ETHAN KROLL is a Partner in Baker McKenzie's Los Angeles office.
MATTHEW S. JENNER is a Partner in Baker McKenzie's Chicago office.
NEIL DONETTI is an Associate in Baker McKenzie's Chicago office.
STEWART LIPELES is a Partner in Baker McKenzie's Palo Alto office.
JULIA SKUBIS WEBER is a Partner in Baker McKenzie's Chicago office.

International Tax Watch

How Best to Regard? Reg. §1.861-20 and Disregarded Sales of Inventory Property

By Ethan Kroll, Matthew S. Jenner, Neil Donetti, Stewart Lipeles, and Julia Skubis Weber

I. Introduction

As many readers already know, on December 28, 2021, the Treasury Department and the Internal Revenue Service (the "IRS") issued final regulations relating to the allocation and apportionment of foreign income taxes imposed with respect to disregarded payments.[1] The final regulations are a necessary first step in the U.S. foreign tax credit analysis, as they determine the foreign tax credit limitation category, and, where appropriate, the income group, of foreign income taxes. The regulations generally apply retroactively to taxable years beginning after December 31, 2019.[2]

In this column, we focus on the final regulations' rules for allocating and apportioning foreign income taxes in connection with disregarded sales of inventory property. While this specific aspect of the final regulations appears, on its face, to be an issue of limited importance and interest, readers who are familiar with the operations of multinational enterprises will recognize that disregarded payments for inventory arise in a wide range of scenarios. Moreover, as we will discuss, there is significant uncertainty as to how these regulatory provisions operate. This column therefore seeks both to highlight and to resolve this uncertainty.

II. General Background

Although a complete overview of the disregarded payment regulations is outside of the scope of this column, a brief summary of those rules is essential. Generally speaking, Reg. §1.861-20 provides rules for allocating and apportioning foreign income taxes that a controlled foreign corporation (a "CFC") pays or accrues to the CFC's "Code Sec. 904 categories"[3] and to "income groups" within each Code Sec. 904 category.[4] The "income groups" are: (i) numerous subpart F income groups;[5] (ii) the tested income group;[6] and (iii) the residual group, which consists of income that is not in a subpart F income group, tested income group, or previously taxed earnings and profits ("PTEP") group.[7]

Reg. §1.861-20 directs the taxpayer to allocate and apportion each foreign income tax in the following steps. In the first step, the taxpayer assigns items of "foreign gross income"[8] to groupings under the rules of Reg. §1.861-20(d).[9] In this context, the term "groupings" refers to the statutory and residual income groupings under the relevant Code section that are relevant for determining the availability of a foreign tax credit. For example, if the operative Code section is Code Sec. 904, the groupings would be the Code Sec. 904 categories—*e.g.*, general, passive, Code Sec. 951A, foreign branch. If the operative Code section is Code Sec. 960 because the transaction involves CFCs, the groupings would be the income groups within each Code Sec. 904 category.

In the second step, the taxpayer allocates and apportions deductions allowed under foreign law to foreign gross income in the statutory and residual groupings under the rules of Reg. §1.861-20(e). In the third and final step, the taxpayer allocates and apportions the foreign income tax to the foreign taxable income (*i.e.*, foreign gross income reduced by the deductions allowed under foreign law)[10] in the statutory and residual groupings under the rules of Reg. §1.861-20(f).

As part of the first step, Reg. §1.861-20(d)(1) provides rules for assigning items of foreign gross income to the statutory or residual groupings in contexts where the taxpayer also realizes, recognizes, or takes into account a "corresponding U.S. item."[11] The term "corresponding U.S. item" means the item of U.S. gross income or U.S. loss, if any, that arises from the same transaction or other realization event from which an item of foreign gross income also arises.[12] Generally, if a taxpayer pays or accrues foreign income tax imposed on foreign taxable income that includes an item of foreign gross income with respect to which the taxpayer also realizes, recognizes, or takes into account a corresponding U.S. item, then that item is assigned to the grouping to which the corresponding U.S. item is assigned (the "General Assignment Rule").[13]

Reg. §1.861-20(d)(3)(v) then provides specific rules to assign foreign gross income related to "disregarded payments" (the "Disregarded Payment Rules"). Generally, "disregarded payments" are amounts transferred to or from a "taxable unit," or payments in exchange for property involving a taxable unit, in connection with a transaction that is disregarded for U.S. federal income tax purposes but that is nevertheless reflected on the taxable unit's separate set of books and records.[14] For foreign corporations, "taxable units" include CFCs, foreign disregarded entities that a CFC owns, and a CFC's branches.[15] If a taxpayer includes an item of foreign gross income because it receives a disregarded payment, then the Disregarded Payment Rules apply to assign that item to a statutory or residual grouping.[16]

Special rules may classify at least a portion of each disregarded payment as a "reattribution payment" (the "Reattribution Payment Rules").[17] At a high level, a payment is treated as a reattribution payment to the extent that payment is allocated to U.S. gross income that is recognized by or reattributed to a payor taxable unit.[18] The operative rule then assigns the related foreign gross income from the reattribution payment based on the U.S. gross income to which the payment was allocated.[19] This U.S. gross income is then reattributed from the payor taxable unit to the payee taxable unit.[20]

III. Disregarded Payment Rules for Inventory Sales

A specific set of rules applies to assign foreign gross income from a disregarded payment received by a taxable unit in exchange for property, including inventory. If a taxable unit includes a foreign gross income item attributable to foreign law gain that results from a disregarded payment the taxable unit receives in exchange for inventory, that item is assigned under rules concerning items of foreign gross income with no corresponding U.S. item under Reg. §1.861-20(d)(2).[21]

An item of foreign gross income with no corresponding U.S. item generally is assigned to the grouping to which the corresponding U.S. item would be assigned if the transaction resulted in the recognition of gross income or loss under U.S. federal income tax law in the U.S. taxable year in which the foreign income tax is paid or accrued.[22] In other words, the rule asks taxpayers to "regard" the disregarded transaction. Specific rules apply to assign an item of foreign gross income depending on the type of transaction: (i) foreign law distributions;[23] (ii) foreign law dispositions;[24] and (iii) foreign law transfers between taxable units.[25] The theory here appears to be that there is a discrete set of transactions that could give rise to foreign gain or loss and could still be disregarded for U.S. federal income tax purposes.

