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# *Preliminary highlights of the proposed foreign tax credit regulations*

November 30, 2018

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## *In brief*

Treasury and the IRS have released proposed regulations (the Proposed Regulations) under Sections 78, 861, 901, 904, 954, 960, and 965. The Proposed Regulations, released November 28, are the first form of administrative guidance with respect to the foreign tax credit (FTC) regime following the enactment of the 2017 tax reform act ([the Act](#)). Of relevance to the Proposed 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, and modified the sourcing rules related to inventory and interest expense. (For prior coverage on the Act, refer to the ‘See also’ section below.)

The Proposed 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.

While PwC is in the process of reviewing the Proposed Regulations in detail, some of the key highlights we have identified thus far are set forth below. Look for our in-depth published Insight on the Proposed Regulations in the coming days. In addition, we will discuss the Proposed Regulations in an upcoming Tax Reform Readiness series webcast (details are forthcoming).

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## *In detail*

### **Background**

The Act introduced a new FTC regime by making significant changes to the FTC rules (*e.g.*, the repeal of Section 902, the addition of the Section 951A and foreign branch income categories, amendments to Section 960, and the addition of Section 904(b)(4)) and the applicable expense allocation and apportionment rules used in

determining the Section 904 FTC limitation (*e.g.*, the repeal of the FMV method of asset valuation for purposes of Section 864(e)(2)).

These changes complicated the FTC limitation calculation and raised a number of issues with regard to the interaction of the new FTC regime and other provisions enacted pursuant to the Act, including the new GILTI provision

under Section 951A. Furthermore, despite the extent and breadth of the changes to the FTC regime, the Act did not provide specific transition rules relating to the carry forward of excess FTCs from the general limitation basket.

(See our previous [PwC Insight](#) regarding relevant FTC provisions of the Act.)

### **Proposed regulations**

The November 28 release of the Proposed Regulations is the first form of guidance relating to the new FTC regime. Because of the overall need for guidance, the Proposed Regulations were highly anticipated for clarifying certain computational aspects of the new regime. The issues addressed by the Proposed Regulations can be placed into six broad categories of guidance, which relate to:

- (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, as well as the determination of the Section 78 gross-up amount
- (2) the determination of the FTC limitation, including rules relating to expense allocation and apportionment under Sections 861 through 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) transition rules relating to overall foreign loss (OFL), separate limitation loss (SLL), and overall domestic loss (ODL) accounts as well as to the carryover and carryback of unused foreign taxes
- (5) the Section 954(b)(4) high-tax exception, and
- (6) the application of the Section 965(n) election.

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

#### **Section 960 deemed-paid credits**

The Proposed 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 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 (by reference to foreign law) to subpart F or tested income, (2) if paid or accrued in the CFC's US taxable 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 Proposed Regulations provide that no foreign income taxes are properly attributable to Section 956 inclusions.

Section 960(b) and (c) generally provide FTCs and related FTC limitation for foreign income taxes imposed on distributions of previously taxed earnings and profits (PTEP). The Proposed 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 PTEP distribution. 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 Proposed Regulations also clarify that excess limitation accounts under Section 960(c) are available for Section 960(b) FTCs related to GILTI PTEP.

The denial of FTCs for Section 956 inclusions will increase the need to

apply the Section 956 proposed regulations before they are finalized 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).

#### **Section 78 gross-up**

The Proposed Regulations generally implement Section 78 as provided in the statute, with cross-references to clarify its application in the case of certain FTC limitations (e.g., Section 907(a)) or disallowances (e.g., Section 901(j)(3)). However, notwithstanding the Act's various effective dates and prior to any potential technical corrections, the Proposed Regulations provide that a Section 245A dividend received deduction is not available for Section 78 gross-up amounts occurring after 2017 but before the first tax year beginning after 2017.

#### **Expense allocation & apportionment and adjustments to FTC limitation**

As a general matter, the Section 904 FTC limitation takes into account certain allocated and apportioned expenses (e.g., applying the rules set forth in Sections 861 through 865 and the regulations thereunder for purposes of determining foreign source taxable income) and certain adjustments required pursuant to Section 904(b)(4) (i.e., adjustments to foreign source taxable income and worldwide taxable income).

The Proposed Regulations amend 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 changes made by the Act to Section 864(e) and Section 904. The Proposed Regulations also set forth rules relating to the application of Section 904(b)(4) for purposes of the FTC limitation.

**Observation:** Treasury and the IRS acknowledge that the expense apportionment and allocation rules under the Section 861 regulations may significantly reduce the Section 904(a) FTC limitation in the GILTI basket. This would be a particularly harsh result given that no carryforward of credits is allowed with respect to taxes in the GILTI basket. Thus, the Proposed Regulations provide for exempt income and exempt asset treatment under Section 864(e) with respect to income in the GILTI basket that is offset by the Section 250 deduction and a corresponding percentage of CFC stock that is characterized as a GILTI basket asset.

This rule generally provides taxpayers some relief with respect to the allocation and apportionment of US interest expense. Broadly, the Proposed Regulations would 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 the tax book value method or the modified gross income method.

Treasury and the IRS note that it expects to examine the apportionment and allocation rules for other expenses as well (e.g., R&E, stewardship, and G&A expenses).

In addition to modifying the Section 861 regulations, the Proposed 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). 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 FTC limitation in

Section 904 categories other than the Section 245A subgroup.

