Final and proposed foreign tax credit regulations: Additional analysis

December 20, 2019

In brief

Treasury and the IRS on December 2 released final regulations (the Final Regulations) under Sections 861, 901, 904, 905, 954, 960, 965, 986, and 988, and proposed regulations (the New Proposed Regulations) under Sections 704, 861, 904, 905, 954, 960, 965, 1502, 6227, and 6889. The Final Regulations are the first comprehensive binding administrative guidance with respect to the new foreign tax credit (FTC) regime following the enactment of the 2017 tax reform act (the Act). Of relevance to the Final Regulations, the Act limited the FTC for US corporate taxpayers by repealing the indirect credit under Section 902, amending the deemed-paid credit under Section 960, introducing two new FTC limitation baskets under Section 904, and modifying the treatment of certain foreign tax redeterminations under Section 905. (For prior coverage on the Act, refer to the 'See also' Section at the end of this Insight.)

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, and the extent of deemed-paid FTCs with respect to subpart F and global intangible low-taxed income (GILTI) inclusions. The Final Regulations confirm the possibility of incremental US tax for US shareholders of foreign subsidiaries that are subject to high foreign tax rates by apportioning expenses to net GILTI inclusions and also provide complex rules for categorizing and tracking foreign subsidiary stock and earnings.

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 and other expenses and certain aspects of foreign tax redeterminations.

The Final and New Proposed Regulations were published in the Federal Register on December 17, 2019. Varying effective dates apply to different provisions of the Final Regulations and of the New Proposed Regulations.

In detail

Background

In order to alleviate potential double taxation on foreign earnings previously taxed by a foreign government, US taxpayers generally may claim a direct credit for foreign taxes paid on such earnings, and US corporate taxpayers generally may claim an indirect credit for foreign taxes paid on the earnings of certain foreign corporate subsidiaries. Prior to the Act, US corporate taxpayers generally could claim an indirect FTC under Section 902 for foreign taxes paid by certain foreign subsidiaries, while Section 960 allowed a deemed-paid credit for foreign taxes that related to a subpart F inclusion.

In connection with the enactment of Section 245A, which permits domestic corporations to deduct the foreign-source portion of dividends, the Act repealed Section 902. While the Act generally permits US corporate taxpayers to continue claiming an FTC on foreign taxes deemed paid in connection with subpart F inclusions, it modified Section 960 to apply only to the extent the foreign tax is 'properly attributable' to such an inclusion.

Under Section 904, a US taxpayer's available FTC generally is limited to the foreign tax imposed on foreign-source taxable income in specific separate limitation categories ('baskets'). The Act introduced two new separate limitation baskets for foreign branch income and amounts includible in gross income as GILTI under newly enacted Section 951A.

Furthermore, a US corporate taxpayer is deemed to pay 80% of the foreign taxes paid by a foreign corporation on its income that ultimately is part of the shareholder's GILTI inclusion. While FTCs limited under Section 904 generally may be carried back one year and then carried forward 10 years, the Act denied the carryover provisions for foreign taxes attributable to a GILTI inclusion.

The Act also modified the treatment of interest expense by prohibiting it to be apportioned on the basis of the fair market value of assets, instead requiring taxpayers to apportion interest expense on the basis of the tax book value of the taxpayer's assets. Finally, the Act required taxpayers to account for all foreign tax redeterminations in the year to which the foreign taxes relate, rather than, in some circumstances, through prospective adjustments.

Accounting considerations

Tax law changes or interpretations are accounted for in the period in which the law is enacted or the guidance is issued, and these changes generally would be included in income from continuing operations from an intraperiod allocation perspective. Final and temporary regulations have the weight of law and, therefore, should be accounted for in the period in which they are issued. On the other hand, while proposed regulations are not yet enforceable, they can be indicative of current thinking by Treasury and the IRS and provide insight into positions expected to be taken during examination of tax returns, which then could have an impact on the assessment of tax positions. Companies will have to make a technical assessment of the sustainability of their tax positions and apply the guidance under ASC 740 to determine the impact on financial reporting.

The Final Regulations

Deemed-paid foreign tax credits under Section 960

Taxes properly attributable to subpart F or tested income

Section 960(a) deems a US corporate shareholder to pay the foreign income taxes that are 'properly attributable' to subpart F income of a controlled foreign corporation (CFC) with respect to which such shareholder recognizes an income inclusion. Similarly, Section 960(d) deems a US corporate shareholder to pay 80% of the 'inclusion percentage' of the foreign income taxes that are properly attributable to tested income taken into account in determining the shareholder's GILTI inclusion.

The proposed FTC regulations issued in December 2018 (the 'Prior Proposed Regulations') provided a framework for determining foreign income taxes that are properly attributable to subpart F or tested income. The Final Regulations retain this framework, which requires first dividing each CFC's current-year gross income, deductions, and taxes into income groups (e.g., tested income, foreign base company sales income, foreign base company services income, etc.) within

Section 904 categories, and then allocating and apportioning the foreign taxes paid or accrued by the CFC among such income groups.

As a general matter, the Final Regulations provide that foreign income taxes are only properly attributable to subpart F or tested income if such taxes are allocated and apportioned to subpart F or tested income and paid or accrued in the CFC's US tax year in which a subpart F or GILTI inclusion occurs. In that case only an amount of foreign taxes in proportion to the portion of the CFC's subpart F or tested income that is included in a US shareholder's gross income are treated as properly attributable to such income. The foreign income taxes that are allowed as deemed-paid foreign tax credits with respect to GILTI inclusions are, as noted above, further limited to 80% of the inclusion percentage of the CFC's foreign income taxes allocated and apportioned to the tested income group, in accordance with Section 960(d).

The Final Regulations confirm that the amount of foreign income taxes deemed paid under Section 960(a) with respect to subpart F inclusions is reduced to the extent that the US shareholder reduces its subpart F income by reason of a qualified deficit under Section 952(c)(1)(B). However, no similar adjustments apply to the application of the current-year E&P limitation or chain deficit rules of Sections 952(c)(1)(A) or (C).

The Final Regulations also confirm that no foreign income taxes are properly attributable to Section 956 inclusions under Section 951(a)(1)(B).

***Observation**:* The inability to claim FTCs with respect to Section 956 inclusions will increase taxpayers' reliance on the Section 956 regulations and therefore increase the importance of monitoring circumstances in which the Section 245A dividends received deduction (DRD) may be unavailable or limited (e.g., insufficient holding periods, hybrid deduction accounts, extraordinary reductions, etc.). As before the Act, taxpayers should continue to be cautious of situations in which Section 956 inclusions may be unintentionally triggered (e.g., through CFC guarantees of US shareholder debt).

Taxes imposed on distributions of previously taxed earnings and profits (PTEP)

Section 960(b) provides for deemed-paid FTCs with respect to Section 959(a) distributions of PTEP received by US shareholders, as well as Section 959(b) distributions of PTEP from lower-tier CFCs to upper-tier CFCs. Section 960(c) provides for adjustments to a US shareholder's Section 904 limitation in the year of receipt of a Section 959(a) PTEP distribution to allow for additional FTCs to be claimed for foreign taxes paid with respect to such PTEP distributions.