A "foreign law disposition" is an event that foreign law treats as a taxable disposition or deemed disposition of property, but that U.S. federal income tax law does not treat as a disposition causing the recognition of gain or loss.[26] Presumably, a disregarded sale of inventory would qualify as a foreign law disposition because foreign law treats the transfer as a taxable disposition, but the transfer is not a recognition event for U.S. federal income tax purposes.

Under the foreign law disposition rules, foreign law gain from a foreign law disposition of inventory is assigned to the grouping to which a corresponding U.S. item of gain or loss would be assigned on a taxable disposition of inventory under U.S. federal income tax law.[27] That U.S. item is determined as if the inventory is disposed of in exchange for an amount equal to the gross receipts or other value used under foreign law to determine the amount of the foreign gross income items arising from the foreign law disposition in the U.S. taxable year in which the taxpayer pays or accrues the foreign income tax.[28] Importantly, these rules apply only to assign the foreign gross income from the disregarded sale and do not affect a subsequent regarded sale of the same inventory.[29] If a taxpayer disposes of inventory that it previously purchased in exchange for a disregarded payment and recognizes U.S. gross income from that disposition, then the General Assignment Rule applies and assigns the foreign gross income from that disposition to the grouping to which the corresponding U.S. item is assigned (without regard to specific reattribution rules applicable in other circumstances).[30]

As noted above, generally speaking, if a taxable unit recognizes income as a result of a regarded payment and makes a disregarded payment to another taxable unit of the same CFC, Reg. §1.861-20(d)(3)(v)(B) provides rules for potentially reattributing a portion of the regarded income to the payee taxable unit (*i.e.*, a reattribution amount). Any taxes resulting from the disregarded payment are then generally allocated consistent with the reattribution amount. If these rules applied instead of Reg. §1.861-20(d)(2), the foreign taxes on a manufacturer's income from disregarded sales of inventory to distributors that recognize foreign base company sales income upon reselling the inventory could be allocated to the same income group as the foreign base company sales income.[31] The Reattribution Payment Rules under Reg. §1.861-20(d)(3)(v)(B) do not apply to assign foreign gross income resulting from disregarded sales of property, however. Reg. §1.861-20(d)(3)(v)(D) applies instead because Reg. §1.861-20(d)(3)(v)(D) clearly states that it applies to disregarded sales of property.[32]

IV. Hypothetical Corresponding U.S. Items

Assigning a corresponding U.S. item that would result from "a taxable disposition of property" under U.S. law (the "Hypothetical Corresponding U.S. Item") is not clear when the underlying transaction is disregarded because the regulations do not explain how to hypothesize a taxable disposition. Assume that a CFC owns two disregarded entities, with one disregarded entity selling inventory (a "Selling DRE") to the other (a "Buying DRE"). To allocate the foreign income tax imposed on the Selling DRE's gain on its sales, Reg. §1.861-20(d)(2)(ii)(C) requires a taxpayer to hypothesize that the Selling DRE disposes of the inventory in a taxable disposition under U.S. law and receives the amount that the Buying DRE pays. The Hypothetical Corresponding U.S. Item would be the hypothetical U.S. gross income that results from that hypothetical disposition.

From our perspective, a logical approach would be to hypothesize a regarded transaction consistent with the branch rule in Code Sec. 954(d)(2).[33] The branch rule is a reasonable analog because it respects branches or disregarded entities as such for purposes of testing whether income is or is not foreign base company sales income yet also acknowledges that the transactions are otherwise disregarded for U.S. federal income tax purposes.[34] Thus, one way to assign the Hypothetical Corresponding U.S. Item to the CFC's income groups is to follow the branch rule so that the Hypothetical Corresponding U.S. Item is assigned to the CFC's subpart F income group if the Selling DRE's income constitutes foreign base company sales income under the branch rule, and the Hypothetical Corresponding U.S. Item is otherwise assigned to the CFC's tested income group. As readers will recall, under the branch rule, where a CFC carries on activities through a branch outside of the CFC's country of incorporation, and the use of that branch has substantially the same tax effect as if that branch were a wholly owned subsidiary of the CFC, then the branch is treated as a separate corporation for purposes of determining the CFC's subpart F income.[35] Importantly, a company that manufactures and/or sells through a CFC that has disregarded subsidiaries or branches must apply the branch rule independent of Reg. §1.861-20. To that end, the approach we are recommending leverages work that taxpayers are already required to perform and attempts to avoid an incoherent result, where the branch rule categorizes income in one way and taxes that are allocated and apportioned to that income are categorized differently.

A sales branch is treated as a separate corporation under the branch rule where its income is taxed at an effective rate that is less than 90 percent of, and at least five percentage points less than, the hypothetical effective tax rate that would apply to the income under the laws of the CFC's country of creation or organization if, under those laws, the CFC's entire income was considered derived by the CFC from sources within that country from doing business through a permanent established therein, received in that country, and allocable to the permanent establishment, and the corporation was managed and controlled in that country (the "Sales Branch Rule").[36] Likewise, a manufacturing branch is treated as a separate corporation under the branch rule where income allocated to the remainder of the CFC is taxed at an effective rate that is less than 90 percent of, and at least five percentage points less than, the hypothetical tax rate that would apply to the income under the laws of the manufacturing branch's country if, under those laws, the entire income of the CFC was considered derived by the corporation from sources within the branch's country from doing business through a permanent establishment therein, received in that country, and allocable to the permanent establishment, and the corporation was created or organized under the laws of, and managed and controlled in, that country (the "Manufacturing Branch Rule").[37] Where a CFC engages in both manufacturing and sales through branches, the branch rule regulations turn off the Sales Branch Rule in favor of the Manufacturing Branch Rule, which compares the tax rates of the manufacturing and sales jurisdictions.[38] The branch rule contains additional rules that cover more complicated fact patterns, which are outside the scope of this column.

Importantly, the branch rule regulations provide that income that a branch or disregarded subsidiary derives does not constitute foreign base company sales income if the income would not have constituted foreign base company sales income if a CFC had in fact derived that income.[39] Exceptions to foreign base company sales income treatment apply to income that a CFC derives from selling property it manufactures, products that were manufactured in the CFC's jurisdiction of creation or organization, and products to customers for use, consumption, or disposition in the CFC's jurisdiction of creation or organization.[40] Thus, for example, if the Selling DRE were to manufacture the relevant property, the branch rule could not apply to characterize the Selling DRE's income as subpart F income, and, by extension, foreign income taxes on that income could not be allocated and apportioned to subpart F income. Moreover, even if the Buying DRE were not to satisfy the exceptions to foreign base company sales income, the branch rule would not apply to characterize the Buying DRE's income from a further disregarded sale of the property as subpart F income, and foreign income taxes on that income would not be allocated and apportioned to subpart F income, unless the Buying DRE were to otherwise recognize subpart F income pursuant to the application of the branch rule (*e.g.*, because of a tax rate disparity).

