Hon. Charles P. Rettig  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224  

Re: Comments on the Proposed Regulations Concerning Foreign Tax Credits

Dear Commissioner Rettig:

Enclosed please find comments on the proposed regulations regarding foreign tax credits. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon  
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury  
Lafayette G. “Chip” Harter III, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury  
Douglas L. Poms, International Tax Counsel, Department of the Treasury  
Brian Jenn, Deputy International Tax Counsel, Department of the Treasury  
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Hon. Michael Desmond, Chief Counsel, Internal Revenue Service  
Drita Tonuzi, Deputy Chief Counsel (Operations), Internal Revenue Service  
Daniel M. McCall, Deputy Associate Chief Counsel (International - Technical), Internal Revenue Service
Comments on Proposed Regulations Regarding Foreign Tax Credits

These comments (the “Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Michael Caballero, Paul Crispino, Ronald Dabrowski, Joshua Ruland, Caren Shein, Joseph Sullivan, Dirk Suringa, and John Woodruff. Helpful comments were provided by Jon Baloch, Brandon Bickerton, Alan Cathcart, Pamela Fuller, Deborah Jacobs, Robert Kantowitz, Brandon King, Cory O’Neill, Marina Vishnepolskaya, Shun Tosaka, and Elizabeth Zanet. The Comments have been reviewed by Joan Arnold for the Committee on Government Submissions and Eric Sloan, Vice Chair, Government Relations.

Although members of the Section of Taxation may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: March 18, 2019
ABA Comments on the Proposed Foreign Tax Credit Regulations

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I. EXECUTIVE SUMMARY

Section 901 allows taxpayers to claim a credit against their U.S. tax liability for the amount of any foreign income taxes paid or accrued in order to prevent the double taxation of foreign source income.\(^1\) The foreign tax credit includes both foreign taxes paid directly by the taxpayer, as well as any foreign taxes deemed paid under section 960 in the case of a domestic corporation that owns 10 percent or more of the interest in a controlled foreign corporation (within the meaning of section 957, a “CFC”). To ensure that the foreign tax credit only reduces U.S. tax on foreign source income, and not U.S. tax on domestic source income, section 904 provides detailed rules that limit the ability of a taxpayer to claim a foreign tax credit to the portion of its U.S. tax liability that is attributable to foreign source income (the “FTC Limitation”). Section 904 also provides that the FTC Limitation must be done separately with respect to certain categories (each a separate category” or a “basket”).

Public Law 115-97 (the “Act”), enacted on December 22, 2017, made significant changes to the foreign tax credit and related rules. In particular, the Act added two foreign tax credit baskets to section 904(d), repealed section 902 and collapsed the deemed paid credit into section 960, as well as numerous other changes to the foreign tax credit rules. The Act also made changes to the rules for allocating and apportioning expenses, which are an essential component of determining a taxpayer’s FTC Limitation, including repealing the fair market value method of asset valuation for purposes of allocating interest expense under section 864(e)(2), and adding section 904(b)(4), which addresses the allocation of expenses in light of the dividends received deduction (“DRD”) under section 245A. These changes were part of a substantial revision of the international tax rules under the Code, including the addition of section 951A, which requires a U.S. shareholder of a CFC to include certain amounts of so-called “global intangible low-taxed income” (“GILTI”) in income on a current basis in a manner similar to the historical subpart F rules of the Code.

On December 7, 2018, the Department of Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) published Proposed Regulations under sections 78, 861, 901, 904, 960, and 965 (the “Proposed Regulations”).\(^2\) We commend Treasury and the Service for issuing the Proposed Regulations, which provide much-needed guidance on a host of foreign tax credit issues. We recommend, however, that certain portions of the regulations be reconsidered, and there are areas in which additional clarification would be helpful.

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\(^1\) References to a “section” are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

Section II of the Comments contains background information, and Section III contains a detailed discussion of our recommendations. Our recommendations are summarized below.

A. Carryover Rules and Other Transition Issues

1. We recommend that taxpayers be permitted to reconstruct the allocation of pre-2018 general basket OFLs, SLLs, and ODLs to the foreign branch category using post-2017 rules even if taxpayers do not have excess foreign taxes in the pre-2017 general basket.

2. We recommend that the regulations, when finalized, permit taxpayers to elect to determine their asset values for their first post-2017 year based solely on the year-end tax book value (or alternative tax book value), and not require averaging during the transition year. Alternatively, if the regulations retain an averaging approach for determining asset values in the transition year, we recommend that taxpayers that elect to use the first quarter values should be permitted to do so without regard to the earnings adjustment to the stock of certain foreign corporations under Treasury Regulation section 1.861-12T(c).

B. Expense Allocation and GILTI

1. We recommend that expenses allocated against GILTI basket income not be taken into account in determining GILTI basket income for purposes of applying section 904. Alternatively, consideration could be given to eliminating expense allocation only if the taxpayer establishes that its net CFC tested income is subject to a minimum foreign effective tax rate of 13.125%.

2. Alternatively, we recommend that Treasury and the Service adopt the direct approach of not taking into account expenses allocated to GILTI basket income for purposes of applying section 904, and that such provision remain operative until section 864(f) becomes operative.

C. Tax Exempt Assets and Income

1. We recommend that in the interests of administrability, Treasury and the Service remove assets giving rise to the FDII deduction from the application of the exempt asset rules. Alternatively, we recommend adopting one of two possible formulary approaches for determining the portion of a taxpayer’s assets that are treated as giving rise to the Section 250 FDII Deduction.

2. We recommend that the clarification of Proposed Regulation section 1.861-8(d)(2)(iv) be accomplished by inserting the word “solely” before “by reason of.”

3. We recommend that Treasury and the Service clarify the operation of Treasury Regulation section 1.861-9(e)(4) in the case of individual members of an LLC, LLP, or similar entity by specifying that such individual is considered to be a limited partner for purposes of this rule.
4. We recommend that Proposed Regulation section 1.861-9(e)(8)(ii) be amended to provide in relevant part that the “SPL lender must assign an amount of income corresponding to the matching income amount for the taxable year that is attributable to the same loan to the same statutory and residual groupings of gross income from which the SPL interest expense is deducted by the SPL lender (or any other person in the same affiliated group as the SPL lender).”

5. We recommend that in applying the modified gross income method, Treasury and the Service should allow upper-tier CFCs to take into account the gross tested income (net of interest expense) of lower-tier CFCs in allocating their interest expense, as well as certain other technical changes to the provisions.

6. We recommend the elimination of tested loss assets and income from the section 864(e) expense allocation rules.

D. Definition of Current Year Taxes and Year in Which Such Taxes Should be Taken into Account

1. We recommend a revision of the definition of current year taxes in Proposed Regulation section 1.960-1(a)(4) by removing the fourth sentence. In addition, to clarify the intent of the current year taxes definition, we recommend that the preamble include an explanation that the change to the definition was intended to avoid an inference that the regulation was changing current law regarding the timing for when a foreign tax liability accrues and potentially may be claimed as a foreign tax credit.

2. We respectfully recommend that Treasury and the Service reconsider the approach of prorating current year taxes based on the foreign earnings on which they are imposed.

3. To address taxes that may not accrue under the all events standard until after the U.S. income tax return is filed, we recommend that the regulations permit estimates and then adjust such estimates using one of two options. First, a taxpayer could track the difference but not immediately file an amended return. Instead, whenever it is otherwise required to file an amended return under section 905(c) it would include this adjustment. Second, or in addition, a de minimis rule under which differences of less than a certain percentage, such as five percent, of total foreign taxes for all CFCs for a year would not need to be adjusted.

4. We recommend reconsideration of the rule in Proposed Regulation section 1.960-1(a)(4) that “current year taxes include . . . foreign income taxes that accrue in the controlled foreign corporation’s current taxable year in which or with which the foreign taxable year ends.” In our view, a rule prorating current year taxes based on the foreign earnings on which they are imposed would be consistent with the matching principle underlying the foreign tax credit rules, may result in fewer permanently lost credits, and can be accomplished without adding significant administrative complexity.

5. If Treasury and the Service decline to adopt the proration recommendation above, we recommend that clarification be provided for Proposed Regulation section 1.960-
1(d)(3)(ii) as to how current year foreign taxes are allocated to the section 904 baskets where a foreign corporation’s U.S. and foreign tax year ends differ. Specifically, we recommend clarifying whether foreign taxes assigned to separate categories are based on the current year income to which the taxes are deemed to relate, or based on the current and prior year foreign income on which the taxes are imposed.

6. We recommend the revision of the last sentence of Proposed Regulation section 1.960-1(d)(3)(ii)(B)(2) to provide that a withholding tax on a disregarded payment from a disregarded entity to its CFC owner in a year subsequent to the year in which the disregarded entity’s earnings were included by a U.S. shareholder as subpart F income or GILTI as a tax imposed on previously taxed earnings and profits (“PTEP”) rather than a timing difference.

7. We recommend that the last two sentences of Proposed Regulation section 1.960-1(d)(2)(i) be revised to clarify its operation with respect to GILTI PTEP.

8. We recommend that Treasury and the Service provide that a section 78 gross up is not required for taxes deemed paid under section 960(b)(1) on a distribution of PTEP.

9. We recommend a modification of the facts of example in Proposed Regulation section 1.960-1(f) to illustrate the final step in Proposed Regulation section 1.960-1(c), computing deemed paid taxes under section 960(b)(1).

10. We recommend clarifying the PTEP transition rule by eliminating Proposed Regulation section 1.960-3(d)(3)(i).

11. We recommend that Proposed Regulation section 1.960-4 be modified to clarify that paragraphs (c) and (d), which require “with” and “without” calculations to determine how much excess limitation and how much deemed paid taxes in a section 904(d) category are attributable to a subpart F inclusion as opposed to other income in the category, are not needed and thus do not apply to the section 951A category.

E. Foreign Branch Income

1. We recommend the final regulations include a discussion of the competing policy considerations raised and choices made to facilitate interpretations of the foreign branch rules by taxpayers, the Service and the courts.

2. We recommend that Treasury and the Service cross-reference to the regulations under section 964, which generally also operate to conform foreign books and records to U.S. federal income tax principles. Further, we recommend that Treasury and the Service consider including additional examples to illustrate the operation of the rules.

3. We recommend that the final regulations include a discussion articulating the policy for the treatment of disregarded payments for these payments to facilitate interpretations of these rules by taxpayers, the Service and the courts.
4. We recommend that the final regulations clarify whether and to what extent other
general principles of U.S. federal income tax law apply to disregarded transactions.

5. We recommend that Treasury and the Service explicitly provide that a disregarded
payment that would be capitalized into amortizable or depreciable basis, if it were
regarded, results in reallocation in the years and the amounts that amortization or
depreciation deductions would arise if the disregarded sale were regarded.

6. We recommend that the rules regarding transfers of intangible property be limited to
apply only to transfers that occur after the date that the Proposed Regulations are
published.

7. We recommend that the final regulations provide additional guidance on the
treatment of transfers other than contributions by a foreign branch owner to a foreign
branch (e.g., transfers from a foreign branch to the foreign branch owner or transfers
between branches).

8. We recommend that the final regulations provide that deemed contingent payments
are deductible against either general category income or foreign branch category
income, as applicable.

9. We recommend that the final regulations include examples illustrating the
consequences of the Disregarded Section 367(d) Rule if the relevant intangible is
wholly or partially sold in a disregarded transaction or if the transferor has basis in
the property.

10. We recommend that the final regulations correct the clerical error reflected in section
904(d)(2)(H)(i) and provide that foreign income taxes imposed on base differences
are related to general category income (rather than foreign branch category income).

11. We recommend that the final regulations provide additional guidance and potentially
examples on the application of the rules in Proposed Regulations section 1.904-
6(a)(1) to foreign branch income, in particular with respect to disregarded reallocation
transactions.

F. Disallowance of Deemed Paid Credits on Section 956 Inclusion

1. We recommend that the final regulations make certain technical clarifications to the
rules related to disregarded payments.

2. We recommend that the final regulations permit a deemed paid credit for foreign
income taxes paid by a CFC in the case of an inclusion under sections 951(a)(1)(B)
and 956.

G. Additional Issues Under the Section 904 Regulations

1. We recommend that the final regulation either clarify that the entire amount of the
earnings that would constitute section 959(c)(1) earnings remain section 959(c)(1)
earnings or that the regulations specify a mechanism for allocating section 959(c)(1) earnings to Section 962.

2. We recommend that the final regulation include a more substantial articulation of what circumstances constitute a base and a timing difference, including additional examples.

H. Section 965(n)

1. We recommend that the final regulations suspend restrictions on changing any elections under either the foreign tax credit or expense allocation regulation, including any such elections that are included in the final regulations, whether from year-to-year or on a retroactive basis, for a three year period beginning in 2018.

2. We recommend that the final regulations revise the portions of the Proposed Regulations concerning section 965(n) to permit taxpayers to coordinate its operation with the FTC Limitation.
II. BACKGROUND

A. Overview

Domestic corporations and individuals (together, “U.S. taxpayers”) are subject to U.S. federal income tax on both U.S.-source and, to a certain extent under various rules, foreign source income.3 Foreign source income also may be subject to foreign income or similar taxes, and thus the U.S. tax system provides a credit against a taxpayer’s U.S. tax liability for foreign income taxes paid or accrued in respect of foreign source income.4 This credit is intended to relieve double taxation of foreign source income, which would result if that income were taxed by both the foreign jurisdiction and the United States. In effect, the U.S. foreign tax credit regime cedes primary taxing jurisdiction with respect to foreign source income to foreign jurisdictions. In general, only foreign income, war profits, or excess profits taxes or taxes imposed as a substitute for such taxes are creditable against U.S. tax.

The foreign tax credit regime operates, very generally, in the following way. Section 901 provides for a “direct” foreign tax credit, which allows a U.S. taxpayer to claim a credit with respect to foreign taxes that the taxpayer paid or accrued directly within a taxable year.

U.S. taxpayers may also claim “indirect” foreign tax credits for foreign taxes “deemed paid” by the U.S. taxpayer. Under section 960, a U.S. shareholder of a CFC that is a domestic corporation may claim a credit for foreign taxes paid by that CFC that are properly attributable to income that is included in the income of the U.S. shareholder under section 951(a)(1) (i.e., subpart F income and amounts included as a result of investment in U.S. property under section 956), and section 951A (i.e., GILTI inclusion amounts).5 Prior to the Act, section 902 allowed a domestic corporation to claim a foreign tax credit with respect to dividend distributions received from foreign corporations at least 10% owned by the domestic corporation. Because after the Act dividends from a foreign corporation are generally exempt from U.S. tax, and foreign taxes can only be deemed paid under either the subpart F or GILTI rules, the indirect

3 Prior to the Act, the United States taxed U.S. taxpayers on their worldwide income regardless of its source. Following the Act, domestic corporations are subject to taxation on a modified territorial basis, with a significant portion of foreign source income taxed currently under various provisions, and with a 100% DRD for repatriated earnings received by domestic corporations from ten percent-owned foreign corporations.

Section 906 also provides a foreign tax credit to foreign corporations and nonresident alien individuals in certain limited circumstances. The Proposed Regulations did not specifically address any issues under section 906 and thus the operation of the new rules in the context of these taxpayers is beyond the scope of this report.

4 I.R.C. § 901(a).

5 I.R.C. § 960(a), (d).
credit is now fully contained in section 960. The Act added section 960(d) to provide that the credits that are deemed paid in the case of GILTI inclusions are only 80 percent of the foreign taxes properly attributable to that income. Although the repeal of section 902 was a part of implementing the new tax system, it also meant that the simplification provided by the multi-year pooling approach was lost, and the amount potentially allowable as a credit is now based solely on current-year taxes attributable to subpart F and GILTI inclusions.

Section 904 limits the overall amount of foreign tax credit allowed for the taxable year to the amount of U.S. tax attributable to foreign source income. In addition, section 904(d) provides that the FTC Limitation is applied separately to certain categories or baskets of income: passive category income, general category income, GILTI income, and foreign branch income (the “passive basket,” the “general basket,” the “GILTI basket,” and the “branch basket,” respectively). These baskets are designed to further limit the extent to which “cross-crediting”—the use of excess credits on high-taxed foreign source income to reduce the U.S. residual tax on low-taxed foreign source income—is permitted. A U.S. taxpayer may engage in such cross-crediting (that is, blending of high-tax and low-tax income for purposes of calculating the limitation amount) solely within each basket other than the passive basket, but may not do so with income of separate baskets.

The maximum amount of foreign tax credit allowed with respect to income in each basket is determined by multiplying a taxpayer’s pre-credit U.S. tax liability by a fraction (the “Section 904 Fraction”), the numerator of which is the taxpayer’s foreign source taxable income in the relevant basket, and the denominator of which is the taxpayer’s worldwide taxable income. When a taxpayer has less than the maximum amount of creditable taxes allowable in a basket, the taxpayer is said to be in an “excess limitation” position. When a taxpayer has more creditable taxes in a basket than the allowed maximum, the taxpayer is said to be in an “excess credit” position. Excess foreign tax credits may generally be carried back for one year and forward for ten years to any year in which the taxpayer is in an excess limitation position. Importantly, excess credits in the GILTI basket may neither be carried back nor carried forward, and instead expire if they are not creditable in the current tax year.

The FTC Limitation is based on net foreign source income, and thus in order to compute the FTC Limitation, a taxpayer must determine the amount of its taxable income from foreign sources within each limitation category by allocating and apportioning

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6 I.R.C. § 904(a).
7 I.R.C. § 904(d).
8 I.R.C. § 904(c).
9 I.R.C. § 904(c).
10 Although there are technical differences between the allocation and apportionment of expenses under the relevant regulations, for ease of reading this report will simply refer to the combined steps of allocation and
deductions among U.S. source gross income and foreign source income in each of the baskets.\textsuperscript{11} Deductions are generally allocated to the gross income to which the deductions factually relate. However, certain deductions are subject to special rules, for example, deductions for interest expense are generally allocated based on the tax basis of the assets, and research and experimental expenses are allocated based on either sales or gross income.\textsuperscript{12} Such ratios are generally computed by treating all members of an affiliated group of corporations as a single corporation.\textsuperscript{13}

Prior to the Act, the foreign tax credit limitation was computed separately for passive category income and general category income.\textsuperscript{14} Passive category income includes most passive income, such as portfolio interest, dividends, and certain kinds of income specified as passive. The general category included all other foreign source income and for this reason is sometimes reserved to as the “residual basket.” Passive basket income is treated as general category income if earned by a qualifying financial services entity. Because the passive basket is designed to prevent taxpayers shifting investment-type income offshore to create additional income for purposes of the FTC Limitation, high taxed passive income (that is, if the income is subject to a rate of foreign tax that exceeds the highest applicable U.S. tax rate) and associated taxes are included in the general basket. Dividends, subpart F inclusions, interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC were assigned to the passive basket on a “look-through” basis; that is, the income will be assigned to the passive basket for the U.S. shareholder if attributable to passive category income of the CFC.\textsuperscript{15} Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a similar basis.\textsuperscript{16}

The Act added two baskets to section 904(d). The passive basket was largely unchanged, but the Act effectively subdivided the former general basket into the new general basket and the GILTI and branch baskets. Notwithstanding this change, many of the other pre-Act rules concerning the operation of the foreign tax credit baskets were not modified to adjust for this change. For example, the rules providing for look-through treatment under section 904(d)(3) and (4) were not changed.

Finally, special rules apply to address instances where there is a net loss in one of the baskets or U.S. source income. A foreign loss in one basket (a “separate limitation loss” or “SLL”) first offsets foreign source income in the other baskets. Any remaining

\footnotesize{apportionment as “allocation” except in instances where a distinction between the two is relevant to the particular issue.}

\begin{itemize}
\item [11] Reg. §§ 1.861-8(b) and -8T(c).
\item [12] Reg. §§ 1.861-9, -9T, and 1.861-17.
\item [13] I.R.C. § 864(e)(1) and (6); Reg. § 1.861-14T(e)(2).
\item [14] I.R.C. § 904(d).
\item [15] I.R.C. § 904(d)(3); Reg. § 1.904-5.
\item [16] I.R.C. § 904(d)(4).
\end{itemize}
loss is termed an “overall foreign loss” or “OFL” and may be used to offset U.S. source income. In both cases, the U.S. taxpayer must establish SLL and OFL accounts that are used to recapture such losses in subsequent years. For example, when a loss in one basket is used to offset income in another basket, any income earned in the loss category in a subsequent year is recharacterized as income in the basket which was previously reduced as a result of the loss. Similar rules apply in the case of overall foreign losses that reduced U.S. source income. Parallel rules apply when there is a net loss with respect to U.S. source gross income. Such loss, an “overall domestic loss” or “ODL,” reduces foreign source income in the various baskets. In subsequent years, the ODL is recaptured by resourcing U.S. source income as foreign income in the baskets in which the ODL had reduced foreign source income in the year it occurred.

B. The Proposed Regulations

The Act represents one of the most significant revisions to the Code’s international tax provisions and includes direct amendments to the foreign tax credit and the associated expense allocation rules, as well as broader changes to the overall manner in which the United States taxes foreign source income that indirectly impacts the operation of the foreign tax credit. As part of issuing implementing guidance under the international provisions of the Act, Treasury and the Service published the Proposed Regulations, which address the following issues: (1) the allocation and apportionment of deductions under section 861 through 865; (2) adjustments to the foreign tax credit limitation under section 904(b)(4); (3) transition rules for overall foreign loss, separate limitation loss, and overall domestic loss accounts under section 904(f) and (g), and for the carryover and carryback of unused foreign taxes under section 904(c); (4) the addition of baskets under section 904(d) and other necessary updates to the regulations under section 904, including revisions to the look-through rules and other updates to reflect pre-Act statutory amendments; (5) the calculation of the exception from subpart F income for high-taxed income under section 954(b)(4); (6) the determination of deemed paid credits under section 960 and the gross up under section 78; (7) and the application of the election under section 965(n).17 The Proposed Regulations note that Treasury and the Service expect to reexamine the apportionment and allocation rules for expenses not discussed in the Proposed Regulations.

III. DETAILED DISCUSSION

A. Carryover Rules and Other Transition Issues

The Proposed Regulations provide transition rules for carryforwards from taxable years beginning before January 1, 2018 (“pre-2018 years”) to taxable years beginning after December 31, 2017 (“post-2017 years”) of excess foreign taxes, OFL accounts, SLL accounts, and the component elements of net operating losses (“NOLs”).18 The Proposed


Regulations also provide transition rules for the recapture in post-2017 years of SLLs and generated in pre-2018 years; and for the carryback of overall domestic losses (“ODLs”) and excess foreign taxes from the first post-2017 year to the last pre-2018 year. These rules provide helpful and necessary guidance for taxpayers, subject to the comments discussed below, we recommend that they be finalized in the form in which they were proposed.

