Baker McKenzie.

Tax News and Developments
North America

Client Alert

January 15, 2019

Treasury and IRS Release Proposed Foreign Tax Credit Regulations

In This Issue:

Introduction

Changes to the Expense Allocation Rules

FTC limitation and basketing rules

Section 960 Regulations

Section 965 Rules

I. Introduction.

The Tax Cuts and Jobs Act (the "TCJA") introduced the most significant changes to the foreign tax credit ("FTC") provisions of the Internal Revenue Code (the "Code") since 1986. Among other things, Congress repealed section 902 as part of its adoption of a quasi-participation exemption regime with section 245A, added two new FTC baskets for global intangible low-taxed income ("GILTI") and foreign branch income, and modified section 960 to apply a "properly attributable to" standard in lieu of multi-year pooling. At the same time, Congress left other provisions, like the section 861 expense allocation rules, largely untouched, leaving taxpayers with a lot of uncertainty.

On November 28, 2018, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") released proposed regulations providing guidance for determining allowable FTCs under the new rules (the "Proposed Regulations"). The Proposed Regulations cover a wide range of topics and attempt to conform the TCJA changes with respect to a number of Code provisions, including sections 78, 861, 904, and 960. The Proposed Regulations also address certain FTC issues that pre-date the TCJA. In this alert, we discuss the highlights and key takeaways from the Proposed Regulations. Any comments on the Proposed Regulations and requests for a public hearing must be received by Treasury before February 5, 2019.

II. Changes to the Expense Allocation Rules.

A. Addressing the New GILTI, FDII, and Section 245A Rules.

1. GILTI Expense Allocation Rules Provide Only Partial Relief for Taxpayers.

The most noteworthy aspect of the Proposed Regulations are the rules requiring the allocation of expenses to the new GILTI basket for purposes of determining a US taxpayer's FTC limitation. Many taxpayers had hoped that Treasury would take the view that the residual US tax on a GILTI inclusion, after applying the section 250 deduction, would be treated as a minimum tax. Treasury, however, made it clear in the preamble to the Proposed Regulations (the "Preamble") that it believes Congress did not intend GILTI to be a minimum tax and that the provisions enacted by the TCJA are not consistent with viewing GILTI in this manner. The Preamble cites as support for its position Congress's addition of the GILTI basket in section 904(d)(1) and amendment of section 904(c) without otherwise amending section 904 or sections 861 through 865 to provide special treatment of expenses allocable to this new FTC basket. The Preamble also cites the addition of section 904(b)(4)(B), which requires domestic corporations to disregard certain deductions other than those that are "properly allocable or apportioned to" amounts includible under section 951A(a) or 951(a)(1), thus suggesting that deductions are supposed to be allocated to the new GILTI basket.

While many will be disappointed with the requirement to allocate expenses to the GILTI basket, Treasury gave taxpayers some relief in the Proposed Regulations by allowing taxpayers to treat a portion of the section 951A inclusion and the related foreign corporation stock as exempt income and an exempt asset, respectively, for section 904 purposes. Because the section 250 deduction effectively exempts a portion of a domestic corporation's GILTI inclusion (and corresponding section 78 gross-up amount) from tax, the Proposed Regulations provide that gross income offset by the section 250 deduction is treated as exempt income, and the stock giving rise to the GILTI inclusion is treated as a partially exempt asset for purposes of the expense allocation and apportionment rules.

> **Observation:** By treating a portion of CFC stock giving rise to GILTI as exempt, the Proposed Regulations effectively remove a portion of a domestic corporation's CFC stock from both the numerator and the denominator of the fraction for the apportionment of deductions on the basis of assets (e.g., for interest expense allocation purposes).

Because gross income from a GILTI inclusion could be in a statutory grouping other than the section 951A category of income for section 904 purposes (for example, if the income is also passive category income), Prop. Treas. Reg. § 1.861-8(e)(14) provides rules for apportioning the section 250 deduction attributable to the GILTI inclusion and the corresponding section 78 gross-up among the various categories. The rules require taxpayers to apportion the section 250 deduction attributable to GILTI ratably among the groupings based on the relative amounts of gross income in each grouping.

To determine the portion of CFC stock that is treated as an exempt asset, the Proposed Regulations require the domestic corporation to multiply its ownership percentage in the CFC stock by the fraction of such domestic corporation's deduction allowed under section 250(a)(1)(B)(i) (taking into account any reduction under the taxable income limitation of section 250(a)(2)(B)(ii)) divided by the domestic corporation's GILTI inclusion. The fraction is applied to the CFC stock that is characterized as "GILTI inclusion stock." GILTI inclusion stock is the domestic corporation's aggregate portion of the value of CFC stock assigned to one of five categories under the rules in Prop. Treas. Reg. § 1.861-13(a) and includes: (i) the section 951A category; (ii) a particular category of gross income that is resourced under a treaty; (iii) the gross tested income statutory grouping within the foreign source passive category; (iv) the gross tested income statutory grouping within the US source general category; and (v) the gross tested income statutory grouping within the US source passive category. A portion of a domestic corporation's CFC stock is treated as an exempt asset even if the CFC has a tested loss for the taxable year.

2. FDII Expense Allocation Rules.

As with the portion of a domestic corporation's gross income from a GILTI inclusion, a domestic corporation's gross income that is foreign-derived intangible income ("FDII") is also treated as exempt income based on the amount of the section 250 deduction allowed. The Proposed Regulations reduce the value of the domestic corporation's assets that produce FDII for expense allocation and apportionment purposes to account for the fact that a portion of the income from such assets is treated as exempt. The exempt portion of the domestic corporation's assets is equal to the amount of such corporation's FDII-producing assets multiplied by a fraction that equals the amount of its deduction

allowed under section 250(a)(1)(A) (taking into account any reduction under the taxable income limitation of section 250(a)(2)(B)(i)) divided by its total FDII for the year. Treating FDII-producing assets as tax-exempt assets for expense allocation purposes may offset some of the benefits associated with treating a portion of CFC stock giving rise to GILTI as exempt.

The Proposed Regulations further provide that no portion of CFC stock is treated as an FDII-producing exempt asset for expense allocation purposes. This is the case even if the CFC in question pays deemed royalties to its US parent under section 367(d) that qualify for FDII benefits.

Prop. Treas. Reg. § 1.861-8(e)(13) provides a rule to allocate and apportion the section 250 deduction attributable to FDII. The FDII portion of the section 250 deduction is treated as definitely related and allocable to the class of gross income that is included in the taxpayer's FDII. If there are multiple classes of gross income, the deduction is allocated ratably based on the relative amounts of gross income.

3. Section 245A Expense Allocation Rules and Section 904(b)(4).

Certain tax-exempt assets are not taken into account for purposes of allocating and apportioning any deductible expenses under section 864(e)(3). The statute provides that a similar rule applies for the portion of any dividend income eligible for a dividends received deduction under sections 243 and 245(a). The TCJA added another dividends received deduction to the Code under new section 245A. When applicable, section 245A permits domestic corporations to claim a dividends received deduction equal to the foreign-source portion of a dividend from a specified 10-percent owned foreign corporation. Congress, however, did not amend section 864(e)(3) to include dividends eligible for the section 245A deduction as tax-exempt income for expense allocation and apportionment purposes. Prop. Treas. Reg. § 1.861-8(d)(2)(iii)(C) clarifies that dividends eligible for the section 245A deduction are not treated as exempt income (nor are any assets treated as exempt by reason of the section 245A deduction).

Congress, instead, provided an alternative approach in new section 904(b)(4) that requires domestic corporations to disregard, for purposes of determining their FTC limitation under section 904(a), both: (i) the foreign-source portion of any dividend income from a 10-percent owned foreign corporation; and (ii) any deductions properly allocable and apportioned to such income. The Proposed Regulations note that this alternative approach requires taxpayers to first allocate and apportion expenses to income eligible for a deduction under section 245A (and the related foreign corporation stock that produced such income) before the income and corresponding deductions are disregarded. Importantly, the deductions are disregarded for both: (i) determining the amount of foreign source income (i.e., the numerator) in the basket to which the deductions are allocated; and (ii) calculating worldwide taxable income (i.e., the denominator) for all baskets subject to the FTC limitation, including the GILTI basket.

