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Report No. 1408  
February 5, 2019

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Re: *Report No. 1408 – Report on the Proposed Foreign Tax Credit Regulations*

Dear Messrs. Kautter, Rettig, and Paul:

I am pleased to submit Report No. 1408, commenting on the proposed regulations issued by the Internal Revenue Service and the Department of the Treasury modifying the determination of the foreign tax credit limitation under Section 904 in response to changes made to the foreign tax credit rules and related provisions by the legislation informally known as the Tax Cuts and Jobs Act of 2017 (the "Act").

The modifications of the foreign tax credit rules required in light of the extensive changes that the Act made to the overall system of US federal income taxation of foreign earnings are extraordinarily complex. We commend Treasury and the IRS for proposing rules that to a large extent

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implement adaptations of the foreign tax credit regime to the new laws. We discuss in the Report certain clarifications and modifications that we have identified to further the policies underlying the foreign tax credit regime.

We appreciate your consideration of our Report. If you have any questions or comments regarding our Report, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,



Deborah L. Paul  
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**New York State Bar Association Tax Section**

**REPORT ON THE PROPOSED FOREIGN TAX CREDIT REGULATIONS**

**February 5, 2019**

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## **I. Introduction**

This Report<sup>1</sup> comments on proposed regulations (the “Proposed Regulations”)<sup>2</sup> issued by the Department of Treasury (“Treasury”) and the Internal Revenue Service (the “IRS”) on December 7, 2018, modifying the determination of the foreign tax credit limitation under Section 904<sup>3</sup> in response to changes made to the foreign tax credit rules and related provisions by the legislation informally known as the Tax Cuts and Jobs Act (the “TCJA”).<sup>4</sup>

Part II of this Report provides a summary of our recommendations. Part III outlines the changes to the international tax rules of the Code under the TCJA as well as corollary changes to the foreign tax credit rules. Part IV contains a detailed analysis of the Proposed Regulations and the discussion of our recommendations.

The modifications of the foreign tax credit rules required in light of the extensive changes that the TCJA made to the overall system of US federal income taxation of foreign earnings are extraordinarily complex. We commend Treasury and the IRS for proposing rules that to a large extent implement adaptations of the foreign tax credit regime to the new laws. We discuss below certain clarifications and modifications that we have identified to further the policies underlying the foreign tax credit regime.

## **II. Summary of Recommendations**

### **A. Expense Apportionment**

- (1) Under the Proposed Regulations, for purposes of the CFC netting rule, hybrid debt issued by a controlled foreign corporation as defined in Section 957(a) (a “CFC”) will no longer be treated as related party indebtedness for purposes of determining excess related group indebtedness. We agree with that decision. In a related area, we note that in circumstances where a deduction for interest expense is disallowed under US tax law, pursuant to Temporary Treasury Regulations Section 1.861-12T(f)(1), this may result in foreign assets funded by such debt not being included for purposes of calculating the amount of interest

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<sup>1</sup> The principal authors of this report are Peter Connors and Ansgar Simon, with substantial drafting from Adam Kool and Jon Endean. Helpful comments were made by Kimberley Blanchard, Peter Blessing, Andrew Braiterman, Deborah Paul, Stephen Shay, Michael Schler, Andrew Solomon and Eric Wang. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee or the House of Delegates of the New York State Bar Association.

<sup>2</sup> REG-105600-18, 83 Fed. Reg. 63,200 (Dec. 7, 2018).

<sup>3</sup> Unless otherwise stated, all “Section” references are to the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>4</sup> The TCJA is formally known as “An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018,” Pub. L. No. 115-97.

which is allocated to foreign sources under Treasury Regulations Section 1.861-9. We recommend that consideration be given to narrowing the scope of this provision. See Part IV.A.2 below.

## **B. Transition Rules for Foreign Tax Credits**

- (2) The Proposed Regulations introduce an election to allocate excess foreign tax credit carryforwards from pre-TCJA years relating to the general category to the foreign branch income category to the extent they would have related to that category if the post-TCJA basketing rules had applied in the year the foreign income taxes were originally paid or accrued. We agree with the IRS and Treasury that general category excess credits should be allocable to the foreign branch income basket, but we believe that the approach taken in the Proposed Regulations is administratively challenging and could be unnecessarily burdensome for many taxpayers. We propose a simpler alternative. See Part IV.B.1 below.
- (3) The Proposed Regulations also provide transition year guidance for overall foreign losses and separate limitations losses, which generally follows the allocation of unused foreign taxes. However, we question why reallocation of these loss accounts should be tied to unused foreign tax carryforwards (if any) that appear otherwise unrelated to the loss. We recommend that Treasury and the IRS consider an approach that combines greater administrative convenience and a proper reflection of the fact that loss accounts relate to the reduction of foreign income, rather than foreign tax carryforwards. See Part IV.B.2 below.

## **C. Basketing under Section 904**

- (4) Business profits of a US person<sup>5</sup> that are attributable to a QBU (as defined below) are allocated to the foreign branch income basket. However, uncertainty exists about the definition of a QBU. Therefore, we recommend that the definition, including the definition a trade or business that gives rise to a QBU, be further clarified and illustrated by example. We also recommend additional guidance regarding the contours of the books and records requirement. See Part IV.C.1.a.(i) below.
- (5) A service partnership's provision of temporary services in a foreign country (for example, in connection with a specific project) might not give rise to a QBU with respect to the partnership's domestic partners in a case where no separate books and records are maintained. At the same time, foreign activities of the service partnership in another

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<sup>5</sup> A United States person (“US person”) is defined in Section 7701(a)(30) to comprise (1) citizens and residents of the United States, (2) domestic partnerships, (3) domestic corporations, (4) estates other than foreign estates and (5) certain trusts.



country may constitute a permanent establishment or otherwise give rise to a QBU. We believe that this creates an unwarranted distinction. We propose considering excluding a service partnership and individual owners of a service partnership from the application of the separate books and records requirement or, alternatively, clarifying that the requirement to maintain a separate set of books and records is satisfied with respect to the provision of services if the partnership providing the services or the service partner clearly identifies the source of the income by country. See Part IV.C.1.a.(ii) below.

- (6) In general, the Proposed Regulations rely on a foreign branch's books and records to measure foreign branch income for purposes of Section 904. We agree with that approach and recommend that the same approach be taken for both genuine branches and disregarded entities. See Part IV.C.1.b.(i) below.
- (7) In some cases there may be no books and records attributable to the foreign branch. This would generally be the case for deemed partnerships and joint ventures that do not exist as separate entities for commercial law purposes. For those cases, we recommend application of the well-established principles of Sections 864(c)(2), (c)(4) and (c)(5). See Part IV.C.1.b.(ii) below.
- (8) The Proposed Regulations generally take into account disregarded payments to the extent they appear on the books and records of a foreign branch or QBU. While we believe there is substantial merit in this approach, we are concerned that reassigning certain US source income to the foreign branch income basket without affecting the source of the payment does not properly match foreign taxes and foreign income. Further, the Proposed Regulations deviate from a books-and-records approach for payments of interest and interest equivalents between the owner and the QBU. We believe that this might create planning opportunities with respect to the foreign income taxes of the QBU. Accordingly, Treasury and the IRS should consider whether the general approach to books and records should be adopted with respect to interest and interest equivalents, and, if so, consider relying on existing anti-abuse provisions under Section 987 and the related Treasury regulations to avoid manipulations through debt and debt-like transactions between owner and QBU. Also, we recommend clarification of the treatment of transfers of intellectual property from a foreign branch to a foreign branch owner. See Part IV.C.1.b.(iii) below.
- (9) We doubt that inter-branch transactions should be taken into account for purposes of determining the foreign branch income basket on the basis that the Proposed Regulations address basketing, but not character or source. Inter-branch payments should therefore not affect the calculation of the foreign tax credit limitation. See Part IV.C.1.b.(iv) below.

- (10) The Proposed Regulations create a new category of section 951A income with respect to GILTI inclusions that are not passive income. Passive income does not include high-taxed income, which is allocated to a residual category. The example mentioned in the Proposed Regulations relates to income derived from a partnership interest of a limited partner or a corporate general partner that owns less than 10 percent of the value of the partnership. We recommend that in the case of a CFC, look-through to the underlying items of income, gain, loss and deduction of the partnership be available, in some cases on an elective basis, in other cases possibly on a mandatory basis. To avoid unwarranted planning where pass-through treatment is elective, we recommend that Treasury and the IRS consider a requirement that each United States shareholder (as defined in Section 951(b), a “US shareholder”) of a CFC treat a partnership interest held by a CFC on a consistent basis. See Part IV.C.2 below.

#### **D. Base Differences**

- (11) The Proposed Regulations intend to define base differences between foreign and US tax law narrowly and give two examples: life insurance proceeds and gifts, if they are taxable under foreign tax law. We recommend that the elements of a base difference be further elaborated. It would be helpful if Treasury and the IRS could provide additional examples to illustrate what a base difference is. See Part IV.D and also IV.E.4 below

#### **E. Timing Differences of Income Inclusions and the Accrual or Payment of Taxes with Respect to Section 960(a) and (d)**

- (12) The Proposed Regulations under Section 960(d) limit the deemed-paid foreign tax credit for tested foreign income taxes to foreign income taxes accrued, under general US federal income tax (“US tax”) principles, in the CFC’s tax year as determined for US tax purposes. The limitation to current year taxes can create mismatches when foreign taxes accrue in a different year than the year such taxes accrue under US tax principles. The effect of this mismatch is exacerbated by the fact that foreign income taxes relating to the Section 951A category income basket may not be carried forward or carried back, unlike other foreign income taxes. We recommend that Treasury and the IRS consider an approach that more closely attributes foreign income taxes to the foreign income on which they are imposed. See IV.E.1 below.
- (13) Mismatches can also occur in the case of subpart F inclusions for which Section 960(a) provides a deemed-paid credit. The Proposed Regulations take the same approach for foreign income taxes as with respect to Section 951A category income, and some of the results are irreversible under the regulatory framework of the Proposed Regulations, regardless of the fact that excess foreign tax credits with respect to general and passive category income may be carried back and forward under Section 904(c). We recommend

that Treasury and the IRS consider an alternative approach that more closely attributes foreign income taxes to subpart F income inclusions. See Part IV.E.2 below.

- (14) We further recommend that, if Treasury and the IRS were to retain their interpretation of the attribution of taxes to foreign income along the lines of the Proposed Regulations, the concept of a PTEP group tax (as defined below) of a CFC be expanded to include foreign income taxes that are not deemed paid by a corporate US shareholder of that foreign corporation under Sections 960(a) or 960(d) because of a lack of associated foreign income in the relevant Section 904 category. See Part IV.E.3 below.
- (15) The Proposed Regulations treat foreign taxes imposed on disregarded payments by a disregarded entity to its owner CFC as a timing difference. We recommend that final regulations clarify the scope and mechanism for allocating foreign taxes imposed on disregarded payments. See Part IV.E.4 below.

#### **F. Treatment of Foreign Taxes with Respect to Section 956 Inclusions**

- (16) Section 956 (relating to deemed income inclusions for investments by a CFC in United States property) was not repealed by the TCJA, even though this is on its face hard to reconcile with the overall approach of moving to a new territorial tax regime. The Proposed Regulations do not permit a credit for foreign taxes deemed paid with respect to an inclusion pursuant to Section 951(a)(1)(B) (i.e., the amount determined for a US shareholder under Section 956). We believe that consistency between Section 245A and Section 956 is a sensible policy, but we observe a tension between the approach of the Proposed Regulations and the language of Section 960(a). See Part IV.F below.

### **III. Background: Changes to the International Tax Rules of the Code and Related Changes to the Foreign Tax Credit Rules**

#### **A. Changes to the International Tax Provisions**

The TCJA made a number of changes to the international tax rules. New Section 951A gives rise to a separate regime under which a US shareholder<sup>6</sup> of any CFC<sup>7</sup> is required to currently include so-called “global intangible low-taxed income” (“GILTI”) determined with respect to all CFCs of which it is a US shareholder. New Section 250(a)(1) provides for a related deduction of generally 50% of the amount of GILTI and the amount treated as a dividend under Section 78 that

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<sup>6</sup> A US shareholder in Section 951(b) is any United States person that directly or indirectly, and actually or constructively owns 10 percent or more of the stock of a foreign corporation by vote or value.

<sup>7</sup> A CFC is defined in Section 957(a) as a foreign corporation if stock with more than 50% of the total vote or value of its shares is actually or constructively owned by US shareholders on any day during its taxable year.

is attributable to the GILTI inclusion to a domestic corporate US shareholder.<sup>8</sup> GILTI in effect represents a measure of returns from non-subpart F foreign income of CFCs in excess of 10 percent of investment in qualified business assets (consisting of depreciable personal property as defined in more detail in Section 951A(d)), aggregated over all CFCs of which the US person is a US shareholder. The GILTI regime provides for a type of minimum tax regime or add-on tax regime for such returns.<sup>9</sup>

Earnings of a CFC other than subpart F income and GILTI are generally exempt from US tax in the hands of a corporate US shareholder under new Section 245A. Section 245A allows a domestic corporate US shareholder a deduction equal to the foreign source portion of dividends made after December 31, 2017 by a “specified 10-percent owned foreign corporation,” which comprises CFCs and any other foreign corporation in which it is a US shareholder. The deduction is subject to a minimum holding period requirement (Section 246) and is disallowed for certain hybrid dividends. This exemption of foreign source dividends under Section 245A in effect changed the US tax system from a worldwide tax system with deferral to a mixed system of current inclusion (of GILTI and subpart F income) and limited territoriality with respect to the residual earnings.

To effect the transition from the prior system to the post-TCJA quasi-territorial system, US shareholders of CFCs with deferred unrepatriated earnings and profits were required under new Section 965 to effectively end deferral on those earnings and profits by including them (net of deficits in earnings and profits of other CFCs, if any) in income as subpart F income of the CFC for the last taxable year that begins before January 1, 2018.<sup>10</sup> The inclusion of net earnings that were previously unrepatriated is subject to US tax at a rate of 8 percent or, for earnings invested in liquid assets, 15.5 percent for a corporate US shareholder.<sup>11</sup>

On January 3, 2019, then-House Ways and Means Committee Chairman Kevin Brady introduced a draft of a “Tax Technical and Clerical Corrections Act” that, if enacted, would provide for technical, clerical, and deadwood-related corrections to recent tax legislation, including the TCJA.<sup>12</sup>

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<sup>8</sup> The GILTI provisions are discussed in New York State Bar Tax Section Report No. 1394 (May 4, 2018) (the “GILTI I Report”) and Report No. 1406 (Nov. 26, 2018).

<sup>9</sup> See GILTI I Report at 15-17.

<sup>10</sup> Section 965(a) and (b).

<sup>11</sup> Section 965(c).

<sup>12</sup> We will refer to the bill as the “2019 Technical Corrections Bill.”

## **B. Changes to Foreign Tax Credit Rules**

The foreign tax credit regime mitigates the potential double taxation of income from foreign sources by ceding primary income taxing jurisdiction to the country of source and unilaterally providing for a credit of such foreign income taxes against the US tax liability with respect to such income. The rules consist of (1) provisions that determine the amount of foreign taxes a taxpayer is considered to have incurred and for which it may claim a credit; and (2) rules for limiting the available foreign tax credit by (a) determining the amount of foreign source income with respect to which foreign income taxes are creditable and (b) limiting the credit separately for various categories of income. Under Section 904, the maximum foreign tax credit with respect to each category of foreign source income is equal to a fraction of (pre-credit) US tax liability that is equal to the ratio that the category of foreign income bears to the entire taxable income.<sup>13</sup>

### *1. Changes to the Determination of Deemed-Paid Foreign Income Taxes*

The TCJA repealed Section 902, which provided a “deemed-paid foreign tax credit” to a domestic corporation that received a dividend from a foreign corporation in which it owned at least 10 percent of the voting stock. The amount of the deemed-paid foreign tax credit bore the same proportion to all post-1986 foreign taxes of the foreign corporation (to the extent not deemed previously distributed with prior dividends) as the amount of the dividend bore to the undistributed post-1986 earnings and profits of the foreign corporation. Section 14301(a) of the TCJA repealed the deemed-paid credit regime of Section 902, because the new territorial regime under Section 245A in effect exempts the foreign-source portion of any dividend from a specified foreign corporation from US tax. In addition, new Section 245A(d)(1) disallows any foreign tax credit for any taxes paid or accrued with respect to an exempt dividend (generally foreign withholding taxes imposed with respect to such a dividend). It also disallows any deduction of such foreign taxes under Section 164 in lieu of a foreign tax credit.<sup>14</sup>

Before it was amended by the TCJA, Section 960(a)(1) provided that a corporate US shareholder is deemed to have paid a portion of the CFC’s foreign income taxes with respect to amounts of the CFC’s subpart F income and amounts described in Section 956 included by the US shareholder under Section 951(a)(1) as if the inclusion were a dividend to which Section 902 applied. Post-TCJA, Section 960 provides that if an “item of income” is included by a corporate US shareholder under Section 951(a)(1) with respect to a CFC (of which it is a US shareholder), then the shareholder is deemed to have paid an amount of the CFC’s foreign income taxes that is “properly attributable to such item of income.”

The TCJA also added a corresponding provision for GILTI inclusions, but limited the creditable foreign taxes to 80 percent of the “inclusion percentage” of the aggregate tested foreign

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<sup>13</sup> Section 904(a).

<sup>14</sup> Section 245(d)(2).

income taxes paid or accrued by the CFC.<sup>15</sup> The aggregate tested foreign income taxes in turn are the foreign income taxes paid or accrued by the foreign corporation that are “properly attributable” to the tested income of the CFC that is taken into account by the domestic corporate US shareholder under the GILTI regime.<sup>16</sup>

The legislative history suggests that the purpose of these changes was to impose a minimum combined tax on the income subject to the GILTI regime. As noted in the GILTI I Report, the strongest evidence pointing to the notion that Congress intended a flat-rate theory is that the conference report to the TCJA illustrates the operation of the GILTI provisions by showing how no residual US tax is owed if the foreign tax rate is at least 13.125 percent,<sup>17</sup> although this may have merely been intended as an illustrative rate.<sup>18</sup> The lower rate of tax combined with the more restrictive foreign tax credit rules under the GILTI regime are in contrast to the rules applicable to subpart F income which, while subject to immediate and full inclusion, has no limitations on the use of foreign tax credits, to the extent they are properly attributable to the items of subpart F income.

