

Preliminary highlights from the final and proposed foreign tax credit regulations

December 5, 2019

In brief

Treasury and the IRS, on December 2, 2019, released [final regulations](#) (the Final Regulations) under Sections 861, 901, 904, 905, 954, 960, 965, and 986, and [proposed regulations](#) (the New Proposed Regulations) under Sections 704, 861, 904, 905, 954, 960, 965, 1502, 6227, and 6889. The Final Regulations provide guidance with respect to the foreign tax credit (FTC) regime under the 2017 tax reform legislation (the Act). Various effective dates apply under the Final and New Proposed Regulations.

Of relevance to the Final Regulations, the Act limited the FTC for US corporate taxpayers by repealing the indirect credit under Section 902, amended the deemed-paid credit under Section 960, introduced two new FTC limitation baskets under Section 904, modified the sourcing rules related to inventory and interest expense, and altered the manner in which foreign tax redeterminations are taken into account under Section 905. (For prior coverage of the Act's FTC provisions, see the 'See also' section at the end of this document.)

The Final Regulations provide guidance related to the mechanics of determining the FTC limitation under Section 904 (including the allocation and apportionment of expenses), the scope of the new foreign branch basket, the extent of deemed paid FTCs with respect to subpart F and global intangible low-taxed income (GILTI) inclusions, and foreign tax redeterminations, while clarifying and amending several notable provisions of prior proposed regulations published on December 7, 2018 (the Prior Proposed Regulations).

The New Proposed Regulations supplement the Final Regulations and provide important guidance with respect to other aspects of the new FTC regime, including: the allocation and apportionment of creditable foreign taxes; the allocation and apportionment of other expenses; and certain aspects of foreign tax redeterminations. PwC is in the process of reviewing the Final and New Proposed Regulations in detail; some of the key highlights we have identified thus far are set forth below. An in-depth Insight on the Final and New Proposed Regulations will be published in the coming days. In addition, we will discuss the FTC guidance on a PwC webcast: [Tax Readiness: The Final, Temporary and Proposed FTC regulations](#), scheduled for December 16 at 2:00 pm ET.

In detail

Background

The Act introduced a new FTC regime by making significant changes to the prior FTC rules e.g., repealing of Section 902, adding the Section 951A and foreign branch income categories, amending Sections 905 and 960, and adding Section 904(b)(4) — and to the applicable expense allocation and apportionment rules used in determining the Section 904 FTC limitation (e.g., by repealing of the fair market value method of asset valuation for purposes of Section 864(e)(2)).

These changes complicated the FTC limitation calculation and raised a number of issues as to the interaction of the new FTC regime and other provisions enacted pursuant to the Act (e.g., the new GILTI provision under Section 951A). Further, despite the extent and breadth of the changes to the FTC regime, the Act generally did not provide specific transition rules.

(See our previous PwC Insight regarding relevant foreign tax credit provisions of the Act.)

Highlights of the Final Regulations

The lengthy Final Regulations generally follow and finalize the Prior Proposed Regulations but with important differences in response to stakeholder comments. The Final Regulations also finalize parts of proposed regulations issued in 2007 under Section 905(c) (relating to foreign tax redeterminations).

The issues addressed by the Final Regulations generally include: (1) the determination of deemed-paid credits pursuant to Section 960, including computational rules and rules relating to the assignment of foreign taxes to the GILTI basket; (2) the determination of the FTC limitation, including rules relating to expense allocation and apportionment under Sections 861-865 and adjustments under Section 904(b)(4); (3) the new Section 904(d) separate categories and related conforming changes, including amendments to the look-through rules; (4) certain aspects of foreign tax redeterminations under Sections 905(c) and 986; (5) transition rules relating to overall foreign loss, separate limitation loss, and overall domestic loss accounts as well as to the carryover and carryback of unused foreign taxes; and (6) other guidance under Sections 78, 901(j), 904(f) and (g), 954, and 965.

The following provides a high-level summary of key rules set forth in the Final Regulations.

Section 960 deemed-paid credits

The Final Regulations provide detailed guidance and computational rules with respect to foreign income taxes deemed paid by US shareholders under Section 960.

Section 960(a) and (d) limit indirect foreign tax credits to foreign income taxes properly attributable to subpart F or tested income. In general, the Final Regulations, consistent with the Prior Proposed Regulations, provide that foreign income taxes paid or accrued by a foreign corporation are properly attributable to subpart F or tested income only (1) if allocable and apportioned to foreign taxable income that constitutes subpart F or tested income for US federal tax purposes, (2) if paid or accrued in the CFC's US tax year that includes subpart F or tested income, and (3) in proportion to the CFC's subpart F or tested income that is included in a US shareholder's gross income. The additional statutory limitations under Section 960(d) also apply to foreign income taxes properly attributable to tested income.