> **Observation:** The overall effect of this approach for allocating expenses to section 245A dividends is to increase the FTC limitation within the separate category to which the disregarded deductions are allocated and apportioned (because the numerator and denominator both increase by the same amount)

while decreasing the limitation in the other categories (because only the denominator increases).

Because section 904(b)(4) disregards both the income "other than amounts includible under section 951(a)(1) or 951A(a)" and the deductions "properly allocable" to such income (and the assets which produced such income), the Proposed Regulations under section 904(b) provide rules for purposes of determining these amounts. The Proposed Regulations clarify that income "other than amounts includible under section 951(a)(1) or 951A(a)" refers to section 245A-eligible income.

For purposes of determining the deductions "properly allocable or apportioned" to the section 245A-eligible income and the related stock, the Proposed Regulations take the approach of dividing each FTC basket into two subgroups: (i) a section 245A subgroup; and (ii) a non-section 245A subgroup. Prop. Treas. Reg. § 1.904(b)-3(b) then treats each section 245A subgroup as a statutory grouping under Treas. Reg. § 1.861-8(a)(4). Gross income is only included in the section 245A subgroup if it is dividend income for which a deduction is allowed under section 245A. Further, the only asset included in a section 245A subgroup is the portion of the value of stock of each specified 10-percent owned foreign corporation that is assigned to the section 245A subgroup.

Stock of a specified 10-percent owned foreign corporation that is not a CFC generally is assigned, in its entirety, to a section 245A subgroup. This is because stock of a non-CFC cannot give rise to an inclusion under section 951(a)(1) or 951A(a). In contrast, the value of CFC stock is subdivided between a section 245A and a non-section 245A subgroup under the rules described in Prop. Treas. Reg. § 1.861-13(a)(5). These rules generally assign the portion of CFC stock that does not generate a GILTI or subpart F inclusion to the section 245A subgroup. The Proposed Regulations also assign to the section 245A subgroup the portion of CFC stock, if any, which generates income eligible for a dividends received deduction under 245(a)(5) (relating to US source earnings from a specified 10-percent owned foreign corporation). Deductions allocated and apportioned with respect to CFC stock in the section 245A subgroup (e.g., interest expense) are similarly disregarded for purposes of the FTC limitation calculation.

B. Tax Book Value Method.

1. Repeal of the FMV Method for Interest Expense Apportionment.

The TCJA repealed the fair market value ("FMV") method for interest expense apportionment for taxable years beginning after December 31, 2017. As a result, taxpayers are required to apportion interest expense under one of the other two existing methods: the tax book value method or the alternative tax book value method. As in the past, these two other methods require a taxpayer to determine asset basis within each statutory grouping by averaging the book value of each asset at the beginning and end of the taxable year. A special rule provides that where this averaging would result in "substantial distortion" of asset values, taxpayers must use a different method of asset valuation that "more clearly reflects the average value of assets weighted to reflect the time such assets are held by the taxpayer during the taxable year." The Proposed Regulations describe major corporate transactions such as acquisitions or dispositions as events that could result in such a distortion.

> **Observation:** Taxpayers who have engaged in significant transactions in 2018 should consider the potential impact of the "substantial distortion" rule and determine the potential benefit or detriment of alternative methods for computing asset values for interest expense apportionment purposes.

Taxpayers that were using the FMV method must change to one of the other remaining methods. The change is compulsory and taxpayers need not request the Commissioner's approval to adopt the new method. Because these taxpayers may have not had a reason to calculate the adjusted tax basis of their assets as of the first day of their taxable year, the Proposed Regulations provide a limited transition rule. A taxpayer that was using the FMV method may elect to determine asset values using the tax book values at the end of the first quarter of the first taxable year beginning after December 31, 2017, rather than the first day of that year. This election must be applied to all members of the taxpayer's affiliated group.

> **Observation:** As the Preamble notes, the TCJA repealed the FMV method only with respect to allocating and apportioning interest expense. Taxpayers may continue to use the FMV method when appropriate to allocate and apportion other non-interest expenses.

2. Stock Basis Adjustment Rules.

The current regulations under section 861 generally require taxpayers to make certain adjustments to stock basis in 10-percent owned corporations for purposes of applying the tax book value method. Specifically, taxpayers must increase stock basis by any earnings and profits ("E&P") earned by the corporation that are attributable to the stock during the time period the taxpayer owned the stock and must decrease stock basis by any deficit of the corporation attributable to the stock during that period. In the Preamble, Treasury noted that some taxpayers have taken the position that previously taxed earnings and profits are not E&P for this purpose (previously taxed earnings and profits are referred to as "PTEP" throughout the Proposed Regulations rather than the colloquial "PTI"). However, the Proposed Regulations confirm that all E&P under section 959(c), including PTEP, are taken into account for purposes of the adjustment described in Treas. Reg. § 1.861-12(c)(2).

> **Observation:** Amounts treated as PTEP after the application of section 965, therefore, are taken into account for purposes of the interest expense apportionment rules. These adjustments may cause more expenses to be allocated to the GILTI basket.

As in the past, the Proposed Regulations provide that basis increases to CFC stock under section 961 are not taken into account for purposes of expense allocation. In a related provision, the Proposed Regulations require taxpayers to adjust the basis in certain 10-percent owned foreign corporations to the extent section 965(b) applied for purposes of calculating the taxpayer's section 965 inclusion. After this calculation, taxpayers that had E&P deficit foreign corporations could elect under Prop. Treas. Reg. § 1.965-2(f)(2)(i) to increase their basis amounts in their deferred foreign income corporations ("DFICs") by the amount of deficits allocated under section 965(b) and decrease their basis amounts in their E&P deficit foreign corporations by an equivalent amount. The Proposed Regulations

treat taxpayers as if they had made this election for purposes of applying the tax book value method. The deemed election, however, only counts basis decreases. A basis increase in any DFIC stock, from an actual or deemed election, is not taken into account for expense apportionment purposes regardless of whether the taxpayer made the election. The Preamble requests comments on alternative ways to account for section 965(b) that minimize taxpayer burdens without distorting the measurement of a CFC's tax book value.

> **Observation:** This rule effectively requires all taxpayers that allocated deficits under section 965(b) to separately track two basis figures for their top-tier CFCs. These rules are on top of the complex basis rules in the proposed GILTI regulations. Thus, taxpayers may be required to track three basis amounts for certain CFCs with tested losses.

C. CFC Stock Characterization Rules.

The Proposed Regulations introduce new Prop. Treas. Reg. § 1.861-13, which characterizes CFC stock to allocate and apportion deductions for the purposes of section 904. There are separate but similar rules for applying the asset method and the modified gross income method for apportioning deductions with respect to asset basis. The Proposed Regulations adopt a five-step process for characterizing CFC stock. The five steps involve allocating the CFC stock to various groupings based on the type of income that the stock of the CFC generates, has generated, or may reasonably be expected to generate.

1. Asset Method.

Taxpayers using the asset method to characterize CFC stock must do so according to the following steps:

1. First, a taxpayer characterizes the value of the CFC stock by assigning the underlying assets of the CFC to one of twenty (or more) statutory groupings using the asset method described in Temp. Treas. Reg. § 1.861-12T(c)(3)(ii). Where there are chains of CFCs, the analysis begins with the assets of the lowest-tier CFC. As in the past, this requires a taxpayer to determine which type of income each asset generates, has generated, or may reasonably be expected to generate. The taxpayer first allocates the assets to either the general or passive basket.