In the preamble to the Proposed Regulations (the “Preamble”), Treasury and the IRS reject the flat-rate theory of no GILTI tax if the foreign income tax rate is at least 13.125% on such foreign income on the grounds that Congress did not modify Section 904 or expressly provide for special treatment of expenses allocable to the section 951A category. The Preamble also points to the addition of Section 904(b)(4)(B) as supporting the view that Congress contemplated that deductions should be allocated and apportioned to the section 951A category.

Before its amendment by the TCJA, Section 78 provided that the foreign taxes deemed paid by shareholders under pre-TCJA Section 902(a) or Section 960(a)(1) were treated as a dividend for all purposes of the Code. This “Section 78 gross-up” for foreign taxes ensures that the foreign tax credit limitation under Section 904(a) is determined by reference to pre-tax foreign income. The TCJA amended Section 78 to reflect the changes to the above provisions: it applies to foreign taxes deemed paid under Section 960(a) and (d),<sup>19</sup> in the case of Section 960(d) without

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<sup>15</sup> Section 960(d)(1). The inclusion percentage is the ratio of (1) the amount of the GILTI inclusion by the US shareholder and (2) the aggregate amount of tested income, i.e., unreduced by any tested losses of any CFC. Section 960(d)(2) and Section 951A(c)(1)(A).

<sup>16</sup> Section 960(d)(3).

<sup>17</sup> H.R. Rep. No. 115-466, at 626-27 (2017) (Conf. Rep.) (the “Conference Report”) (“Since only a portion (80 percent) of foreign tax credits are allowed to offset US tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no US residual tax is owed by a domestic corporation is 13.125 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 13.125 percent, the total combined foreign and US tax rate on GILTI ranges between 10.5 percent and 13.125 percent.”).

<sup>18</sup> The quoted language is under the heading “Illustration of effective tax rates on FDII and GILTI.” *Id.* at 626.

<sup>19</sup> The reference to Section 960(b) in amended Section 78 appears to be a technical error. See 2019 Technical Corrections Bill §4(l)(1).

regard to the 80 percent limitation of the inclusion percentage of the aggregate tested foreign income taxes, and excludes the gross-up amount from dividend treatment for purposes of Section 245A. Amended Section 78 is effective for tax years of foreign corporations beginning after December 31, 2017 and tax years of domestic corporate US shareholders in which or with which such tax year ends.

## 2. *Changes to the Foreign Tax Credit Limitation*

The TCJA made changes that impact the calculation of the foreign tax credit limitation both with respect to the determination of foreign source income and the categories of income with respect to which the limitation is separately determined.

### a. *Determination of Foreign Source Income*

Under Section 862(b), foreign source income is determined by deducting expenses, losses, and other deductions properly apportioned or allocated to gross foreign source income, and a ratable portion of any expenses, losses and other deductions that cannot be definitely allocated to an item or class of gross foreign source income. Section 864(e) provides more specific rules regarding interest expense allocation. Section 864(e)(2) requires taxpayers to apportion interest expense on the basis of assets rather than income. Before its modification by the TCJA, Section 864(e)(2) gave taxpayers flexibility in determining the asset value in one of three ways: the tax book value, the alternative tax book value, or the fair market value method. A change from the fair market value method to the tax book or alternative tax book value methods, however, required approval from the Commissioner. As modified by the TCJA, Section 864(e)(2) now requires the allocation and apportionment of interest expenses under a single method, the adjusted basis of assets. There is no explanation of this change in the legislative history or the Joint Committee Report.

The TCJA further added Section 904(b)(4), originally as Section 904(b)(5),<sup>20</sup> which provides that, for purposes of determining the Section 904 limitations, the foreign source income and entire net income of any corporate US shareholder with respect to any specified 10-percent owned foreign corporation are calculated without regard to the foreign source portion of any dividend from the foreign corporation and any deductions properly allocable or apportioned to (i) income from stock of the foreign corporation (other than GILTI, subpart F inclusions and Section

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<sup>20</sup> Originally enacted as Section 904(b)(5) it was renumbered by Pub. L. No. 115-141, §401(d)(1)(D)(xiii), which repealed former Section 904(b)(4) as deadwood and renumbered Section 904(b)(5) as Section 904(b)(4), effective March 23, 2018. Its heading is “Treatment of Dividends for which Deduction is Allowed Under Section 245A.” The 2019 Technical Corrections Bill, if enacted, would change the heading to “Certain Income and Deductions with Respect to Stock of Specified 10-Percent Owned Foreign Corporations.” 2019 Technical Corrections Bill §4(mm)(34).

956 inclusions) or (ii) the stock of the foreign corporation to the extent income with respect to the stock is not GILTI, a subpart F inclusion or a Section 956 inclusion.

*b. Determination of the Section 904 Limitation*

The foreign tax credit limitation is determined separately for various “baskets” or categories of income. Before its modification by the TCJA, Section 904(d)(1) provided for two separate categories of income: passive category income and general category income. In addition, under 904(d)(6), the foreign tax credit limitation is separately determined for each item of income that a taxpayer elects to re-source from US source income to foreign source income under an income tax treaty with the United States, each giving rise to a “specified separate category.”<sup>21</sup> Two other resourcing provisions under the Code are Section 865(h) (gain from the sale of stock of a foreign corporation or certain intangibles that is re-sourced under a US income tax treaty) and Section 904(h)(10) (US income tax treaty re-sourcing of certain amounts derived by a US-owned foreign corporation). While income re-sourced under these provisions is not subject to the separate item-by-item limitation of Section 904(d)(6), the gain re-sourced under Section 865(h) gives rise to a specified separate category of income,<sup>22</sup> and 904(h)(10) re-sourced amounts are likewise subject to a similar “amount-by-amount” separate basket under Section 904(h)(10)(A).

The TCJA added two new separate categories of income: (1) the Section 951A category income basket as new Section 904(d)(1)(A), which comprises GILTI, but only to the extent the GILTI is not otherwise categorized as passive income; and (2) the foreign branch income basket as new Section 904(d)(1)(B), which comprises “the business profits of [a] United States person which are attributable to 1 or more qualified business units as defined in Section 989(a) in 1 or more foreign countries,” but likewise excludes passive category income.<sup>23</sup> Pre-TCJA Section 904(d)(1)(A) (passive income) and 904(d)(1)(B) (general income) were re-designated as Sections 904(d)(1)(C) and (D), respectively.

Section 904(d)(2)(H) provides that foreign taxes imposed on an amount that does not constitute income under US tax principles (generally referred to as a “base difference”) falls into the separate category described by Section 904(d)(1)(B). This cross-reference was not changed by the TCJA. As a result, foreign taxes related to amounts that are not income under US tax principles relate to the separate category of foreign branch income for taxable years beginning after December 31, 2017, but general category income for pre-January 1, 2018 taxable years. The 2019

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<sup>21</sup> Prop. Treas. Reg. §1.904-4(m). Other specified separate categories result from the application of Sections 245(a)(10) or 901(j) as well as Sections 865(h) or 904(h)(10) discussed below.

<sup>22</sup> Section 865(h)(1)(B).

<sup>23</sup> Section 904(d)(1)(B), Section 904(d)(2)(J).



Technical Corrections Bill would instead continue to assign foreign taxes imposed on an amount representing a base difference to the general basket.<sup>24</sup>

If there are excess foreign tax credits (“unused foreign taxes” under the Proposed Regulations) with respect to any basket, they may be carried back to the immediately preceding tax year of the taxpayer and then carried forward to each of the subsequent 10 tax years, where they can reduce residual US tax on foreign source income falling within the same basket. Unused foreign taxes may not be deducted under Section 164(a) in a carryback or carryforward year for which a taxpayer does not elect to credit foreign income taxes and instead deducts foreign income taxes. No carryback or carryforward is allowed for unused foreign taxes attributable to Section 951A category income (but it would be allowed for any foreign taxes attributable to GILTI that is passive category income).

A separate limitation loss (“SLL”) in a separate category for any taxable year reduces foreign source income in the non-loss separate categories on a proportionate basis.<sup>25</sup> To the extent the aggregate amounts of SLLs for any taxable year exceed the aggregate amount of separate limitation incomes for that taxable year, the excess reduces US source income.<sup>26</sup> If in a later year the taxpayer generates income from the SLL separate category, the income is recharacterized as income from the separate categories of income that the SLL previously reduced.<sup>27</sup> An overall foreign loss (“OFL”) for any taxable year – i.e., if for the taxable year the amount of deductions apportioned and allocated to foreign source income exceeds gross foreign source income – is recaptured in later years by recharacterizing foreign source income as US source income in whole or in part, thereby reducing the taxpayer’s foreign tax credit limitation in the later year.<sup>28</sup> The amount of the recaptured OFL is allocated to the separate categories to the extent of available foreign source income, and if the aggregate amount of maximum potential recapture in all overall foreign loss accounts exceeds the recaptured OFL it is allocated on the basis of the loss accounts’ maximum potential recapture for the taxable year of recapture.<sup>29</sup> An overall domestic loss (“ODL”) that reduces foreign source income is treated as reducing each separate category on a proportionate basis.<sup>30</sup> In subsequent taxable years, an ODL is recaptured by treating US source income as foreign source income in an amount equal to the lesser of the ODL or 50 percent of the taxpayer’s US

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<sup>24</sup> Section 6(b)(3) of the 2019 Technical Corrections Bill.

<sup>25</sup> Treas. Reg. §1.904(g)-3(d).

<sup>26</sup> Section 904(f)(5)(A) and (B).

<sup>27</sup> Section 904(f)(5)(C). For each category of income that was reduced by an SLL, the category of income with the SLL establishes a separate limitation loss account. SLL recapture will apply proportionately to the separate limitation loss account with respect to the SLL category (if the later year income in the separate category is not sufficient for complete recapture for all separate limitation loss accounts). Treas. Reg. §1.904(f)-8(a).

<sup>28</sup> Sections 904(f)(1) and (3).

<sup>29</sup> Treas. Reg. §1.904(f)-2(a), (c) and (d).

<sup>30</sup> Treas. Reg. §1.904(g)-3(b).

source taxable income.<sup>31</sup> The TCJA amended Section 904(g) by adding an election that permits a taxpayer to increase the 50 percent recapture limit up to 100 percent for unrecaptured ODLs that arose in taxable years beginning before January 1, 2018 and are recaptured in taxable years beginning after December 31, 2017 and before January 1, 2028.

The TCJA also changed Section 905, relating to redeterminations of foreign tax. Section 905 now provides that accrued foreign taxes that are not paid within two years after the end of the taxable year to which the taxes relate or are refunded after being paid are to be taken into account for the taxable year to which they relate. For pre-TCJA taxable years, Section 905 required that in these cases foreign taxes are taken into account when paid.

### **C. Outline of the Proposed Regulations**

The Proposed Regulations address (1) the allocation and apportionment of deductions under Sections 861 through 865 and adjustments to the foreign tax credit limitation under Section 904(b)(4); (2) transition rules for overall foreign loss, separate limitation loss, and overall domestic loss accounts under Section 904(f) and (g), and for the carryover and carryback of unused foreign taxes under Section 904(c); (3) the addition of new separate categories of income under Section 904(d) and related updates to the regulations under Section 904, including revisions to the look-through rules; (4) the calculation of the exception from subpart F income for high-taxed income under Section 954(b)(4); (5) the determination of deemed-paid credits under Section 960 and the gross-up under Section 78; and (6) the application of the election under Section 965(n). The provisions discussed in this Report are briefly outlined below

#### *1. Revisions to the Expense Allocation and Apportionment Rules*

The Proposed Regulations provide that Section 951A category income is subject to the general expense allocation rules. The portion of the GILTI inclusion that is offset by a Section 250 deduction, however, and a portion of the CFC stock giving rise to such portion of the GILTI inclusion are treated as exempt income and an exempt asset, respectively. The Proposed Regulations include rules for allocating and apportioning the Section 250 deduction. A corresponding rule is included for the portion of a domestic corporation's gross foreign derived intangible income ("FDII") as defined in Section 250(b), and assets that produce gross income that is FDII, respectively.

Under Proposed Regulations Section 1.861-8(d)(2)(ii)(C)(1), a portion of a domestic corporation's gross income that results from a GILTI inclusion (and the corresponding Section 78 gross-up) is treated as exempt income based on the amount of the Section 250 deduction allowed to the US shareholder under Section 250(a)(1). Similarly, the value of a domestic corporation's

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<sup>31</sup> Section 904(g)(1). The ODL account for each separate category is reduced ratably to the extent that the income is less than the total ODL carried forward. Treas. Reg. §1.904(g)-2(a).

asset (i.e., stock in the relevant CFC) that produces GILTI is reduced to reflect the fact that the income from the asset is treated, in part, as exempt. The provisions also apply to the domestic corporation's gross income that is included in FDII.

Changes were also made to the CFC netting rule. Under this provision, the foreign source income generated by a loan from a CFC will be reduced.<sup>32</sup> The formula for determining the amount of the reduction is based on several ratios. They contain special rules for hybrid debt. To the extent there are increases in both third-party indebtedness and related group indebtedness, a reallocation rule applies.

Treasury Regulations Section 1.861-10(e)(8)(vi) provides that, for purposes of applying the CFC netting rule of Treasury Regulations Section 1.861-10(e), certain related party hybrid debt (i.e., an instrument classified as debt for foreign tax purposes but equity for US tax purposes) is treated as related group indebtedness, but the income derived from the hybrid debt is not treated as interest income derived from related group indebtedness. As a result, no interest expense is generally allocated to income from the hybrid debt, but the debt may nevertheless increase the amount of allocable related group indebtedness for which a reduction in assets is required under Treasury Regulations Section 1.861-10(e)(7). The Proposed Regulations revise Treasury Regulations Section 1.861-10(e)(8)(vi) to provide that hybrid debt is not treated as related group indebtedness for purposes of the CFC netting rule. Proposed Regulations Section 1.861-10(e)(8)(vi) also provides that hybrid debt is not treated as related group indebtedness for purposes of determining the foreign base period ratio, which is based on the average of related group debt-to-asset ratios in the five prior taxable years, even if the hybrid debt was otherwise properly treated as related group indebtedness in a prior year.

## 2. *Transition Rules for OFL, SLL, ODL, and Excess Foreign Tax Credit Carryovers*

To effect the change to the new basketing rules, the Proposed Regulations provide transitional rules with respect to the carryover and carryback of excess foreign tax credits from pre-TCJA years.<sup>33</sup> Proposed Regulations Section 1.904-2(j)(1)(ii) provides that unused foreign taxes paid or accrued or deemed paid with respect to a separate category of income that are carried forward from a pre-TCJA taxable year to a taxable year beginning after December 31, 2017 are allocated to the same post-2017 separate category as the pre-TCJA separate category to which they relate. The Proposed Regulations contain an exception that permits taxpayers to assign unused foreign taxes in the pre-2018 separate category for general category income to the post-TCJA separate category for foreign branch category income to the extent they would have been assigned

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<sup>32</sup> Treas. Reg. §1.861-10(e).

<sup>33</sup> Prop. Treas. Reg. §1.904-2(j).

to that separate category if the taxes had been paid or accrued based on post-TCJA separate categories.

Taxpayers that have excess credits from post-TCJA taxable years are also permitted to carry back credits to pre-TCJA years. The Proposed Regulations provide that any unused foreign taxes with respect to general category income or foreign branch category income in a post-TCJA taxable year that are carried back to a pre-TCJA taxable year are allocated to the pre-TCJA general category income basket. Any excess foreign tax credits with respect to passive category income or income in a specified separate category in a post-TCJA taxable year that are carried back to a pre-TCJA taxable year are allocated to the same pre-TCJA separate category.

The Proposed Regulations also contain transition rules for recapture in a post-TCJA taxable year of an OFL or SLL from a pre-TCJA separate category that offset US source income, or income in another pre-TCJA separate category, respectively, in a pre-TCJA taxable year. They likewise provide rules for the recapture of an ODL that offsets income in a pre-TCJA separate category. Proposed Regulations Section 1.904(f)-12(j) provides that any SLL or OFL accounts in the pre-TCJA separate category for passive category income or income in a specified separate category remain in the same post-TCJA separate category. Any SLL or OFL account in the pre-TCJA separate category for general category income is allocated between the post-TCJA separate categories for general category income and foreign branch category income in the same proportion that any unused foreign taxes with respect to the pre-TCJA separate category for general category income are allocated to those post-TCJA separate categories. Therefore, a taxpayer that does not apply the exception described above for recharacterizing branch income will be required to treat all of its SLL or OFL accounts in the pre-TCJA separate category for general category income also as general category losses. In addition, if there are no unused foreign taxes in the pre-TCJA general category carried forward, the Proposed Regulations provide that all SLL or OFL accounts in the pre-TCJA separate category for general category income remain in the general category.

### *3. Revisions to the Foreign Tax Credit Limitation Rules*

Section 904(d)(1)(A) defines a new, separate category for amounts includible in gross income under Section 951A (other than passive category income). Consistently, Proposed Regulations Section 1.904-4(g) provides that the gross income included in the Section 951A category is generally the gross income of a US shareholder from a GILTI inclusion (directly or indirectly through a pass-through entity). The Proposed Regulations also provide that the Section 951A category income does not include any amounts under Section 951A(a) that are passive category income. In addition, a GILTI inclusion that is allocable to passive category income under the look-through rules in Regulations Section 1.904-5(c)(6) is excluded from Section 951A category income.

