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Global Tax Alert

# US Treasury issues highly-anticipated proposed foreign tax credit regulations



On 28 November 2018, the United States (US) Treasury Department (Treasury) and Internal Revenue Service (IRS) released proposed regulations (REG-105600-18), providing guidance on various issues related to determining allowable foreign tax credits (FTCs) following the enactment of the law commonly known as the *Tax Cuts and Jobs Act* (TCJA). The package contains proposed regulations under various Code provisions that relate to determining the FTC, including Internal Revenue Code (Code) Sections 78, 861, 904, and 960 (collectively, the Proposed Regulations).

Generally, portions of the Proposed Regulations that relate to statutory amendments in the TCJA would apply to tax years beginning after 22 December 2017; provisions that do not directly relate to the TCJA would apply for tax years ending on or after the date of filing of the Proposed Regulations for (public inspection) in the Federal Register.[1] Certain portions of the Proposed Regulations contain rules that relate to the TCJA, as well as rules that do not. These regulations generally apply to tax years that satisfy both of the following two conditions: (1) the tax year begins after 22 December 2017, and (2) ends on or after the date of filing of the Proposed Regulations (for public inspection) in the Federal Register. Other effective dates for some of the Proposed Regulations are discussed in the Section of the Alert that discusses the relevant provisions.

## FTC changes in the TCJA

In connection with the enactment of the global intangible low-taxed income (GILTI) regime, two of the most significant changes made by the TCJA to the FTC provisions of the Code were modifications to the deemed paid foreign tax provisions under Section 960 and the introduction of two additional income limitation categories under Section 904 (Section 904 category).

### Deemed paid foreign taxes under Section 960

Section 960(a), as amended by the TCJA, treats a US corporation that includes an item of income in its gross income with respect to a controlled foreign corporation (CFC) under Section 951(a) as paying the amount of the CFC's foreign taxes "properly attributable" to that inclusion. The statute by its terms, therefore, appears to require a direct tracing of foreign taxes paid by a CFC attributable to the earnings on which those foreign taxes are paid.

Section 951A requires a US shareholder of any CFC to currently include the US shareholder's GILTI for each tax year — computed based on the CFC's attributions — in gross income in a manner similar to an inclusion of subpart F income under Section 951. Section 960(d) treats a US corporation with a GILTI inclusion as having paid foreign taxes equal to 80% of the product of: (i) its "inclusion percentage" and (ii) the aggregate "tested foreign income taxes" paid or accrued by its CFCs. A US corporation's inclusion percentage for a tax year means the ratio (expressed as a percentage) of: (i) its GILTI inclusion to (ii) the aggregate of its pro rata shares of the tested income of its CFCs. A CFC has "tested income" for a tax year to the extent: (i) the CFC's gross income for the tax year (tested gross income), excluding items of gross income in certain categories (excluded gross income), exceeds (ii) the deductions (including taxes) "properly allocable" (under rules similar to those of Section 954(b)(5)) to the tested gross income (tested deductions). Tested foreign income taxes of a CFC means the foreign taxes paid or accrued by the CFC that are "properly attributable to the tested income of the CFC" that is taken into account by the US corporation under Section 951A.

Finally, upon a distribution of previously-taxed earnings and profits (E&P) (PTI) by a CFC to a domestic corporation, including PTI attributable to a GILTI inclusion, Section 960(b) treats a domestic corporation as having paid so much of the CFC's foreign taxes: (i) as are "properly attributable" to such portion and (ii) that the domestic corporation has not been deemed to have paid under Section 960 in either the tax year or a prior tax year. This provision also applies to PTI distributed through a chain of ownership (so from a lower-tier CFC to an upper-tier CFC, before ultimately coming into the United States).

### Expense allocation and apportionment and additional categories under Section 904(d)

Treas. Reg. Section 1.861-8 through -18 (expense allocation regulations) generally prescribe rules for allocating and apportioning expenses, losses, and other deductions (collectively, deductions) for purposes of computing the net US and foreign source income of a US taxpayer. Certain expenses, such as interest expense and research and development expense, have specific operative regulations that apply only to such expenses. Additionally, the expense allocation regulations provide rules for how CFCs allocate their expenses for US tax purposes.

The TCJA added Section 904(b)(4), which contains special expense allocation rules for determining the amount of a US shareholder's foreign source income for purposes of the Section 904 limitation with respect to stock of a "specified 10-percent owned foreign corporation" with foreign source earnings that are eligible for the deduction allowed under Section 245A (Section 245A deduction) to a domestic corporate shareholder upon receipt of such earnings as a dividend from the foreign corporation.

## Detailed discussion of Proposed Regulations

This Alert is separated into the following four parts.

- Part 1 addresses certain modifications that would be made by the Proposed Regulations to the existing expense allocation and apportionment regulations under Section 861, and other rules related to the application of those regulations, due to changes made by the TCJA.
- Part 2 covers the changes made by the Proposed Regulations to the regulations under Section 904 to account for the addition of the GILTI and foreign branch income categories.
- Part 3 explains the rules provided by the Proposed Regulations for determining deemed paid foreign taxes under Section 960.
- Part 4 discusses other miscellaneous provisions of the Proposed Regulations.

## Part 1: Expense allocation and apportionment regulations under Sections 861 through 865

Excess foreign taxes in the GILTI basket cannot be carried forward or back to another tax year. Thus, for taxpayers subject to an effective rate of foreign income tax greater than 13.125% on the earnings giving rise to the GILTI inclusion, any US shareholder level deductions allocated to the US shareholder's Section 951A category income for purposes of applying the Section 904 limitation will result in a dollar-for-dollar increase in additional income that will be taxed at the full US rate.

The legislative history to the TCJA suggests that Congress did not anticipate taxpayers paying "GILTI tax" if the underlying income was subject to an effective rate of foreign tax of at least 13.125%. The preamble to the Proposed Regulations indicates Treasury received numerous comments recommending that no US shareholder level deductions be allocated to Section 951A category income, to prevent residual US taxation where there are sufficient foreign taxes to prevent US residual tax on the GILTI inclusion. The Proposed Regulations do not adopt the commentators' recommendation but do provide limited relief by providing for exempt income and exempt asset treatment with respect to income in the Section 951A category that is offset by the "Section 250 deduction" and a corresponding percentage of the stock of CFCs that generate such income.