   Within each FTC basket, the taxpayer then assigns the assets to subgroups, each of which is considered a separate statutory grouping. These subgroups include: (i) foreign source gross tested income; (ii) US source gross tested income resourced under a treaty (separated for each applicable treaty); (iii) other US source gross tested income; (iv) foreign source gross subpart F income; (v) US source gross subpart F income resourced under a treaty (separated for each applicable treaty); (vi) other US source gross subpart F income; (vii) foreign source gross section 245(a)(5) income; (viii) US source gross section 245(a)(5) income; (ix) any other foreign source gross income; and (x) any other US source gross income.

If section 901(j) applies to income from a particular country, an additional subgroup is created for income from sources in that country (section 901(j) generally denies FTCs for taxes imposed by certain sanctioned countries).

The taxpayer then repeats this process for the next highest-tier CFC, until it reaches the top-tier CFC.

2. Second, a taxpayer assigns a portion of the CFC stock to the section 951A (GILTI) category. To do this, a taxpayer takes the portion of the CFC stock assigned to general basket foreign source gross tested income and multiplies this amount by the US shareholder's inclusion percentage (i.e., the US shareholder's GILTI inclusion divided by its aggregated pro rata share of tested income under section 951A(c)(1)(A)). A portion of this amount may be treated as an exempt asset under the rules discussed above. The remaining amount not assigned to the GILTI category remains a general category asset.

3. Third, CFC stock that was assigned because income was resourced under an applicable treaty is assigned to a treaty category. Different rules apply depending on whether the stock was assigned to the US gross tested income category or the US gross subpart F income category.

4. Fourth, any portions of the value of the CFC stock assigned to a foreign source statutory grouping that were not assigned under Step 2 are aggregated within the general category or passive category, as appropriate. Any portions of the value of the CFC stock assigned to a US source statutory grouping that were not assigned under Step 3 are aggregated within the US source category, which is the residual grouping for purposes of the expense and allocation rules. Any CFC stock assigned to a section 901(j) country remains a separate category.

5. Fifth, and finally, a taxpayer determines the section 245A subgroup and non-section 245A subgroup for each separate category. These rules are discussed above in Section II.A.3.

After completing these five steps, a taxpayer can apportion deductions to the various FTC baskets on the basis of assets (e.g., for interest expense). The Proposed Regulations contain helpful examples that illustrate the application of these complex rules.

2. Modified Gross Income Method.

If a taxpayer uses the modified gross income method to characterize CFC stock, the taxpayer generally follows the same five steps detailed above. However, for Step 1, the taxpayer applies the rules of Treas. Reg. § 1.861-12(c)(3)(iii) to assign the modified gross income of the CFC to the statutory groupings discussed above. For this purpose, a CFC chain combines its gross income within each statutory grouping.

D. Other Special Allocation Rules.

1. Research and Experimental Expenditures.

The Proposed Regulations make no substantive changes to the rules for the allocation and apportionment of research and experimental ("R&E") expenditures. The only proposed change is a one-time exception to the five-year binding election period that would allow a taxpayer to change its method for apportioning excess R&E expenditures (i.e., by using the sales method or the gross income method). The Preamble requests comments on whether additional changes should be made.

Prior to the publication of the Proposed Regulations, there was substantial uncertainty regarding how, or even if, the rules for the allocation and apportionment of R&E expenditures, in their current form, apply with respect to the GILTI basket. The Preamble confirms that, in Treasury's view, taxpayers must allocate and apportion R&E expenditures to GILTI basket income. The Preamble provides an example illustrating the proper allocation and apportionment of R&E expenditures to the GILTI basket. However, the example provides almost no assumed facts and no analysis, raising more questions than it answers.

2. Specified Partnership Loans.

The Preamble identifies certain loans to foreign partnerships that, in Treasury's view, can result in a distortion of a taxpayer's FTC limitation. The Proposed Regulations target a structure in which: (i) a US group owns CFCs through a foreign partnership; and (ii) the foreign partnership borrows from the US group. Under the current regime, a US group generally apportions its share of the foreign partnership's interest expense using the adjusted bases of the group's assets. However, the interest income received by the US group is generally treated as foreign source income in its entirety. In Treasury's view, this creates a mismatch.

To counter this result, the Proposed Regulations treat a loan by a partner to a partnership as a "specified partnership loan." Taxpayers must source the interest income from a specified partnership loan in the same manner as the related interest expense. To avoid double counting the specified partnership loan under this matching rule and the interest expense apportionment rule, the Proposed Regulations disregard the receivable of the specified partnership loan for the purposes of interest expense apportionment. This matching rule applies to debt and to any transaction that gives rise to interest equivalents that are apportioned under the interest expense apportionment rules. The Proposed Regulations also include two anti-abuse rules that are intended to prevent taxpayers from circumventing the matching rule for specified partnership loans through the juxtaposition of third-parties or CFCs.

3. Revised CFC Netting Rule.

The Proposed Regulations also seek to modify the special interest expense allocation and apportionment provisions of Treas. Reg. § 1.861-10(e) (the "CFC Netting Rule"). The CFC Netting Rule is an exception to the general interest expense allocation provisions that, if applicable, requires the direct allocation of a portion of the taxpayer's interest expense to certain interest income of the taxpayer. The CFC Netting Rule is complex, but its general

purpose is to prevent taxpayers from borrowing in the US and on-lending the proceeds to related CFCs in an effort to create an income and deduction sourcing mismatch. Specifically, in the absence of any rules to the contrary, all of the income from the related CFC loan would be foreign source income, but only a part of the interest expense from the third-party loan would be foreign source under the interest expense apportionment rules that look to asset basis. To remedy the mismatch, the CFC Netting Rule replaces the general interest expense apportionment rules when a taxpayer increases both its third-party debts payable and its debts receivable from related CFCs. The CFC Netting Rule directly allocates interest expense from the increase in third party debts to interest income from the increase in debts receivable from related CFCs. To avoid double counting assets under both the CFC Netting Rule and the general interest expense apportionment rules, the increase in debts receivable from related CFCs is removed from the interest expense apportionment computation.

The existing regulations treat hybrid instruments that are equity for US purposes and debt under foreign law as related group indebtedness, except that income derived from the hybrid instrument is not subject to direct allocation. Thus, as a general matter, under the current regulations, such hybrid instruments may be disregarded from the interest expense allocation calculation to the extent that they are treated as allocable related group indebtedness. This has the effect of reducing the taxpayer's basis in foreign source income-producing assets, thereby reducing the amount of the taxpayer's interest expense apportioned to the taxpayer's foreign source income.

The Proposed Regulations describe the above rules as having a distortive effect on the allocation and apportionment of interest expense. In response, the Proposed Regulations would no longer treat instruments that are equity for US purposes and debt for local as related group indebtedness. Thus, equity instruments that give rise to interest expense under foreign law would be treated as regular equity for the purposes of the CFC Netting Rule. As a result, the CFC Netting Rule would no longer cause hybrids to be disregarded (in whole or in part) from a shareholder's interest expense apportionment computation.

4. Worldwide Affiliated Group Rules.

Beginning in taxable years beginning after December 31, 2020, section 864(f) will permit a US affiliated group to elect to apportion the interest expense of its members on a worldwide basis. This election can be beneficial because it generally would allow US members of a worldwide group to allocate third-party interest expense to domestic source income to the extent that the US members of the worldwide group are not more highly leveraged than the foreign members of the worldwide group. The Proposed Regulations do not provide guidance with respect to section 864(f). The Preamble instead notes that the implementation of section 864(f) will require a reexamination of the allocation rules, "including in particular the apportionment of interest, research and experimentation . . . , stewardship, and general & administrative expenses," as well as the CFC Netting Rule. Treasury requests comments from taxpayers to assist with its review.

III. FTC limitation and basketing rules.

A. Transition Rules for the GILTI and Foreign Branch Baskets.

The TCJA introduced two new FTC baskets-the GILTI basket and the foreign branch basket. To deal with the additional baskets, the Proposed Regulations provide much-needed transition rules.

