lends the loan proceeds to FDE, and FDE uses the proceeds to acquire the stock of FT. For U.S. tax purposes, USP deducts interest paid on the bank loan, and USS does not recognize interest income from the disregarded loan to FDE. However, for Country X tax purposes, the interest paid by FDE to USS is regarded and gives rise to a loss that can be surrendered (through group relief or a foreign consolidation regime) to offset the operating income of FT.[38]

The preamble to the Proposed Section 267A Regulations observes that under the current Code Sec. 1503(d) regulations, the disregarded loan from USS to FDE does not give rise to a DCL "because interest paid on the loan is not regarded for U.S. tax purposes" and because the regarded interest expense of USP is not attributed to FDE.[39] The preamble observes further that the result would generally be the same if USS were the obligor on the bank loan, citing Reg. §1.1503(d)-7(c), Example 23. Although this result under the current regulations is clear, the preamble states that Treasury and IRS are studying these transactions because they "raise significant policy concerns that are similar to those relating to the [deduction/no inclusion] outcomes addressed by sections 245A(e) and 267A, and the double-deduction outcomes addressed by section 1503(d)."[40]

Although the concern raised by Treasury and IRS regarding the current DCL regulations relates to the potential deduction/no inclusion outcome, the approach to disregarded payments in the DCL regulations can also create what is arguably a phantom DCL in fact patterns where the disregarded payment would be an item of income of the foreign disregarded entity rather than an item of deduction. For example, assume USP owns FDE, a disregarded entity that is tax resident of Country X. FDE provides services to USP, and USP makes a payment to FDE to compensate FDE for those services. FDE's books and records reflect the revenue from USP, as well as expenses arising from payments to third parties in the ordinary course of its business. From a Country X tax perspective, FDE is profitable and pays local tax. But from a U.S. tax perspective, FDE has losses because the services income it receives from USP is disregarded. The losses are considered a DCL and are subject to the domestic use limitation rules of Code Sec. 1503(d).[41] Alternatively, if the disregarded payment were instead a payment between FDE and another member of the USP consolidated group, FDE's services income would be taken into account and there would be no DCL, absent redetermination under the matching rule of Reg. §1.1502-13(c).[42]

The Final Section 267A Regulations do not resolve these concerns. The preamble to the Final Section 267A Regulations states that Treasury and IRS "continue to study disregarded payment structures" and may issue guidance in the future.[43] The preamble states that Treasury and IRS are also studying the interaction of the DCL rules and the matching rule of Reg. §1.1502-13(c).[44]

C. Assessment

The enactment of Code Sec. 267A may have softened the government's longstanding reluctance to regard

disregarded payments in the context of the DCL rules. One question in considering whether and how to address the policy concerns identified by Treasury and the IRS is whether those concerns could most effectively be addressed through an anti-abuse rule that disallows or limits deductions, or through a more generally applicable rule regarding disregarded payments. While an anti-abuse rule could be tailored to target specific fact patterns, it may require a principal purpose or similar facts and circumstances test that may be difficult to administer. Furthermore, the anti-abuse approach would leave the case of a foreign branch with disregarded income and a phantom DCL as a trap for the unwary.

IV. TCJA Foreign Tax Credit and GILTI Regulations and Disregarded Payments

A. Foreign Branch Income Under the TCJA

The TCJA introduced the concept of "foreign branch income" in two provisions: the separate foreign tax credit limitation for foreign branch income in Code Sec. 904(d)(1)(B) and the exclusion of foreign branch income from deduction eligible income for purposes of FDII in Code Sec. 250(b)(3)(A)(i)(VI). In both cases, although Congress expressed a clear intent to identify and target foreign branch income, the underlying policy rationale is less clear. The rules immediately raised questions regarding the treatment of disregarded payments because disregarded payments may have an effect on the foreign tax base of a foreign branch, and because they may reflect economic activity within a foreign branch. Ignoring disregarded payments would potentially distort foreign branch income, if foreign branch income is understood to relate to economic activity in the branch or the likelihood that a foreign country will tax such income. The foreign tax credit proposed regulations issued in 2018 (the "2018 Proposed FTC Regulations")[45] and final regulations issued in 2019 (the "2019 Final FTC Regulations")[46] tackle these issues (for purposes of both the foreign tax credit and FDII) by providing that disregarded payments between a branch owner and a branch can result in reattribution of income to and from a foreign branch.[47]

1. Policies Underlying Foreign Branch Income

The policy underlying the enactment of Code Sec. 904(d)(1)(B), which created the separate category for foreign branch income, is unclear, except that the obvious immediate purpose of a Code Sec. 904(d) category is to permit crediting of foreign taxes on foreign income within the category, and to prevent cross-crediting of such foreign taxes against income in other categories. The Senate Budget Committee report issued in connection with the TCJA provides as follows in the "Reasons for Change":

> Under present law, multinational enterprises have the ability to cross-credit foreign taxes attributable to low-tax subpart F income with those attributable to high-tax branch income and minimize overall tax liability. Changing the U.S. international tax system from a worldwide system of taxation to a participation exemption system of taxation exacerbates the incentive under present law to shift profits abroad. The Committee believes that this provision would operate to prevent excess foreign taxes credits generated in high-tax branch countries to be used to reduce U.S. tax owed on income generated in a low-tax country.[48]

It is unclear why Congress was concerned about the cross-crediting of taxes on foreign branch income against taxes on subpart F income. Such cross-crediting was permitted under pre-TCJA law, and the taxation of foreign branch income and subpart F income was not otherwise changed by the TCJA. The cross-crediting of foreign taxes against GILTI is separately prohibited by the separate foreign tax credit limitation for GILTI.[49] Nonetheless, the purpose of the foreign branch income category is clearly to prevent cross-crediting. There is no indication of Congress's view of the proper treatment of foreign taxes on disregarded payments in this regard.

The policy underlying the exclusion of foreign branch income from deduction eligible income in Code Sec. 250 is also unclear. Although to some extent the GILTI and FDII regimes were designed to subject a U.S. corporation to the same rate of U.S. tax on foreign "intangible" income, whether earned directly or in a CFC, this principle does not seem to apply to income earned through foreign branches. Unlike GILTI or FDII, intangible income earned by a U.S. corporation through a foreign branch is subject to the full corporate income tax rate. It is possible that the exclusion of foreign branch income

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from FDII was intended to encourage the movement of economic activity from foreign countries to the United States, particularly in cases where losses from such activities were deductible against the U.S. tax base. In this regard, the Senate Budget Committee provides as follows in its "Reasons for Change" relating to FDII:

> One of the Committee's goals in tax reform is to remove the tax incentive to locate intangible income abroad and encourage U.S. taxpayers to locate intangible income, and potentially valuable economic activity, in the United States."[50]