1. **Carryforward of Excess Foreign Taxes**

   The Proposed Regulations generally provide that pre-2018 excess foreign taxes are allocated to the same post-2017 separate basket from which the excess foreign taxes are carried. The Proposed Regulations also provide a “branch carryover exception” for general basket excess taxes. Under the branch carryover exception, a taxpayer may choose to allocate pre-2018 excess foreign taxes in the general basket to the taxpayer’s post-2017 basket category to the extent those taxes would have been allocated to the latter category if the taxes were paid or accrued in a post-2017 year.

   We believe these rules for carryovers of excess foreign taxes to be appropriate and consistent with prior transition rules. The branch carryover exception will provide a helpful mechanism for taxpayers to address potential mismatches arising from the creation of the branch basket and mitigate the risk of double taxation arising over multiple tax years.

   The Preamble to the Proposed Regulations includes a specific request for comments on the credit carryforward rules:

   The proposed regulations request comments regarding whether the final regulations should include a simplified rule for taxpayers that choose to reconstruct the allocation of general category unused foreign taxes (for example, by looking to the relative amounts of foreign branch category and general category income or assets in which the first post-2017 taxable year to which the unused foreign taxes are carried), what form such a rule should take, and whether there are any special concerns regarding members that have left a consolidated group.

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19 See Prop. Reg. §§ 1.904-2(j)(2), 1.904(f)-12(j)(2)(ii), 3(ii). The Proposed Regulations do not specifically provide transition rules for the carryforward of ODL accounts or the recapture of OFL accounts. We understand that Treasury and the Service did not consider this guidance to be necessary for the operation of the existing rules, which nevertheless require the creation and maintenance of ODL accounts with respect to specific limitation categories, and the recapture of OFL accounts with respect to specific limitation categories.

20 Cf. former I.R.C. § 904(d)(2)(J) (allocating taxes from the pre-1987 nonbusiness interest income category to the post-1986 passive category and taxes from the pre-1987 general category to the post-1986 general category, except in the latter case to the extent the taxpayer could prove that the taxes would have been allocated to a different limitation category had it existed before 1987).

We agree that taxpayers should be permitted to elect a simplified rule for reconstructing the allocation of excess foreign taxes from the pre-2018 general basket between the post-2017 general basket and the branch basket. Certain taxpayers may lack the data necessary to reconstruct the allocation of up to 10 prior years of excess foreign taxes to the branch basket, which is a prerequisite for the application of the branch carryover exception. Their excess taxes may have accumulated during years for which data is no longer available, for example. In addition, reconstructing excess foreign taxes over a 10 year period imposes a significant administrative burden on taxpayers, and the revenue impact of this approach as compared to a simplified safe-harbor approach likely will not be enough to justify the added administrative burden imposed on taxpayers. The need for such an election would increase significantly if our recommendation below—to permit taxpayers to reconstruct pre-2018 basket losses without choosing the branch carryover exception—is not adopted. If that recommendation is not adopted, we recommend that the final regulations should permit taxpayers to use a safe harbor method, in lieu of the branch carryover exception, to allocate and recapture losses with respect to the branch basket.

As noted in the preamble to the Proposed Regulations, one potential model for a safe harbor approach would be the safe harbor method set forth in Treasury Regulation section 1.904-7(f)(4)(ii). Under that approach, a taxpayer would allocate excess foreign taxes from the pre-2018 general basket between the post-2017 general basket and the branch basket on the basis on which the taxpayer allocates and apportions interest expense for its first post-2017 tax year. In prior transition years (taxable years following a change in the number of baskets under section 904(d) such as 1987 and 2007), Treasury and the Service have recognized the difficulties for taxpayers and the government in reconstructing the appropriate limitation categories of taxes and earnings when the rules change and have provided safe harbors to ease the administrative burden.22 We recommend a similar approach be adopted in this case, although the necessary scope of the safe harbor (only general basket taxes associated with the new branch basket) would be narrower than in prior transition rules.

2. Carryforward and Recapture of Loss Accounts

The Proposed Regulations generally provide that pre-2018 OFL and SLL account balances carry over to the same post-2017 basket, and that pre-2018 SLL and ODL accounts are recaptured out of income in the same post-2017 basket. We believe these basic rules are appropriate and generally consistent with prior transition rules.23

22 See, e.g., Reg. § 1.904-7(g)(3)(ii)(C); see generally T.D. 9260, 71 Fed. Reg. 24,516, 24,520 (Apr. 25, 2006) (“[A] reasonable approximation of the amounts properly included in the look-through pools, based on available records obtained through reasonable, good-faith efforts by the taxpayer, will adequately substantiate the reconstruction required by the statute.”).

23 See, e.g., Reg. § 1.904(f)-12(a)(1) (“If a taxpayer has a balance in an overall foreign loss account at the end of its last taxable year beginning before January 1, 1987 . . . the amount of that balance shall be recaptured in subsequent years by recharacterizing income received in the income category described in
The Proposed Regulations also provide that taxpayers choosing to apply the branch carryover exception may allocate OFLs and SLLs from the pre-2018 general category between the post-2017 general basket and the branch basket, as well as recapture ODLs from the pre-2018 general basket out of those two baskets, in proportion to the allocation of excess foreign taxes between the two baskets pursuant to the branch carryover exception. The allocation out of branch income, however, applies only if the taxpayer elects the branch excess credit carryover exception. Taxpayers that do not choose to apply the branch carryover exception cannot make this allocation and instead are required to treat all pre-2018 general basket losses as post-2017 general basket losses.

We recommend that taxpayers be permitted to reconstruct the allocation of pre-2018 general basket OFLs, SLLs, and ODLs to the foreign branch category using post-2017 rules even if taxpayers do not have excess foreign taxes in the pre-2017 general basket. It is true that the limitation category of OFLs and ODLs typically correlates with the limitation category of excess foreign taxes, but that is not always the case. For example, foreign taxes may not yet have been imposed on income that was general basket income pre-2018 but that would have been branch basket income. If a taxpayer is willing and able to prove to the satisfaction of the Service how pre-2018 losses attributable to the general category would have been allocated between the general category and the branch basket had the latter category existed, they should be permitted to undertake that burden.24 If the taxpayer fails to establish a reasonable allocation, then the default treatment should remain the general category. As noted above, if this recommendation is not adopted, we recommend that Treasury and the Service permit taxpayers to use a safe harbor method for allocating foreign taxes to allocate and recapture losses with respect to the branch basket.

**Recommendation**

We recommend that taxpayers be permitted to reconstruct the allocation of pre-2018 general basket OFLs, SLLs, and ODLs to the foreign branch category using post-2017 rules even if taxpayers do not have excess foreign taxes in the pre-2017 general basket.

3. **Transition for Taxpayers Using the Fair Market Value Method in Prior Taxable Years**

Section 864(e)(2) generally requires that interest expense be apportioned based on assets and not gross income beginning with the Tax Reform Act of 1986. Prior to the Act, the regulations provided a default rule that the allocation of interest would be based

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section 904(d) as in effect for taxable years beginning after December 31, 1986 . . . that is analogous to the income category for which the overall foreign loss account was established . . . .”)

24 See, e.g., Reg. § 1.904(f)-12(a)(2)(ii) (permitting taxpayers to trace a pre-effective date OFL in the general basket to one or more specific post-effective date baskets if the taxpayer can demonstrate that the loss is attributable to one or more baskets of section 904(d)(1), as in effect for post-effective date taxable years).
The regulations also permitted taxpayers to elect to use one of two alternative methods for valuing assets: the fair market value method, which (as one would expect) uses the fair market value of the assets for this purpose (the “FMV Method”), or the alternative tax book value method, which uses straight line depreciation to compute U.S. tax basis to provide parity with the depreciation of foreign assets, which generally must be done on a straight-line basis under section 168(g). Taxpayers making such elections are only permitted to elect out of either method with the consent of the Commissioner. Under all of these methods, the value of assets for a taxable year was computed using an average of the beginning of year and end of year values. Thus, taxpayers were required to determine such amounts on an annual basis at the close of the year, and would use the year end close from the prior year for purposes of averaging both amounts to determine the basis or value for this purpose.

The Act amended section 864(e)(2) to no longer permit taxpayers to use the FMV Method for taxable years ending after December 31, 2017. Accordingly, taxpayers that had elected to use the FMV Method must use either the default rule, adjusted tax basis, or the alternative tax book value method, beginning with their first post-2017 taxable year.

The Proposed Regulations permit a taxpayer who is required to change from the FMV Method of interest expense apportionment to determine their beginning of the year asset values for purposes of determining the average value for the year by treating the value of its assets as of the beginning of the first post-2017 year as equal to the value of its assets at the end of the first quarter of the post-2017 year, and not at the beginning of the year, provided certain conditions are met. Although not discussed, presumably allowing taxpayers to use the first quarter end values was done because (1) taxpayers cannot simply use the year end values from their computations done for the prior year’s tax return, in light of the required change, and (2) taxpayers will need to determine tax basis for purposes of computing their FDII deduction under section 250 for the year, which relies on the average of a taxpayer’s tax bases of its assets at the end of each quarter, and thus will be required to compute tax basis for a significant portion of their assets at the end of the first quarter, but not at the start (which is also the end of the prior taxable year).

In general, this election is appropriate and will help taxpayers to ease the transition to a new method of interest allocation and apportionment. However, many taxpayers still may find it difficult to compute their first-quarter values, as this approach could not have been anticipated. Although the Proposed Regulations provide helpful relief, ultimately either a beginning of the year or end of first quarter date requires ascertaining values for all of a taxpayer’s assets at a time in the past. The quarter end

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25 Reg. § 1.861-9T(g).
26 Reg. § 1.861-9T(h).
27 Reg. § 1.861-9(i).
28 Reg. § 1.861-9(i)(2)(i).
approach is further complicated in light of the earnings adjustments required by Treasury Regulation section 1.861-12(c)(2)(i). Applying those adjustments to determine asset values at the end of the first quarter will also require the taxpayer to determine the earnings of all CFCs in which it holds an interest for the first three months of the year. We therefore recommend that the regulations, when finalized, permit taxpayers to elect to determine their asset values for their first post-2017 year based solely on the year-end tax book value (or alternative tax book value), and not require averaging during the transition year. Such an election would ease administrative burden, particularly at a time when taxpayers are facing a number of significant compliance challenges presented by transitioning to the new rules. The proposed year end approach would remain subject to the condition set forth in the Proposed Regulations that it not create a “substantial distortion of asset values.” This rule would also be consistent with a rule adopted for the transition year following the 1986 Act, which also permitted taxpayers to elect to simply use the year-end values and not average for the first taxable year beginning after 1986.30

Alternatively, if the regulations retain an averaging approach for determining asset values in the transition year, we recommend that taxpayers that elect to use the first quarter values should be permitted to do so without regard to the earnings adjustment to the stock of certain foreign corporations under Treasury Regulation section 1.861-12T(c). This approach would provide parity with the beginning of the year amounts, which are computed without regard to earnings in the current period as the measurement date is immediately prior to the start of the year, and would avoid the administrative burden of computing earnings for such purpose, presumably requiring a retroactive closing of the books for all of a multinational group’s relevant entities.

**Recommendation**

We recommend that the regulations, when finalized, permit taxpayers to elect to determine their asset values for their first post-2017 year based solely on the year-end tax book value (or alternative tax book value), and not require averaging during the transition year. Alternatively, if the regulations retain an averaging approach for determining asset values in the transition year, we recommend that taxpayers that elect to use the first quarter values should be permitted to do so without regard to the earnings adjustment to the stock of certain foreign corporations under Treasury Regulation section 1.861-12T(c).

**B. Expense Allocation and GILTI**

The preamble to the Proposed Regulations has an extensive discussion regarding whether expense allocation and apportionment should apply in determining the section 904 FTC Limitation for the GILTI foreign tax credit basket. In justifying the application of expense allocation and apportionment to the GILTI basket, the preamble focused on the intent evidenced by the structure of the Act and the lack of express statutory language limiting the application of existing expense allocation rules, except through the application of section 904(b)(4). In so doing, the preamble acknowledges the Conference

30 Treas. Reg. § 1.861-9T(g)(2)(i).
Report’s explanation of the GILTI regime as not imposing residual U.S. tax if the foreign tax rate equals or exceeds 13.125%.³¹ Nevertheless, Treasury and the Service apparently concluded that this part of the legislative history was not sufficient to constitute actionable guidance. Further, the recently released “Blue Book” from the Joint Committee on Taxation repeats that legislative history but notes that it “assumes” that no expenses are otherwise allocable against the GILTI income and that if such expenses exist, the effective rate of taxation could exceed 13.125%.³²

We respectfully request reconsideration of whether that relatively clear language in the legislative history should be considered indicative of intent. We nevertheless acknowledge the mixed messages that the various international and foreign tax credit related provisions of the Act are sending. In light of this uncertainty, we think it prudent to start with an assessment of the legal authority existing in the Code and then to explore an appropriate policy course within that legal authority.

With regard to legal authority, the Act did not change the scope of regulatory authority provided to the Secretary in section 864(e). Section 864(e) in general provides the statutory framework for allocating and apportioning interest expense and other non-directly allocable or apportionable expenses for purposes of applying the Code’s international provisions. Section 864(e)(7)(G) provides the Secretary with regulatory authority to prevent the application of section 864(e) to “any provision of this subchapter to the extent the Secretary determines that the application of this subsection for such purposes would not be appropriate.” The relevant subchapter encompasses sections 861

³¹ H.R. Rep. 115-466 at 626-27. Specifically, the Conference Report provided that:

Under a 21-percent corporate tax rate, and as a result of the deduction for FDII and GILTI, the effective tax rate on FDII is 13.125 percent and the effective U.S. tax rate on GILTI (with respect to domestic corporations) is 10.5 percent for taxable years beginning after December 31, 2017, and before January 1, 2026. [text of footnote 1525: Due to the reduction in the effective U.S. tax rate resulting from the deduction for FDII and GILTI, the conferees expect the Secretary to provide, as appropriate, regulations or other guidance similar to that under amended section 965 with respect to the determination of basis adjustments under section 705(a)(1) and the determination of gain or loss under section 986(c).] Since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed by a domestic corporation is 13.125 percent. [text of footnote 1526: 13.125 percent equals the effective GILTI rate of 10.5 percent divided by 80 percent. If the foreign tax rate on GILTI is 13.125 percent, and domestic corporations are allowed a credit equal to 80 percent of foreign taxes paid, then the post-credit foreign tax rate on GILTI equals 10.5 percent (= 13.125 percent × 80 percent), which equals the effective GILTI rate of 10.5 percent. Therefore, no U.S. residual tax is owed.] If the foreign tax rate on GILTI is zero percent, then the U.S. residual tax rate on GILTI is 10.5 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 13.125 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5 percent and 13.125 percent. At foreign tax rates greater than or equal to 13.125 percent, there is no residual U.S. tax owed on GILTI, so that the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.

³² Joint Committee on Taxation, General Explanation of Public Law 115-97 at 381 (Dec. 2018) (the “Blue Book”).
through 999. This grant of regulatory authority allows the Secretary to implement appropriate rules for allocating indirect expenses to the GILTI basket for purposes of implementing the foreign tax credit limitation rules.

With respect to policy implications, a number of factors support eliminating indirect expense allocation against GILTI basket income for purposes of applying section 904. One of the primary features of the reformed international tax system under the Act is a parity in effective tax rates between foreign derived intangible income ("FDII") and GILTI in light of the deduction available to each type of income under section 250. Parity in the U.S. taxation of foreign market income effectively takes taxation out of the investment decision-making process. Expense apportionment against GILTI income imposes a 21% effective tax against such income and therefore materially distorts investment decisions and disparately taxes prior investment decisions.

Further, the current U.S. tax rules systematically over-allocate interest expense against foreign source income, including for purposes of applying section 904. Under current law, interest expense is allocated on a “water’s edge” basis, such that only interest expense incurred by domestic corporations is taken into account. Accordingly, interest expense allocation does not take into account debt incurred by foreign subsidiaries, such that foreign subsidiary income is overburdened under the interest expense allocation rules. As the preamble to the Proposed Regulations notes, section 864(f), which allows taxpayers an election to allocate interest expense on a worldwide basis, is not applicable until tax years beginning after December 31, 2020. Section 864(f) was first enacted in 2004 with a prospective effective date that has been delayed a number of times.33 Section 864(f) is of much greater importance under the worldwide tax base created by the GILTI rules, as compared to its potential operation under the pre-Act deferral system.

While section 864(f) is a pending change to the Code rules relating to interest, other Act provisions directly and indirectly affect the U.S. tax treatment of interest expense. Section 163(j) imposes a general limitation on interest expense deductibility tied to a measure of taxable income. The GILTI rules, by implementing a worldwide tax base, address policy concerns under prior law that domestic corporation debt and the corresponding interest deductions were funding foreign subsidiaries’ deferred income. These provisions ameliorate the need for expense apportionment against GILTI by limiting the amount of interest allowed as a deduction in a given tax year and by eliminating the former deferral regime governing most foreign earnings.

Within the inherent limits of crafting complex business tax reform legislation, it is relatively clear that Congress and the Administration sought to promote tax rate parity with respect to foreign market income. The GILTI regime and the associated foreign tax credit rules are but an evolving set of pieces carrying out this policy. It is similarly relatively clear that the existing expense apportionment rules systematically run counter to that parity policy and that existing law, through section 864(f), will ameliorate those issues over time. In light of these complex and interconnected changes to the U.S.

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33 Section 864(f) has been delayed three times, most recently in 2010. Hiring Incentives to Restore Employment, P.L. 111-147, §551(a).
international tax rules, the ability to at least defer expense allocation against GILTI basket income for purposes of applying section 904 would allow for a more measured and thoughtful approach in implementing the various pieces of the law.

There are a number of potential regulatory mechanisms to achieve this goal. The most direct would be to provide that expenses allocated against GILTI basket income are not taken into account in determining GILTI basket income for purposes of applying section 904. Alternatively, consideration could be given to eliminating expense allocation only if the taxpayer establishes that its net CFC tested income, as defined in section 951A(c), is subject to a minimum foreign effective tax rate. We would suggest 13.125% as an appropriate rate. Such foreign effective tax rate could be determined under the principles of the “high-tax exception” of section 954(b)(4). For taxpayers with net CFC tested income below the minimum rate, the regular expense allocation rules would apply. Either such approach would align with section 904(b)(4)’s approach of disregarding interest expense, in contrast with section 864(e)(3)’s approach of eliminating assets and income that would otherwise attract expenses.

In light of these considerations and the associated options, and assuming that any of the prior recommendations are not adopted, we recommend that Treasury and the Service adopt the direct approach of not taking into account expenses allocated to GILTI basket income for purposes of applying section 904, and that such provision remain operative until section 864(f) becomes operative.

**Recommendations**

We recommend that expenses allocated against GILTI basket income not be taken into account in determining GILTI basket income for purposes of applying section 904. Alternatively, consideration could be given to eliminating expense allocation only if the taxpayer establishes that its net CFC tested income is subject to a minimum foreign effective tax rate of 13.125%.

Alternatively, we recommend that Treasury and the Service adopt the direct approach of not taking into account expenses allocated to GILTI basket income for purposes of applying section 904, and that such provision remain operative until section 864(f) becomes operative.

**C. Tax Exempt Assets and Income**

**1. FDII Assets**

Proposed Regulation section 1.861-8(d)(2)(ii) addresses the definition of exempt assets and exempt income in applying section 864(e)(3) in the context of the newly-enacted section 250 deduction. Specifically, these rules provide that the section 250 deduction creates exempt gross income and partially exempt assets. The section 250 deduction is relevant to both GILTI and FDII.

The identification of exempt income for both FDII and GILTI is generally straightforward, simply referencing the amount of the deduction. The proposed rules
identifying an exempt GILTI asset rely in large part on the statutory and regulatory framework addressing the treatment of CFC stock in applying the expense allocation rules.\footnote{See Prop. Reg. § 1.861-13.} Those rules focus on the extent to which CFC stock is attributable to GILTI income giving rise to the section 250 deduction. The stock characterization rules therefore identify and account for otherwise exempt “tested income” earned by a CFC. The provisions also account for any subpart F income generated with respect to CFC stock.

The rules for identifying an exempt asset in the context of FDII present a more significant challenge. The Proposed Regulations provide the following rules for applying section 864(e)(3) in light of the FDII deduction (the “FDII Allocation Rule”):

The term “exempt asset” includes the portion of a domestic corporation’s assets that produce gross income included in foreign-derived intangible income equal to the amount of such assets multiplied by the fraction that equals the amount of the domestic corporation’s deduction allowed under section 250(a)(1)(A) (taking into account the reduction under section 250(a)(2)(B)(i), if any) divided by its foreign-derived intangible income. No portion of the value of stock in a foreign corporation is treated as an exempt asset by reason of this paragraph \footnote{Prop. Reg. § 1.861-8(d)(ii)(C).} including by reason of a transfer of intangible property to a foreign corporation subject to section 367(d) that gives rise to income eligible for a deduction under section 250(a)(1)(A).\footnote{I.R.C. § 250(b)(1).}

Pursuant to the Act’s changes to section 864(e)(2), interest expense allocation and apportionment must be determined using the adjusted basis of assets. The exempt asset determination under section 864(e)(3) is therefore most significant in the context of interest expense allocation. However, we recommend that the final regulations further clarify the operation of this rule, including specifically the identification of “assets that produce gross income included in foreign derived intangibles income.” For this purpose, we have identified alternative approaches for how FDII assets may be identified for purposes of applying section 864(e)(3). The consistency of these approaches with the operation of the FDII rules depend to some extent on the underlying purpose of the exclusion for net deemed tangible income return (“NDTIR”) from receiving favorable treatment under the GILTI rules. Specifically, the issue is whether NDTIR is an attempt to effectively separate between the return to tangible and intangible assets, or whether it is more in the nature of identifying some above normal return to any business and attributing such amount to the business intangible assets. A third option is to exclude FDII assets from the application of section 864(e)(3). FDII itself is determined under a complex formula as the product of a taxpayer’s “deemed intangible income” (“DII”) multiplied by a fraction, the numerator of which is “foreign-derived deduction eligible income” (“FDDEI”) and the denominator of which is “deduction eligible income” (“DEI”).\footnote{I.R.C. § 250(b)(1).} This formula can be expressed as follows:
The definitions of both DII and FDDEI are derived from the definition of DEI. DII is DEI minus the corporation’s “deemed tangible income return” (“DTIR”), which, in turn, is defined as 10 percent of the adjusted basis in the corporation’s tangible assets (determined under the qualified business asset investment or “QBAI” rules of section 951A) that give rise to DEI. FDDEI is the portion of DEI that is attributable to certain foreign market transactions in goods and services.

The amount of the deduction under section 250 (the “Section 250 FDII Deduction”) is then computed by multiplying FDII by the statutory rate of 37.5%, potentially reduced depending on the amount of a taxpayer’s taxable income. Because this percentage can vary from year to year, we refer to this percentage as the “Effective Deduction Percentage.”