Alternatively, one could hypothesize that the Selling DRE is a CFC that sells the inventory to the Buying DRE, which is also a CFC. This approach would represent an extreme literalist, as well as a distortive, approach to the application of Reg. §1.861-20(d)(2), as it would cause transactions that are not regarded for U.S. federal income tax purposes generally to be regarded solely for the purpose of allocating and apportioning foreign income taxes. In that case, the taxpayer would apply rules under Code Sec. 954(d) other than the branch rule to determine whether the corresponding U.S. item would be foreign base company sales income or tested income. This approach could assign the Hypothetical Corresponding U.S. Item in a manner different from the approach based on the branch rule. If, for example, the Selling DRE were to have purchased property from another disregarded entity, and none of the exceptions to foreign base company sales income were to apply otherwise, this alternative could assign the income the Selling DRE recognizes to a subpart F income group even if the branch rule were not to treat the Selling DRE's income as subpart F income.

As we indicate above, we believe that the better view is that the branch rule approach properly assigns Hypothetical Corresponding U.S. Items to income groups and therefore properly allows for the allocation and apportionment of foreign income tax to the U.S. taxable income to which they relate. Example 10 in Reg. §1.861-20 supports the view that treating the Selling DRE as a CFC may not be appropriate.[41] In that example, a foreign disregarded entity ("FDE"), operating in Country A, transfers Asset F to its domestic owner for no consideration in a transaction that U.S. tax law treats as a remittance, but Country A treats as a distribution. Country A imposes a $30 tax on FDE on its gain on the disposition of Asset F. There is no corresponding U.S. item because FDE does not recognize any income on the disposition under U.S. law. The example assigns the gain to the foreign branch category of income because "the sale of Asset F in a regarded transaction would have resulted in foreign branch category income." Thus, the example hypothesizes a regarded transaction and still respects FDE as a foreign branch in assigning the Hypothetical Corresponding U.S. Item to the Code Sec. 904 categories rather than treating the FDE as a separate corporation. This result indicates that we should also respect a foreign disregarded entity of a CFC as a disregarded entity rather than hypothesize that it is a corporation in determining the income group to which the taxpayer assigns the Hypothetical Corresponding U.S. Item. The branch rule aligns with this approach, as the branch rule only treats a branch as a CFC after testing whether the branch itself satisfies certain requirements.

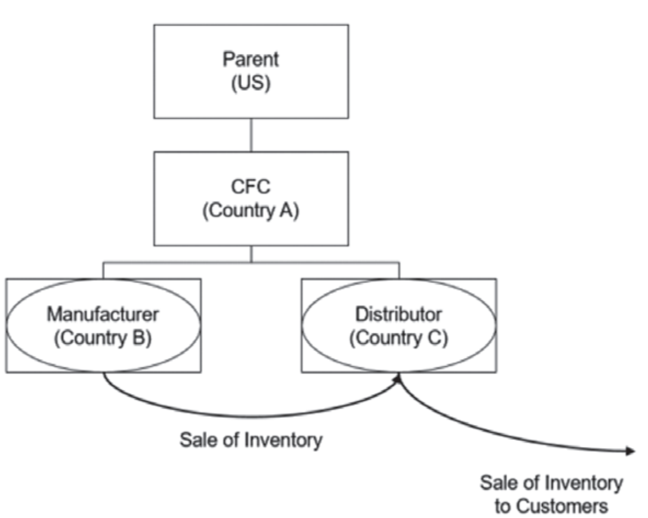
Further, one of the objectives of Reg. §1.861-20 is to ensure, to as great an extent as possible, that foreign income taxes follow the U.S. income to which they relate so foreign taxes on one type of income cannot offset U.S.

federal income tax on another type of income. As we note above, the branch rule construct aligns with the objective of allocating taxes to the income group that contains the income on which the taxes are imposed. Under the alternative, foreign income tax could be assigned to the CFC's general category foreign base company income group while the CFC has tested income under the branch rule because the disregarded entity does not fail the tax rate disparity test. This result would be distortive and would separate the taxes from their related category of income.

To illustrate the above, we now turn to three examples. In the first example, a disregarded manufacturer sells inventory to a disregarded entity, which in turn sells that inventory to end customers. In the second example, a disregarded manufacturer sells inventory to a disregarded master distributor, which in turn sells that inventory to a disregarded sub-distributor that ultimately sells the inventory to end customers. The facts in the third example are the same as the facts in the first example, except that the disregarded manufacturer also pays a disregarded royalty to use certain intellectual property to manufacture inventory.

> **Example 1.** Disregarded manufacturer sells to a disregarded distributor, which in turn sells to end customers
>
> Assume that a U.S. parent ("USP") owns a CFC incorporated in Country A and that the CFC owns two entities disregarded as separate from the CFC for U.S. federal income tax purposes: a foreign manufacturer located in Country B and a foreign distributor located in Country C. The foreign manufacturer produces inventory for $60, sells it to the foreign distributor for $80, and is subject to a 25 percent effective foreign tax rate on its income from the inventory sale. The foreign distributor sells the inventory to end customers for $100, has selling costs of $15, and is subject to a 10 percent effective foreign tax rate on its income from the inventory sale.

EXAMPLE 1.



This example assumes that the payment that the manufacturer receives is reflected on its separate set of books and records. The payment therefore constitutes a "disregarded payment" because the sale is disregarded for U.S. federal income tax purposes. Because the manufacturer receives the disregarded payment in exchange for inventory, Reg. §1.861-20(d)(3)(v)(D) applies and provides that the special rules under Reg. §1.861-20(d)(2) apply. Under those rules, the manufacturer's income from the sale of inventory is "assigned to the grouping to which a corresponding U.S. item of gain or loss would be assigned on a taxable disposition of the property under Federal income tax law."

