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Proposed Foreign Tax Credit Regulations

Expense Allocation Rules Provide Limited GILTI Relief but Otherwise Make Limited Changes—Indirect Credit Rules Are Complex and Differ Significantly from the Former "Pooling" Regime

SUMMARY

The IRS and Treasury Department have issued proposed regulations (the "Proposed Regulations") intended to implement the new foreign tax credit provisions of the 2017 tax reform legislation (the "Act"). Significant features of the Proposed Regulations include the following:

- In general, treatment of "global intangible low taxed income" or "GILTI" (as described later in this memo) as a separate "basket" for foreign tax credit purposes, together with retention of the existing expense allocation rules under Section 861 of the Internal Revenue Code of 1986, as amended (the "Code").
  - This means that shareholder-level expenses will be allocated to GILTI inclusions, which will make it even more difficult for U.S. corporate taxpayers to credit fully all deemed paid foreign taxes attributable to GILTI. The Proposed Regulations, however, do provide limited relief to corporate groups that have foreign taxes attributable to GILTI: they would allow corporate taxpayers to treat foreign corporate stock in respect of which they have GILTI as partially tax-exempt, which would cause a portion of the shareholder-level deductions that would otherwise be allocated to such stock to be allocated instead to other assets.
  - Further, with respect to noncorporate taxpayers, notwithstanding that they are fully subject to the newly adopted GILTI inclusion rules, the Proposed Regulations do not address how those rules will interact with existing Section 962 of the Code (which grants noncorporate taxpayers an election to treat themselves as corporations for foreign tax credit purposes). In the absence of regulatory clarifications, it is unclear the extent to which making an election under Section 962 of the Code can be used effectively to mitigate the 37% maximum tax rate that otherwise would apply to GILTI inclusions of noncorporate taxpayers.
- An entirely new system for "deemed-paid" credits under Section 960 of the Code, which is now the only section of the Code under which "deemed paid" credits are allowed. These rules are highly complex and very different from the former "pooling" system that previously applied to foreign tax credits allowed under Section 902 of the Code, and approximate (but are not exactly) a tracing regime. These new indirect credit rules require annualized tracking, which means that timing

mismatches may lead to unexpected outcomes. Accordingly, timing rules will be more important than before, in part because there are no carryovers of foreign tax credits in the GILTI basket (where many corporate taxpayers will have excess credits), and in part because foreign taxes that are not attributable to current Subpart F income or "tested income" for GILTI purposes or directly imposed on Section 959 distributions of previously taxed income will not be eligible for foreign tax credits at all.[1]

- New rules for the "foreign branch" basket that, for certain purposes, treat a foreign branch as a separate entity for foreign tax credit purposes. These provisions also include a transition rule that permits (but does not require) taxpayers to treat pre-2018 taxes that would have been allocated to the new "foreign branch" basket as "foreign branch" taxes.
- Rules that deny a "deemed paid" credit for inclusions under Section 956 (*i.e.,* income arising from a CFC's investments in U.S. property).
- Confirmation, as previously announced, that income resulting from the "Section 78 gross-up" (as described below) will be allocated to the same basket as the deemed paid taxes that result in the gross-up.

The Proposed Regulations are generally proposed to be effective for 2018 taxable years, meaning that U.S.-parented multinationals will have limited time to assess the impact of the Proposed Regulations on the tax positions reported in their year-end financials.

BACKGROUND

A. GENERAL BACKGROUND ON FOREIGN TAX CREDITS

To prevent double taxation of income that is taxed both in the United States and in a foreign jurisdiction, the U.S. tax system permits taxpayers to claim foreign tax credits ("FTCs") in respect of foreign income taxes. In general, foreign taxes are creditable in the United States only if those taxes are directly paid by a U.S. taxpayer. However, in certain cases (*e.g*., foreign taxes paid by a subsidiary), a domestic corporation (but not a U.S. individual, unless that individual makes a "Section 962 election" to be taxed at corporate rates) may be entitled to a "deemed paid" credit for its share of the foreign taxes that were "indirectly" paid by the subsidiary. If a "deemed paid" credit is claimed, an additional amount (the so-called "Section 78 Gross-Up") must be included in income so that the total amount of income recognized by the domestic corporation as a result of a taxable inclusion plus the "deemed paid" credit equals the amount of income that would have been recognized had the domestic corporation earned the relevant income (and paid the applicable foreign tax) directly.

FTCs are also subject to a complex set of restrictions that are imposed by Section 904 (the "FTC Limitation"). In general, the FTC Limitation provides that FTCs may not exceed the U.S. income tax on a taxpayer's foreign-source income. Furthermore, the FTC Limitation is computed separately for each "basket" or relevant type of foreign-source income (*e.g.,* "passive" income, "general" income, etc.) that is earned by a taxpayer.

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1 References herein to a "Section" are to sections of the Code and the Treasury regulations ("Treasury Regulations" or "Treas. Reg.") promulgated thereunder.