1. Carryover of Unused Foreign Taxes.

The general rule in the Proposed Regulations is that foreign taxes that are carried forward under section 904(c) from pre-2018 to post-2017 taxable years are allocated to the same basket (i.e., the general or passive basket). The Proposed Regulations provide an exception that allows taxpayers to carry forward foreign taxes to the FTC basket to which the taxes would have been allocated had all four FTC baskets existed in the pre-2018 taxable year. Under Prop. Treas. Reg. § 1.904-2(j)(1)(iii), the exception generally applies to unused foreign taxes paid or accrued and carried forward with respect to general category income. The exception is not available for deemed-paid foreign taxes and thus applies to section 901 credits only. A taxpayer applies this exception on its tax return, either as originally filed or amended. There is an all-or-nothing element to the exception, as it must be applied to all of a taxpayer's unused general basket foreign tax carryforwards. The exception also permits taxpayers to carry forward some or all of their unused general basket foreign taxes from pre-2018 taxable years to the foreign branch basket, presumably because the foreign branch basket does not include passive income and could not be GILTI (had the GILTI basket existed) for taxable years beginning before 2018. Treasury recognized that it may be difficult for taxpayers to reconstruct their FTC allocations, so the Preamble requests comments on whether a simplified rule should also be included and what such a rule should look like (e.g., a pro rata allocation based on a taxpayer's first post-2017 taxable year).

> **Observation:** Taxpayers that have unused general basket foreign tax carryforwards from pre-2018 years should calculate whether the elective exception would benefit them, e.g., whether some of the unused foreign taxes would be creditable in the foreign branch basket in 2018 or a later taxable year.

2. Carrybacks.

The TCJA is clear that taxes in the GILTI basket cannot be carried back or forward. In contrast, the TCJA does not specifically address carrybacks of taxes in the new foreign branch basket to pre-2018 taxable years. The Proposed Regulations provide a transition rule that allows a taxpayer to carry back taxes in the foreign branch basket in its first post-2017 taxable year to the general basket in its last pre-2018 taxable year. The proposed rule makes sense because section 904(c) generally allows a one-year carryback and foreign branch income cannot include passive income. On the other hand, excess taxes in the general or passive basket must be carried back within the same basket.

> **Observation:** Prior to the Proposed Regulations, taxpayers were concerned because the TCJA contained no carryback guidance. This rule provides welcome relief for taxpayers that wish to carry back excess foreign branch basket taxes.

3. OFLs, SSLs, and ODLs.

The Proposed Regulations also provide transition rules for a taxpayer's overall foreign loss ("OFL"), separate limitation loss ("SLL"), and overall domestic loss ("ODL") accounts. The general rule for all of these accounts is that OFLs, SLLs, and ODLs that offset pre-2018 passive basket income remain associated with the passive basket. OFLs, SLLs, and ODLs that offset pre-2018 general basket income, however, are allocated between the general basket and the foreign branch basket in the same proportion that the taxpayer allocates its foreign taxes between those baskets under the carryforward rule discussed above.

B. Foreign Branch Income Basket.

1. General Rules and Definitions.

The TCJA introduced the new foreign branch basket in section 904(d)(1)(B). Foreign branch income is defined as business profits of a US person attributable to one or more qualified business units ("QBUs") as defined in section 989(a). The Proposed Regulations provide guidance on the foreign branch definition and the items of gross income attributable to a foreign branch. Some of the most significant provisions in the Proposed Regulations address the treatment of disregarded transactions, as discussed further below.

A foreign branch is a QBU with certain modifications. Under the section 989 regulations, a QBU exists with respect to activities if two requirements are met: (i) the activities constitute a trade or business; and (ii) separate books and records are kept for those activities. The Proposed Regulations modify the QBU definition for purposes of the foreign branch basket as follows. First, the trade or business must be outside the United States. Second, activities that give rise to a permanent establishment in a foreign country under a relevant US tax treaty are presumed to constitute a trade or business. Third, the Proposed Regulations clarify that disregarded activities are considered in determining whether a trade or business exists. Fourth, a partnership or trust must have a trade or business to constitute a QBU because the rule that otherwise treats a partnership or trust as a per se QBU does not apply for this purpose. Finally, separate books and records are not required for partnerships and trusts to constitute a QBU.

The Proposed Regulations provide that gross income is attributable to a foreign branch to the extent the gross income is reflected on the separate books and records of the foreign branch (as adjusted for federal income tax purposes). The Proposed Regulations specifically exclude, however, the following items from the foreign branch basket: (i) items of income from activities carried out in the United States; (ii) items of income arising from stock, including subpart F inclusions, GILTI inclusions, qualified electing fund inclusions, and gain from the disposition of stock (except certain dispositions of stock that would be dealer property as defined under the subpart F regulations); and (iii) gain realized on the disposition of a disregarded entity, partnership interest, or other pass-through interest.

For purposes of the third excluded category, a limited exception treats gain realized on the disposition of a disregarded entity, partnership, or other pass-through entity as foreign branch income if the gain is reflected on the books and records of a foreign branch and

the interest is held by the foreign branch in the ordinary course of its active trade or business. 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 disregarded entity, partnership or other pass-through entity. In the case of a sale of an interest in a partnership or other pass-through entity, the interest sold also must represent a 10-percent or greater interest in the entity.

> **Observation:** Interestingly, income from the sale of a disregarded entity does not constitute foreign branch income, other than in the limited exception discussed above. In other words, income from the sale of foreign branch assets could give rise to something other than foreign branch income (e.g., general basket income).

An anti-abuse rule applies to items inappropriately recorded (or not recorded) to avoid federal income tax or the purpose of sections 904 or 250. This anti-abuse rule requires that the income of the branch owner and the relevant branch or branches must be adjusted to reflect the substance of the transaction. For purposes of the anti-abuse rule, related party interest received by a foreign branch is presumed to be income of the branch owner, unless the interest satisfies the definition of financial services under Prop. Treas. Reg. § 1.904-4(e)(1)(ii). Finally, as described further below, the Proposed Regulations address disregarded transactions by reallocating income between the general basket and foreign branch basket.

Treasury has requested comments on: (i) how to reduce administrative and compliance burdens related to determining disregarded transaction adjustments; (ii) whether special rules should apply to true branches or financial institutions with branches that are subject to regulatory capital requirements; and (iii) whether special apportionment rules should apply to reallocate income between the general basket and foreign branch basket.

2. Adjustments for Disregarded Transactions.

Prior to the Proposed Regulations, the treatment of disregarded payments for purposes of the foreign branch basket income rules was unclear. Foreign branch income, defined as business profits of a US person attributable to a foreign branch, would not include disregarded payments, but disregarded payments would be reflected on a QBU's books and records. The Proposed Regulations clarify that the QBU's books and records will be adjusted to conform to federal income tax principles, and provide adjustments to reallocate income between the general basket and foreign branch basket to reflect disregarded transactions. These adjustments do not change the total amount, character, or source of the US person's gross income. Under the ordering rules, adjustments for disregarded payments from a branch to its branch owner are determined first, followed by adjustments for disregarded payments from a branch owner to its branch. Similar rules apply to disregarded payments made between foreign branches of the same foreign branch owner.

> **Observation:** These rules may provide benefits for taxpayers seeking to obtain the benefit of FDII, which excludes foreign branch income as defined in section 904(d)(2)(J). Items of income that previously appeared to fall within the branch basket (and, thus, not qualify as FDII) may be reallocated to another basket and be eligible for the benefit if these rules are finalized.

If a branch makes a payment to its owner that, if regarded, would be allocable to the non-passive income of the branch (as reflected on the branch's books and records), the gross income of the foreign branch is adjusted downward to reflect the disregarded payment and the branch owner's general basket is adjusted upward by the same amount. The determination of whether a payment is allocable to the non-passive income of the foreign branch is made using the expense allocation and apportionment principles applicable to regarded transactions and by treating foreign source branch income and US source branch income each as a statutory grouping.