Given the lack of clarity around the legislative policies underlying the rules for foreign branch income in the foreign tax credit rules and in the FDII regime, commenters to the 2018 Proposed FTC Regulations recommended that Treasury and IRS provide a "discussion of the tax policy considerations relevant to proposed §1.904-4(f)."[51] The preamble to the 2019 Final FTC Regulations includes such a discussion and provides that Treasury and IRS "balanced various policy objectives" in drafting regulations regarding the attribution of business profits to a qualified business unit ("QBU") to determine foreign branch income as defined in Code Sec. 904(d)(2)(J)(i), including:

> Attributing gross income to a foreign branch in a manner that is commensurate with its business activities; administrability for taxpayers and the IRS; conformity with local country tax law; and giving effect to the policies of sections 250(b)(3)(A)(i)(VI) and 904(d)(1)(B), which limit, respectively, the deduction under section 250 and the allowance of a credit under section 901 by reference to the amount of business profits attributable to a QBU.[52]

It has been observed that the last policy objective listed is somewhat of a tautology because it simply refers to the "policies" of the statutory provisions, "pointedly failing to indicate what those policies might be."[53]

2. Disregarded Payment Reattribution Rules

The opacity of the policies notwithstanding, the 2019 Final FTC Regulations define "foreign branch category income" for purposes of both Code Sec. 904(d) and Code Sec. 250 and provide rules addressing the treatment of disregarded payments. As a general rule, the regulations treat gross income as foreign branch income "to the extent the gross income (as adjusted to conform to Federal income tax principles) is reflected on the separate set of books and records … of the foreign branch."[54] The 2019 Final FTC Regulations include several exceptions, including exceptions for income attributable to U.S. activities, income arising from stock, and income arising from a disposition of interests in a partnership or disregarded entity.[55]

The general rule looking to income reflected on the branch's books and records is broadly consistent with the more specific policy objectives identified in the preamble: it is likely to capture income commensurate with the business activities of the branch, it is administrable for taxpayers and the IRS, and it is likely to conform to some degree with local country tax law.

Disregarded payments between a branch owner and a disregarded entity or foreign branch, or between disregarded entities or foreign branches owned by a single owner, do appear on a branch's books and records. However, absent an additional rule for disregarded payments, these payments would not constitute foreign branch income under the general rule because Reg. §1.904-4(f)(2)(i) requires income reflected on the books and records of the branch to be "adjusted to conform to Federal income tax principles." Such conformity would typically include an adjustment to disregard disregarded payments because such payments are not taken into account for U.S. federal tax purposes.[56] The 2019 Final FTC Regulations therefore adopt special rules for disregarded payments in Reg. §1.904-4(f)(2)(vi) that result in the reattribution of items to and from the foreign branch income category.

One key feature of the reattribution rules is that they apply only for purposes of assigning income to foreign branch category income or general category income.[57] The 2019 Final FTC Regulations provide:

> [Reattribution] does not change the total amount, character, or source of the United States person's gross income; does not change the amount of a United States person's income in any separate category other than the foreign branch and general categories …; and has no bearing on the analysis of whether an item of gross income is eligible to be resourced under an income tax treaty.[58]

When the reattribution rules were proposed in the 2018 Proposed FTC Regulations, the preamble explained that the regulations "do not treat disregarded transactions as 'regarded' for Federal income tax purposes; rather, they provide that certain disregarded transactions result in a redetermination of whether gross income of the United

States person is attributable to its foreign branch or to the foreign branch owner."[59]

In providing that the reattribution rules affect only the Code Sec. 904(d) category and not character or source, Treasury and IRS rejected the suggestions of commenters that had requested that the character and source of income that is reattributed under these rules "be determined by reference to the disregarded transaction giving rise to the reattribution."[60] For example, if a foreign branch owner earned U.S. source sales or royalty income from third parties, and made a disregarded payment to its foreign branch for services performed that were allocable to the U.S. source income, the result would be a reattribution of U.S. source income to the foreign branch and the reattribution would not increase the taxpayer's limitation in the foreign branch income category.[61] In the 2019 Final FTC Regulations, Treasury and IRS rejected these comments on the basis that Code Sec. 904(d) relates to the "separate application of section 904 with respect to certain categories of regarded gross income of a taxpayer."[62] The preamble to the 2019 Final FTC Regulations expresses concern about the crediting of foreign taxes against U.S. source income, and the risk that taxpayers could manipulate the foreign source income limitation of Code Sec. 904 by increasing foreign source income through transactions with foreign branches.[63]

Although Treasury and IRS stop short of fully "regarding" disregarded payments in these reattribution rules, the effect in many cases is to take disregarded payments into account for purposes of determining foreign branch income. The preamble to the 2019 Final FTC Regulations describes the policy for the disregarded payment rule in terms of the overall policies animating its interpretation of the term "foreign branch income":

> [T]he Treasury Department and the IRS have determined that the disregarded payment rule furthers the various policies related to the attribution of gross income to a foreign branch. The disregarded payment rules are designed to utilize information that is already available to taxpayers, making the rule more administrable. Taking disregarded payments into account will also give effect to the economic activity of a foreign branch (or a foreign branch owner) while reducing mismatches between the amount of gross income attributable to a foreign branch and the foreign tax base.[64]

In other words, Treasury and IRS are of the view that disregarded payments should be taken into account in some way in determining foreign branch income because such an approach is administrable (given that the amounts are reflected on books and records) and gives effect to economic activity of the foreign branch, and because it is likely that the foreign country treats disregarded payments as regarded items of income and deduction for purposes of its local income tax. If the foreign branch income category is to be interpreted to include income that is likely to be subject to foreign tax as income of the branch, it is necessary to give effect in some way to disregarded payments.

3. Application of the Disregarded Payment Reattribution Rules

The disregarded payment reattribution rules can result in the reattribution of income between the general category and the foreign branch category in the case of disregarded payments between a foreign branch and foreign branch owner, or between foreign branches owned by a single foreign branch owner. The regulations define a disregarded payment for purposes of the reattribution rules as an amount "transferred to or from a disregarded entity in connection with a transaction that is disregarded for Federal income tax purposes and that is reflected on the separate set of books and records of a foreign branch," or other amounts reflected on the books and records of a foreign branch, distributions to or contributions from the foreign branch owner, or payments in exchange for property "if the transaction to which the amount is attributable were regarded for Federal income tax purposes."[65]

If a foreign branch makes a disregarded payment to its foreign branch owner and the disregarded payment is allocable to gross income that would be attributable to the foreign branch under the ordinary rules defining foreign branch income, "the gross income attributable to the foreign branch is adjusted downward to reflect the allocable amount of the disregarded payment, and the gross income attributable to the foreign branch owner is adjusted upward by the same amount."[66] A disregarded payment is considered allocable to gross income attributable to the foreign branch "to the extent a deduction for that payment or any disregarded cost recovery deduction relating to that payment, if regarded, would be allocated and apportioned to gross income attributable to the foreign branch" under the principles of Code Sec. 861 by treating foreign source gross income and U.S. source gross income in each separate category each as a statutory grouping.[67]