Computing a taxpayer's income in each FTC "basket" means that deductions must be allocated and apportioned among the different categories of income that are earned by a taxpayer. In many cases the applicable rules[2] provide that a particular deduction is "definitely related" to a particular item of gross income (so, for example, wages paid to employees of an office will generally be "definitely related" to the business income earned by that office). However, certain significant expenses (*e.g.*, interest and stewardship costs) are generally not "definitely related" to a specific item of gross income[3] and must be allocated and apportioned among the types of gross income earned by a taxpayer under a method prescribed by the applicable regulations.

B. CHANGES MADE BY THE ACT

The Act made significant changes to the U.S. FTC system and related provisions, including the following:

- Introducing the GILTI regime, which generally (i) requires "United States shareholders" of "controlled foreign corporations" ("CFCs") to recognize annually as current income the amount of "tested income" earned by the CFCs that is in excess of a 10% "normal" return on the CFCs' tangible assets (whether or not such income is distributed), but also (ii) introduces a participation exemption system for corporations that effectively exempts the remaining amounts (*i.e.*, amounts covered by the 10% "normal return") of CFCs (and certain other interests in foreign corporations) from shareholder-level taxation when distributed;
- Repealing the old "Section 902" deemed paid FTC rule that allowed U.S. corporations to claim a "deemed paid" FTC when dividends were paid from 10% (or greater)-owned foreign corporations (but adding a partial replacement for indirect FTCs under Section 960 of the Code for GILTI and Subpart F income inclusions of U.S. corporations);
- Adding a new FTC basket for GILTI. In contrast to most FTC baskets, foreign taxes allocated to the GILTI basket cannot be carried back to prior years or forward to future years, and only 80% of such foreign taxes attributable to a U.S. taxpayer in any year are allowed as foreign tax credits);
- Adding a new FTC basket for "foreign branch" income (including income of partnerships), which limits the cross-creditability of foreign taxes between branches and CFCs; and
- Repealing the "fair market value" method for apportioning interest expense (meaning that interest must be allocated under the "tax book value" method or the "alternative tax book value" method).

C. GENERAL BACKGROUND ON GILTI

The Act introduced the GILTI regime, which effectively taxes U.S. shareholders of CFCs on the U.S. shareholder's *pro rata* share of any income of the CFC in excess of a 10% "normal" return on the depreciable tangible assets of the CFCs (the "net deemed tangible income return"). The amount of GILTI to be included in the gross income of a U.S. shareholder of a CFC equals the excess of the U.S. shareholder's "net CFC tested income" over the U.S. shareholder's net deemed tangible income return. "Net CFC tested income" is defined as the excess (if any) of a U.S. shareholder's *pro rata* share of "tested income" from CFCs over "tested losses" from CFCs. "Tested income" and "tested loss" are computed at

2 *See generally* Treas. Reg. § 1.868-8 and Treas. Reg. § 1.861-8T.

3 Limited exceptions to this general rule exist for—for example—interest paid in respect of "qualified nonrecourse indebtedness."

the CFC level, and each U.S. shareholder's *pro rata* share of these amounts is then determined under the same rules that apply to Subpart F income. "Net deemed intangible income return" is equal to 10% of the U.S. shareholder's *pro rata* share of the "qualified business asset investment" ("QBAI") (in general, tangible depreciable property used in a trade or business, measured by adjusted basis) held by the U.S. shareholder's CFCs, reduced by net interest expense taken into account for calculating tested income or loss. The GILTI inclusion is equal to the combined total of the tested income and tested loss allocated to a taxpayer from all CFCs with respect to which the taxpayer is a U.S. shareholder, over the U.S. shareholder's *pro rata* share of the CFCs' net deemed tangible income return, which is determined under allocation rules similar to those applicable to tested income and Subpart F income.

The Act allows U.S. shareholders that are corporations both a 50% deduction ("the Section 250 deduction") with respect to GILTI inclusions for taxable years beginning before 2026 (which results in an effective corporate tax rate of 10.5% on GILTI inclusions) and a foreign tax credit for 80% of the foreign taxes related to that income. The result of the operation of these two rules is that, for a corporate U.S. shareholder, foreign income subject to a 13.125% tax rate or higher would be effectively exempt from U.S. tax on GILTI, but for the expense allocation rules described below, which may result effectively in additional taxation for U.S. shareholders even in respect of income subject to foreign tax at a rate above 13.125%.[4]

DISCUSSION

A. EXPENSE ALLOCATION RULES

As discussed more fully below, the Proposed Regulations require allocation of certain shareholder-level expenses to reduce GILTI, which may result in additional taxation for U.S. shareholders even when tested income is subject to foreign tax at a rate above 13.125%. CFC stock is treated as partially exempt from expense allocation, however, which somewhat mitigates the impact of expense allocation to reduce GILTI income.