Proposed Regulations Section 1.904-4(f) provides rules for the foreign branch income category. Branches subject to this basket are QBUs of US persons, but the Proposed Regulations

do not include any foreign branch of a domestic pass-through entity, while allowing it to be a branch of the owner of an interest in the domestic pass-through entity. Foreign branch income includes (a) income attributable to foreign branches of the US person, held directly or indirectly through disregarded entities; (b) a distributive share of any partnership income that is attributable to a foreign branch held by the partnership, both directly or indirectly through disregarded entities, or held indirectly by the partnership through another partnership or other pass-through entity that holds the foreign branch directly or indirectly through disregarded entities; and (c) income from other pass-through entities determined under similar principles to that of partnerships. In accordance with Section 904(d)(2)(J)(ii), income assigned to the passive category is not foreign branch category income. The Proposed Regulations also make clear that the activities of a partnership that conducts a trade or business can constitute a foreign branch, even if it fails to maintain a separate set of books and records with respect to the activities that constitute the trade or business.

The Proposed Regulations provide special rules for disregarded transactions. Under these rules, gross income attributable to a foreign branch that is not passive category income must be adjusted to reflect certain transactions that are disregarded for US tax purposes. This rule applies to transactions between a foreign branch and its foreign branch owner, as well as transactions between or among foreign branches involving payments that would be deductible or capitalized if the payment were regarded for federal income tax purposes. For example, a payment made by a foreign branch to its foreign branch owner may, to the extent allocable to non-passive category income, result in a downward adjustment to the gross income attributable to the foreign branch and an increase in the general category gross income of the US person. The Proposed Regulations provide an exception from the special rules regarding disregarded transactions that applies to contributions, remittances, and payments of interest (including certain interest equivalents). The Proposed Regulations do not propose any special rules for determining the amount of deductions allocated and apportioned to foreign branch category income, including deductions reflected on the books and records of foreign branches.

#### 4. *Allocation and Apportionment of Taxes*

The rules governing the allocation and apportionment of foreign income taxes to and among categories of foreign source income have been amended by the Proposed Regulations.

In an apparent clerical error, Section 904(d)(2)(H)(i) provides for an allocation of foreign income taxes imposed on income that is not considered income for US tax purposes—a so-called base difference—to the foreign branch income basket. The Proposed Regulations provide that base differences arise only in limited circumstances. In contrast, a computational difference attributable to differences in the amounts, as opposed to the types, of items included in US taxable income and the foreign tax base does not give rise to a base difference. The Proposed Regulations provide that, in the case of a base difference, the income is allocated to the separate category described in

Section 904(d)(2)(H)(i), i.e., they follow the statutory allocation to the foreign branch income basket.

Proposed Regulations Section 1.904-6 also addresses foreign branches. As a general rule, foreign tax reflected on the books and records of a foreign branch is allocated based on general principles. When a disregarded payment from a foreign branch to the foreign branch owner results in a reallocation to general category income, any related withholding tax is likewise allocated and apportioned to the general category. For a reallocation of general category income to foreign branch income resulting from a disregarded payment from a foreign branch owner to its foreign branch, foreign income taxes imposed with respect to the reallocated income is accordingly allocated and apportioned to foreign branch income.

#### 5. *Income Re-Sourced Under a Treaty*

Section 904(d)(6) provides that any item of income that would be treated as derived from US sources absent any treaty obligation of the United States that permits the item to be re-sourced as foreign source income and that is in fact treated as derived from foreign sources by application of a US tax treaty, is subject to the foreign tax credit limitation rules (i.e., Sections 904(a), (b) and (c), and Sections 907 and 960) separately with respect to each item.

Under the Proposed Regulations, for purposes of allocating foreign income taxes to each separate grouping of Section 904(d)(6) income, the principles of Regulations Section 1.904-6 apply to allocate to the Section 904(d)(6) separate category all foreign income taxes related to the income included in that group, including taxes imposed by a third country.

#### 6. *Revisions to the Determination of the Deemed Paid Tax Credit Rules and the Section 78 Gross-Up*

The TCJA also made significant changes to the deemed-paid foreign tax credit provisions by repealing Section 902 and moving away from the pooling approach of relating foreign income taxes to a pool of foreign income. Instead, after the TCJA deemed-paid foreign tax credits are available (subject to general limitations) to the extent the taxes are *attributable* to an item of income.

The deemed-paid foreign tax credit with respect to subpart F income under Section 960(a) is determined in each subpart F income group with respect to a section 904 category (i.e., passive category income and general category income). The foreign income taxes properly attributable to an item of income are, under the Proposed Regulations, the corporate US shareholder's proportionate share of the current year taxes of the CFC that are allocated and apportioned to the subpart F income group within a section 904 category to which the item of income is attributable. No tax is deemed paid by a corporate US shareholder of a CFC with respect to a subpart F income group to which current year taxes of the CFC are allocated and apportioned (including by reason

of timing differences) if no portion of a subpart F inclusion is attributable to that subpart F income group.<sup>34</sup>

Similarly, the Proposed Regulations provide that tested foreign income taxes deemed paid by a corporate US shareholder under Section 960(d) are determined with respect to the tested income group within each applicable Section 904 category (i.e., passive category income and general category income). Tested foreign income taxes are properly attributable to the respective tested income group in proportion to the share of the CFC's current year taxes.

The Proposed Regulations take the view that an inclusion under Section 951(a)(1)(B) relating to Section 956 is not an inclusion of an item of income with respect to the CFC but is instead an inclusion of an amount determined under the formula in Section 956(a). Accordingly, the Proposed Regulations do not allow for a deemed-paid foreign tax credit under Section 960(a) with respect to an inclusion under Section 951(a)(1)(B).

Section 960(b)(1) provides that a domestic corporation that is a US shareholder of a CFC is deemed to have paid the CFC's foreign income taxes that the US shareholder has not previously been deemed to pay and that are properly attributable to a distribution from the CFC that the US shareholder excludes from its income under Section 959. Section 960(b)(2) provides a corresponding rule for distributions from CFCs. The Proposed Regulations establish a set of rules for determining the amount of taxes deemed paid when a US shareholder receives a distribution, based on attributable taxes paid or accrued by either the distributing CFC or a lower-tier CFC in a current or prior year.

Upon a distribution of previously taxed earnings and profits of a CFC, prior to the Act, under Section 960(b), the taxpayer's Section 904 limitation could increase. The Act redesignated former Section 960(b), without change, as Section 960(c). The Proposed Regulations treat a GILTI inclusion amount as a subpart F inclusion for purposes of Section 960(c). Therefore, the Proposed Regulations modify Regulations Sections 1.960-4 and 1.960-5 to reflect the additional application of Section 960(c) to GILTI inclusion amounts.

#### **IV. Discussion**

##### **A. Expense Apportionment**

The TCJA did not modify many of the existing expense allocation rules, which have been in place since 1988, and the Proposed Regulations generally apply the existing expense allocation regime to the new Section 951A category. The enactment of Section 951A and the resulting Section 951A category has a significant impact on a taxpayer's foreign tax credit limitation. A taxpayer may not carry back or carry forward unused foreign taxes relating to the Section 951A

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<sup>34</sup> Prop. Treas. Reg. §1.960-2(b).

category income basket, in contrast to unused foreign taxes relating to any of the other categories of income under Section 904(d). The adverse “bunching” effects of the inability to carry back or carry forward unused foreign taxes can be exacerbated by expense allocations to Section 951A category income.

*1. Section 250 Deduction As Tax-Exempt Income*

The TCJA added new Section 904(b)(4)(B), which, for purposes of determining taxable income from foreign sources and entire taxable income in the calculation of the foreign tax credit limitation, disregards foreign source dividend income from specified foreign corporations and deductions allocable to income with respect to stock in such corporations (other than amounts includible under Sections 951A(a) or 951(a)(1)) and deductions allocable to such stock (except to the extent that such stock produces amounts includible under Section 951A(a) or 951(a)(1)). In light of this statutory addition, and because the Section 250 deduction effectively exempts a portion of certain income, Treasury and the IRS determined that for purposes of applying the expense allocation and apportionment rules, gross income offset by the Section 250 deduction is treated as exempt income and the stock or other asset giving rise to that income is accordingly treated as a partially exempt asset. In contrast to the approach of Section 904(b)(4)(B), however, the Proposed Regulations remove the stock giving rise to the income offset by the Section 250 deduction from the asset base but do not remove any interest expense from the amount that gets apportioned among the US shareholder’s remaining assets.

We agree with the approach taken in the Proposed Regulations that treats stock in a CFC as a tax-exempt asset to the extent of the amount of the Section 250 deduction for purposes of allocating and apportioning expenses. Such an exemption generally has the effect of lowering the expenses apportioned to section 951A category income.

However, the effect of exempting Section 250 exempted income and the related assets giving rise to it will depend on the particular facts. While the Section 250(a)(1)(B) deduction percentage reduces the expense allocation to section 951A category income, the deduction under Section 250(a)(1)(A) with respect to FDII likewise gives rise to tax-exempt assets commensurate with the Section 250(a)(1)(A) deduction percentage and reduces the expense allocation to FDII. Further, because Section 250 allows for a deduction of 50 percent of GILTI, but only 37.5 percent of FDII (unless either is further limited by a net operating loss carryforward or an excess of deductions over non-GILTI and non-FDII gross income), a given amount of GILTI results in a greater reduction of expense allocation to Section 951A category income than the same amount of FDII. Depending on the amount of GILTI and FDII that a taxpayer has, the approach of exempting Section 250 exempted income and the related assets could in some circumstances lead to an increase in the expense allocation to section 951A category income.

As well, the approach may lead to an increase in the expense allocation to other separate categories of income, as shown in the following example:



### Example

A US corporation has \$1,000 of interest expense, \$1,000 of Section 951A category income and a related Section 250(a)(1)(B) deduction of \$500, \$1,000 of FDII and a related Section 250(a)(1)(A) deduction of \$375, US assets with a tax book value (“TBV”) of \$15,000 (of which \$10,000 relates to US source FDII assets) and CFC stock with TBV of \$15,000. The CFC wholly owned by the US corporation has \$1,000 of gross tested income, \$500 of subpart F income in the passive category income basket and no QBAI (within the meaning of Section 951A (d)). Assuming that the US corporation is not a US shareholder in any other CFC, it consequently has GILTI of \$1,000, an inclusion percentage of 100% and total worldwide assets of \$30,000. The CFC stock is characterized as \$10,000 Section 951A stock and \$5,000 passive category subpart F stock, and the US assets are residual US category assets.

Since Proposed Regulations Section 1.861-8(d)(2)(ii)(C)(1) applies both to assets that give rise to FDII and GILTI, a portion of the US assets and GILTI assets are treated as exempt under Section 904(b)(4)(B) for purposes of expense allocation because of Section 250. Thus, for apportioning interest expense of the US Corporation the impacts can be illustrated as follows:

#### Interest Expense Apportionment Impact on Section 951A Category Before Section 250 Exemption

- Interest Expense: \$1,000
- Section 951A Category Stock: \$10,000
- Worldwide Assets: \$30,000
- Interest Expense Apportioned to Section 951A Category Income:  
 $\$1,000 \times (\$10,000/\$30,000) = \$333$
- Net Section 951A Category Income: \$667 (i.e., \$1,000 – \$333)
- Net Passive Category Income: \$333 (i.e., \$500 – [ $\$1,000 \times (\$5,000/\$30,000)$ ])

#### Interest Expense Apportionment Impact on Section 951A Category After Section 250 Exemption on GILTI Only

- Interest Expense: \$1,000
- Section 951A Category Stock: \$5,000 (i.e., \$10,000 – \$5,000)
- Worldwide Assets: \$25,000 (i.e., \$30,000 - \$5,000)
- Interest Expense Apportioned to Section 951A Category Income:  
 $\$1,000 \times (\$5,000/\$25,000) = \$200$
- Net Section 951A Category Income: \$800 (i.e., \$1,000 – \$200)
- Net Passive Category Income: \$300 (i.e., \$500 – [ $\$1,000 \times (\$5,000/\$25,000)$ ])

#### Interest Expense Apportionment Impact on Section 951A Category After Section 250 Exemption on GILTI and FDII

- Interest Expense: \$1,000
- Section 951A Category Stock: \$5,000 (i.e., \$10,000 – \$5,000)
- FDII Asset: \$6,250 (i.e., \$10,000 – \$3,750)
- Worldwide Assets: \$21,250 (i.e., \$30,000 – \$5,000 – \$3,750)
- Interest Expense Apportioned to Section 951A Category:  
 $\$1,000 \times (\$5,000/\$21,250) = \$235$
- Net Section 951A Category Income: \$765 (i.e., \$1,000 – \$235)
- Net Passive Category Income: \$265 (i.e., \$500 – [ $\$1,000 \times (\$5,000/\$21,250)$ ])

In the example, exempting income and assets commensurate with the Section 250 deduction reduced the amount of interest expense apportioned to Section 951A category income as compared to no exemption. At the same time, it increased the relative fraction of assets for the other baskets, thereby in effect reducing the foreign tax credit limitation of other separate categories of income. In the example above, the approach increased the amount of interest expense allocated to another separate category income basket, passive category income, as compared to no exemption. We believe that this is the correct result and that the treatment of Section 250 as giving rise to partially exempt assets, in a consistent manner with respect to both GILTI and FDII, is a correct interpretation of Section 864(b)(3).<sup>35</sup>

## 2. *CFC Netting Rule*

The Proposed Regulations make changes to the interest allocation rules that are not based on TCJA legislative changes. One change, which we do not address in this Report, relates to the treatment of interest expense incurred on a partnership borrowing from a partner.<sup>36</sup> A second change relates to the so-called CFC netting rule.<sup>37</sup> Both rules are aimed at preventing taxpayers from manipulating the foreign tax credit limitation through the interest allocation rules.

The CFC netting rule is an anti-abuse provision that is aimed at preventing the generation of low taxed foreign source income through the creation of intercompany loans. For example, assume a US corporation borrows from a third party and lends to the US corporation's foreign subsidiary. Interest income from the loan to the CFC would be foreign source. However, absent the CFC netting rule, interest expense on the third-party loan would be allocated based on the US corporation's worldwide assets and would be only partially apportioned to foreign source income. Thus, the effect of the third-party borrowing and the intercompany loan would be to generate foreign source income that is only partially offset by interest expense that is allocated to it, thereby

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<sup>35</sup> We note that any allocation and apportionment of expenses to Section 951A category income will generally provide an incentive for a CFC to attempt to reduce its foreign tax rate to a rate below 13.125 percent in order to achieve a maximum effective tax rate on GILTI of 13.125 percent.

<sup>36</sup> Prop. Treas. Reg. §1.861-9(e)(8)(ii)

<sup>37</sup> Prop. Treas. Reg. §1.861-10(e)(8)(vi)

increasing the foreign tax credit limitation. In this way, the taxpayer could arguably manipulate its foreign tax credit limitation.

The CFC netting rules are intended to put the taxpayer in roughly the same position for purposes of the limitation as if the CFC had borrowed directly from the third-party lender by ignoring the US shareholder to CFC funding.

As described below, the CFC netting rules apply mechanically by comparing third-party borrowing ratios to related party borrowing ratios. When there is an increase in both third-party borrowing and related party indebtedness, a portion of the interest expense will be allocated against the foreign source income generated on the loan to the CFC. The assets that have been funded by the debt that generated the directly allocable interest expense are then eliminated from the calculation of worldwide assets for purposes of apportioning the US shareholder's remaining interest expense.

Application of the CFC netting rule turns on a comparison of the debt-to-asset ratios of the US corporation and that of related party indebtedness, referred to as "US shareholder indebtedness" and "related party indebtedness." The applicability of the CFC netting rule in any given year will depend on whether the taxpayer has both "excess related group indebtedness" ("ERGI") and "excess US shareholder indebtedness" ("ESI"). ERGI equals the amount by which related group indebtedness (average current-year loans to CFCs) exceeds allowable related group indebtedness (generally, the average current-year assets of CFCs multiplied by the average of the previous five years' ratios of average loans to CFCs to their average assets). If there is an increase in both ratios over a five-year period, a portion of the third-party interest expense is netted against foreign-source interest income from US shareholder loans. Furthermore, if the rules are triggered, then there is also an adjustment in asset values. This generally results in a reduction in the foreign income-generating assets of the US shareholder for purposes of apportioning remaining interest expense, which may be an advantage to a taxpayer seeking to reduce interest expense allocation to foreign source income.

In addition to applying to direct loans to a CFC, the CFC netting rules also apply to certain stock in a CFC. For example, they apply when an investment in a CFC is treated as debt for foreign tax law purposes but stock for US tax purposes, such as hybrid debt.<sup>38</sup> Similarly, the rules apply where the loan is made indirectly through a foreign subsidiary. For example, a US corporation, after borrowing from a third party, might make a capital contribution to a subsidiary in a low-taxed jurisdiction, which might, in turn, lend to a foreign subsidiary in a high-taxed jurisdiction. The

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<sup>38</sup> Prop. Treas. Reg. §1.861-10(e)(8)(vi).

loan made by the first CFC would be treated as a loan made by the US shareholder, and the loan is treated as related party indebtedness.<sup>39</sup>

Under the existing regulations, while related party hybrid debt is treated as related group indebtedness, the income derived from the hybrid debt is not treated as interest income derived from related group indebtedness. As a result, no interest expense is generally allocated to income from the hybrid debt, but the debt may nevertheless increase the amount of allocable related group indebtedness for which a reduction in assets is required under Regulations Section 1.861-10(e)(7). The Preamble<sup>40</sup> notes that this has a distortive effect on the general allocation and apportionment of other interest expense under Regulations Section 1.861-9. The Proposed Regulations revise Regulations Section 1.861-10(e)(8)(vi) to provide that hybrid debt is not treated as related group indebtedness for purposes of the CFC netting rule. Proposed Regulations Section 1.861-10(e)(8)(vi) also provides that hybrid debt is not treated as related group indebtedness for purposes of determining the foreign base period ratio, which is based on the average of related group debt-to-asset ratios in the five prior taxable years, even if the hybrid debt was otherwise properly treated as related group indebtedness in a prior year. The Preamble states that this is necessary to prevent distortions that would otherwise arise in comparing the ratio of a year in which the hybrid debt was treated as related group indebtedness to the ratio of a year in which the hybrid debt was not treated as related group indebtedness.