In order to effectuate these rules, the Prior Proposed Regulations would have provided that CFCs' PTEP and attributable taxes must be assigned to one of 10 PTEP groups within Section 904 baskets of annual PTEP accounts. Notice 2019-01, issued in December 2018 following the release of the Prior Proposed Regulations, proposed expanding the number of PTEP groups to 16; however, the Final Regulations consolidate certain of the PTEP groups described in Notice 2019-01 and therefore limit the tracking of PTEP to 10 groups per separate limitation category per year.

***Observation**:* Two of these PTEP groups refer to Section 245A(d), which denies an FTC for any foreign taxes paid or accrued with respect to a distribution for which a DRD is allowed under Section 245A. This may signal that future regulations could extend Section 245A(d) to foreign income taxes paid or accrued with respect to certain PTEP distributions, potentially on the basis that if Section 245A(d) applies to a subpart F inclusion then it should continue to apply to the related earnings until they are fully repatriated to the United States.

Consistent with the Prior Proposed Regulations, the Final Regulations confirm that the only foreign income taxes that result in deemed-paid FTCs under Section 960(b) are those foreign income taxes imposed solely by reason of the receipt of a distribution of PTEP (e.g., foreign dividend withholding taxes) and not, for example, taxes imposed on the distributing corporation. Taxes imposed on disregarded distributions similarly are not subject to Section 960(b), but may be considered properly allocable to subpart F income groups or tested income groups of the CFC treated as the payor of the tax and therefore eligible to be deemed paid by a corporate US shareholder under Sections 960(a) or (d). Additionally, the Final Regulations confirm that GILTI inclusions are treated in the same manner as subpart F inclusions for purposes of increasing a US shareholder's Section 904 limitation pursuant to Section 960(c) in the year that the US shareholder receives the associated PTEP distribution.

Base differences and timing differences

The Final Regulations finalize certain clarifications regarding the treatment of foreign income taxes imposed on items of income that do not constitute income for US federal income tax purposes ('base differences') as well as foreign income

taxes imposed on items of income that are recognized for US federal income tax purposes in a different US tax year ('timing differences') originally contained in the Prior Proposed Regulations.

The Final Regulations seek to narrow the definition of a base difference, providing that a base difference only arises when foreign law imposes tax on 'a type of item' that does not constitute gross income for US tax purposes. Separately, the Final Regulations confirm that foreign taxable income and income taxes attributable to base differences must be assigned to the residual income group at the CFC level, and therefore such taxes never can be claimed as deemed-paid FTCs.

As discussed further below, the New Proposed Regulations propose a new regulation section for allocating and apportioning foreign income taxes, including taxes imposed with respect to base and timing differences.

With respect to timing differences, the Final Regulations clarify that allocable foreign income taxes are allocated and apportioned to a CFC's relevant income groups for the US tax year in which the taxes are paid or accrued as if the foreign taxable income on which the tax is imposed was recognized under federal income tax principles in that same tax year.

In adding the new GILTI and foreign branch separate limitation categories, the Act changed the specific citation to general basket income. As a result, Section 904(d)(2)(H) provides that foreign taxes imposed with respect to base differences are assigned to the basket described in Section 904(d)(1)(B): the foreign branch basket. Although Treasury and the IRS received many comments asking them to correct what appears to be a mistaken cross-reference to the branch basket, and affirmatively allocate foreign taxes imposed with respect to a base difference to the general basket, they did not do so. Therefore the Final Regulations continue to allocate foreign taxes imposed with respect to base differences by reference to Section 904(d)(1)(B).

***Observation**:* The Final Regulations clarify that a foreign income tax imposed in a post-2017 US tax year with respect to income included in a CFC's foreign taxable income base in a pre-2018 year is assigned to the CFC's tested income group if the pre-2018 income would be tested income if recognized in the US tax year in which the foreign income tax was imposed. Under the Prior Proposed Regulations, it was unclear whether such taxes might be allocable and apportionable to CFCs' income groups for the US tax year in which the income was included (e.g., whether such taxes might be allocable and apportionable to income included under Section 965 and therefore no longer creditable).

Allocation and apportionment of expenses

Other than conforming to the Act's repeal of the fair market value method, the Prior Proposed Regulations did not alter the general framework for allocating and apportioning expenses that existed before the Act. Those regulations, however, contained targeted clarifications and 'anti-abuse' rules, such as the treatment of the Section 250 deduction in determining exempt income and assets. The Prior Proposed Regulations also contained detailed rules with respect to the characterization of CFC stock under an asset or modified gross income method that reflect the enactment of Sections 245A, 250 and 904(b)(4) The Final Regulations generally follow the Prior Proposed Regulations, with a few notable changes.

Downstream partnership loans

The Prior Proposed Regulations included a targeted rule for so-called 'specified partnership loans' -- loans to partnerships by a partner or a member of the same affiliated group as a partner. To the extent that a taxpayer's affiliated group took into account both the interest income and a distributive share of the interest expense with respect to a specified partnership loan, the proposed rule would have assigned the interest income to the same source and separate limitation category as the related expense, while also excluding that portion of the receivable from the taxpayer's interest apportionment asset base.

The Final Regulations retain the general rule for such arrangements, which are renamed 'downstream partnership loans.' The Final Regulations also clarify previously proposed anti-abuse rules extending the application of these provisions to certain back-to-back loans or loans made through CFCs, with additional clarification provided as to the adjustment of income items where the anti-abuse rules apply. For example, where a US shareholder partner has a subpart F inclusion attributable to an interest payment from a partnership in which it (or a member of its affiliated group) is a partner, the subpart F inclusion, rather than any interest income directly recognized by the US shareholder partner, is recharacterized to match the source and basket of the associated interest expense. Finally, the Final Regulations clarify that the downstream partnership loan rules do not create additional gross income, but apply solely to match existing income and

expenses related to such loans. As further discussed below, the New Proposed Regulations would provide similar rules to debt issued by a partner to a partnership.

CFC stock characterization

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, for purposes of characterizing the stock of a CFC in the various statutory groupings, the US shareholder of the CFC must use the same method (i.e., either the asset method or modified gross income method) that the CFC uses to apportion its interest expense.

In applying the asset method at the level of a debtor CFC (including for purposes of apportioning the CFC's interest expense among gross tested income and various subpart F income groupings), the Final Regulations clarify that the rules in Treas. Reg. sec. 1.861-12(c)(2) apply with respect to the stock of any lower-tier CFCs, such that, for example, the tax book value of such lower-tier CFCs is adjusted for lower-tier earnings and profits (and deficits therein). In addition, the Final Regulations differ from the Prior Proposed Regulations by requiring a CFC, in apportioning its interest expense under a modified gross income method, to consider the gross tested income (net of interest expense) of lower-tier CFCs. The Final Regulations do not change the long-standing rule that subpart F income of lower-tier CFCs is disregarded when applying the modified gross income method to apportion the interest expense of a debtor CFC.