#### *GILTI basket*

The Act created a new basket for amounts includible under Section 951A (the GILTI basket). The Proposed Regulations narrowly define both the income and foreign taxes assigned to the GILTI basket. Generally, the only income included in the GILTI basket is a US shareholder's GILTI inclusion and the related Section 78 gross up. The proposed CFC look-through rules do not allocate interest, rents, and royalties received from CFCs to the GILTI basket. In addition, the Proposed Regulations limit the foreign taxes allocated to the GILTI basket to those taxes deemed paid under Section 960(d) or (b).

#### *Foreign branch basket*

The Act also created a new basket for business profits of a US person attributable to a foreign branch. The Proposed 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. The Proposed Regulations clarify that the branch income category is determined on an aggregate basis and not a branch-by-branch basis, and that only branches of a US person (as opposed to a branch of a foreign corporation) are within the definition.

In general, the Proposed Regulations provide that branch income does not include income arising from activities conducted in the United States, 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 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 Proposed 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 rules provided in the Proposed Regulations recognize the broad impact that the determination of foreign branch income can have not only on the FTC limitation but also the computation of amounts available for deduction under Section 250. In general, the Proposed Regulations adopt an approach of reallocating gross income to and from foreign branches and their owners based on how the deduction for such payment would be allocated and apportioned between US-source and foreign-source general category income under the principles of Treas. Reg. secs. 1.861-8 through -14T and 1.861-17 if the payment were regarded. Taxpayers will need to consider the impact of this approach in light of their current business flows. In some cases, taxpayers may need to seek resourcing of US-source income under an income tax treaty to utilize foreign taxes assigned to the foreign branch income category.

#### *Transition rules*

The Proposed Regulations generally maintain the basket of various attributes (e.g., foreign tax credit carryforwards, as well as OFL, SLL, and ODJ recapture accounts) carried forward from pre-2018 years. However, the Proposed Regulations provide taxpayers with an election to re-allocate a portion of general basket FTC carryforwards 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. A taxpayer making this election also must reassign a portion of its OFL, SLL, and ODL recapture accounts to the foreign branch basket.

Separately, the Proposed Regulations relating to the apportionment of R&E expenses allow all taxpayers to elect between the sales and gross income methods in their first post-2018 tax year, without regard to the prior regulations' limitation on switching methodologies.

*Additional guidance under Sections 901(j), 954(b)(4), and 965*

The Proposed Regulations include additional guidance with respect to the determination of FTCs in light of the 'toll tax' under Section 965. As with foreign income taxes imposed on distributions of Section 965 PTEP during tax years beginning before 2018 and claimed as credits under prior Section 960(a)(3), the Proposed Regulations disallow credits under new Section 960(b) for the applicable percentage of foreign income taxes imposed on distributions of Section 965 PTEP during tax years beginning after 2017. The Proposed Regulations also clarify how the Section 904 limitation is determined for the taxable year of the Section 965 inclusion when a Section 965(n) election is made.

The Proposed Regulations also 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), unrelated to the Act.

**Observation:** The Proposed Regulations provide detailed rules for determining the amount of PTEP, provide numerous groupings of such amounts into the three-tier system of Section 959, and provide the mechanics for determining the amount of foreign taxes deemed paid under Section 960(b) when such PTEP are distributed through a chain of corporations and foreign taxes are imposed on such distributions. However, the Proposed Regulations do not address the ordering of such PTEP upon a distribution by a CFC, which is important as foreign taxes considered properly attributable to various types of PTEP (e.g., Section 965 PTEP) are subject to special limitations. The Proposed Regulations request comments on the appropriate ordering of distributions, and provide that future guidance under Section 959 will address the ordering of distributions out of PTEP.

*Applicability dates*

The portion of the Proposed Regulations relating to statutory amendments enacted by the Act apply to taxable years beginning after December 22, 2017.

Other portions of the Proposed Regulations, which do not relate to the Act, apply to taxable years ending on or after the date the regulations are filed for public inspection in the Federal Register. Notably, certain portions of the Proposed Regulations include provisions that relate to the Act, as well as provisions that do not relate to the Act. In such instance, those regulations generally apply to taxable years that (1) begin after December 22, 2017, and (2) end on or

after the date the regulations are filed for public inspection in the Federal Register.

Special applicability dates apply to certain portions of the Proposed Regulations, including those that may impact a taxpayer's Section 965 determination.

In addition, a special applicability date is provided with respect to the portion of the Proposed Regulations relating to Section 78, which cause the second sentence of Prop. Reg. sec. 1.78-1(a) to apply to Section 78 dividends received after December 31, 2017, with respect to a taxable year of a foreign corporation beginning before January 1, 2018.

**The takeaway**

The Proposed Regulations provide needed guidance related to the mechanics of determining the use of FTCs in the context of significant new international tax rules that were enacted as part of the 2017 tax reform act. The above-mentioned highlights are not an exhaustive list of the provisions in the Proposed Regulations. Our in-depth Insight will be published in the coming days.

**See also:**

PwC Tax Insight: [Tax reform readiness: Implications of the Section 965 proposed regulations](#) (September 13, 2018)

PwC Tax Insight: [Republican tax bill will significantly impact US international tax rules](#) (December 21, 2017)

## **Let's talk**

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

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