The distortive effect under Regulations Section 1.861-9 referred to in the Preamble appears to be the reduction in the taxpayer's foreign assets used in the ratio of foreign assets to worldwide assets. Since dividends from the hybrid debt are not treated as interest, it seems appropriate to us, consistent with the Proposed Regulations, that the hybrid debt should not be treated as related group indebtedness, as such hybrid debt should not result in a reduction in foreign assets for purposes of interest expense allocation.

It should be noted that a taxpayer could achieve the same result as that addressed by the Proposed Regulations without a hybrid debt instrument by instead engaging in CFC to CFC loans that are funded by shareholder contributions. As in the case of the hybrid debt, there is no interest income to the US shareholder on the relevant transactions, as interest income does not include dividends or subpart F inclusions from the lender CFC. Hence, the same distortion appears to arise.

Another aspect of the interest allocation rules merits revisiting. Temporary Treasury Regulations Section 1.861-9T(c)(1) provides that interest expense does not include interest that is permanently disallowed. Yet the interest may be fully deductible for foreign tax-law purposes if it is in a branch (and it will reduce earnings and profits if it is in a CFC). Assets funded by disallowed interest are reduced by Temporary Treasury Regulations Section 1.861-12T(f)(1). Thus, if the

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<sup>39</sup> Prop. Treas. Reg. §1.861-10(e)(8)(v)

<sup>40</sup> 83 Fed. Reg. at 63203 (Section I.D.).

stock of a CFC is funded with debt where the interest is repayable in stock for which the interest expense is disallowed under Section 163(l), the stock is not included in the assets to which interest expense is allocated. There are no regulations addressing when an asset is considered to be funded by debt. Taxpayers may take expansive views of how the concept of “funded” should be interpreted. This may include refinancings. Consideration should be given to narrowing the scope of this provision.

Finally, we make one general observation on the impact of the CFC netting rules in the post-TCJA era. Prior to the TCJA, the effect of the CFC netting rules was to require an increased allocation of interest expense to foreign source income in situations that would otherwise permit taxpayers to increase their foreign tax credit limitations in ways that were arguably abusive. We note that under the new regime, it is possible that taxpayers may find it advantageous to be within the application of the CFC netting rules. Although application of the CFC netting rules will generally continue to reduce taxpayers’ overall net foreign source income, the rules will in many cases shift interest expense to the general basket (which in many cases will consist primarily of low-taxed interest and royalty income) and away from the Section 951A category income basket (which in many cases will have excess credits). The full implications of the CFC netting rule post-TCJA have yet to be understood. If the Treasury and IRS undertake a broad review of the expense allocation rules, the continued impact and utility of the CFC netting rule should be considered, particularly in light of its complexity.

## **B. Transition Rules**

### *1. Carryovers of Excess Foreign Tax Credits from Pre-TCJA Taxable Years to Post-TCJA Taxable Years and Vice Versa*

The Proposed Regulations provide transition rules for the carryover of unused foreign taxes from pre-TCJA taxable years to Post-TCJA taxable years and for the carryback of unused foreign taxes from post-TCJA taxable years to pre-TCJA taxable years.<sup>41</sup> The unused foreign tax is, with respect to each separate category for any taxable year, the excess of the amount of creditable foreign tax paid or accrued, or deemed paid under Section 960 (or deemed paid under pre-TCJA Section 902), in that taxable year over the applicable foreign tax credit limitation under Section 904.<sup>42</sup>

The principal mismatch between pre- and post-TCJA categories is with respect to the pre-2018 general basket that was in effect split into the foreign branch income and the post-2017

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<sup>41</sup> Prop. Treas. Reg. §1.904-2(j)

<sup>42</sup> Prop. Treas. Reg. §1.902-2(c)(1). *See also* Treas. Reg. §1.904-2(b)(2).

general basket.<sup>43</sup> The general rule is that unused foreign taxes are carried back or forward to the same pre-2018 and post-2017 separate category.<sup>44</sup> Unused foreign taxes with respect to foreign branch category income from a post-2017 taxable year that are carried back to a pre-2018 taxable year are allocated to general category income. This would include unused foreign taxes relating to income included under the GILTI regime that is characterized as passive income, because the disallowance of carrybacks and carryforwards of unused excess foreign taxes relating to Section 951A category income does not apply to inclusions under Section 951A that are characterized as passive income.<sup>45</sup>

The Proposed Regulations contain an exception that permits taxpayers to elect to assign unused foreign taxes in the pre-2018 separate category for general category income to the post-2017 separate category for foreign branch category income to the extent they would have been assigned to that separate category if the taxes had been paid or accrued in a post-2017 taxable year (the “Re-Allocation Election”).<sup>46</sup> We believe that it is correct to provide for a carryforward to the foreign branch income basket because the pre-2017 general income basket corresponds to the combination of the baskets for general category income and foreign branch income for post-2017 tax years.

The Re-Allocation Election is administratively challenging, however, as it requires a taxpayer to reconstruct and partition the pre-2018 general income basket into foreign branch income and general income baskets by reference to the post-TCJA classification for prior tax years. The ten year carryforward under Section 904(c) exacerbates the complexity as the reconstruction of disregarded payments for up to 10 years preceding the first post-2017 tax year could be required.

We therefore recommend that a simplified alternative be offered, that provides administrative convenience and maps pre-2018 unused foreign taxes from the general category income basket to the post-2018 general category income basket by reference to a single year. It would be simplest for taxpayers to use the first post-2017 year as the reference year, as this would not require reconstruction of prior-year determinations and calculations. This approach should overall result in less distortion than the default rule. We acknowledge, however, that this approach may result in a potential for manipulation by taxpayers that have not yet closed their first post-2017 tax year. For taxpayers for which the first post-2017 year has not yet closed, the relevant

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<sup>43</sup> A “pre-2018” basket is a basket with respect to a taxpayer’s last taxable year that begins before January 1, 2018, and a “post-2017” basket is a basket with respect to a taxpayer’s first taxable year beginning after December 31, 2017.

<sup>44</sup> Prop. Treas. Reg. §1.904-2(j)(1)(ii) and (2)(ii). “Pre-2018 separate categories” are the separate categories of income for taxable years beginning before January 2018, and “post-2017 separate categories” are the separate categories of income for taxable year beginning after December 31 2017.

<sup>45</sup> Section 904(c). Prop. Treas. Reg. §1.904-2(a) would disallow a carryback or carryforward for Section 951A category income that is resourced under a treaty.

<sup>46</sup> Prop. Treas. Reg. §1.904-2(j)(1)(iii).

reference year could be the last pre-2018 taxable year. As tax returns are still in the process of being prepared, reconstruction of baskets using the post-TCJA categories for that year may be less challenging than it would otherwise be.<sup>47</sup>

We note that a simplified method should be chosen that does not allow for taxpayer planning activity. Further, if a simplified method is adopted, the Re-Allocation Election should no longer be available to taxpayers so that taxpayers cannot elect among various methods to maximize the utilization of unused foreign tax credits as the intent of the simplified method is to provide genuine administrative simplification.

We are aware that using only one year may lead to an over-allocation or under-allocation to the foreign branch income basket or the general income basket. But that is already the case under the Proposed Regulations if a taxpayer elects to allocate unused foreign taxes attributable to pre-2018 general category income in their entirety to the post-2017 general category income basket. Specifically, if a concern behind the TCJA's split-up of the old general category income basket into foreign branch income and general category income basket was that unused foreign taxes relating to generally higher taxed foreign branch income should no longer be available to benefit from an excess foreign tax credit limitation in the general category income basket *sans* foreign branch income (containing, e.g., foreign source royalty payments not subject to foreign withholding tax under an applicable US income tax treaty), then the existing transition rule should, in general, be more taxpayer-friendly than any of the elections.

If the Re-Allocation Election is maintained in final regulations, we believe that Treasury and the IRS should simplify the reconstruction of the general basket and we ask whether disregarded payments between a branch and its owner (including transfers of property described in Section 367(d)(4) subject to the rules of Section 367(d) and 482 under Proposed Treasury Regulations Section 1.904-4(f)(2)(vi)(D)) should have to be reconstructed.

## 2. *Overall Foreign Losses and Separate Limitation Losses*

The Proposed Regulations contain transition rules for recapture in a post-2017 taxable year of an OFL and of SLLs from a pre-2018 separate category that offset US source income, or income in another pre-2018 separate category, respectively, in a pre-2018 taxable year. They also provide rules for the recapture in a post-2017 taxable year of an ODL that offsets foreign source income in a pre-2018 separate category in a pre-2018 taxable year.

Proposed Regulations Section 1.904(f)-12(j) provides that any SLL or OFL accounts in the pre-2018 separate category for passive category income or income in a specified separate category

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<sup>47</sup> We have also considered a three-year averaging, but this would open a potential for manipulation if done by reference to post-2017 year, or require complex multi-year reconstruction of baskets if done by reference to pre-2018 tax years.

would remain in the same post-2017 separate category.<sup>48</sup> Any SLL or OFL account in the pre-2018 separate category for general category income would be allocated, on the first day of the first taxable year of the taxpayer that begins after December 31, 2018, to the post-2017 separate category of general category income, unless the taxpayer makes the Re-Allocation Election described above. If the Re-Allocation Election is made, the general category loss accounts would be re-allocated on the first day of the first taxable year beginning after December 31, 2018, between the post-2017 separate categories for general category income on the one hand and foreign branch category income on the other in the same proportion that any unused foreign taxes with respect to the pre-2018 separate category for general category income are allocated to those post-2017 separate categories. A taxpayer that does not have any unused foreign taxes in the pre-2018 separate category for general category income would be required to allocate the pre-2018 SLL or OFL account to the post-2017 separate category for general category income.<sup>49</sup>

It is not clear why the allocation of losses should follow the allocation of unused foreign taxes. SLL and OFL loss accounts in a separate category reflect that income in the separate category of the loss account was reduced by the SLL or OFL. A pre-2018 general category loss account in any separate SLL category, in other words, represents both foreign branch income and post-2017 general category income that was reduced. If the general principles of the OFL and SLL rules applied, the reduction would have been made ratably in the applicable pre-2018 taxable year.

However, an approach to reconstructing foreign branch income loss accounts and post-2017 general category loss accounts out of pre-2018 general category loss accounts, in a manner akin to the Re-Allocation Election, would be substantially more complex than the Re-Allocation Election. In addition, unlike the carryforward of unused foreign taxes, it would not always be limited to 10 years preceding the first post-2017 taxable year. We therefore do not believe that such an approach should replace the one proposed in the Proposed Regulations.

Re-allocating based on unused foreign tax carryforwards (if any), however, seems unrelated to the income that was initially reduced by the SLL. It also seems unnecessarily inflexible that, even if a Re-Allocation Election is made, no portion of the general category loss account can be re-allocated to a newly created foreign branch income loss account if there are no unused foreign taxes carried forward. We therefore recommend that Treasury and the IRS consider an approach that combines greater administrative convenience and a proper reflection of the fact that loss accounts relate to the reduction of foreign income.

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<sup>48</sup> Prop. Treas. Reg. §1.904(f)-12(j)(2)(i).

<sup>49</sup> Prop. Treas. Reg. §1.904(f)-12(j)(3)(i).



## C. Basketing under Section 904

### 1. Foreign Branch Income

Business profits of a US person (other than a partnership, according to the Proposed Regulations)<sup>50</sup> that are attributable to a qualified business unit within the meaning of Section 989 (a “QBU”) in a foreign country are allocated to a separate basket.<sup>51</sup> This excludes items of income that are passive category income under Section 904(d)(1)(C).<sup>52</sup>

Foreign branch income includes (a) income attributable to foreign branches of the US person held directly or indirectly through disregarded entities; (b) the distributive share of partnership income that is attributable to foreign branches held by the partnership directly or indirectly through disregarded entities, or held indirectly by the partnership through another partnership or other pass-through entity that holds the foreign branch directly or indirectly through disregarded entities; and (c) income from other pass-through entities determined under similar principles to that of partnerships. The Proposed Regulations also make clear that the activities of a partnership that conducts a trade or business can constitute a foreign branch, even if it fails to maintain a separate set of books and records with respect to the activities constituting the trade or business.<sup>53</sup>

Under the Proposed Regulations, certain transactions that are otherwise disregarded for US tax purposes are, solely for purposes of determining the foreign tax credit limitation, taken into account in order to “accurately reflect the gross income attributable to a foreign branch.”<sup>54</sup> Only foreign branch income is adjusted under this rule; passive category income by contrast is not.<sup>55</sup>

As drafted, this rule applies to transactions between a foreign branch and its foreign branch owner, as well as transactions between or among foreign branches involving payments that would be deductible or capitalized if the payment were regarded for US tax purposes. For example, a payment made by a foreign branch to its foreign branch owner may, to the extent allocable to non-passive category income, result in a downward adjustment to the gross income attributable to the

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<sup>50</sup> Prop. Treas. Reg. §1.904-4(f)(1)(i). Thus, the Proposed Regulations would not assign foreign source income of a domestic partnership’s QBU *ipso facto* to the foreign branch income basket. In the case of a partner that is an individual or corporate US person, the allocation to foreign branch income would be made at the partner level. But so would income of a QBU of a foreign partnership and it would not be excluded from foreign branch income by not being income of a US person. By contrast, a foreign corporation’s distributive share of the income of a domestic or foreign partnership could not be foreign branch income and therefore would not reduce, e.g., Section 951A category income. We agree with this clarification.

<sup>51</sup> Section 904(d)(1)(B).

<sup>52</sup> Section 904(d)(2)(J)(ii); Prop. Treas. Reg. §1.904-4(f)(1)(ii).

<sup>53</sup> Prop. Treas. Reg. §1.904-4(f)(3)(iii)(C)(2).

<sup>54</sup> 83 Fed. Reg. 63210.

<sup>55</sup> Prop. Treas. Reg. §1.904-4(f)(2)(vi).

foreign branch and an increase in the general category gross income of the US owner. The Proposed Regulations provide an exception from the special rules regarding disregarded transactions that applies to contributions, remittances, and payments of interest (including certain interest equivalents)<sup>56</sup> but do not propose any special rules for determining the amount of deductions allocated and apportioned to foreign branch category income, including deductions reflected on the books and records of foreign branches.

*a. Identification of QBUs*

*(i) In General*

A foreign branch is defined for purposes of Section 904(d)(1) and the Proposed Regulations as a QBU within the meaning of Section 989(a), which is a “separately and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records.”

There is no meaningful legislative history to guide taxpayers in applying this provision. Some have suggested that the provision was aimed at taxpayers that used royalties to increase their general basket limitation. Others have suggested that this provision merely reflects some disfavor toward branches. The General Explanation of the TCJA by the Joint Committee of Taxation illustrates application of the provision by reference to an example involving a domestic corporation that has a foreign branch.<sup>57</sup>

Proposed Regulations Section 1.904-4(f)(3)(iii) defines “foreign branch” by reference to existing guidance under Treasury Regulations Section 1.989(a)-1(b)(2)(ii) and (b)(3). Accordingly, a set of activities generally constitutes a foreign branch where three requirements are satisfied:

- (1) the activities constitute a trade or business (as determined under Section 162 principles),<sup>58</sup>
- (2) a separate set of books and records is maintained with respect to the activities,<sup>59</sup> and
- (3) such trade or business is conducted outside the United States.<sup>60</sup>

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<sup>56</sup> Prop. Treas. Reg. §1.904-4(f)(2)(vi)(C).

<sup>57</sup> See Joint Committee on Taxation, *General Explanation of Public Law 115-97*, JCS-1-18 (December 2018), at 395-96.

<sup>58</sup> Treas. Reg. 1.989(a)-1(b)(2)(ii)(A); Treas. Reg. 1.989(a)-1(c).

<sup>59</sup> Treas. Reg. 1.989(a)-1(b)(2)(ii)(B).

<sup>60</sup> It appears that the Proposed Regulations intend that the rules of Treas. Reg. 1.989(a)-1(c) are to be applied in determining whether a set of activities constitutes a trade or business for these purposes .

In determining whether these factors are satisfied, any activity that produces income or loss that is, or is treated as, effectively connected with the conduct of a trade or business within the United States is not taken into account.

Notwithstanding the general requirement that a set of activities maintain a separate set of books and records to qualify as a foreign branch, the Proposed Regulations also make clear that the activities of a partnership that conducts a trade or business outside the United States can constitute a foreign QBU even if it fails to maintain a separate set of books and records with respect to the activities that constitute the trade or business.<sup>61</sup> On the other hand, the Proposed Regulations indicate that activities carried out outside the United States that constitute a permanent establishment under the terms of an applicable US income tax treaty are presumed to constitute a trade or business conducted outside the United States,<sup>62</sup> but the existence of a permanent establishment outside the United States does not conclusively give rise to a trade or business outside the United States for purposes of the foreign branch income rules.

Taxpayers regularly enter into transactions in which it is not always clear whether a partnership for tax purposes has arisen, such as collaboration agreements.<sup>63</sup> In an agreement of this sort, foreign start-up company A and domestic established pharma company B may enter into a collaboration agreement to develop, manufacture and commercialize a potential product discovered by A that would address one or more disorders (some yet to be determined) and diseases. B will for this purpose advance funds to A for the continued research and development, and for application for a variety of initial approvals to advance to various test phases, and additional payments may be made at a later time.

It is not always clear whether a collaboration agreement of this kind gives rise to a separate deemed partnership between the collaborating companies; under the Proposed Regulations, it is in addition not clear whether the activities of the deemed partnership could then be treated as a QBU. This potentially gives taxpayers flexibility to structure in a manner that categorizes foreign source income, e.g., royalty income or sales income, as foreign branch income or general category income, if a trade or business is conducted in a foreign country.