Foreign branch category income

Source and character of income allocated in connection with disregarded payments

The Act created a new separate limitation category for foreign branch income. The Prior Proposed Regulations determined foreign branch income by reference to the books and records of a foreign branch, including certain payments that otherwise are disregarded for US tax purposes. The Final Regulations generally define foreign branch income consistently with the Prior Proposed Regulations.

Gross income attributable to a foreign branch that is not passive category income generally must be adjusted to reflect disregarded payments between a foreign branch and its foreign branch owner, and between foreign branches (the disregarded payment rule). The Final Regulations confirm the Prior Proposed Regulations' rule that the disregarded payment rule does not impact the source of a related item of regarded gross income, or whether an item of regarded gross income can be resourced under an applicable tax treaty, which is based on the language of the treaty and corresponding authorities. Therefore, the Final Regulations do not include special rules for determining the source and character of gross income that is reattributed under the disregarded payment rule.

Contrary to taxpayers' recommendations, the Final Regulations do not include a rule netting disregarded payments between a foreign branch owner and its foreign branches. Thus, when a disregarded payment is made between a foreign branch owner and a foreign branch, the payment must be allocated to gross income of the payor to determine the source and character of the amount that is reattributed. The Final Regulations, however, provide clarification on the ordering rule in the case of transactions involving multiple back-to-back disregarded payments between a foreign branch and foreign branch owner, and also clarify that when there is no disregarded payment between the foreign branch and its owner, disregarded payments between foreign branches have no effect.

Disregarded transfers of intangible property

Treas. Reg. sec. 1.904-4(f)(2)(vi)(D) (the intangible property rule) requires taxpayers to use the principles of Section 367(d) to impute payments, over time, for certain transfers of intangible property in disregarded transactions. Addressing the application of Section 367(d) principles to transactions involving the remittance of intangible property (as described in Section 367(d)(4)) between a foreign branch and its foreign branch owner, the Final Regulations provide that the foreign branch is treated as a separate foreign corporation. Thus, if a foreign branch remits Section 367(d)(4) property to its owner, the foreign branch is treated as having sold the transferred property under the principles of Section 367(d).

In response to comments, however, the Final Regulations narrow the intangible property rule. First, the rule does not apply to transfers that occurred before December 7, 2018 (Date Prior Proposed Regulations published in the Federal Register). Second, the final intangible property rule is not applicable to transfers by a foreign branch or foreign branch

owner that owns the intangible property transitorily (taking into account ownership by both the foreign branch owner transferor and any predecessor to the foreign branch owner), subject to certain limitations.

Special rule for certain disregarded payments

The Final Regulations clarify that for purposes of attributing income under the disregarded payment rule, disregarded payments that would be capitalized into amortizable or depreciable basis may give rise to adjustments in the year or years in which the amortization or depreciation deductions would be allowed if those payments had been regarded. The Final Regulations also provide further guidance on certain disregarded payments that would not be deductible if they were regarded, including rules concerning disregarded sales of property that reattribute gross income when basis would be recovered other than through depreciation, amortization, or other disregarded cost recovery deductions.

Foreign branch definition

The Final Regulations define a foreign branch as a QBU (as defined in Treas. Reg. secs. 1.989(a)-1(b)(2)(ii) and (b)(3)) that conducts a trade or business outside the United States. Under the Prior Proposed Regulations, activities conducted outside the United States that constituted a permanent establishment under an income tax treaty were presumed to meet the trade or business standard of the foreign branch definition. The Final Regulations expand this rule; rather merely creating a presumption, than provide that activities conducted outside of the United States that constitute a permanent establishment are deemed to meet the trade or business standard of the foreign branch definition. The Final Regulations also include a standard to construct hypothetical books and records when a foreign branch does not have a separate set of books and records.

Ordinary course of business exception

Under the Prior Proposed Regulations, the disposition of an interest in a pass-through entity (e.g., a partnership) would have been treated as occurring in the ordinary course of the foreign branch's active trade or business to the extent that the foreign branch engages in the same or a related trade or business as the partnership or other pass-through entity (other than through a less than 10-percent interest). The Final Regulations provide that this rule applies only when the foreign branch (1) owns 10 percent or more of the interests in the pass-through entity and (2) directly engages in the same, or a related, trade or business as that of the pass-through entity.

Items resourced under treaties

Under the Prior Proposed Regulations, Treas. Reg. sec. 1.904-6, which provides rules for the allocation and apportionment of taxes to separate limitation categories, would have allocated foreign income taxes to a separate category determined under Section 904(d)(6), which applies when a taxpayer elects the benefits of a treaty obligation to resource an item of income. The Final Regulations clarify that (1) taxes imposed by a third-party jurisdiction (i.e., foreign taxes paid to a foreign jurisdiction other than the treaty jurisdiction on an item of resourced income) and (2) gains, and foreign taxes on gains, that are subject to a separate limitation under Section 865(h) also are allocated in accordance with Section 904(d)(6) and the regulations thereunder.

Modifications to the FTC look-through rules

Distributive shares of partnership income

Former Treas. Reg. sec. 1.904-5(h) and the prior Prop. Treas. Reg. sec. 1.904-4(n) provided that a partner's distributive share of partnership income is characterized as passive income to the extent that the distributive share is a share of income earned or accrued by the partnership in the passive category. The Final Regulations retain this general rule in Treas. Reg. sec. 1.904-4(n)(1)(i). However, under the Prior Proposed Regulations, this general rule did not apply to a limited partner or a corporate general partner that owns less than 10 percent of the value in a partnership; rather, such partner's entire distributive share of income was assigned to the passive category. The Final Regulations modify this exception such that the exception no longer includes a corporate general partner that owns less than a 10-percent interest. In the preamble to the Final Regulations, Treasury and the IRS note that a corporate general partner's distributive share of income of the partnership should be characterized based on the income of the partnership, regardless of the corporate general partner's ownership threshold. Treasury and IRS further note that there is minimal administrative benefit to assign a less than 10-percent corporate general partner's income to the passive category rather than following the general rule that assigns the distributive share of income based on the income of the partnership.

Treatment of disallowed interest deductions

Section 904(d)(3)(C) places interest received or accrued from a CFC by a US shareholder in a separate basket to the extent that the interest is 'properly allocable' to income of the CFC in that basket. Treas. Reg. sec. 1.904-5(c)(2)(ii) provides for a four-step process for allocating interest paid or accrued by a CFC to a US shareholder. Clarifying the application of Treas. Reg. sec. 1.904-5(c)(2)(ii) when the interest expense is not allowed as a deduction at the CFC level, the Final Regulations provide that such four-step process is applied in the year the interest income is taken into account even if the interest expense is not actually deductible by the CFC in that year.

Foreign tax redeterminations

In 2007, and again in 2010, Treasury and the IRS issued temporary and proposed regulations governing the treatment of foreign tax redeterminations under Section 905(c). However, the temporary regulations expired before they were finalized. Then, in connection with its repeal of Section 902, the Act amended Section 905(c), to give effect to all foreign tax redeterminations in the year to which the taxes relate; by contrast; prior law accounted for certain redeterminations by way of prospective adjustments to the earnings and tax pools of certain foreign corporations.