Upon a taxable disposition of the inventory under U.S. federal income tax law, the corresponding U.S. item is the manufacturer's income from the sale. Under Reg. §1.954-3, the arrangement fails the tax rate disparity test in the Manufacturing Branch Rule because income allocated to the remainder of the CFC is taxed at a 10 percent effective tax rate, which is less than 90 percent of and more than five percentage points less than the hypothetical 25 percent effective tax rate that would apply to the income under the laws of Country B. The manufacturer is thus treated as an entity separate from the CFC for purposes of the branch rule. The manufacturer's $20 of income is not foreign base company sales income, however, because the manufacturer manufactured the inventory.[42] Likewise, if the arrangement did not fail the tax rate disparity test, the branch rule would not apply and the manufacturer would not be treated as an entity separate from the CFC. In that case, the income attributable to the manufacturer would again constitute tested income. Accordingly, the corresponding U.S. item is tested income assigned to the CFC's tested income group. The income is general category income as it does not fall within one of the types of income constituting passive category income.[43] Therefore, the manufacturer's income is assigned to the CFC's tested income group within the general category. Reg. §1.861-20(f) then allocates Country B tax to the CFC's tested income group within the general category.

The distributor's subsequent sale of inventory to end customers is a regarded transaction. The income that the CFC recognizes on the distributor's sale represents a corresponding U.S. item of the foreign sales income that is included in the base on which the foreign income tax is imposed. Because there is a corresponding U.S. item, Reg. §1.861-20(d)(1) applies.[44]

Under Reg. §1.861-20(d)(1), the sales income is assigned to the same income group as the corresponding U.S. item. Reg. §1.861-20(d) assigns the sales income to either the CFC's foreign base company sales income group or the tested income group within the general category depending on whether the sales income is foreign base company sales income under the branch rule. Reg. §1.861-20(f) then allocates the foreign income tax to the CFC's tested income group or to the foreign base company sales income group based on the income that Reg. §1.861-20(d) assigned to these groups.

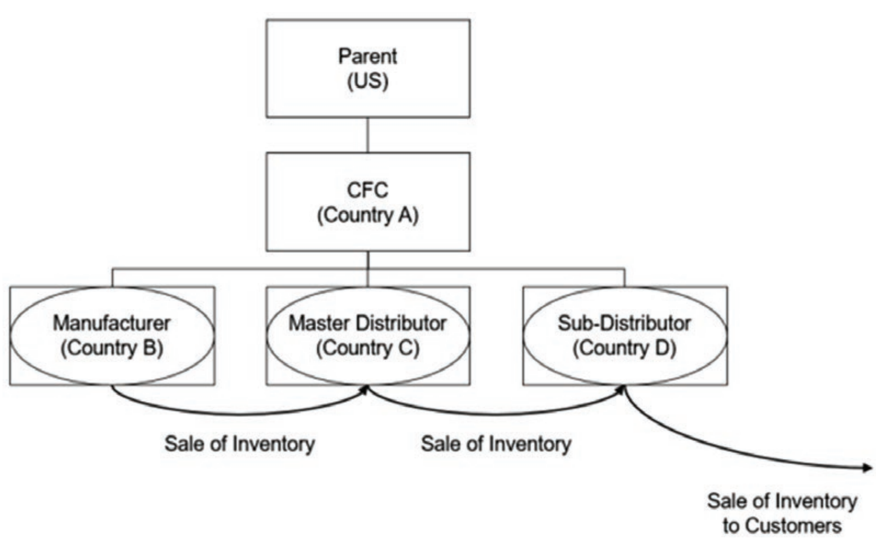
Finally, as with the manufacturer's sale of inventory, foreign income tax that is imposed on the distributor's income from sales of inventory is allocated to the CFC's foreign base company income group or to the tested income group within the general category depending on whether the distributor's sales income constitutes foreign base company sales income or tested income.

As noted above, where a CFC engages in both manufacturing and sales through branches, the branch rule regulations turn off the Sales Branch Rule in favor of the Manufacturing Branch Rule to essentially compare the effective tax rates of the manufacturing and sales jurisdictions.[45] Accordingly, the manufacturer again is treated as an entity separate from the CFC because the remainder of the CFC is taxed at a 10 percent effective tax rate, which is less than 90 percent of and more than five percentage points less than the hypothetical 25 percent effective tax rate that would apply to the income under the laws of Country B. Importantly, only the portion of the CFC's income attributable to the sale activities of the distributor (here, we will assume $5, consistent with the profit of the distributor) is allocated to the sales remainder and tested under these rules. As a result, the distributor's portion of the CFC's sales income on its sales of inventory purchased from the manufacturer generally constitutes foreign base company sales income, except to the extent that portion of the income is derived from sales of inventory to customers in Country A.[46] Reg. §1.861-20(f) then allocates the foreign income tax on the distributor's sales income to the CFC's tested income group or to the foreign base company sales income group based on the income that Reg. §1.861-20(d) assigns to these groups.

Example 2. Disregarded manufacturer sells to a disregarded master distributor, which, in turn, sells to a disregarded sub-distributor that ultimately sells to end customers

Alternatively, assume that the Country A CFC owns three disregarded entities instead of two: a foreign manufacturer located in Country B, a foreign master distributor located in Country C, and a foreign sub-distributor located in Country D. The foreign manufacturer produces inventory for $50, sells that inventory to the foreign master distributor for $70, and is subject to a 25 percent effective foreign tax rate on its income. The foreign master distributor, in turn, sells that inventory to the foreign sub-distributor for $90 (and has selling costs of $10), which then sells the inventory to end customers for $100 (and has selling costs of $5). Each of the foreign master distributor and

EXAMPLE 2.



the foreign sub-distributor is subject to a 10 percent effective foreign tax rate on its income.

The analysis with respect to the distributor's disregarded payment to the manufacturer in the first example applies to the master distributor's disregarded payment to the manufacturer in this example.

We assume that the $90 payment that the master distributor receives from the sub-distributor for its inventory is reflected on the master distributor's separate set of books and records. That payment therefore constitutes a "disregarded payment" because, as with the payment to the manufacturer, the sale is disregarded for U.S. federal income tax purposes. Because the master distributor receives the disregarded payment in exchange for the inventory, Reg. §1.861-20(d)(3)(v)(D) again applies and provides that Reg. §1.861-20(d)(2) applies. Under those rules, the master distributor's income from the sale of inventory is "assigned to the grouping to which a corresponding U.S. item of gain or loss would be assigned on a taxable disposition of the property under Federal income tax law."