For a payment from a branch owner to a branch that, if regarded, would be allocable to the owner's general basket income (and, as such, is not reflected on the branch's books and records), the gross income of the branch owner is adjusted downward to reflect the disregarded payment and the gross income of the branch is adjusted upward by the same amount. The determination of whether a payment is allocable to the general basket income of the foreign branch owner is made using the expense allocation and apportionment principles applicable to regarded transactions and by treating each of foreign source general category income and US source general category income as a statutory grouping.

The Proposed Regulations also provide rules for applying the adjustment described in the preceding paragraph in the case of specific types of disregarded transactions. First, for disregarded sales of property between the branch and its owner, the adjustments apply to the extent the payment, if regarded, would reduce gross receipts. Second, if a foreign branch owner transfers intangible property, as defined in section 367(d)(4), to a foreign branch, the gross income attributable to the foreign branch is reduced by the amount of deemed section 367(d) payments that would be required if the branch were treated as a corporation.

> **Observation:** The language of the rule regarding disregarded transfers of intangible property applies to transfers that are either "to or from" a foreign branch. The Proposed Regulations do not give any further guidance as to how an inbound transfer of section 367(d)(4) property from a foreign branch to its owner ought to be treated, beyond stating that the "principles of section 367(d) and section 482" should apply.

Finally, contributions to the branch, remittances from the branch, and certain interest and interest equivalents are disregarded payments excluded from the reallocation rules because these payments reflect the shift or return of capital, rather than payments for goods or services.

C. Allocating and Apportioning Foreign Taxes.

1. Base and Timing Differences.

The TCJA contained an apparent error in which Congress failed to update a cross-reference in section 904(d)(2)(H)(i). As a result, foreign taxes imposed on amounts that are not income under US tax principles ("base differences") are allocated to the foreign branch basket, rather than the general basket. The Joint Committee on Taxation has clarified that this was not Congress's intent in the recently issued Bluebook.

> **Observation:** A US corporation that has a base difference in its first post-2017 taxable year may find relief from this apparent error because excess taxes in the foreign branch basket can generally be carried back to the pre-2018 general basket (as discussed above in Section III.A.2.).

The Proposed Regulations do not attempt to fix the cross-reference, but instead contain their own cross-reference to section 904(d)(2)(H)(i), effectively putting base differences into the foreign branch basket. Thus, the Proposed Regulations would leave it to Congress to correct the error in the cross-reference. The Preamble explains that base differences only arise in "limited circumstances," such as the receipt of life insurance proceeds or gifts, when foreign taxes are imposed on a "type" of income that is not taxed under US federal income tax principles. The Preamble provides that foreign taxes imposed on income are more likely to be attributable to a "timing difference," which the Proposed Regulations define as "an item of income that constitutes income under Federal income tax principles but is not recognized for Federal income tax purposes in the current year." These taxes are allocated to the FTC basket to which the tax would be allocated if the income were recognized under federal income tax principles in the current year.

> **Observation:** At the CFC level, foreign taxes imposed on base differences are allocated to the "residual income group" from which no FTCs are deemed paid (discussed below in Section IV.B.2.).

The Proposed Regulations also clarify that taxes imposed on a distribution of PTEP are not attributable to a base difference, but are instead considered attributable to a timing difference. Accordingly, such taxes are allocated to the same FTC basket as the underlying PTEP.

2. Foreign Branch Taxes.

The Proposed Regulations, in Prop. Treas. Reg. § 1.904-6(a)(1)(i), clarify that the amount of foreign taxes paid with respect to a separate category of income includes only those taxes that are related to income in that separate category. Like the foreign branch income rules discussed above in Section III.B., special rules apply for the purposes of allocating foreign taxes reflected on the books and records of a foreign branch. Generally, any foreign tax reflected on the books and records of a foreign branch is allocated and apportioned under Prop. Treas. Reg. § 1.904-6(a)(1). A disregarded payment or a transfer that results in an adjustment to the gross income attributable to a foreign branch (under the rules of Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(A) discussed above) is considered a “disregarded reallocation transaction.” If there is a disregarded reallocation transaction, the Proposed Regulations reallocate the foreign taxes imposed by reason of the transaction to the same FTC basket as the income.

If foreign tax is imposed by reason of a disregarded payment and the payment is not a disregarded reallocation transaction, different rules apply. If the disregarded payment is from a foreign branch to a foreign branch owner, the foreign taxes are allocated and apportioned under the general principles of Prop. Treas. Reg. § 1.904-6(a)(1). The Proposed Regulations provide an example of foreign taxes being imposed on the gain from the transfer of an appreciated asset from a foreign branch to its foreign branch owner. These taxes are treated as attributable to a timing difference and are allocated and

apportioned to the FTC basket to which the gain on a sale would have been assigned if it were recognized for federal income tax purposes. On the other hand, if the disregarded payment that is not a disregarded reallocation transaction is from a foreign branch owner to a foreign branch, the foreign taxes are allocated and apportioned to the foreign branch basket.

> **Observation:** This rule provides useful insight into whether foreign taxes imposed on disregarded transactions are attributable to base or timing differences. However, no rules are provided for payments or transfers between foreign branches. This rule also is less helpful with respect to CFCs that participate in disregarded transactions because they do not have foreign branches. Additional guidance to address disregarded transactions at the CFC level would be helpful.

D. Other FTC Basketing Rules.

1. Look-Through Rules.

Look-through rules apply to dividends, interest, rents, and royalties received or accrued by a US person from CFCs under section 904(d)(3) and noncontrolled 10-percent owned foreign corporations under section 904(d)(4). Section 904(d)(3) also applies look-though treatment to subpart F inclusions to treat subpart F inclusions as passive basket income only to the extent that the amount is attributable to passive basket income. The TCJA did not change the look-through rules, but treats GILTI as subpart F income for section 904(d)(3) purposes.

In 2004, the section 904(d) baskets were reduced from nine separate baskets to two (general and passive basket), but the look-through regulations were not updated to reflect the reduction in baskets. These regulations still assigned dividends, interest, rents, and royalties based on the separate income basket to which the payment was allocable, rather than excluding income from the passive basket to the extent not allocable to passive basket income. The Proposed Regulations now provide that the look-through rules only apply to payments allocable to the passive basket. All other payments are assigned under the general basketing rules under Treas. Reg. § 1.904-4. Similarly, subpart F and GILTI inclusions are passive basket income to the extent attributable to passive basket income.

2. Items Resourced Under a Treaty.

Section 904(d)(6) was enacted in 2010 and created a separate section 904(d) basket for each item of income that is: (i) US source under domestic law; (ii) resourced as foreign source under the relevant treaty; and (iii) the taxpayer chooses to benefit from that treaty. The statute also provided Treasury with the authority to issue regulations necessary or appropriate to carry out the purposes of section 904(d)(6), including guidance that allowed items of income to be aggregated. The Proposed Regulations are the first set of regulations issued under section 904(d)(6). The Proposed Regulations provide that items of income under the same treaty can be grouped together (rather than requiring separate baskets for each item of income resourced under the same treaty). The Proposed Regulations also clarify that section 904(d)(6) applies to items of income resourced under a competent authority agreement. Treasury has requested comments on whether to limit

separate section 904(d)(6) baskets to foreign taxes of the jurisdiction that is a party to the tax treaty pursuant to which the income is resourced.

Given the administrative burden on individuals and the likelihood that US citizens would not generate excess limitation, the Proposed Regulations also turn off the application of section 904(d)(6) for US citizens who are residents in the relevant treaty country.

3. Export Financing Interest, High-Taxed Income, and Financial Services Income.

Before the TCJA, export financing interest, high-taxed income, and certain financial services income were excluded from the passive basket and categorized as general basket income. With the addition of the GILTI basket and the foreign branch basket, the Proposed Regulations clarify that export financing interest and high-taxed income are still excluded from the passive basket, but are now categorized under the general rules of Treas. Reg. § 1.904-4 into either the general basket, the GILTI basket, or the foreign branch basket.