Before discussing the possible approaches for revising the regulatory rule, we note that unlike the treatment of GILTI as tax exempt under section 864(e)(3), the application of the exempt asset rules to FDII may be favorable or unfavorable to specific taxpayers, depending on their particular circumstances. Sales and services income generated by FDII assets will generally be U.S. source, such that the application of the exempt asset rules to such FDII assets would reduce the amount of interest expense allocated to that income. That result would generally be taxpayer unfavorable as a greater percentage of interest expense will be allocated against foreign source income. Of course, other types of income such as foreign source royalty income may qualify as FDDEI and therefore also generate FDII that qualifies for the section 250 FDII Deduction. Reducing the amount of assets that produce foreign source income would generally be taxpayer favorable.

The concern with the FDII Allocation Rule is that it requires the identification of “the portion of a domestic corporation’s assets that produce gross income included in foreign-derived intangible income.” Although the portion of assets that produce the FDII deduction presumably corresponds to the portion of the income that produce this deduction, it becomes important to determine what portion of a taxpayer’s income is FDII. However, the FDII rules rely heavily on the formulaic approach described above. One aspect of that formulaic approach is that FDII does not include a routine return on tangible assets, which is computed by reducing the amount of DEI by a 10 percent return on the taxpayer’s QBAI, which is the basis in its assets that are depreciable under section 167.\(^\text{37}\) This determination is not based on any factual analysis regarding the actual rate of return on such assets but is assumed for all QBAI of all taxpayers. (It also should be noted that removing the QBAI from the operation of section 864(e)(3) in the context of GILTI is addressed in the mechanics of the regulations because such income produces exempt income and thus is subject to the rules of section 904(b)(4) for expense allocation purposes.) Thus, the portion of assets producing QBAI should not produce FDII.

\(^{37}\) I.R.C. §§ 250(b)(2)(B) and 951A(d)(1).
A second aspect of the FDII formulary approach is the portion of income that is foreign-derived, and thus gives rise to the section 250 deduction, is based on the relative amount of FDDEI to DEI, or in formulary terms: \( \frac{\text{FDDEI}}{\text{DEI}} \).

This formulary approach raises the issue of the best way to identify the “portion of a domestic corporation’s assets that produce gross income included in foreign-derived intangible income.” There are a number of possible approaches for making this determination, from a formulary approach to one that attempts to trace to the underlying asset based on a factual analysis of the income each asset produces. For the reasons discussed below, we believe a factual approach imposes undue administrative burden on taxpayers and the government.

**OPTION 1.** Given the inherent complexity in the FDII determination, we believe consideration should be given to entirely excluding FDII related assets from the exempt asset definition. Within the FDII calculation, basis in tangible assets directly results in QBAI and DTIR, which reduces the amount of income eligible for the section 250 deduction. QBAI therefore provides that certain income is subject to the full 21% corporate tax rate and is in no sense “exempt.” While the QBAI exclusion from the section 250 benefit manifests only through the operation of the FDII formula, there is a clear underlying policy. Tangible asset basis generates the “ordinary” return that is not intended to be supported by the section 250 deduction. Accordingly, tangible asset basis could appropriately be excluded from the exempt asset determination.

With regard to intangible assets, the costs to develop self-created intangibles are generally expensed under section 174. Therefore, such intangibles would carry a zero basis and would not attract interest allocation or apportionment under section 864(e). In contrast, purchased intangibles would have basis, subject to adjustments for amortization that might be includible in an exempt asset determination. We also acknowledge the Act’s prospective changes to section 174, which would generally provide for 5-year amortization of the costs to develop self-created intangibles starting in tax years beginning after December 31, 2021. We nevertheless view the changing treatment of self-created intangibles in conjunction with the differing treatment of purchased intangibles as indicative of an inherent arbitrariness in applying the exempt asset rules to the FDII deduction. Taxpayers with similar asset mixes may be subject to disparate treatment under the proposed exempt asset rule depending on their business model and point in their business cycle.

Based on the above, any attempt at a precise measure of exempt assets arising due to the FDII deduction would be inherently complex, if just to account accurately for the effect of QBAI in the relevant asset base, and would be inherently inaccurate and distortive as applied to intangible assets.\(^3\) Further, given the effects of QBAI and the

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\(^3\) In contrast, these concerns do not arise with respect to the GILTI section 250 deduction. As discussed above, there is a robust statutory (and pending regulatory) framework to “sort” the basis in CFC stock between and among taxable (subpart F and GILTI income) and tax-exempt (sections 245A and 250 eligible) income generated by the CFC and its CFC subsidiaries.
prevalence of zero asset intangibles, an appropriate exempt asset definition would not be expected to produce significant exempt assets (although that could change with the amortization of self-created intangibles in tax years beginning in 2022). Further, any benefits of more accurate expense apportionment would only come with significant further compliance costs.

For these reasons, we recommend that in the interests of administrability, Treasury and the Service move assets giving rise to the FDII deduction from the application of the exempt asset rules.

**OPTION 2.** If Treasury and the Service choose to retain rules applying exempt asset treatment for FDII generating assets, we believe the rules need to take into account the “full taxation” effect of QBAI and facilitate administrability. Nevertheless, even within these parameters, we have found it difficult to craft a satisfactory rule. Of course, this report was filed prior to the issuance of proposed guidance under section 250, which likely will provide clarity regarding how the various parts of the FDII formula are determined. We believe a formulary approach is necessary and offer the following potential options:

**Option 2A:**

\[
\text{Exempt Assets} = \frac{\text{Aggregate basis of intangible property giving rise to DEI}}{\text{FDDEI}} \times \frac{\text{FDDEI}}{\text{DEI}} \times \text{Effective deduction percentage}
\]

where the effective deduction percentage is the deduction allowed under section 250(a)(1)(A) (taking into account the reduction under section 250(a)(2)(B)(i), if any) divided by FDII.

Option 2A treats all tangible assets as producing a fully taxable return pursuant to the QBAI/DTIR measurement and therefore focuses only on intangible assets.

**Option 2B:**

\[
\text{Exempt Assets} = \frac{\text{Aggregate basis of intangible property giving rise to FDDEI}}{\text{FDDEI}} \times \frac{\text{FDII}}{\text{FDDEI}} \times \text{Effective deduction percentage}
\]

Option 2B isolates the QBAI “full taxation” effect through the FDII/FDDEI computation. Option 2B presents some complexity in having to identify FDDEI asset basis, which will in many cases require a splitting of assets as contemplated in the regulations. This determination could be simplified by determining FDDEI property aggregate basis by multiplying DEI asset aggregate basis by FDDEI/DEI.

**Recommendation**

We recommend that in the interests of administrability, Treasury and the Service remove assets giving rise to the FDII deduction from the application of the exempt asset rules. Alternatively, we recommend adopting one of two possible formulary
approaches for determining the portion of a taxpayer’s assets that are treated as giving rise to the Section 250 FDII Deduction.

2. Value of Stock Attributable to Previously Taxed Earnings and Profits

Proposed Regulations section 1.861-8(d)(2)(iv) provides that “[n]o portion of the value of stock in a controlled foreign corporation is treated as an exempt asset by reason of the adjustment under §1.861-12(c)(2) in respect of previously taxed earnings and profits described in section 959(c)(1) or (c)(2).” The adjustment in Proposed Regulation section 1.861-12(c)(2) is made to account for the change in value attributable to earnings and profits of CFCs. Consistent with the preamble, we believe this rule is solely because it has produced and retains earnings attributable to subpart F or GILTI inclusions that will not be subject to tax upon subsequent distribution. Nevertheless, we recommend that the rule in Proposed Regulation section 1.861-8(d)(2)(iv) be clarified to confirm that it operates independently of the GILTI exempt asset rules in Proposed Regulation section 1.861-8(d)(2)(ii)(C)(3). That is, the rule only provides that no portion of CFC stock is treated as an exempt asset because the CFC has a section 959(c)(1) or (c)(2) account. Such stock could nevertheless be treated as an exempt asset to the extent of a section 250 deduction attributable to a current-year GILTI inclusion.

We recommend that the clarification of Proposed Regulation section 1.861-8(d)(2)(iv) be accomplished by inserting the word “solely” before “by reason,” such that the revised provision reads:

No portion of the value of stock in a controlled foreign corporation is treated as an exempt asset 

solely by reason of the adjustment under §1.861-12(c)(2) in respect of previously taxed earnings and profits and profits described in section 959(c)(1) or (c)(2).

Recommendation

We recommend that the clarification of Proposed Regulation section 1.861-8(d)(2)(iv) be accomplished by inserting the word “solely” before “by reason of.”

3. Treatment of Certain Individual Partners in a Certain Pass-through Entities

Treasury Regulation section 1.861-9(e)(4)(i) requires that certain partners with a less than 10 percent interest in a partnership directly allocate their distributive shares of partnership interest expense against their distributive shares of partnership gross income. This treatment applies to all limited partners (whether corporations or individuals) and to corporate general partners. Accordingly, individual general partners would not be subject to this direct tracing rule. These rules generally track the approach under the current interest allocation regulations, as applied in Treasury Regulation section 1.861-9T(e)(4)(i). The propagation of new legal entities, such as limited liability companies (“LLCs”) and limited liability partnerships (“LLPs”), has introduced uncertainty as to the treatment of partners or members in such entities as these entities generally provide
limited liability for the obligations of the partnership but also permit significant participation in the operations of the partnership (for example, a partner in a professional services partnership, such as a law or accounting firm). We recommend that Treasury and the Service clarify the operation of these rules in the case of individual members of an LLC, LLP, or similar entity by specifying that such individual is considered to be a limited partner for purposes of this rule. In keeping with the general framework of the regulations, we believe it would be appropriate that members of such entities with a less than 10 percent interest are per se not treated as general partners. It seems clear in most of these cases that the fungibility of money principle that is the source of the interest allocation regulations generally is not applicable in the case of a small partner in one of these entities, as the debts of the LLP or LLC generally are not supporting the partner or member’s other assets, and thus allocating such expense against the income of the partnership is most consistent with the economic reality of these situations. Moreover, this approach would provide administrative simplicity to such partners and avoid the need to have information on the worldwide assets of the LLP or LLC.

**Recommendation**

We recommend that Treasury and the Service clarify the operation of Treasury Regulation section 1.861-9(e)(4) in the case of individual members of an LLC, LLP, or similar entity by specifying that such individual is considered to be a limited partner for purposes of this rule.

4. Specified Partnership Loans

The Proposed Regulations contain rules that address the expense allocation consequences of loans from partners (and related persons) to partnerships. In general, these rules eliminate, partly or wholly, the loan as an asset of the lending partner (or related person) and match the lender’s interest income with the allocation of the interest expense to the lending partner or the related person. The Proposed Regulations provide anti-avoidance rules for certain financing arrangements involving third-parties and loans from CFCs.

We suggest that the final regulations clarify these rules and provide examples of their operation. In particular, while the provisions of Proposed Regulation section 1.861-9(e)(8)(ii) appear intended solely to match otherwise existing income and expense, the operative language of the regulations could be read to require a taxpayer to take into income the “matching income amount” in addition to any other gross income earned by the taxpayer. We presume that such treatment was not intended. We recommend that Proposed Regulation section 1.861-9(e)(8)(ii) be amended to provide in relevant part that the SPL lender must assign an amount of income corresponding to the matching income amount for the taxable year this is attributable to the same loan to the same statutory and residual groupings of gross income from which the SPL interest expense is deducted by the SPL lender (or any other person in the same affiliated group as the SPL lender).

In addition, we recommend revising the anti-avoidance rules for certain third-party and CFC loans to simplify and clarify their operation. With respect to the third-
party loan rules, there is a general principal purpose test and then a per se rule “if the loan to the unrelated person would not have been made or maintained on substantially the same terms irrespective of the loan of funds by the unrelated person to the partnership.” We recommend converting the per se rule to an explicit, adverse factor in the application of the general rule.

With regard to the CFC rules, the anti-abuse rule applies “if the loan was made or transferred with a principal purpose of avoiding” the specified partnership loan rules. The consequence of applying the anti-abuse rules is that the loan is treated as a loan receivable held directly by the U.S. shareholder of the CFC. We recommend that additional guidance should be included to clarify when a CFC loan to a partnership is considered as having a principal purpose of avoidance. For example, direct or indirect funding of the loan by the U.S. shareholder may be viewed as indicative of an avoidance purpose. It is unclear what other circumstances should be relevant for purposes of the anti-avoidance rule. In addition, guidance should clarify the tax consequences that arise when a U.S. shareholder is deemed to hold the loan under the rule. For example, the regulation could provide whether such treatment affects the nature of the assets held by the U.S. shareholder. An example of how such treatment would relate to the matching rule would be useful.

Recommendation

We recommend that Proposed Regulation section 1.861-9(e)(8)(ii) be amended to provide in relevant part that the “SPL lender must assign an amount of income corresponding to the matching income amount for the taxable year that is attributable to the same loan to the same statutory and residual groupings of gross income from which the SPL interest expense is deducted by the SPL lender (or any other person in the same affiliated group as the SPL lender).”

5. Application of Interest Expense Apportionment Rules to CFCs Holding Lower-Tier CFCs

a) Modified Gross Income Method

For purposes of applying section 904, Proposed Regulation section 1.861-13 applies to characterize CFC stock based on the section 904 baskets, the U.S. source residual income category, and the tax exempt income produced by the CFC. As discussed in more detail below, if Treasury and the Service do not provide more general relief with respect to the allocation of expenses to the GILTI basket, we recommend the following incremental changes with respect to the proposed stock characterization rules in Proposed Regulation section 1.861-12 and -13.

Under the proposed revisions to the modified gross income method of Treasury Regulation section 1.861-9T(j), an upper-tier CFC apportions its interest expense by generally “tiering up” the gross income net of interest expense of lower-tier CFCs. In doing so, however, the upper-tier CFC does not take into account gross subpart F or section 951A tested income (net of interest expense) earned by lower-tier CFCs. Gross
income also does not include dividends received from lower-tier CFCs. Accordingly, interest expense would generally be allocated against an upper-tier CFC’s directly earned subpart F and tested income, if any, and otherwise would be allocated against exempt income. This approach is similar to that of the current regulations, which also ignore gross subpart F income (net of interest expense) of lower-tier CFCs.

In addition, the Proposed Regulations retain current law’s asset method for CFCs. Under that method, the assets of lower-tier CFCs effectively tier up to a higher-tier CFC for purposes of characterizing the stock of the lower-tier CFC in the hands of the upper-tier CFC. The asset method contains no exception for subpart F income or section 951A tested income generating assets of lower-tier CFCs. Accordingly, under the asset method, it appears that interest expense of an upper-tier CFC would be allocated and apportioned against the subpart F and section 951A tested income producing assets of the lower-tier CFCs because the upper-tier CFC takes into account the subpart F and section 951A tested income producing assets of its subsidiaries.

Prior to the Act, when section 904 had two baskets and most CFC income qualified for deferral under the subpart F rules, the gross income method generally resulted in a residual allocation to the general limitation basket and was without distortive consequences.

Under the Act, there is effectively a worldwide tax base under which income is taxed at differing rates (including potentially at a zero percent rate). Losses attributable to tested income are attributed to U.S. shareholders under section 951A’s “net CFC tested income” rules. In addition, interest expense allocable to tested income is attributed to a U.S. shareholder to reduce its “net deemed tangible income return” under section 951A(b)(2). Accordingly, the allocation of CFC level interest expense to tested income has two consequences – it reduces tested income, thereby reducing GILTI income, and it reduces the 10 percent of allocable qualified business asset investments (“QBAI”) as defined in section 951A, thereby preventing the otherwise available reduction in GILTI income through the “net deemed tangible income return” mechanic. These effects are obviously offsetting to some extent as relates to a taxpayer’s foreign tax credit limitation calculation.39

The original subpart F regime shares losses between CFCs under the much more restrictive rules of section 952(c)(1)(C). Those rules reduce the subpart F income of “qualified chain members” and do not rely on blending attributes at the U.S. shareholder level. Therefore, the mechanics and policy of section 951A are fundamentally different from those of the original subpart F regime.

We believe that, in applying the modified gross income method, Treasury and the Service should allow upper-tier CFCs to take into account the gross tested income (net of interest expense) of lower-tier CFCs in allocating its interest expense. The section 951A GILTI regime is inherently a group-based concept with aggregation occurring at the U.S.

39 The Act’s legislative history does not elaborate on the policy origins of this treatment. It appears that Congress may have departed from the long-held norm of debt fungibility and considered interest expense allocable to tested income as creating a double benefit through the creation of QBAI.
shareholder level. In our view, it would be better to give regard to (or take into account) the grouping of income inherent in the section 951A regime and provide for systematically dissimilar results under the asset and gross income methods. Further, there appears to be little policy justification to allocate the interest expense of CFC holding companies against exempt income for purposes of sections 904 and 951A.\footnote{Assume two scenarios. In the first, CFC1 is an operating company that incurs interest expense of 100 on a loan that finances the acquisition of operating assets that generate 200 of tested income. The interest expense deduction would be allocated to gross tested income leaving net tested income of 100. Now, assume that CFC1 borrows and contributes the borrowed funds to a lower-tier operating CFC2. CFC1 incurs 100 of interest expense and CFC2 has 200 of gross tested income. Under the proposed regulations, none of CFC1’s interest expense would be allocated to tested income of CFC2, and instead it would be allocated only to CFC’s directly earned gross income, if any. And it is not clear how CFC1’s interest expense would be allocated if it had no gross income other than dividends from CFC2, as those dividends would not be taken into account as gross income of CFC1.} In addition, it appears distortive to allow the interest expense allocation of upper-tier operating companies to disregard the results of the lower-tier CFCs.

We have considered whether existing regulations implementing the gross income method should be modified such that the subpart F income of lower-tier CFCs should be taken into account by upper-tier CFCs in apportioning their interest expense. On balance, we believe that the section 952(c) chain deficit rules provide the appropriate mechanism for attributing and sharing losses between CFCs under the legacy subpart F rules. Because these rules operate at the CFC, and not at the U.S. shareholder level, there remains no need to attribute lower-tier subpart F income to upper-tier CFCs under the modified gross income rules.

We have also considered the implications of exempt income on the modified gross income method’s income attribution rules. Exempt income has two sources: first, it is created through the operation of the section 951A tested loss rules and net deemed tangible income return rules; second, it arises from categories of income that are treated as neither tested income nor subpart F income. With regard to the section 951A-created exempt income, it is part of the tested income that would be attributed to upper-tier CFCs and should attract expense allocation in the same manner as non-exempt tested income.

With regard to income that is exempt because it is outside of the section 951A and legacy subpart F rules, such exempt income would include certain related party dividends, gross income that is treated as exempt because of the section 952(c) qualified deficit or chain deficit rules, and foreign oil and gas exempt income (“FOGEI”). We believe such income should not be attributed from lower-tier CFCs to upper-tier CFCs under the modified gross income method.

- For related party dividends, the income should tier up or not based on its characterization at the CFC that earned the underlying income. Under no circumstances should the distribution of such earnings give
rise to income subject to tiering. This approach is consistent with that of the Proposed Regulations.41

- For income “sheltered” by section 952(c) deficits, the section 952(c) attribution rules are themselves the appropriate sharing mechanism. Such income should not affect the characterization of any higher-tier deductions.

- With respect to FOGEI, we believe that the absence of any sharing or “look-through” rules in computing FOGEI or with respect to distributions sourced to FOGEI earnings makes such income distinct from subpart F and net CFC tested income. As a practical matter, FOGEI is determined on largely a separate entity basis and the expenses of any affiliate cannot affect the amount of such FOGEI. Accordingly, in applying section 904 and the modified gross income method, we believe FOGEI should not be attributed from lower-tier to upper-tier CFCs.

We therefore recommend that in applying the modified gross income method, Treasury and the Service should allow upper-tier CFCs to take into account the gross tested income (net of interest expense) of lower-tier CFCs in allocating its interest expense.

**Recommendation**

We recommend that in applying the modified gross income method, Treasury and the Service should allow upper-tier CFCs to take into account the gross tested income (net of interest expense) of lower-tier CFCs in allocating their interest expense, as well as certain other technical changes to the provisions.

**b) Asset Method**

We also recommend that the application of the asset method to stock of lower-tier CFCs be clarified in light of the GILTI rules. Under the asset method, a taxpayer generally characterizes its assets based on the gross income they generate, have generated, or may reasonably be expected to generate.42 Special asset characterization rules apply under the existing and Proposed Regulations to characterize stock in CFCs.43 Consistent with the existing regulations, the Proposed Regulations provide that the tax book value of an upper-tier CFC’s stock in a lower-tier CFC is characterized as an asset in the relevant “separate categories” based on the assets of the lower-tier CFC. That rule applies by its terms, however, only for purposes of characterizing a top-tier CFC’s stock in its U.S. shareholder’s hands.44 Moreover, the rule applies for purposes of

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42 Reg. § 1.861-9T(g).


44 Prop. Reg. § 1.861-12(c)(3)(i)(A) (which applies for purposes of applying operative sections other than section 904) and (c)(3)(ii).
characterizing stock into “separate categories,” which is a reference to the separate foreign tax credit limitation categories. A similar rule should also apply for purposes of characterizing the stock of a lower-tier CFC in the hands of an upper-tier CFC under the asset method. Such rule should clarify that the stock of the lower-tier CFC that is characterized by reference to its assets producing tested income should be characterized as an asset generating tested income.

6. Treatment of Tested Losses

Without elaboration, the Proposed Regulations request comments on whether “additional rules are required to account for gross tested income earned in lower-tier CFCs, including gross tested income of lower-tier CFCs that produce tested losses.”

We believe the policy considerations relevant to lower-tier tested loss CFCs extend beyond the modified gross income method and apply equally with respect to first-tier tested loss CFCs. In particular, we believe compelling arguments exist to exclude the gross income and assets of tested loss CFCs from the expense apportionment rules as applied to both first-tier and lower-tier CFCs. Tested loss entities already fundamentally affect the treatment of the section 951A income basket under section 904. As noted, tested losses offset and reduce other positive tested income in the GILTI inclusion calculation. This treatment results in exempt income in the tested loss company. As an offset to that treatment, any interest expense of tested loss CFCs that is allocable to tested income (including potentially the interest expense of a holding company under the recommendations discussed herein) is taken into account in determining the net deemed tangible income return. Any QBAI of the tested loss company is disregarded for such determination. The foreign income taxes attributable to tested income of a tested loss CFC are disregarded. The tested loss itself reduces the foreign tax credits that are deemed paid by CFCs with positive tested income. Given the labyrinth of specifically enacted, negative rules addressing the interaction of tested loss CFCs with the taxpayer’s overall foreign tax credit calculations, we recommend the elimination of such assets and income from the section 864(e) expense allocation rules.

Recommendation

We recommend the elimination of tested loss assets and income from the section 864(e) expense allocation rules.