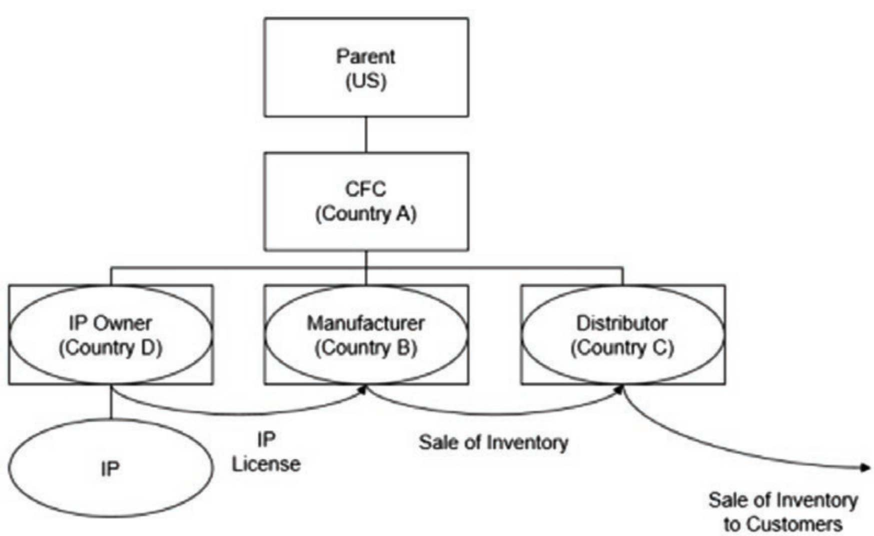
The corresponding U.S. item for the master distributor's sale of the inventory to the sub-distributor, if that sale was a taxable disposition under U.S. federal income tax law, is the master distributor's income from the sale. As previously stated, where a CFC engages in both manufacturing and sales through branches, the Manufacturing Branch Rule trumps the Sales Branch Rule.[47] For this purpose, the master distributor is treated as if it alone is the remainder of the CFC.[48] The manufacturer again is treated as an entity separate from the CFC because the remainder of the CFC (here, the master distributor) is taxed at a 10 percent effective tax rate, which is less than 90 percent of and more than five percentage points less than the hypothetical 25 percent effective tax rate that would apply to the income under the laws of Country B. The master distributor, in buying inventory from the manufacturer and reselling it to the sub-distributor, is treated as selling the inventory on behalf of the manufacturer.[49] The master distributor's $10 of income thus constitutes foreign base company sales income.[50] Accordingly, the corresponding U.S. item is foreign base company sales income assigned to the CFC's subpart F income. Therefore, the master distributor's sales income is assigned to the CFC's subpart F income group, and Reg. §1.861-20(f) allocates the Country C tax to that group.

Alternatively, if the arrangement did not fail the tax rate disparity test, the branch rule would not apply and the manufacturer would not be treated as an entity separate from the CFC. In that case, the master distributor's sales income would constitute tested income, and the corresponding U.S. item would be tested income assigned to the CFC's tested income group.

As noted above, the Disregarded Payment Rules with respect to inventory sales apply only to assign foreign gross income from disregarded sales and do not affect subsequent regarded sales of the same inventory.[51] Accordingly, the analysis with respect to the sub-distributor's sale of that inventory to end customers mirrors the analysis with respect to the distributor's sale to end customers in the first example.

Example 3. Disregarded manufacturer sells to a disregarded distributor, which, in turn, sells to end customers, and disregarded manufacturer pays a royalty for use of intellectual property

EXAMPLE 3.



> The third example is the same as the first, except that the manufacturer's cost of goods sold includes a $10 royalty to a different disregarded subsidiary of the CFC (the "IP Owner"), in exchange for the right to use certain intellectual property (the "IP"). We assume that the manufacturer increases its cost of goods sold in the year in which it makes the royalty payment.

As noted above, upon a taxable disposition of the inventory under U.S. federal income tax law, the corresponding U.S. item is the manufacturer's income from the sale. Under the branch rule, the manufacturer's sales income still does not constitute foreign base company sales income essentially because the manufacturer manufactured the inventory. Accordingly, the corresponding U.S. item is tested income assigned to the CFC's tested income group and constitutes general category income.[52] Therefore, the manufacturer's sales income is assigned to the CFC's tested income group within the general category, and Reg. §1.861-20(f) allocates the Country B tax to the CFC's tested income group within the general category.

The fact that the manufacturer pays a royalty to the IP Owner does not change the analysis with respect to the manufacturer's disregarded sale of inventory. Although the disregarded entity that pays the royalty in this fact pattern manufactures the products it sells and therefore cannot recognize foreign base company sales income, local law arrangements that allow a branch to reduce its potential foreign base company sales income by making base eroding payments to an entity that is not subject to the branch rule because it neither manufactures nor sells should not give rise to branch rule exposure in respect of the royalty recipient. The branch rule applies only to branches or disregarded subsidiaries that engage in manufacturing and selling activities. A private letter ruling that the IRS issued in 2009 supports this position.[53]

Further, the distributor's regarded sale of inventory to end customers is once again a regarded transaction. The Disregarded Payment Rules with respect to inventory sales, as noted above, apply only to assign foreign gross income from disregarded sales and do not affect subsequent regarded sales of the same inventory.[54] Accordingly, the analysis with respect to the distributor's regarded sale of inventory again mirrors the analysis with respect to the regarded sales in the first two fact patterns.

The final piece of the puzzle is to allocate and apportion the foreign income taxes with respect to the $10 royalty payment. Because the royalty increases the cost of goods sold, it must be analyzed under the Reattribution Payment Rules. The application of the Reattribution Payment Rules turns on whether the manufacturer has any income to which that increase can be allocated. If the manufacturer has no income (or the royalty exceeds its income), then, under the facts of this particular example, all or a portion of the royalty payment would be treated as a remittance. Accordingly, the analysis of the royalty payment depends on whether the disregarded payment the distributor makes to the manufacturer can cause a reattribution of income to the manufacturer. The answer to this question is not particularly clear. As an initial matter, and as discussed above, the Reattribution Payment Rules do not appear to apply in the case of a disregarded payment in exchange for property. If the Reattribution Payment Rules do not apply, then one interpretation is that income cannot be reattributed as a result of the disregarded payment. Assuming this interpretation is correct, the manufacturer would not have income attributed to it, and the disregarded royalty payment could not be treated as a reattribution payment.[55] As a result, the manufacturer's royalty payment would be treated as a remittance (*i.e.*, the excess of a disregarded payment over the amount treated as a reattribution payment or contribution, which in this case would be the entire disregarded royalty payment) to the IP Owner. The operative rule under the Disregarded Payment Rules treats the remittance as if it is made ratably out of the manufacturer's accumulated after-tax income (by characterizing the manufacturer's assets) and assigns the IP Owner's income from that remittance to the groupings of the IP Owner accordingly.[56] To the extent the manufacturer's assets are characterized as generating tested income, the royalty income (and related taxes) would also be allocated to the tested income group.