The Final Regulations clarify that a foreign income tax attributable to a timing difference is allocable and apportioned to the foreign corporation's income groups for the year in which the tax is paid or accrued. Consequently, a tax imposed in a post-2017 year with respect to pre-2018 income is assigned to a tested income group if the pre-2018 income, if recognized in the year the tax was imposed, would be tested income.

The Final Regulations provide that no foreign income taxes are properly attributable to Section 956 inclusions.

Observation: This rule will increase the need to rely on the Section 956 final regulations and possibly result in adverse tax consequences if a Section 956 inclusion is unintentionally triggered (e.g., through a CFC guarantee of US shareholder debt).

Sections 960(b) and (c) generally provide foreign tax credits and related foreign tax credit limitation for foreign income taxes imposed on distributions of previously taxed earnings and profits (PTEP). The Final Regulations limit the foreign income taxes to which Section 960(b) applies to foreign income taxes imposed solely by reason of the receipt of a distribution of PTEP. Thus, for example, a tax imposed on the distributing corporation, or a tax imposed on a disregarded distribution, are not subject to Section 960(b), although they may be properly attributable to subpart F income or tested income for the year in which the tax is paid or accrued. The Final Regulations also provide for 10 groups of PTEP that must be tracked (as opposed to the 16 groups described in Notice 2019-01) and clarify that excess limitation accounts under Section 960(c) are available for Section 960(b) FTCs related to GILTI PTEP.

Expense allocation and apportionment; adjustments to FTC limitation

In general, the Section 904 FTC limitation takes into account certain expenses (as allocated and apportioned under the rules set forth in Sections 861 through 865 and the regulations thereunder) and certain adjustments to foreign source and worldwide taxable income required by Section 904(b)(4).

The Final Regulations generally follow the Prior Proposed Regulations in amending existing regulations (i.e., Treas. Reg. secs. 1.861-8 through -13 and Treas. Reg. sec. 1.861-17) to clarify how to allocate and apportion deductions and introduce rules that account for relevant changes made by the Act. Thus, the Final Regulations continue to provide for the allocation and apportionment of expenses to each FTC basket, including the GILTI basket. For purposes of apportioning these expenses, gross income in the GILTI basket is treated as exempt to the extent of the taxpayer's Section 250 deduction attributable to GILTI, and a portion of GILTI-producing assets is treated as exempt based on that deduction.

Similar treatment applies with respect to the deduction for foreign derived intangible income (FDII). However, the Final Regulations clarify that the portion of a domestic corporation's assets that produce gross foreign derived deduction eligible income (FDDEI) is treated as an exempt asset based on the ratio of the taxpayer's portion of its section 250 deduction attributable to FDII to its gross FDDEI.

In characterizing CFC stock for purposes of apportioning interest expense, the Final Regulations generally follow the Prior Proposed Regulations and require taxpayers to characterize the stock of CFCs as an asset in 10 statutory groupings within each of the general and passive categories (plus a Section 901(j) income category) based on either an asset method or a modified gross income method. The Final Regulations clarify that when applying an asset method, the tax book value of lower-tier subsidiary stock is increased by lower-tier earnings and profits. The Final Regulations also make a change to the Prior Proposed Regulations to permit a CFC, in apportioning its interest expense under a modified gross income method, to consider the gross tested income of lower-tier CFCs.

The Prior Proposed Regulations contained detailed rules to determine the FTC basket of interest income on debt issued by a partnership to a partner (a Specified Partnership Loan). The Final Regulations retain these rules and provide additional guidance with respect to their application. The New Proposed Regulations (discussed below) would extend these rules to debt issued by a partner to a partnership.

Neither the Final Regulations nor the New Proposed Regulations (discussed below) prescribe new guidance with respect to the allocation and apportionment of state and local taxes. However, the Final Regulations withdraw examples that had illustrated the allocation and apportionment of these taxes in the context of foreign subsidiaries. Treasury and the IRS have indicated they intend to study further, and request comments on, the appropriate method for allocating and apportioning state and local taxes.