The high-taxed income exception provides grouping rules to determine whether the income is high-taxed. The Proposed Regulations update these grouping rules to include the additional GILTI basket. Additionally, the Proposed Regulations amend the grouping rule to determine foreign QBU grouping without reference to source. Treasury requested comments on whether additional changes should be made to high taxed income rules.

Similarly, financial services income defined under section 904(d)(2)(C)(i) is still excluded from the passive basket, but the GILTI and foreign branch basket are applied before the general basket. Therefore, any financial services income not in the passive basket, GILTI basket, or foreign branch basket would be categorized in the general basket. The Proposed Regulations do not change the financial services definition under Treas. Reg. § 1.904-4(e)(3), but Treasury has requested comments on whether the gross income-based test should be modified with respect to related party payments.

IV. Section 960 Regulations.

A. Computational Rules.

The TCJA amended sections 960(a) and (d) to provide that, when a domestic corporation that is a US shareholder of a CFC has a subpart F or GILTI inclusion, the domestic corporation is treated as having paid the foreign income taxes paid or accrued by the CFC that are "properly attributable to" the CFC's income giving rise to the subpart F or GILTI inclusion. If a CFC makes a distribution of PTEP to another CFC or to a domestic corporation that is a US shareholder of the CFC, section 960(b) treats the recipient corporation as having paid the foreign income taxes that are properly attributable to the distribution and that have not already been deemed paid by a domestic corporation. The Proposed Regulations set forth rules for calculating these deemed paid FTCs under section 960.

The Proposed Regulations provide certain computational rules that apply for purposes of calculating deemed paid foreign taxes of a domestic corporation from a subpart F or GILTI

inclusion or of a CFC that receives a distribution of PTEP from another CFC. In particular, the Proposed Regulations direct taxpayers to apply the following six steps in the following order, beginning with the lowest-tier CFC in each chain with respect to which the relevant domestic corporation is a US shareholder:

1. Assign the items of gross income of the relevant CFC for the current taxable year (other than income arising from the receipt of a distribution of PTEP from another CFC) to "section 904 categories" and to "income groups" within those section 904 categories. The rules for assigning income to section 904 categories and to income groups within those categories are described below in Section IV.B.1. Separate rules apply for income arising from the receipt of a distribution of PTEP from another CFC, which are described below in Section IV.D.

2. Allocate and apportion deductions of the CFC to the section 904 categories and income groups within the section 904 categories. Deductions for current year foreign income taxes ("current year taxes") may also be allocated and apportioned to "PTEP groups" if the CFC received a distribution of PTEP from another CFC, as described in further detail in Section IV.D. below. We describe the rules for allocating and apportioning deductions to section 904 categories and to income groups within those categories below in Section IV.B.2.

3. Calculate the current year taxes that are deemed paid by the relevant domestic corporation with respect to the CFC's income giving rise to a subpart F or GILTI inclusion. These rules are described in further detail in Section IV.C. below. In addition, if the relevant CFC receives a distribution of PTEP from another CFC, the foreign income taxes deemed paid by the recipient CFC with respect to the distribution are calculated, as discussed in Section IV.D. below.

4. Separate any previously taxed earnings arising from a subpart F or GILTI inclusion of the relevant domestic corporation for the current taxable year from other earnings of the CFC and add the previously taxed earnings to an "annual PTEP account" and a "PTEP group" within the annual PTEP account. These rules are described in further detail in Section IV.D. below.

5. Apply the prior four steps for each next higher-tier CFC in the relevant chain of CFCs.

6. Finally, if the relevant domestic corporation received a distribution of PTEP from the highest-tier CFC in the chain, calculate the foreign income taxes deemed paid by the domestic corporation with respect to the distribution, as summarized in Section IV.D. below.

   Observation: The Proposed Regulations' reference to "current year taxes" is significant. Because of the repeal of section 902, the addition of the "properly attributable to" standard, and the denial of FTCs for section 956 inclusions (discussed below in Section IV.C.3.), a CFC can no longer carry forward FTCs to later taxable years unless the foreign taxes are properly attributable to PTEP. Therefore, any foreign taxes of a CFC that are not deemed paid in the current

year as a result of a GILTI or subpart F inclusion (or attributable to PTEP) are effectively lost forever.

B. Section 904 Categories and Income Groups.

1. Assignment of Gross Income.

The Proposed Regulations first assign a CFC's gross income to section 904 categories. For this purpose, the section 904 categories are the categories described in sections 904(d)(1)(A)-(D), i.e., the GILTI category, the foreign branch category, the passive category, and the general category. The rules under section 904 and the regulations thereunder generally apply for purposes of assigning items of gross income to section 904 categories. Because a CFC cannot earn foreign branch income or GILTI, the Proposed Regulations provide that gross income is generally assigned to either the general or passive category. There is an exception for income relating to a distribution of PTEP received from another CFC, which is discussed in further detail in Section IV.D. below.

Once a CFC's items of gross income have been assigned to the appropriate section 904 category, the items of gross income are further assigned to income groups within each section 904 category. Other than income relating to a distribution of PTEP received from another CFC, the Proposed Regulations assign gross income to a subpart F income group, the tested income group, or the residual income group. The Proposed Regulations specify numerous subpart F income groups. In particular, there is a separate subpart F income group for items of foreign base company income that are treated as a single item of income under Treas. Reg. § 1.954-1(c)(1)(iii). For example, within the general basket, the Proposed Regulations create separate subpart F income groups for foreign base company sales income, foreign base company services income, and different types of foreign personal holding company income. For subpart F income other than foreign base company income, there are separate subpart F income groups for insurance income described in section 952(a)(1), income subject to the international boycott factor described in section 952(a)(3), income from bribes, kickbacks and other payments described in section 952(a)(4), and income subject to section 901(j) that is described in section 952(a)(5).

In contrast to the many subpart F income groups within each section 904 category, the Proposed Regulations create only a single income group within each section 904 category for tested income.

Finally, any income in each section 904 category that is not assigned to one of the subpart F income groups or to the tested income group is assigned to the residual income group. For example, income that is excluded from tested income under one of the exceptions in section 951A(c)(2)(A)(i) (such as foreign oil and gas extraction income) would generally be assigned to the residual income group.

2. Allocation and Apportionment of Deductions.

After a taxpayer assigns a CFC's items of gross income to section 904 categories and income groups within the section 904 categories, the taxpayer allocates and apportions the CFC's deductions to the appropriate section 904 categories and income groups. For

deductions other than current year taxes, the Proposed Regulations set forth a three-step process for allocating and apportioning deductions.

First, the taxpayer allocates and apportions any deductions of the CFC that are definitely related to less than all of the CFC's gross income under the expense allocation rules in sections 861 through 865 and 904(d) and the regulations thereunder. Second, deductions with respect to related party interest are allocated and apportioned among the subpart F income groups within the passive category using the principles of Treas. Reg. §§ 1.904-5(c)(2) and 1.954-1(c)(1)(i). Third, any remaining deductions of the CFC are allocated and apportioned under the expense allocation rules in sections 861 through 865 and 904(d) and the regulations thereunder.

The Proposed Regulations contain separate rules for allocating and apportioning current year taxes among section 904 categories and income groups within those categories. Generally, current year taxes are allocated and apportioned under the rules of Treas. Reg. §§ 1.904-6(a)(1)(i) and (ii) on the basis of the CFC's taxable income computed under foreign law in each section 904 category and each income group within those categories. For example, if a CFC has an income group that consists solely of interest income and that interest income is exempt from tax in the CFC's country, then none of the CFC's current year taxes would be allocated and apportioned to that income group.

The Proposed Regulations include special rules for current year taxes that are attributable to base differences or timing differences (discussed above in Section III.C.1.). Taxes that are attributable to base differences are allocated to the residual income group. Taxes that are attributable to timing differences are allocated and apportioned to the section 904 category and income group to which the tax would have been assigned if the income on which the tax is imposed were recognized for US federal income tax purposes in the year in which the tax was imposed. Current year taxes imposed because of a CFC's receipt of a distribution of PTEP from another CFC are not governed by the rules applicable to timing differences, and instead are allocated and apportioned to a PTEP group within an annual PTEP account under special rules described in the Proposed Regulations.