The Final Regulations contain rules on foreign tax redeterminations that generally follow the approach of the 2007 temporary and proposed regulations, other than the use of prospective adjustments, which were eliminated by the Act. The Final Regulations also broaden the definition of a foreign tax redetermination and provide 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 were filed in the Federal Register (December 17, 2019).

Transition rules accounting for new separate categories

Carryovers and carrybacks of unused foreign taxes under Section 904(c)

The default rule under the Final Regulations is that excess foreign taxes attributable to pre-2018 general category income are carried forward in post-2017 years as general category income excess foreign taxes. The Prior Proposed Regulations, however, provided taxpayers with the ability to carry forward pre-2018 excess general category taxes into the foreign branch category in its first post-2017 tax year to the extent the taxpayer chose to reconstruct the portion of the excess taxes that would have been excess branch category taxes in pre-2018 tax years if the branch category had existed in such years.

The Final Regulations maintain the reconstruction alternative and add additional flexibility. Specifically, the Final Regulations provide a safe harbor that permits a taxpayer to allocate unused general category excess foreign taxes to the post-2017 separate category for foreign branch category income in the same proportion that the amount of foreign income taxes that were paid or accrued by the taxpayer's foreign branches bears to all foreign income taxes assigned to the general category that were paid, deemed paid, or accrued by the taxpayer with respect to the tax year in which the tax accrued. In the alternative, a taxpayer can choose to reconstruct those foreign taxes that would be excess branch category taxes in pre-2018 tax years if the foreign branch category existed during such years.

Separate limitation losses, overall foreign losses, overall domestic losses, and net operating loss carryforwards

Regarding the transition rules for pre-2018 losses, the default rule under the Final Regulations is that separate limitation loss (SLL), overall foreign loss (OFL), and overall domestic loss (ODL) accounts, as well as net operating losses (NOLs) attributable to the pre-2018 general category income, remain (or are recaptured/treated) in post-2017 years as general category income. However, the Prior Proposed Regulations would have provided that if a taxpayer chose to reconstruct its excess foreign taxes attributable to the foreign branch category (as discussed above), the taxpayer was required also to carry forward the same proportion of its SLL, OFL, and ODL accounts, as well as the portion of any NOL attributable to general category income to the foreign branch category. The Final Regulations change this alternative, however, and add an additional safe harbor.

With respect to a pre-2018 SLL or OFL account arising from a loss in general category income, or the portion of an NOL attributable to general category income, the taxpayer may choose to allocate a portion of such account to the foreign

branch category based on reconstructing that portion of the account or NOL that would have been attributable to the foreign branch category had the category existed in pre-2018 tax years. Similarly, with respect to an SLL or ODL account with respect to pre-2018 tax years that is with respect to losses that offset general category income, the taxpayer may carry forward such accounts with respect to foreign branch category income (and recapture the accounts as foreign branch category income) based on a reconstruction of the extent to which the losses in such accounts would have offset foreign branch income if that category existed in pre-2018 tax years.

As an alternative to the reconstruction method above, the Final Regulations provide a separate safe harbor method for each of the above described situations:

- In the case of a pre-2018 SLL or OFL account with respect to general category income, a taxpayer may choose to recapture such account from the first available income in the taxpayer's post-2017 general category income or foreign branch category income (or on a proportionate basis if such income exceeds the loss account).
- With respect to the portion of an NOL carryforward attributable to general category income, the taxpayer may choose to treat the NOL as attributable to general category income and foreign branch category income to the extent of any general category income and foreign branch category income, respectively, that is available in the carryforward year to be offset by the NOL carryforward.
- Finally, with respect to a taxpayer that chose either the reconstruction method or safe harbor method with respect to its pre-2018 excess general category taxes (discussed above), and has a pre-2018 SLL or ODL account that exists due to a prior reduction of general category income, the taxpayer may choose to recapture the balance in the loss account in subsequent tax years ratably as income in the taxpayer's post-2017 separate categories for general and foreign branch category income based on the proportion in which any unused foreign taxes in the pre-2018 separate category for general category income are allocated under the transition rules in Treas. Reg. secs. 1.904-2(j)(1)(iii)(A) or (B).

In relation to the transition rules above, the Final Regulations require a taxpayer either to apply the general carryover rule for all the accounts (or amounts) described above that exist, or to apply a special rule (i.e, reconstruction or safe harbor) for all such pre-2018 accounts (or amounts). If a special rule is chosen, the taxpayer may determine separately which special rule to apply to each account (or amount). A taxpayer may make the choice to apply a special rule on a timely filed original return or an amended return.

***Observation**:* The expansion of the transition rules provides taxpayers additional flexibility in considering how to treat excess taxes, recapture accounts, and NOLs related to general category income in post-2017 tax years. Because of the limitation of either applying the general rule or a special rule to all accounts (or amounts), taxpayers should assess the feasibility of choosing the reconstruction alternative and the impact of applying any safe harbor method (e.g., recapturing an OFL account out of any general category or foreign branch category income).

Other guidance

The Final Regulations clarify that the foreign income taxes taken into account for purposes of determining whether the Section 954(b)(4) 'high-tax' exception to subpart F income is satisfied with respect to an item of income do not take into account reductions that may occur as a result of future distributions to shareholders, unless such foreign income taxes are reasonably certain to be returned by the foreign taxing jurisdiction. The Final Regulations also finalize a rule proposed in 2012 to coordinate the recapture of OFL and SLL accounts in connection with the disposition of property with the general recapture ordering rules proposed in Treas. Reg. sec. 1.904(g)-3.

The Final Regulations also provide additional guidance with respect to Section 965(g), which provides that no FTCs are allowed with respect to the applicable percentage of foreign income taxes paid with respect to E&P subject to the Section 965 'toll tax.' The Final Regulations extend this disallowance to the applicable percentage of foreign taxes paid, including foreign taxes deemed paid under Section 960(b), upon distributions of Section 965(a) or Section 965(b) PTEP. Further, the Final Regulations provide that post-1986 foreign income taxes that were not deemed paid in connection with the toll tax cannot be claimed as deemed-paid FTCs under Section 960(b) in a later year when the resulting Section 965 PTEP is distributed. These rules apply to tax years of foreign corporations that begin after December 31, 2017, and end on or after December 4, 2018, and to tax years of US persons in which or with which such tax years of foreign corporations end.

The New Proposed Regulations

Allocation and apportionment of expenses

R&E expenditures

The New Proposed Regulations include significant proposed changes to the rules on the allocation and apportionment of R&E expenditures. The New Proposed Regulations would treat all R&E expenditures as allocable to 'gross intangible income,' which is defined as all gross income attributable to intangible property, including royalties, intangible property sales income, income from platform contribution transactions, and amounts taken into account under Section 367(d). Gross intangible income does not include dividends or any amounts included in income under Sections 951, 951A, or 1293. As a result, R&E deductions would not be apportioned to the GILTI basket.

The New Proposed Regulations would maintain the prior regulations' use of Standard Industrial Classification Manual Code (SIC code) categories, such that R&E expenditures are treated as definitely related to gross intangible income in a particular SIC code category (or categories).