D. Definition of Current Year Taxes and Year in Which Such Taxes Should be Taken into Account.

1. Background

Prior to the Act, deemed paid foreign taxes were computed under sections 902 and 960 based on multi-year “pools” of earnings and taxes. Beginning with its first taxable year beginning after December 31, 1986 in which the corporation had a domestic corporate shareholder that was entitled to claim deemed paid credits, a foreign corporation computed its earnings and profits and foreign taxes for each year and added
them to its “post-1986 undistributed earnings” and “post-1986 foreign tax” pools.\textsuperscript{45} When the corporation distributed a dividend or an amount was included in its U.S. shareholders’ income under section 951(a), deemed paid taxes were computed based on the total amount of earnings and taxes in the post-1986 pools. The multi-year pooling approach evened out the effective tax rate over different years and prevented credits from being lost where, for example, a foreign corporation had profits in some years and losses in others.\textsuperscript{46}

The Act repealed section 902 and revised section 960 to eliminate the multi-year approach. Under new section 960, only taxes “properly attributable” to a current year inclusion may be deemed paid by a domestic corporation. Section 960(a), as amended by the Act, provides that if a domestic corporation includes an item of income under section 951(a)(1), “such domestic corporation shall be deemed to have paid so much of such foreign corporation's foreign income taxes as are properly attributable to such item of income.” Similarly, new section 960(d)(1) provides that if a domestic corporation includes an amount in gross income under section 951A, the domestic corporation “shall be deemed to have paid foreign income taxes equal to 80 percent of the product of (A) such domestic corporation's inclusion percentage, multiplied by (B) the aggregate tested foreign income taxes paid or accrued by controlled foreign corporations.” Section 960(d)(3) then defines tested foreign income taxes as “the foreign income taxes paid or accrued by such foreign corporation which are properly attributable to the tested income of such foreign corporation taken into account by such domestic corporation under section 951A.”

The legislative history provides limited guidance on how to determine which taxes are “properly attributable” to a CFC’s earnings. The House Report states, “It is anticipated that the Secretary would provide regulations with rules for allocating taxes similar to rules in place for purposes of determining the allocation of taxes to specific foreign tax credit baskets,” citing Treasury Regulation section 1.904-6 in a footnote.\textsuperscript{47} Treasury Regulation section 1.904-6 provides as a general rule that “[t]axes are related to income if the income is included in the base upon which the foreign tax is imposed.”\textsuperscript{48}

The Proposed Regulations under section 960 would define taxes properly attributable to items of income. With respect to subpart F inclusions, Proposed Regulation section 1.960-2(b)(2) provides:

\begin{enumerate}
\item Properly attributable. The amount of the controlled foreign corporation’s foreign income taxes that are properly attributable to the items of income in the
\end{enumerate}

\textsuperscript{45} See former I.R.C. § 902(c), as in effect for taxable years of foreign corporations beginning before January 1, 2018.

\textsuperscript{46} See Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 869 (May 1987).

\textsuperscript{47} H.R. Rep (Conf.) No. 115-466, 115th Cong., 1st Sess. 642, fn. 1528 (2017). The Senate and Conference Committee adopted the House version of the bill on this point.

\textsuperscript{48} Reg. § 1.904-6(a)(1)(i).
subpart F income group of the controlled foreign corporation to which a subpart F inclusion is attributable equals the domestic corporation’s proportionate share of the current year taxes of the controlled foreign corporation that are allocated and apportioned under §1.960-1(d)(3)(ii) to the subpart F income group. No other foreign income taxes are considered properly attributable to an item of income of the controlled foreign corporation.

Proposed regulation section 1.960-1(d)(3)(ii) provides the general rule that current year taxes are allocated among the baskets based on the income to which the tax relates under the foreign tax law. Proposed regulation section 1.960-1(d)(4) provides a parallel definition for taxes properly attributable to tested income.

Proposed regulation section 1.960-1(a)(4) would define current year taxes that may be properly attributable to an amount included under section 951(a) or 951A:

The term current year taxes means foreign income taxes paid or accrued by a controlled foreign corporation in a current taxable year. Foreign income taxes accrue when all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. See §§1.446-1(c)(1)(ii)(A) and 1.461-4(g)(6)(iii)(B) (economic performance exception for certain foreign taxes). Withholding taxes described in section 901(k)(1)(B) that are withheld from a payment accrue when the payment is made. Foreign income taxes calculated on the basis of net income recognized in a foreign taxable year accrue on the last day of the foreign taxable year. Accordingly, current year taxes include foreign withholding taxes that are withheld from payments made to the controlled foreign corporation during the current taxable year, and foreign income taxes that accrue in the controlled foreign corporation’s current taxable year in which or with which its foreign taxable year ends. Additional payments of foreign income taxes resulting from a redetermination of foreign tax liability, including contested taxes that accrue when the contest is resolved, “relate back” and are considered to accrue as of the end of the foreign taxable year to which the taxes relate.

2. Accrual of Foreign Income Taxes

Proposed Regulation section 1.960-1(a)(4) cites final regulations under sections 446 and 461 for the general principle that a foreign tax liability accrues when all events test is met (subject to an economic performance exception for certain foreign taxes). These regulations state that an accrual basis taxpayer incurs a liability in the year all events occur which fix the fact of the liability, the amount of the liability is determinable with reasonable accuracy, and economic performance has occurred with respect to the liability (the “All Events Test”). The all events test thus requires a facts and circumstances analysis. Treasury Regulation section 1.461-4(g) provides that for certain types of liabilities, including taxes, payment constitutes economic performance. The economic performance regulations, however, provide a special rule for foreign income taxes that effectively excludes these amounts from the economic performance

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49 Reg. §§ 1.446-1(c)(1)(ii)(A) and 1.461-4(g)(6)(iii)(B).
rule by treating a liability to pay a creditable foreign income tax as accrued, even though prior to payment, when the other historical requirements of the all events test are met.\footnote{Reg. § 1.461-4(g)(6)(iii)(B).}

There is no indication in the Proposed Regulations or preamble that Treasury and the Service intended for the Proposed Regulations to change those rules. We presume Proposed Regulation section 1.960-1(a)(4) is intended to simply restate and summarize current law concerning the timing for accruing a foreign income tax. In most cases, a foreign income tax liability accrues on the last day of the foreign taxable year because that is the date on which all events have occurred fixing the fact of the liability, and the amount of the liability is determinable with reasonable accuracy. In Revenue Ruling 61-93, which is frequently cited for the proposition that foreign taxes accrue at the end of the foreign tax year, the Service reviewed the requirements of the all events test (which at the time did not include the economic performance requirement).\footnote{Rev. Rul. 61-93, 1961-1 C.B. 390, \textit{modifying} I.T. 4033, 1950-2 C.B. 52.} The ruling does not, however, establish an absolute rule that foreign taxes accrue at the end of the foreign tax year. Instead, it states:

> From the foregoing, it is apparent that, for the purpose of the foreign tax credit, foreign income taxes are considered as accrued in the taxable year in which the taxpayer’s liability for such foreign taxes becomes fixed and determinable. Generally such accrual occurs in the United States taxable year within which the taxpayer’s foreign taxable year ends.

The fourth sentence of Proposed Regulation section § 1.960-1(b)(4), however, states without qualification that “[f]oreign income taxes calculated on the basis of the net income recognized in a foreign taxable year accrue on the last day of the foreign taxable year.” The statement, while true in most cases, is not necessarily true in all cases. Revenue Ruling 61-93 acknowledged this. We assume the inclusion of this additional discussion regarding the time at which a foreign tax is paid or accrued was not intended to modify existing law, in which case, eliminating the language will restore that position. Alternatively, if the intent of the language was to modify current law, we respectfully recommend that a revision of the foreign tax accrued rules be deferred to a separate project to allow for specific comments and fuller consideration of any potential changes. We thus recommend that the definition of current year taxes be revised by removing the fourth sentence. To further clarify the intent of the current year taxes definition, we recommend that the preamble include an explanation that the revision to the definition was intended to avoid an inference that the regulation was changing current law regarding the timing for when a foreign tax accrues.

**Recommendation**

We recommend a revision of the definition of current year taxes in Proposed Regulation section 1.960-1(a)(4) by removing the fourth sentence. In addition, to clarify the intent of the current year taxes definition, we recommend that the preamble include an explanation that the change to the definition was intended to avoid an
inference that the regulation was changing current law regarding the timing for when a foreign tax liability accrues and potentially may be claimed as a foreign tax credit.

3. **Year in Which Foreign Income Taxes are Taken into Account**

   Proposed Regulation section 1.960-1(a)(4) provides that “current year taxes include . . . foreign income taxes that accrue in the controlled foreign corporation’s current taxable year in which or with which the foreign taxable year ends.” This statement is consistent with the conclusion in Revenue Ruling 61-93. This approach is also consistent with the proposed regulations issued in 1993 under section 898 (the “Section 898 Proposed Regulations”), which considered whether a difference between the U.S. and foreign taxable years of a CFC should be addressed through an allocation of the taxes in a manner that matched them with the relevant income on which the taxes were imposed. As discussed below, the Section 898 Proposed Regulations declined to adopt this approach, but that decision may not be appropriate for purposes of new section 960. First, the revision of section 960(c) by the Act removes any authority concern as the revised statute focuses on taxes attributable to income, and prorating the taxes will necessarily result in the taxes included under 960(a) being more closely related to the income included under section 951(a) and 951A. Second, the pooling approach of section 902 has been repealed. The question is whether a rule that does not provide for allocation of taxes is appropriate in a world where foreign taxes that cannot be deemed paid in the year paid or accrued are permanently lost. We respectfully recommend that Treasury and the Service reconsider the approach of prorating current year taxes based on the foreign earnings on which they are imposed. This approach may result in fewer permanently lost credits.

   A rule treating any foreign taxes that accrue within the U.S. tax year as current year foreign taxes may not create significant concern on an ongoing basis for a CFC with a business that produces similar income, both in terms of amount and character, in most years. For example, assume a CFC has a fiscal year ending 10/31/20 for U.S. tax purposes, and is required to use a calendar year for foreign tax purposes. Under Proposed Regulation section 1.960-1(a)(4), foreign taxes accruing on 12/31/19 are treated as current year taxes in the U.S. fiscal year ending 10/31/20, even though five sixths of the taxes are imposed on earnings included in the U.S. return for the 2019 fiscal year (assuming the taxpayer earns income ratably during the relevant periods). If the CFC earns the same type of income (assume in this case tested income) and approximately the same amount of income in fiscal years 10/31/19 and 10/31/20, the mismatch generally would not significantly impact its deemed paid taxes under section 960(d).

   The decision to not adopt a proration approach in the Section 898 Proposed Regulations was reached at a time when the multi-year pooling rules applied to the taxes paid by a CFC, and thus the separation of taxes from the related income that occurs when a foreign corporation has a different taxable year for U.S. and foreign tax purposes was substantially mitigated over time. In addition, a U.S. corporate shareholder could carryover excess foreign taxes under section 904(c), which is no longer possible for

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income in the GILTI Basket, which will be most of a U.S. multinational’s foreign income. In addition to the changes to the foreign tax credit system, the operation of the GILTI rules suggests the need for a different approach. A U.S. shareholder of a CFC with a tested loss is not permitted a deemed paid credit for any foreign income taxes related to the CFC’s tested income.\(^{53}\) Because the determination of when a CFC has a tested loss is after reduction from foreign taxes, taxes may result in a CFC having a tested loss in one year and thus losing all of the foreign taxes for a given period. While this is possible in any year the separation of taxes from the related income taken into account in a different period significantly exacerbates the problem. For example, assume a CFC with a cyclical business, \textit{i.e.}, it has significant earnings in some years and losses or limited earnings in other years. Further assume that income accrues ratably over the year, and all income is characterized as general category tested income. The CFC earns 120 in its 2019 calendar year and accrues 36 of foreign taxes on 12/31/19. In calendar year 2020, the CFC’s earnings are 12 and it accrues 2 of foreign taxes on 12/31/20. In calendar year 2021, CFC again earns 120 and accrues 36 of foreign taxes on 12/31/21. For the U.S. tax year ending 10/31/20, the CFC would include earnings for two months of 2019 (November and December) and 10 months of 2020 (January – October). CFC has 30 of gross tested income \((2/12 \times 120) + (10/12 \times 12)\). The foreign taxes properly attributable to that income under the Proposed Regulations are the 36 of foreign taxes accruing on 12/31/19. The result is a tested loss for the year (30-36) and the 36 of taxes are permanently lost as credits. Now assume CFC earns 120 in calendar year 2021. For the U.S. tax year ending 10/31/21, the CFC would include two months of 2020 earnings and 10 months of 2021 earnings, resulting in 102 of gross tested income \((2/12 \times 12) + 10/12 \times 120\). The foreign taxes properly attributable to the 102 of earnings are only the 12 of foreign taxes accruing on 12/31/20.

In the Preamble to the 1993 proposed regulations under section 898, the Service recognized that mismatches similar to the one illustrated above could occur when U.S. and foreign tax years differ, but cited several reasons for not adopting a different rule.

A foreign income tax accrues only when the liability for it is fixed and the amount of the liability can be determined. This event generally occurs at the end of the foreign taxable year with respect to a foreign income tax that is imposed on that year's income. Consequently, with the enactment of section 898, a mismatch may arise between the income that comprises a subpart F or foreign personal holding company inclusion and the creditable foreign taxes related to the inclusion when the foreign taxable year of a specified foreign corporation ends later than the corporation's United States taxable year.

Adherence to the foreign tax accrual rule in the context of section 898 may result in income being taxed under subpart F without the associated foreign income taxes being available as a credit under section 960. While we considered several options to address the effect of the foreign tax accrual rule in this context, we believe that adherence to the foreign tax accrual rule is justified for several

\(^{53}\) See sections 951A(c)(2)(B) (defining tested loss) and 960(d) (foreign taxes are deemed paid with respect to a section 951A inclusion, and a U.S. shareholder cannot have a section 951A inclusion from a tested loss CFC).
reasons. First, unlike section 338 (i), there is no direct authority in section 898 to modify the rule. Second, rules that require the pooling of post-1986 undistributed earnings and foreign taxes mitigate the effect of the foreign tax accrual rule. Third, determining the foreign taxes on a specified foreign corporation's taxable income prior to the end of the foreign taxable year may not be possible, especially where that foreign taxable year has not ended by the filing date of the applicable U.S. tax return.

Accordingly, modifying the foreign tax accrual rule for specified foreign corporations that have foreign taxable years which differ from their required year would result in speculative foreign tax accruals, necessitating a corrective mechanism, and would result in a set of highly complex rules which would be difficult to administer. Such an approach would place additional pressure on the foreign tax credit rules, in particular, on the section 905(c) rules. Finally, the potential mismatch resulting from adherence to the foreign tax accrual rule is mitigated by the rule, discussed below, that applies to the first taxable year after section 898 was enacted and that spreads over four taxable years the recognition of certain income otherwise required to be recognized in one year as a result of section 898.54

The first two reasons for not modifying the foreign tax accrual rule (no authority under section 898, and the pre-Act pooling approach smoothing out mismatches) are not relevant under current law section 960. The third reason, difficulty in determining the amount of tax attributable to each period, remains relevant, but it should not present insurmountable difficulties in most cases. Given that most domestic corporations file Federal income tax returns more than 10 months after the close of their taxable year (a calendar year domestic corporation’s return is due, on extension, on October 15 of the following year), where there is a naturally occurring difference between the foreign and U.S. tax year ends, the relevant foreign tax year will in most cases have closed and the amount of accrued foreign taxes can be determined with reasonable accuracy before the U.S. return is filed.

We recognize, however, that this may not be the case where the U.S. and foreign tax years would be the same, but the CFC elects a one month deferral rule under section 898(c)(2). For example, the taxable year for foreign purposes and the U.S. shareholder’s taxable year end on 12/31, but the CFC’s year for U.S. purposes ends on 11/30. As of 11/30, the foreign year will be nearly over and a CFC could reasonably estimate its foreign tax liability. In the case of a large multi-national with many 11/30 CFCs, each CFC is as likely to over as to under-estimate its tax liability, thus the aggregate amount will often be close to the actual amount. If the estimate is wrong, section 905(c) could apply to require adjustments, but arguably is not needed where in the aggregate an amount very close to the correct amount of foreign taxes is reported. Instead, we recommend that you consider two options. First, a taxpayer could track the difference but not immediately file an amended return. Instead, whenever it is otherwise required to file an amended return under section 905(c) it would include this adjustment. Second, or

in addition, a de minimis rule under which differences of less than a certain percentage, such as five percent, of total foreign taxes for all CFCs for a year would not need to be adjusted.

The fourth concern expressed in the Section 898 Proposed Regulations preamble was the potential for frequent section 905(c) redeterminations because foreign taxes accruing after the close of the U.S. tax year would have to be accounted for as additional assessments of foreign tax for the year. This concern has largely been obviated by the Act, because unless mitigated by regulations, taxpayers likely will need to file one or more amended returns for each year in any case. Further, this concern could be addressed by modifying the foreign tax accrual rules consistent with existing guidance under Section 901 for changes in ownership of disregarded entities and partnerships, which was promulgated after the Section 898 Proposed Regulations. With respect to changes in ownership of disregarded entities, Treasury Regulation section 1.901-2(f)(4)(ii) states:

If there is a change in the ownership of such disregarded entity during the entity's foreign taxable year and such change does not result in a closing of the disregarded entity's foreign taxable year, foreign tax paid or accrued with respect to such foreign taxable year is allocated between the transferor and the transferee. . . The allocation is made based on the respective portions of the taxable income of the disregarded entity (as determined under foreign law) for the foreign taxable year that are attributable under the principles of §1.1502-76(b) to the period of ownership of each transferor and transferee during the foreign taxable year.

The section 901 regulations thus treat a portion of the foreign taxes that accrue under the all events test at the end of a disregarded entity’s foreign tax year effectively as relating back and properly accruing in a prior period. Because the taxes are treated as accrued in the earlier period, section 905(c) is not implicated.

Returning to an earlier example, CFC and its U.S. shareholder use a fiscal year ending 10/31, but the CFC is required to use the calendar year as its taxable year for foreign purposes. The CFC earns 120 of tested income (and no other income) in its 2019 calendar year and accrues 36 of foreign taxes on 12/31/19. In calendar year 2020, the CFC’s earnings are again all tested income but CFC has only 12 of tested income and accrues 2 of foreign taxes on 12/31/20. In calendar year 2021, CFC earns 120 of tested income and accrues 36 of foreign taxes on 12/31/21. For the U.S. tax year ending 10/31/20, CFC has 30 of gross tested income ((2/12 x 120) + (10/12 x 12)). The foreign taxes properly attributable to that income under the Proposed Regulations are the 36 of foreign taxes accruing on 12/31/19. Under the Proposed Regulations, CFC has a tested loss for the year (30 - 36) and the 36 of taxes are permanently lost as credits. For the U.S. tax year ending 10/31/21, the CFC would include two months of 2020 earnings and 10 months of 2021 earnings, resulting in 102 of gross tested income ((2/12 x 12) + 10/12 x 120). Under the proposed regulation, the foreign taxes properly attributable to the 102 of earnings are only the 2 of foreign taxes accruing on 12/31/20.
Under the proration approach recommended above, two months of the 36 of foreign taxes accruing on 12/31/19 (36 x 2/12 = 6), and 10 months of foreign taxes accruing on 12/31/20 (2 x 10/12 = 1.67) would be treated as properly attributable to CFC’s 30 of gross tested income for the U.S. tax year ending 10/31/20. CFC then would have 22.33 of net tested income and the U.S. shareholder potentially could claim 80% of the 7.67 of foreign taxes as credits. For the U.S. tax year ending 10/31/21, 2 months of foreign taxes accruing on 12/31/20 (2 x 2/12 = .33) and 10 months of foreign taxes accruing on 12/31/21 (36 x 10/12 = 30). CFC then would have net tested income of 71.67 (102-30.33) and the U.S. shareholder potentially could claim 80% of the 30.33 of foreign tax credits. Over the two-year period, under the Proposed Regulations, the U.S. shareholder has 80% x 2 of potentially creditable taxes on its section 951A inclusions, while under the proration approach it has 80% x 41 of potentially creditable foreign taxes.

The proration approach assumes that a taxpayer earns its income relatively evenly throughout its tax year, and/or that its results in each month are consistent from year-to-year. However, a taxpayer could still have significant mismatches, for example, if a large portion of its income and foreign taxes in a particular year was the result of a single large transaction, and that transaction occurred in different tax years for U.S. and foreign tax purposes. The approach described here would provide some relief, but would not completely solve the problem. Providing an election to compute a CFC’s taxable income on a monthly or quarterly basis may alleviate the problem. Alternatively, the regulations could adopt a rule similar to the “extraordinary items” rule in Treasury Regulation section 1.1502-76(b)(2), assigning certain taxes to period based on the day the event giving rise to the tax occurs.

Recommendations

We respectfully recommend that Treasury and the Service reconsider the approach of prorating current year taxes based on the foreign earnings on which they are imposed.

To address taxes that may not accrue under the all events standard until after the U.S. income tax return is filed, we recommend that the regulations permit estimates and then adjust such estimates using one of two options. First, a taxpayer could track the difference but not immediately file an amended return. Instead, whenever it is otherwise required to file an amended return under section 905(c) it would include this adjustment. Second, or in addition, a de minimis rule under which differences of less than a certain percentage, such as five percent, of total foreign taxes for all CFCs for a year would not need to be adjusted.

4. Allocation of Current Year Taxes

Proposed Regulation section 1.960-1(d)(3)(ii) would provide that “[c]urrent year taxes are allocated and apportioned among the section 904 categories under the rules of §1.904-6(a)(1)(i) and (ii) on the basis of the amount of taxable income computed under foreign law in each section 904 category included in the foreign tax base.” As discussed above, current year taxes include “foreign income taxes that accrue in the controlled
foreign corporation’s current taxable year in which or with which the foreign taxable year ends.” We recommend that the final regulations provide further clarification as to how these rules apply where foreign and U.S. tax years differ and more specifically to what extent the foreign taxes are assigned to baskets by reference to the current year income versus the prior year income on which a portion of the foreign tax is imposed.

For example, assume CFC has a September 30 U.S. tax year end, and calendar year for foreign purposes. Foreign taxes accruing on 12/31/18 are treated as current year taxes for the U.S. year ending 9/30/19, but nine months of those taxes were imposed on earnings that for U.S. purposes were earned in the transition tax year but after the testing dates. In its 9/30/19 tax year, CFC earns exclusively tested income. Are nine months of foreign taxes characterized as taxes on tested income based on the year in which they accrue, or based on the earnings of the prior year to which they relate, in which case they likely would be general category residual grouping taxes and not creditable?

Moving forward a year, assume CFC earns exclusively tested income for its tax year ending 9/30/19, and both tested income and subpart F income in its tax year ending 9/30/20. For the tax year ending 9/30/20, are the nine months of taxes characterized based on prior year earnings and thus exclusively tested foreign taxes, or based on current year earnings and thus allocated to both tested foreign income and subpart F income?

If taxes are characterized based on prior year earnings because that is what the foreign country is taxing, the result may be a mismatch and lost credits where a CFC does not earn the same type of income each year.