The Final Regulations also set forth rules relating to the application of Section 904(b)(4) for purposes of the FTC limitation. Specifically, the Final Regulations clarify that Section 864(e)(3) does not apply to dividends for which a Section 245A deduction is allowed. Instead, Section 245A dividends and deductions properly allocable to the "Section 245A subgroup" are disregarded under Section 904(b)(4).

Observation: This has the effect of increasing the denominator of the Section 904(a) FTC limitation fraction in general, which can cause a reduction in the Section 904 FTC limitation in FTC baskets other than the Section 245A subgroup.

GILTI basket

The Prior Proposed Regulations narrowly defined both the income and foreign taxes assigned to the new basket for amounts includible under Section 951A (the GILTI basket). The Final Regulations follow this approach.

Under the Final Regulations the only income generally included in the GILTI basket is a US shareholder's GILTI inclusion and the related Section 78 gross up. Consistent with the Prior Proposed Regulations, the Final Regulations do not apply the Section 904(d)(3) CFC look-through rules to assign interest, rents, and royalties received from CFCs to the GILTI basket. The Final Regulations generally limit the foreign taxes allocated to the GILTI basket to those taxes deemed paid under Section 960(d) or (b). However, the New Proposed Regulations, discussed below, would also assign certain foreign taxes paid by a US person with respect to a CFC's income to the GILTI basket.

Foreign branch basket

The Act also created a new basket for business profits of a US person attributable to a foreign branch. The Final Regulations generally determine the amount of a US person's gross income allocable to the branch basket by reference to the branch's books and records, with certain adjustments. For this purpose, a US person determines branch income on an aggregate basis and not a branch-by-branch basis.

Consistent with the Prior Proposed Regulations, the Final Regulations provide that branch income does not include (1) income arising from activities conducted in the United States, (2) income arising from a stock investment (e.g., a dividend, deemed inclusion under Sections 951, 951A, or 1293, or gain from the disposition of such stock), or (3) gain from the disposition of a partnership or other flow-through entity (e.g., a disregarded entity) unless undertaken in the ordinary course of the trade or business of the branch. Importantly, the Final Regulations take into account certain disregarded payments and transfers in determining whether a branch exists, and provide for a reallocation of gross income and foreign taxes imposed on such payments made between a branch and its owner, or between separate branches.

Observation: The Final Regulations amend a much-criticized provision in the Prior Proposed Regulations that would have applied the principles of Section 367(d) to disregarded transfers of intangible property between a branch and its owner. As finalized, the rule explicitly carves out 'transitory branches' that may exist, for example, where a CFC is treated as liquidating into its US shareholder as a result of a check-the-box election.

The Final Regulations also simplify a long-standing rule for assigning partners' distributive share of partnership income to FTC baskets. The distributive share of a limited partner owning less than 10 percent in the partnership generally is assigned to the passive basket, while the distributive share of all other partners is assigned to the same basket as the partnership income of which it is a share (e.g., foreign branch category income, general category income, or income in a specified separate category).

Foreign tax redeterminations

In 2007, Treasury and the IRS published temporary and proposed regulations under Section 905(c), governing foreign tax redeterminations. The Final Regulations adopt the general approach of the 2007 temporary and proposed regulations, while broadening the definition of a foreign tax redetermination and providing more detailed rules for translating the amount of foreign tax paid or accrued into US dollars. Under the Final Regulations, a foreign tax redetermination includes not only an event (e.g., a foreign tax settlement or refund) that increases or decreases a taxpayer's foreign tax liability, but also payment of foreign tax after 24 months of the close of the relevant tax year and a change to a reasonably estimated accrual. The Final Regulations under Section 905(c) are effective for foreign tax redeterminations occurring in tax years ending on or after the date the Final Regulations are filed in the Federal Register.

Observation: The Act amended Section 905(c), to require all foreign tax redeterminations to be taken into account in the tax year to which they relate – generally, the tax year in which the income subject to the relevant foreign law was recognized for foreign tax purposes. However, the New Proposed Regulations, rather than the Final Regulations, generally implement these revisions to Section 905(c).

Transition rules

The Final Regulations generally maintain the basket of various attributes (e.g., FTC carryforwards, as well as overall foreign loss (OFL), separate limitation loss (SLL), and overall domestic loss (ODL) recapture accounts) carried forward from pre-2018 years. However, the Final Regulations provide taxpayers with an election to re-allocate a portion of general basket FTC carryforwards and OFL, SLL, and ODL recapture accounts to the foreign branch basket equal to the amount of FTCs that would have been allocated to the foreign branch basket if it had existed prior to 2018. Because of

the complexity associated with reconstructing the branch basket in prior periods, the Final Regulations provide computational safe harbors for each elective transition rule.