Conversely, if a foreign branch owner makes a disregarded payment to its foreign branch and the disregarded payment is allocable to gross income attributable to the foreign branch owner, "the gross income attributable to

the foreign branch owner is adjusted downward to reflect the allocable amount of the disregarded payment, and the gross income attributable to the foreign branch is adjusted upward by the same amount."[68] And, likewise, disregarded payments from a foreign branch owner to its foreign branch are allocable to gross income attributable to the foreign branch owner "to the extent a deduction for that payment or any disregarded cost recovery deduction relating to that payment, if regarded, would be allocated and apportioned to gross income attributable to the foreign branch owner" under Code Sec. 861 principles.[69]

Similar rules apply to disregarded payments between foreign branches owned by the same foreign branch owner if either foreign branch makes a disregarded payment to, or receives a disregarded payment from, the foreign branch owner.[70] The regulations provide for ordering rules in these situations.[71]

The regulations separately address disregarded payments made in connection with the sale or exchange of property. These rules are, on the one hand, complex (as compared to disregarding a transaction), but, on the other hand, intuitive once the decision is made to regard the transaction and apply normal tax principles to determine its consequences. In the case of a disregarded sale of non-inventory property, disregarded payments are allocable to gross income recognized with respect to a regarded sale or exchange of that property "to the extent of the adjusted disregarded gain with respect to the transferred property."[72] The 2018 Proposed FTC Regulations did not include rules relating to disregarded payments that would give rise to cost recovery deductions or disregarded sales of depreciable property. In response to comments, the 2019 Final FTC Regulations introduced detailed rules relating to disregarded sales of property that reattribute gross income when basis would be recovered through depreciation, amortization, or other disregarded cost recovery deductions.[73] In the case of a disregarded sale of inventory property, similar rules apply "to the extent the disregarded payment, if regarded, would, for purposes of determining gross income, be subtracted from gross receipts that are regarded for Federal income tax purposes."[74] In each case, the timing of the reattribution of income to or from the foreign branch income category occurs "only in the taxable year or years in which gain is recognized by reason of the disposition of property with an adjusted disregarded basis in a transaction that is regarded for Federal income tax purposes."[75]

If the disregarded payment reattribution rules apply, the amount of any disregarded payment that results in a reattribution of income "must be determined in a manner that results in the attribution of the proper amount of gross income to each of a foreign branch and its foreign branch owner under the principles of section 482, applied as if the foreign branch were a corporation."[76]

The disregarded payment reattribution rules do not apply to certain types of disregarded payments. No reattribution results from a remittance from a foreign branch to its owner or from a contribution by the foreign branch owner to its foreign branch.[77] Further, no reattribution results from disregarded payments of interest or interest equivalents that, if regarded, would be described in Reg. §§1.861-9(b) and 1.861-9T(b).[78] The preamble to the 2018 Proposed FTC Regulations states that disregarded interest payments reflect a shift of, or return on, capital, rather than business profits.[79] Although Treasury and IRS received comments disputing this assessment, the 2019 Final FTC Regulations retained the rule excluding disregarded interest payments from the disregarded payment reattribution rules. Treasury and IRS observed that disregarded interest payments could otherwise be used to "strip" the foreign branch category and manipulate the limitations in Code Secs. 250(b)(3)(A)(i)(VI) and 904(d)(1)(B).[80] The preamble to the 2019 Final FTC Regulations also expresses concern that a "taxpayer seeking to increase foreign branch category income could instead borrow money from the foreign branch and shift income from the general category through disregarded interest payments made to the foreign branch."[81] Finally, no reattribution results from a disregarded payment made to a foreign branch that, if regarded, could not result in foreign branch income under the general rules defining foreign branch income.[82]

4. Reattribution of Deemed Disregarded Payments for Intangible Property

The 2019 Final FTC Regulations include a much commented-upon rule for transfers of intangible property. This rule provides that although remittances and contributions generally do not give rise to the reattribution of income to or from the foreign branch category, gross income in the foreign branch category must be adjusted under the principles of the disregarded payment reattribution rules "to reflect all transactions that are disregarded for Federal income tax purposes in which property described in section 367(d)(4) is transferred to or from a foreign branch or between foreign branches, whether or not a disregarded payment is made in connection with the transfer."[83] The amount of any adjustment under this rule is determined using "the principles of sections 367(d) and 482."[84] As a result, the rule applies to remittances or contributions of intangible property and deems the foreign branch or foreign branch owner to

make "annual payments contingent on the productivity or use of the property, the amounts of which are determined under the principles of section 367(d)."[85]

Comments to the 2018 Proposed FTC Regulations requested that this intangible property rule be withdrawn, citing several policy objections. Of particular interest is the suggestion that foreign countries would not allow a deduction for Code Sec. 367(d) deemed payments from a foreign branch to a foreign branch owner and "the intangible property rule would result in mismatches between the gross income attributable to a foreign branch and the gross income of the foreign branch for foreign tax purposes."[86] The 2019 Final FTC Regulations, however, retained the intangible property rule, acknowledging that while the rule "may increase compliance burdens and increase the disparity between the gross income attributable to a foreign branch and the gross income taxable by a foreign country," the benefits of the rule outweigh those concerns.[87] The principal benefit cited is the protection against "manipulation" of foreign branch income through the taxpayer's ability to structure a disregarded transaction as a remittance or contribution, on the one hand, or a sale, exchange, or license, on the other hand.[88]

The application of the intangible property rule to transfers by the foreign branch to the foreign branch owner has the effect of reattributing income from the foreign branch owner to the foreign branch. It is unlikely that a foreign country would take such deemed income into account for foreign tax purposes. Furthermore, if the income of the foreign branch owner to which deemed royalty is allocable is U.S. source income, the reattribution may result in U.S. source income in the foreign branch category. The result does not appear to be premised on policies related to cross-crediting. Rather, it appears more likely that the concern animating the application of this rule to remittances of intangible property arises from concerns that such remittances could be used to avoid the Code Sec. 250 limitation on foreign branch income.

5. Allocation of Foreign Taxes to Foreign Branch Income

The 2019 Final FTC Regulations provide rules for the allocation and apportionment of foreign taxes to foreign branch category income. Generally, foreign tax reflected on the books and records of a foreign branch is allocated and apportioned to the category of income to which it relates under Reg. §1.904-6. Accordingly, in the case of a disregarded payment that results in gross income being reattributed to or from the foreign branch under the reattribution rules described above, any foreign tax imposed solely by reason of the disregarded transaction is allocated and apportioned to the reattributed gross income.[89]

Disregarded payments that do not result in the reattribution of income are subject to different rules, depending on whether the payment is from the foreign branch to the foreign branch owner or from the foreign branch owner to the foreign branch. A foreign tax imposed on such a disregarded payment from a foreign branch to a foreign branch owner is allocated and apportioned "based on the nature of the item (determined under Federal income tax principles) that is included in the foreign tax base."[90] For example, foreign tax imposed with respect to the recognition of gain on appreciated property that is remitted to the foreign branch owner is allocated and apportioned to the separate category to which the gain would be allocated if it were recognized for U.S. federal tax purposes. On the other hand, a gross basis withholding tax on a remittance is considered a timing difference in taxation of the income out of which the remittance is made, and is allocated and apportioned based on the tax book value of foreign branch assets under the principles of Reg. §1.987-6(b).[91] A foreign tax imposed on receipt of a disregarded payment from a foreign branch owner to a foreign branch is allocated and apportioned to the foreign branch income category.[92]