### Exempt income and exempt asset treatment

The Proposed Regulations provide for exempt income and exempt asset treatment with respect to income in the Section 951A category that is offset by the Section 250 deduction for inclusions under Section 951A(a) and a corresponding percentage of the stock of CFCs that generates such income. This will generally have the effect of reducing the amount of expenses apportioned to the Section 951A category.

The Proposed Regulations treat a portion of the stock of a CFC with respect to which the domestic corporation is a US shareholder as exempt even if the CFC has a tested loss for the tax year.

The following example, based on an example in the Proposed Regulations, illustrates the potential benefit to the taxpayer of treating a portion of the stock it holds in a CFC as an exempt asset and the income generated from the stock as partially exempt income.

**Facts**. USP directly owns 100% of the stock of CFC1 and CFC2. The tax book value of CFC1 and CFC2's stock is $10,000 and $9,000, respectively. The following table is assumed to reflect the characterization of the stock under Prop. Reg. Section 1.861-13, USP's net GILTI inclusion and USP's net Section 250 deduction with respect to its GILTI inclusion.

| | CFC1 | CFC2 |
|---|---|---|
| Tax book value | 10,000 | 9,000 |
| Section 951A category stock | 6,100 | 4,880 |
| General category stock | 3,900 | 4,120 |
| USP GILTI inclusion | 610 | |
| Section 250 deduction | 305 | |

On these facts, 305 of USP's income would be exempt income. The portion of the value of the stock of CFC1 and CFC2 that is treated as an exempt asset equals the portion of the value of the stock of CFC1 and CFC2 that is GILTI inclusion stock multiplied by 50% ($305/$610). Accordingly, the exempt portion of the stock of CFC1 is $3,050 (50% x $6,100) and the exempt portion of CFC2's stock is $2,440 (50% x $4,880), i.e., 5,490. For expenses that are allocated and apportioned on the basis of assets, such as interest expense, the exempt portion of USP's assets, i.e., 5,490, would not attract any expense. For expenses that are allocated and apportioned based on gross income, USP would only have 305 of gross Section 951A category income, not 610.

Unlike the treatment of the Section 250 deduction, the Proposed Regulations confirm that the Section 245A deduction does not give rise to exempt income. Similarly, no asset is treated as an exempt asset by reason of the Section 245A deduction. The Proposed Regulations also confirm that undistributed PTI of a CFC does not result in any portion of the stock in a CFC being treated as an exempt asset.

The Proposed Regulations similarly provide for exempt income and exempt asset treatment with respect to income offset by the Section 250 foreign derived intangible income (FDII) deduction and a corresponding percentage of the assets that generate FDII.

### Allocation of the Section 250 deduction

The Proposed Regulations provide rules for allocating and apportioning the Section 250 deduction attributable to FDII and the Section 250 deduction attributable to GILTI (and the corresponding Section 78 gross up). The portion of the

Section 250 deduction attributable to FDII is treated as definitely related and allocable to the specific class of gross income that is included in the taxpayer's foreign-derived deduction eligible income (as defined in Section 250(b)(4)). In cases where the income is allocated to a class that contains multiple categories under Section 904(d) or US source income, the deduction is apportioned ratably based on the relative amounts of gross income in the different income groupings.

The Proposed Regulations provide a similar rule for the portion of the Section 250 deduction attributable to a GILTI inclusion (and the corresponding Section 78 gross up). In certain cases, gross income from the GILTI inclusion could be in a grouping other than the grouping for Section 951A category income (for example, because it is US source or passive category income). In such cases, the Section 250 deduction attributable to GILTI inclusion and the Section 78 gross up is apportioned ratably based on the relative amounts of gross income in the different income groupings.

## Special rule for certain partnership loans

Generally, interest received from a partnership is sourced and categorized by reference to certain attributes of the partnership paying the interest, e.g., whether the partnership is foreign or domestic or whether the partnership has a US trade or business to which the interest is attributed. However, a partner in a controlled partnership generally allocates and apportions its distributive share of interest expense attributable to the loan based on the partner's foreign source asset ratio.

The preamble to the Proposed Regulations indicates Treasury and IRS are aware that certain loans made to a partnership by a US partner person, or a member of the affiliated group of which the US partner is also a member, can distort the determination of the FTC limitation under Section 904 when the same person takes into account both a distributive share of the interest expense and the interest income with respect to the same loan

To prevent these distortive effects, the Proposed Regulations would provide that, to the extent the lender in a "specified partnership loan transaction" takes into account both interest expense and interest income with respect to the same loan, the interest income is assigned to the same statutory and residual groupings as those groupings from which the interest expense is deducted at the partner level. This results in a direct matching of the interest income and expense and preventing the distortions noted in the preamble. Rules are provided for disregarding a portion of the specified partnership loan as an asset for expense allocation and apportionment purposes, and for combating transactions that could circumvent the general rule.

## Revision to CFC netting rule relating to hybrid debt

Under the "CFC netting rules" in Treas. Reg. Section 1.861-10(e), certain related party hybrid debt is treated as related group indebtedness, but the income derived from the hybrid debt is not treated as interest income derived from related group indebtedness. As a result, no interest expense is generally allocated to income from the hybrid debt, but the debt may nevertheless increase the amount of allocable related group indebtedness for which a reduction in assets is required under Treas. Reg. Section 1.861-10(e)(7). The Proposed Regulations revise the CFC netting rules to provide that hybrid debt is not related group indebtedness for purposes of the CFC netting rule. Additionally, the Proposed Regulations provide that hybrid debt is not treated as related group indebtedness for purposes of determining the foreign base period ratio, which is based on the average of related group debt-to-asset ratios in the five prior tax years.

## Valuation of assets

*Repeal of fair market value method*. The TCJA repealed the fair market value method for purposes of apportioning interest expense for tax years that begin after 31 December 2017. As a result, taxpayers that were using the fair market value method must switch to either the tax book value or the alternative tax book value method for their first tax year beginning after 31 December 2017. The Proposed Regulations provide automatic approval for taxpayers required to make this change. Additionally, the Proposed Regulations provide transitional relief so that for the first tax year beginning after 31 December 2017, a taxpayer that had been using the fair market value method may choose to determine asset values using an average of the end of the first quarter and the year-end values of its assets instead of beginning and year-end values of its assets. The relief is only available if all the members of an affiliated group (as defined in Treas. Reg. Section 1.861-11T(d)) make the same choice and no substantial distortion would result.