Under the prior final regulations, the first step in allocating and apportioning R&E expenditures is allocating the expenditures for R&E that are undertaken solely to meet legal requirements imposed by a political entity and that cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside a single jurisdiction directly to gross income within that jurisdiction (the legally mandated R&E rule). The New Proposed Regulations would eliminate this step.

Under the prior final regulations, the second step is apportioning a fixed percentage of the R&E expenditures that remain after the first step to the jurisdiction where R&E activities are conducted that incur more than half of the R&E expenditures (the exclusive apportionment rule). The New Proposed Regulations maintain the exclusive apportionment rule, but only where R&E expenditures are apportioned for purposes of determining the Section 904 FTC limitation. Also, because, as discussed below, the New Proposed Regulations repeal the gross income method, exclusive apportionment applies to 50 percent of the taxpayer's R&E deductions.

Under the prior final regulations, the third step is apportioning the R&E expenditures that remain after the second step under either the sales method or the gross income method. The New Proposed Regulations would eliminate the optional gross income method. The sales method would be based on the gross receipts from sales and leases of products as well as services.

Under the sales method, the sales from a corporation controlled by the taxpayer are taken into account if the controlled corporation can reasonably be expected to benefit directly or indirectly from the taxpayer's research expense. Under the New Proposed Regulations, this includes a controlled corporation only if the taxpayer can be expected to license, sell, or transfer intangible property or transfer secret processes to that corporation. If a corporation controlled by the taxpayer has entered into a cost sharing arrangement (CSA) with the taxpayer for the purpose of developing intangible property, the controlled corporation is not reasonably expected to benefit from the taxpayer's share of the research expense. The New Proposed Regulations explicitly provide that a taxpayer's R&E expenditures do not include any expenditure that is not deductible by reason of the second sentence under Treas. Reg. sec. 1.482-7(j)(3)(i) (relating to a cost sharing transaction, as defined in Treas. Reg. 1.482-7(b)(1), owed to a controlled participant in a CSA). However, the New Proposed Regulations also provide that intangible development costs with respect to a CSA are not subject to this exclusion.

Treasury and the IRS requested comments on the following topics with respect to the allocation and apportionment of R&E expenditures:

- Whether a different classification method (e.g., North American Industry Classification System (NAICS)) is more appropriate to use
- Whether contract research arrangements reimbursed by a foreign affiliate are generally paid or incurred by the taxpayer in connection with its trade or business such that a deduction under Section 174 is allowable, and whether a special rule for such expenditures should be considered

***Observation**:* Many taxpayers will welcome the New Proposed Regulations because they would prevent the apportionment of R&E expenditures to the GILTI basket. However, R&E expenditures apportioned away from the GILTI basket may still reduce foreign source income, creating two potential risks that taxpayers will have to consider on an individual basis. First, a significant portion of many taxpayer's non-GILTI basket foreign source income is eligible for the Section 250 deduction for foreign-derived intangible income (FDII). Apportioning expenses to FDII may significantly reduce the benefit of the Section 250 deduction. Second, taxpayers with little foreign source income outside the GILTI basket may see R&E expenditures apportioned to other baskets that reduce the availability of FTCs in other baskets and potentially create a separate limitation loss that reduces GILTI basket FTC limitation.

Furthermore, the New Proposed Regulations articulate that R&E expenses should be allocated and apportioned to gross intangible income, such as royalty income received from a CFC that has licensed intellectual property from its US shareholder, and not to the Subpart F income or inclusion under Section 951A arising from income derived by the CFC from the exploitation of the licensed intellectual property that is included in the US shareholder's tax return. Based on this principle, and to create parity in operating models, Treasury and the IRS should consider whether the same principles should be applied to, for example, only the disregarded royalty paid by a foreign branch (and not the sales income arising from the exploitation of the intellectual property) that is reallocated from the foreign branch to a foreign branch owner under the foreign branch reallocation provisions.

***Observation*:** For several years, there has been some uncertainty regarding how amortization deductions arising from an election under Section 59(e) should be treated under Section 174 and the regulations allocating and apportioning R&E expenses. In this regard, **t**he New Proposed Regulations would provide a helpful clarification that R&E expenses include those expenses capitalized under Section 59(e) and amortized over 10 years.

Stewardship expenses

The New Proposed Regulations contain guidance for the allocation and apportionment of stewardship expenses. Under Treas. Reg. sec. 1.861-8(e)(4)(ii), stewardship expenses are allocable to dividends received or to be received from related corporations. Under the New Proposed Regulations, stewardship expenses would be allocable to dividends and inclusions received or accrued, or to be received or accrued, under Sections 78, 951, 951A, 1291, 1293, and 1296 from related corporations. Accordingly, stewardship expenses also would be allocated to Section 78 dividends and subpart F, GILTI, and passive foreign investment company (PFIC) inclusions.

Current Treas. Reg. sec. 1.861-8(e)(4)(ii) does not provide an exclusive method for apportioning stewardship expenses. Rather, the current regulations provide examples of permissible methods of apportionment, including comparisons of each related corporation's gross receipts, gross income, or unit sales volume, which taxpayers may use so long as such method does not result in substantially disproportionate results. Under the New Proposed Regulations, stewardship expenses would be apportioned based on the taxpayer's stock assets, which would be characterized in the same manner as for interest expense apportionment (i.e., the tax book value or adjusted tax book value of the taxpayer's stock assets other than stock of affiliated corporations).

In the preamble to the New Proposed Regulations, Treasury and the IRS signaled their intent to issue further guidance in this area. Particularly, Treasury and the IRS requested comments on the following topics:

Exceptions where stewardship expenses should be treated as definitely related to a more limited class of gross income

Certain cases where the allocation and apportionment of stewardship expenses should be made on a separate-entity, rather than an affiliated group, basis

The definition of stewardship expenses and how to readily distinguish such expenses from supportive expenses

Any additional changes to the rules for allocating and apportioning stewardship and similar expenses.

***Observation**:* By using the interest expense apportionment architecture to apportion stewardship, the New Proposed Regulations would remove all US source assets from most taxpayers' stewardship apportionment bases. This could cause most taxpayers' stewardship expenses to be apportioned solely to foreign source income. In addition, this will increase the importance of taxpayers appropriately characterizing stock assets for purposes of allocating and apportioning expenses.

Litigation payments

The New Proposed Regulations include new specific rules addressing the allocation and apportionment of litigation payments (i.e., damage awards, prejudgment interest, and settlement payments). The New Proposed Regulations would distinguish between three types of litigation payments: litigation payments arising from damages or injury related to a product or service (product liability litigation payments), litigation payments arising from damages or injury related to the production of products or provision of services (litigation payments from production or service provision related claims), and litigation payments arising from investor claims related to negligence, fraud, or other malfeasance (litigation claims from investor claims).

Product liability litigation payments would be allocable to the class of gross income produced by the specific sales of the products or services that gave rise to the claims for damage or injury. Litigation payments from the production of products or provision of services would be allocable to the class of gross income ordinarily produced by the assets used to produce the products or services that are involved in the event. Litigation payments from investor claims would be allocable to all income of the corporation. Apportionment would be made in the same manner as interest expense (i.e., on an asset basis).