6. Assessment

The guiding principles animating the treatment of disregarded payments for purposes of determining foreign branch category income in the 2019 Final FTC Regulations are reasonable. To a large extent the rules are motivated by a policy of reattributing income to a foreign branch when it is likely that the foreign country will tax such income, and reattributing income from a foreign branch to a foreign branch owner when it is not likely that the foreign country will tax such income. This policy is broadly consistent with a policy of preventing double taxation by permitting a foreign tax credit within a Code Sec. 904(d) category. On the other hand, the fact that disregarded payments are not truly regarded and the source of income that is reattributed to the foreign branch category is not affected by the reattribution means that U.S. source income may be assigned to the foreign branch category, which may artificially limit the creditability of foreign taxes on income earned outside the United States. In addition, the rules that give rise to deemed disregarded payments under Code Sec. 367(d) with respect to transfers of intangible property are likely to create mismatches between the foreign branch category and the incidence of foreign tax. It may be that

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these rules are animated more by policies relating to the location of economic activity and the Code Sec. 250 deduction than by policies relating to the foreign tax credit, just as the Code Sec. 367(d) rules themselves were motivated by policies outside of the foreign tax credit.

B. Code Sec. 902 Repeal and the GILTI Foreign Tax Credit

The TCJA's repeal of Code Sec. 902 and amendments to Code Sec. 960 have led to a new emphasis on connecting foreign taxes to items of income in the 2018 Proposed FTC Regulations, 2019 Final FTC Regulations, and the foreign tax credit regulations proposed in December 2019 (the "2019 Proposed FTC Regulations"[93]). The result is a general trend towards a deemed paid foreign tax credit that applies at the level of an item of income or an income group. This approach has led Treasury and IRS to provide additional guidance on the allocation and apportionment of foreign taxes, including foreign taxes on disregarded payments, in the 2019 Proposed FTC Regulations. Although the relevance of disregarded payments to GILTI and the GILTI foreign tax credit are not immediately apparent in the text of the TCJA, Treasury's interpretation and administration of the GILTI foreign tax credit has made it critical to associate foreign taxes with items of income that comprise GILTI. Because foreign taxes not attributable to tested income or subpart F income cannot be credited, longstanding uncertainty associated with characterizing foreign taxes on disregarded payments has taken on new importance.

1. The GILTI Foreign Tax Credit

Code Sec. 960(d) permits a limited foreign tax credit for foreign taxes "properly attributable" to tested income. The 2018 Proposed FTC Regulations and 2019 Final FTC Regulations responded to the repeal of foreign tax pooling under Code Sec. 902 and the limitation of the Code Sec. 960(d) GILTI foreign tax credit to current year taxes by assigning foreign taxes to "foreign income groups" (*e.g.*, tested income group, several different subpart F groups). In order for a foreign tax to be considered properly attributable to tested income and creditable under Code Sec. 960(d), it must be allocated and apportioned to the "tested income group" of the CFC.[94] Foreign taxes assigned to the residual grouping are not creditable because such taxes are not attributable to any income inclusion by the U.S. shareholder under Code Sec. 960. Whereas under prior law, foreign taxes on disregarded payments within a CFC would have been added to the Code Sec. 902 pool of foreign taxes, it is now necessary to assign these foreign taxes to a usable "income group" in order to claim any foreign tax credit under Code Sec. 960.

In connection with the more granular approach taken towards the Code Sec. 960 credit in the 2018 Proposed FTC Regulations and the 2019 Final FTC Regulations, Treasury and IRS provided additional guidance for allocating and apportioning foreign taxes in the 2019 Proposed FTC Regulations. In Proposed Reg. §1.861-20, the critical first step in the process of allocating and apportioning foreign taxes is to assign items of foreign gross income to statutory and residual groupings. The regulations address several circumstances in which this exercise is challenging because of differences between foreign tax law and U.S. tax law and the difficulty of identifying a "U.S. corresponding item" for some items of foreign gross income.[95]

2. Foreign Taxes on "Upward" and "Downward" Disregarded Payments

Foreign taxes on disregarded payments present such a circumstance where there is an item of foreign gross income, but it is difficult to identify a U.S. corresponding item. The 2019 Proposed FTC Regulations adopt rules addressing disregarded payments that diverge from the approach taken towards disregarded payments in the rules for foreign branch category income in the 2019 Final FTC Regulations.[96] The 2019 Proposed FTC Regulations provide separate rules for "upward" disregarded payments (*i.e.*, payments by a foreign branch to its foreign branch owner), "downward" disregarded payments (*i.e.*, payments by a foreign branch owner to its foreign branch), and disregarded payments in connection with the sale or exchange of property between a foreign branch and its foreign branch owner. It appears that disregarded payments between foreign branches owned by the same CFC foreign branch owner are treated as upward disregarded payments under these rules.[97]

In the case of upward disregarded payments, the 2019 Proposed FTC Regulations assign the item of foreign gross income to the statutory or residual grouping based on the accumulated after-tax income of the foreign branch, which is "deemed to have arisen in the statutory and residual groupings in the same ratio as the tax book value of the assets of the branch in the groupings," unless an anti-avoidance rule applies or a material distortion

results.[98] This rule is inconsistent with the treatment of foreign taxes on disregarded payments under the foreign branch category income rules, which allocate and apportion foreign taxes by reattributing income as discussed above.[99] Rather, Proposed Reg. §1.861-20 would treat all foreign taxes with respect to "upward" disregarded payments in the same manner that a foreign gross basis withholding tax imposed on a remittance from a branch to a foreign branch owner is treated under the 2019 Final FTC Regulations.[100]

In the case of downward disregarded payments, the 2019 Proposed FTC Regulations assign the item of foreign gross income resulting from a disregarded payment to the residual grouping.[101] This rule is also inconsistent with the treatment of foreign taxes on disregarded payments under the foreign branch category income rules, which allocate and apportion foreign taxes by reattributing income as discussed above.[102]

The 2019 Proposed FTC Regulations take a different approach to disregarded payments received in connection with a disregarded sale or exchange of property between a foreign branch and foreign branch owner. In the case of a disregarded sale or exchange of property, the item of foreign gross income is assigned to the grouping to which the corresponding U.S. item of income would be assigned if the sale or exchange had been a regarded sale or exchange.[103] In this way, the foreign taxes are assigned in the same way as a timing difference: foreign law taxes gain on the asset appreciation at the time of the disregarded sale, whereas U.S. law will tax such gain later in the year of a regarded disposition of the asset.