We recommend that the QBU standard as well as the trade or business standard be further clarified. Consideration should be given to the temporary regulations under prior Section 367(a)(3). While former Section 367(a)(3) was repealed by the TCJA,<sup>64</sup> the temporary regulations issued under that section offer a useful standard for foreign branch status. Similar to the standard applied in Treasury Regulations Section 1.989(a)-1(c), they require an “integral business” and a

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<sup>61</sup> Prop. Treas. Reg. §1.904-4(f)(3)(iii)(C).

<sup>62</sup> Prop. Treas. Reg. §1.904-4(f)(3)(iii)(A).

<sup>63</sup> See CCA 201323015 (collaboration agreement gives rise to partnership for US federal income tax purposes).

<sup>64</sup> Section 14102(e)(1) of the TCJA.

group of activities that includes “every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit.”<sup>65</sup> If each party to a collaboration agreement determines its own revenue with respect to the collaboration agreement from specified income streams, this collaboration should arguably not create a trade or business under this standard. In any case, whether and to what extent the Proposed Regulations could treat such an arrangement as a branch should be clarified. On the other hand, if a US person conducts a trade or business in two foreign countries and the activities in each country are complementary to the other, or are the same or similar activities, and the multi-country activities could constitute an integral business (but at least one of them would not separately so qualify), regulations should clarify that they can be combined into a single QBU for purposes of the foreign branch income rules.

In addition, it is not clear when the existence of a permanent establishment would fall short of rising to the level of a QBU. The Proposed Regulations depart in this respect from temporary regulations under prior Section 367(a)(3), which deem a permanent establishment to give rise to the conduct of a foreign branch (and therefore the conduct of a trade or business) for purposes of the branch loss recapture rule,<sup>66</sup> but would not under the general rules of Treasury Regulations Section 1.367(a)-2(b).

Examples in the Proposed Regulations presume the existence of a QBU, and do not illustrate it. To assist taxpayers in better understanding the contours of the QBU rules, we recommend that final regulations under Section 904(d)(2)(J) provide more detail and illustrate with examples what level and type of activities constitute a trade or business, and should outline in more detail the contours of the books and records requirement.

(ii) *Application to Service Partnership*

The QBU rules described above, if taken literally, apply to both US partnerships and their individual US partners where the partnership is a service partnership performing law, accounting, architecture, engineering, consulting or any other professional services. Such a partnership may conduct business in some foreign countries through a separate branch or permanent establishment that maintains a set of books and records. In other countries, a service partnership may provide services temporarily in connection with a specific project without maintaining an office or similar permanent presence and instead be subject to tax only with respect to services provided in that country. If temporarily provided services are not treated as giving rise to a QBU, the income from such services would in some cases qualify as foreign branch income and in other cases as general income. It is foreign branch income if it is attributable to a QBU in a foreign country. This would be the case if the services are provided by, and the income and expenses therefor are reflected on the books and records of, a foreign office. By contrast, if the domestic service partnership provides

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<sup>65</sup> Temp. Treas. Reg. §§1.367(a)-6T(g)(1) and 1.367(a)-2(b)(2).

<sup>66</sup> Temp. Treas. Reg. §§1.367(a)-6T(g)(1)

the services from a domestic QBU, i.e., an office in the United States, the foreign source income would be allocated to general category income.

There is nothing to indicate that this was the intended scope of the provision. We see very little opportunity for abuse in these circumstances. The regulations under Section 989 describe separate books and records to include “books of original entry that include cash receipts and disbursements” in the case of a cash basis taxpayer.<sup>67</sup> The regulations do not, however, indicate what is required for books and records to be maintained on a separate basis.

Consideration should be given to providing a more lenient “books and records” test for service partnerships and individual owners of service partnerships. For example, we believe that Treasury and the IRS could interpret the requirement to maintain a separate set of books and records as satisfied with respect to the provision of services if the individual or partnership providing the services clearly identifies the source of the income by country.

*b. Measurement of Foreign Branch Income – Books and Records*

The Proposed Regulations measure a taxpayer’s gross income attributable to a foreign branch based on the books and records maintained by the taxpayer with respect to the foreign branch (as adjusted to conform to US tax principles). This approach is consistent with the method by which items of income, gain, deduction and loss are attributed to a QBU for purposes of Section 987 and Treasury Regulations Section 1.987-2(b). We generally agree with the approach taken in the Proposed Regulations and believe that reliance on a foreign branch’s books and records (with appropriate adjustments) represents an administrable approach for measuring a US taxpayer’s foreign branch income for purposes of Section 904. However, as we discuss below, we believe certain clarifications and revisions to the Proposed Regulations may be appropriate.

*(i) Same Approach for True Branches and Disregarded Entities*

The Preamble requests comments with respect to whether special rules are appropriate to distinguish between (1) a genuine branch (i.e., a set of activities in which a US person is directly engaged and with respect to which such person is subject to foreign income tax, rather than a disregarded entity) and (2) a QBU that is conducted through a disregarded entity that is treated as a separately taxable entity for foreign income tax purposes. For the reasons described below, we believe that adopting a set of rules analogous to existing guidance in Treasury Regulations Section 1.987-2(b) presents the most administrable approach to measuring foreign branch income for purposes of Section 904, regardless of whether the QBU is a genuine branch or held in a disregarded entity.

The question posed in the Preamble appears to be a reference to the approach taken in the dual consolidated loss regulations under Code Section 1503(d). Under the dual consolidated loss rules, different attribution methods apply in the case of (1) a genuine branch, and (2) an entity that is disregarded for US tax purposes. With respect to a genuine branch, Treasury Regulations Section 1.1503(d)-5(c)(2)(i) generally applies the principles of Section 864(c)(2), (c)(4), and (c)(5) to determine the extent to which income should be sourced to the branch. This approach in essence reflects a presumption that the foreign jurisdiction's approach to taxation of branches can be approximated by applying analogous US tax rules. In contrast, under Treasury Regulations Section 1.1503(d)-5(c)(3)(i) branch income of a US person that is attributable to an entity that is a disregarded entity for US tax purposes is measured by reference to the books and records of the disregarded entity, as adjusted to conform to US tax principles.

As discussed in our report on FDII, we believe that adopting the rules of Section 987 (and specifically Treasury Regulations Section 1.987-2) reflects a thoughtful and administrable approach for determining foreign branch income. We believe this is the case whether the foreign branch income is attributable to a genuine branch or a disregarded entity. As a practical matter, we note that it is likely that both a genuine branch and a disregarded entity will keep books and records with respect to its foreign branch income, and as such in either case books and records will typically be available to taxpayers as a basis for measuring the income of a foreign branch. We further note that the statutory text of Section 904(d)(1)(J) specifically refers to QBUs, which suggests that Congress expected Treasury and the IRS to adopt rules analogous to Treasury Regulations Section 1.987-2 for purposes of Section 904(d)(1)(J). Finally, we believe that applying the same standards to genuine branches and branches conducted through disregarded entities minimizes planning opportunities and traps for the unwary that would depend on whether a US person directly engages in a given set of business activities or instead houses these activities in a disregarded entity.

*(ii) Approach Where No Books and Records Are Available*

As the Proposed Regulations acknowledge, there may be certain instances in which foreign branch income could be generated without books and records maintained with respect to the branch's activities. For example, in the case of a partnership that fails to maintain books and records for the relevant branch activities, Proposed Regulations Section 1.904-4(f)(3)(iii)(C)(2) provides that the partnership is treated as maintaining a separate set of books and records with respect to the foreign branch. The partnership must then determine, as context requires, the items that would be reflected on such books and records in applying Proposed Regulations 1.904-4(f). As discussed above, such a fact pattern may be particularly likely in the case of arrangements that

are treated as partnerships for US tax purposes but lack legal personality (e.g., certain contractual joint ventures and/or profit sharing arrangements).<sup>68</sup>

In the case where foreign branch income is generated without books and records attributable to the activity, we believe that final regulations should provide that the principles of Sections 864(c)(2), (c)(4) and (c)(5) will apply in constructing any deemed books and records in a manner analogous to the approach taken under the dual consolidated loss regulations with respect to genuine branches (although, for clarity, we would recommend applying such a rule whether or not the QBU was a genuine branch or was held in a disregarded entity).<sup>69</sup> Such an approach should explicitly incorporate the principles of Treasury Regulation Section 1.861-8 as well to assist taxpayers in measuring the extent to which expenses should be allocable to a foreign branch.

This approach would essentially construct books and records of the foreign branch based on the assumption that a foreign jurisdiction's sourcing rules can be roughly approximated by relying on similar rules applicable to foreign branches subject to tax in the United States. Thus, for example, if a US person were engaged in the sale of widgets in a foreign jurisdiction, the principles of Section 864 could be utilized to determine (1) the extent to which gross income associated with widget sales should be attributed to the branch, and (2) the extent to which expenses of the US person should be attributed to the foreign branch, in each case by reference to the application of Section 864 principles, applied as if the US person were instead a foreign person, and the activities attributable to the foreign branch were instead conducted in the United States. We believe that such an approach would allow both the IRS and taxpayers to rely on a relatively well established body of authority, thereby enhancing both taxpayer and government certainty with regard to the application of Proposed Regulations Section 1.904-4(f) where books and records are not retained by a foreign branch.

(iii) *Disregarded Payments Between Foreign Branches and Foreign Branch Owners*

As noted above, the Proposed Regulations generally take into account transactions with respect to a foreign branch that are otherwise disregarded for US tax purposes. This is true whether such disregarded payments are made as between a foreign branch owner and a foreign branch, or whether such payments are made as between two foreign branches.<sup>70</sup> Such payments between a foreign branch owner and a foreign branch are taken into account as upward or downward adjustments to general basket income and foreign branch income, depending on whether the

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<sup>68</sup> Similar issues may arise with respect to foreign branches that are not subject to foreign tax in a jurisdiction as a result of either (1) the absence of an income tax in such jurisdiction, or (2) a foreign branch that does not constitute a "permanent establishment" under an income tax treaty.

<sup>69</sup> See Treas. Reg. §1.1503(d)-5(c)(2)(i).

<sup>70</sup> Prop. Treas. Reg. §1.904-4(f)(2)(vi)(A).

payment is made from the foreign branch to the foreign branch owner, or from the foreign branch owner to the foreign branch. However, certain payments, including payments of interest and interest equivalents, remittances from foreign branches, and contributions to foreign branches, do not result in adjustments to foreign branch income or general basket income under the Proposed Regulations.<sup>71</sup>

As discussed in greater detail in our report on FDII, we acknowledge that taking into account transactions between a foreign branch owner and a foreign branch is necessary in certain cases to provide an accurate reflection of the net income attributable to a foreign branch.<sup>72</sup> However, we believe that there are a number of complexities that should be addressed where disregarded payments are taken into account to adjust gross income.

The first of our concerns relates to the recharacterization of domestic source general basket income into domestic source foreign branch income. Specifically, under the Proposed Regulations, when a foreign branch owner makes an otherwise disregarded payment to a foreign branch, it is possible for domestic source general basket income to be converted into domestic source foreign branch income.<sup>73</sup> This is the case notwithstanding that the payment would presumably be subject to tax in the foreign jurisdiction in which the foreign branch is organized. Thus, for example, if a foreign branch owner made a \$10 payment to a foreign branch and the \$10 payment were allocable to domestic source general basket income, the Proposed Regulations would effectively deny a taxpayer a foreign tax credit with respect to this \$10 payment (because it retains its characterization as domestic source<sup>74</sup>) even though the \$10 would be subject to tax in the foreign jurisdiction. This result seems to run counter to the general aim of the Section 904 rules to match a foreign tax credit to the foreign income upon which such taxes were assessed.

We also believe that the Proposed Regulations pose complex issues with respect to interest and interest equivalent payments. As noted above, interest and interest equivalent payments are excluded from the general rule that disregarded transactions between a foreign branch owner and a foreign branch should be taken into account in calculating foreign branch income. It appears that the reasoning for this approach was that in certain cases, interest payments can reflect a reallocation of income within a group of related persons, analogous to contributions or remittances (depending on the direction of the interest payment). However, unlike contributions or remittances to or from a foreign branch, otherwise disregarded payments of interest are likely to generate taxable income or a tax deduction to the extent regarded by the foreign jurisdiction in which a foreign branch is organized. As such, by ignoring entirely interest payments among foreign branch owners and

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<sup>71</sup> Prop. Treas. Reg. §1.904-4(f)(2)(vi)(C).

<sup>72</sup> New York State Bar Tax Section Report No. 1399 (Sept. 4, 2018), at 7-9.

<sup>73</sup> Prop. Treas. Reg. §1.904-4(f)(2)(vi)(A).

<sup>74</sup> *Id.* (“An adjustment to the attribution of gross income under this paragraph (f)(2)(vi) does not change the total amount, character, or source of the United States person's gross income.”)



foreign branches, the Proposed Regulations invite incongruity between the measurement of a branch's taxable income for US tax purposes and for purposes of the foreign jurisdiction's tax rules.<sup>75</sup> We believe this incongruity has potential to be both a trap for the unwary and a planning opportunity. Treasury and the IRS should therefore consider whether the general approach to books and records with respect to a QBU under the Section 987 regulations should be adopted in respect of interest and interest equivalents, or if not, provide an explanation why maintenance of books and records of a QBU for purposes of Section 904(d)(2)(J) ought to deviate from the maintenance for Section 987 purposes with respect to interest and interest equivalents.<sup>76</sup> The Section 987 regulations contain detailed anti-tax avoidance rules that could (*mutatis mutandis*) apply for purposes of calculating foreign branch income.<sup>77</sup> Starting with the books and records is, for obvious reasons, administratively less burdensome and, in the case of a Section 987 QBU, avoids the need for a (at least partial) duplication of books and records. In light of the existing anti-abuse rule for recording, or not recording, items in a QBU's books and records, the concerns that Treasury and the IRS may have regarding debt between branch and owner that go beyond those that appear to be addressed in the Section 987 anti-tax avoidance rules (or a modified form thereof) should be clarified.

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<sup>75</sup> We note, however, that the approach of ignoring such interest payments may also disincentivize "earnings stripping" of foreign branches through the use of leverage, which taxpayers may otherwise consider in order to increase eligibility for the FDII deduction under Section 250. Specifically, because foreign branch income is excluded from "deduction eligible income" for purposes of the FDII deduction, taxpayers seeking to increase their FDII deduction are incentivized to decrease foreign branch income. In the event the Proposed Regulations were modified such that disregarded interest payments from a foreign branch to the foreign branch owner were taken into account in measuring foreign branch income, this could incentivize taxpayers to increase interest expense at the foreign branch in order to reduce foreign branch income, thereby increasing the amount of the taxpayer's income eligible for the FDII deduction.

<sup>76</sup> Treas. Reg. §1.987-2(b)

<sup>77</sup> Specifically, Treasury Regulations Section 1.987-2(b)(3)(ii) lists factors indicative of a tax avoidance purpose that warrant adjustments to the books and records of a QBU and factors that indicate the absence of a tax avoidance purpose. The latter comprise the recording (or not recording) of an item (1) for a significant and bona fide business purpose; (2) in a manner that is consistent with the economics of the underlying transaction; (3) in accordance with generally accepted accounting principles (or similar comprehensive accounting standard); (4) in a manner that is consistent with the treatment of similar items from year to year; (5) in accordance with accepted conditions or practices in the particular trade or business of the eligible QBU; (6) in a manner that is consistent with an explanation of existing internal accounting policies that is evidenced by documentation contemporaneous with the timely filing of a US federal income tax return for the taxable year; and (7) as a result of a transaction between legal entities (for example, the transfer of an asset or the assumption of a liability), even if the transaction is not regarded for US federal income tax purposes (for example, a transaction between a disregarded entity and its owner). By contrast, factors that may indicate that a principal purpose of recording (or failing to record) an item on the books and records of a QBU is the avoidance of US federal income tax include (1) the presence or absence of an item on the books and records that is the result of one or more transactions that are transitory, for example, due to a circular flow of cash or other property; (2) the presence or absence of an item on the books and records that is the result of one or more transactions that do not have substance; (3) the presence or absence of an item on the books and records that results in the taxpayer (or a person related to the taxpayer within the meaning of section 267(b) or section 707(b)) having offsetting positions with respect to the functional currency of a section 987 QBU; and (4) the absence of any or all of the factors indicating the absence of a tax-avoidance purpose.

Finally, the Proposed Regulations contemplate that Section 367(d) and Section 482 would apply to a transfer of intellectual property described in Section 367(d)(4) from a foreign branch to its owner, as if the foreign branch were a corporation.<sup>78</sup> The purpose of this provision should be clarified. If the concern is that a taxpayer could, through the transfer of intangibles, easily manipulate whether income from the intangibles is allocable to the foreign branch income basket, the same approach arguably should apply to all transfers of properties by the branch to the owner or the owner to the branch.<sup>79</sup> If the rule is not expanded to apply to all such transactions, we would recommend clarification of the treatment of transfers of intellectual property from a foreign branch to a foreign branch owner, given that Section 367(d) by its terms does not apply to an “inbound” transfer of intellectual property.<sup>80</sup>

Notwithstanding the complexities associated with taking into account disregarded transactions when calculating foreign branch income, we believe that significant planning opportunities may exist if disregarded transactions are not taken into account. As the Proposed Regulations correctly note, interest payments, royalties, rents, and similar deductible items paid between a foreign branch and its owner if not properly addressed may result in potential shifts between general basket income and foreign basket income without economic justification. We believe that the Proposed Regulations correctly acknowledge that for purposes of both Section 904 and the FDII deduction under Section 250, disregarded transactions must be taken into account to provide an accurate measure of foreign branch income. However, we recommend that the technical issues highlighted above be considered and addressed as the Proposed Regulations are finalized.