1. In General; Allocation of Expenses to Reduce GILTI

The Proposed Regulations largely retain (with limited modifications, discussed below) the existing expense allocation and apportionment rules that are issued under Section 861. However, the preamble to the Proposed Regulations suggests that the pending implementation of Section 864(f) (which will allow

4 The Act also provides for a special regime for foreign-derived intangible income ("FDII") of U.S. corporations. In general, FDII is the portion of a U.S. shareholder's net deemed intangible income that is attributable to sales of property to foreign persons for foreign use or to services provided to persons, or with respect to property, located outside the United States. The Act allows a deduction (the "Section 250 FDII deduction") equal to 37.5% of a U.S. corporate shareholder's FDII, resulting in an effective tax rate of 13.125% on FDII.

affiliated groups to elect to allocate interest and similar expenses on a worldwide basis, starting in 2021 and subsequent taxable years) may necessitate a full re-examination of the existing allocation rules.[5]

The most significant aspect of the new expense allocation rules may be the requirement that shareholder-level expenses, such as interest and certain stewardship expenses,[6] be allocated to reduce GILTI income. This requirement is especially significant to U.S.-parented multinational groups with foreign operations that are subject to relatively high rates of foreign tax because allocating shareholder-level expenses to GILTI-producing assets reduces GILTI-basket foreign-source income (but does not reduce GILTI inclusions). Therefore, if a corporate U.S. shareholder is in an excess GILTI foreign tax credit position, interest or stewardship expenses that are allocated to GILTI-producing assets are essentially lost because: (i) those deductions displace FTCs that otherwise would have sheltered the GILTI income and (ii) the displaced FTCs cannot be used to shelter other types of income. Moreover, because GILTI FTCs cannot be carried forward to future years or back to prior years, the displaced GILTI FTCs are permanently lost.

Arguably this effect is distortive and inconsistent with the legislative history of GILTI (which can be read to suggest that Congress did not intend for U.S. shareholders of CFCs that pay an effective foreign tax rate of 13.125% or more to owe incremental U.S. tax under the GILTI rules). This prompted many commentators to ask that the IRS and Treasury Department issue regulations that would require no shareholder-level expenses to be allocated to the GILTI basket.[7] Additionally, U.S. groups that are in an "excess limitation" position for the GILTI basket (because their CFCs are subject to an effective tax rate of less than 13.125%) may be unaffected by allocations to the GILTI basket. This means that, in certain cases, requiring that interest and other shareholder-level expenses be allocated to the GILTI basket arguably encourages U.S. groups to earn foreign income that is taxed at very low (*i.e.*, sub-13.125%) rates. On the other hand, allocating no interest expense to GILTI-producing assets arguably would be distortive because borrowing to invest in GILTI-producing assets would allow taxpayers to borrow to fund

[5] 83 FR 63201.

[6] As discussed above, most other significant expenses are "definitely related" to a specific item or class of income.

[7] The preamble to the Proposed Regulations states that the Treasury Department and the IRS "have received comments suggesting that section 951A, in combination with section 904(d)(1)(A) . . . was intended to provide that the income of a United States shareholder derived through the CFC would be subject to additional U.S. tax if the foreign effective tax rate is below a particular rate, and should be effectively exempt from U.S. tax if the foreign effective tax rate is at or above that rate. These comments generally cite language in [the Conference Report to the Act] illustrating that no U.S. 'residual tax' applies to foreign earnings subject to a foreign effective tax rate of 13.125 percent or more." 83 FR 63200. The Conference Report states, "At foreign tax rates greater than or equal to 13.125 percent, there is no residual U.S. tax owed on GILTI, so that the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate." H.R. Rep. 115–466, 626-627.

investments earning low-taxed income and use the interest deductions from the borrowing to offset U.S.-source (or other foreign-source) income subject to tax at a higher rate.[8]

2. "Discount" for FDII and GILTI

Although the Proposed Regulations require the allocation of interest and other shareholder expenses to GILTI-producing assets, the impact of this allocation is somewhat mitigated by a rule treating a portion of a taxpayer's CFC stock as an "exempt" asset to which interest and other shareholder-level expenses need not be allocated.[9] The portion of the CFC stock that is treated as "exempt" is equal to the value of the taxpayer's GILTI inclusion stock multiplied by the ratio of the taxpayer's Section 250 deduction to its Section 951A inclusion.[10] This partial exemption effectively reduces the value of the GILTI-producing assets for expense allocation purposes, and as a result less interest expense will be allocated to those assets than would have been the case absent the reduction. The "discounted" interest thus effectively is allocated to other income.[11] Under the Proposed Regulations, however, the Section 250 deduction itself is specially allocated to GILTI.[12]

It should be noted that these partial exemptions apply only to taxpayers that are eligible for a Section 250 deduction (*i.e*., in general, domestic corporations but not individuals). In addition, substantial amounts of interest and other shareholder-level deductions can be "lost" notwithstanding this relief. For example, consider a U.S.-parented multinational ("USP") with one CFC ("CFC"). The book value of USP's stock in CFC is $2000. In 2019, CFC earns $200 of gross tested income and pays $40 of foreign income tax (meaning that USP has $160 in net tested income and a $40 Section 78 Gross-Up). USP's Section 951A inclusion is $200 ($160 net tested income + $40 Section 78 Gross-Up). USP's Section 250 deduction is $100 (50% of $200), $80 of which is allocated to GILTI and $20 of which is allocated to the Section 78 Gross-Up. In 2019, USP also earns U.S.-source income of $200, and the book value of USP's U.S. assets is likewise $2000. For this year, USP has $120 in interest expense, no other deductions and no QBAI. USP uses the book value method:

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8 For a further discussion of the policy considerations that relate to this issue, *see* New York State Bar Association Tax Section Report on the GILTI Provisions of the Code (May 4, 2018), *available at* https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2018/1394_Report.html.