It seems more likely, however, that a disregarded payment made in exchange for inventory does cause a reattribution of income—not under the Reattribution Payment Rules, but under Reg. §1.904-4(f), where a regarded sale of inventory essentially causes the distributor to recognize income that could be reattributed to the manufacturer. This income could then be further reattributed to the IP Owner under the Reattribution Payment Rules. In particular, the rules and principles of Reg. §1.904-4(f)(2)(vi) generally apply to determine a taxable unit's gross income.[57] There are special rules in Reg. §1.904-4(f)(2)(vi)(B)(2) that apply to allocate disregarded payments with respect to sales of non-inventory property and inventory property. With respect to sales of non-inventory property, the rules provide:

> [D]isregarded payments from a foreign branch … to another foreign branch in respect of non-inventory property are allocable to the gross income attributable to the foreign branch, if any, that is recognized with respect to a ***regarded sale or exchange of that property*** (including gross income arising in a later taxable year) to the extent of the adjusted disregarded

gain with respect to the transferred property, and in the same proportions as the source and separate category of the gain recognized on the regarded sale or exchange of the transferred property.[58]

This rule allocates a disregarded payment for non-inventory property to the gross income from a later regarded sale of the same non-inventory property. For sales of inventory property, the rules provide:

[T]he principles of paragraphs (f)(2)(vi)(B)(2)(i) and (ii) of this section apply in the case of disregarded payments in respect of inventory property … between foreign branches 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.[59]

This rule applies similar principles to inventory sales and thus allocates a disregarded payment for inventory to the gross income from a later regarded sale of the same inventory. Applying these concepts, an item of inventory produces gross income on the distributor's regarded sale of that inventory. Under Reg. §1.904-4(f)(2)(vi)(B)(2), an earlier disregarded payment for that item of inventory by the distributor to the manufacturer could cause gross income from the distributor to be attributed to the manufacturer to the extent of the manufacturer's disregarded gain on the disregarded sale. The royalty payment could then be treated as a reattribution payment to the extent it is allocated to the manufacturer's income. As a result, any taxes on the royalty payment would ultimately be assigned to the same grouping as the reattributed income (foreign base company sales income or tested income as the case may be).

Under the facts of the third example, the distributor's sales to customers give rise to regarded U.S. income of $25 ($100 minus the sum of the regarded cost of goods sold of $60 plus $15 of selling costs). To the extent the distributor sells the inventory to customers outside of Country C, the income attributable to those sales activities ($5) is foreign base company sales income, whereas the remaining income from the sales ($20) is tested income. The earlier disregarded payment for the inventory from the distributor to the manufacturer could be allocated to this regarded gross income under Reg. §1.904-4(f)(2)(vi)(B)(2) to the extent of the manufacturer's disregarded gain from the sales ($10, which reflects the addition of the $10 royalty to the $60 of cost of goods sold referenced above). The rules do not indicate how to allocate this payment, but a reasonable approach would be to allocate the disregarded payment *pro rata* to all of the distributor's regarded U.S. income, which would reattribute a *pro rata* amount of tested income ($8) and foreign base company income ($2) to the manufacturer. Under the Reattribution Payment Rules, the royalty payment could then be allocated (we will assume *pro rata*) to this income, causing a portion of the income to be reattributed to the IP Owner and potentially resulting in a portion of the taxes on the royalty ($2 of $10) being allocated to foreign base company sales income group. This produces a counterintuitive result if, as discussed above, all of the manufacturer's income and taxes are assigned and allocated to the tested income group. To better align these results, the taxpayer may want to argue that the disregarded payment from the distributor to the manufacturer should be fully allocated to the $20 of tested income recognized on the distributor's sale, given the factual relationship between the payment and the tested income produced by the manufacturer. This approach would achieve a more intuitive result in which the IP Owner's $10 of royalty income would be assigned fully to the tested income group (to the extent it is treated as a reattribution payment). In other fact patterns, the results may be less satisfying. For example, if the royalty in the third example were increased to $15, the manufacturer's disregarded gain (and reattributed income) would decrease to $5. Therefore, only $5 would be available to be reattributed to the IP Owner and the other $10 of the royalty would be treated as a remittance. To the extent the manufacturer's assets are characterized as generating tested income, however, the royalty income (and related taxes) would also be allocated to the tested income group.

V. Conclusion

Simply put, Reg. §1.861-20 does not provide taxpayers with clear guidance on how to allocate and apportion taxes in connection with disregarded sales of inventory property. Yet, taxpayers that must determine the category and group in which their foreign income taxes fall have no choice but to try to divine what Treasury intended in directing them to hypothesize a regarded disposition. Following an analogous framework in the branch rule regulations is a reasonable approach, as it achieves an allocation and apportionment of foreign income taxes to the U.S. income group to which they relate. Similarly, allowing disregarded payments for inventory to reattribute income properly acknowledges that disregarded inventory payments belong to the same ecosystem as other disregarded transactions. We hope that these common sense conclusions provide some relief to readers who continue to have to contend with the dizzyingly (and, perhaps, unnecessarily) complex regulatory schemes that continue to emerge.

ENDNOTES

1 *See* T.D. 9959, Jan. 4, 2022.

2 Reg. §1.861-20(i). Reg. §1.861-20(d)(3)(v), the paragraph that specifically applies to disregarded payments, applies to years that begin after December 31, 2019 and end on or after November 2, 2020. Unless otherwise noted, all Section references are to the United States Internal Revenue Code of 1986, as amended (the "Code"), and all Reg. § references are to Treasury regulations issued under the Code.

3 For a more detailed discussion of the allocation and apportionment rules in Reg. §1.861-20, *see* Julia Skubis Weber, Stewart Lipeles, and Joshua D. Odintz, *The Foreign Tax Credit Rules Are Coming into Focus*, TAXES, March 2021. The term "Code Sec. 904 category" refers to a separate category of income described in Reg. §1.904-5(a)(4)(v), which includes the general and passive categories, as well as other categories of income to which Code Sec. 904(a), (b), and (c) separately apply, such as under Code Sec. 245(a)(10), 865(h), 901(j), 904(d)(6), or 904(h)(10). *See* Reg. §1.960-1(b)(23).