*(iv) Disregarded Payments Between Foreign Branches*

Although we acknowledge that in the case of payments between a foreign branch owner and a foreign branch it may be desirable to take into account otherwise disregarded payments, we disagree with the Proposed Regulations’ approach in applying these principles to payments between foreign branches. Specifically, we do not believe that it is necessary for branch-to-branch payments to be taken into account. Such payments should not change the basketing of any item as foreign branch income, and should net within the broader calculation of foreign branch income, since the Proposed Regulations’ approach of taking into account these transactions would not change the character or source of the payments.<sup>81</sup> As a result taking these transactions into account should not change the results under Section 904. Thus, we believe that this specific aspect of the

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<sup>78</sup> Prop. Treas. Reg. §1.904-4(f)(2)(vi)(D).

<sup>79</sup> Prop. Treas. Reg. §1.904-4(f)(2)(vi)(D)(2) and (3) (transfers of money, securities and other property from the branch owner to the branch are disregarded, and remittances by the branch to the owner are likewise disregarded, except for transfers of intangible property).

<sup>80</sup> In this regard, note that the Proposed Regulations as drafted apply this rule when property is transferred “to *or from* a foreign branch” (emphasis added). Prop. Treas. Reg. §1.904-4(f)(2)(vi)(D).

<sup>81</sup> Prop. Treas. Reg. §1.904-4(f)(2)(vi)(A).

Proposed Regulations' approach to disregarded transactions reflects unnecessary administrative complexity, and should therefore be removed in future guidance.

2. *Amount Includible in Gross Income under Section 951A: Exception for Passive Income*

The TCJA created a new separate category of income under Section 904(d)(1) in addition to foreign branch income. This category is defined as “any amount includible in gross income under section 951A (other than passive category income)” (the “Section 951A category income”).<sup>82</sup>

The scope of the passive income included under Section 951A should be narrow, as passive income is defined as foreign personal holding company income within the meaning of Section 954(c). Foreign personal holding company income, however, is subpart F income for a CFC and therefore includible in the income of a US shareholder under Section 951(a)(1)(A) and not Section 951A. Passive income in turn does not include high-taxed income,<sup>83</sup> which is treated as income in another separate category (or specified separate category) based on the general rules. In the case of a CFC, this high-tax kick-out should also re-apportion the passive income to the residual group under Section 960(a), as Section 951A category income does not include high-taxed income that otherwise would be subpart F income.<sup>84</sup> Another type of otherwise passive income that is excluded from passive category income is export financing interest.<sup>85</sup> Passive income not included in subpart F income because of the *de minimis* exception or application of the earnings and profits limitation for foreign base company income, by contrast, should be passive category tested income.<sup>86</sup>

The Preamble mentions as one item of income that is not foreign personal holding company income but is nonetheless passive category income (absent a high-tax and export financing kick-out), namely, the distributive share of income from a less-than-10 percent partnership interest (by value). Under Treasury Regulations Section 1.904-5(h)(2) and Proposed Regulations Section 1.904-5(n), the general look-through rule with respect to a partner's distributive share of partnership income does not apply to a limited partner or a corporate general partner that owns less

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<sup>82</sup> Section 904(d)(1)(A).

<sup>83</sup> Section 904(d)(2)(B)(iii)(II); Prop. Treas. Reg. §1.904-4(b)(2)(ii). High-taxed income is otherwise passive income if the sum of (1) foreign income taxes paid or accrued by the taxpayer with respect to the income and (2) foreign income taxes deemed paid under Section 902 (before the effective date of its repeal) and Section 960 exceeds the US income tax that would have been imposed on such income if the highest individual or corporate income tax rate (as applicable) applied. Section 904(d)(2)(F).

<sup>84</sup> Section 951A(c)(2)(A)(i)(III), Section 954(b)(4)

<sup>85</sup> Section 904(d)(2)(B)(iii)(I).

<sup>86</sup> Section 954(b)(3), excluding from insurance income and foreign base company income under subpart F gross insurance income and foreign base company income if in the aggregate it is less than 5% of gross income or, if less, \$1 million for the taxable year and see Section 952(c)(1), limiting the subpart F income of a CFC to earnings and profits for such taxable year.

than 10 percent of the value of the partnership, and the partner's distributive share of partnership deductions from the partnership is allocated and apportioned only to the partner's passive income from that partnership.<sup>87</sup> Gain from the sale of a partnership interest is likewise treated as passive, unless the partner owns 25 percent or more of the capital or profits interest in the partnership directly, indirectly or by attribution (in which case the partner is treated as selling its proportionate share of the assets of the partnership attributable to the partnership interest).<sup>88</sup>

Treasury and the IRS have asked whether the rules for treating a partner's distributive share of partnership income as passive income should be modified. For the reasons below, we believe that a look-through rule should be available to CFCs regardless of whether the CFC owns 10 percent or more of the interests in the partnership.

The partnership rules above are rules of administrative convenience. Generally, a CFC would have an interest in a partnership as a limited partner that is less than 10 percent by value only in limited circumstances. In a typical joint venture, for example, a CFC would rarely have an interest below 10 percent. In the case of a less-than-10 percent interest, a CFC should be able to elect to treat its distributive share on a look-through basis.

Moving income from passive category income to the Section 951A category income basket pursuant to such an election may not always be attractive because no carryovers are available for unused foreign taxes attributable to that basket. However, in some cases, a lower-taxed distributive share of income may provide additional limitation for foreign taxes attributable to the Section 951A category income basket that would otherwise become unusable.

In order to avoid unwarranted planning resulting from such a look-through election for a less-than-10-percent partnership interest, consideration should be given to making this a CFC-level election so that all US shareholders of a CFC would be required to treat partnership income of a CFC on a consistent basis. The election would generally be made only by a CFC that has the available information.

Second, once an election has been made not to treat the distributive share of partnership income as per se passive, the election should apply consistently to future years (or at least for a fixed period, such as five years), so that it cannot be used as a changing foreign tax credit planning instrument by the CFC from one year to another. An exception might be considered if the partnership no longer provides the information (and the decision not to provide the information is not under the control of the CFC or one or more of its shareholders).

Third, look-through arguably can apply mandatorily with respect to any domestic partnership, as it is required to provide IRS Forms K-1 to its partners, which should provide

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<sup>87</sup> Treas. Reg. §1.904-5(h)(2), Prop. Treas. Reg. §1.904-5(n)(1)(ii)(A).

<sup>88</sup> Treas. Reg. §1.904-5(h)(3), Prop. Treas. Reg. §1.904-5(h)(2).

sufficient information for a limited partner to determine the separate category of income shown on the K-1 on a look-through basis. Consideration should also be given, for the same reason, to requiring look-through with respect to any foreign partnership that provides IRS Forms K-1 to its partners.

We believe that a corporate general partner should generally be able to obtain information sufficient to determine its distributive share of the underlying income. For the same reasons described above, consideration should be given to require look-through to the items of income included in a corporate general partner's distributive share of the partnership's income.

These rules, if adopted, should apply with respect to partnership interests in general, i.e., for purposes of the Section 951A category income basket, the inclusion in subpart F income and the other separate categories.

### 3. *Treaty Resourcing*

Section 904(d)(6) requires that if an item of income from US sources is re-sourced as foreign source income under an applicable US income tax treaty, Sections 904(a), (b) and (c) (as well as Sections 907 and 960) apply separately for each item to a taxpayer that chooses the benefits of the tax treaty. Under the Proposed Regulations, items are grouped on the basis of the basket from which they are re-sourced, giving rise to various "specified separate treaty re-sourced categories" of income.<sup>89</sup> The Proposed Regulations suggest that this grouping is also done for each applicable US income tax treaty separately. We agree with this approach that reasonably simplifies a strict item-by-item approach without generally allowing for cross-crediting with respect to differently taxed income.

Treasury and the IRS have asked whether foreign income taxes relating to the income in any specified separate treaty re-sourced category should include only foreign taxes paid or accrued to the treaty country or should also include third-country taxes on the same income.<sup>90</sup> The Preamble does not suggest any other category to which the foreign tax is to be allocated, and it would presumably be allocated under the general rules of Section 904(d)(1), where it may or may not be eligible for a foreign tax credit depending on the available limitation based on income without regard to the treaty re-sourced income.

The third-country foreign tax relates neither to items of income not treated as such for US tax purposes nor to items of income included for US tax purposes at a different time. Thus, the base and timing difference rules (see Section IV.C.4. below) should not apply to the third-country taxes. The third-country foreign taxes, in other words, relate to the treaty re-sourced income, but

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<sup>89</sup> Prop. Treas. Reg. §1.904-4(k)(2)..

<sup>90</sup> Treas. Regs. §1.904-6; Prop. Treas. Reg. §1.904-6(k)(3).

the proposal appears to be an exception to the general allocation and apportionment rules of Treasury Regulations and Proposed Treasury Regulations Section 1.904-6(a)(1)(i).

The issue raised in the Preamble suggests a fact pattern in which a US owner of a branch derives income in a third country, but the item of income is subject to treaty resourcing under an income tax treaty that applies to the branch:

Example: Domestic corporation *USP* owns all of the equity in a foreign subsidiary *FB*, which has elected to be disregarded as separate from *USP* for US tax purposes but is subject to tax on a net income basis in its country of organization, *C*. Under the bilateral income tax treaty between the United States and *C*, *USP* is entitled to re-source the income earned through *FB* if subject to tax in *C* but treated as US source for US tax purposes. *FB* operates in a third country, *D*, through a branch that is treated as such for purposes of US tax law, *C* tax law and *D* tax law. The *D* branch derives US source royalty income that is subject to income tax in *D*. *C* also taxes the US source royalty income, but grants *FB* a tax credit for income taxes paid to *D*.

In this example, a threshold question could be whether re-sourcing under the treaty would apply. Under the US Model Treaty, for example, re-sourcing can apply if the item of income “may be taxed” in the other contracting state.<sup>91</sup> That is, the item of income must be subject to tax in the contracting state, here, country *C*. In the example, one could argue that the income is subject to tax in country *C* but that no residual tax is due to country *C* because of country *C*’s provision of a foreign tax credit for country *D* taxes. On the other hand, one could argue that country *C* has ceded primary taxing jurisdiction to country *D* and that thus the item of income is not subject to tax in country *C*.

Assuming that re-sourcing does apply, arguments can be made for and against the view that the taxes paid to country *D* should be considered to be related to the re-sourced income. As country *C*, the other contracting state under the treaty, grants a tax credit, it arguably does not tax the country *D* branch income, or only to the extent of any residual country *C* tax. Yet, if the same income were derived in country *C* and not through a branch in another country, it would have been fully subject to tax in country *C* and assigned to the relevant specified separate treaty re-sourced category. Absent the branch in the third country, country *D*, in other words, substantially the same amount would have been subject to full country *C* foreign taxes and the entire amount of these foreign taxes would have been related to the specified separate treaty re-sourced category. Arguably, the income should be considered as derived through the other contracting state. The use of a foreign branch in country *D* by the disregarded entity branch in country *C* does not serve the purpose of obtaining a foreign tax credit benefit under Section 904 that would not have been obtained if the disregarded entity branch had derived the income directly, and not through the

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<sup>91</sup> See infra note 92 .

branch in *D*. This assumes, of course, that the existence of the disregarded entity branch has other independent business purposes and has not been inserted between the US owner and the branch in country *D* for the purpose of availing the US owner of the re-sourcing benefits of an income tax treaty.

The re-sourcing provisions of treaties tend to address re-sourcing of income only for foreign tax credit purposes in relation to the other contracting state.<sup>92</sup> This could be interpreted as an argument that country *D* taxes should not be considered to be related to the re-sourced income. One could argue that the re-sourcing under the treaty with country *C* is for purposes of crediting country *C* taxes. But, one could also argue that it is not surprising that a treaty would not address creditability of third-country taxes, and that, once the income is re-sourced under the treaty, it is re-sourced for all purposes and that domestic law then applies to the re-sourced income. Section 904(d)(6), accordingly, is not limited to the foreign taxes of the other contracting state.

Further, suppose the facts of the example were reversed, i.e., the United States had a treaty with country *D* but not country *C*, and suppose that some amount of country *C* taxes and country *D* taxes are paid. In this example, there is less of an argument to treat the third-country taxes (i.e., the country *C* taxes) as related to the re-sourced income, because country *D* does not provide any foreign tax credit for the country *C* taxes. In this example, it appears that much more plausible that a third country (i.e., *C*) would get an unwarranted benefit from the resourcing under the US tax treaty with country *D* if country *C* taxes were considered to relate to the resourced income. The resourcing rule should apply only with respect to taxes imposed by the treaty counterparty (i.e., *D* in this example) (or, as discussed above, arguably taxes of the treaty counterparty that would be payable absent the treaty counterparty providing a foreign tax credit). Unlike the example discussed above involving a treaty with country *C*, the example involving a treaty with country *D* does not involve non-treaty country taxes displacing treaty country taxes that otherwise would be attributable to a specified separate treaty re-sourced category. Further, using the disregarded entity branch in country *C* does in fact impose additional foreign tax that would not have been imposed if the disregarded entity in country *C* had not been interposed.

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<sup>92</sup> The Relief from Double Taxation clauses under income tax treaties generally afford a tax credit only to the extent of taxes paid to the other contracting states, but re-source the entire amount of income, although generally for “the purposes of this article.” *See, e.g.*, Canada (2007), art. XXIV.3(a) (“Profits, income or gains ... of a resident of a Contracting State which may be taxed in the other Contracting State in accordance with the Convention ... shall be deemed to arise in that other State”); People’s Republic of China (1986), Art. 22.3 (similar); US Model Tax Treaty (2016), art. 23.3 (“For the purposes of applying paragraph 2 of this Article, an item of gross income, as determined under the law of the United States, derived by a resident of the United States that, under this Convention, may be taxed in \_\_\_\_\_ shall be deemed to be income from sources in \_\_\_\_\_”). The amount of the tax credit to be afforded under the tax treaty addresses only the amount of taxes paid to the other contracting state and does not address third-country taxes. *See, e.g.*, Canada art. XXIV.1. (“the United States shall allow to a citizen or resident of the United States, or to a company electing to be treated as a domestic corporation, as a credit against the United States tax on income the appropriate amount of income tax paid or accrued to Canada”); China (1986) art. 22.1.a) (similar); US Model Tax Treaty (2016), art. 23.2.a) (“the income tax paid or accrued to \_\_\_\_\_ by or on behalf of such resident or citizen”).

We note that preventing third-country taxes from being attributable to treaty re-sourced income would arguably be a departure from the overall framework of the foreign tax credit regime. The foreign tax credit limitation is determined by apportioning income to the various separate categories of income, including the specified separate categories, and then attributing foreign taxes to the income to which it is related, whatever category it may be in.<sup>93</sup> Section 904(d)(6) does not appear to say that the general rule of relating foreign income taxes to income should be interpreted differently.

#### **D. Treatment of Base Differences**

Under Section 904(d)(2)(H), foreign tax imposed on an amount that is not income under US tax principles is treated as imposed on income in the separate category described in Section 904(d)(1)(B). Prior to the TCJA, Section 904(d)(1)(B) described the general category, but after the TCJA, the same Section describes foreign branch income, and the TCJA did not modify the cross-reference. This is a technical error, and the 2019 Technical Corrections Bill, if enacted, would change the reference to general category income, as described in 904(d)(1)(D).<sup>94</sup> We have previously argued that legislation should be adopted that allocates base difference items not exclusively to the general basket but, based on a facts and circumstances test, to the basket that the item would be in if it were subject to US tax.<sup>95</sup>

The Proposed Regulations expressly refer to Section 904(d)(2)(H), i.e., absent the technical correction, they would also treat such foreign tax as imposed on foreign branch income.<sup>96</sup> The items of income mentioned in the regulations are gifts and life insurance proceeds, if treated as income in another jurisdiction. Treasury and the IRS have indicated that base differences “arise only in limited circumstances,” but do not provide further examples (apart from gifts and life insurance proceeds). Any computational differences in the amount of income as opposed to the type of income included in US taxable income is not a base difference.<sup>97</sup> Any timing differences, by contrast, are allocated and apportioned to the appropriate separate categories to which the tax would be allocated and apportioned if recognized under US tax principles.

Apart from life insurance proceeds and gifts, there are no examples in the Proposed Regulations or the current regulations that would illustrate base difference items and contrast them

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<sup>93</sup> Section 904(a) and (d)(1); Treas. Reg. §1.904-6(a)(1)(i).

<sup>94</sup> 2019 Technical Corrections Bill §Section 6(b)(3).

<sup>95</sup> GILTI I Report at 83.

<sup>96</sup> Prop. Treas. Reg. §1.904-6(a)(1)(iv).

<sup>97</sup> 83 Fed. Reg. at 63213.



with computational matters or, in some cases, timing matters. It would be helpful if Treasury and the IRS could provide additional examples to illustrate what a base difference is.

Would, for example, a contribution to a CFC that is tax-free to the transferee under Section 118 or Section 1032 give rise to a base difference if treated as a taxable contribution for purposes of the relevant foreign tax laws, or would it be treated as a computational difference? Would the recognition of gain under the tax laws of a foreign country with respect to contributed property in a transaction that qualifies for Section 351 under US tax law principles be a base difference or treated as a timing difference in the recognition of gain?

## **E. Section 960 and Timing Differences of Income Inclusions and the Accrual or Payment of Taxes**

### *1. Timing Differences and Section 960(d)*

Section 960(d) permits a deemed-paid foreign tax credit only for “tested foreign income taxes,” which are (with respect to a corporate US shareholder) foreign income taxes paid or accrued by a CFC that are properly attributable to the tested income of the CFC taken into account by the corporate US shareholder. The amount of the deemed-paid foreign tax credit is then reduced to 80% of the inclusion percentage of the aggregate tested foreign income taxes paid or accrued by all CFCs with respect to the US shareholder.<sup>98</sup>

The Proposed Regulations determine the foreign income taxes of a CFC that are properly attributable to the tested income as the US shareholder’s proportionate share of the current year taxes of the CFC (which in turn are allocated and apportioned to the “tested income” group within each Section 904 category of the CFC).<sup>99</sup> Current year taxes, in turn are foreign income taxes that are attributed to the income to the extent they are paid or accrued in the US taxable year, and they are considered to accrue under the economic performance test for foreign taxes, i.e., when all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy.