9 Existing temporary regulations do not require allocation of interest and other shareholder expenses to tax-exempt assets, but also eliminate the value of such assets from the denominator of the expense allocation fraction. Treas. Reg. § 1.861-8T(d)(2).

10 That is, the fraction the numerator of which is the participation deduction claimed by the taxpayer and the denominator of which is the sum of the taxpayer's GILTI inclusion and the related "Section 78 Gross-Up" dividend for deemed paid foreign taxes.

11 A similar rule applies to assets that provide FDII.

12 Any portion of the deduction attributable to FDII, is likewise allocated to FDII. By contrast, the Proposed Regulations provide that the dividends received deduction under Section 245A (*i.e.*, the participation exemption) does not give rise to exempt income and does not cause any stock on which the dividend is received to be treated as exempt.

- $2000 of USP's CFC stock is initially assigned to the Section 951A category, but $1000 of the CFC stock is treated as an exempt asset (*i.e.*, $2000 multiplied by USP's inclusion percentage of 50%, which is equal to the ratio of USP's $100 Section 250 deduction to USP's $200 Section 951A inclusion). The $1000 of excluded CFC stock is excluded from both the numerator and the denominator of the ratio for apportioning interest expense to the Section 951A category. Accordingly, USP is treated as having $1,000 of Section 951A assets and $3,000 of total assets.
- $80 of USP's interest expense ($120 * ($2,000 / $3,000)) is apportioned to U.S. assets, and $40 of USP's interest expense ($120 * ($1,000 / $3,000) is apportioned to the CFC's stock, all of which is treated as a Section 951A asset.
- Therefore, USP's foreign-source GILTI (numerator of Section 904(a) fraction for GILTI basket) is $60 ($200 - $100 - $40). USP's worldwide gross income is $400, and its worldwide net income (denominator) is $180 ($400 gross income minus $100 Section 250 deduction minus $120 interest expense). The tentative U.S. tax on USP's worldwide income is $37.80 ($180 * 21%). USP's GILTI basket FTC limitation is $12.60 ($60 / $180 * $37.80), so $27.40 of the foreign taxes paid by CFC are not creditable. This is the relevant limitation because $12.60 is less than $32 (80% of the foreign taxes attributable to the GILTI included by USP). None of the $27.40 of excess foreign tax credits can be carried forward or back.

3. Additional Expense Allocation Rules

The Proposed Regulations also make the following modifications to the expense allocation rules:

- Solely for expense allocation purposes, taxpayers are deemed to have made a Section 1.965-2(f) election (so an E&P deficit in a CFC will reduce basis for expense allocation purposes and—accordingly—the amount of shareholder-level expenses attributed to the CFC), but basis increases in a CFC that are attributable to the Section 965 deemed repatriation are excluded.[13]
- Clarification that partially exempt assets (*e.g.*, domestic corporate shares eligible for the 50% dividends received deduction) can still attract a *pro rata* portion of expenses.
- A transition rule for taxpayers that used the fair market value allocation method (which, as noted above, was repealed by the Act). Under this rule, affiliated groups may generally elect to value their assets in 2018 by reference to end-of-first-quarter and year-end (instead of beginning of year and year-end) values.
- Several new anti-avoidance rules, including rules that disregard the impact of "specified partnership loans" (*i.e.,* in general, loans to partnerships that are held by partners or their affiliates),[14] certain back-to-back loans that are ultimately held by third parties,[15] and certain loans held by CFCs[16] for expense allocation purposes.

B. FOREIGN TAX CREDIT LIMITATION RULES

1. In General

The Proposed Regulations update the existing FTC "basketing" rules under Section 904 to take into account the new foreign branch and GILTI baskets that were added by the Act. In addition, the Proposed

[13] *See* Prop. Treas. Reg. § 1.861-12(c)(2)(i)(B)(ii).

[14] *See* Prop. Treas. Reg. § 1.861-9(e)(8)(ii).

[15] *See* Prop. Treas. Reg. § 1.861-9(e)(8)(iii).

[16] *See* Prop. Treas. Reg. § 1.861-9(e)(8)(iv).

Regulations include transition rules governing carryovers of FTCs between periods before and after the effective date of the Act and guidance on the calculation of income in the new foreign branch basket.

2. Calculation of Foreign Branch Income

The Act added a new foreign tax credit basket for "foreign branch income," which includes the aggregate of the income earned by a U.S. taxpayer's foreign branches. Generally, foreign branch income is determined based on the amount of income that is reflected on each foreign branch's separate books and records. Allocations of income from U.S. or foreign partnerships may be treated as foreign branch category income to U.S. partners to the extent attributable to a foreign branch of the partnership.

The Proposed Regulations provide that the income of the foreign branch must be adjusted to take into account certain transactions (other than payments of interest and certain interest equivalents) between a branch and its owner, and between branches with the same owner, that would otherwise be disregarded for U.S. federal income tax purposes. Under this provision, income from deductible payments made by a foreign branch is not treated as foreign branch category income by the owner of the branch, but is allocated to a basket in the hands of the recipient under the general basketing rules. Thus, while these transactions are still disregarded for purposes of determining overall foreign source income, they are regarded for purposes of moving foreign source income from one basket (*e.g.,* the foreign branch income basket) to another (*e.g.,* the general basket). The effect of regarding these transactions will generally be to make it more difficult for U.S. taxpayers to manage both the amount of foreign tax paid by the branch and the use of those taxes as foreign tax credits in the foreign branch income basket.