Separately, the Final Regulations relating to the apportionment of research and experimentation (R&E) expenses allow all taxpayers to elect between the sales and gross income methods in any year beginning after December 31, 2017, and before January 1, 2020, without regard to the prior regulations' limitation on switching methodologies. Doing so constitutes a binding election for the taxpayer's last tax year beginning before 2020 and the following four years.

Additional guidance under Sections 78, 901(j), 904(f) and (g), 954(b)(4), and 965

The Final Regulations include additional guidance with respect to the determination of FTCs in light of the "toll tax" under Section 965. Section 965(g) disallows a credit or deduction for the applicable percentage of foreign taxes paid with respect to E&P subject to the toll tax. The Final Regulations apply this disallowance to the applicable percentage of foreign tax paid (or deemed paid under Section 960(b)) on the distribution of Section 965(b) PTEP. The Final Regulations also limit the scope of Section 960(b), to prevent post-1986 foreign taxes not deemed paid in connection with the toll tax from being deemed paid as a result of the distribution of Section 965 PTEP.

The Act amended Section 78 to apply to all foreign taxes deemed paid under Sections 960(a), (b), or (d). The Final Regulations decline to exclude taxes deemed paid under Section 960(b) from the Section 78 gross-up.

Finally, the Final Regulations include definitional guidance relating to foreign taxes paid to certain countries under Section 901(j) and the subpart F high-tax exception under Section 954(b)(4), and clarify the eight-step OFL, SLL, and ODL recapture process under Treas. Reg. sec. 1.904(g)-3, all unrelated to the Act.

Observation: Several key provisions in the Final Regulations — such as the allocation of foreign taxes to FTC baskets, the definition and treatment of foreign tax redeterminations, and Section 965(g) FTC disallowance rules — differ little from the Prior Proposed Regulations but are subject to significant future revision in the New Proposed Regulations.

Highlights of the New Proposed Regulations

The New Proposed Regulations supplement the Final Regulations and provide important guidance with respect to other aspects of the new FTC regime, including: (1) the allocation and apportionment of creditable foreign taxes; (2) the allocation and apportionment of other expenses; (3) certain aspects of foreign tax redeterminations; and (4) other issues related to financial services income, loss recapture rules, foreign personal holding company income (FPHCI), the FTC disallowance under Section 965(g), and the FTC limitation for consolidated groups.

The following provides a high-level summary of key rules set forth in the New Proposed Regulations.

Allocation and apportionment of creditable foreign taxes

The New Proposed Regulations would generally consolidate the rules for allocating and apportioning creditable foreign income taxes into new Prop. Reg. sec. 1.861-20. Except as modified under the rules of an operative section (e.g., section 904), the new regulations would provide rules to associate foreign taxes to items of gross income for various operative provisions of the Code, including Section 904(d) basketing, Section 960 deemed paid FTCs, Section 965(g) FTC disallowance, and the allocation of partnerships' CFTEs under Section 704(b). The new rules set forth in Prop. Reg. sec. 1.861-20 are proposed to apply, when issued as final regulations, to tax years beginning after December 31, 2019.

The New Proposed Regulations generally follow the paradigm of Treas. Reg. sec. 1.904-6 of the Final Regulations: foreign taxes are generally associated with foreign gross income considered in determining the foreign tax base, which is characterized under U.S. tax principles and assigned to relevant separate categories for purposes of conducting the section 904 foreign tax credit limitation. The regulations also provide detailed rules for taxes attributable to base and timing differences, taxable year-end mismatches, disregarded transactions, nonrecognition transactions, and reverse hybrid entities.

Allocation and apportionment of other expenses

The New Proposed Regulations contain additional guidance for the allocation and apportionment of stewardship expenses, certain litigation payments, and R&E expenditures.

The regulations would require stewardship expenses to be allocated and apportioned based on the tax book value or adjusted tax book value of the taxpayer's stock assets (other than stock of affiliated corporations). The New Proposed Regulations would adopt the same rule for litigation payments (i.e., damages, prejudgment interest, and settlement payments) made in respect of investor claims regarding corporate negligence, fraud, or other malfeasance. A similar rule would apply for litigation payments in respect of events incident to the production of goods or provision of services (e.g., damages arising from industrial accidents), but based solely on the assets involved in the event. Product liability litigation payments would be allocated to the classes of gross income produced by the sales or services giving rise to the claim.