The accrual rule has two effects. First, if years with high foreign income and years with low foreign income, as determined for US tax purposes, do not properly match the foreign income taxes because of different US and foreign tax years, the available deemed-paid foreign tax credit may not match the US tax determinations. Too much or too little foreign income taxes may then be attributed to the foreign income included as GILTI. Second, as the properly attributable tested foreign income taxes may mismatch foreign income for purposes of Section 960(d), they would

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<sup>98</sup> See Prop. Treas. Reg. §1.960-2(c)(2). The inclusion percentage for a corporate US shareholder equals the fraction of the aggregate tested income of all CFCs with respect to which it is a US shareholder that is included by the shareholder as GILTI (prior to the deduction under Section 250).

<sup>99</sup> Prop. Treas. Reg. §1.960-2(c)(4), Prop. Treas. Reg. §1.960-1(b)(4).

likewise not properly match tested income of the CFC, which may give rise to a tested loss. No foreign income taxes relating to a tested loss are eligible for the deemed-paid foreign tax credit of Section 960(d), however, and timing mismatches may therefore result in a complete loss of a deemed-paid foreign tax credit if a tested loss arises.<sup>100</sup>

To illustrate the first scenario, assume that a domestic corporation, *USP*, owns all of the stock of a CFC, *FS*, which in turn has no further subsidiaries. Both *USP* and *FS* have the calendar year as their US taxable year, but *FS* has a June 30 year end for foreign tax purposes. *FS* is formed on July 1, 2019. For calendar year 2019, *FS* has \$80 of tested income all of which is included as GILTI by *USP*. No foreign taxes accrue with respect to that income within 2019 by December 31, 2019. In 2020, *FS* has another \$80 of net income (before foreign income taxes) in the first two quarters and a loss of \$50 in the last two quarters. In addition, \$20 of income taxes accrue as of June 30, 2020 with respect to the \$160 of foreign pre-tax income. As a result, for 2020 *FS* has tested income (net of foreign taxes) of \$10. Assume that *USP* is not a US shareholder in any other CFC and has no deemed tangible income return with respect to 2019 and 2020.<sup>101</sup>

Under the Proposed Regulations, *FS* has, for 2019, current year taxes of \$0 and tested income of \$80; and for 2020, current year taxes of \$20 allocated to the tested income group, tested income of \$10 and a Section 78 gross-up of \$20. Without regard to any additional expense allocations, *USP* will have a GILTI inclusion of \$80 for 2019 and (with Section 78 gross-up) \$30 for 2020. *USP*'s related US tax liability (pre-foreign tax credit) will amount to \$8.40 with respect to the GILTI inclusion (after taking into account the Section 250 deduction, if fully available) in 2019 and \$3.15 in 2020; in addition, *USP* will have \$16 (80% of \$20) of deemed-paid foreign taxes in the Section 951A category income basket, prior to determining the foreign tax credit limitation under Section 904. *USP* therefore will not owe any residual US tax in 2020. Over the two-year period, however, *USP* will in effect have paid an aggregate amount of US federal and foreign income tax of \$28.40 on \$110 of grossed-up GILTI, because there is no carryback of unused foreign taxes related to Section 951A category income.

The result would be different if the inclusion were of subpart F income in both years. The foreign income taxes accrued in 2020 would relate to subpart F income, and there would be \$6.30 of tax liability with respect to the \$30 of subpart F inclusion (as grossed up under Section 78), which would leave \$13.70 of unused foreign taxes to be carried back to 2019 to offset US tax of \$16.80. There would be residual US tax here, because a subpart F inclusion does not benefit from the Section 250 deduction.<sup>102</sup>

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<sup>100</sup> Section 960(d)(3) and Prop. Treas. Reg. §1.960-2(c)(3)

<sup>101</sup> See Section 951A(b)(2),

<sup>102</sup> Issues relating to subpart F inclusions and Section 960(a) are addressed below.

Mismatched attribution of foreign taxes to foreign income is not confined to mismatched US and foreign tax years. Mismatches can also result because transactions are subject to different timing for the recognition of income or loss or differences in cost recovery.

In addition, the effects of mismatched foreign and US tax years, occur not only in situations of fluctuating income, but also for CFCs that engage in extraordinary transactions (regardless of whether they give rise to losses or income) or a CFC with steadily increasing income from one year to the next, if foreign income tax accrual continuously lags behind. A mismatch in US and foreign taxable years may thus irreversibly result in a mismatch of foreign taxes and related foreign income for a CFC.

In the GILTI Report we expressed concern that timing mismatches may disqualify foreign income taxes from being treated as attributable to the underlying income, as determined for US tax purposes, when the foreign taxes are paid or accrue in a different taxable year, on the theory that they would not be considered properly attributable to the tested income as determined under US tax law principles. The Proposed Regulations have not adopted this approach (i.e., they do not preclude a deemed-paid foreign tax credit in the year of accrual, because the income to which the taxes are properly attributable (in part) precedes the current year). Instead, they apply the same approach to timing differences as for the non-Section 951A category income baskets, assigning foreign income taxes to the same basket to which they would have been allocated and apportioned if the income were recognized under US tax principles in the year in which the tax was imposed and determined.<sup>103</sup>

While we are not disputing the long-established approach to when foreign income taxes are to be considered as accrued,<sup>104</sup> the Proposed Regulations do not seem to attempt to match properly attributable foreign income taxes to the relevant foreign income. But Section 960(a) and Section 960(d) both provide that a deemed-paid foreign tax credit is available for “so much of such . . . foreign income taxes as are properly attributable to such . . . income” (Section 960(a)) or “foreign income taxes paid or accrued by such foreign corporation which are properly attributable to the tested income of” the CFC (Section 960(d)). And although Section 960(d) does refer to the accrual or payment of the foreign taxes, it does not refer to foreign income taxes paid or accrued *during the taxable year*, as is expressly stated for purposes of the direct tax credit afforded by Section 901(b). Section 960(d)(3) specifically states that no deemed-paid foreign tax credit is available unless the foreign taxes are paid or accrued (as applicable). There is no constraint to when they accrue (or are paid); but once accrued (or paid) they have to be “properly attributable” to the tested income of the CFC. By limiting the deemed-paid foreign tax credit under Section

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<sup>103</sup> Prop. Treas. Reg. §1.904-6(a)(1)(iv).

<sup>104</sup> Treas. Reg. §1.461-4(g)(6)(iii)(B) (economic performance test for foreign income tax); *see Santa Free Drilling Co. v. Riddell*, 217 F. Supp 630 (S.D.Cal. 1963).

960(d) to current year taxes, the Proposed Regulations seem different from the language of the Code.

Section 960 clearly contemplates that a foreign tax credit be available (subject to applicable limits) for foreign income taxes attributable to foreign income. While pooling of foreign income and foreign taxes under prior Section 902 mitigated the effects of timing differences, the existing approach to timing differences does not properly work and take account of the different role that amended Section 960 plays. As the example above shows, and the illustrations with respect to subpart F income below will show, the Section 951A category income basket as well as the income grouping (discussed below) with respect to subpart F inclusions require a different approach to attributing foreign income taxes to foreign income.

In the GILTI I Report, we suggested that relief should be provided in a manner similar to Section 905(c)(2)(B) (as amended by the TCJA), which provides that, if accrued foreign taxes are not paid within two years after the end of the taxable year to which the taxes relate, or are refunded after being paid, then they are taken into account in the US taxable year to which they relate. The Proposed Regulations seemingly implement Section 905(c) principles by providing that, in determining foreign income taxes for a US taxable year, additional tax payments from a redetermination of the foreign income tax liability, including from a contest where taxes do not accrue until the contest is resolved, are treated as accruing as of the end of the foreign taxable year to which the taxes relate. We therefore recommend that Treasury and the IRS reconsider the approach and consider providing for an approach that attributes foreign income taxes for a foreign taxable year that does not match the US taxable year to both US taxable years to which the foreign income taxes actually relate.

If the requirement that tested foreign income taxes are only those that are properly attributable to tested income of a given US tax year is construed along those lines, they should also be determined in the same manner for purposes of determining tested income in the first place. Tested income is gross income (with certain exceptions such as subpart F income) less deductions *including taxes*.<sup>105</sup> Tested loss is the excess of deductions *including taxes* over gross income (with exceptions such as subpart F income).<sup>106</sup> While Section 951A(c)(2) does not further explain how these foreign taxes are to be determined, the regulations proposed under Section 951A determine “allowable deductions” of a CFC as if the foreign corporation were a domestic corporation.<sup>107</sup> Foreign income taxes therefore seem to be deductible in the year when accrued, i.e., when they constitute current year taxes as defined in Proposed Regulations Section 1.960-1(b)(3).

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<sup>105</sup> Section 951A(c)(2)(A)(ii) and Prop. Treas. Reg. §1.951A-2(b)(1).

<sup>106</sup> Section 951A(c)(2)(B)(i) and Prop. Treas. Reg. §1.951A-2(b)(2).

<sup>107</sup> Prop. Treas. Reg. §1.951A-2(c)(2); Treas. Reg. §1.952-2(b)(1).

This in effect adds another layer of divorcing gross tested income from properly attributable foreign income taxes.

To illustrate, assume that *FS*, a CFC that is wholly owned by domestic corporation *USP*, has a calendar year as its US tax year and a June 30 year end for foreign tax purposes. Assume that *FS* has no further subsidiaries or interests in lower-tier CFCs. In 2019, *FS* has tested income (before taxes) of \$80, all of which is earned in the last two quarters of 2019, and \$0 foreign income taxes accrued as of June 30, 2019 and December 31, 2019. In 2020, *FS* has an additional \$80 in tested income (before taxes) for the first two quarters and a loss of \$70 for the last two quarters (before taxes), and as of June 30, 2020, accrues \$16 of foreign income taxes with respect to the \$160 of foreign income earned in the last two quarters of 2019 and the first two quarters of 2020.

As a result, *FS* has tested income for 2019 of \$80, but a tested loss for 2020 of \$6 (\$80 less \$70 of income for the year before taxes, less \$16 of foreign income taxes), because there are no current year taxes for 2019 and current foreign taxes of \$16 for 2020. None of the \$16 of foreign income taxes will qualify as deemed-paid foreign income taxes. Section 960(d) allows for a deemed-paid foreign tax credit only for a portion of “tested foreign income taxes,” which must be properly attributable to tested income of the CFC. Current year taxes that are attributable to a tested loss (even if they created the loss in the first place) are not creditable under Section 960(d).

Economically, however, \$8 of the foreign income taxes arguably relate to the \$80 of 2019 (pre-tax) tested income of *FS* and the remaining \$8 of foreign income tax to the \$10 of 2020 (pre-tax) tested income of *FS*. If the foreign taxes would be properly attributed to gross tested income in this manner, *FS* would qualify as a tested income CFC for both years, because it would have \$72 of tested income in 2019 and \$2 of tested income in 2020, with foreign income taxes for each year that could be credited against such income (subject to the reductions under Section 960(d)(1) and (2)).

In order to achieve this result, a portion of the foreign income taxes would have to be attributed back to the preceding current tax year, and this example likewise makes a pro-rationing approach plausible. A pro-rationing approach, however, may not be appropriate for mismatches that are exacerbated by extraordinary transactions, or timing differences arising from different cost recovery systems. Regulations should allow taxpayers to establish on a reasonable, and consistent, basis how foreign income taxes relate to foreign income. For extraordinary transactions, this can be done through a “with-and-without” approach that compares the foreign income tax that would have been imposed without the transaction occurring with the amount actually incurred, and allocating the incremental taxes (or lesser taxes) to the year in which for US tax purposes the extraordinary transaction is considered as occurring. While we do not dispute that such a determination may be complex, we believe that complexity is warranted in light of the amounts potentially at stake with respect to the Section 951A category income basket.

## 2. *Timing Differences and Section 960(a)*

Proposed Regulations Section 1.960-2(b) provides rules for computing the amount of foreign income taxes deemed paid by a corporate US shareholder of a CFC under Section 960(a). Under Section 960(a), a domestic US shareholder of a CFC is deemed to have paid in respect of any item of income included in gross income under Section 951(a)(1) so much of the CFC's foreign income taxes as are properly attributable to such item of income. The Proposed Regulations specify that the amounts of the CFC's foreign income taxes that are properly attributable to the relevant items of income are the corporate US shareholder's proportionate share of the current year taxes of the CFC that are allocated and apportioned to the subpart F income groups (within the relevant section 904 category of income) as the "items of income" to which the foreign income taxes are attributable. These subpart F income groups comprise the various items of foreign base company income listed in Treasury Regulations Section 1.954-1(c)(1)(iii)<sup>108</sup> and the other classes of subpart F income listed in Sections 952(a)(1), (a)(3), (a)(4) and (a)(5).<sup>109</sup>

The Proposed Regulations then determine the foreign income taxes deemed paid by the US shareholder under Section 960(a) with respect to the Section 951(a)(1)(A) inclusion of subpart F income as the amount of the CFC's "foreign income taxes that are properly attributable to *the items* of income in a subpart F income group of the" CFC.<sup>110</sup> The attribution, in other words, is not done strictly on an item-by-item basis, but by aggregating the items into the various subpart F groups for each relevant Section 904 category.<sup>111</sup> Importantly, however, there has to be an allocation of income to the relevant subpart F income group. The Proposed Regulations further define the properly attributable foreign income taxes of the CFC deemed paid by a US shareholder as the US shareholder's proportionate share of the CFC's current year taxes (allocated and apportioned to the subpart F income groups).

As in the case of GILTI inclusions, this will lead to distortions where the US taxable year and the foreign taxable year do not coincide. Not all such distortion can be smoothed out through the carryback and carryforward of unused foreign taxes under Section 904(c).

To illustrate, assume that *FS*, a CFC that is wholly owned by domestic corporation *USP*, has a calendar year as its US tax year and a June 30 year end for foreign tax purposes. Assume that *FS* has no further subsidiaries or interest in lower-tier CFCs. In 2019, *FS* has foreign base company services net income before taxes (and no other income) of \$80, all of which is earned in the last

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<sup>108</sup> These are the various categories of foreign personal holding company income, foreign base company sales income, foreign based company services income. Section 952(a)(2), Section 954(a) and Treas. Reg. §1.954-1(c)(1)(iii).

<sup>109</sup> Insurance income, income subject to the international boycott factor, income from certain bribes, kickbacks and similar payments, and income to which Section 901(j) applies.

<sup>110</sup> Prop. Treas. Reg. §1.960-2(b)(1).

<sup>111</sup> See example in Prop. Treas. Reg. §1.960-2(b)(5)

two quarters of 2019, and \$0 foreign income taxes accrued as of June 30, 2019. In 2020, *FS* has an additional \$80 of foreign base company services income (before taxes) for the first two quarters and a loss of \$80 for the last two quarters (before taxes), and as of June 30, 2020, accrues \$20 of foreign income taxes with respect to the \$160 of foreign income earned in the last two quarters of 2019 and the first two quarters of 2020.

In this example, *FS* has general category income in the foreign base company services income group of \$80 in 2019, but a loss of \$20 (after taxes) in 2020. As a result, *USP* will not be deemed to have paid any foreign income taxes in 2019 (because none accrued) or 2020 (because there was no foreign base company services income). The mismatch between taxable years can therefore not be ameliorated through the carryforward and carryback mechanism of Section 904(c).<sup>112</sup>

Treasury and the IRS should reconsider this approach and consider the approach outlined above with respect to Section 960(d). The argument here appears to be even stronger that proper attribution should track and apportion income following foreign determinations, including pro-rating it over several US taxable years if US and foreign taxable years do not match. Section 960(a) has no reference to accrual (or payment), but solely to attribution. The approach of the Proposed Regulations, which in effect substitutes accrual (or payment) for attribution is not mandated by the language of the Code, unlike the language of Section 901(b). Regulations should reflect this.

### 3. *Timing Differences and Section 960(b)*

If a lower-tier CFC distributes earnings and profits that are attributable to amounts included in the gross income of a US shareholder under Section 951(a) or Section 951A to a higher-tier CFC, the amount is not included again in the gross income of the upper-tier CFC (a “Section 959(b) distribution”).<sup>113</sup> Similarly, if a CFC distributes earnings and profits of a CFC that are attributable to amounts included in the gross income of a US shareholder under Section 951(a) or Section 951A, the amount is not included again in the gross income of the US shareholder (or any transferee US person) (a “Section 959(a) distribution”).<sup>114</sup> Section 959(c) provides ordering rules that allocate a Section 959(a) distribution and a Section 959(b) distribution to categories of

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<sup>112</sup> Prop. Treas. Reg. §1.960-1(d)(3)(ii)(A) provides that current year taxes are allocated and apportioned among the section 904 categories on the basis of the amount of taxable income computed under foreign law in each section 904 category that is included in the foreign tax base. The Proposed Regulations expressly state that “only foreign income taxes of a controlled foreign corporation that are associated under these rules with a subpart F inclusion or GILTI inclusion amount of a domestic corporation that is a United States shareholder of the controlled foreign corporation, or with previously taxed earnings and profits, are eligible to be deemed paid.” Prop. Treas. Reg. §1.960-1(a)(1).

<sup>113</sup> Section 959(b), Section 951A(f)(1)(A).

<sup>114</sup> Section 959(a)(1), Section 951A(f)(1)(A).

previously taxed earnings and profits and, last, to earnings and profits that were not previously so included.