The Proposed Regulations also exclude certain categories of items from the foreign branch category, specifically:

- Income arising from activities carried out in the United States.
- Income arising from stock, including dividends and gain from the disposition of stock (unless the stock would be dealer property), and Subpart F and GILTI inclusions.
- Gain from a branch's disposition of an interest in a disregarded entity or partnership, except gain on partnership interests where the gain is recorded on the branch's books and records and the interest is held in the ordinary course of the branch's active trade or business. (An interest is considered to be held in the ordinary course of the foreign branch's active trade or business if the foreign branch engages in the same, or a related, trade or business as the disregarded entity or partnership the interest in which is being sold or exchanged.)

3. Look-Through Rules

Generally, dividends, interest, rents and royalties paid by a CFC to its U.S. shareholder are not passive income except to the extent such payments are attributable to passive income of the CFC under "look-through" rules in the Proposed Regulations. Likewise, Subpart F and GILTI inclusions in respect of a CFC are treated as passive income to the extent the inclusions are attributable to passive income of the

CFC.[17] Importantly, these "look-through" rules do not treat interest, rents and royalties from a CFC as GILTI.

4. Transition Rules

The Proposed Regulations provide as a default rule that excess FTCs carried over from taxable years beginning before 2018 generally carry over into the same basket to which they were allocated under prior law (*i.e.*, the general or passive basket). However, the Proposed Regulations allow taxpayers to elect to assign pre-2018 FTC carryovers in the general category to the foreign branch category to the extent those FTCs would have been allocated to the foreign branch category had the foreign taxes been paid or accrued post-2017. This election enables taxpayers to avoid the double taxation that could result due to FTC basket mismatches, such as those arising from timing differences in the recognition of income for U.S. and foreign purposes. For instance, if a foreign branch earns income that is recognized for foreign tax purposes in 2017, and the foreign branch incurs foreign taxes with respect to that income in 2017, but the income is not recognized for U.S. tax purposes until 2018, in the absence of the election described above, the FTC carryovers would be in the general basket, while the corresponding income would be in the foreign branch basket, potentially limiting the use of the FTC carryovers as a result of the FTC Limitation.

The Proposed Regulations do not permit a taxpayer to reallocate pre-2018 FTC carryovers to the GILTI basket, as the preamble to the Proposed Regulations states that a determination of GILTI income in pre-2018 periods is not possible.[18] This rule is generally taxpayer-friendly, because GILTI basket FTCs cannot be carried over and accordingly pre-2018 FTCs would be lost if assigned to the GILTI basket.

Post-2017 general and foreign branch basket FTCs that are carried back to pre-2018 periods are allocated to the general basket, while FTCs in the passive category and other "specified separate categories" (such as the special categories for income resourced under treaties) are carried back to the same category to which they were allocated in the post-2017 year. Under the Act, GILTI basket FTCs may not be carried back.

C. RULES FOR CALCULATING DEEMED PAID TAXES

1. In General; Pooling System Replaced with Tracing-Like Regime for Deemed Paid Foreign Taxes

As discussed above, the Act repealed the credit for foreign taxes "deemed paid" in respect of dividends from 10%-owned foreign corporations[19] and, by extension, the "pooling" system thereunder for tracking

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[17] Special look-through rules apply to income subject to the special category under § 901(j)(1)(B) (*i.e.*, for income from source countries with respect to which the U.S. has severed diplomatic relations, the government of which the U.S. does not recognize, etc.).

[18] 83 FR 63208.

[19] *See* Section 902, as in effect prior to the Act.

foreign taxes. The Proposed Regulations replace the former pooling system with a set of detailed rules for calculating foreign taxes incurred by a CFC that are "deemed paid" by a U.S. shareholder, and the shareholder's FTCs in respect thereof. The new rules provide that foreign taxes are only eligible to be treated as deemed paid, and the resulting FTCs are only available to a U.S. shareholder, in respect of Subpart F and GILTI inclusions and distributions of previously taxed earnings and profits ("PTEP"). With some exceptions, these rules approximate a "tracing" regime under which FTCs are only available to the extent the underlying foreign taxes are attributable to particular items of income giving rise to Subpart F or GILTI inclusions to the U.S. shareholder, or to foreign taxes imposed on distributions of PTEP. The Proposed Regulations also bear similarities to the "annual layers of earnings" system that governed the pre-1987 indirect foreign tax credit. As discussed further below, the timing of accruals of income and foreign taxes is of heightened importance due to the mechanics of the "tracing" regime.