3. Assessment

It is difficult to defend the approach taken towards the allocation and apportionment of foreign taxes on disregarded payments, except perhaps on administrative grounds. The preamble to the 2019 Proposed FTC Regulations does not explain the policy underlying the rule, nor does it explain why the rule diverges from the treatment of disregarded payments in the foreign branch category income provisions in the 2018 Proposed FTC Regulations, which were adopted in the 2019 Final FTC Regulations. The approach taken in Proposed Reg. §1.861-20 has been described as following a distribution/contribution model. According to a distribution/contribution model, an upward disregarded payment resembles a distribution or remittance, and foreign taxes should therefore be allocated and assigned based on the assets of the foreign branch (consistent with the treatment of foreign withholding taxes on remittances in the 2019 Final FTC Regulations). In contrast, a downward disregarded payment resembles a contribution, and foreign taxes should be allocated and apportioned to the residual grouping in the same manner as foreign tax on a contribution to capital, which would be a base difference. Under this model, even disregarded payments made for value, such as service fees, are treated in the same manner as distributions and contributions.

A distribution/contribution model may have been followed in order to avoid complexity associated with treating a foreign branch or disregarded entity as a regarded entity, *i.e.*, "tracing" of items of foreign gross income to ultimate U.S. corresponding items. Government officials have remarked that a tracing approach of treating the foreign branch as a foreign corporation could require the construction of deemed earnings and profits and potentially rules for previously taxed deemed earnings and profits in order to accurately characterize distributions of after-tax income of the foreign branch.

While the administrative concerns are legitimate, the approach towards foreign taxes on disregarded payments in Proposed Reg. §1.861-20 is unsatisfying. Foreign taxes on disregarded payments between a CFC foreign branch owner and its foreign branches (or between foreign branches owned by a single CFC owner) are better regarded for U.S. federal tax purposes as taxes on the gross income of the CFC foreign branch owner or foreign branch to which the disregarded payment is allocable. One of the policies animating Treasury's interpretation of foreign branch income under Code Sec. 904(d)(1)(B) was "conformity with local country tax law."[104] Treasury and IRS cited the disregarded payment rules in that context for "reducing mismatches between the amount of gross income attributable to a foreign branch and the foreign tax base," while at the same time they were considered administrable because they were "designed to utilize information that is already available to taxpayers."[105] These same policy considerations are present in the case of disregarded payments between a foreign branch and CFC foreign branch owner. The assignment of foreign taxes on downward disregarded payments to the residual grouping is a particularly harsh outcome that lacks a strong policy rationale and should be revisited. As discussed in the next section, it seems likely that this approach will be abandoned in favor of the approach adopted in the context of the GILTI high-tax exclusion.

C. GILTI High-Tax Exclusion

1. Allocation of Foreign Taxes to Tested Income Within a Tested Unit

The allocation and apportionment of foreign taxes on disregarded payments is equally relevant to the potential application of the GILTI high-tax exclusion provided in final regulations issued in July 2020 (the "2020 Final GILTI Regulations").[106] Under these final regulations, the GILTI high-tax exclusion election applies on the basis of a "tested unit," by treating tested income attributable to a tested unit as an item of income.[107] A tested unit means a CFC, an interest held directly or indirectly by a CFC in a passthrough entity that is a tax resident of a foreign country or is not treated as fiscally transparent for purposes of the CFC's country of tax residence, or a branch of a CFC.[108] Under a combination rule, same-country tested units of a CFC are treated as a single tested unit.[109] In order to determine the effective foreign tax rate and potential applicability of the high-tax exception, foreign taxes must be allocated to tested income within a tested unit.

With respect to disregarded payments, the 2020 Final GILTI Regulations generally follow the model adopted in the 2019 Final FTC Regulations relating to the foreign branch income category, with some adjustments. Gross income of a tested unit is generally determined based on the items of gross income reflected on the books and records of the tested unit, 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."[110] This approach is consistent with the 2019 Proposed GILTI Regulations, but the 2020 Final GILTI Regulations provide additional guidance as to how the principles of the foreign branch income category rules apply in the context of the GILTI high-tax exclusion. In applying the principles of Reg. §1.904-4(f)(2)(vi), the CFC is treated as the "foreign branch owner," the tested units are treated as foreign branches, and the reattribution rules 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.[111] In addition, the exclusion for disregarded interest payments does not apply in the context of the GILTI high-tax exclusion to the extent that the amount of disregarded interest is deductible in the country of tax residence of the payor tested unit.[112] The final regulations also provide that such disregarded interest is allocated and apportioned ratably to all of the gross income of the payor tested unit.[113] Finally, the final regulations provide ordering rules for reallocations with respect to multiple disregarded payments.[114]

If the gross income of a tested unit is adjusted to account for disregarded payments, foreign taxes are allocated and apportioned consistently with the reattribution of income to or from a tested unit.[115]

2. Assessment

In applying the GILTI high-tax exclusion, the effective tax rate on tested units is most accurately determined by giving effect to all items that are taken into account in determining income for foreign tax purposes, including disregarded payments received from the CFC foreign branch owner or other foreign branches. The model adopted by the 2020 Final GILTI Regulations in this regard is better suited to this purpose than Proposed Reg. §1.861-20.[116] We can expect that the allocation and apportionment of foreign taxes for purposes of the GILTI foreign tax credit will be conformed to the allocation of foreign taxes for purposes of the GILTI high-tax exclusion. Otherwise, income could qualify for the GILTI high-tax exclusion and thereby be excluded from tested income even though foreign taxes with respect to such income would not be creditable under Code Sec. 960(d), such as, for example, if the foreign branch incurred foreign taxes with respect to a disregarded payment for services provided to the CFC branch owner.

V. BEAT and Internal Dealings

Code Sec. 59A applies a base erosion minimum tax to the members of certain large U.S. corporate taxpayer groups that meet gross receipts and other thresholds.[117] To the extent a U.S. branch or disregarded entity of a foreign person is subject to net-basis U.S. tax, the Code Sec. 59A rules effectively treat it in a manner similar to a U.S. corporation for purposes of determining whether the gross receipts threshold of Code Sec. 59A(e)(1)(B) is met. By extension, final regulations under Code Sec. 59A exclude from the definition of "base erosion payment" amounts paid or accrued by a U.S. corporation to a foreign related person that are subject to U.S. tax as income effectively connected with the conduct of a U.S. trade or business (or business profits attributable to a U.S. permanent establishment).[118]

A. Deductions Allowable Against U.S. Effectively Connected Income or Business Profits

Deductions allowed to a foreign corporation with respect to U.S. effectively connected income may be treated as base erosion payments to the extent the deductions are with respect to an amount paid or accrued to a foreign related party.[119] Similar rules are provided for foreign corporations that determine taxable income on a net basis pursuant to an applicable income tax treaty (other than taxpayers that determine taxable income based on the Authorized OECD Approach ("AOA"), as discussed below). In general, allowable deductions with respect to U.S. business profits may be treated as base erosion payments to the extent the deductions are with respect to an amount paid or accrued by the foreign corporation to a foreign related party.[120] Special rules are provided for interest expense allocated to U.S. effectively connected income or to business profits.[121]