4 *See* Reg. §1.960-1(d)(3)(ii) (referring to Reg. §§1.904-6 and 1.861-20) and Reg. §1.904-6 (referring, in turn, to Reg. §1.861-20).

5 There is a subpart F income group for: (i) each item of foreign base company income treated as a single item of income under Reg. §1.954-1(c)(1)(iii), such as foreign base company sales income, foreign base company services income, and foreign personal holding company income comprising dividends, interest, rents, royalties, and annuities; (ii) insurance income described in Code Sec. 952(a)(1); (iii) income subject to the international boycott factor described in Code Sec. 952(a)(3); (iv) income from certain bribes, kickbacks, and other payments described in Code Sec. 952(a)(4); and (v) income subject to Code Sec. 901(j) described in Code Sec. 952(a)(5). Reg. §1.960-1(d)(2)(ii)(B).

6 Reg. §1.960-1(d)(2)(ii)(C).

7 Reg. §1.960-1(d)(2)(ii)(D). The CFC's United States shareholders are allowed a credit for the foreign income taxes that Reg. §1.861-20 allocates and apportions to the subpart F income groups or tested income group, but are not allowed a credit for the foreign income taxes that are allocated and apportioned to the residual group. *See* Reg. §1.960-1(a), (e).

8 The term "foreign gross income" means the items of gross income included in the base upon which a foreign income tax is imposed. Reg. §1.861-20(b)(6).

9 Reg. §1.861-20 applies for purposes of various Code sections that require allocating and apportioning foreign income taxes.

10 Reg. §1.861-20(b)(14).

11 Reg. §1.861-20(b)(2).

12 Reg. §1.861-20(b)(2). "U.S. gross income" means the items of gross income that a taxpayer recognizes and includes in taxable income under U.S. federal income tax law for its U.S. taxable year.

13 Reg. §1.861-20(d)(1).

14 Reg. §1.861-20(d)(3)(v)(E)(4).

15 Reg. §1.861-20(d)(3)(v)(E)(9).

16 Reg. §1.861-20(d)(3)(v)(A).

17 *See* Reg. §1.861-20(d)(3)(v)(B).

18 More specifically, the term "reattribution payment" means the portion of a disregarded payment equal to the sum of all "reattribution amounts" that are attributed to the recipient of the disregarded payment. Reg. §1.861-20(d)(3)(v)(E)(7). A "reattribution amount" is an amount of U.S. gross income that is initially assigned to a grouping of a taxable unit, but that is, because of a disregarded payment by that taxable unit (the "Payor"), attributed to another taxable unit (the "Payee"). Reg. §1.861-20(d)(3)(v)(E)(5). The rules and principles of Reg. §1.904-4(f)(2)(vi) or Reg. §1.951A-2(c)(7)(ii)(B) apply to determine the extent to which a disregarded payment made by a taxable unit is made up of reattribution amounts. Reg. §1.861-20(d)(3)(v)(B)(2). Once the taxpayer determines the totality of any reattribution amounts, the Disregarded Payment Rules assign related foreign gross income items to the relevant groupings in proportion to the reattribution amounts in each grouping. Reg. §§1.861-20(d)(3)(v)(B)(1), (2). In addition, the operative rule reattributes U.S. gross income from the Payor to the Payee. *See* Reg. §1.904-4(f)(2)(vi)(A). If a taxable unit receives a disregarded payment that is allocated to the U.S. gross income of another taxable unit, the U.S. gross income of the Payor is adjusted downward to reflect the allocable amount of the disregarded payment and the U.S. gross income of the Payee is adjusted upward by the same amount. Reg. §1.861-20(d)(3)(v)(B)(2); Reg. §1.904-4(f)(2)(vi)(A). Importantly, a reattribution payment does not impact the assignment of foreign gross income in the grouping of the Payor, but may reduce the amount of foreign gross income in the grouping of the Payor to the extent it is deductible in the foreign jurisdiction. Reg. §1.861-20(d)(3)(v)(B)(3).

19 Reg. §1.861-20(d)(3)(v)(B)(1).

20 Reg. §1.861-20(d)(3)(v)(B)(2).

21 Reg. §1.861-20(d)(3)(v)(D); *see* Reg. §1.861-20(d)(2).

22 Reg. §1.861-20(d)(2)(ii)(A).

23 Reg. §1.861-20(d)(2)(ii)(B).

24 Reg. §1.861-20(d)(2)(ii)(C).

25 Reg. §1.861-20(d)(2)(ii)(D).

26 Reg. §1.861-20(b)(9). A disregarded sale of property also seems to fit the description of a foreign law transfer between taxable units, but those rules instruct taxpayers to assign foreign income pursuant to the Disregarded Payment Rules, which would result in a circular application of the regulations. *See* Reg. §1.861-20(d)(2)(ii)(D).

27 Reg. §1.861-20(d)(2)(ii)(C).

28 Reg. §1.861-20(d)(2)(ii)(C).

29 Reg. §1.861-20(d)(3)(v)(D).

30 Reg. §1.861-20(d)(3)(v)(D).

31 For example, assume a Country A CFC owns two disregarded entities: a Country B manufacturer and a Country C distributor. The Country B manufacturer produces inventory and sells it to the Country C distributor. The Country C distributor then makes regarded sales of the inventory to end customers. As a result of its regarded sales of inventory, the distributor includes amounts of gross income that constitute foreign base company sales income and are initially assigned to a statutory or residual grouping. If Reg. §1.861-20(d)(3)(v)(B) applied to assign the manufacturer's income on its disregarded sale of inventory to the distributor instead of Reg. §1.861-20(d)(2), that income would be a reattribution amount to the extent that it was initially assigned to a grouping on receipt by the distributor but was attributed to the manufacturer because of the distributor's disregarded payment to the manufacturer. *See* Reg. §1.861-20(d)(3)(v)(E)(5). The manufacturer's resulting foreign gross income item then would be assigned to the same statutory or residual groupings to which those reattribution amounts were initially assigned. Reg. §1.861-20(d)(3)(v)(B). Thus, even if the manufacturer's income constituted tested income for U.S. federal income tax purposes generally, the manufacturer's income would nevertheless be assigned to the general category, subpart F income grouping under the reattribution rules.