Interest expense

As discussed above, the Final Regulations include downstream partnership loan rules addressing the source and separate category of interest income and expense related to loans to a partnership by a US person (or a member of its affiliated group) that owns an interest (directly or indirectly) in the partnership. The New Proposed Regulations would apply a similar rule to ‘upstream partnership loans’ (i.e., loans made by a partnership to a partner). Such rules would provide that, to the extent a borrower in an upstream partnership loan transaction takes into account both interest expense and interest income with respect to the same loan, the interest income would be assigned to the same statutory and residual groupings as those groupings from which the matching amount of interest expense is deducted (as determined under the allocation and apportionment rules in Treas. Reg. secs. 1.861-9 through -13). In applying the allocation and apportionment rules for this purpose, the New Proposed Regulations would also provide that the borrower would not take into account as an asset its proportionate share of the loan.

The upstream partnership loans rules would also extend to transactions that are not loans but that give rise to deductions that are allocated and apportioned in the same manner as interest expense under Treas. Reg. sec. 1.861-9T. Similar to the downstream partnership loan rules, the upstream partnership loan rules would also contain ‘anti-avoidance’ rules to cover back-to-back third-party loans that are intended to circumvent the purposes of the proposed rules. Treasury and IRS state in the preamble to the New Proposed Regulations that applying the downstream partnership loan rules to upstream partnership loans would reduce distortions that otherwise could affect the foreign tax credit limitation.

The New Proposed Regulations also would clarify the application of the special rule under Treas. Reg. sec. 1.861-12T(f) with respect to an asset in connection with which interest expense accruing during a taxable year is capitalized, deferred, or disallowed. Specifically, the proposed rule would provide that, in such instances, the value of the asset for allocation and apportionment purposes would be reduced by the principal amount of indebtedness the interest on which is so capitalized, deferred, or disallowed. For this purpose, assets would be considered ‘connected with debt’ only if using the debt proceeds to acquire or produce the asset causes the interest to be capitalized, deferred, or disallowed. Examples are provided in the New Proposed Regulations to illustrate the application of this proposed rule.

Lastly, the New Proposed Regulations would treat a partnership’s guaranteed payments for the use of capital (GPUCs) to its partners similar to interest payments for purposes of allocating and apportioning deductions and determining foreign personal holding company income. Treasury and the IRS state in the preamble to the New Proposed Regulations that because GPUCs are similar to a loan from a partner to a partnership (i.e., a downstream partnership loan) and raise the same policy concerns, the New Proposed Regulations explicitly treat GPUCs similar to interest deductions. This expansive treatment of GPUCs as interest equivalents mirrors the treatment of GPUCs under proposed regulations issued under Section 163(j).

The preamble to the New Proposed Regulations notes that Treasury and the IRS continue to study the rules for allocating and apportioning interest deductions, and that the future implementation of other code provisions (e.g., Section 864(f)) likely will necessitate a reexamination of the existing expense allocation rules. Accordingly, comments are requested with respect to potential future guidance on the allocation and apportionment of interest expense.

***Observation**:* The New Proposed Regulations generally leave the interest expense apportionment architecture unchanged but propose narrow technical rules to address perceived abuses.

Net Operating Losses

The Final Regulations provide that Section 904(b)(4) applies before application of the SLL and OFL rules in Section 904(f), as well as the ODL rules in Section 904(g). The New Proposed Regulations include a coordination rule with respect to the adjustments required under Section 904(b)(4) with the NOL provisions. Accordingly, for purposes of determining the source and separate category of an NOL, the SLL, OFL, and ODL rules would be applied without taking into account the adjustments required under Section 904(b). Treasury and the IRS indicated that the fact that the amount of an NOL eligible to be carried back or forward to another year under Section 172 is not affected by the adjustments required under Section 904(b) supports this approach.

Allocation and apportionment of foreign income taxes

Current Treas. Reg. sec. 1.904-6 provides that the allocation and apportionment of foreign income taxes to a Section 904 separate limitation category is made by reference to foreign law to determine the base upon which the foreign tax is imposed and by reference to US law to determine the character of that base (and taxes imposed thereupon).

The New Proposed Regulations would expand upon the general rule contained in Treas. Reg. sec. 1.904-6 in a new Prop. Reg. sec. 1.861-20. The New Proposed Regulations would provide that foreign income taxes are allocated and apportioned among the statutory and residual groupings in a three-step process. First, the items of gross income under foreign law ('foreign gross income') on which a foreign tax is imposed would be assigned to a grouping; second-deductions allowed under foreign law ('foreign law deduction') would be allocated and apportioned to the income based on foreign law (or the principles of the Section 861 regulations if there are no rules under foreign law); and, finally, foreign income taxes would be allocated and apportioned to the income (as determined after Step 2).

General rule

Prop. Reg. sec. 1.861-20(d)(1) would provide a general rule that the foreign gross income is assigned to a grouping by characterizing the item under US law. If an item of gross income or loss is recognized under US law from the same event that results in the recognition of foreign gross income (a corresponding US item), the foreign gross income is assigned to the same statutory or residual grouping as the corresponding US item. In the case of a corresponding US item that is an item of loss (or zero), the foreign gross income is assigned to the same grouping to which an item of gain would be assigned had the event given rise to an item of gain under US law.

Timing differences

The New Proposed Regulations also contain specific rules for assigning foreign gross income to a grouping if the taxpayer does not have a corresponding US item in the US tax year in which the taxpayer paid or accrued the foreign tax imposed on the foreign gross income, either because the event giving rise to the foreign gross income is a nonrecognition event under US tax law or the event giving rise to the foreign gross income does not result in the recognition of gross income or loss under US law in the same US tax year.

In both cases, the New Proposed Regulations would assign the foreign gross income to the grouping to which the corresponding US item would be assigned if the event giving rise to the foreign gross income resulted in the recognition of gross income or loss under US law in the same US tax year in which the foreign income tax is paid or accrued.

If foreign gross income is excluded from gross income under US federal income tax principles, and the transaction is not described as a base difference, the New Proposed Regulations provide that such income is assigned to the grouping to which the related income would be assigned if it was not excluded from US gross income.

Base differences

Under the New Proposed Regulations, if there is no corresponding US item because of a base difference, any foreign tax imposed on the base difference generally would be assigned to the residual grouping and for purposes of Section 904 would be assigned to the separate limitation category described in Section 904(d)(2)(H)(i). The New Proposed Regulations provide an exclusive list of seven events that result in a base difference: death benefits described in Section 101, gifts and inheritance described in Section 102, contributions to capital under Section 118, the receipt of property

described in Sections 1032 or 721, returns of capital under Section 301(c)(2), and distributions to partners described in Section 733.

Observation: The inclusion of an exclusive list of circumstances where a base difference will be considered to arise would provide clarity to an area that has been murky for many years. It is anticipated that comments will be provided with respect to the exclusive list, particularly with respect to the inclusion of the portion of a distribution that is considered a return of capital. Note that any foreign taxes imposed as a result of a transaction that is considered a base difference where a CFC is considered the taxpayer will not be able to be claimed as an indirect credit under Section 960.