With respect to distributions of PTEP (*i.e.*, Section 959(a) and (b) distributions), only foreign taxes imposed on the distribution itself are treated as deemed paid. Such taxes would include withholding taxes on the distribution, and income taxes imposed on a CFC in respect of a distribution of PTEP from a lower-tier CFC. As further discussed below, foreign income taxes imposed in a later year on a CFC's Subpart F or tested income that was included in income by a U.S. shareholder in a prior year (therefore arguably causing those earnings and profits to be "previously taxed") nonetheless are not eligible to be treated as foreign taxes attributable to previously taxed income; such taxes can only give rise to FTCs to the extent attributable to a Subpart F or GILTI inclusion for the later year (*i.e.,* the year in which the tax accrued for U.S. tax purposes).

Under a special rule, no foreign taxes are deemed paid, and no FTCs are allowed, in respect of income inclusions by a U.S. shareholder under Section 956 (regarding investments by a CFC in U.S. property, such as loans by CFCs to U.S. affiliates and certain guarantees made by CFCs). Although separately proposed regulations[20] would disapply Section 956 to the extent an actual dividend from a CFC would qualify for the Section 245 "participation exemption," Section 956 remains applicable to non-corporate shareholders. Because Section 960 allows a foreign tax credit for "any item of income under Section 951(a)(1)" and Section 951(a)(1)(B) is the section of the Code that requires U.S. shareholders of CFCs to recognize Section 956 inclusions, it is not entirely clear whether this aspect of the Proposed Regulations is consistent with the Code.

The Proposed Regulations also provide that the Section 78 Gross-Up, which results in an additional income inclusion for U.S. shareholders that receive FTCs in respect of "deemed paid" taxes of a CFC, is not eligible for the dividends received deduction under Section 245A.

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[20] *See* Prop. Treas. Reg. § 1.956-1(a)(2).

2. Timing of Income and Foreign Tax Accruals and the Availability of Deemed Paid Foreign Tax Credits

The determination of which foreign taxes are deemed paid is made on an annual basis. As a result, FTCs generally are not available in respect of foreign taxes imposed on Subpart F or tested income in a loss year, because there are no Subpart F or GILTI inclusions that would give rise to deemed paid taxes. FTCs arising from foreign taxes incurred in a loss year are therefore permanently lost. In addition, the foreign tax "tracing" regime functions by allocating foreign taxes to a set of subcategories corresponding to different types of items giving rise to Subpart F or GILTI inclusions ("income groups"). A loss in any income group in any given year may result in the loss of FTCs in respect of foreign taxes in that income group, even if the CFC has net income overall. As a result, the timing of accruals of foreign taxes and the associated income items is especially important under the new regime.

In particular, differences in the timing of accruals of income or foreign taxes for U.S. and foreign purposes may result in the stranding of foreign taxes and loss of the corresponding FTCs. The Proposed Regulations generally provide that the timing of a CFC's accrual of foreign taxes for purposes of calculating FTCs is determined under general U.S. tax rules, including the rules that otherwise determine the accrual of tax liabilities and rules such as the "relation back" doctrine with respect to contested taxes.[21] Thus, foreign income taxes calculated on the basis of net income will accrue in the U.S. taxable year of the CFC with or within which its foreign taxable year ends, and are eligible for a deemed paid credit in the taxable year of the U.S. shareholder with or within which the U.S. taxable year of the CFC ends, even if a portion of the foreign taxable year of the CFC falls within an earlier or later U.S. taxable year of the CFC or its U.S. shareholder.[22]

If foreign taxes and the associated income accrue in different U.S. taxable years (for instance, as a result of differences in mark-to-market regimes, differences in taxable years, differences in deductions allowable or depreciation conventions or differences in income recognition), the foreign taxes attributable to the "timing difference" are allocated to the category and income group to which the corresponding income would be allocated if incurred in that year. This rule, however, only serves to categorize the foreign taxes into the appropriate category and income group; the foreign taxes are not treated as accruing in the same year as the corresponding income. This rule has the effect of divorcing foreign taxes from the associated income. As described above, FTCs are not allowed in respect of foreign taxes allocated to an income

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[21] *See*, *e.g.*, § 461 (providing rules for the accrual of deductions or credits for U.S. federal income tax purposes); *Seagate Tech., Inc.* v. *C.I.R.*, T.C. Memo. 2000-361 ("The relation-back doctrine, established by the Supreme Court in *Arrowsmith* v. *Commissioner*, stands for the principle that a subsequent event which is so integrally related to a prior event that the two events are in effect part and parcel of the same transaction, should be treated as having the same character as the prior event. The doctrine is premised on the idea that the tax consequences should be the same if the subsequent event had occurred at the time of the prior event.") (citing *Arrowsmith* v. *Commissioner*, 344 U.S. 6 (1952))).

[22] *See* 83 FR 63214.

group in which there is no net income for the year, and are lost permanently. In addition, taxes attributable to a timing difference are *not* allocated to a "PTEP group" if the associated income accrued in a prior year, and therefore do not give rise to FTCs in respect of distributions of PTEP; generally, the only taxes attributable to a PTEP group are taxes imposed on distributions of PTEP.[23]

To the extent a taxpayer consistently has net income in a given income group each year, timing differences may have little effect, because the foreign taxes may be treated as deemed paid in respect of other income in the income group in the year the taxes accrue. However, a timing difference in respect of an extraordinary transaction (giving rise to income of a type or in an amount that the taxpayer does not regularly incur) or in respect of volatile income streams may result in a significant loss of FTCs, because there may be no income available to bring up the foreign taxes in the appropriate income group if the income that gave rise to those taxes accrues in a different taxable year. Moreover, because the foreign taxes allocated to the income group are also treated as a deduction reducing net income in the group, a timing difference may increase the likelihood of a loss in an income group in a given year. Monitoring and managing the timing of accruals of income and taxes for U.S. and foreign tax purposes therefore takes on special importance under the new regime, both for the reasons set forth above and because FTCs attributable to GILTI may not be carried forward or back.