The final regulations under Code Sec. 59A released in December 2019 (the "2019 Final BEAT Regulations"[122]) take a different approach for taxpayers that determine taxable income under an applicable tax treaty based on the AOA. Instead of testing whether deductions allowed with respect to business profits are with respect to an amount paid or accrued to a foreign related person, the regulations focus only on notional deductions related to "internal dealings" between the U.S. permanent establishment and the home office (or other branches), treating them as amounts paid or accrued to a foreign related person and therefore potentially as base erosion payments.[123] The internal dealings rule is tempered with respect to interest expense; in the case of interest expense, only interest expense in excess of the interest expense that would otherwise be allocable to the U.S. branch under domestic law would be treated as paid or accrued to a foreign related person under the internal dealings rule.[124]

B. Assessment

Where a disregarded entity is coterminous with a U.S. permanent establishment, the effect of the internal dealings rule often will be to regard disregarded payments between the disregarded entity and its owner. This is the case even though such payments are otherwise disregarded for U.S. tax purposes, and even though the internal dealing construct under the AOA was intended to be relevant only for purposes of determining the business profits of a permanent establishment and was not intended to be given effect (or regarded) for other purposes. Indeed, under the AOA, internal dealings need not be accompanied by payment flows at all.

The policy case for treating deductions allowed with respect to U.S. business profits differently under Code Sec. 59A depending on whether the business profits are determined on the basis of traditional allocation principles or on the basis of the AOA seems weak. Both sets of rules are intended to determine an appropriate amount of business profits to be subject to U.S. net-basis tax. The regulations could lead to drastically different results in cases that seem similar from a Code Sec. 59A perspective. Assume a foreign corporation operates in the United States through a permanent establishment and has no U.S. subsidiaries or other affiliates. In such a case, there is no foreign person that is related to the foreign corporation. If the foreign corporation determined the business profits of its U.S. permanent establishment by allocating or apportioning certain of its deductions to the permanent establishment, then there could be no amounts paid or accrued to a foreign related person and therefore no base erosion payments. If instead the foreign corporation determined the business profits of its U.S. permanent establishment under the AOA, then any deductions related to services or other items provided by the home office would be amounts paid or accrued to a foreign related person and could be base erosion payments.

VI. Conclusion

Since the enactment of the TCJA at the end of 2017, policymakers have faced new challenges in dealing with the treatment of disregarded payments. These challenges arise in the first instance in determining whether it is appropriate, within the context of a specific statutory scheme, to take disregarded payments into account. Furthermore, in cases where it is appropriate to take disregarded payments into account, the question of how to do so raises difficult policy and design challenges. While in some cases it might be appropriate simply to regard the disregarded payment, other cases may call for more modest measures. Absent more fundamental changes, we can expect the treatment of disregarded payments in U.S. tax law to continue to evolve.

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ENDNOTES

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[1] The Tax Cuts and Jobs Act of 2017, P.L. 115-97, 131 Stat. 2054.

[2] *See* IRS Notice 98-11, 1998-1 CB 433 (Jan. 16, 1998) (announcing regulations to treat disregarded entities owned by controlled foreign corporations ("CFCs") as corporations separate from their CFC owner for purposes of preventing the use of disregarded payments to reduce foreign tax while avoiding the corresponding creation of foreign personal holding company income under the subpart F rules, later the subject of a proposed moratorium in a bill passed by the Senate as part of the IRS Restructuring and Reform Bill of 1998, P.L. 105-206, 112 Stat. 685, and a five-year delay under IRS Notice 98-35, 1998-2 CB 34 (June 19, 1998)). Note the tension between these proposals and the policies of Code Sec. 954(c)(6), enacted in 2006, which provides an exception from foreign personal holding company income for payments from one CFC to another that are sourced from the non-subpart F income of the payee, and Code Sec. 951A, which generally aggregates the tested income of related CFCs. *See also* Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, at 28 (May 2009) (proposing to treat foreign eligible entities as disregarded only if organized in the same country as the owner, with an exception for first-tier entities wholly owned by a U.S. person).

[3] S. Rep. No. 99-313, at 419–420 (1986). For an overview of the DCL rules, *see* Gregg D. Lemein, Stewart R. Lipeles & John D. McDonald, *Final Dual Consolidated Loss Regulations Close Some Doors but Leave Some Ajar*, TAXES, Nov. 2007, at 19.

[4] *See* Reg. §1.1503(d)-2.

[5] *See* Reg. §1.1503(d)-6.

[6] Reg. §1.1503(d)-3(a)(1).

[7] *See* Reg. §1.1503(d)-5(c)(1)(ii) ("Items of income, gain, deduction, and loss that are otherwise disregarded for U.S. tax purposes shall not be regarded or taken into account for purposes of this section."); Reg. §1.1503(d)-7(c), Example 23.

[8] Reg. §1.1503(d)-5(c)(3)(i).

[9] As discussed below, Treasury and IRS have stated that they are reconsidering the treatment of disregarded payments in the DCL context in light of the enactment of Code Sec. 267A. *See infra* Part III.B.

[10] Reg. §1.1503(d)-3(a)(2)(i).

[11] Reg. §§1.1503(d)-3(a)(2)(ii)(A), 1.1503(d)-7(c), Example 6.

[12] *See* Reg. §1.881-3(a)(2)(i)(C); *see also* Reg. §1.881-3(e), Example 3 (illustrating the application of the rule to a disregarded intermediate entity). Proposed regulations issued in April 2020 relating to the anti-hybrid rules would further amend Reg. §1.881-3 to provide explicitly that a disregarded entity "may be treated as a party to a financing transaction with its owner." Proposed Reg. §1.881-3(a)(2)(i)(C), 85 FR 19858, 19871 (Apr. 8, 2020). For a discussion of Proposed Reg. §1.881-3 (and interplay between the anti-conduit rules and anti-hybrid rules under Code Sec. 267A, discussed below), *see* Nicholas C. Mowbray & Alex T. Ruff, *When the Anti-Conduit Rules Became Synonymous with Anti-Hybrid Rules: A Discussion of Proposed Reg. § 1.881-3*, J. TAX'N FIN. PRODUCTS, 2020, at 47.

[13] *See* Reg. §1.894-1(d)(5), Example 3 (concluding that a hybrid entity may claim benefits of the treaty with its own country if it is liable to tax in that country).

[14] 77 FR 8127, 8129 (Feb. 14, 2012).

[15] *Id.*

[16] Reg. §1.704-1(b)(4)(viii)(c)(1).

[17] Reg. §1.704-1(b)(4)(viii)(c)(3).

[18] Reg. §1.704-1(b)(4)(viii)(c)(3)(iv).

[19] Reg. §1.704-1(b)(4)(viii)(c)(2)(iii).

[20] 84 FR 35539, 35539 (July 24, 2019).

[21] *Id.* at 35540.

[22] *Id.*; *see also* Reg. §1.909-2(b)(4)(i) (noting that a foreign tax credit splitter arrangement results from allocations of CFTEs resulting from inter-branch payments in which foreign income taxes and the related income are allocated to different partners).