Any foreign income taxes that are allocable to the residual group within a section 904 category pursuant to the rules described above cannot be credited under section 960 in any taxable year.

> **Observation:** The allocation of base difference taxes to the residual group results in an effective permanent disallowance of any credits. As a result, the determination of whether a particular foreign tax imposed on a CFC arises from a base or a timing difference can be very important for the US shareholder. Taxpayers may take some comfort at least in the Preamble's clarification that base differences arise only in "limited circumstances" and in the examples in the Proposed Regulations of taxes that arise from mere timing differences. As noted above, we hope to see additional guidance in this area.

The following sections describe the rules for treating foreign income taxes that are allocable to a subpart F income group or the tested income group as deemed paid by a US shareholder.

C. Taxes Deemed Paid Under Section 960.

Prop. Treas. Reg. § 1.960-2 provides rules for determining the amount of foreign income taxes deemed paid under sections 960(a) and 960(d).

1. Subpart F Income.

A domestic corporate shareholder that has a subpart F inclusion with respect to its CFC is deemed to pay the CFC's foreign income taxes that are properly attributable to the items of income of the CFC that give rise to the subpart F inclusion of that shareholder. Prop. Treas. Reg. § 1.960-2(b).

The amount of taxes that are properly attributable to the items of income in each subpart F income group within a section 904 category equals the domestic corporate shareholder's proportionate share of the current year taxes of the CFC that are allocated and apportioned to the subpart F income group. The domestic corporation's proportionate share of current year taxes of the CFC that are allocated and apportioned to the subpart F group is determined by a fraction (no less than zero and no greater than one) equal to the domestic corporation's subpart F inclusion that is attributable to that subpart F income group divided by the total net income in that subpart F income group.

> **Observation:** If taxes are allocated and apportioned to subpart F income groups to which no portion of a subpart F inclusion is attributable, then such taxes are not considered deemed paid.
>
> **Observation:** The denominator of the proportionate share fraction is not reduced to reflect prior year deficits (including qualified deficits) because the denominator reflects a current year figure. However, the denominator is reduced to reflect the current year E&P limitation under section 952(c)(1)(A).

2. GILTI Inclusions.

Under Prop. Treas. Reg. § 1.960-2(c), a domestic corporate shareholder that has a GILTI inclusion with respect to its CFC is deemed to pay: (a) 80 percent of all tested foreign income taxes (i.e., the amount of the CFC's foreign income taxes that are properly attributable to tested income taken into account by the domestic corporation under section 951A) multiplied by (b) the inclusion percentage of the US shareholder.

The amount of taxes that are properly attributable to tested income taken into account by the domestic corporation under section 951A equals the domestic corporate shareholder's proportionate share of the current year taxes of the CFC that are allocated and apportioned to the tested income group within each section 904 category of the CFC. The domestic corporation's proportionate share of current year taxes of the CFC that are allocated and apportioned to each tested income group is determined by a fraction (no less than zero and no greater than one) equal to the income in the tested income group that is included in computing the domestic corporation's aggregated pro rata shares of tested income under section 951A(c)(1)(A), divided by the total income in the tested income group.

> **Observation:** The domestic corporation computes only a single inclusion percentage with respect to all of its tested income, regardless of the section 904 category to which the tested income is assigned.

3. Denial of Section 956 FTCs.

The Proposed Regulations provide that no foreign income taxes are deemed paid under section 960(a) with respect to a section 956 inclusion. The asserted reasoning for this provision is that an inclusion under section 951(a)(1)(B) is not an inclusion of an "item of income" of the CFC, but, instead, is an inclusion equal to an amount that is determined under the formula in section 956(a).

> **Observation:** The reasoning for this provision is questionable. Section 960(a) refers to "any item of income under section 951(a)(1) *with respect* to any controlled foreign corporation," not an item of income "of the CFC." Further, an inclusion under section 951(a)(1)(A) is not "an 'item of income' of the CFC.'"

> **Observation:** The combination of this rule with Prop. Treas. Reg. § 1.956-1(a)(2), which generally provides that the section 956 amount is reduced by the amount of the deduction that would be allowed under section 245A if the shareholder had received the same amount as a distribution, dramatically changes the operation of section 956. The combined rules may result in double taxation for any unfortunate taxpayers who happen to have a CFC with an investment in US property if the CFC has untaxed earnings and the taxpayer cannot satisfy the section 245A requirements as modified.

The proposed regulations under section 956 generally would apply prospectively to taxable years of CFCs beginning on or after those rules are finalized. However, the Proposed Regulations under section 960 generally would apply to taxable years of CFCs beginning after December 31, 2017.

> **Observation:** If finalized in their current form, the Proposed Regulations under section 960, including the denial of FTCs for section 956 inclusions, could impact 2018 transactions undertaken by CFCs with calendar taxable years.

4. Domestic Partnerships.

To the extent a domestic corporate shareholder owns a CFC through a domestic partnership, the domestic corporation is deemed to have paid foreign income taxes as if the domestic corporation had included the subpart F or GILTI inclusion amount from the CFC directly, rather than as a distributive share of the partnership's income.

D. Section 960(b) and PTEP Groups.

Prop. Treas. Reg. § 1.960-3 provides rules for determining foreign income taxes deemed paid under section 960(b).

1. PTEP Groups.

Prop. Treas. Reg. § 1.960-3(c)(1) requires a CFC to establish a separate, annual account (an "annual PTEP account") for its E&P for its current taxable year to which subpart F or GILTI inclusions of US shareholders of the CFC are attributable. Each account must correspond to the inclusion year of the PTEP and to the section 904 category of the inclusions at the US shareholder level.

> **Observation:** Because PTEP accounts are defined in relation to the section 904 categories of inclusions at the US shareholder level, a CFC may have an annual PTEP account in the section 951A category or a treaty category, even though income of the CFC that gave rise to the PTEP cannot initially be assigned to those categories.

Prop. Treas. Reg. § 1.960-3(c)(2) provides that the amount in an annual PTEP account is further assigned to one or more of ten groups of PTEP (each, a "PTEP group") within the account, based on the type of inclusion whose taxation created the PTEP.

> **Observation:** The PTEP groups serve a similar function to the subpart F income groups and tested income groups. They are the mechanism for associating foreign taxes paid or accrued, or deemed paid, by a CFC with section 959 distributions of PTEP.

> **Observation:** Treasury indicated in the Preamble that it may consider consolidating PTEP groups as part of finalizing the Proposed Regulations. However, Treasury and the IRS subsequently issued Notice 2019-1, which would already expand the ten PTEP groups to sixteen.

Under Prop. Treas. Reg. § 1.960-3(c)(3), a CFC accounts for the receipt of a section 959(b) distribution by adding the distribution amount to an annual PTEP account and PTEP group that corresponds to the annual PTEP account and PTEP group from which the distributing CFC made the distribution. Similarly, the distributing CFC reduces the annual PTEP account and PTEP group within the account from which the distribution is made by the distribution amount.

A CFC must also reduce PTEP groups that relate to PTEP described in section 959(c)(2) to account for the reclassification of amounts into those groups as PTEP described in section 959(c)(1) ("reclassified PTEP"), and increase the PTEP group that corresponds to the reclassified amount.

2. PTEP Group Taxes.

A CFC accounts for the foreign income taxes that it pays, accrues, or is deemed to pay with respect to the amount in each PTEP group ("PTEP group taxes"). PTEP group taxes are accounted for with respect to PTEP assigned to a PTEP group within an annual PTEP account.