Foreign taxes are also stranded, and related FTCs lost, if the foreign taxes are attributable to a "base difference" (*i.e.*, items that are taxable under foreign law but excluded from income for U.S. federal income tax purposes). Foreign taxes in respect of a base difference are allocated to the residual income group, and the Proposed Regulations provide that taxes in the residual group are not eligible for a deemed paid credit.[24]

Other taxes attributable to the residual income group include income that otherwise would have been Subpart F but for the fact that it was "high-taxed income" under Section 954(b)(4) and taxes on foreign oil

23 Specifically, "PTEP group taxes" include only (1) taxes imposed on previously taxed income solely as a result of a § 959 dividend (such as withholding taxes or income taxes of a CFC in respect of a § 959 dividend from a lower-tier CFC), (2) foreign income taxes attributable to the PTEP group of a lower-tier CFC that are deemed paid by the upper-tier CFC as a result of a § 959 distribution from the lower-tier CFC, and (3) certain taxes attributable to reclassified PTEP arising under § 956. PTEP group taxes do not include foreign income taxes imposed on Subpart F income or tested income, or foreign taxes imposed on income that was recognized for U.S. purposes in a prior year under the timing difference rule.

24 The preamble to the Proposed Regulations, however, indicates that base differences occur only in "limited circumstances," such as in the case of life insurance proceeds or gifts. This is consistent with IRS authorities predating the Act stating that the IRS considers base differences to be rare. *See*, *e.g.*, 66 FR 268-01 (2001) (preamble to prior expense allocation and apportionment regulations stating that "Treasury and the IRS believe that base differences (in which foreign tax is imposed on an amount that the United States would never recognize as income, such as a gift) rarely occur."); FSA 200210026 ("In general, the base difference rule [under prior expense allocation regulations] is intended to have very narrow application.").

and gas extraction income within the meaning of Section 907(c)(1). Deemed paid FTCs therefore are not available in respect of such taxes.

3. Detailed Steps for Computing Foreign Taxes Deemed Paid

Step 1: Assign CFC Income to Baskets and Income Groups. To compute foreign taxes deemed paid under the Proposed Regulations, a CFC's items of gross income are first allocated to income baskets (such as the general and passive baskets), and to "income groups" within each basket. Distributions of PTEP are allocated to separate "PTEP groups."

"Income groups" include a series of Subpart F groups:

- Each category of foreign base company income treated as a single item of income under Section 1.954-1(c)(1)(iii) is treated as a separate group;[25]
- Insurance income under Section 952(a)(1);
- Income subject to an international boycott factor under Section 952(a)(3);
- Income from certain bribes, kickbacks and other payments under Section 952(a)(4); and
- Income from sources in foreign countries subject to Section 901(j) (*i.e.*, countries with respect to which the U.S. has severed diplomatic relations, the government of which the U.S. does not recognize, etc.).

(Other income groups relevant at the shareholder level include a "tested income group" for GILTI income and a residual income group for income not allocated to the Subpart F or GILTI income groups. There is no "tested income group" within the foreign branch and GILTI baskets, because CFCs cannot earn foreign branch income and the status of income as GILTI is determined at the shareholder level. As noted above, there is no deemed paid credit for foreign taxes attributable to the residual income group).

[25] These categories consist of (A) separate categories for nonpassive foreign personal holding company income in each of the following categories: (i) dividends, interest, rents, royalties and annuities; (ii) gain from certain property transactions; (iii) gain from commodities transactions; (iv) foreign currency gain; and (v) income equivalent to interest; (B) separate categories for (i) foreign base company sales income; (ii) foreign base company services income; (iii) foreign base company shipping income; (iv) foreign base company oil related income; and (v) full inclusion foreign base company income; and (C) separate categories for each group of passive foreign personal holding company income under the grouping rules of § 1.904-4(c)(3), (4) and (5), as described below.

The grouping rules of § 1.904-4(c)(3), (4) and (5) generally divide passive foreign personal holding company of a CFC, and of each "qualified business unit" of the CFC (a "QBU," which is generally any separate and clearly identified unit of a trade or business that maintains separate books and records), into: (A) a separate group for income from sources within the country of operation of the QBU; (B) separate groups for income from sources without the country of operation of the QBU that is (i) subject to a withholding tax of 15% or greater; (ii) subject to a withholding tax of less than 15% (but greater than zero); (iii) subject to no withholding tax; or (iv) subject to no withholding tax, but subject to a foreign tax other than a withholding tax; and (C) separate groups for (i) certain rents and royalties; (ii) certain partnership income that is not subject to the look-through rules (generally, income from partnerships in which the CFC owns an interest of less than 10%); and (iii) certain currency gain or loss.