*Rules for adjusting stock basis in nonaffiliated 10% owned corporations*. The Proposed Regulations confirm that PTI is taken into account for purposes of adjusting the basis of stock in a 10% owned corporation for purposes of apportioning expenses on the basis of the tax book value of assets. The Proposed Regulations clarify further that the reference to the "rules of Section 1248" in Treas. Reg. Section 1.861-12T(c)(2)(i)(B) is intended to provide rules for determining the pro rata share of E&P attributable to the taxpayer's shares, and not for determining the amount of E&P taken into account for that purpose.

It had previously been unclear as to which values are used for averaging beginning and year-end values in the case of 10% owned corporations whose stock basis is adjusted under Treas. Reg. Section 1.861-12(c)(2) (including rules described in Treas. Reg. Section 1.861-12T(c)(2)). The Proposed Regulations clarify that the beginning and end-of-year values of stock are determined without regard to any adjustments under Sections 961(a) or 1293(d), and before making any required adjustment for E&P, which is made only after the average of the beginning and end of year values has been determined.

*Stock basis and Section 965(b) PTI*. Under Section 965(b)(4), the E&P of an E&P deficit foreign corporation are increased by the amount of the "specified E&P deficit" of such corporation taken into account by its US shareholder to reduce its inclusion amount under Section 965(a). If the increase in E&P is taken into account for purposes of increasing the adjusted basis of the stock of a foreign corporation for expense apportionment purposes, and there is no corresponding reduction to the adjusted basis in such stock, the tax book value of the stock would be overstated by the amount of the increase. Accordingly, the Proposed Regulations provide that, solely for expense apportionment purposes, a taxpayer is treated as having made the basis shifting election provided under Prop. Reg. Section 1.965-2(f)(2)(i), but only for reducing the basis of the foreign corporation. The special rule would apply to the last tax year of a foreign corporation beginning before 1 January 2018.

## Characterization of CFC stock to account for Section 951A category income and Section 904(b)(4)

Treas. Reg. Section 1.861-12T(c) generally provides characterization rules for certain stock held by a US taxpayer, including stock in CFCs. The purpose of the Treas. Reg. Section 1.861-12T(c) stock characterization rules is to characterize the stock by reference to the income that the stock generates to its owner. Prior to the TCJA, it was appropriate to characterize the stock in a CFC by reference to the category of the earnings of the CFC. The "look-through rules" of Section 904(d) ensured that the income would maintain its character when taken into account by the US shareholder.

Section 951A category income, however, is a US shareholder concept. In contrast, at the CFC level, the tested income that gives rise to a GILTI inclusion would generally be in the General category. The Proposed Regulations provide special rules, which apply only when Section 904 is the operative section, to take into account the disparate characterization of an item of income at the CFC level as opposed to the characterization of the income at the US shareholder level. Specifically, Prop. Reg. Section 1.861-13 provides a five-step process for characterizing CFC stock held by a US shareholder directly or indirectly through a pass-through entity. The Proposed Regulations provide formulas to be applied at each step where a portion of the CFC stock is to be assigned to an income category.[2]

- Step 1: Characterize stock as generating income in statutory groupings under the asset or modified gross income method. The Proposed Regulations provide for up to 10 subgroups of income that may constitute separate statutory groupings within each of the CFC's general category and passive category.[3]
- Step 2: Assign the portion of the stock characterized as producing "general category gross tested income" in Step 1 to the Section 951A category. A formula is provided to determine this portion, and the remaining portion of the CFC stock remains a general category asset.
- Step 3: Assign stock to a treaty category.
- Step 4: Aggregate stock within each separate category and assign stock to the residual grouping.
- Step 5: Determine Section 245A and non-Section 245A subgroups for each separate category and US source category.

Stock of the CFC that is general category stock, passive category stock, and US source category stock is subdivided between a Section 245A subgroup and a non-Section 245A subgroup for purposes of applying Section 904(b)(4) and Prop. Reg. Section 1.904(b)-3(c) (see later). Each subgroup is treated as a statutory grouping under Treas. Reg. Section 1.861-8(a)(4) for purposes of allocating and apportioning deductions under Treas. Reg. Sections 1.861-8 through 1.861-14T and 1.861-17 in applying Section 904 as the operative section. Deductions apportioned to each Section 245A subgroup are disregarded under Section 904(b)(4). See Prop. Reg. Section 1.904(b)-3.

Deductions apportioned to the statutory groupings for gross Section 245(a)(5) income are not disregarded under Section 904(b)(4); however, a portion of the stock assigned to those groupings is treated as exempt under Treas. Reg. Section 1.861-8T(d)(2)(ii)(B).

The portion of the general category stock of the CFC that is assigned to the Section 245A subgroup of the general category equals the value of the general category gross tested income stock of the CFC that is not assigned to the Section 951A category under Step 2, plus the value of the portion of the stock of the CFC that is assigned to the specified foreign source general category income statutory grouping.

The value of stock of a CFC that is not assigned to the Section 245A subgroup within the general or passive category or the residual grouping is assigned to the non-Section 245A subgroup within such category or grouping. The value of stock of a CFC that is assigned to the Section 951A category, the separate category for income described in Section 901(j)(1), or a particular treaty category is always assigned to a non-Section 245A subgroup.

### Allocation and apportionment of research and experimental expenditures (R&E)

In general, R&E expenditures are apportioned between groupings within product categories according to either a sales or gross income method of apportionment at the taxpayer's election. See Treas. Reg. Section 1.861-17(c) and (d). The taxpayer's use of either method constitutes a binding election to use the method chosen for that year and for the subsequent four years. Within this five-year period, the election may only be revoked with the Commissioner's consent. A taxpayer may change the election at any time after five years, but the new election is binding for a new five-year period.

The Proposed Regulations would allow a one-time exception to the five-year binding election period for R&E apportionment. Specifically, even if a taxpayer is subject to the binding election period, for the taxpayer's first tax year beginning after 31 December 2017, the taxpayer may change its apportionment method without obtaining the Commissioner's consent. This one-time change of method constitutes a binding election to use the method chosen for that year and for the next four tax years. No other changes were made to the R&E apportionment regulations. However, revised R&E apportionment regulations are anticipated.