Significantly, in the case of R&E expenditures, Prop. Reg. sec. 1.861-17 would revamp the existing regulations by providing rules that would allocate deductions solely to the classes of gross income produced by resulting intangible property, thereby preventing R&E expenditures from being allocated to subpart F, GILTI, and PFIC inclusions. In addition, the New Proposed Regulations would eliminate the optional gross income method of apportionment, the direct allocation of legally mandated R&E expenditures, and the option to demonstrate increased exclusive apportionment. Importantly, while the rules of Prop. Reg. sec. 1.861-17, when issued as final regulations, would apply to tax years beginning after December 31, 2019, taxpayers that are on the sales method for tax years beginning after December 31, 2017, and before January 1, 2020, may rely on the rules set forth in Prop. Reg. sec. 1.861-17 if they apply them consistently (i.e., in 2018 and 2019).

With respect to insurance companies, the New Proposed Regulations would clarify that the term exempt income includes dividends for which a dividends received deduction (DRD) is allowed and tax-exempt interest, without regard to proration rules that reduce an insurance company's losses incurred based on DRDs or tax exempt interest. In addition, the New Proposed Regulations would provide deductions for life insurance reserves and that certain other amounts under Section 818(f) must be allocated and apportioned based on a separate-entity method, taking into account solely the items of the life insurance company that has the reserves.

The New Proposed Regulations also would extend the Specified Partnership Loan rules finalized in the Final Regulations to upstream partnership loans (i.e., loans issued by a partner to a partnership), clarify the application of the special rule under Treas. Reg. sec. 1.861-12T(f) with respect to capitalized, deferred, and disallowed interest expense, and treat guaranteed payments for the use of capital described in Section 707(c) similarly to interest deductions for purposes of allocating and apportioning deductions and for determining FPHCI under Section 954(c)(1)(E).

Foreign tax redeterminations

The New Proposed Regulations would take into account the Act's amendments to Section 905(c) to require all foreign tax redeterminations to be taken into account in the year to which the redetermination of foreign taxes relate. This rule would apply for purposes of determining foreign tax credits, the amounts of subpart F and GILTI inclusions and corresponding Section 78 gross-ups, and earnings and profits. Where the redetermined foreign taxes relate to pre-Act years, the regulations would also require adjustments to pools of post-1986 undistributed earnings and foreign income taxes.

In addition, the New Proposed Regulations contain rules regarding successor entities that require the redetermination of US tax liability to be made as if the foreign tax redetermination occurred in the hands of the original taxpayer (the person with legal liability for the tax in the relevant tax year to which the foreign tax redetermination relates), and notification requirements (such as through an amended return), which include modified filing requirements when there is no change to the taxpayer's US tax liability as a result of taking into account a foreign tax redetermination.

Other issues

The New Proposed Regulations would address a number of other FTC-related issues, including: adopting a consistent definition of financial services entity for purposes of FTCs, subpart F, and PFICs; coordinating and ordering loss recapture rules under Sections 91, 367(a), 904(f) and (g), and 1503(d); taking into account redetermined foreign taxes and foreign taxes conditioned on future distributions for purposes of the subpart F high-tax exception; clarifying how the principles of Treas. Reg. sec. 1.904-6 (including those related to timing differences) apply with respect to the FTC disallowance under Section 965(g); and providing rules for determining the source and FTC basket of consolidated net operating losses.

The takeaway

The Final Regulations provide needed guidance related to the mechanics of determining the FTC limitation under Section 904 (including the allocation and apportionment of expenses), the scope of the new foreign branch basket, the extent of deemed-paid FTCs with respect to subpart F and GILTI inclusions, certain aspects of foreign tax redeterminations, and other FTC issues.

The New Proposed Regulations provide additional important guidance related to the allocation and apportionment of various expenses (such as stewardship expenses and R&E expenditures), the treatment of foreign income taxes attributable to base and timing differences, retroactive adjustments for foreign tax redeterminations, and other FTC issues. Taxpayers should review and assess the impact of the provisions in the New Proposed Regulations and consider commenting on issues that Treasury should address.

The above-mentioned highlights are not an exhaustive list of the provisions in the Final and New Proposed Regulations. We expect to publish an in-depth Insight in the coming days.

See also

- PwC Tax Insight: [Treasury issues proposed rules related to foreign tax credits](#)
- PwC Tax Insight: [Preliminary highlights of the proposed foreign tax credit regulations](#)

Let's talk

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