[23] *See* Layla J. Aksakal and Rocco V. Femia, *Section 909 and Loss Surrender: Temporary Regulations Strike Balance*, TAX MGM'T INT'L J. (Dec. 14, 2012).

[24] Reg. §1.909-2(b)(2)(i).

[25] Reg. §1.909-2(b)(2)(ii).

[26] Reg. §1.909-2(b)(2)(ii).

[27] Reg. §1.909-2(b)(2)(iii).

[28] Reg. §1.909-3(b).

[29] *See* 85 FR 19802 (Apr. 8, 2020). The disregarded payment rules were introduced in proposed regulations issued in 2018 (the "Proposed Section 267A Regulations"). 83 FR 67612 (Dec. 28, 2018). *See generally* Lori Hellkamp & Alden Dilanni-Morton, *It's Time to Look Again at the Anti-Hybrid Rules*, TAX NOTES INT'L 1387 (June 22, 2020); Mowbray & Ruff, *supra* note 12.

[30] Reg. §1.267A-2(b)(2)(i).

[31] The Final Section 267A Regulations include similar rules for deductions for "deemed branch payments," which can also give rise to a deduction/no inclusion result. A "deemed branch payment" is an amount of interest or royalties allowable as a deduction in computing the business profits of a U.S. permanent establishment under an income tax treaty, to the extent the amount is deemed to be paid to the home office, is not regarded under the home office's tax law, and, were the payment to be regarded as interest or royalties under the home office's tax law, the home office would include the payment in income. *See* Reg. §1.267A-2(c)(2).

[32] A disregarded payment results in a disqualified hybrid amount to the extent the disregarded payment exceeds the "dual inclusion income," or the amount of income that is included, for foreign tax purposes, in the income of the tax resident to which the disregarded payment is made. *See* Reg. §1.267A-2(b)(3)(i).

[33] Reg. §1.267A-6(c)(3), Example 3.

[34] The disregarded payment results in a disqualified hybrid amount to the extent it exceeds the dual inclusion income of FX and US1. *See* Reg. §1.267A-6(c)(3), Example 3.

[35] 85 FR at 19811 (Apr. 8, 2020).

[36] *See* Reg. §1.267A-2(a)(4).

[37] 83 FR at 67624 (Dec. 28, 2018).

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *See* Joseph M. Calianno & Kagney Petersen, *An Opportunity and a Possible Trap Under the U.S. Dual Consolidated Loss Regs*, TAX NOTES INT'L 499 (May 12, 2008).

[42] *See* PwC, Comment Letter on REG-104352-18 Proposed Regulations Under Section 1503(d) (Feb. 28, 2019).

[43] 85 FR at 19821 (Apr. 8, 2020).

[44] *Id.* at 19822.

[45] 83 FR 63200 (Dec. 7, 2018).

[46] 84 FR 69022 (Dec. 17, 2019).

[47] For a more comprehensive discussion of the Code Sec. 904(d) category for foreign branch income, *see* William Skinner, *The Branch Basket Takes Final Shape*, INT'L TAX J., Jan.–Feb. 2020, at 13, and Brian Jenn, *Navigating the Foreign Branch Basket Under the New Final Regulations*, INT'L TAX J., Mar.–Apr. 2020, at 13.

[48] Staff of Comm. on the Budget U.S. Senate, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Prt. 115-20, at 393 (Comm. Print 2017).

[49] *See* Code Sec. 904(d)(1)(A).

[50] Staff of Comm. on the Budget U.S. Senate, 115th Cong., *supra* note 48, S. Prt. 115-20, at 375.

[51] 84 FR at 69031 (Dec. 17, 2019).

[52] *Id.*

[53] Kimberly S. Blanchard, *Out on a Limb: The New Significance of the Foreign Branch*, TAX NOTES FED. 37, 40 (Jan. 6, 2020).

[54] Reg. §1.904-4(f)(2)(i).

[55] *See* Reg. §1.904-4(f)(2)(ii)–(iv).

[56] *See, e.g.*, Reg. §1.1503(d)-5(c)(1)(ii) (discussed in Part II.A.1 above).

[57] The disregarded payment reattribution rules produce outcomes that in some ways resemble the consolidated return intercompany transaction rules of Reg. §1.1502-13. However, the intercompany transaction rules respect transactions between separate entities but require matching of timing and attributes to prevent distortions.

[58] Reg. §1.904-4(f)(2)(vi)(A).

[59] 83 FR at 63210 (Dec. 7, 2018).

[60] 84 FR at 69031 (Dec. 17, 2019).