32 Further, under the rules of statutory interpretation, "the specific governs the general." *See, e.g.*, *Nitro-Lift Techs., L.L.C. v. Howard*, 568 US 17, 21, 133 SCt 500, 504 (2012). Since Reg. §1.861-20(d)(3)(v)(D) is a specific rule that applies to foreign gross income from gain on disregarded sales of property, and Reg. §1.861-20(d)(3)(v)(B) is a rule that applies to foreign gross income from disregarded transactions generally, Reg. §1.861-20(d)(3)(v)(D) takes precedence over Reg. §1.861-20(d)(3)(v)(B).

33 In the absence of applicable Treasury regulations or other tax guidance, or where regulations are unclear or ambiguous, courts allow taxpayers to apply a reasonable approach to interpreting ambiguities or addressing gaps in Treasury regulations. *Gottesman & Co.*, 77 TC 1149, Dec. 38,442 (1981); *Corn Belt Hatcheries of Arkansas, Inc.*, 52 TC 636, Dec. 29,668 (1969); *Henry C. Beck Builders, Inc. v.*, 41 TC 616, Dec. 26,652 (1964); *State Farm Mutual Automobile Insurance Company*, 130 TC 263, Dec. 57,472 (2008); *Applied Research Associates, Inc.*, 143 TC 310, Dec. 60,052 (2014).

34 As a general canon of construction, related provisions of the law should be drawn upon as necessary to function as a coherent whole. *See, e.g.*, *United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates*, 484 US 365, 371, 108 SCt 626, 630 (1988) ("Statutory construction … is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme.") (citations omitted).

35 Code Sec. 954(d)(2).

36 Reg. §1.954-3(b)(1)(i)(b).

37 Reg. §1.954-3(b)(1)(ii)(b).

38 Reg. §1.954-3(b)(1)(ii)(c)(1).

[39] Reg. §1.954-3(b)(2)(ii)(e).

[40] *See* Reg. §1.954-3(a)(2)-(4).

[41] *See* Reg. §1.861-20(g)(11).

[42] *See* Reg. §1.954-3(a)(4). A branch's income does not constitute foreign base company sales income to the extent it would not be foreign base company sales income if it were derived by a separate CFC under similar circumstances (*e.g.*, with the application of the manufacturing exception under Reg. §1.954-3(a)(4)). Reg. §1.954-3(b)(2)(ii)(e).

[43] *See* Reg. §1.904-4(b)(2).

[44] *See also* Reg. §1.861-20(d)(3)(v)(D) ("If a taxpayer recognizes U.S. gross income as a result of a disposition of property that was previously received in exchange for a disregarded payment, any item of foreign gross income that the taxpayer recognizes as a result of that same disposition is assigned to a statutory or residual grouping under paragraph (d)(1) of this section …").

[45] Reg. §1.954-3(b)(1)(ii)(c)(1).

[46] *See* Reg. §1.954-3(b)(1)(ii)(b), (c)(1).

[47] Reg. §1.954-3(b)(1)(ii)(c)(1).

[48] Reg. §1.954-3(b)(1)(ii)(c)(1).

[49] Reg. §1.954-3(b)(2)(ii)(c).

[50] Technically, the master distributor's income does not constitute foreign base company sales income to the extent that the master distributor sells inventory in Country C. Reg. §1.954-3(a)(3), (b)(2)(ii)(e). In this example, however, the master distributor sells exclusively to the sub-distributor in Country D.

[51] Reg. §1.861-20(d)(3)(v)(D).

[52] *See* Reg. §1.904-4(b)(2).

[53] *See* LTR 200945036 (Nov. 6, 2009). In LTR 200945036, a CFC in Country 5 owned several disregarded entities that were each located in countries other than the CFC's country of incorporation. Two disregarded entities, DE 2 and DE 3, were sales branches located in Countries 2 and 3, respectively. DE 4 and DE 5 were possible manufacturing branches (as was DE 2) located in Country 4. The final disregarded entity, DE 1, was located in Country 1 and licensed royalty-bearing intangible property to DE 2. DE 2 entered into a unilateral advance pricing agreement with Country 2's tax authorities that provided a transfer pricing methodology to be used to allocate profits to DE 2. In applying the Manufacturing Branch Rule, the IRS articulated that, in determining the amount of foreign base company sales income and the tax rate applicable to that income, "only the income, war profits, excess profits, or similar tax laws (or the absence of such laws) of the countries involved" are taken into account—Country 2 or Country 3 with respect to DE 2 or DE 3 and Country 4 with respect to DE 4 or DE 5 (depending on whether Country 4 was where products sold through DE 2 or DE 3 were manufactured). The determination did not involve DE 1 or Country 1.

[54] Reg. §1.861-20(d)(3)(v)(D).

[55] A reattribution payment is the sum of the portions of a disregarded payment that constitute reattribution amounts, which are amounts of U.S. gross income initially assigned to a statutory or residual grouping that includes one taxable unit's gross income but that are attributed to another taxable unit under Reg. §1.861-20(d)(3)(v)(B)(2) because the former taxable unit makes a disregarded payment to the second taxable unit (in the example above, the manufacturer). Reg. §1.861-20(d)(3)(v)(E)(5), (7). Accordingly, the manufacturer's disregarded royalty payment cannot comprise a reattribution amount (and thus cannot cause a reattribution payment) where the manufacturer has no U.S. gross income attributed to it in the first place.

[56] Reg. §1.861-20(d)(3)(v)(C)(1)(i). Accumulated after-tax income is deemed to arise in the same proportions as the groupings to which the tax book value of the manufacturer's assets are assigned (or would be assigned, if the manufacturer was a U.S. person) for purposes of apportioning interest expense under the asset method in Reg. §§1.861-9 and -9T in the taxable year in which the remittance is made. Reg. §1.861-20(d)(3)(v)(C)(1)(i).

[57] Reg. §1.951A-2(c)(7)(ii)(B)(2). As noted above, Reg. §1.861-20(d)(3)(v)(E)(7) defines "reattribution payment" to mean the sum of all portions of a disregarded payment that constitute "reattribution amounts," which are determined under Reg. §1.861-20(d)(3)(v)(B)(2). Reg. §1.861-20(d)(3)(v)(B)(2), in turn, guides taxpayers to Reg. §1.904-4(f)(2)(vi) and Reg. §1.951A-2(c)(7)(ii)(B) to determine the extent to which a disregarded payment is made up of reattribution amounts and to adjust the U.S. gross income of each taxable unit accordingly.

[58] Reg. §1.904-4(f)(2)(vi)(B)(2)(ii) (emphasis added).

[59] Reg. §1.904-4(f)(2)(vi)(B)(2)(iii).