In addition, income from distributions of PTEP by lower-tier CFCs is allocated to a "PTEP group." A separate PTEP group corresponds to each (1) taxable year in which the lower-tier CFC recognized the previously taxed earnings and profits and (2) the separate category to which the resulting income inclusion was assigned (*e.g.,* GILTI).

Step 2: Allocate CFC Expenses. Once a CFC's income has been allocated to baskets, and income groups within baskets, the CFC allocates and apportions expenses and deductions to reduce income in baskets and income groups. Deductions for foreign taxes are allocated in the same manner as foreign taxes are allocated for purposes of determining the FTCs in a given category, as described above.

Current-year foreign taxes are applied to reduce gross income in their functional currency, but are translated into USD for purposes of computing foreign taxes deemed paid.

Step 3: Compute Foreign Taxes Deemed Paid in Respect of Subpart F and GILTI Inclusions. Current year foreign taxes incurred by a CFC are considered "deemed paid" with respect to a Subpart F or GILTI inclusion to the extent those taxes are "properly attributable" to the income items that gave rise to the Subpart F or GILTI inclusions.

With respect to GILTI inclusions, a U.S. shareholder's "inclusion percentage" is required to determine the amount of taxes deemed paid by the U.S. shareholder in respect of the inclusion. The shareholder computes a single inclusion percentage with respect to all of its tested income, regardless of the basket of the income.[26]

With respect to Subpart F inclusions, the amount of foreign taxes "properly attributable" to an item of income is equal to the U.S. shareholder's proportionate share of the current year taxes of the CFC that are allocated and apportioned to the Subpart F income group within the basket to which the item of income is attributable.

A U.S. shareholder's proportionate share for each Subpart F income group is equal to the current year taxes allocated to that group multiplied by a fraction equal to the Subpart F inclusion that is attributable to that Subpart F income group divided by the total income in that Subpart F income group.

Step 4: Adjust PTEP Accounts. The CFC maintains PTEP accounts for each year in which the PTEP is included by the U.S. shareholder, and the basket of the inclusion by the U.S. shareholder. Foreign taxes are allocated to PTEP groups, including current year taxes paid in respect of a distribution of PTI to a

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26 A U.S. shareholder's inclusion percentage is the ratio of the U.S. shareholder's GILTI inclusion amount with respect to its CFCs to the aggregate amount of the U.S. shareholder's *pro rata* share of tested income of those CFCs. *See* Treas. Reg. § 1.960-2(c)(2).

CFC, and taxes deemed paid by the CFC. Taxes attributable to a PTEP group are reduced to the extent deemed paid by a U.S. shareholder or another CFC.[27]

Step 5: Repeat for Higher-Tier CFCs. Steps 1-4 are repeated for each next higher-tier CFC in a chain.

Step 6: Calculate Foreign Taxes Deemed Paid in Respect of PTI Distributions. For the highest-tier CFC, taxes deemed paid by U.S. corporate shareholders in respect of a distribution of PTI under Section 959(a) are calculated. A U.S. corporate shareholder that receives a distribution of PTI is treated as having paid the foreign income taxes "properly attributable" to the PTEP group of the distributing CFC. As described above, generally only foreign taxes imposed on the distribution itself are treated as "properly attributable" to a PTEP group.[28]

D. APPLICABILITY AND REQUEST FOR COMMENTS

In general, the Proposed Regulations under Section 960 are applicable to taxable years beginning after December 31, 2017, consistent with the effective date of the Act. The rule providing that the Section 78 Gross-Up is not eligible for the Section 245A deduction applies to Section 78 dividends received after December 31, 2017, by reason of taxes deemed paid under Section 960(a) with respect to a taxable year of a foreign corporation beginning before January 1, 2018. Other Proposed Regulations are generally applicable to taxable years beginning after December 31, 2017 and ending on or after December 4, 2018.

The Treasury Department requests comments on all aspects of the Proposed Regulations, including (i) the proposed expense allocation regime and its anticipated impacts; (ii) whether additional rules are required to account for gross tested income earned in lower-tier CFCs, including gross tested income of lower-tier CFCs that produce tested losses; (iii) whether there should be a simplified rule for reconstructing the allocation of unused foreign taxes from prior years; (iv) the high-taxed income rules, and income grouping for purposes thereof; (v) treatment of payments between branches and the home office, including the treatment of "true branches" and whether the proposed rules in respect of such payments should be simplified; (vi) special rules for branches of financial institutions with regulatory capital requirements; (vii) treatment of a less-than-10% partner's distributive share of partnership income as passive category income; (viii) deemed paid taxes in connection with unique aspects of GILTI; and (ix) conforming amendments to other regulations.

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27 In Notice 2019-01, the Treasury Department and IRS stated their intention to issue proposed regulations requiring each annual PTEP account to be segregated into 16 different PTEP groups, based on the provision that gave rise to the PTEP (such as § 965(a) or § 959(e)) and whether the PTEP has been reclassified as a result of an inclusion under § 956. The proposed regulations would also provide, among other things, ordering rules for determining the PTEP group that is the source of a distribution.

28 *Supra* note 23.

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