### Section 904(b)(4)

Section 904(b)(4) provides that, for purposes of the FTC limitation under Section 904(a), the foreign-source income (and entire taxable income) of a US shareholder of a specified 10-percent owned foreign corporation is determined without regard to: (i) the foreign-source portion of any dividend received from such foreign corporation; and (ii) deductions properly allocated and apportioned to: (a) income with respect to stock of the foreign corporation (other than subpart F income and GILTI); and (b) stock of the foreign corporation (to the extent income with respect to such stock is not subpart F income or GILTI).

In general, disregarding both the dividend income eligible for a deduction under Section 245A as well as the associated deduction under Section 245A has no effect on the FTC limitation in any separate category because they generally net to zero. However, additional deductions that are disregarded under Section 904(b)(4)(B) generally have the effect of increasing the FTC limitation with respect to the separate category to which the deductions are allocated and apportioned, because both the numerator (foreign source taxable income in the category) and the denominator (worldwide taxable income) of the fraction are increased by the same amount. In contrast, the limitation in other categories will generally decrease because the numerator (foreign source taxable income in the category) is unchanged but the denominator (worldwide taxable income) of the fraction is increased.

In contrast to Section 864(e)(3), which removes the exempt income and assets from the determination before deductions are allocated and apportioned under the rules of Reg. Sections 1.861-8 through -17, Section 904(b)(4) provides that the deductions are disregarded after they have been allocated and apportioned.

The Proposed Regulations contain detailed mechanical rules for determining the portion of stock to which Section 904(b)(4) applies.

## Part 2: Changes to the regulations under Section 904

The Proposed Regulations include various revisions and additions to the Section 904 regulations to reflect changes made under the TCJA, principally in respect of the addition of the Section 951A and foreign branch categories of income.

## Foreign branch income

Section 904(d)(2)(J) defines foreign branch income as the business profits (excluding any passive category income) of a US person attributable to one or more qualified business units (QBU), within the meaning of Section 989(a), in a foreign country. The amount of business profits attributable to any such foreign QBUs is to be determined under Treasury regulations. The Proposed Regulations generally define a foreign branch (in accordance with the definition of a QBU under Section 989) as activities of a corporation, partnership, or individual that constitute the conduct a trade or business outside the United States and with respect to which a separate set of books and records is maintained. However, activities of a partnership that rise to the level of a trade or business outside of the United States would be treated as a foreign branch even in the absence of a separate set of books and records. Further, the Proposed Regulations do not adopt Section 989(a)'s per se treatment of a partnership (or trust) as a QBU of a partner (or beneficiary). Activities related to disregarded transactions between the QBU and its home office are taken into account in determining whether a QBU carries on a trade or business outside of the United States. And activities taking place in a foreign country that rise to the level of a permanent establishment under a US income tax treaty with that country are presumed to constitute a trade or business conducted outside of the United States. However, the Proposed Regulations do not provide any general guidance on what constitutes a "trade or business" for this purpose and presumably the determination would rely on applicable authorities (subject to the specifications made by the Section 989 regulations) that apply for deciding what a "trade or business" is for Sections 162, 212, or 864 purposes.

Foreign branch category income would primarily include income of a US person (other than a pass-through entity) attributable to foreign branches held by the US person (directly or indirectly through disregarded entities), and a distributive share of partnership income attributable to a foreign branch held by the partnership (directly or indirectly through another partnership or pass-through entity). Therefore, a foreign person (including a CFC) cannot have foreign branch income. The Proposed Regulations also exclude from foreign branch income any passive income, unless passive income is subject to the high-tax kick-out (discussed later) (or is export financing interest or financial services income).

Generally, gross income attributable to a foreign branch is any gross income reflected on the foreign branch's books and records (as adjusted to conform to US Federal income tax principles). However, the Proposed Regulations generally *exclude* the following items from this determination *even if* reflected on the foreign branch's books and records (subject to limited exceptions):

- Income from US-based activities
- Income arising from corporate stock, including stock gain or inclusions under Sections 951(a), 951A, or 1293(a) or
- Gain from the disposition of an interest in a pass-through entity or a disregarded entity

The last item is surprising, but perhaps Treasury was analogizing to a stock sale. Nonetheless it is interesting that gain from the sale or change of foreign branch assets, at least from a US perspective, is not foreign branch income. A limited exception is provided for sales of these interests by a foreign branch in the ordinary course of its active trade or business. For these purposes, an interest is considered to be held in the ordinary course of the foreign branch's active trade or business if the foreign branch engages in the same or a related trade or business as the partnership, other pass-through entity or disregarded entity.

The Proposed Regulations include an anti-abuse rule that will attribute an item to one or more foreign branches or a foreign branch owner to reflect the substance of the transaction if a principal purpose of recording, or failing to record, an item on the books and records of a foreign branch is the avoidance of US Federal income tax or avoiding the purposes of Section 904 or Section 250. Under this anti-abuse rule, interest received by a foreign branch from a related person is presumed to be attributable to the foreign branch owner (and not to the foreign branch) unless the interest income is financial services income.

*Disregarded transactions and reallocation of gross income*. The Proposed Regulations provide special rules that take into account certain disregarded payments for purposes of determining the proper amount of gross income attributable to a foreign branch. Specifically, if a foreign branch owner makes a disregarded payment to its foreign branch, and the disregarded payment is allocable to general category gross income of the foreign branch owner that was not reflected on the books and records of any foreign branch of the foreign branch owner (applying principles of Section 861 as if the payment were regarded and treating foreign source and US source general category gross income each as a statutory grouping), the foreign branch owner's gross income is decreased by the allocable amount of the disregarded payment, and the foreign branch's gross income is increased by the same amount. Similarly, if a foreign branch makes a disregarded payment to its foreign branch owner that is allocable to non-passive gross income of the foreign branch reflected on its books and records (applying principles of Section 861 as if the payment were regarded and treating foreign source gross income and US source gross income in the foreign branch category each as a statutory grouping), the foreign branch's gross income is decreased by the allocable amount of the disregarded payment, and the foreign branch owner's general category gross income is increased by the same amount. Rules are provided for disregarded payments between foreign branches owned by the same foreign branch owner; however, those rules do not change the total amount, character, or source of the US person's gross income.