[61] It is possible that this result could be mitigated by reason of a treaty resourcing provision.
[62] 84 FR at 69031 (Dec. 17, 2019).
[63] *Id.* at 69032.
[64] *Id.* at 69031.
[65] Reg. §1.904-4(f)(3)(v).
[66] Reg. §1.904-4(f)(2)(vi)(A).
[67] Reg. §1.904-4(f)(2)(vi)(B)(1)(ii).
[68] Reg. §1.904-4(f)(2)(vi)(A).
[69] Reg. §1.904-4(f)(2)(vi)(B)(1)(i).
[70] Reg. §1.904-4(f)(2)(vi)(A).
[71] *See* Reg. §1.904-4(f)(2)(vi)(F).
[72] Reg. §1.904-4(f)(2)(vi)(B)(2)(i)–(ii).
[73] These rules introduce the concepts of "tentative disregarded basis" (*i.e.*, the basis the property would have if the disregarded payment were treated as cost under Code Sec. 1012(a)); "disregarded cost recovery deductions" (*i.e.*, amounts that would be allowed as a deduction and that would give rise to an adjustment under Code Sec. 1016(a)(2) if the transfer were regarded); "disregarded section 1016(a)(1) expenditures" (*i.e.*, disregarded payments that, if regarded, would be described in Code Sec. 1016(a)(1)); "adjusted disregarded basis" (*i.e.*, tentative disregarded basis, reduced by disregarded cost recovery deductions and increased by disregarded Code Sec. 1016(a)(1) expenditures); and "adjusted disregarded gain" (*i.e.*, the lesser of (1) adjusted disregarded basis of the property, reduced by the adjusted basis at the time of the disregarded transfer, and (2) the gain (if any) attributable to the regarded sale or exchange of the transferred property). *See* Reg. §1.904-4(f)(3).
[74] Reg. §1.904-4(f)(2)(vi)(B)(2)(iii).
[75] Reg. §1.904-4(f)(2)(vi)(B)(3)(ii).
[76] Reg. §1.904-4(f)(2)(vi)(E). Note that Code Sec. 482 literally applies at the level of "organizations, trades, or businesses (whether or not incorporated …)."
[77] Reg. §1.904-4(f)(2)(vi)(C)(2)–(3).
[78] Reg. §1.904-4(f)(2)(vi)(C)(1).
[79] 83 FR at 63210 (Dec. 7, 2018).
[80] 84 FR at 69033 (Dec. 17, 2019).
[81] *Id.*
[82] Reg. §1.904-4(f)(2)(vi)(C)(4). For example, foreign branch income does not include gain from the sale of stock or gain from the sale of a partnership interest (other than a sale or exchange of a partnership interest that meets the ordinary course of business exception of Reg. §1.904-4(f)(2)(iv)(B)). *See* Reg. §1.904-4(f)(2)(iii)–(iv). As a result, a disregarded sale of stock or disregarded sale of a partnership interest does not result in reattribution to foreign branch category income.
[83] Reg. §1.904-4(f)(2)(vi)(D)(1).
[84] Reg. §1.904-4(f)(2)(vi)(D)(1).
[85] Reg. §1.904-4(f)(2)(vi)(D)(1). In effect, the intangible property rule deems a disregarded payment to exist for the purpose of regarding the deemed disregarded payment under the reattribution rules.
[86] 84 FR at 69033 (Dec. 17, 2019).
[87] *Id.*
[88] *Id.* The 2019 Final FTC Regulations adopted an exception for intangible property that is held by the foreign branch or foreign branch owner for only a transitory period. *See* Reg. §1.904-4(f)(2)(vi)(D)(3). This exception is intended to apply, for example, to a repatriation of intangible property from a CFC that elected to be treated as a disregarded entity, and immediately thereafter distributed intangible property to its U.S. owner. *See* 84 FR at 69033 (Dec. 17, 2019).
[89] Reg. §1.904-6(a)(2)(ii).
[90] Reg. §1.904-6(a)(2)(iii)(A).
[91] Reg. §1.904-6(a)(2)(iii)(A).
[92] Reg. §1.904-6(a)(2)(iii)(B). This rule does not apply to disregarded payments that, if regarded, could not give rise to foreign branch category income.
[93] 84 FR 69124 (Dec. 17, 2019).
[94] Taxes properly attributable to tested income are current year taxes "that are allocated and apportioned under §1.960-1(d)(3)(ii) to the tested income group within each section 904 category of the controlled foreign corporation. No other foreign income taxes are considered properly attributable to tested income." Reg. §1.960-2(c)(4).
[95] *See* Proposed Reg. §1.861-20(d).
[96] A disregarded payment is defined in the same way as in the regulations on the foreign branch category. For purposes of Proposed Reg. §1.861-20, a foreign branch owner can include a foreign corporation. Proposed Reg. §1.861-20(d)(3)(ii)(D).
[97] Proposed Reg. §1.861-20(d)(3)(ii)(A) refers to an item of foreign gross income included by reason of a "receipt of a disregarded payment made by a disregarded entity or other foreign branch." This language appears to include the receipt by a disregarded entity or foreign branch of a disregarded payment made by a disregarded entity or foreign branch.
[98] Proposed Reg. §1.861-20(d)(3)(ii)(A). Tax book value of branch assets is determined in accordance with Reg. §1.987-6(b)(2).
[99] *See* Reg. §1.904-6(a)(2)(ii)(A).
[100] *See* Reg. §1.904-6(a)(2)(iii)(A).
[101] Proposed Reg. §1.861-20(d)(3)(ii)(B).
[102] *See* Reg. §1.904-6(a)(2)(ii)(B). To the extent there is a foreign tax imposed by reason of receipt of a disregarded payment that is not subject to the reattribution rules, the 2019 Final FTC Regulations generally allocate that foreign tax to the foreign branch income category. Reg. §1.904-6(a)(2)(iii)(B).
[103] *See* Proposed Reg. §§1.861-20(d)(3)(ii)(C), 1.861-20(d)(2)(i).
[104] 84 FR at 69031 (Dec. 17, 2019).
[105] *Id.*
[106] 85 FR 44620 (July 23, 2020).
[107] Reg. §1.951A-2(c)(7)(ii). The 2020 Final GILTI Regulations in this respect depart from the approach of the proposed regulations issued in 2019 (the "2019 Proposed GILTI Regulations"), which applied the high-tax exclusion election on a QBU-by-QBU basis. *See* 84 FR 29114 (June 21, 2019).
[108] Reg. §1.951A-2(c)(7)(iv)(A). If a branch does not give rise to a taxable presence in the country in which it is located, the branch is considered a tested unit only if, under the tax law of the CFC's country of tax residence, the branch is eligible for an exclusion, exemption, or similar relief such as a preferential rate. Reg. §1.951A-2(c)(7)(iv)(A)(3).
[109] Reg. §1.951A-2(c)(7)(iv)(C).
[110] Reg. §1.951A-2(c)(7)(ii)(B)(2).
[111] Reg. §1.951A-2(c)(7)(ii)(B)(2)(i)–(ii).
[112] Reg. §1.951A-2(c)(7)(ii)(B)(2)(iii).
[113] Reg. §1.951A-2(c)(7)(ii)(B)(2)(iv).
[114] Reg. §1.951A-2(c)(7)(ii)(B)(2)(v).
[115] Reg. §1.951A-2(c)(7)(iii)(B).
[116] The government's approach to associating income of tested units to taxes may be informed by ongoing work at the OECD, in particular with respect to Pillar Two of the OECD's Programme of Work for Addressing the Tax Challenges of the Digitalisation of the Economy. The purpose of Pillar Two is to ensure that all income earned by a multinational enterprise is subject to a minimum level of tax. Cross-border payments that are not subject to a minimum level of tax may be subject to a denial of deduction, a denial of treaty benefits, or the imposition of source-based taxation. To the extent the level of taxation is determined on a jurisdiction-by-jurisdiction basis, technical issues similar to those addressed in the GILTI high-tax exclusion will need to be addressed.
[117] For a discussion of the BEAT rules, *see* Marcellin N. Mbwa-Mboma, David M. Abrahams, & José E. Murillo, *Identifying Base Erosion Payments and Waiving Deductions Under the Final and New Proposed BEAT Regulations*, Tax Mgm't Int'l J. (Mar. 13, 2020), and Stewart Lipeles, Jeff Maydew, Julia Skubis Weber, Joshua Odintz, Alexandra Minkovich & Katie Rimpfel, *The Final and Proposed BEAT Regulations: A Favorable Turn*, Taxes, Mar. 2020, at 7.
[118] Reg. §1.59A-3(b)(3)(iii).
[119] Reg. §1.59A-3(b)(4)(ii).
[120] Reg. §1.59A-3(b)(4)(v)(A).
[121] *See* Reg. §1.59A-3(b)(4)(i).
[122] 84 FR 66968 (Dec. 6, 2019).
[123] *See* Reg. §1.59A-3(b)(4)(v)(B).
[124] Reg. §1.59A-3(b)(4)(i)(E). Proposed regulations issued in 2018 under Code Sec. 59A had treated all interest expense with respect to internal dealings as paid or accrued to a foreign related person. *See* Proposed Reg. §1.59A-3(b)(4)(v)(B), 83 FR 65956 (Dec. 21, 2018). For a discussion of the 2018 proposed regulations, *see* Danielle E. Rolfes, Guy A. Bracuti, Jesse F. Eggert, Joshua S. Kaplan & Seevun Kozar, *BEAT: An Overview of the Statute and Proposed Regulations*, Tax Mgmt. Memorandum (Dec. 9, 2019).

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