If this interpretation is the one intended by the Proposed Regulations, we recommend that the relation back approach suggested in Section III D.1.b), above, is needed to prevent the potential for significant lost credits. Under the relation back approach, 9/12 of foreign taxes accruing on 12/31/20 would be treated as current year taxes accruing in the U.S. tax year ending 9/31/20, allowing taxes treated as related to tested income to be associated with the tested income. Alternatively, Treasury and the Service could modify the Proposed Regulations to provide that foreign taxes accruing and treated as current year taxes in the U.S. tax year with or within which the foreign year ends are characterized based on earnings the U.S. recognizes in that year.

**Recommendations**

We recommend reconsideration of the rule in Proposed Regulation section 1.960-1(a)(4) that “current year taxes include . . . foreign income taxes that accrue in the controlled foreign corporation’s current taxable year in which or with which the foreign taxable year ends.” In our view, a rule prorating current year taxes based on the foreign earnings on which they are imposed would be consistent with the matching principle underlying the foreign tax credit rules, may result in fewer permanently lost credits, and can be accomplished without adding significant administrative complexity.
If Treasury and the Service decline to adopt the proration recommendation above, we recommend that clarification be provided for Proposed Regulation section 1.960-1(d)(3)(ii) as to how current year foreign taxes are allocated to the section 904 baskets where a foreign corporation’s U.S. and foreign tax year ends differ. Specifically, we recommend clarifying whether foreign taxes assigned to separate categories are based on the current year income to which the taxes are deemed to relate, or based on the current and prior year foreign income on which the taxes are imposed.

5. Base and Timing Differences

a) Background

Proposed Regulation section 1.960-1(d)(3)(ii)(B)(1) states that current year taxes that are attributable to a timing difference are treated as related to the appropriate section 904 category, and income group within that section 904 category, to which the particular tax would be assigned if the income on which the tax is imposed were recognized under U.S. tax principles in the year in which the tax was imposed. This rule cross references the definition of timing differences in Proposed Regulation section 1.904-6(a)(1)(iv):

If, under the law of a foreign country. . ., a tax is imposed on 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 (a timing difference), that tax is allocated and apportioned to the appropriate separate category or categories to which the tax would be allocated and apportioned if the income were recognized under Federal income tax principles in the year in which the tax was imposed.

Proposed Regulation section 1.960-1(d)(3)(ii)(B)(2) would distinguish between taxes imposed on a timing difference and taxes imposed on a distribution of PTEP:

Current year taxes imposed by reason of the controlled foreign corporation’s receipt of a section 959(b) distribution are not allocated and apportioned under the general rule for timing differences but are allocated or apportioned to a PTEP group. Current year taxes imposed with respect to previously taxed earnings and profits by reason of any other timing difference are allocated or apportioned, under the general rule described in paragraph (d)(3)(ii)(B)(1) of this section, to the income group to which the income that gave rise to the previously taxed earnings and profits was assigned in the inclusion year. For example, a net basis tax imposed on a controlled foreign corporation’s receipt of a section 959(b) distribution by the corporation’s country of residence is allocated or apportioned to a PTEP group. Similarly, a withholding tax imposed with respect to a controlled foreign corporation’s receipt of a section 959(b) distribution is allocated and apportioned to a PTEP group. In contrast, a withholding tax imposed on a disregarded payment from a disregarded entity to its controlled foreign corporation owner is treated as a timing difference and is never treated as related to a PTEP group, even if all of the controlled foreign corporation’s earnings are previously taxed earnings and profits, because the tax is not imposed solely by reason of a section 959(b) distribution. Such a withholding tax,
however, may be treated as related to a subpart F income group or tested income group under the general rule for timing differences.

Proposed Regulation section 1.960-1(d)(3)(ii)(B)(2) generally provides that current year taxes that are imposed solely by reason of a CFC’s receipt of a section 959(b) distribution of PTEP are not allocated and apportioned under the general rule for timing differences but, rather, are allocated or apportioned to a PTEP group. Thus, for example, recipient income taxes and withholding taxes imposed on the receipt of a section 959(b) distribution are allocated and apportioned to a PTEP group. In contrast, however, the Proposed Regulation provides that a withholding tax, and presumably a recipient income tax, imposed on a disregarded payment from a disregarded entity to its CFC owner is treated, not as related to a PTEP group, but as a timing difference because “the tax is not imposed solely by reason of a section 959(b) distribution.”

With respect to the allocation of taxes imposed in connection with foreign branches, Proposed Regulation section 1.904-6(a)(2) would provide extensive and complex rules to account for disregarded payments. The preamble notes that disregarded payments between a foreign branch and its U.S. owner, or between two foreign branches of the same U.S. person, may involve disregarded payments that are subject to foreign tax, and such payments could result in a reallocation of gross income between the foreign branch category and the general category.

b) Comments - Taxes Imposed on Disregarded Payments

The Proposed Regulations do not explain the policy reasons for treating a disregarded payment as a timing difference rather than a tax related to a PTEP group. Technically, the reason is that a foreign tax on a distribution from a disregarded entity to a CFC owner is not “solely by reason of the controlled foreign corporation’s receipt of a section 959(b) distribution” because the distribution itself is disregarded and consequently falls outside of the applicable requirements. While this may be true, it is relatively easy to identify when and why a foreign country is imposing a tax in respect of a distribution from a disregarded entity. The concerns expressed in the Proposed Regulations in respect of disregarded payments and the foreign branch category (which may have been a factor in the determination that disregarded payments should not be related to a PTEP group) are not present in the context of a CFC owner and its disregarded entities because there is no ability to convert one type of income to another as there is in the context of a foreign branch, i.e., between foreign branch and deduction eligible income under section 250(b)(3)(A). Further, whether the foreign tax is treated as being related to a PTEP group or to a timing difference, taxpayers would be required in any event to determine which section 904 category and grouping within that category, for example, section 951(a) or 951A, the foreign tax relates to. The principal difference between these alternate treatments appears to be whether the foreign tax can only be claimed as a credit in the current year or can be attached to a PTEP group and be claimed in the year in which the associated PTEP is repatriated.

Many multinationals have established chains of ownership having one or more disregarded entities. Although the Proposed Regulations treat a foreign tax imposed on a
distribution from a disregarded entity to its CFC owner as timing differences, associating the foreign tax to the CFC owner’s existing PTEP groups would (1) better conform the treatment of such payments to their treatment as distributions for foreign tax purposes, (2) provide consistent treatment with situations involving distribution by a CFC, and (3) prevent the separation of these taxes from the related income, consistent with the general policy of the foreign tax credit limitation and the basis for the enactment of section 909. Thus, if an actual distribution occurs for foreign law purposes and the foreign jurisdiction imposes a withholding tax or a net basis tax on the CFC owner in respect of that distribution, the foreign distribution tax would be allocated and apportioned to and among the CFC owner’s PTEP groups to that extent. One particularly concerning aspect of this approach, and which is symptomatic of the broader concern about associating foreign taxes with the related income, is that the Proposed Regulations’ treatment of such foreign distribution taxes as a timing difference, appears to result in the permanent loss of such taxes if the CFC owner does not have current year income, or current year income in the same section 904 category and grouping in the year in which such foreign taxes accrue.

In light of these policy concerns, including to avoid the risk of losing foreign taxes completely, the Proposed Regulations would appear to encourage taxpayers to either reincorporate their foreign disregarded entities or seek to distribute the income of the disregarded entity in the same year as the CFC owner’s associated subpart F income or tested income arises, to avoid the potential of losing foreign distribution taxes permanently. We, therefore, recommend that the final regulation treat a disregarded payment from a disregarded entity to its CFC owner that is recognized as an actual distribution for foreign tax purposes as a tax imposed on a PTEP distribution rather than as a timing difference.

We also note that the concerns in this prior section about the treatment of taxes imposed on disregarded distributions from a disregarded entity to a CFC is a subset of the broader area of base and timing differences, which are discussed below in Section G.1.

**Recommendation**

We recommend the revision of the last sentence of Proposed Regulation section 1.960-1(d)(3)(ii)(B)(2) to provide that a withholding tax on a disregarded payment from a disregarded entity to its CFC owner in a year subsequent to the year in which the disregarded entity’s earnings were included by a U.S. shareholder as subpart F income or GILTI as a tax imposed on PTEP rather than as a timing difference.

**6. Clarify References to the Branch and GILTI Baskets at CFC Level**

Proposed Regulation section 1.960-1(d)(2) provides rules for assigning items of gross income of a CFC to section 904 categories and groupings within each category. Paragraph (i) addresses the first step, assigning gross income to a section 904(d) category. The last sentence states that “income of a controlled foreign corporation, other
than gross income relating to a section 959(b) distribution, cannot be assigned to the section 951A category or the foreign branch category. See §1.904-4(f) and (g).”

Proposed Regulation section 1.904-4(f) and (g) make clear that the foreign branch category and section 951A category apply only at the U.S. shareholder level. A CFC, however, may have one or more section 951A category PTEP groups, and the clause “other than gross income relating to a section 959(b) distribution” makes sense in that context. A CFC cannot have a PTEP category related to foreign branch income because a CFC can neither earn foreign branch income nor receive a distribution characterized as previously taxed foreign branch income.

To avoid confusion, we recommend that the last two sentences of Proposed Regulation section 1.960-1(d)(2)(i) be revised to read:

Income of a controlled foreign corporation, other than gross income relating to a section 959(b) distribution out of the section 959(c)(2) PTEP category for section 951A inclusions or the section 959(c)(1) category for reclassified section 951A PTEP, cannot be assigned to the section 951A category. Income of a controlled foreign corporation can never be assigned to foreign branch category income. See §1.904-4(f) and (g) and §1.960-3(c)(2).

Recommendation

We recommend that the last two sentences of Proposed Regulation section 1.960-1(d)(2)(i) be revised to clarify its operation with respect to GILTI PTEP.

7. Section 78 Gross Up on Distributions of Previously Taxed Earnings and Profits

Prior to its repeal, section 960(a)(3) provided for a deemed paid credit for foreign income taxes paid in respect of PTEP. Section 960(a)(3) relied on section 902 as its mechanism for providing the deemed paid credit in respect of the distribution of PTEP. Prior to the enactment of the Act, section 78 treated deemed paid taxes under section 902 or section 960(a)(1) as a dividend from the foreign corporation to the domestic corporation for all purposes of the Code, other than section 245. To prevent a second U.S. tax on the gross up for the PTEP deemed paid taxes, the existing regulations provide that deemed paid taxes are not treated as a section 78 dividend to the extent such taxes relate to PTEP.

The Act made two relevant changes in respect of PTEP deemed paid taxes. First, section 960(a)(3) was repealed and replaced with section 960(b) to the same relevant effect. Second, section 78 was amended to reflect that deemed paid credits in respect of section 960(a), (b) and (d) are treated as dividends from the foreign corporation to the domestic corporation. Unlike prior law, section 78 now directly references the gross up in respect of PTEP deemed paid taxes under section 960(b). As a result, it is now less clear that the section 78 gross up on PTEP deemed paid taxes is not a taxable dividend. In addition, the Proposed Regulations would modify and replace the existing regulations
under section 78 and 960, removing the provisions that specifically exclude PTEP
deemed paid credits from gross income as a dividend pursuant to section 78.

Interpreting amended section 78 to impose tax on the gross up of PTEP deemed
paid taxes would result in a second incidence of tax on the same income because the
domestic corporation has already been subject to U.S. tax on that income. For example,
assume that a domestic corporation wholly owns CFC1 and that CFC1 wholly owns
CFC2. Further assume that CFC2 earns 100 of subpart F income that is included in the
domestic corporation’s gross income pursuant to section 951(a)(1)(A) in 2019. In a
subsequent year, CFC2 distributes the 100 to CFC1 and a 10 percent withholding tax is
imposed on the distribution, leaving CFC1 with 90 of section 959(c)(2) PTEP in the
section 951(a)(1) grouping and 10 of associated PTEP taxes. CFC1 later distributes the
90 of PTEP to the domestic corporation. Under prior law, section 960(a)(3) would have
provided a deemed paid credit for the 10 but the gross up of that amount would not have
been subject to U.S. tax as a dividend pursuant to Treasury Regulation section 1.78-1(b)
and 1.960-3(b). This conclusion is consistent with general tax principles that income
generally should be taxed only once, as the domestic corporation has already been subject
to tax on the 10 in connection with its subpart F inclusion under section 951(a).
Requiring the gross up of the PTEP deemed paid taxes to be subject to tax a second time,
so that 110 would be included in the domestic corporation’s gross income even though
there was only 100 of earnings, would impose a second U.S. tax on the same item of
income.

There is nothing in the Act’s legislative history to indicate that Congress intended
to impose a second incidence of tax on the gross up of deemed paid credits under section
960(b), notwithstanding the amendment of section 78. The relevant legislative history is
clear that the revisions to section 78 were intended only as conforming changes to reflect
the repeal of section 902. Further, the Blue Book confirms that the section 78 gross up
was not intended to apply to deemed paid taxes on PTEP distributions but stated that a
technical correction may be needed to effectuate this result.55

We do not believe that a technical correction is needed. A review of the history
of section 78 and its interaction with section 902 and section 960(a), as described in this
section, demonstrates that section 78 has always applied to deemed paid credits on PTEP.
As noted above, section 960(a)(3) relied on section 902 as the mechanism for providing
deemed paid credits on such income. Although section 78 did not directly reference
section 960(a)(3), it did reference section 902 so that any gross up in respect of PTEP
deemed paid taxes would have been treated as a dividend under section 78 prior to its
amendment. Treasury recognized this connection but used its regulatory authority to
promulgate regulations providing that the gross up on PTEP deemed paid taxes would not
be subject to tax a second time.

We recommend that the final regulations adopt the approach of existing final
regulations and clarify that the section 78 gross up on PTEP deemed paid taxes is

55 Joint Committee on Taxation, General Explanation of Public Law 115-97 at 363 (Dec. 2018).
excluded from the domestic corporation’s gross income pursuant to section 959(a), notwithstanding the amendment of section 78 to reference section 960(b) taxes.

**Recommendation**

We recommend that Treasury and the Service provide that a section 78 gross up is not required for taxes deemed paid under section 960(b)(1) on a distribution of PTEP.

8. **Foreign Income Taxes Imposed on PTEP Distributions**

The example in Proposed Regulation section 1.960-1(f) illustrates five steps of the six-step process in Proposed Regulation section 1.960-1(c) for computing deemed paid taxes on current inclusions and PTEP distributions. Based on the facts presented, the sixth step, computing deemed paid taxes under section 960(b)(1) on a PTEP distribution to a U.S. shareholder, does not apply. Focusing on the discussion of PTEP taxes in the example, CFC2 makes a PTEP distribution to CFC1 that is not subject to foreign withholding tax, but CFC1 is subject to income tax on the distribution. In Step 2, the example shows how current year taxes in CFC1 are allocated to the PTEP account associated with the distribution from CFC2, but because Step 6 is not relevant under the facts, the example does not demonstrate that current year taxes as well as withholding taxes on PTEP distributions may be deemed paid under section 960(b).

The example does not apply step 6 and thus does not raise the issue whether a section 78 gross up is required for foreign taxes deemed paid under section 960(b)(1). As discussed in Section III D.7., above, Congress did not intend to require a gross up on PTEP taxes, and we believe Treasury and the Service can implement the intended rule without a technical correction. We, therefore recommend that the example be expanded to include facts illustrating the application of step 6 and the application of section 78.

**Recommendation**

We recommend a modification of the facts of example in Proposed Regulation section 1.960-1(f) to illustrate the final step in Proposed Regulation section 1.960-1(c), computing deemed paid taxes under section 960(b)(1).

9. **Associating pre-2018 PTEP with Foreign Income Taxes**

Section 1.960-3(d)(3) provides rules for treating foreign income taxes associated with PTEP groups established in pre-2018 inclusion years as PTEP group taxes. PTEP group taxes, in turn, can be considered properly attributable to a PTEP group in a given section 904 category and deemed paid under section 960(b) and section 1.960-3(b). With respect to pre-2018 PTEP groups, foreign income taxes can be treated as PTEP group taxes only if, in relevant part, those foreign income taxes were paid or accrued in a taxable year of a CFC that began before January 1, 2018. This condition suggests that taxes imposed on that pre-2018 PTEP group in tax years beginning after December 31,

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56 See Prop. Reg. § 1.960-3(b)(1) - (3).
2018, are not intended to be PTEP group taxes. Such taxes may arise, for example, upon distributions sourced from a pre-2018 PTEP group from a lower-tier CFC to an upper-tier CFC in a post-2017 tax year. It is unclear what the underlying policy is for such a rule, and therefore recommend that the regulations be clarified by eliminating Proposed Regulation section 1.960-3(d)(3)(i).

**Recommendation**

We recommend clarifying the PTEP transition rule by eliminating Proposed Regulation section 1.960-3(d)(3)(i).

**10. Proposed regulation section 1.960-4 – Additional Foreign Tax Credit in the Year of Receipt of Previously Taxed Earnings and Profits**

In the preamble to the Proposed Regulations, Treasury and the Service request comments on whether additional amendments (in addition to including references to section 951A) are needed in Proposed Regulation section 1.960-4 to account for unique aspects of the section 951A category. The final regulations are generally adequate to address any potential increase in limitation with respect to section 951A. Although there are significant differences in the calculations of deemed paid taxes on subpart F and section 951A inclusions, Proposed Regulation section 1.960-4 applies after these steps and focuses on the final section 904 limitation in each category in the year of the original inclusion and the year in which PTEP is distributed. The section 904 limitation is computed in the same way for section 951(a) and section 951A inclusions.

Some of the calculations required under Proposed Regulation section 1.960-4, however, can be simplified for the section 951A category. Specifically, Proposed Regulation section 1.960-4(c) and (d) provide:

(c) Determination of increase in limitation for the taxable year of inclusion. The amount of the increase in the applicable limitation under section 904(a) for the taxable year of inclusion which arises by reason of the inclusion of the amount in gross income under section 951(a) shall be the amount of the applicable limitation under section 904(a) for such year reduced by the amount which would have been the applicable limitation under section 904(a) for such year if the amount had not been included in gross income for such year under section 951(a).

(d) Determination of foreign income taxes allowed for taxable year of inclusion by reason of section 951(a) amount. The amount of foreign income taxes allowed as a credit under section 901 for the taxable year of inclusion which were allowable solely by reason of the inclusion of the amount in gross income for such year under section 951(a) shall be the amount of foreign income taxes allowed as a credit under section 901 for such year reduced by the amount of foreign income taxes which would have been allowed as a credit under section 901 for such year if the amount had not been included in gross income for such year under section 951(a). For purposes of this paragraph, the term “foreign income taxes” includes foreign income taxes paid or accrued, and foreign income
taxes deemed paid under section 902, section 904(d), and section 960(a), for the taxable year of inclusion.

These provisions require a “with” and “without” calculation to determine how much excess limitation and how much deemed paid taxes in a section 904(d) category are attributable to the subpart F inclusion as opposed to other income in the category. The rule is needed because a taxpayer may have both subpart F inclusions and other income in the passive or general category, or a treaty category. In contrast, section 951A inclusions are segregated in a separate category that cannot include any other income. The with and without calculations thus are not needed. We recommend that the final regulation clarify the application of Proposed Regulation section 1.960-4(c) and (d) to the section 951A category.

Recommendation

We recommend that Proposed Regulation section 1.960-4 be modified to clarify that paragraphs (c) and (d), which require “with” and “without” calculations to determine how much excess limitation and how much deemed paid taxes in a section 904(d) category are attributable to a subpart F inclusion as opposed to other income in the category, are not needed and thus do not apply to the section 951A category.

E. Foreign Branch Income

1. Overview

As described above, the Act added a new basket for foreign branch income, but Congress left its definition and implementation almost entirely to Treasury and the Service. Additionally, the scope of the branch basket is relevant not only for foreign tax credit purposes, but it also is relevant as a category of income that is explicitly excluded from DEI and thus is not entitled to the section 250 deduction for FDII.

Section 904(d)(2)(J)(i) provides that “foreign branch income” means “the business profits of [a] United States person which are attributable to 1 or more qualified business units . . . in one or more foreign countries.” The Proposed Regulations provide that a foreign branch is “a qualified business unit (QBU), as defined in § 1.989(a)-1(b)(2)(ii) and (b)(iii), that conducts a trade or business outside the United States.” That is, although the Proposed Regulations define a foreign branch by reference to the definition of a QBU under the section 989 regulations, the regulations modify that definition by requiring that the QBU (i) engage in a trade or business by eliminating certain per se QBUs described in the section 989 regulations, and (ii) do so outside the United States.

57 I.R.C. § 904(d)(2)(J)(i) (“[T]he amount of business profits attributable to a qualified business unit shall be determined under rules established by the Secretary.”).

The Proposed Regulations provide that gross income is attributable to a foreign branch if it is reflected on the books and records of a foreign branch, subject to a number of adjustments set forth in the regulations. Deductions of the foreign branch, the foreign branch owner and certain other parties are allocated under the generally applicable expense allocation rules set forth in Treasury Regulations sections 1.861-8 through 1.861-13, and 1.861-17.59

The Proposed Regulations also include rules to allocate foreign income taxes to gross income in the foreign branch income category. In general, allocation of foreign income taxes to foreign branch income follows the general rule in Proposed Regulations 1.904-6(a)(1), which itself is an updated version of Treasury Regulation section 1.904-6(a)(1).60 The general allocation rules allocate taxes to the basket that includes the related income. For this purpose, “taxes are related to income if the income is included in the base upon which the tax is imposed.”61 In the case of the branch basket, the Proposed Regulations include special rules for certain disregarded payments as described in the table below.