Prop. Treas. Reg. § 1.960-3(d) defines PTEP group taxes as consisting of: (i) the current year taxes paid or accrued by the CFC as the result of its receipt of a section 959(b)

distribution that are allocated and apportioned to the PTEP group; (ii) foreign income taxes that are deemed paid by the CFC with respect to an amount in a PTEP group; and (iii) in the case of a reclassified PTEP group, foreign income taxes that were paid, accrued, or deemed paid with respect to an amount that was initially included in a section 959(c)(2) PTEP group and subsequently added to a corresponding reclassified PTEP group. PTEP group taxes are reduced by the amount of foreign income taxes in the group that are deemed paid by a US shareholder under section 960(b)(1) or by another CFC under section 960(b)(2), and foreign income taxes relating to a PTEP group that is reclassified to a section 959(c)(1) PTEP group.

Under Prop. Treas. Reg. § 1.960-3(b)(1), a domestic corporation that receives a section 959(a) distribution is deemed to have paid the foreign income taxes that are properly attributable to the section 959(a) distribution from the PTEP group of the distributing CFC, to the extent the PTEP group taxes have not already been deemed to have been paid in the current taxable year or any prior taxable year.

The amount of foreign income taxes that are properly attributable to a domestic corporation's receipt of a section 959(a) distribution from a PTEP group within a section 904 category equals its proportionate share of PTEP group taxes associated with the PTEP group. The domestic corporation's proportionate share of foreign income taxes associated with a section 959(a) distribution from a PTEP group is determined by a fraction equal to the amount of the section 959(a) distribution attributable to the PTEP group over the total amount of PTEP in the PTEP group.

> **Observation:** A single section 959(a) distribution could be attributable to multiple PTEP groups, with respect to multiple inclusion years, of the distributing CFC. The Proposed Regulations do not provide ordering rules for determining the annual PTEP account and PTEP group to which a section 959 distribution is attributable. Such rules were subsequently provided in Notice 2019-1.

Prop. Treas. Reg. § 1.960-3(b)(2) provides similar rules for taxes deemed paid under section 960(b)(2) with respect to a CFC's receipt of a section 959(b) distribution.

Under Prop. Treas. Reg. § 1.960-3(b)(5), the distributive share of a US shareholder partner of a US shareholder partnership's section 959(a) distribution from a partnership CFC is treated as a section 959(a) distribution received by the US shareholder partner from the partnership CFC.

Prop. Treas. Reg. § 1.960-3(d)(3) provides a rule relating to foreign income taxes paid or accrued in a taxable year of a CFC that began before January 1, 2018, with respect to an annual PTEP account, and a PTEP group within such account, that was established for an inclusion year of a CFC that began before January 1, 2018. Specifically, such foreign income taxes may be deemed paid under section 960(b) with respect to a section 959 distribution in a year of the CFC that begins after December 31, 2017, if such taxes were not included in the CFC's post-1986 foreign income taxes used to compute foreign taxes deemed paid under former section 902 in any taxable year that began before January 1, 2018, and were not treated as deemed paid under former section 960(a)(3) by a domestic corporation that was a US shareholder of the CFC.

E. Section 78 Gross-Up.

1. Basketing the Section 78 Gross-Up.

Prop. Treas. Reg. § 1.904-4(o) provides that the amount included in income under section 78 by reason of taxes deemed paid under section 960 is assigned to the FTC basket to which the taxes are allocated.

Observation: This provision is consistent with the comment in the preamble to the proposed regulations under section 951A that indicated that Treasury anticipated that the section 78 gross-up related to the section 951A inclusion would be assigned to the GILTI basket. Previously, taxpayers had faced uncertainty with respect to this question.

2. Interaction with Section 245A.

Under section 78, as amended by the TCJA, taxes deemed paid under section 960 that are treated as a dividend under section 78 are ineligible for a section 245A deduction. However, due to a mismatch between the effective dates of amended section 78 and section 245A, 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 shareholder's inclusions under section 951 for the CFC's fiscal year ending in 2018.

To avoid this result, Prop. Treas. Reg. § 1.78-1 provides that section 78 dividends received after December 31, 2017, that relate to taxable years of foreign corporations that begin before January 1, 2018, will not be treated as dividends for purposes of section 245A.

> **Observation:** Treasury attempts to justify this provision based on the argument that Congress did not intend to treat US shareholders of fiscal year CFCs more favorably than US shareholders of calendar year CFCs with respect to the section 78 dividend. While this may be accurate, it is questionable whether Treasury has the authority to amend the effective date of a statutory provision. Arguably, such amendment requires a legislative technical correction.

V. Section 965 Rules.

A. Distributions of Section 965 PTEP.

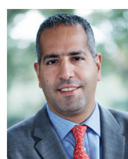
The proposed regulations under section 965 reserved on the application of revised section 960(b) to distributions of section 965 PTEP. The Proposed Regulations introduce a new rule that provides no credit is allowed for the "applicable percentage" of any foreign taxes deemed paid under new section 960(b) on the distribution of section 965(a) PTEP or section 965(b) PTEP. For this purpose, the PTEP rules discussed above in Section IV.D. apply. Like the proposed rule that applies under former section 960(a)(3), any foreign taxes attributable to the portion of a DFIC's earnings offset under section 965(b) are not eligible for the deemed paid credit under section 960(b).

> **Observation:** Taxpayers with unused FTCs that are properly attributable to their section 965(a) PTEP may be able to apply this rule to access the FTCs on a

www.bakermckenzie.com

For additional information please contact the authors of this Client Alert or any member of Baker McKenzie's North America Tax Practice Group.

Jeffrey Maydew
+1 312 861 2560
jeff.maydew
@bakermckenzie.com


Rafic Barrage
+1 202 452 7090
rafic.barrage
@bakermckenzie.com

Matthew Jenner
+1 312 861 8238
matthew.jenner
@bakermckenzie.com

Contributors
Ashleigh Browne
Erik Christenson
Matthew Hayes
Reza Nader
Michelle Ng
Adam O'Brien
Samuel Pollack
Elaine Wilkens

distribution of the section 965(a) PTEP, although the taxes would be subject to a haircut, like the other taxes deemed paid as a result of section 965.

B. Section 965(n) Election.

Section 965(n) provides an election for taxpayers to forgo the use of their net operating losses ("NOLs") for purposes of calculating their section 965 inclusions. The proposed regulations under section 965 clarify that this election also applies to any NOL for the year of the section 965 inclusion. The Proposed Regulations further clarify that, if the section 965(n) election creates or increases a current year NOL, the taxable income of the taxpayer for that year cannot be less than the amount provided for in Prop. Treas. Reg. § 1.965-7(e)(1)(ii) (i.e., the taxpayer's section 965(a) inclusion, increased by any the corresponding section 78 gross-up, and reduced by the taxpayer's section 965(c) deductions) (the "the net section 965 inclusion").

The Proposed Regulations also add a rule for computing a taxpayer's section 904 FTC limitation for the year of the section 965(n) election. Essentially, the rule provides that, instead of basketing the net section 965 inclusion according to normal basketing principles, the net section 965 inclusion is allocated between baskets in the same proportion that the taxpayer's deductions taken for the taxable year are allocated between baskets. The rule appears arbitrary and the Preamble offers no explanation of the reasoning behind the rule. This may be concerning for taxpayers who where required to make the section 965(n) election before the Proposed Regulations were released.

Tax News and Developments is a periodic publication of Baker McKenzie's North America Tax Practice Group. This Alert has been prepared for clients and professional associates of Baker McKenzie. It is intended to provide only a summary of selected recent legal developments. For this reason, the information contained herein should not be relied upon as legal advice or formal opinion or regarded as a substitute for detailed advice in individual cases. The services of a competent professional adviser should be obtained in each instance so that the applicability of the relevant jurisdictions or other legal developments to the particular facts can be verified. To receive *Tax News and Developments* directly, please contact taxnews@bakermckenzie.com.

Your Trusted Tax Counsel®
www.bakermckenzie.com/tax

©2019 Baker & McKenzie. All rights reserved. Baker & McKenzie International is a Swiss Verein with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner, or equivalent, in such a law firm. Similarly, reference to an "office" means an office of any such law firm.

This may qualify as "Attorney Advertising" requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.