Foreign law distributions and inclusions and reverse hybrid entities

The New Proposed Regulations contain special rules for distributions that both US and foreign law recognize, certain foreign law distributions such as consent and stock dividends, and inclusions under foreign law CFC regimes and from reverse hybrid entities.

In the case of a distribution from a corporation that is recognized as such for both US and foreign tax law purposes, foreign gross income arising from the distribution would be treated as a dividend, return of capital, or capital gain to the extent of the portions of the distribution that are treated as such under US tax law. The foreign gross income would be assigned to the same statutory and residual groupings as the corresponding amounts of dividend and capital gain as computed under US law. Foreign gross income arising from the portion of the distribution that is a return of capital under US law would be treated as a base difference.

If foreign (but not US) law recognizes a deemed distribution or consent dividend (a foreign law distribution), the foreign gross income would be assigned to a statutory or residual grouping by applying the proposed rule described above as though US law recognized the distribution as such in the year in which the taxpayer paid or accrued tax on the foreign law distribution.

If a taxpayer (including an upper-tier CFC) includes an item of foreign gross income by reason of a foreign law regime similar to the subpart F provisions under Sections 951 through 959 (a foreign law subpart F regime), that item would be assigned to the same statutory or residual grouping as the gross income of the foreign law CFC that gave rise to the foreign gross income.

Foreign gross income recognized from a reverse hybrid is assigned to the statutory and residual groupings by treating that foreign gross income as the income of the reverse hybrid and applying the general rules of Prop. Reg. sec. 1.861-20(d). Prop. Reg. sec.1.904-6(f), however, includes special rules assigning certain items of foreign gross income recognized by a US shareholder of a CFC that is a reverse hybrid to the Section 951A category (based upon the 'GILTI inclusion percentage') for purposes of applying Section 904. Comments are requested on the interaction of Prop. Reg. sec.1.904-6(f) with the Section 245A(g) DRD regulatory authority and the Section 909 splitter rules.

Observation: As currently drafted, Prop. Reg. sec. 1.904-6(f) does not appear to be effectively coordinated with Section 909 and does not appear to effectuate the intent of the rule as articulated in the preamble. The apparent intent of the rule is to have a US shareholder assign the US shareholder's inclusion percentage of its foreign taxes to the Section 951A category. However, because the rule only operates to assign the inclusion percentage of foreign gross income to the Section 951A category, the general operation of the rules in the New Proposed Regulations would appear to bifurcate the foreign taxes between the US shareholder's Section 951A category and general category income.

Disregarded payments and sales of a disregarded entity

If the foreign gross income arises from a disregarded payment made by a disregarded entity or other foreign branch, the New Proposed Regulations generally would assign the income to the statutory and residual groupings by deeming the payment to be made ratably out of the after-tax income of the foreign branch, computed for US tax purposes, and deeming the after-tax income of the foreign branch to arise in the statutory and residual groupings in the same ratio as the tax book value of the assets (including stock) owned by the foreign branch. If the foreign gross income arises from a disregarded payment made by a foreign branch owner, the item generally is assigned to the residual grouping. In the case of a disregarded payment arising from the disregarded sale or exchange of property, however, the foreign gross income would be assigned to the statutory and residual groupings under the general rule for timing differences (i.e., as if the sale or exchange resulted in the recognition of gross income or loss under US law in the US tax year in which the foreign tax is

paid or accrued). Importantly, for purposes of applying the above rules, the regulations expand the scope of the term 'foreign branch owner' to include a CFC, as appropriate.

If a taxpayer recognizes an item of foreign gross income that is gain from the sale of a disregarded entity, and US law characterizes the transaction as a sale of the assets of the disregarded entity, the foreign gross income is assigned to the statutory and residual groupings in the same proportion as the gain that the taxpayer would have recognized if foreign law also treated the transaction as a sale of assets.

Observation: The proposed rule assigning foreign taxes imposed on disregarded payments made by a foreign branch owner to a foreign branch appears overbroad in the context where the rule applies to a payment by a CFC. Specifically, Treasury and the IRS should consider treating the foreign tax imposed on a disregarded payment from a CFC to its branch (e.g., disregarded entity) that is deductible under foreign law in the same manner as the foreign tax is treated if it is imposed on a payment by the branch to the CFC.

Observation: The rule provided with respect to the treatment of foreign tax imposed on the sale of a disregarded entity appears intended to generally align the US tax treatment with the foreign tax treatment of a sale of stock rather than the underlying assets of a disregarded entity. However, where foreign tax is imposed on the sale of a disregarded entity based on an indirect transfer of a subsidiary of the disregarded entity, the foreign law gross income may actually be taxing the same asset as is taxed under US tax law. Treasury and the IRS may want to consider whether the application of this rule should be modified to take such situations into account.

Observation: Although the New Proposed Regulations generally follow the architecture of Treas. Reg. sec. 1.904-6 of the Final Regulations, they would provide several detailed and specific rules for various structures and transactions, based on their characterization under both US and foreign tax law. While most rules for allocating and apportioning foreign tax expense would be centralized in Prop. Reg. sec. 1.861-20, the New Proposed Regulations also contain special operating rules that modify the general allocation and apportionment for particular Code sections (e.g., Sections 904 and 960). This additional regulatory detail may provide more clarity to some circumstances, but also potentially could create significant complexity, while increasing taxpayers' compliance burden. Taxpayers should review the potential impact of these provisions in any circumstances where they pay or accrue material foreign tax.

Financial services entity

Section 904(d)(2)(D) defines financial services income as certain income earned by a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, which would be treated as passive basket income under general rules. Long-standing regulations only allow a financial services entity to earn financial services income. For this purpose, a financial services entity is defined as either (1) an entity if 80 percent of its income for the year falls into one of 25 categories of active financing income or (2) a member of an affiliated group that would meet the 80-percent test if it were a single entity.

The New Proposed Regulations would adopt a consistent definition of financial services entity for purposes of FTCs, subpart F, and PFICs. This would significantly narrow the scope of financial services entities. The Proposed Regulations also would provide a more limited rule for financial services groups, but it would only apply to affiliated groups that would satisfy the active financing requirements of Section 954(h)(2)(B)(i), not to groups that would qualify as financial services entities under any of the separate definitions for insurance companies.

Observation: Current law provides that certain passive income of a financial services entity is assigned to the general basket, and is excluded from deduction-eligible income that may qualify for the FDII deduction under Section 250. Given the significantly narrower scope of financial services entities in the New Proposed Regulations, taxpayers that do not qualify as financial services entities under the New Proposed Regulations could be required to allocate more income to the passive basket. However, the lack of financial services entity status also could mean that more income qualifies for the FDII deduction.

Life insurance company rules under Section 818(f)

Section 818(f)(1) provides that the deduction for life insurance reserves, policyholder dividends and death benefits, as well as certain other deductions (Section 818(f) expenses), are treated as items that cannot be definitely allocated to an item or class of gross income (but for an irrevocable election, which had to be made on or before September 15, 1985).