These rules do not cause the disregarded payments to be regarded for US federal tax purposes, but simply are taking into account the payments in calculating the amount of otherwise regarded gross income attributable to a foreign branch or foreign branch owner. The following is an example provided by the Proposed Regulations (in abbreviated and edited form) of how the disregarded transaction reallocation rule applies.

**Facts**. USP, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch. In 2019, P accrued and recorded on its books and records (and not FDE's books and records) $1,000x of general limitation gross income from the performance of services to unrelated parties, $400x of which was foreign source for services performed outside the US by employees of FDE and $600x of which was US source for services performed in the US. Absent the special rules for disregarded transactions, the $1,000x gross income would be general limitation income not attributable to FDE. FDE provided services in support of P's $1000x gross income from services. P compensated FDE for its services with a disregarded arm's length payment of $400x. The $400x deduction for P's payment to FDE would be allocated and apportioned to P's $400x of foreign source services income if the payment were regarded for US tax purposes.

**Analysis**. The disregarded payment from P to FDE is not recorded on FDE's separate books and records (as adjusted to conform to US tax principles) because it is disregarded for US tax purposes. However, the disregarded payment is allocable to P's gross income because, if the payment were regarded, the $400x deduction would be allocated to P's $1,000 of gross services income and apportioned between US and foreign source income under Treas. Reg. Section 1.861-8. Under the proposed rule, the gross income attributable to FDE (and the gross income attributable to P) is adjusted to take the disregarded payment into account. As such, P's $400 foreign source gross income is attributable to FDE. Therefore, P's $400x foreign source gross constitutes foreign branch gross income.

Contributions, remittances, and interest payments (including certain interest equivalents) are generally not subject to these special rules for disregarded transactions because, as noted in the preamble, these transfers generally reflect a shift of, or return on, capital rather than a payment for goods or services. However, to prevent non-economic reallocations, the Proposed Regulations would require the amount of gross income attributable to a foreign branch (and amount attributable to a foreign branch owner) to be adjusted to account for consideration that would be owed in any disregarded transaction in which Section 367(d)(4) property (generally, intangible property within the meaning of Section 936(h)(3)(B)) is transferred to or from a foreign branch if the transaction were regarded, whether or not a disregarded payment is made (disregarded allocation transaction).

The Proposed Regulations also require that the amount of each disregarded payment used to make an adjustment to the gross income of a foreign branch be determined in accordance with the arm's length standard of Section 482.

The Proposed Regulations do not propose any special rules for determining the amount of deductions to be allocated and apportioned to foreign branch category income (including deductions reflected on a foreign branch's books and records), and therefore the general rules under the Section 861 regulations apply for allocating and apportioning deductions between the foreign branch income category and the other Section 904 income categories.

*Allocation and apportionment of foreign taxes to the foreign branch category*. Generally, foreign taxes are allocated and apportioned to a Section 904 category by reference to the Section 904 category of income to which the taxes relate. The Proposed Regulations include a special set of rules to coordinate the allocation of foreign taxes with the determination of foreign branch income. In the case of a disregarded payment from a foreign branch to a foreign branch owner that results in foreign branch income being reallocated to the general category, any foreign tax imposed solely by reason of that disregarded payment would be allocated and apportioned to the general category.

Similarly, with respect to a disregarded payment from a foreign branch owner to a foreign branch that results in general category income being reallocated to the foreign branch category, any foreign tax imposed solely by reason of that transaction is allocated and apportioned to the foreign branch category.

In the case of any other disregarded payment from a foreign branch to a foreign branch owner, a foreign tax imposed solely by reason of that disregarded payment is allocated and apportioned to a separate category under the base and timing difference rules of Prop. Reg. Section 1.904-6(a)(1) (discussed later).

Finally, in the case of any other disregarded payment from a foreign branch owner to a foreign branch, any foreign tax imposed solely by reason of that disregarded payment is allocated and apportioned to the foreign branch category.

## Clarification of the base and timing difference rules

Under existing Treasury regulations, foreign income taxes are allocated to the Section 904(d) category that includes the income to which the taxes relate. For this purpose, foreign taxes relate to an amount of income if the income is included in the base upon which the tax is imposed, although the income is characterized under US tax principles. However, Section 904(d)(2)(H)(i) (as amended by the TCJA) provides foreign taxes imposed on an amount which does not constitute income under US tax principles (a base difference) is placed in the foreign branch basket. It has been generally understood that the cross-reference to the foreign branch basket is a scrivener's error, which would, hopefully, be addressed in Treasury regulations. Unfortunately, the Proposed Regulations would confirm that foreign taxes paid on base differences are, in fact, placed in the foreign branch basket.

The preamble to the Proposed Regulations, however, states that base differences are expected to arise only in limited circumstances, such as with items of gifts and life insurance proceeds, and specifically noting that foreign tax imposed on a PTI distribution is attributable to a timing difference and thus is treated as tax imposed on the E&P from which the distribution is made.

## Revisions to the Section 904(d) look-through rules

As discussed above, the TCJA expanded the number of Section 904 categories from generally two (i.e., passive and general) to four, but made no changes to the look-through rules under Section 904(d). In particular, under Section 904(d)(3), dividends, interest, rents, and royalties (look-through payments) received or accrued by a US shareholder from a CFC are not treated as passive category income unless allocable to the passive category income of the CFC. However, the terms of current Treas. Reg. Section 1.904-5 generally treat look-through payments as income in a separate category to the extent allocable to income of the CFC in that category.

The Proposed Regulations conform the look-through regulations to current Section 904(d)(3) (as amended by the TCJA) to provide look-through treatment solely for payments allocable to a CFC's passive income. Deductible payments received from a CFC that are not allocated to the CFC's passive income under the look-through rules are assigned to the general category as the residual category. Importantly, even if the look-through payment could be considered as allocable to tested income of a CFC, the payment would not be treated as Section 951A category income under the Proposed Regulations. The Proposed Regulations similarly deny look-through treatment for deductible payments made by a foreign branch to a related person that are allocable to foreign branch category income.

The Proposed Regulations apply the same look-through treatment for GILTI inclusions under Section 951A to treat any amount included in gross income by a US shareholder as a subpart F income inclusion or GILTI inclusion as passive category income to the extent attributable to income received or accrued by the CFC that is passive category income.