If a Section 959(a) distribution is made to a corporate US shareholder or a Section 959(b) distribution is made to a higher-tier CFC, the US shareholder or recipient higher-tier CFC is deemed to have paid the amount of the distributing foreign corporation's foreign income taxes that is (1) properly attributable to such portion and (B) has not been deemed to have been paid by the US shareholder (or a US shareholder in the case of a lower-tier to higher-tier CFC).<sup>115</sup>

When a corporate US shareholder receives a Section 959(a) distribution, the foreign income taxes deemed paid with respect to the distribution for the taxable year the distribution is received are creditable, and the foreign tax credit limitation under Section 904 is increased.<sup>116</sup>

Proposed Regulations Section 1.960-3 provides rules for determining the amount of foreign income taxes deemed paid with respect to a Section 959(a) distribution or Section 959(b) distribution. It provides for an annual account for each year (an “annual PTEP account”) of previously taxed earnings and profits (“PTEP”) for each year. The previously taxed earnings and profits are subdivided within each annual PTEP account into the section 904 categories, and within each such annual PTEP account in a section 904 category further into PTEP groups.<sup>117</sup> The Proposed Regulations then interpret Section 960(b) as follows: foreign income taxes deemed paid with respect to a Section 959(a) inclusion are the amount of the CFC's income tax properly attributable to the section 959(a) *distribution* with respect to the PTEP group that is treated as being distributed (in accordance with the ordering rules of Section 959(c)) and that have not been deemed paid by the corporate US shareholder under Section 960 for the current or any prior taxable year.<sup>118</sup> And for a section 959(b) distribution, the amount of foreign income taxes deemed paid by the recipient CFC with respect to a PTEP group that is being distributed is the amount of the CFC's foreign income taxes properly attributable to the section 959(b) *distribution* from the PTEP group and that has been deemed to have been paid by a corporate US shareholder in the current taxable year or any prior taxable year. A typical example would be a dividend withholding tax.

Section 960(b) itself does not limit the deemed-paid foreign income taxes to those attributable to the distribution itself. Section 960(b)(1) states that, with respect to any portion of a Section 959(a) distribution, the corporate US shareholder

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<sup>115</sup> Section 960(b).

<sup>116</sup> Section 960(c). The increase is the lesser of the amount of the foreign taxes or an “excess limitation amount” established by the US taxpayer which is increased each year by the excess foreign tax credit limitation resulting from inclusions under Section 951 and Section 951A and reduced by the amount of the increase of the foreign tax credit limitation on account of using any portion of the excess limitation.

<sup>117</sup> Prop. Treas. Reg. §1.960-3(c).

<sup>118</sup> Prop. Treas. Reg. §1.960-3(b)(1).



shall be deemed to have paid so much of such foreign corporation's foreign income taxes as (A) are properly attributable to such portion and (B) have not been deemed to have ... been paid by such domestic corporation under this section [960] for the taxable year or any prior taxable year.

Section 960(b)(2) similarly states that, with respect to any portion of a Section 959(b) distribution, the recipient CFC

shall be deemed to have paid so much of such other controlled foreign corporation's foreign income taxes as (A) are properly attributable to such portion and (B) have not been deemed to have been paid by a domestic corporation under this section [960] for the taxable year or any prior taxable year.

The Proposed Regulations further interpret the foreign income taxes that are properly attributable to equal the domestic corporation's or recipient CFC's proportionate share of the PTEP group taxes with respect to the PTEP group within the section 904 category. PTEP group taxes in turn are foreign income taxes that are paid, accrued, or deemed paid with respect to an amount in each PTEP group within an annual PTEP account, and they equal the current year taxes paid or accrued by the CFC that are allocated and apportioned to the PTEP group and foreign income taxes deemed paid by a recipient CFC in respect of a Section 959(b) distribution.<sup>119</sup>

This set of definitions is narrower than the statutory language. Specifically, it does not include prior year foreign income taxes for which a deemed-paid foreign tax credit was not available because there was a loss in the subpart F group. This is so because such foreign income taxes (1) are not current year taxes in the year of distribution that are paid or accrued by the CFC and allocated to a PTEP group in an annual PTEP account (as there would be no earnings and profits to which the taxes relate, if imposed in respect of the current year of distribution, and as the taxes would not be imposed in the current year, if the distribution occurs in a later year); and (2) they are not a foreign income tax imposed on the recipient CFC.

Foreign income taxes of a distributing CFC for which no deemed-paid foreign tax credit was available in the year they were imposed for lack of subpart F income may nonetheless be properly attributable to a portion of a Section 959(a) or Section 959(b) distribution and therefore be described in Section 960(b). In other words, Section 960(b) might be considered as an alternative to bringing up foreign income taxes that were not creditable in the year in which they were paid or accrued because there was no income in the relevant PTEP group under the timing mismatch scenarios described above. This would be so because these foreign taxes (1) have not been deemed paid in the current or any prior taxable year by a US shareholder and (2) are properly attributable, at least in part, to the prior year PTEP group.

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<sup>119</sup> Prop. Treas. Reg. §1.960-3(b)(3) and (d)(1).

In the example of the last section, the foreign income taxes paid in 2020 with respect to the general category income in the foreign base company services income group and the PTEP group for earnings and profits attributable to subpart F inclusions would, on a section 959(a) distribution by *FS* to *USP* be properly attributable to the 2019 general category income in the same PTEP group, and thus become creditable. By making foreign income taxes that were not creditable as current year taxes attributable to PTEP groups upon a Section 959(a) distribution or, *mutatis mutandis*, a Section 959(b) distribution, mismatched foreign income taxes would become available for foreign tax credit at least at a later time when a distribution is made out of the relevant PTEP group.

The Proposed Regulations do not, however, treat foreign income taxes in a manner that would allow them to be so attributed to a prior year PTEP group upon distribution. The foreign income taxes accrued in 2020 by *FS* are not PTEP group taxes as defined in the Proposed Regulations because they are not attributable to a distribution.

If the approach in the prior sections is not adopted to provide for the proper attribution of foreign income taxes to foreign income for purposes of Section 960(a) and Section 960(d), we recommend that Treasury and the IRS expand the concept of a PTEP group tax to include foreign income taxes that are not deemed paid by a corporate US shareholder under Sections 960(a) or 960(d) because of a lack of associated foreign income in the relevant Section 904 category. While this will not solve the problem that such taxes are in effect “stranded” without becoming available to a US shareholder for credit in the year they accrue or in the year in which the related foreign income was realized, they at least become available at some point upon a distribution of the PTEP group in the relevant category and of the relevant year.

#### 4. *Treatment of Foreign Taxes Paid with Respect to Certain Disregarded Payments Under Section 960(a) and (d)*

To determine whether foreign taxes are properly attributable, foreign taxes are allocated and apportioned under Proposed Regulations Section 1.960-1(d)(3)(ii) to either the tested income group or the subpart F income groups within the Section 904 category of the CFC. If foreign taxes are attributable to another group (such as a residual income group or a PTEP group), they do not qualify as a deemed-paid foreign tax credit under Section 960(a) or (d). It appears not entirely clear to what category foreign income taxes imposed on a distribution by a disregarded subsidiary of a CFC to its owner CFC are attributable. This affects both withholding taxes imposed on the (disregarded) distribution and foreign income taxes imposed on the owner CFC with respect to the receipt of the distribution.

For current year taxes attributable to a base or timing difference, Proposed Regulations Section 1.960-1(d)(3)(ii)(B)(1) provides specific rules: taxes attributable to base differences are always allocated to the residual group, and taxes attributable to a timing difference are related to “the appropriate section 904 category and income group within a section 904 category to which

the particular tax would be assigned if the income on which the tax is imposed were recognized under US tax principles in the year in which the tax was imposed.”<sup>120</sup>

The Proposed Regulations provide that withholding tax on disregarded payments to a CFC is treated as a timing difference and not related to a PTEP group, but may be treated as related to the subpart F group or the tested income group.<sup>121</sup> They do not expressly provide for the treatment as a base or timing difference of foreign income taxes imposed on the recipient owner CFC. The definition of base difference in Proposed Regulations Section 1.904-6(a)(1)(iv) suggests that each class of foreign tax imposed in respect of a disregarded distribution (or any other disregarded payment for that matter) might relate to a base difference as the tax is imposed on a type of item that does not constitute income under US tax principles. It may not fall within the scope of this definition because a disregarded payment is never an item or because the item as determined for foreign income tax purposes, i.e., a dividend distribution, does in fact constitute income under US tax principles. However, it is not clearly within the definition of a timing difference either because the disregarded payment is not an item of income that constitutes income under US tax principles but is not recognized in the current year for US tax purposes. While we agree that a disregarded distribution from a disregarded entity to its owner (or, for that matter, from a disregarded entity to its disregarded entity owner in the case of a chain of disregarded entities) should be treated as an item giving rise to a timing difference under Section 904, we recommend that the definition be expanded to clearly reflect this. Consideration should also be given to treating all disregarded payments between disregarded entity and owner as well as between two disregarded entities with the same owner as giving rise to timing differences with respect to related foreign income taxes.

Foreign income taxes attributable to a disregarded distribution timing difference, including withholding taxes on disregarded payments, are treated as relating to the appropriate Section 904 category and income group “to which the particular tax would be assigned if the income on which the tax is imposed were recognized under federal income tax principles in the year in which the tax was imposed.”<sup>122</sup> This is nearly identical to the language used to allocate foreign taxes attributable to timing differences under Proposed Regulations Section 1.904-6(a)(1)(iv). However, the Proposed Regulations under Section 960 offer no further guidance on what it would mean for such a payment to be “recognized under federal income tax principles.” In other words, a withholding tax imposed on a disregarded distribution by a disregarded entity to its owner CFC would require a US shareholder to treat such disregarded payment as if it were not a disregarded payment to determine the appropriate separate category to which the foreign withholding taxes relate, but there appears to be no applicable guidance as to how that works in practice.

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<sup>120</sup> Consequently, those taxes attributable to base differences do not qualify for the deemed paid credit under Section 960(a) or (d).

<sup>121</sup> Prop. Treas. Reg. §1.960-1(d)(3)(ii)(B)(2).

<sup>122</sup> Prop. Treas. Reg. §1.960-1(d)(3)(ii)(B)(1).

For disregarded payments from a foreign branch, the Proposed Regulations offer special rules for certain types of disregarded payments, but it is not clear that they apply to payments to a CFC (as a “foreign branch” by definition has a US person as its owner).<sup>123</sup> If they did apply, the Proposed Regulations regarding the treatment of taxes relating to disregarded payments to or from a foreign branch offer two methods for classifying such taxes: one for disregarded reallocation transactions,<sup>124</sup> which should not apply here, and one for all other disregarded payments. The latter method treats “a gross basis withholding tax on a remittance” as “attributable to a timing difference in taxation of the income out of which the remittance is made, and is allocated and apportioned to the separate category or categories to which a Section 987 gain or loss would be assigned under [Treasury Regulations Section] 1.987-6(b).”<sup>125</sup> In other words, the disregarded distribution would be treated like a remittance, its attribution to separate categories of income is based on the asset method of Treasury Regulations Section 861-9T(g), and the foreign income taxes are then attributed to the relevant separate categories.<sup>126</sup>

While the method under the Proposed Regulations for treating disregarded payments to or from a foreign branch is complex, it also provides a useful mechanic for determining how to properly allocate and apportion taxes paid with respect to a foreign branch. We recommend that Treasury and the IRS clarify how Proposed Regulations Section 1.904-6 is intended to apply.

#### **F. Treatment of Foreign Income Taxes Attributable to Section 956 Inclusions**

Section 960(a), as modified by the TCJA, provides that a domestic corporation that includes in gross income any “item of income under Section 951(a)(1) with respect to any controlled foreign corporation” of which the domestic corporation is a US shareholder is deemed to have paid the amount of the CFC’s foreign income taxes that are “properly attributable” to such item of income.

Before its modification by the TCJA, Section 960(a) stated that “if there is included in the gross income of a domestic corporation any amount attributable to earnings and profits of a foreign corporation which is a member of a qualified group (as defined in Section 902(b)), with respect to the domestic corporation, then, except to the extent provided in regulations, Section 902 shall be applied as if the amount so included were a dividend paid by such foreign corporation.”

Inclusions under Section 951(a)(1) comprise (1) the US shareholder’s pro rata share of the CFC’s subpart F income for the tax year and (2) the amount determined under Section 956 with

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<sup>123</sup> See Prop. Treas. Reg. §1.904-6(a)(2).

<sup>124</sup> A disregarded allocation payment is “a disregarded payment or transfer described in §1.904-4(f)(2)(vi)(D) [i.e., property described in section 367(d)(4) is transferred to or from a foreign branch] that results in an adjustment to gross income attributable to the foreign branch under §1.904-4(f)(2)(vi)(A).”

<sup>125</sup> Prop. Treas. Reg. §1.904-6(a)(2)(iii)(A).

<sup>126</sup> Treas. Reg. §1.987-6(b)(2).

respect to such shareholder for such year to the extent not excluded from gross income under Section 959(a)(2) as previously taxed subpart F income or GILTI. Under Section 956, a US shareholder of a CFC is required to include in gross income the excess of the shareholder's pro rata share of the average of the amounts of United States property (as defined in Section 956(c)) held by the CFC as of the close of each quarter of its taxable year over prior year inclusions under Section 956. The inclusion is limited to the US shareholder's pro rata share of the current and accumulated earnings and profits (reduced by distributions of earnings and profits during the taxable year).<sup>127</sup>

Section 956 was not repealed or amended by the TCJA, even though it is hard to reconcile with the territorial tax regime of new Section 245A that generally exempts, through a 100% deduction, the foreign-source portion of any dividends received from a foreign corporation by a domestic corporation that is a US shareholder with respect to the foreign corporation. The deduction is disallowed, however, in two situations. First, the deduction under Section 245A is disallowed for a hybrid dividend, which is any amount received from a foreign corporation that is a CFC if the foreign corporation received a deduction or other tax benefit with respect to the foreign taxes imposed. Second, the deduction under Section 245A is disallowed if the domestic corporation that receives the dividend does not satisfy a minimum holding period of at least 365 days during the 731-day period beginning on the date that is 365 days before the date on which the foreign corporation's shares become ex-dividend with respect to the dividend or was not a US shareholder at all times during that 365 minimum holding period.<sup>128</sup> Section 245A(d) provides that neither a foreign tax credit under Section 901 nor a deduction is permitted for any foreign taxes paid or accrued (or treated as paid or accrued) with respect to the foreign source portion of a dividend from a foreign corporation.

Treasury and the IRS issued proposed regulations (the "Section 956 Proposed Regulations") to address the disparity in tax treatment between dividends that benefit from the Section 245A deduction and Section 956 inclusions that would not.<sup>129</sup> According to the preamble of the Section 956 Proposed Regulations, this discrepancy is "a result directly at odds with the manifest purpose of Section 956."<sup>130</sup> To remove this discrepancy, the Section 956 Proposed Regulations reduce a corporate US shareholder's amount included under Section 956 by the amount that the US shareholder could have deducted under Section 245A(a) if, instead of the CFC making an investment in United States property, the CFC had distributed the amount to the US shareholder as a dividend.<sup>131</sup> Section 956 amounts for which the Section 245A dividend would be

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<sup>127</sup> Sections 956(a) and (b)(1).

<sup>128</sup> Sections 245A(e) and 246(c)(5).

<sup>129</sup> REG-114540-18, 83 Fed. Reg. 55,324 (Nov. 5, 2018).

<sup>130</sup> 83 Fed. Reg. at 55,326.

<sup>131</sup> Prop. Treas. Reg. §1.956-1(a)(2).

disallowed would continue to be includible in the income of a US shareholder under Section 951(a)(1)(B).

Under pre-TCJA Section 960(a), an amount included under Section 951(a)(1)(B) brought with it a deemed-paid foreign tax credit in the same manner as a subpart F inclusion. The Proposed Regulations by contrast take the view that no deemed-paid foreign tax credit would be available under Section 960(a) with respect to an inclusion under Section 951(a)(1)(B). The approach of the Proposed Regulations is in tension with the language of Section 960(a), as described above. The Preamble defends the approach on the basis that an inclusion under Section 951(a)(1)(B) is not an inclusion of an “item of income” *of* the CFC; rather, it is an inclusion equal to “an amount” determined under the formula in Section 956(a). The Proposed Regulations would not allow for any deemed-paid foreign tax credit under Section 960(a) with respect to an inclusion under Section 951(a)(1)(B).<sup>132</sup>

Although the Preamble does not address any reason other than the “item of income” justification for the denial of the deemed-paid foreign tax credit,<sup>133</sup> the approach in the Proposed Regulations appears to extend the Section 956 Proposed Regulations and mirror Section 245A.

For the class of dividends from a foreign corporation to a US shareholder that are ineligible for the deduction under Section 245A (generally, where the holding period requirement is not satisfied or the dividend is a hybrid dividend), the dividend is fully taxed in the US and there is apparently no credit allowed for taxes imposed on the foreign corporation. The Proposed Regulations would adopt a similar approach under Section 960(a) in respect of the class of Section 956 inclusions that remains after the Section 956 Proposed Regulations (scenarios involving an unsatisfied holding period or hybridity). We believe that consistency between Section 245A and Section 956 is a sensible policy, but we observe a tension between the approach of the Proposed Regulations and the language of Section 960(a).

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<sup>132</sup> Last sentence of Prop. Treas. Reg. § 1.960-2(b)(1) (“No foreign income taxes are deemed paid under section 960(a) with respect to an inclusion under section 951(a)(1)(B)”).

<sup>133</sup> The Preamble refers to items of income *of* the CFC. The express language of Section 960(a), however, allows for the credit with respect to inclusions of items of income *with respect to* any CFC. Section 951(a)(1)(A) arguably does not result in an inclusion of items *of* the foreign corporation any more than Section 956 does, but of net income in various categories of subpart F income. Further, the statement in the Preamble that “an inclusion under section 951(a)(1)(B) is not an inclusion of an ‘item of income’ *of* the CFC” (emphasis added) arguably differs from the “with respect to” test of Section 960(a). One could question why a Section 951(a)(1)(B)/956 inclusion is not an inclusion of items “with respect” to a CFC.