Therefore, when a life insurance company computes its Section 904 FTC limitation, its Section 818(f) expenses generally reduce its US source income and foreign source income ratably.

However, issues arise as to how to allocate and apportion Section 818(f) expenses if the life insurance company is a member of an affiliated group of corporations including both life and nonlife members (life-nonlife consolidated group) that join in filing a consolidated return. Treasury and the IRS noted that they were aware of at least five different ways in which the allocation and apportionment may be undertaken, including on a separate-entity basis, on a separate-entity basis after taking into consideration the effects of intercompany reinsurance transactions, on a single-entity basis (treating the entire life-nonlife consolidated group as a single entity), on a life sub-group basis, and based on a facts and circumstances analysis. After considering various comments with respect to these methods, Prop. Reg. sec. 1.861-14(h)(1) would adopt the separate-entity method.

At the same time, Treasury and the IRS are concerned that the separate-entity method could create opportunities for consolidated groups to use intercompany transactions to shift their Section 818(f) expenses and achieve a more desirable foreign tax credit result. Accordingly, they have requested comments on whether a life sub-group method would more accurately reflect the relationship between Section 818(f) expenses and the income-producing activities of the life subgroup as a whole, and whether the life sub-group method is less susceptible to abuse because it might prevent a consolidated group from inflating its Section 904 FTC limitation through intercompany transfers of assets, reinsurance transactions, or transfers of Section 818(f) expenses. The Treasury and the IRS also request comments regarding the appropriate application of Treas. Reg. sec. 1.1502-13(c) to neutralize the ancillary effects of separate-entity computation of insurance reserves, such as the computation of limitations under Section 904.

Observation: Taxpayers may have used a variety of methods to allocate the Section 818(f) expenses of one or more life insurance companies in a life-nonlife consolidated group. Companies should evaluate the impact of the proposed separate entity method on their Section 904 FTC limitation calculations. It appears from the preamble to the New Proposed Regulations that neither the single entity approach nor the facts and circumstances analysis have been favored by Treasury and the IRS. Affected companies should consider providing comments regarding the proposed method and the related requests, including with respect to intercompany reinsurance.

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 also would require adjustments to pools of post-1986 undistributed earnings and foreign income taxes.

In addition, the New Proposed Regulations would provide rules regarding successor entities that would 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.

Observation: The New Proposed Regulations would provide that both the increased FTC and the E&P reduction arising from a foreign tax redetermination occur in the same year (i.e., the year to which the redetermined foreign tax relates). This could produce collateral consequences, including impacting a taxpayer's toll charge under Section 965.

Consolidated groups

The New Proposed Regulations would update the existing consolidated return regulations to reflect changes in the FTC rules over the years, such as eliminating out-of-date references to the per-country limitation. In addition, the New Proposed Regulations would provide that the amount of foreign source income in each separate limitation category, used as the numerator in the Section 904 FTC Limitation fraction, is determined by applying the rules of Treas. Reg. sec. 1.1502-11, as well as Sections 904(f) and (g), on a group-wide basis, rather than applying those rules on a separate member basis and combining the results.

In addition, the New Proposed Regulations would provide new rules for purposes of determining the source and separate category of a consolidated NOL. The existing consolidated return regulations already provide detailed rules specifying

what portion of a consolidated NOL is allocated to a departing member. The New Proposed Regulations propose a new mechanism to determine what portion of that allocated loss is treated as domestic or foreign, which will affect how that departing member applies the OFL and ODL rules going forward.

***Observation*:** All the proposed separate-return rules in the New Proposed Regulations that affect sourcing (through allocation and apportionment of expenses) would implicitly affect 'static' consolidated return filers (that is, groups whose membership remains the same throughout the year) as well as 'dynamic' groups (with members joining and leaving).

The consolidated return rules of the New Proposed Regulation are proposed to affect years that will have already ended —i.e., to apply in tax years for which the original due date is after the final regulations are published in the Federal Register. This unique effective date rule is allowed under Section 1501, since affiliated groups that elect to file consolidated returns consent to be bound by regulations prescribed prior to the due date of their return. For instance, if the regulations are published in December 2020, the new rules would apply to consolidated return years that ended on September 30, 2020 (with a January 15, 2021 original due date) or later.

Observation: Since the proposed changes to the consolidated return rules affect the nature (foreign vs domestic source components) of consolidated NOLs allocated to departing members, these changes could affect dispositions that already will have closed, Consolidated groups engaged in M&A activity should take these proposed rules into account when drafting the tax provisions of their purchase and sale agreements.

Other issues

The New Proposed Regulations propose new guidance or clarifications with respect to other FTC issues. First, the New Proposed Regulations would clarify that additional income amounts recognized by reason of a branch loss recapture or dual consolidated loss (DCL) recapture are not taken into account until after ODLs, OFLs, and SLLs are determined, but nonetheless could trigger an ODL, OFL, or SLL recapture. For purposes of determining how much of the additional income with respect to a branch loss or DCL recapture would be subject to the ODL, OFL, or SLL recapture rules, any current-year increase to an ODL, OFL, or SLL account balance would be taken into account.

In addition, the New Proposed Regulations would exclude foreign income taxes that are contingent on future distributions of earnings in determining whether an item of income satisfies the Section 954(b)(4) high-tax exception, and also clarify that foreign tax redeterminations must be taken into account in the adjusted year for this purpose.

The New Proposed Regulations also would clarify that subpart F income resulting from the recognition of a prior-year's recapture account established under Section 952(c)(2) does not constitute a current-year item of income for purposes of assigning items to income groups and computing deemed-paid FTCs under Section 960.

Finally, the New Proposed Regulations would provide that foreign income taxes are considered attributable to a distribution of Section 965 PTEP (and therefore subject to the Section 965(g) partial disallowance of FTCs) if such taxes would be properly allocated and apportioned to a distribution of such PTEP, regardless of whether such a distribution actually is made or recognized. Thus, for example, an FTC would not be available for the applicable percentage of foreign income taxes imposed on a US shareholder with respect to a consent dividend or stock dividend attributable to Section 965 PTEP.

The takeaway

The Final Regulations provide needed guidance with respect to calculating the amount of foreign taxes that are treated as paid or accrued, the separate limitation categories with respect to which those taxes are allocable, and the extent to which a credit is allowed for those taxes. This guidance includes limiting FTCs with respect to GILTI inclusions, which can result in incremental US tax. The Final Regulations also provide complex rules for categorizing and tracking foreign subsidiary stock and earnings.

Taxpayers and their advisors should review the guidance carefully and model the effect of the new regulations to assess the impact of the final and proposed rules.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

International Tax Services

David Sotos
(408) 808-2966
david.sotos@pwc.com

Elizabeth Nelson
(202) 312-7562
elizabeth.nelson@pwc.com

Carl Dubert
(202) 414-1873
carl.dubert@pwc.com

Mergers and Acquisitions Tax

Dave Friedel
(202) 414-1606
david.b.fredel@pwc.com

Elizabeth Hall
(646) 818-7715
elizabeth.a.hall@pwc.com

Transfer Pricing

Greg Ossi
(202) 414-1409
greg.ossi@pwc.com