## Revisions to the high-tax kick-out

Section 904(d)(2)(B)(iii) generally provides that passive income does not include income subject to a foreign rate of foreign tax (and/or deemed paid under Section 960) in excess of 21% (HTKO). The Proposed Regulations would revise the current HTKO rules to provide that passive income subject to the HTKO (and the foreign taxes imposed on such income) is treated as income of another Section 904 category to the extent such income falls within that category. The Proposed Regulations also revise the grouping rules for determining the amount of foreign tax imposed on passive income for purposes of applying the HTKO. In particular, the Proposed Regulations group the passive category income from dividends, subpart F and GILTI inclusions from each foreign corporation, and passive category income derived from each QBU, rather than by source of the foreign corporation's or QBU's income.

### Transition rules unused foreign taxes under Section 904(c)

*Carryovers of pre-2018 taxes*. The Proposed Regulations provide that foreign taxes paid or accrued (or deemed paid) with respect to a Section 904 category and carried forward to a tax year beginning after 31 December 2017, are allocated to the same post-2017 Section 904 category as the pre-2018 Section 904 category from which the unused foreign taxes are carried. So, pre-2018 excess general limitation taxes carry forward to the post-2017 excess general limitation category. However, taxpayers may assign directly paid (under Section 901) pre-2018 general category taxes to the post-2017 foreign branch category to the extent the taxes would have been assigned to the foreign branch category if the taxes had been paid or accrued in a post-2017 tax year.

*Carrybacks of post-2017 taxes*. The Proposed Regulations require that any unused foreign taxes in the general income or foreign branch category incurred in a post-2017 tax year that are carried back to a pre-2018 tax year are allocated to the pre-2018 general category. Any excess foreign taxes with respect to passive category income or income in a specified separate category in a post-2017 tax year that are carried back to a pre-2018 tax year are allocated to the same pre-2018 separate category.

### Transition rule for the recapture of pre-2018 OFLs, SLLs, and ODLs

The Proposed Regulations provide transition rules for the recapture of pre-2018 overall foreign loss (OFL), separate limitation loss (SLL), and overall domestic loss (ODL) accounts. Pre-2018 SLL or OFL accounts in the passive category remain in that category post-2017. Pre-2018 general category SLL or OFL accounts are allocated to the general and foreign branch category based on the allocation used to allocate pre-2018 unused taxes between post-2017 categories. Consequently, a pre-2018 general category SLL or OFL of any taxpayer who does not apply that exception in Prop. Reg. Section 1.904-2(j)(1)(iii) will remain in the general category. Similar rules apply with respect to recapture of a pre-2018 ODL as well as to the foreign components of pre-2018 net operating losses.

## Part 3: Rules determining deemed paid foreign taxes under Section 960

The Proposed Regulations would establish a six-step process for computing deemed paid foreign taxes under new Section 960(d). The six-steps are performed for each CFC of a US shareholder, starting with the lowest tier CFC. The preamble to the Proposed Regulations notes that the regulations do not provide rules for the allocation of distributions among different types of PTI, indicating that future regulations under Section 959 will provide ordering rules. Proposed regulations under Section 959 are expected to be issued in early 2019.

### Step 1: Assign income to Section 904 categories and income groups

The CFC's items of gross income for the current tax year would first be assigned to a Section 904 category pursuant to the regulations under Section 904 and, and then to an income group within that category. For these purposes, the Section 904 categories are: (1) Section 951A category income; (2) foreign branch category income; (3) passive category income; (4) general category income; and (5) specified separate categories (e.g. treaty resourced income). However, Section 951A category income and foreign branch category income are only applicable at the US shareholder level and thus are not relevant for step 1.

Once income has been assigned to a Section 904 category, it is further assigned to income groups within each Section 904 category. The income groups are: subpart F income groups, tested income group, and residual income group. The subpart F income groups are further divided for each type of subpart F income as defined in Section 952, with passive foreign personal holding company being sub-divided based on, among other things, the foreign taxes imposed on such income.

### Step 2: Allocate and apportion deductions, including foreign taxes

Gross income of the CFC in each income group within each Section 904 category is then reduced by deductions for the current tax year. First, the Proposed Regulations would apply the rules of Sections 861 through 865 and 904(d) to allocate and apportion deductions, other than foreign taxes, that are definitely related to less than all of the CFC's gross income as a class. Second, related party interest expense would be allocated to and apportioned among the subpart F income groups within the passive income category. Finally, all other deductions would be allocated and apportioned.

Current year foreign taxes would also reduce gross income of the CFC in each income group within each Section 904 category based on the Section 904 regulations for allocating and apportioning foreign taxes. Current year foreign taxes would include foreign withholding taxes paid by the CFC in the current tax year, and foreign taxes that accrue on the last day of the CFC's foreign tax year that ends with or within the CFC's tax year under US law.

Except as discussed later, the Proposed Regulations would treat foreign taxes resulting from a timing difference as allocable to the same Section 904 category and income group to which the taxes would have been allocable if the income had been recognized under US Federal income tax principles in the same year in which the foreign tax was imposed. In contrast, current year foreign taxes resulting from a base difference would be allocable to the residual income group and thus not creditable, like any foreign taxes allocated and apportioned to that group.

Also as part of this step 2, the Proposed Regulations would treat a PTI group (as defined in the step 4 discussion that follows) as an income group within the Section 904 category for purposes of allocating and apportioning current year foreign taxes imposed "solely by reason of the receipt of" a distribution of PTI by a CFC. Current year foreign taxes imposed on PTI as a result of any other timing difference would be allocated and apportioned under the timing difference rule discussed earlier. Thus, withholding tax or net basis tax imposed on a CFC's receipt of a distribution of PTI would be treated as taxes incurred "solely by reason of the receipt of" the distribution and allocated or apportioned to a PTI group. Conversely, withholding tax imposed on a disregarded distribution would be treated as a timing difference and not related to a PTI group, even if all of the CFC's earnings are PTI, because the tax was not imposed "solely by reason of the receipt of" a distribution of PTI.