60 Prop. Reg. § 1.904-6(a)(2)(i).
61 Reg. § 1.904-6(a)(1).
<table>
<thead>
<tr>
<th>Special rules for allocation of foreign taxes for foreign branches[62]</th>
<th>Foreign branch to foreign branch owner</th>
<th>Foreign branch owner to foreign branch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disregarded reallocation transactions</td>
<td>Any foreign income tax imposed <em>solely by reason of</em> the payment, such as a withholding tax imposed on the disregarded payment, is allocated and apportioned to the general category.</td>
<td>Any foreign income tax imposed <em>solely by reason of</em> the payment is allocated and apportioned to the foreign branch category.</td>
</tr>
<tr>
<td>Other disregarded payments</td>
<td>Foreign tax imposed <em>solely by reason of</em> that disregarded payment is allocated and apportioned to a separate category under the general principles based on the nature of the item (determined under U.S. federal income tax principles) that is included in the foreign tax base.[63]</td>
<td>Any foreign tax imposed <em>solely by reason of</em> the disregarded payment is allocated and apportioned to the foreign branch category.</td>
</tr>
</tbody>
</table>

The remainder of this section on foreign branch income proceeds as follows. First, we briefly summarize our understanding of the policy trade-offs reflected in the Proposed Regulations. Second, we discuss the U.S. Tax Conforming Adjustments. Third, we address the treatment of disregarded payments in the Proposed Regulations. Fourth, and finally, we discuss the allocation of foreign income taxes to foreign branch income under Proposed Regulation section 1.904-6(a)(2).

\[62\] Prop. Reg. § 1.904-6(a)(2).

\[63\] Prop. Reg. § 1.904-6(a)(2)(iii)(A). The Proposed Regulations specifically provide:

For example, if a remittance of an appreciated asset results in gain recognition under foreign law, the tax imposed on that gain is treated as attributable to a timing difference with respect to recognition of the gain, and is allocated and apportioned to the separate category to which gain on a sale of that asset would have been assigned if it were recognized for Federal income tax purposes. However, a gross basis withholding tax on a remittance is attributable to a timing difference in taxation of the income out of which the remittance is made, and is allocated and apportioned to the separate category or categories to which a section 987 gain or loss would be assigned under §1.987-6(b).
2. Policy Trade-offs Reflected in the Proposed Regulations

We recognize that there are several significant policy trade-offs presented in defining the scope of income and taxes to include in the branch basket, including, among others:

- **Balancing ability to cross-credit or claim a deduction for FDII.** By adding a new basket, we can infer that Congress intended to limit taxpayers’ ability to cross-credit certain foreign income taxes. Specifically, Congress intended that foreign income taxes attributable to foreign branch income should not be creditable against foreign source income from other foreign source income. Congress also excluded foreign branch income from the class of income eligible for the FDII deduction. Thus, the scope of what constitutes branch income can be both beneficial or detrimental depending on a taxpayer’s specific facts.

- **Addressing differences between U.S. and foreign law while minimizing or eliminating double taxation.** As is often the case, there will be differences between the foreign tax law and U.S. tax law in determining the income that is properly attributable to a branch, including specifically from the existence of disregarded entities and disregarded transactions. A narrow definition of foreign branch income could cause (or increase) the incidence of double taxation.

- **Drafting accurate rules but preserve administrability.** There is a body of existing regulations and other guidance defining foreign branches and similar concepts, which could facilitate administration of this issue, but none of these existing definitions are entirely consistent with the policy underlying the branch basket. Further, the Proposed Regulations apply a books-and-records approach to gross income (adjusted to conform to U.S. federal income tax principles), but rely on existing regulations to determine the appropriate allocation of deductions.

Treasury and the Service did not articulate the policy goals that they sought to balance in either the preamble or the Proposed Regulations themselves. Given the fact that the foreign branch income regime is both novel and complex, it is likely that ambiguities will arise when applied to the myriad factual situations that exist requiring taxpayers, the Service and even the courts to interpret these regulations. We recommend that Treasury and the Service provide guidance, even if only as discussion in the preamble to the final regulation, the policy considerations raised and choices made to facilitate these interpretations in the future.

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65 See, e.g., Reg. § 1.1503(d)-5; see also Reg. § 1.367(a)-6T and 1.882-1 through 1.882-5.
**Recommendation**

We recommend the final regulations include a discussion of the competing policy considerations raised and choices made to facilitate interpretations of the foreign branch rules by taxpayers, the Service and the courts.

### 3. U.S. Tax Conforming Adjustments

As noted above, the Proposed Regulations define the gross income in the branch basket by reference to the books and records of the foreign branch, adjusted to conform to U.S. federal income tax principles. In this comment letter we refer to these adjustments as the “U.S. Tax Conforming Adjustments.” Neither the Proposed Regulations nor the accompanying preamble include a whole or partial list of the U.S. Tax Conforming Adjustments. However, certain adjustments are implicitly described by special rules, including: (1) the elimination of gross income attributable to disregarded payments; (2) the treatment of transfers of intangibles to a branch under the principles of section 367(d); and (3) the application of section 482 to disregarded payments.

We recommend that Treasury and the Service consider a cross-reference to the regulations under section 964, which generally also operate to conform foreign books and records to U.S. federal income tax principles. Further, we recommend that Treasury and the Service consider including additional examples to illustrate some of the more common principles, including specifically:

1. Treatment of income created as a fiction of U.S. federal income tax law, such as remedial income allocated to a partner in a partnership that elects the remedial allocation method under Section 704(c). In this case, we would generally expect that such income would increase the amount of gross income recognized by the branch as compared with its books and records.

2. Any special timing, character or sourcing rules required by the consolidated return regulations. It is not clear the extent to which the consolidated return regulations affect the timing, character or source of gross income reflected on the books and records of the foreign branch.

**Recommendation**

We recommend that Treasury and the Service cross-reference to the regulations under section 964, which generally also operate to conform foreign books and records to

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67 Reg. § 1.704-3(d).
68 The corresponding remedial deductions allocated to another partner would presumably be allocated under the principles of Reg. § 1.861-8.
U.S. federal income tax principles. Further, we recommend that Treasury and the Service consider including additional examples to illustrate the operation of the rules.

4. Disregarded Payments

As noted above, the Proposed Regulations generally disregard payments from a foreign branch owner to its foreign branch (and vice versa). Such payments, however, may result in a reallocation of gross income recognized by the foreign branch owner (or the foreign branch).70 In broad strokes, reallocation for this purpose means that general category income is reduced and foreign branch income is correspondingly increased, or vice versa depending on the direction for the disregarded payment. Such reallocation applies to the extent that the payment, if it were regarded, would be allocated or apportioned against general category income, whether U.S. or foreign source income (or would be allocated or apportioned against foreign branch income).71 Reallocation under the Proposed Regulations affects only the basket in which gross income falls; it does not change amount, source or character of the income recognized by the foreign branch owner (or the foreign branch).72 The Proposed Regulations also provide rules to address the allocation and apportionment of taxes attributable to disregarded payments.73

a) General Explanation of Possibilities Considered and Policy Choices Made

As a threshold matter, we note that disregarded payments might be treated in various ways, which generally fall along a spectrum from totally disregarding such a payment to fully regarding such a payment. Further, disregarding or regarding a payment could occur for one or more purposes (e.g., basket of income), but not for others (e.g., amount of income). Four possibilities along this spectrum are:

1. Disregard the payments entirely – the Proposed Regulations adopt this approach with respect to amount, source and character of income. They also adopt this approach with respect to the category of income to a certain extent.74

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70 Prop. Reg. § 1.904-4(f)(2)(vi). Note that the Proposed Regulations in section 1.904-4(f)(2) describe this process as “attribution,” while the Proposed Regulations in § 1.904-6(a)(2)(iv)(A) describe this process as “reallocation.”


73 Prop. Reg. § 1.904-6(a)(2).

74 That is, a disregarded payment is not taken into account to the extent that it would not, if it were regarded, reduce (a) general category income of the foreign branch owner payor or (b) foreign branch income of the foreign branch payor. Prop. Reg. § 1.904-4(f)(2)(vi).
2. Trace the payments (from other income). The Proposed Regulations adopt this approach with respect to taxes imposed solely by reason of a payment that is not a disregarded reallocation transaction.\(^{75}\)

3. Redetermine certain characteristics of other income - the Proposed Regulations adopt this approach to increase (or decrease) foreign branch income and decrease (or increase) general category income in respect of payments between the foreign branch owner and the foreign branch.\(^{76}\)

4. Regard the payments - the Proposed Regulations adopt this approach with respect to taxes imposed solely by reason of a payment that is a disregarded reallocation transaction.\(^{77}\)

On the whole, while policy justifications can be inferred from these rules, we recommend that Treasury and the Service articulate a broader policy to accompany the series of individual, isolated rules. We believe that such an explanation would facilitate future interpretations made by taxpayers, the Service and ultimately the courts.

**Recommendation**

We recommend that the final regulations include a discussion articulating the policy for the treatment of disregarded payments for these payments to facilitate interpretations of these rules by taxpayers, the Service and the courts.

**b) Other General Principles of U.S. Federal Income Tax Law**

The Proposed Regulations provide that “[t]he amount of each disregarded payment used to make an adjustment . . . must be determined in a manner that results in the attribution of the proper amount of gross income to each of a foreign branch and its foreign branch owner under the principles of section 482, applied as if the foreign branch were a corporation.”\(^{78}\)

Because the Proposed Regulations, in many ways, give effect to otherwise disregarded payments, other general principles of U.S. federal income tax law could also apply to those payments. For example, pursuant to the step transaction doctrine, the sale of section 367(d)(4) property from a foreign branch owner to a foreign branch for cash followed by the contribution of the cash to the foreign branch pursuant to a binding commitment, could be recharacterized as a contribution of the property to the foreign branch.

\(^{75}\) Prop. Reg. § 1.904-6(a)(2)(iii)(A). As noted above, it is not clear how precisely this tracing mechanism is to be applied when, in many instances, a serial application of the timing rule must be applied.


\(^{77}\) Prop. Reg. § 1.904-6(a)(2)(ii)(A).

branch in a transaction deemed to be subject to Section 367(d). Because the Proposed Regulations provide that the principles of section 482 apply, the omission of the statement that other general principles of U.S. federal income tax law apply could be interpreted to mean that these general principles do not apply. We recommend that the final regulations clarify whether and to what extent other general principles of U.S. federal income tax law apply. In addition, we recommend including additional examples illustrating how general principles might apply (such as an example of the binding commitment prong of the step transaction doctrine described above).

Recommendation

We recommend that the final regulations clarify whether and to what extent other general principles of U.S. federal income tax law apply to disregarded transactions.

c) Illustrations of the Treatment of Disregarded Payments

The Proposed Regulations provide that disregarded payments redetermine general category income (or foreign branch income) to the extent that the payment, if it were regarded, would be allocated and apportioned against general category income (or foreign branch income) under the principles of Treasury Regulation sections 1.861-8 through 1.861-13 and 1.861-17.79 In addition, if a disregarded payment is made in a disregarded sale of property and the payment would be capitalized into the basis of the property acquired, “the principles [described in the previous sentence] apply . . . to the extent the disregarded payment, if regarded, would . . . be subtracted from gross receipts that are regarded for Federal income tax purposes.”80 The preamble notes that “[t]his [reallocation] rule applies to transactions between a foreign branch and its foreign branch owner, as well as transactions between or among foreign branches, involving payments that would be deductible or capitalized if the payment were regarded for Federal income tax purposes.”81

We recommend that Treasury and the Service explicitly provide that a disregarded payment that would be capitalized into amortizable or depreciable basis, if it were regarded, results in reallocation in the years and the amounts that amortization or depreciation deductions would arise if the disregarded sale were regarded. The Proposed Regulations explicitly provide that a disregarded payment may increase (or decrease) foreign branch income and decrease (or increase) general category income. They also explicitly provide that disregarded payments do “not change the total amount, character, or source of the United States person’s gross income.”82 The Proposed Regulations do not contain an explicit statement, however, with respect to payments that are deductible in the year of the payment. The below example illustrates this point.

Example 1. Disregarded purchase of depreciable property.

Facts. Foreign branch owner sells depreciable property with $0 of basis to foreign branch for $1,000. If the payment were regarded, the foreign branch would take depreciable basis in the property and would be entitled to depreciate that basis over five years on a straight-line basis. Under the principles of Treasury Regulation sections 1.861-8 through 1.861-13 and 1.861-17, these depreciation deductions would be allocated and apportioned to gross income attributable to the foreign branch.

Analysis. The payment made by the foreign branch to the foreign branch owner for the purchase of depreciable property is a disregarded payment described in Proposed Regulations section 1.904-4(f)(2)(vi). Therefore, the gross income attributable to the foreign branch is reduced by, and the general category gross income attributable to the foreign branch owner is correspondingly increased by, a total of $1,000. Because the payment would, if regarded, be capitalized into the basis of the property and depreciated over five years, the gross income attributable to the foreign branch is reduced by, and the general category gross income attributable to the foreign branch owner is correspondingly increased by, $200 in each of years one through five. See Proposed Regulation section 1.904-4(f)(2)(vi)(B)(3).

Recommendations

We recommend that Treasury and the Service explicitly provide that a disregarded payment that would be capitalized into amortizable or depreciable basis, if it were regarded, results in reallocation in the years and the amounts that amortization or depreciation deductions would arise if the disregarded sale were regarded.

d) Transfer of Intangible Property

The Proposed Regulations provide special rules with respect to the transfer of intangible property described in section 367(d)(4). Specifically, the Proposed Regulations provide that “[i]n determining the amount of gross income that is attributable to a foreign branch . . . the principles of sections 367(d) and 482 apply. We refer to this rule as the “Disregarded Section 367(d) Rule.” For example, if a foreign branch owner transfers property described in section 367(d)(4), the principles of section 367(d) are applied by treating the foreign branch as a separate corporation to which the property is transferred in exchange for stock of the corporation in a transaction described in section 351.”83 Therefore, the Proposed Regulations require that a foreign branch owner is treated as transferring section 367(d)(4) intangible property to the foreign branch “in exchange for payments which are contingent upon the productivity, use, or disposition of such property . . . .”84 As a result, to the extent that these deemed payments would be


properly allocated and apportioned to gross income of the foreign branch, the redetermination rules in Proposed Regulation section 1.904-2(f)(vi) would apply to reduce gross income attributable to the foreign branch and to increase the general category gross income attributable to the foreign branch owner.

We have four recommendations with respect to transfers of intangible property. First, we recommend that the Disregarded Section 367(d) Rule apply only to transfers occurring after the date that the Proposed Regulations were published. On its face, the Proposed Regulations would apply to all transfers of Section 367(d) property to a foreign branch, even if the transfer occurred prior to the release of the Proposed Regulations or even prior to the enactment date of the Act. Section 367(d) is an administratively cumbersome provision, in that it generally requires a taxpayer to determine an arms’-length royalty and maintain it for an up to twenty-year period. Further, determining such a royalty retrospectively could result in significant cost and complexity.

Second, we recommend that Treasury and the Service provide additional guidance on the application of the Disregarded Section 367(d) Rule to transfers other than contributions from the foreign branch owner to the foreign branch. For example, it is not clear how the remittance of section 367(d) intangible property from a foreign branch to its foreign branch owner should be treated under the principles of section 367(d). It is possible that the remittance of the section 367(d) intangible property should be treated as a deemed license of the intangible property (in a manner similar to a contribution of intangible property to a branch) or in some other manner.

Third, we recommend that Treasury and the Service explicitly provide that the contingent payments deemed received by the transferor give rise to deemed payments made by the transferee, which would be deductible if regarded. Section 367(d) itself is silent on this issue and Treasury Regulation section 1.367(d)-1T(c)(2) provides only that the earnings and profits of the payor are reduced and that the payor may treat the amount of the deemed payment as an expense for purposes of Subpart F of the Code. We acknowledge that this issue is perhaps better addressed in the regulations under Section 367(d) themselves, but under the Proposed Regulations, (i) reallocation of income from foreign branch category income to general category income (or vice versa) is based on the proper allocation and apportionment of deductions, (ii) transfers of intangible property are to be treated based on the principles under section 367(d) and (iii) neither the statutory provision nor the regulations under section 367(d) clearly indicate that the transferor is entitled to a deduction for the deemed payments. Therefore, it is not entirely clear how the principles of section 367(d) apply for this purpose.

Fourth, we recommend that Treasury and the Service consider including examples, similar to those described above with respect to depreciable property, illustrating the consequences of the Disregarded Section 367(d) Rule: (1) if the section 367(d) intangible property is wholly or partially sold in a disregarded transaction, or (2) if the transferor has basis in the section 367(d) intangible property.

85 Reg. § 1.367(d)-1(c)(3)(ii).
Recommendations

We recommend that the rules regarding transfers of intangible property be limited to apply only to transfers that occur after the date that the Proposed Regulations are published.

We recommend that the final regulations provide additional guidance on the treatment of transfers other than contributions by a foreign branch owner to a foreign branch (e.g., transfers from a foreign branch to the foreign branch owner or transfers between branches).

We recommend that the final regulations provide that deemed contingent payments are deductible against either general category income or foreign branch category income, as applicable.

We recommend that the final regulations include examples illustrating the consequences of the Disregarded Section 367(d) Rule if the relevant intangible is wholly or partially sold in a disregarded transaction or if the transferor has basis in the property.

5. Allocation of Foreign Income Taxes to Foreign Branch Income

As a general rule, the Proposed Regulations allocate and apportion foreign taxes reflected on the books and records of a foreign branch under the rules applicable the allocation and apportionment of other foreign taxes, subject to an exception for disregarded payments. Specifically, as a general rule, foreign taxes paid or accrued with respect to a separate category includes only those taxes related to income in that separate category. Taxes are related to income if the income is included in the base upon which foreign law imposes the tax. Income included in the foreign tax base is calculated under foreign law, but characterized as income in a separate category under U.S. federal income tax principles.

The Proposed Regulations also contain two special rules that are relevant here: i) rules for the treatment of base and timing differences; and ii) rules for the treatment of certain disregarded transactions. With respect to base and timing differences, the Proposed Regulations provide that taxes imposed on a type of income “that does not constitute income under Federal income tax principles (a base difference) [are] treated as imposed with respect to income in [the branch basket]” and b) on 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 (a timing difference), that tax is allocated and apportioned to the appropriate separate category or categories to which the tax would...
be allocated and apportioned if the income were recognized under Federal income purposes in the year in which the tax was imposed. 89

With respect to certain disregarded transactions, the Proposed Regulations provide that taxes are allocated in the manner described in the table below.

<table>
<thead>
<tr>
<th>Special rules for allocation of foreign taxes for foreign branches 90</th>
<th>Foreign branch to foreign branch owner</th>
<th>Foreign branch owner to foreign branch</th>
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<td><strong>Disregarded reallocation transactions</strong></td>
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<td><strong>Other disregarded payments</strong></td>
<td>Foreign tax imposed solely by reason of that disregarded payment is allocated and apportioned to a separate category under the general principles based on the nature of the item (determined under U.S. federal income tax principles) that is included in the foreign tax base. 91</td>
<td>Any foreign tax imposed solely by reason of the disregarded payment is allocated and apportioned to the foreign branch category.</td>
</tr>
</tbody>
</table>

We have the following three recommendations related to the allocation and apportionment of foreign taxes to the branch basket.

First, the cross-reference in section 904(d)(2)(H)(i), which provides that foreign taxes allocated to base differences are related to foreign branch category income, is a clerical error, and we recommend that the final regulations provide that base-difference

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89 Prop. Reg. § 1.904-6(a)(1)(iv).

90 Prop. Reg. § 1.904-6(a)(2).

91 Prop. Reg. § 1.904-6(a)(2)(iii)(A). The regulation provides as follows:

For example, if a remittance of an appreciated asset results in gain recognition under foreign law, the tax imposed on that gain is treated as attributable to a timing difference with respect to recognition of the gain, and is allocated and apportioned to the separate category to which gain on a sale of that asset would have been assigned if it were recognized for Federal income tax purposes. However, a gross basis withholding tax on a remittance is attributable to a timing difference in taxation of the income out of which the remittance is made, and is allocated and apportioned to the separate category or categories to which a section 987 gain or loss would be assigned under §1.987-6(b).”
taxes relate to general category income. Second, we recommend that the final regulations provide additional guidance and potentially examples on the application of the rules in Treasury Regulation section 1.904-6(a)(1) to foreign branch category income, in particular with respect to disregarded reallocation transactions. Third, we recommend that the final regulations make certain technical clarifications to the rules related to disregarded payments.

With respect to base differences, we first note that prior to the Act there were two baskets under section 904(d)(1): (i) the passive basket; and (ii) the general basket. Thus, prior to the enactment of the Act, section 904(d)(2)(H)(i) provided that foreign taxes imposed “on an amount which does not constitute income under United States tax principles shall be treated as imposed on income described in paragraph (1)(B) [of section 904(d)].” At the time enacted, the cross-reference for base differences was to the general basket.

The Act added GILTI category income and foreign branch category income by inserting them before the existing categories (as the general basket is the residual basket, it has remained the last basket listed in section 904(d)(1)). Therefore, rather than adding the new GILTI and branch baskets to the end of the list, GILTI category income was included as a new subparagraph (A) of section 904(d)(1) and foreign branch category income was included in subparagraph (B) of that section, and passive category income and general category income were renumbered as subparagraphs (C) and (D), respectively. However, as noted above, section 904(d)(2)(H)(i) was not changed, in relevant part, by the Act.

We believe that the failure to change the cross-reference in section 904(d)(2)(H)(i) from “paragraph (1)(B)” to “paragraph (1)(D)” was a clerical error and that Treasury and the Service should therefore exercise their regulatory authority [in section 7805(a)] to treat foreign taxes imposed on base differences as related to general category income. We make this recommendation for three reasons. First, there is no mention in the legislative history of this change. Second, both the Blue Book and House Ways and Means Committee Chairman’s discussion draft of the “Tax Technical and Clerical Corrections Act” indicate that the failure to change the cross-reference did not reflect the intent of the drafters. Third, there is no policy justification that we have been able to ascertain, for this change.

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92 The preamble to the Proposed Regulations provides that “[t]he Treasury Department and the IRS recognize that there may be additional circumstances where the application of [the Reg. § 1.904-6(a)(1)] rules may be ambiguous and request comments on whether further guidance is needed to clarify how foreign taxes should be allocated and apportioned between the foreign branch category and other separate categories.” 83 Fed. Reg. at 63,213.

We also recommend that Treasury and the Service include more guidance and possibly examples on the application of the rules in Treasury Regulation section 1.904-6(a)(1) to foreign taxes that are allocated and apportioned to foreign branch category income, in particular with respect to disregarded reallocation transactions and their effects on timing differences. As noted above, foreign taxes paid or accrued with respect to a basket include only those taxes related to income in that basket. Taxes are related to income if the income is included in the base upon which foreign law imposes the tax. Income included in the foreign tax base is calculated under foreign law, but characterized as income in a separate category under U.S. federal income tax principles.94

The following example illustrates three issues raised by the Proposed Regulations. First, if a disregarded reallocation transaction results in a reallocation of gross income from the foreign branch category to the general category, a portion of the taxes paid by the foreign branch could be treated as either related to such reallocated income or related to the foreign branch income. It is not clear whether the entire amount of gross income is the foreign base on which taxes are imposed or some concept of net income, which may or may not be reduced by disregarded reallocation transactions. As a result, foreign taxes might relate to both foreign branch category income and general category income that is reallocated from foreign branch category income, or only to foreign branch category income. Second, under the section 861 regulations, deductions reflected on the books and records of the foreign branch may be apportioned between foreign branch category income and general category income that has been reallocated from the foreign branch. This allocation might similarly impact the allocation and apportionment of foreign income taxes because such an allocation would generally increase foreign branch income relative to the foreign tax base. Third, and somewhat unrelated to the first two points, the category to which foreign taxes imposed on timing differences relate is necessarily determined based on hypothetical events.

Example:

Facts. Foreign branch receives sales income from third party customers. It also pays a royalty to its disregarded owner that is equal to 25 percent of sales revenue as determined by U.S. generally accepted accounting principles (“GAAP”). For purposes of both U.S. federal income tax and U.S. GAAP, sales revenue is equal to $1,000. The amount of the disregarded royalty is therefore $250, all of which would (if the royalty were regarded) be properly allocated and apportioned to the sales income. Furthermore, the foreign branch has other expenses reflected on its books and records of $600, which are properly attributable to the sales income under the principles of Treasury Regulation sections 1.861-8 through 1.861-14T and 1.861-17.