## Step 3: Determination of deemed paid taxes under Sections 960

The Proposed Regulations would provide rules to determine the taxes that are "properly attributable" to subpart F income, for purposes of applying Section 960(a), and to tested income for purposes of applying Section 960(d). In either case, the starting point is the foreign taxes that are allocated and apportioned to the Section 904 categories and to the income groups within those Section 904 categories as discussed in the previous step. Of particular note, the Proposed Regulations would provide that no foreign taxes are deemed paid under Section 960(a) with respect to a Section 956 inclusion. This is the technical result under the Proposed Regulations because a Section 956 inclusion would be sourced from the residual income group and foreign taxes allocated and apportioned to that group cannot be deemed paid (see Step 2 earlier). More generally, however, the preamble to the Proposed Regulations states that Section 960(a) does not apply to deem foreign taxes to have been paid with respect to Section 956 inclusions because, unlike a subpart F inclusion, a Section 956 inclusion does not result from an "item of income" of the CFC but rather is an amount determined based on a formula. This analysis is not convincing because a subpart F income inclusion is not an item of income of a CFC; after all, subpart F is not a pure flow-through regime under which a US shareholder takes into account its pro rata share of a CFC's items of income and loss to the same extent and in the same manner as the CFC. Rather, the inclusion is a net amount based on varying factors, albeit ultimately only when the CFC has positive current E&P. "Amounts" determined under Section 956, however, similarly only result when a CFC has positive E&P and even if those items of income are included, only if and to the extent a CFC invests its earnings in US property. There is no policy justification for this result.

For purposes of Section 960(a), the domestic corporation's proportionate share equals the US dollar amount of current year foreign taxes allocated and apportioned to the subpart F income group from which subpart F income inclusions arise multiplied by the ratio (not to exceed one) of the domestic corporation's subpart F inclusion attributable to that subpart F income group to the total net income in the subpart F income group. No other taxes would be properly attributable to subpart F income. The Proposed Regulations would provide that neither an accumulated deficit nor any prior year deficit reduces the net income in a subpart F income group (the denominator). However, a qualified deficit pursuant to Section 952(c)(1)(B) would reduce the domestic corporation's subpart F income attributable to the group (the numerator). The current year E&P limitation under Section 952(c)(1)(A) or a chain deficit under Section 952(c)(1)(C) would generally reduce both the numerator and the denominator.

The Proposed Regulations would apply similar rules to determine the domestic corporation's proportionate share of current year foreign taxes properly attributable to tested income. In that case, the numerator would be the portion of the tested income in the tested income group within the Section 904 category that is included in computing the domestic shareholder's tested income. The denominator would be the income in the tested income group within the Section 904 category. No other taxes would be properly attributable to tested income. Qualified deficits, the current year E&P limitation, and chain deficits are not relevant to GILTI or tested income and do not affect the calculation.

Additionally, foreign taxes deemed paid under Section 960(b)(2) are calculated with respect to distributions from a PTI group from a lower-tier CFC to an upper-tier CFC. The Proposed Regulations would deem the recipient CFC to have paid the portion of the distributing CFC's foreign taxes that are properly attributable to the distribution from the PTI group and that have not previously been deemed paid by a US corporate shareholder. The amount of the foreign taxes deemed paid by the recipient CFC would be the recipient CFC's proportionate share of the PTI group taxes for that PTI group within the Section 904 Category. The proportionate share would be determined by multiplying the total amount of PTI group taxes (in USD) with respect to the PTI group by the ratio (not to exceed one) of the amount of the distribution from the PTI group over the total amount of PTI in the PTI group (both in functional currency).

The Proposed Regulations would provide special rules for CFCs held through domestic partnerships for foreign taxes properly attributable to both subpart F income and tested income.

### Step 4: Additions to annual PTI accounts and PTI groups

The Proposed Regulations would require taxpayers to track PTI from subpart F inclusions and GILTI inclusions with respect to the CFC's current tax year in "PTI groups" within an "annual PTI account." The annual PTI account would "correspond to the inclusion year of the PTI and to the [S]ection 904 category to which the inclusions under [S]ection 951(a) or GILTI inclusion amounts were assigned at the level of the United States shareholders." There are 10 PTI groups to which PTI would be assigned. The PTI groups generally relate to Section 965(a) inclusions, Section 965(b) PTI, subpart F inclusions other than Section 965 inclusions, GILTI inclusions, Section 956 inclusions, and amounts reclassified as Section 956 PTI that were originally included as one of the other categories.

Foreign income taxes paid, accrued, or deemed paid with respect to PTI are similarly assigned to the PTI group and PTI annual account to which the taxes are properly attributable as determined in step 2 (the PTI group taxes). PTI group taxes are maintained in US dollars. The Proposed Regulations would require adjustments to PTI group taxes when distributions are made or when PTI amounts are reclassified from one PTI group to another under Section 959 (for example, if subpart F PTI is reclassified as Section 956 PTI).

The Proposed Regulations would also establish annual PTI accounts for tax years beginning before 1 January 2018. For these PTI accounts, foreign taxes would be treated as PTI group taxes only if the taxes were: (1) paid or accrued in a tax year of the CFC beginning before 1 January 2018; (2) not previously deemed paid under former Section 902 (as in effect on 21 December 2017); and (3) not deemed paid under former Section 960(a)(3) (as in effect on 21 December 2017).

### Step 5: Repeat steps 1-4 for higher tier CFCs

Each of the prior steps is repeated for each next higher-tier CFC in the chain.

### Step 6: Determination of deemed paid taxes under Section 960(b)(1)

Upon a distribution of PTI from a PTI group within a Section 904 category to a domestic corporation that is a US shareholder of the CFC, the Proposed Regulations would deem the US shareholder to have paid the portion of the CFC's foreign taxes that are properly attributable to the distribution with respect to the PTI group and that have not previously been deemed paid. The same rules discussed in step 3 for determining the taxes properly attributable to a PTI distribution to a CFC shareholder apply for this purpose as well.

## Part 4: Other items

### Treatment of Section 78 gross up for Section 904 and 245A purposes

The Proposed Regulations clarify that the Section 78 gross up is assigned to the same Section 904 category to which the deemed paid taxes under Section 960 are allocated. Therefore, for example, a Section 78 gross up with respect to a GILTI inclusion will be assigned to the Section 951A category.