Committee Chairman’s Discussion Draft on the “Tax Technical and Clerical Corrections Act” (JCX-1-19), January 2, 2019.

94 Reg. § 1.904-6(a)(1)(i); Prop. Reg. § 1.904-6(a)(1)(i).
For foreign tax purposes, however, sales revenue is equal to $1,200 because, for example, foreign law requires current recognition of certain deferred revenue that is not required to be recognized for purposes of either U.S. federal income tax or U.S. GAAP. Foreign tax is imposed on the branch at a rate of 20% and in the amount of $70 (which is 20% of $1,200 minus $250 minus $600).

**Analysis.** Under Proposed Regulation section 1.904-4(f)(2)(vi), the $250 disregarded royalty results in a reallocation of $250 of sales income. As a result, gross income attributable to the foreign branch is reduced from $1,000 to $750 and the general category gross income attributable to the foreign branch owner is correspondingly increased by $250. Furthermore, the $600 of deductions are allocated to the sales income, but are apportioned based on gross income to foreign branch category income and general category income; that is, $450 of these deductions are apportioned to foreign branch category income and $150 of these deductions are apportioned to general category income. Therefore, with respect to branch activities and not taking into account any other operations of the foreign branch owner or its affiliates, foreign branch category income is $300 (that is, $750 minus $450) and general category income is $100 (that is, $250 minus $150).

With respect to foreign taxes, none of the taxes are “solely by reason of” taxes and therefore none of the special rules in subparagraphs (ii) or (iii) of Proposed Regulation section 1.904-6(a)(2) apply.

It is not clear how taxes should be allocated and apportioned to foreign branch category income and general category income: First, the disregarded royalty is deductible for foreign tax purposes but is not deductible for U.S. tax purposes (i.e., it results in a reallocation of gross income). Therefore, the foreign tax base is different from the U.S. tax base. Ignoring for the moment the second difference addressed in subsequent paragraphs, the foreign tax base is $150 (that is, $1,000 of revenue minus $600 of branch-level expenses minus $250 of royalty expense). The U.S. tax base is either $300 (if the U.S. tax base for this purpose is only foreign branch category income) or $400 (if the U.S. tax base is all income from the activities of the branch).

There are several possible approaches for allocating these taxes. The disregarded royalty could be treated as a deduction for this purpose, rather than a disregarded reallocation transaction. This approach is consistent with treating the disregarded royalty as a timing difference. Under this approach all $30 of the taxes would be allocated and apportioned to foreign branch category income, because if the royalty were treated as a deduction foreign branch income would be equal to $150. Or, the disregarded royalty could be treated as a disregarded reallocation transaction, rather than a timing difference. This approach is consistent with the treatment of the disregarded payment income reallocation rules in Proposed Regulation section 1.904-4(f)(2)(vi). Under this approach, the taxes would be apportioned based on gross income such that $22.50 would be apportioned to
foreign branch category income and $7.50 would be apportioned to general category income (that is, $30 multiplied by either $750 / $1,000 or $250 / $1,000, respectively).

Second, the $200 of additional sales income is a timing difference that results in $40 of additional foreign income tax. The rules on timing differences, as noted above, generally require a tracing approach: The $200 of additional sales income will be recognized for U.S. tax purposes in a later year and so the tax is generally treated as related to sales income as if that sales income were recognized in the year the tax is paid. The timing difference rules therefore could imply that a taxpayer should perform a hypothetical calculation to determine how the additional income would be treated. As described above, if the additional $200 of sales income were recognized in the year the taxes were paid, foreign branch category income would first be increased by the amount of the additional sales income, but additional expenses would be apportioned to the foreign branch category income (and away from general category income). This hypothetical calculation would likely be a burdensome calculation and would create significant uncertainty and opportunity for interpretive differences, thereby reducing administrability of the rules. Further, it is not clear that the regulations require such a hypothetical calculation.

In addition, if the hypothetical calculation is required, it is not clear whether only the amount of sales income should be increased or if other facts should be correspondingly changed. For example, since U.S. tax and U.S. GAAP are consistent for this purpose, it could also be argued that the disregarded royalty should be increased – for purposes of this hypothetical calculation – and a corresponding reallocation of gross income should occur.

We recommend that Treasury and the Service consider an alternative approach for allocating taxes to foreign branch income due to the significant ambiguity resulting from the general approach in Treasury Regulation section 1.904-6(a)(1) and Proposed Regulation section 1.904-6(a)(1). The alternative approach could, for example, be formulaic such as the approach described in Proposed Regulation section 1.904-6(a)(2)(iii)(A). That section treats withholding taxes imposed on remittances as attributable to a timing difference, but then provides that the tax “is allocated and apportioned to the separate category or categories to which a section 987 gain or loss would be assigned under §1.987-6(b).” The section 987 regulations require that section 987 gain or loss is allocated and apportioned based on the asset method in Treasury Regulation section 1.861-9T, but regulations for this purpose could rely on any reasonable method under the section 861 regulations or some other formulaic method. This alternative approach could be provided as a safe harbor if moving entirely away from the general approach is not desirable.

Finally, we recommend an additional technical clarification with respect to taxes imposed solely by reason of disregarded payments. As noted above, Proposed Regulation section 1.904-6(a)(2)(ii) provides special rules with respect to certain taxes imposed “solely by reason of” disregarded transactions that are treated as “disregarded
reallocated transactions,” which is a “disregarded payment or other transfer described in §1.904-4(f)(2)(vi)(D) that results in an adjustment to the gross income attributable to the foreign branch under §1.904-4(f)(2)(vi)(A).” Foreign income taxes imposed solely by reason of such payments are allocated entirely to the general category (if the disregarded payment is made from the foreign branch to the foreign branch owner) or entirely to the foreign branch category (if the disregarded payment is made from the foreign branch owner to the foreign branch). A disregarded reallocation transaction might not, however, result in a reallocation of income from foreign branch category income to general category income (or vice versa) in an amount equal to the entire disregarded payment. For example, a disregarded reallocation transaction could consist of a disregarded payment that, if regarded, would be properly treated as a research and experimentation expenditure and therefore would not be entirely allocated and apportioned to general category income (or vice versa) in an amount equal to the entire disregarded payment. In such case, the entire amount of the tax imposed by reason of the disregarded reallocation transaction should not be allocated and apportioned to the general category (or the foreign branch category) but instead should be so allocated and apportioned only to the extent that income is redetermined. Therefore, we recommend modifying the definition of “disregarded reallocation transaction” as follows:

“The term disregarded reallocation transaction means a disregarded payment or a transfer described in §1.904-4(f)(2)(vi)(D) to the extent that it results in an adjustment to the gross income attributable to the foreign branch under §1.904-4(f)(2)(vi)(A).”

Recommendations

We recommend that the final regulations correct the clerical error reflected in section 904(d)(2)(H)(i) and provide that foreign income taxes imposed on base differences are related to general category income (rather than foreign branch category income).

We recommend that the final regulations provide additional guidance and potentially examples on the application of the rules in Proposed Regulation section 1.904-6(a)(1) to foreign branch income, in particular with respect to disregarded reallocation transactions.

We recommend that the final regulations make certain technical clarifications to the rules related to disregarded payments.

F. Disallowance of Deemed Paid Credits on Section 956 Inclusions

1. Overview

In addition to the Proposed Regulations, Treasury and the Service also issued proposed regulations addressing the operation of section 956 under the Act (the “Proposed Section 956 Regulations”). Because our comments concerning the proposed

95 Prop. Reg. §1.904-6(a)(2)(ii)(A), (B).
changes to the amount of taxes deemed paid in the case of amounts invested in U.S. property are integrally related to the proposed changes to the treatment of section 956 amounts, we first summarize the Proposed Section 956 Regulations.

The Proposed Section 956 Regulations are aimed at conforming the treatment of section 956 amounts to the treatment of dividends. Because section 956 amounts are determined with respect to profits remaining after subpart F inclusions, GILTI and dividends have been taken into account, earnings and profits remaining for section 956 purposes are generally of a type that would not be subject to tax in the hands of a corporate U.S. shareholder if distributed as a result of the dividends received deduction under section 245A. However, if such earnings and profits are included in income as a section 956 amount, the earnings and profits would be subject to tax at full corporate tax rates, but also provide an indirect foreign tax credit. The Proposed Section 956 Regulations were issued to address this potential difference between the taxation of dividends and the taxation of section 956 amounts.

This intention is evidenced by the preamble to the Proposed Section 956 Regulations, which states, in relevant part:

Accordingly, the proposed regulations continue the Treasury Department and the IRS’s longstanding practice of conforming the application of section 956 to its purpose. The proposed regulations exclude corporate U.S. shareholders from the application of section 956 to the extent necessary to maintain symmetry between the taxation of actual repatriations and the taxation of effective repatriations. In general, under section 245A and the proposed regulations, respectively, neither an actual dividend to a corporate U.S. shareholder, nor such a shareholder’s amount determined under section 956, will result in additional U.S. tax.

To achieve this result, the Proposed Section 956 Regulations provide that the amount otherwise determined under section 956 with respect to a U.S. shareholder for a taxable year of a CFC is reduced to the extent that the U.S. shareholder would be allowed a deduction under section 245A if the U.S. shareholder had received a distribution from the CFC in an amount equal to the amount otherwise determined under section 956.

Conversely, a dividend of untaxed earnings from a CFC would be subject to tax in the hands of a taxpayer that is not a U.S. corporate ten percent shareholder because section 245A would not apply to grant a deduction.

2. Disallowance of Foreign Tax Credits

The Proposed Regulations address another aspect of the section 956 inclusions under the Act, the amount of foreign taxes deemed paid with respect to such inclusion. Notwithstanding that the underlying earnings that are included under section 956 (and section 951(a)(1)(B)) may have been subject to foreign tax, Proposed Regulation section 1.960-2(b)(1) provides that no foreign income taxes are deemed paid under section 960 with respect to an inclusion under section 951(a)(1)(B). The preamble explains this change by stating that:
Section 960(a) treats foreign income taxes of a CFC as deemed paid by a United States shareholder only with respect to an item of income of a CFC that is included in the gross income of the United States shareholder under section 951(a)(1). Proposed §1.960-2(b)(1) treats taxes as deemed paid under section 960(a) specifically with respect to subpart F inclusions because the inclusions are with respect to items of income of the CFC. In contrast, 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). Therefore, proposed §1.960-2(b)(1) provides that no foreign income taxes are deemed paid under section 960(a) with respect to an inclusion under section 951(a)(1)(B).

In our view, however, this interpretation of section 960 runs counter to a straightforward reading of the Code and the historical operation of section 956. Section 951(a)(1) requires U.S. shareholders to include in income two types of amounts: under subsection (A), the pro rata share of the corporation’s subpart F income for such year; and, under subsection (B), the amount determined under section 956 with respect to such shareholder for such year. Thus, Congress made no distinction in its reference in section 960(a) to section 951(a)(1) between subsections (A) and (B). From this, we believe the appropriate inference is that Congress did not intend to deny a foreign tax credit to a shareholder that must include an amount in income under section 956.

Further, there is no indication in applicable legislative history that Congress intended to deny a foreign tax credit to U.S. shareholders which are required to recognize a section 956 amount as income. In fact, rather than eliminating the application of section 956 to corporate taxpayers, as had been proposed in section 4002 of H.R. 1 and the Senate Mark, this provision was rejected by the Conference Committee and the basic framework of sections 959 and 960 were retained with respect to section 951(a)(1)(B) earnings and profits. Although the changes to the international tax rules made by the other provisions of the Act are inconsistent with the retention of section 956, it is our view that the specific removal of its repeal in the Conference Bill should mean that the operation of section 956 should be unchanged, including that a U.S. shareholder should be allowed a foreign tax credit for foreign taxes allocable to earnings and profits subject to tax under section 956. Accordingly, regulations that stray from this conclusion would need, in our view, more of a rationale for their implementation.

Moreover, the Proposed Regulations justify the denial of foreign tax credits for a section 956 inclusion by relying on what we see as a statutory interpretation of section 960(a) that appears to us to be challenging. That section states in part: “if there is included in the gross income of a domestic corporation any item of income under section 951(a)(1) . . . such domestic corporation shall be deemed to have paid so much of such foreign corporation’s foreign income taxes as are properly attributable to such item of income.” The preamble to the Proposed Regulations discussed this approach by reasoning 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). However, there appears to be no general statutory definition of an “item of income,” despite the ubiquity of the term in the Internal Revenue Code. More often than not, the phrase is used without modifiers to specifically delimit its
meaning, leaving the phrase to be interpreted within the purpose of the statute. On the
other hand, certain Code sections have specifically enumerated the types of income
which are to be included with the meaning of an “item of income,” without defining the
term “item of income” itself. Accordingly, since the phrase item of income is used
without modifiers, the apparent conclusion to be derived is that what constitutes an “item
of income” should be determined with reference to the objectives of section 960(a).

Section 960(a) refers to “any item of income under section 951(a)(1).” Accordingly, what constitutes an “item of income” for purposes of section 960(a) should be
determined based on the objectives of section 951(a)(1): to subject to tax a U.S.
shareholder’s: (A) pro-rata share of items of income specified in subpart F, and (B)
amount determined under section 956. Accordingly, by referring to items of income in
section 951(a)(1), section 960(a) treats an amount determined under section 956 as an
item of income for the purposes of section 960(a).

We also note that section 960(a) prior to the recently-enacted amendments did not
use the term “item of income” but rather the term “amount attributable to earnings and
profits of a foreign corporation.” However, prior regulations did only permit a deemed
paid credit for section 956 inclusions, which are “amount attributable to earnings and
profits” and not an item of income that is included under section 951(a)(1)(A). Accordingly, it seems anomalous to now assert that an item of income in the context of
section 951(a) excludes an “amount of income” determined under section 956.

We acknowledge that, in the case of a U.S. shareholder that is a corporation, it
may be anomalous to allow a deemed paid foreign tax credit with respect to a section 956
amount if the Proposed Section 956 Regulations turn off the application of section 956 to
corporate taxpayers. However, allowing a shareholder who elects the application of
Section 962 (a “Section 962 Shareholder”) to claim a section 960 foreign tax credit
makes logical sense, since section 245A does not apply to such a shareholder and the
Proposed Section 956 Regulations do not turn off the application of section 956 with
respect to such shareholder. Accordingly, one may question whether the Service could
allow a Section 962 Shareholder a foreign tax credit for a section 956 inclusion without
allowing one to a corporate shareholder for whom the Proposed Section 956 Regulations
turn off the application of section 956.

One alternative approach to this issue would be to allow a section 960 credit only
to the extent the distribution of a dividend in the same amount would not be offset by a
section 245A deduction. This proposal ties the determination of the amount of foreign
tax credits available to the U.S. shareholder to whether the section 956 amount is actually
subject to tax. In so doing, it avoids allowing corporate U.S. shareholders foreign tax
credits for amounts that are effectively exempt from tax but allows individuals electing
under section 962 to utilize foreign tax credits for amounts included in their income under
section 956. The same result could also be achieved by treating a section 956 amount as
if it were a dividend solely for the purposes of section 904(b)(4) or by allowing a Section
962 Shareholder to claim a section 245A deduction for an amount included in income
under section 956. Admittedly, questions could arise as to the Service’s authority to
propose these solutions, but in our view, such questions of authority are no more
significant than those that arise with respect to the Service’s existing proposal and we believe that the alternatives proposed above reach an appropriate equity and policy result.

**Recommendation**

We recommend that the final regulations permit a deemed paid credit for foreign income taxes paid by a CFC in the case of an inclusion under sections 951(a)(1)(B) and 956.

3. Application of Section 959(c)

Section 959(a) provides the general rule that earnings and profits attributable to amounts which have been included in the gross income of a U.S. shareholder under section 951(a) are not again included in the gross income of such U.S. shareholder when such amounts are distributed or would otherwise be included in the U.S. shareholder’s income under section 951(a)(1)(B). Section 959(b) provides a corollary rule to ensure that an amount distributed from one foreign corporation to another within the same section 958(a) chain of ownership retains its PTI status in the hands of the distributee. Section 959(c) then provides ordering rules that determine the priority of earnings and profits that are treated as distributed for purposes of section 959(a).

The proposed foreign tax credit regulations do not address the application of section 959(c) in light of the Act and the proposed regulatory changes to the application of section 956 and 960. Section 959(c) provides in relevant part that for purposes of section 959(a) and (b), a dividend is treated as first reducing earnings and profits attributable to amounts included in gross income under section 951(a)(1)(B) (the “section 959(c)(1) earnings”), and then to earnings and profits attributable to amounts included in gross income under section 951(a)(1)(A) (the “section 959(c)(2) earnings”) and then to other earnings and profits (the “section 959(c)(3) earnings”). However, it is unclear under the new regime whether an amount that would be included in a shareholder’s gross income under section 956 but is not because of the application of the proposed section 956 regulations to corporate taxpayers is considered to be described in section 951(a)(1)(B) and, therefore, considered to be included in the section 959(c)(1) earnings. If not, are such earnings and profits relegated to the section 959(c)(3) earnings? Presumably, they cannot be included in the section 959(c)(2) earnings.

Similarly, if a CFC has both a U.S. shareholder that is a corporation and a Section 962 Shareholder, are amounts in the section 959(c)(1) earnings allocated between such shareholders? If the earnings attributable to an investment in U.S. property by a U.S. shareholder that is domestic are moved to the section 959(c)(3) bucket, do the earnings that are included in the Section 962 Shareholder’s income under section 956 remain in the section 959(c)(1) earnings? If so, are they allocated to Section 962 Shareholder? Otherwise, the corporate shareholder would potentially benefit from PTI that relates to an amount included in the income of a Section 962 Shareholder. Further, this would be to the detriment of the Section 962 Shareholder. Consider the following example:
Example: ForCo, a CFC, has two U.S. shareholders: USCo, a U.S. corporation that holds 80% of the voting common stock of ForCo and USI, a U.S. citizen who owns 20% of the voting common stock of ForCo. USI has made a section 962 election. No other shares are outstanding.

In year 1, ForCo earns $120 of non-subpart F general limitation income, has no tested income and makes no distributions. ForCo invests $100 in U.S. property that is not subject to any exception under section 956. ForCo has no earnings and profits from previous years. In year 2, ForCo has no income but makes a distribution of $100 its shareholders in proportion to their relative shareholdings.

If we assume that both the section 956 Proposed Regulations and the section 960 Proposed Regulations are finalized as proposed, does ForCo have earnings in the section 959(c)(1) bucket of $20 or $100? Assuming the answer is $20, then presumably there are no earnings in the section 959(c)(2) bucket and earnings of $100 in the section 959(c)(3) bucket. However, upon the year 2 distribution of $100, if there is no allocation of the section 959(c)(1) bucket earnings between USCo and USI, USCo would receive an $80 distribution, $16 of which should constitute PTI from the section 959(c)(1) earnings and $64 of which constitutes other earnings and profits, presumably offset by a section 245A deduction. On the other hand, USI receives a $20 distribution, $4 of which is PTI and $16 of which is other earnings and profits, subject to tax.

To summarize then, USCo recognizes no income under section 956 but nevertheless receives a $16 distribution of PTI to which it is presumably indifferent since the income in the Section 959(c)(3) bucket is also effectively tax exempt given the deduction available for corporate taxpayers pursuant to section 245A. However, while USI recognized $20 of income pursuant to section 956, it receives no indirect foreign tax credit under the section 960 regulations and only receives $4 of PTI, with $16 being considered a taxable dividend. In effect then, USI pays double tax on $16 of the $20 it receives in the distribution.

Given the foregoing considerations, we suggest that the final regulations either clarify that the entire amount of the earnings that would constitute section 959(c)(1) earnings remain section 959(c)(1) earnings or that the regulations specify a mechanism for allocating section 959(c)(1) earnings to Section 962 Shareholders. At a minimum, we recommend that the Service provide guidance on how such earnings are allocated between the categories of section 959 earnings.

**Recommendation**

We recommend that the final regulations either clarify that the entire amount of the earnings that would constitute section 959(c)(1) earnings remain section 959(c)(1) earnings or that the regulations specify a mechanism for allocating section 959(c)(1) earnings to Section 962.
G. Additional Issues Under the Section 904 Regulations

1. Base and Timing Differences

The Proposed Regulations provide a slightly revised version of the base and timing difference as follows:

(iv) Base and timing differences. If, under the law of a foreign country or possession of the United States, a tax is imposed on a type of item that does not constitute income under Federal income tax principles (a base difference), such as gifts or life insurance proceeds, that tax is treated as imposed with respect to income in the separate category described in section 904(d)(2)(H)(i). If, under the law of a foreign country or possession of the United States, a tax is imposed on 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 (a timing difference), that tax is allocated and apportioned to the appropriate separate category or categories to which the tax would be allocated and apportioned if the income were recognized under Federal income tax principles in the year in which the tax was imposed. If the amount of an item of income as computed for foreign tax purposes is positive but is greater than the amount of income that is currently recognized for Federal income tax purposes, for example, due to a difference in depreciation conventions or the timing of recognition of gross income, or because of a permanent difference between U.S. and foreign tax law in the amount of deductions that are allowed to reduce gross income, the tax is allocated or apportioned to the separate category to which the income is assigned, and no portion of the tax is attributable to a base difference. In addition, a tax imposed on a distribution that is excluded from gross income under section 959(a) or section 959(b) is treated as attributable to a timing difference (and not a base difference) and is treated as tax imposed on the earnings and profits from which the distribution was paid.

The distinction between base and timing differences has been the source of some uncertainty for a number of years. Most of the guidance addressing these issues is non-precedential, and in some instances, even this guidance has reached conflicting results.96 Moreover, prior to the Act, this distinction had less significance as in many instances the foreign tax at issue was generally allocated to the general basket. The addition of two baskets, and the special rules for how the base and timing differences are treated in the Proposed Regulations, has increased the importance of these rules. Accordingly, consistent with the comments elsewhere in this report concerning the more specific application of this distinction, such as in the case of the branch basket, we recommend a more substantial articulation of the two categories, including additional examples.

96 See Cohen and Geiger, Timing and Base Difference Under Section 904(d), 56 Tax. Law. 3 (2002).
Recommendation

We recommend that the final regulations include a more substantial articulation of what circumstances constitute a base and a timing difference, including additional examples.

2. Elections Under the Foreign Tax Credit and Expense Allocation Regulations

The regulations concerning expense allocation and the foreign tax credit contain a number of elections, one of which is the election to use the alternative book value method for apportioning interest expense. Many of these elections have rules limiting flexibility for changing these elections either on a retroactive basis, or from year-to-year. These limitations may have been imposed for different reasons, and in many cases, were important to ensure the administrability of these provisions by the Service. Moreover, taxpayers generally did not need to have additional flexibility in these cases because in most cases the foreign tax credit rules, and the international tax system in which they fit, were generally fixed.

The enactment of the Act and the ongoing guidance process has not only substantially reshaped both the foreign tax credit and international tax rules substantially, but the operation of these rules is still being sorted out as the issuance of regulations continues. The dynamic situation is not limited to the specific regulations that address the computation of a taxpayer’s foreign tax credit and the accompanying limitation, but also the other rules that have been changed in the international area, including under sections 951A, 163(j), etc. Further, these new regulations will in many cases not be finalized prior to the 18-month deadline imposed by section 7805 for making regulations retroactive back to the effective date of a statutory amendment. Accordingly, the foreign tax credit rules and their surrounding environment are in a state of flux that may be more dynamic than at any point in the history of the foreign tax credit.

In light of this circumstance, we recommend that the regulations suspend restrictions on changing any elections under either the foreign tax credit or expense allocation regulations, including any such elections that are included in the final regulations, whether from year-to-year or on a retroactive basis, for a three-year period, i.e., for all taxable years beginning in 2018, 2019 and 2020. Two years seemed like too short a period to meet the goals of the recommendation. Permitting this flexibility removes the possibility of taxpayers making irrevocable elections in the middle of this unavoidably chaotic time, especially when taxpayers are facing compliance challenges that are straining the resources of both in-house and outside advisors.

Recommendation

We recommend that the final regulations suspend restrictions on changing any elections under either the foreign tax credit or expense allocation regulation, including any such elections that are included in the final regulations, whether from year-to-year or on a retroactive basis, for a three-year period beginning in 2018.
H. Interaction of Section 965(n) and Section 904

The Proposed Regulations include new rules that apply section 904 to taxpayers that have made the election under section 965(n) to waive off the use of current or carryover losses against their section 965 income. Although these rules are described as clarifications, we believe that their operation is at odds with the purpose for which the section 965(n) election was enacted. We therefore recommend that Treasury and the Service modify the Proposed Regulations to provide that the OFL, ODL, and SLL rules, including the section 1.904(g)-3 ordering rules, are applied without regard to the section 965 income, such that the section 965 income is unreduced for section 904 purposes.

1. Overview

Section 965(n) allows taxpayers to elect, in a year in which they have an income inclusion under section 965(a), to not take into account the “net section 965 inclusion” in determining the amount the net operating loss (“NOL”) created in the inclusion year or the amount of NOL carryover that is used in the inclusion year. Although the statute is silent on the interaction of the provision with section 904, the most natural reading of the statutory language is that the net section 965 inclusion cannot be offset by current year or carryover losses. On this basis and in light of the intended result that taxpayers would make the election so that they could use tax credits, most notably FTCs, instead of NOLs to reduce the tax liability arising from the net section 965 inclusion, many calendar-year taxpayers filed their 2017 returns following an approach that “walled off” the net section 965 inclusion from being reduced by expenses for section 904 limitation purposes, such that the section 904 limitation was based solely upon the per-basket composition of the earnings and profits giving rise to the net section 965 inclusion.

Treasury and the Service appear to believe this approach is incorrect, as reflected in Proposed Regulation section 1.965-7(e)(1). The preamble simply provides that the new rule “clarifies that the election under section 965(n) applies solely” in determining the amount of the current year NOL and the amount of the NOL carryover absorbed as a

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97 The net section 965 inclusion refers herein to the amount set forth in section 965(n)(2), which is the sum of the taxpayer’s section 965(a) inclusion amount, net of the section 965(c) deduction, plus the (as-haircut) section 78 gross up for corporate U.S. shareholders that elect to credit taxes under section 901.

98 The statutory language is not entirely clear, but Treasury and the Service set forth this interpretation first in Notice 2018-26 and then in Proposed Regulations section 1.965-7(e)(1)(iii). Also, although section 965(n) technically applies to carryover and carryback losses, the discussion herein refers only to carryover losses because the changes to the section 172 rules make it exceedingly unlikely that a U.S. shareholder’s future net operating loss would ever be carried back to a taxable year for which there was a section 965(a) income inclusion.

99 The Blue Book confirms that Congress foresaw that a taxpayer making a section 965(n) election would be able to claim FTCs against their current year tax liability as a result of the current or carryover NOLs not being taken into account against the net section 965 inclusion, as opposed to the pre-section 965(n) result of the FTCs being allowed only as a carryback or carryover. See JCS-1-18 at 363.
The Proposed Regulations then provide new guidance to “coordinate” the application of section 965(n) with the taxpayer’s section 904 limitation.

Although the proposed additions to Proposed Regulation section 1.965-7(e) are not entirely clear and include no examples of their intended operation, they appear to set forth several new operative rules. First, as a general matter, the effect of a taxpayer’s section 965(n) election is that the taxpayer’s taxable income for the year cannot be less than the net section 965 inclusion. This appears to be an attempt to align the provision with other minimum taxable income provisions in the Code, such as former section 965(e)(2) as well as other similar approaches found in sections 860E(a) and 7874(a).

Second, the section 904 regime operates as it otherwise would if the section 965(n) election was not made, but taxpayers must make different—depending on whether such loss is current-year or a carryforward—modifications to coordinate the waived loss amount not being included into the overall determination of taxable income.

For current year losses, meaning losses that create or increase a current year NOL because of the section 965(n) election, the taxpayer excludes this NOL amount—termed the “deferred amount”—from the computation of its FTC Limitation. The deferred amount for this purpose is treated as comprised of a pro-rata share of all of the taxpayer’s deductions, in terms of source and separate category. Once those deductions have been “removed,” then the taxpayer must recompute its final FTC Limitation.

If the taxpayer has a NOL carryforward into the section 965 inclusion year, and the section 965(n) election restricts the amount of the NOL deduction (that is, the NOL carryforward would have offset the net section 965 inclusion but for the election), then the section 1.904(g)-3(b) ordering rules for NOL carryforwards are applied by giving effect to the section 965(n) election for purposes of determining the amount of the NOL absorbed in the year. The source and separate category of that (reduced) NOL deduction, however, is determined by ignoring the section 965(n) election and treating the net section 965 inclusion as “available” to be offset by the NOL deduction, if that result would otherwise occur under the section 1.904(g)-3(b)(3) rules.

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100 83 Fed. Reg. at 63,219 (emphasis added).

101 Id.


103 Prop. Reg. § 1.965-7(e)(1)(i) (as modified).


2. Comments

We recommend Treasury and the Service modify the regulations to allow taxpayers to compute their section 904 limitation in a more simple and straightforward manner that takes into account solely the net section 965 inclusion (that is, a “wall-off” approach). The loss amount that is unabsorbed because of the section 965(n) election would then be factored into the section 904 limitation as the loss is absorbed in other taxable years.

From a policy perspective, the proposed changes are working against the purpose of section 965(n) to alleviate section 904 limitation restrictions for electing taxpayers. A careful review of section 965’s history supports this interpretation.

In the original House version of section 965 that was adopted in November 2017, section 965(n) was not included. Instead, proposed section 965(g)(5) would have allowed a 20-year carryforward period, in lieu of the usual ten-year period set forth in section 904(c), for taxes deemed paid with respect to the taxpayer’s section 965(a) inclusion. The Committee Report accompanying the House Bill explicitly noted that the purpose of the provision was to allow a greater carryover period for taxpayers whose section 904 limitation was restricted for reasons such as NOLs offsetting the section 965(a) inclusion.107

The Senate Version of section 965 did not include the House’s 20-year carryforward provision, however, but rather included section 965(n).108 The Conference Agreement that became the Act adopted the Senate version of section 965 except for certain changes not relevant here,109 and in doing so enacted section 965(n) while not adopting the House’s 20-year carryforward proposal.110 The intended effect of the provision is clear: taxpayers would make the election and thus opt out of the “baseline” result of using NOLs against their net section 965 inclusion with FTCs being carried to other taxable years, in order to “trade” using the FTC (and other tax credits) in lieu of using their NOL.111

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108 H.R. 1, 115th Cong. § 14103(a) (Dec. 20, 2017) (Senate Amendment).
109 H.R. 1, 115th Cong. § 14103(a) (Dec. 21, 2017) (Conference Agreement).
111 See, e.g., New York State Bar Association Report No. 1388 (describing the purpose of the section 965(n) election as allowing taxpayers to utilize “foreign tax credits which would otherwise be allowable in the absence of such net operating losses (which foreign tax credits, given the participation exemption deduction in section 245A and other changes made by the Act, might never be used in the future) . . . .”); see also American Petroleum Institute (API) letter to Treasury Secretary Steven Mnuchin (Mar. 1, 2018) at 2 (“The clear legislative intent of the election was to provide taxpayers the option to forego using their losses in the year of repatriation (i.e., ‘ring-fence’ the losses with such being available for carryover or carryback) and instead apply foreign tax credits to offset the tax related to the repatriated amount.”) Further, as noted above, the TCJA Bluebook confirms that Congress foresaw taxpayers claiming FTCs that
Indeed, there is no other likely purpose for which the section 965(n) election would be made. For example, despite section 965 seeking to impose tax at a 15.5% or 8% rate on deferred foreign income, the mechanism by which this was done—the section 965(c) deduction in lieu of a preferential rate basket for gross section 965(a) income—means that there is no timing benefit to deferring use of the NOL into a later year. Similarly, for financial accounting purposes, the revaluation of a deferred tax asset corresponding to the taxpayer’s NOL carryforward or FTC carryforward would be tax-effected in the same manner, meaning that neither would be more or less valuable in the future.

Congress enacted section 965(n) to provide flexibility to taxpayers who might never get to use their pre-reform foreign tax credits in post-reform years. The approach in the Proposed Regulations is at odds with this purpose and we recommend that it be modified as follows.

3. Proposed Language

We propose as an alternative that Treasury and the Service modify section 1.965-7(e)(1) as follows:

(e)(1)(i) * * * If the section 965(n) election creates or increases a net operating loss under section 172 for the taxable year, then the taxable income of the person for the taxable year cannot be less than the amount described in paragraph (e)(1)(ii) of this section. **Furthermore, the amount described in paragraph (e)(1)(ii) of this section establishes the amount of the taxpayer’s section 904 limitation for the year the section 965(n) election is made. Paragraph (e)(1)(iv) of this section provides rules to coordinate this result with the loss allocation rules of sections 904(f) and § 1.904(g)-3. The amount of deductions equal to the amount by which a net operating loss is created or increased for the taxable year by reason of the section 965(n) election (the “deferred amount”) is not taken into account in computing taxable income or the separate foreign tax credit limitations under section 904 for that year. The source and separate category (as defined in § 1.904–5(a)(4)(v)) components of the deferred amount are determined in accordance with paragraph (e)(1)(iv) of this section.**

* * * * *

(iv) Effect of section 965(n) election—(A) In general. The section 965(n) election for a taxable year applies, **first, to solely for purposes of determining** the amount of net operating loss under section 172 for the taxable year and to **determining** the amount of taxable income for the taxable year (computed without regard to the deduction allowable under

would not otherwise have been available as a result of taxpayers making a section 965(n) election. See note 32, supra.
section 172) that may be reduced by net operating loss carryovers or carrybacks to such taxable year under section 172. The section 965(n) election for a taxable year also applies for purposes of establishing the taxable income taken into account for purposes of section 904, meaning that the amount referred to in paragraph (e)(1)(ii) of this section is not reduced by losses, expenses, and deductions that are allocated and apportioned to the same separate category, nor pursuant to section 904(f) and § 1.904(g)-3. Paragraph (e)(1)(iv)(B) of this section provides a rule for coordinating the section 965(n) election’s effect on section 172 with the computation of the separate foreign tax credit limitations under section 904.

(B) Interaction with Ordering rule for allocation and apportionment of deductions for purposes of the section 904 limitation.

(1) Section 861. Deductions that would have been allowed for the taxable year but for the section 965(n) election, other than the amount of any net operating loss carryover or carryback to that year that is not allowed by reason of the section 965(n) election, are allocated and apportioned under §§ 1.861–8 through 1.861–17 to the relevant statutory and residual groupings, taking into account with the amount described in paragraph (e)(1)(ii) of this section taken into account for these determinations as set forth in § 1.965-6(c).

(2) Net Operating Loss for the Taxable Year. For purposes of determining which items of expense, deduction, and loss are absorbed in the section 965(n) election year and which losses make up the net operating loss for the year that is then carried to other years, separate limitation losses and United States source losses are allocated under section 904(f)(5)(B) and (D), and § 1.904(g)-3, without regard to the amount referred to in paragraph (e)(1)(ii) of this section.

(3) Net Operating Loss Carryover or Carryback into the Taxable Year. The source and separate category of the net operating loss carryover or carryback to the taxable year, if any, is determined under the rules of section 1.904(g)–3(b), with those rules applied without taking into account the amount described in paragraph (e)(1)(ii) of this section.

4. Policy and Authority Considerations

We believe our recommendations better implement the intent and purpose of section 965(n), and are fully within the government’s authority under section 965 to implement.

In considering these issues, we note that there are technical and policy differences between section 965(n) and other similar minimum taxable income provisions. From a technical perspective, section 965(n)’s statutory language is distinguishable in that it does
not contain as the operative rule that the taxpayer’s taxable income, in an abstract sense, “shall in no event be less than” the net section 965 inclusion. Instead, section 965(n)’s structure and operation are premised on the net section 965 inclusion itself being the amount that is left undisturbed by the net operating loss otherwise arising for the year and the net operating loss carryovers into the year.

Section 965(n) is further distinguishable in that it is a Congressionally-provided election necessarily intended to benefit taxpayers. The other similar provisions are revenue collection measures intended to restrict taxpayers’ use of certain tax attributes against a special income item. Interpreting the intersection of section 965(n) and section 904 in a manner that restricts taxpayers’ potential access to foreign tax credits undermines the statutory benefit scheme.

The foregoing is relevant because it demonstrates that section 965(n) is analytically distinct from other areas in which the government has considered the interaction of minimum tax regimes and section 904. If this is the case, in our view, section 965(n) is sufficiently different from these other provisions that a different approach is warranted. Further, from an interpretive standpoint, simply because section 965(n) does not explicitly reference section 904 does not mean that the section 965(n) election cannot apply for section 904 purposes. It is our view that taxpayers would be well served if Treasury and the Service specifically address the proper interaction of the two provisions.

In particular, we believe Treasury and the Service have ample authority under section 965(o) to revise the section 965 regulations in the manner we have recommended above. We note in this regard that in Notice 2019-1, Treasury and the Service relied upon section 965(o) as authority to alter the statutory construct of the section 959 ordering rules, specifically by overriding the longstanding LIFO annual vintage rule for sourcing PTEP distributions and instead prescribing that section 965-related section 959(c)(2) PTEP accounts are distributed first before any section 951A GILTI PTEP accounts, even when the GILTI accounts arise in later taxable years. There are other instances as well where the section 965 regulations alter the normal operation of some other interlocking provision in order to give effect to the desired result for section 965 purposes.

112 Compare section 965(n) with sections 860E(a), 7874(a), and former section 965(e)(2) (all containing the quoted language).

113 See, e.g., FSA 199703013 (Mar. 13, 1997) (rejecting “wall-off” approach in analyzing the interaction of sections 860E(a) and 904, and supporting taxpayer’s approach that led to utilization of foreign tax credits against the tax liability arising from the otherwise U.S.-source REMIC excess interest inclusion).

114 See, e.g., Prop. Reg. § 1.965-3(f)(1), which treats the section 965(c) deduction as not being an itemized deduction for purposes of section 67, despite the section 67(b) list of deductions that are excluded from itemized status not being amended to include the section 965(c) deduction. The provision treats the section 965(a) inclusion as partially tax-exempt and removes the two percent limitation for individuals. The partial tax-exempt treatment is similar to the treatment of the inclusion for basis purposes in the context of investors in partnerships and S corporations passing through section 965 amounts). The Blue Book notes
As a final point, we also note that our recommendations are fully consistent with the approach taken by the Service in Notice 2005-64\textsuperscript{115} to the intersection of section 904, non-deductible dividends under former section 965(e)(2), and taxpayers with NOLs arising in the section 965 dividend inclusion year. Thus, our recommendations are consistent with previously issued guidance under a highly analogous statutory scheme.

**Recommendation**

We recommend that the final regulations revise the portions of the Proposed Regulations concerning section 965(n) to permit taxpayers to coordinate its operation with the FTC Limitation.

5. **Section 905(c) and Foreign Tax Determinations**

The Proposed Regulations do not provide guidance regarding the Act’s amendments to section 905(c) or the treatment of foreign tax redeterminations. We believe such guidance is urgently needed to address the overwhelming administrative burden likely to arise from the Act’s repeal of the pooling approach for purposes of determining the indirect credit under section 902, and thus the necessary elimination of pooling adjustments as a mechanism for taking into account redeterminations of foreign taxes imposed on CFCs. Indeed, because of the Act’s changes to the international tax system, the amount and diversity of foreign tax credits claimed by a U.S. taxpayer will increase. Foreign tax credits in pre-2018 years only arose from countries where the taxpayers had branches, CFCs with subpart F income, or from which amounts had been repatriated. In a post-2017 year, taxpayers will generally have credits arising from foreign taxes in every country in which they operate, in every year. Thus, the frequency of foreign tax redeterminations that occur and affect a taxpayer’s U.S. tax return has increased in many cases very substantially.

These continual changes to the foreign tax liability of CFCs under audit by foreign taxing jurisdictions makes it highly likely that U.S.-parented multinationals will be required to file multiple amended U.S. federal income tax returns with respect to each and every year, in perpetuity. Importantly, the increased burden under this new system will also be significant for the Service, which will be required to process this increased flow of amended returns. And amended federal income tax returns typically trigger the need to file amended State tax returns, thus magnifying the burden imposed on taxpayers and administrators alike. Further, accounting for foreign tax redeterminations on an annual basis undermines certainty and predictability of expected tax results, for example in connection with the determination of whether a taxpayer is entitled to the high-tax exception in section 954(b)(4).

We recommend that Treasury and the Service exercise the full extent of their interpretive authority to mitigate the potential administrative burden and uncertainty that a technical correction may be needed to reflect the section 67 classification. See Blue Book at 362, fn. 1693.

\textsuperscript{115} See Notice 2005-64, § 7.02, 2005-2 C.B. 471 (Sept. 6, 2005).
arising from the rigid annual determination and redetermination of foreign taxes that would otherwise be required by the Act. To the extent that regulations do not sufficiently address the administrative burden presented by foreign tax redeterminations, we recommend that Congress, when considering further modifications to the international provisions of the Act, consider approaches that address this significant concern, for example, by simply allowing taxpayers to elect to include foreign tax redeterminations in the current year.

As we anticipate that guidance addressing foreign tax redeterminations will be the subject of a guidance project after the initial installment of Act guidance has been issued, we provide some preliminary suggestions for potential guidance in this area:

- A CFC’s foreign tax redetermination that relates back to a pre-2018 tax year be treated as an adjustment to the CFC’s post-1986 pools of earnings and taxes under pre-2018 law, in a manner similar to former Treasury Regulation section 1.905-3T(d). Thus, in general, foreign tax adjustments at the CFC level should be taken into account through subsequent pre-2017 distributions and deemed distributions. If there were no such distributions before 2017, CFC-level foreign tax redeterminations generally should be taken into account in connection with the taxpayer’s section 965(a) inclusion in the last pre-2018 tax year (or as a carryforward of excess foreign taxes, described above). To minimize the number of amended returns for pre-2018 years, we recommend that taxpayers be permitted to elect to consolidate in 2017 all pre-2018 foreign tax redeterminations, such that they are taken into account in only one year’s amended returns.

- For taxpayers subject to the jurisdiction of LB&I, we recommend that Treasury and the Service give consideration to allowing, in lieu of an amended return, a schedule to be provided to Exam within some specified period (for example, within 30 days of the commencement of an audit), adjusting the taxpayer’s foreign tax credit for the year or years under audit for all foreign tax redeterminations during those years. A similar but much narrower exception was provided in former Treasury Regulation section 1.904-4T. This proposal would address the category of taxpayers for which the burden is likely to be the most significant—large taxpayers under continuous audit that are most likely to have to file large numbers of amended returns post-Act. The fact that this proposal would not apply to all taxpayers, and that it would only provide relief to taxpayers under audit, does not undermine its usefulness in reducing administrative burden for those taxpayers to whom it would apply. Instead, given the magnitude of the administrative burden, any comprehensive solution is likely to include a number of measures as it seems unlikely that any one solution can address these issues for all taxpayers in all situations.

- Treasury and the Service also may wish to consider developing a new form that taxpayers may file, along with their original return for a year, incorporating all adjustments relating to foreign tax redeterminations for relevant prior years, in lieu of requiring separate amended returns for each prior year.
• We recommend that Treasury and the Service clarify that if a CFC’s tax liability solely with respect to income in a 245A subgroup changes, no redetermination is required because those taxes are not creditable. Similarly, we recommend that Treasury and the Service clarify that because a non-controlled 10-percent owned foreign corporation can never have a subpart F or GILTI inclusion, it also can never have a foreign tax redetermination.

• We recommend that Treasury and the Service give consideration to an alternative approach for determining whether income is eligible for the subpart F high-tax exception—that is, whether it is “subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11.” The Code does not prescribe any mechanism for making this determination, which provides Treasury and the Service with the authority to consider a variety of alternatives for determining, on an objective basis, whether a jurisdiction is a “high tax” jurisdiction for subpart F purposes. Under current regulations, whether income is eligible for the high-tax exception is based on the effective rate of foreign taxes that are or would be deemed paid if the taxpayer were entitled to a deemed-paid foreign tax credit for the income. In the past, this computation was typically based on multiple years of foreign taxes and earnings. Under this regime, the impact of foreign tax redeterminations for a particular year were muted, as they were typically spread across multiple years. Now that deemed paid credits are computed on a strictly annual basis, foreign tax redeterminations may cause taxpayers, many years after the fact, to flip in or out of eligibility to make the high-tax election, potentially more than once. Furthermore, the subpart F high-tax exception is no longer simply relevant for subpart F purposes, but also for purposes of classifying income as entirely exempt from U.S. taxation under the exception from GILTI found in section 951A(c)(2)(A)(i)(III) and the corresponding impact this has on the characterization of the stock of the CFC under Proposed Regulation section 1.861-13. To reduce the uncertainty and instability associated with an annual determination of whether income should be entitled to exemption from subpart F, we recommend giving consideration to an approach that does not depend solely on the section 904(d) high-tax kick-out. Even an approach that applies the section 904(d) high-tax kick-out over some period of years (e.g., a three-year trailing average) would help to provide some degree of certainty as to the consequences of a U.S. taxpayer’s overseas operations. We note that there is no statutory requirement to use any particular method for showing that a taxpayer meets the requirements of the high-tax exception, and in our view adherence to the current mechanism undermines certainty and predictability for taxpayers and creates significant administrative burden and prospects for controversy.

Recommendation

We recommend that Treasury and the Service issue guidance as soon as possible that addresses and simplifies the process for dealing with foreign tax redeterminations under section 905(c).