Under the TCJA, any amount of taxes deemed paid under Section 960 that are treated as a dividend under Section 78 (Section 78 dividend) are generally not eligible for a Section 245A deduction. However, due to the effective dates of amended Section 78 and Section 245A under the TCJA, a US shareholder of a fiscal year CFC could potentially claim a Section 245A deduction with respect to its Section 78 dividend attributable to the US shareholder's inclusions under Section 951 (including by reason of Section 965) for the CFC's fiscal year ending in 2018 (whereas a US shareholder of a calendar year CFC could not do so). To prevent this result, the Proposed Regulations would provide that a Section 78 dividend is not eligible for the Section 245A deduction, applicable to Section 78 dividends that are received after 31 December 2017, by reason of taxes deemed paid under Section 960(a) with respect to a tax year of a foreign corporation beginning prior to 1 January 2018.

The modifications in the Proposed Regulations relating to Section 78 would generally apply to tax years of foreign corporations that begin after 31 December 2017, and to tax years of US shareholders in which or with which such tax years of foreign corporations end. The rule providing that a dividend under Section 78 is not a dividend for purposes of Sections 245 and 245A and certain other rules regarding a Section 78 dividend inclusion would apply to Section 78 dividends that are received after 31 December 2017, by reason of taxes deemed paid under Section 960(a) with respect to a tax year of a foreign corporation beginning before 1 January 2018.

### Changes made to the rules for the high-tax exception under Section 954(b)(4)

Excluded from subpart F income of a CFC is income subject to foreign tax at an effective rate greater than 90% of the US rate (i.e., 18.9%) (the high-tax exception). In the preamble to the Proposed Regulations, Treasury noted that certain jurisdictions purport to have a type of integration regime whereby all or substantially all of the corporate income tax paid by a CFC on its earnings is refunded to its shareholder when the earnings are distributed, even though the shareholder is not subject to any foreign tax on the distribution. Under Treas. Reg. Section 1.954-1(d)(3), a subsequent reduction in corporate foreign income taxes when earnings are later distributed to a shareholder generally does not affect the amount of foreign income taxes used to compute the effective tax rate on an item of income. Treasury expressed concern that some taxpayers form CFCs in these jurisdictions and then claim the high-tax exception, exempting earnings that would otherwise be subpart F income, even though the earnings, ultimately, will bear little to no foreign tax.

The Proposed Regulations modify the high-tax exception to provide that to the extent the foreign taxes paid or accrued by a CFC are reasonably certain to be returned to a shareholder upon a subsequent distribution to the shareholder, the foreign income taxes are not treated as paid or accrued for purposes of the high-tax exception under Section 954(b)(4). The preamble to the Proposed Regulations puts taxpayers on notice that the IRS may challenge taxpayers' position that under current law the income meets the high-tax exception.

### Coordination of the Section 965(n) election with the FTC limitation

Taxpayers who make the Section 965(n) election are allowed to preserve carryback, carryover or current year NOLs rather than have them absorbed by their Section 965 inclusion income. The proposed regulations clarify that where such an election is made, deductions in excess of gross income in the current year must be deferred so that they are not both deducted in the current year and part of an NOL that will be carried to another year. In addition, these deferred deductions must be apportioned among separate categories in proportion to the total deductions allocated and apportioned among those categories under the normal apportionment rules. As a result, the Section 965 inclusion should be apportioned its share of deductions, potentially reducing the ability to claim related foreign taxes as credits. This could impact taxpayers who have already filed 2017 calendar year returns, potentially requiring an amended return.

These rules may not be consistent with the approach taken by impacted taxpayers that have already filed their 2017 tax return. Taxpayers will want to carefully review the Proposed Regulations and evaluate whether the filing of an amended return is required.

## Implications

While the Proposed Regulations provide welcome guidance on the many FTC issues arising from the TCJA, there were also a number of surprises, such as the exclusion of deemed paid taxes with respect to Section 956 inclusions. Additionally, the Proposed Regulations would introduce a complex sequence of computations in order to determine a taxpayer's ultimate FTC capacity, particularly in regard to measuring and characterizing stock in CFCs, as well as for determining deemed paid foreign taxes. Taxpayers with foreign operations will require a significant investment in modeling and compliance to apply the rules.

The Proposed Regulations, which treat GILTI as partially exempt income and the stock giving rise to a GILTI inclusion as a partially exempt asset, provide welcome relief for the many taxpayers that will likely be subject to the Section 904(d) limitation with respect to foreign taxes attributable to their Section 951A category income. The exempt income approach may be a double-edged sword for some taxpayers, however. The Proposed Regulations also provide for exempt income treatment for FDII and assets that give rise to FDII. In some cases, this could have the effect of offsetting the benefit of exempt income treatment for GILTI since a portion of the gross income and assets giving rise to FDII would also be treated as exempt.

The Proposed Regulations target certain arrangements that previously might have resulted in a more favorable FTC position. In particular, the new rules for specified partnership loans and hybrid debt (where CFC netting applies) will have an adverse FTC impact for taxpayers that have those structures in place. Taxpayers that would be adversely impacted will need to consider whether they can restructure their operations so that they do not have excess credits that cannot be utilized.

## Endnotes

1. The Proposed Regulations were available for public inspection on the website of the Federal Register as of 4 December 2018. The Proposed Regulations are scheduled to be published in the *Federal Register* on 7 December 2018.

2. In general, the rules characterize the stock of the CFC as an asset in the various statutory groupings and residual grouping based on the type of income that the stock of the CFC generates, has generated, or may reasonably be expected to generate when the income is included by the US shareholder.

3. The 10 subgroups of income that may constitute separate statutory groupings within each of the CFC's general category and passive category are:

   (1) Foreign source gross tested income (which will be income that gives rise to Section 951A category income)

   (2) For each applicable treaty, US source gross tested income that, when taken into account by a US shareholder under Section 951A, is resourced in the hands of the US shareholder (resourced gross tested income)

   (3) US source gross tested income not described in (2)

   (4) Foreign source gross subpart F income

   (5) For each applicable treaty, US source gross subpart F income that, when included by a US shareholder under Section 951(a)(1), is resourced in the hands of the US (resourced gross subpart F income)

   (6) US source gross subpart F income not described in (5)

   (7) Foreign source gross Section 245(a)(5) income

   (8) US source gross Section 245(a)(5) income

   (9) Any other foreign source gross income (specified foreign source general category income or specified foreign source passive category income, as the case may be)

   (10) Any other US source gross income (specified US source general category gross income or specified US source passive category gross income, as the case may be)

   For each country described in Section 901(j), all gross income from sources in that country is also a statutory grouping.

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